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Citation: 83 Am. Bankr. L.J. 423 2009

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Routine Illegality in Bankruptcy Court, Big-Case Fee Practices

by

Lynn M. LoPucki
and
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[T]he integrity of the bankruptcy system . . . is at stake in the issue of a bankruptcy judge's performance of the duty to review fee applications sua sponte. The public expects, and has a right to expect, that an order of a court is a judge's certification that the result is proper and justified under the law . . . .[1]

I. INTRODUCTION

This Article reports the results of an empirical study showing that the United States bankruptcy courts routinely authorize and tolerate professional fee practices that violate the Bankruptcy Code and Rules. The practices are concentrated in the largest, most visible bankruptcy cases – cases like Lehman Brothers, Worldcom, Kmart, and US Airways. The practices are promoted and taken advantage of by attorneys, investment bankers, accountants, consultants, and other professionals. Some of the firms involved are among the largest and most prestigious in the world. They include Skadden Arps, Weil Gotshal, Kirkland and Ellis, Jones Day, Fried Frank, Blackstone, Houlihan Lokey, and many others.

This Article empirically documents three such practices. The Ordinary-Course-Professionals Practice excuses some or all professionals serving in the ordinary course of the debtor's business from the requirement that they obtain court approval for the payment of their fees. The Prior-Payment-Disclosure Practice ignores the requirement that a final fee application disclose the prepetition payments the professional received in connection with the bankruptcy case. The Disburse-First-and-Decide-Later Practice (Disburse-First

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[1] *In re* Busy Beaver Bldg. Centers, Inc., 19 F.3d 833, 841 (3d Cir. 1994) (quoting *In re* Evans, 153 B.R. 960, 968 (Bankr. E.D. Pa. 1993).

HeinOnline -- 83 Am. Bankr. L.J. 423 2009

Practice) allows debtors to pay 80% or more of the fees sought by professionals before the court has even seen the fee requests.

We gathered the data presented here as part of an empirical study of bankruptcy professional fees in 102 of the largest public-company bankruptcies concluded from 1998 through 2007.[2] Nearly all of the data are from documents filed in those cases. We quote liberally from the documents and have posted copies so that readers can quickly and easily trace our data to their roots.[3]

Regulation of professional fees is necessary because U.S. law permits the debtor's prepetition managers to remain in control of the reorganizing debtor. The managers have the authority to retain professionals on behalf of the estate and to pay them from the estate. But in large, public-company cases, the managers rarely have significant interests in the estates. When they spend money on professionals they spend other people's money - usually creditors' money. For that reason, policymakers have long understood the need for professional fees regulation. In recognition of that need, bankruptcy judges have been responsible for reviewing fee applications and awarding fees since at least 1934.[4]

Despite the fee control system's existence and recurrent efforts to improve it, overpayment has remained a persistent problem. As the House Report on a 1963 bill to strengthen the language of the fee regulation statute explained:

> Experience has shown that this language is inadequate to protect both the creditors and the bankrupt firm from excessive attorney's fees. In bankruptcy, the motivations which normally prevent overcharge are often absent. It matters very little to a bankrupt whether his attorney's fee is large

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[2]Several articles reporting results from that study have already been published. Lynn M. LoPucki & Joseph W. Doherty, *Professional Overcharging in Large Bankruptcy Reorganization Cases*, 5 J. EMPIRICAL LEGAL STUD. 983 (2008); Lynn M. LoPucki & Joseph W. Doherty, *Rise of the Financial Advisors: An Empirical Study of the Division of Professional Fees in Large Bankruptcies*, 82 AM. BANKR. L. J. 141 (2008); Lynn M. LoPucki & Joseph W. Doherty, *The Determinants of Professional Fees In Large Bankruptcy Reorganization Cases*, 1 J. EMPIRICAL LEGAL STUD. 111 (2004).

[3]The documents have been posted at http://lopucki.law.ucla.edu/RoutineIllegalityDocuments/. Documents cited in notes are identified on the website by case name and docket number.

[4]The 1934 law provided

> [T]the judge . . . (9) may allow a reasonable compensation for the services rendered and reimbursement for the actual and necessary expenses incurred in connection with the proceeding and the plan by officers, parties in interest, depositories, reorganization managers and committees or other representatives of creditors or stockholders, and the attorneys or agents of any of the foregoing and of the debtor . . . .

Bankruptcy Act, § 77B(c)(9) (added by Act of June 7, 1934, ch. 424, § 1, 48 Stat. 911 (codified as amended at 11 U.S.C. § 207(c)(9) (1934) (repealed 1938))).

HeinOnline -- 83 Am. Bankr. L.J. 424 2009

> or small since it will be paid out of assets which in any event will normally be completely consumed in distribution. It is the claimant with a lesser priority and the general creditors who, in effect, pay excessive fees through a reduction in the value of the assets available to them.[5]

The fee regulation system is now failing again. Meaningful objections to fee requests are few.[6] Fee cuts average just over one percent of fees requested, probably less than what the professionals charge for preparing their fee applications.[7] From 1998 through 2007, bankruptcy professional fees increased at the rate of more than 10% per year - more than twice the rate of inflation.[8] Those increases reduce creditor recoveries and perhaps the likelihood of successful reorganization. They may also deter bankruptcy filings by companies in need of bankruptcy relief.[9] The practices described here are contributors to that failure in that each makes it easier for debtors to pay higher fees.

The failure of the fee regulation system is just one of many problems resulting from the bankruptcy courts' bizarre competition for large, public company cases.[10] In the 1970s, lawmakers inadvertently conferred on large, public companies the right to choose their bankruptcy courts.[11] Forum shopping became rampant,[12] ultimately leading to competition among the bankruptcy courts to attract large cases. The professionals who influence their clients' choices of courts sought to avoid courts that would limit their fees.[13] This resulted in a pattern of forum shopping to the courts in which profes-

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[5]H. Rep. No. 99 on H.R. 2833, 88th Cong., 1st Sess. (1963). *See also* S. Rep. No. 144 on H.R. 2833, 88th Cong., 1st Sess. (1963).

[6]Lynn M. LoPucki & Joseph W. Doherty, Controlling Professional Fees in Large, Public Company Bankruptcies 5-17 (unpublished manuscript 2008).

[7]*Id.* at 4 ("The professionals charge 2.7% of their fees for compliance with the fee review system, while that system cuts only 1.3% from the amounts applied for.").

[8]Lynn M. LoPucki, Rate of Annual Increase in Reorganization Costs (unpublished spreadsheet 2009).

[9]*See, e.g.*, John D. Stoll et al., *U.S. Squeezes Auto Creditors*, WALL ST. J., Apr. 10, 2009, at A1 ("[T]he [new debt-exchange] offer may be a last chance at avoiding bankruptcy, which GM worries would be more expensive and disruptive than an out-of-court solution.").

[10]LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS 123-35 (2005) (describing the national competition).

[11]*Id.* at 30-37. The inadvertence was the failure of the Bankruptcy Rules Committee to anticipate that judges would want big cases enough that they would not transfer them to more appropriate venues pursuant to 28 U.S.C. § 1412. *Id.* at 38-39.

[12]The pattern of shopping can be tracked in the online database at http://lopucki.law.ucla.edu. Lynn M. LoPucki, Bankruptcy Research Database. Instructions for a search regarding forum shopping are at http://lopucki.law.ucla.edu/how_is_my_district_doing_at_reta.htm (last visited Apr. 4, 2009).

[13]LOPUCKI, *supra* note 10, at 140-43 (reviewing the evidence that forum shoppers seek courts that will permit higher fees).

HeinOnline -- 83 Am. Bankr. L.J. 425 2009

sional fees are highest.[14] Competing courts abandoned the effort to control fees, in part by adopting the practices described in this Article.

Bankruptcy judges may seek to attract large cases for a variety of reasons. Big cases are challenging, glamorous, and career-enhancing work.[15] More importantly, big bankruptcy reorganization is a multi-billion-dollar-a-year industry and a single, aggressive court can hope to attract nearly the entire industry.[16] Success in this competition means prosperity for the local bankruptcy professionals and respect for the judges.[17] Failure can bring a judge derision, ostracism, and adverse comment from the bar if the judge seeks reappointment. Adverse comment can alone be enough to prevent reappointment.[18]

The Delaware bankruptcy court has been the most aggressive competitor. During the decade of the 1980s that court was a one-judge backwater that did not attract even a single large, public company bankruptcy from out of state. Since 2005 - when Congress increased the size of the Delaware court to six judges - that court has attracted 52% of all large public company bankruptcies filed in the United States. The New York bankruptcy court has attracted 21%.[19]

The large majority of bankruptcy judges and lawyers favor amending the

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[14]LoPucki & Doherty, *Professional Overcharging, supra* note 2, at 985 (reporting an empirical finding that "[p]rofessional fees and expenses are 32 percent higher in forum-shopped cases").

[15]Big cases result in substantial publicity for the presiding judges. If they leave the bench, and enter private practice, both their celebrity and their experience make them attractive to clients in the same kinds of cases. Big case practice is generally more prestigious and more lucrative than small case practice, making it preferable as a career opportunity.

[16]*Id.* at 49-50 (describing the Delaware bankruptcy court's capture of an 87% market share in 1996).

[17]*See, e.g.*, Amy Merrick, *Chicago Court Adeptly Attracts Chapter 11 Cases*, WALL ST. J., Dec. 10, 2002, at B1 (congratulatory article about the Chicago bankruptcy court's success in attracting several large cases).

[18]David A. Scholl v. United States, 54 Fed. Cl. 640, 641-42 (2002) (describing denial of reappointment to a judge who was widely criticized for limiting professional fees). The court stated:

> By a memorandum dated March 1, 2000, Chief Judge Becker informed all active Third Circuit judges that the Court had initially approved Judge Scholl's application and would go forward with the required 'public comment' period concerning his reappointment. . . . [After the public comment period] Chief Judge Becker informed Judge Scholl . . . that the Third Circuit has refused to reappoint him . . . . The Chief Judge offered no formal or even informal explanation for the Court's adverse decision."

Failure to attract cases was probably not the sole root cause of Judge Scholl's failure to win reappointment. Nevertheless, during a period of time in which the New York court allowed fees of more than $400 an hour, Judge Scholl and his colleague in Philadelphia capped fees at $200. During the period Judge Scholl served, no large public company filed bankruptcy in Philadelphia. Stan Bernstein, The Reappointment of Bankruptcy Judges: A Preliminary Analysis of the Present Process (unpublished manuscript Oct. 15, 2001) (empirical study finding that 8% of bankruptcy judges seeking reappointment are not reappointed).

[19]Lynn M. LoPucki, Bankruptcy Research Database, *available at* http://lopucki.law.ucla.edu.

HeinOnline -- 83 Am. Bankr. L.J. 426 2009

bankruptcy laws to eliminate forum shopping.[20] The structure of the United States Senate has, however, made reform impossible. The result has been to leave the large majority of noncompeting bankruptcy courts twisting in the criticism, while two courts take the lion's share of the large cases.

The bankruptcy court competition coincided with the rise of an anti-regulatory ideology - law and economics - that exalted competition in every realm.[21] Even today, many legal scholars and judges see court competition as fundamentally no different than business competition. The best courts win, and their victories prove them efficient.[22] What those legal scholars and judges miss is the fundamental difference between court competition and business competition. Businesses must compete within the bounds of the law. Courts may compete by bending or breaking the law. We think that is now happening with respect to bankruptcy court big-case fee practices.

Court competition is not the only factor driving these practices. Fee regulation is unpleasant work.[23] Fee applications consist largely of time records kept in tenths of an hour.[24] A single fee application can run hundreds and sometimes even thousands of pages.[25] Fee reviewers are supposed to read them, but cannot possibly do so.[26] Effective techniques for analyzing fee applications without reading them have not yet been developed. If an attorney works five hours and reports ten, fee reviewers have no way to challenge that

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[20]We base this conclusion on polls taken by Lynn M. LoPucki at five presentations to local organizations with attendance totaling about 400 bankruptcy professionals. About two-thirds favored elimination of forum shopping.

[21]LOPUCKI, *supra* note 10, at 233-44 (discussing the ideological shift with respect to the bankruptcy court competition).

[22]*E.g.*, Robert K. Rasmussen, *Debate: Should a company's freedom to choose where to file for bankruptcy be eliminated?*, CQ RESEARCHER (forthcoming 2009) ("[W]e are best served by allowing companies to take the most difficult cases to courts that have gained the confidence of those with their money on the table.").

[23]Statement of the American Bankruptcy Institute for an Oversight Hearing on Professional Fees in Bankruptcy Cases Before the Subcommittee on Courts and Administrative Practice Senate Committee on the Judiciary, Mar. 24, 1996, 102 Cong. 2d Sess. at 167, 187 (1996) ("[B]ankruptcy judges around the country complain frequently about the inordinate amount of time they spend reviewing fee applications.").

[24]*See, e.g.*, Local Rules for the United States Bankruptcy Court, District of Delaware, Rule 2016-2(d)(iv) (Feb. 1, 2008) ("Activities shall be billed in tenths of an hour (six (6) minutes)").

[25]*E.g.*, Fourth and Final Application of Weil, Gotshal & Manges LLP, As Attorneys for the Debtors, For Final Allowance of Compensation for Professional Services Rendered and for Reimbursement of Actual and Necessary Expenses, *In re* Worldcom, Inc., No. 02-13533 (S.D.N.Y. July 19, 2004) (docket No. 12095) (2,789-page fee application).

[26]In a published roundtable discussion, a San Antonio bankruptcy judge had this response to a Delaware Judge who claimed to "review . . . fee detail:"

> Then I would have to say to my poor law clerk, have this ready for me by the time of hearing. There is no way on God's green earth that I or my law clerk have the time or the resources to go through that kind of detailed review; I do not even have the resources to do a simple audit of a fee application of that size.

The Costs of Bankruptcy: A Roundtable Discussion, 1 AM. BANKR. INST. L. REV. 237, 258 (1993).

HeinOnline -- 83 Am. Bankr. L.J. 427 2009

report. Two of the three illegal practices we document reduce the number of fee applications the judges must review.

Because the practices discussed in this Article are legally indefensible, the professionals promote them as practically necessary. Their argument - made only implicitly - is that the courts are justified in ignoring laws that require wasteful, inefficient practices. Lest the illegitimacy of that argument go unnoticed, we offer this succinct review of the rules governing the relationship between Congress and the bankruptcy courts:

> Congress . . . has the power to define the substantive law that the courts apply in the cases that come before them. Congress may not, of course, overturn the Supreme Court's interpretation of the Constitution, unless it amends the Constitution through the process specified in Article V. With respect to all other law, however, Congress has the final say.[27]

That said, the distinction between practices that are actually wasteful and inefficient and those that are merely claimed to be so, is worth making. For that reason, we present and respond to the waste and inefficiency arguments by which the professional firms seek to justify their illegal practices.

The three practices we document are followed in nearly all large, public-company bankruptcies. That does not mean, however, that they are followed by nearly all bankruptcy judges. Many, if not most, bankruptcy judges are unwilling to engage in these practices or otherwise compete for cases. The practices are nearly universal in big cases only because the case placers choose to file the big cases in the courts that permit the practices.

For example, we found that all twenty-eight courts chosen for the large public company bankruptcies we studied followed the Disburse-First Practice.[28] By contrast, the views of a majority of judges who have addressed the Disburse-First issue in published opinions suggest that they would not approve the Disburse-First Practice. Seven courts have either held the practice of disbursing fees prior to allowance illegal[29] or clearly stated in dicta that

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[27]Todd David Peterson, *Congressional Investigations of Federal Judges*, 90 IOWA L. REV. 1, 36 (2004).

[28]Infra, Appendix 3.

[29]*In re* Commercial Fin. Servs. 231 B.R. 351, 356 (Bankr. N.D. Okla. 1999) ("The Court cannot ignore Section 331's specific command that interim payments, regardless of what they are called, may be distributed only after application, notice, review and a court order."); *In re* Genlime Group, L.P., 167 B.R. 453, 455 (Bankr. N.D. Ohio 1994) ("Section 331 only allows interim disbursements to professionals '[a]fter notice and a hearing'. Consequently, the Debtor's proposed payments to the Professionals on a monthly basis without prior notice to creditors and court approval are impermissible under the Bankruptcy Code."); *In re* Drexel Burnham Lambert Group Inc., 112 B.R. 584, 587 (Bankr. S.D.N.Y. 1990) ("The requirement of award prior to payment is also implicit in the provision enabling the court to permit interim applications more often than every 120 days .... If payment prior to award were permitted, the "disburse" language and the ability to shorten the waiting period would be surplusage."); *In re* Chapel Gate Apts., Ltd. 64 B.R.

HeinOnline -- 83 Am. Bankr. L.J. 428 2009

the practice is illegal.[30] Six others apparently would require firm-specific findings of professional firm hardship and ability to repay.[31] The necessity for such findings would render the Disburse-First Practice unfeasible.[32] Only twelve courts expressed a willingness to approve, without firm specific-findings, the Disburse-First Practice as employed in the twenty-eight cases we studied.[33] The odds that minority of judges drew all twenty-eight cases

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569, 573 (Bankr. N.D. Tex. 1986) ("[T]o allow an attorney for debtor to draw against a retainer at will and without prior Court approval is a *de facto* emasculation of § 331 .... [T]o allow counsel to receive payments ... without notice to the creditors and approval by the Court, is blatantly inconsistent with the statute ....").

[30]*In re* Tri-State Plant Food, Inc., 273 B.R. 250, 260 (Bankr. M.D. Ala. 2002) ("The payment of interim compensation may not be made unless first an application is made, notice given to creditors. . .hearing is held and finally allowance by the Court."); *In re* Bread & Chocolate, Inc. . 148 B.R. 81, 83 (Bankr. D.D.C. 1992) ("[T]he court wants to emphasize that if payment of fees prior to approval of the fees is ever allowed, it ought to be on a finely tuned basis that assures that counsel's incentive to apply for fees is not materially diminished."); *In re* Fitzsimmons Trucking, 124 B.R. 556, 561 (Bankr. D. Minn. 1991) (citing *In re* Park Ave. Partners Ltd. Ptshp, 95 B.R. 605, 617 (Bankr. E.D. Wis. 1988) ("[A]pplication, notice, opportunity for review by U.S. Trustee and parties in interest, and court approval are all necessary before a Chapter 11 debtor is authorized to pay professionals' compensation and to reimburse them for their expenses."); *In re* Pacific Forest Indus., 95 B.R. 740, 745 (Bankr. C.D. Cal. 1989) ("In the case of interim fees, the attorney may apply to the Court not more often than once every 120 days for this compensation. But it is only after notice and a hearing that the Court may allow and disburse such compensation to the applicant.").

[31]*In re* Affinity Health Care Mgmt., 2009 WL 596825 at 3 n.10 (Bankr. D. Conn. Jan. 28, 2009) ("It is necessary that hardship be established *individually* for *each* Professional that desires to participate in the proposed Monthly Payment Procedure."); *In re* Haven Eldercare, LLC., 382 B.R. 180, 185 n.5 (Bankr. D. Conn. 2008) ("It is necessary that hardship be established *individually* for *each* Professional that desires to participate in the proposed Monthly Payment Procedure."); *In re* Maxton Meat Processors Corp., 2000 WL 33673797 at 1 (Bankr. M.D.N.C. Feb. 7, 2000) (declining to approve a disburse-first order because "the circumstances of the present case do not justify the payment of such compensation without notice and an opportunity for hearing with respect to each interim application before compensation"); *In re* W & W. Protection Agency, Inc., 200 B.R. 615, 622 (Bankr. S.D. Ohio 1996) (declining to approve a disburse-first order because the applicant firm had not shown hardship); *In re* Dandy Lion Inns of America, 120 B.R. 1015, 1018 (D. Neb. 1990) (remanding a disburse first order to the bankruptcy court for factual inquiry into the *Knudsen* "limiting factors," including undue hardship and ability to respond to reassessment); *In re* Shelly's, Inc., 91 B.R. 803, 807 (Bankr. S.D. Ohio 1988) (declining to approve a disburse-first order because the applicant firm had not shown hardship or asserted ability to respond to reassessment).

[32]*See, e.g., In re* Haven Eldercare, LLC., 382 B.R. 180, 185 n.5 (Bankr. D. Conn. 2008) ("It is necessary that hardship be established *individually* for *each* Professional that desires to participate in the proposed Monthly Payment Procedure."); *In re* Bread & Chocolate, Inc., 148 B.R. 81, 82 (Bankr. D.D.C. 1992) ("The court abhors the thought of instead turning every application to employ counsel in every Chapter 11 case into a burdensome inquiry into the law firm's financial condition as the sole basis for establishing a certainty of recovery of fees.").

[33]*In re* North Star Mgmt. LP, 308 B.R. 906 (B.A.P. 8th Cir. 2004); *In re* Knudsen Corp., 84 B.R. 668 (B.A.P. 9th Cir. 1988); *In re* Fleming Cos., Inc., 304 B.R. 85 (Bankr. D. Del. 2003); *In re* Act Mfg., Inc., 281 B.R. 468 (Bankr. D. Mass. 2002); *In re* Truong, 259 B.R. 264 (Bankr. D.N.J. 2001); *In re* Mariner Post-Acute Network, Inc., 257 B.R. 723 (Bankr. D. Del. 2000); *In re* Pittsburgh Corning Corp., 255 B.R. 162 (Bankr. W.D. Pa. 2000); *In re* Niover Bagels, Inc., 214 B.R. 291 (Bankr. E.D.N.Y. 1997); *In re* Bennett Funding Group, 213 B.R. 227 (Bankr. N.D.N.Y. 1997); *In re* Jefferson Bus. Ctr. Assocs., 135 B.R. 676 (Bankr. D. Colo. 1992); *In re* Kaiser Steel Corp., 74 B.R. 885 (Bankr. D. Colo. 1987); *In re* Frontier Airlines, Inc., 74 B.R. 973 (Bankr. D. Colo. 1987).

HeinOnline -- 83 Am. Bankr. L.J. 429 2009

by chance is less than one in five hundred million.[34] Case placers are clearly shopping away from judges who are disinclined to approve the Disburse-First Practice. We think the same is probably true for the other practices we consider.

Part II of this Article describes the Ordinary-Course-Professionals Practice. Part III documents the Prior-Payment-Disclosure Practice. Part IV addresses the Disburse-First Practice. Part V notes the existence of other fee practices that violate the Code and Rules, but may or may not be routine. Part VI concludes that the practices discussed in this Article are undermining not only the fee regulatory system imposed by Congress, but also the integrity of the bankruptcy courts.

II. THE ORDINARY-COURSE-PROFESSIONALS PRACTICE

Nearly all of the courts processing large, public company cases follow an Ordinary-Course-Professionals Practice that violates Bankruptcy Rule 2016(a) and Bankruptcy Code § 330(a).

A. DESCRIPTION OF THE PRACTICE

Upon the filing of a case, the debtor applies for an order authorizing the debtor to employ and pay a list of professionals "in the ordinary course" of the debtor's business.[35] The list typically contains only the professionals' names and addresses, and two- or three-word descriptions of the types of services each professional will render.[36] The order - typically entered about thirty days later - authorizes the debtor to employ the professionals and to pay "detailed monthly invoices" submitted by the professionals over the remainder of the cases.[37]

Table 1 and Appendix 1 together present the results of a survey of the ordinary course practice in fourteen recent large, public company bankruptcies.[38] The data show remarkable uniformity in the practice. The courts

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[34] 2^{28} equals 536,870,912.

[35] The set of Ordinary Course Professionals orders that we surveyed is posted at http://lopucki.law.ucla.edu/RoutineIllegalityDocuments/.

[36] Notice of Filing of Amended Exhibit A to Motion of the Debtors Pursuant to Sections 105(a), 327, 328, and 330 of the Bankruptcy Code Authorizing the Debtors to Employ Professionals Utilized in the Ordinary Course of Business, *In re* Worldcom, Inc., No. 02-13533 (Bankr. S.D.N.Y. Aug. 26, 2002) (docket No. 787) (describing ordinary course professionals only as "Trademark Counsel," "Litigation Counsel," and "Regulatory Issues").

[37] *E.g.*, Order Pursuant to Sections 105(a), 327, 328 and 330 of the Bankruptcy Code Authorizing the Debtors to Employ Professionals Utilized in the Ordinary Course of Business, *In re* Worldcom, Inc., No. 02-13533(Bankr. S.D.N.Y. Sept. 4, 2002) (docket No. 882) (hereinafter Worldcom Ordinary Course Order) ("[T]the Debtors are authorized and empowered to pay compensation and reimburse expenses to each of the Ordinary Course Professionals retained pursuant to this Order in the customary manner in the full amount billed by each Ordinary Course Professional upon receipt of reasonably detailed invoices . . . .").

[38] The sample is a sample of convenience from among the sixty-two cases described *infra* in notes 90-91

HeinOnline -- 83 Am. Bankr. L.J. 430 2009

entered orders excusing interim fee applications in Boston Chicken and Pacific Gas. The courts entered orders excusing all applications in the other twelve cases.

TABLE 1. ORDINARY-COURSE-PROFESSIONALS PRACTICE

Case name	Were fee applications required?	Was payment on reasonably detailed invoices?	To whom were invoices sent?	When was the employment affidavit filed in relation to the employment order?
aaiPharma	No	Yes	Debtor	30 days after order
Boston Chicken	Final*	"invoices"	Debtor**	No deadline
Conseco	No	Yes	Debtor	30 days after order
Crown Pacific	No	Yes	Debtor	30 days after order
Grand Union	No	Yes	Debtor	No affidavit required
Hayes Lemmerz	No	Yes	Debtor	20 days after order
Kmart	No	Yes	Debtor	20 days after order
Mirant	No	Yes	Debtor	30 days after order
Oglebay Norton	No	Not specified	Debtor	Before payment
Pacific Gas & Electric	Final*	Not specified	Debtor	Before order
Ultimate Electronics	No	Yes	Debtor	20 days after order
US Airways (2004)	No	Yes	Debtor	45 days after order
Worldcom	No	Yes	Debtor	15 days after order
XO Communications	No	Yes	Debtor	20 days after retention

* The order authorized interim payments without applications, but required final applications.
** Unless a copy was requested by "one of the other recipients identified in the Knudsen Order"

Most of these "ordinary course orders" required that each professional file the "verified statement" required by Rule 2014(a) as a condition of employment. But, as shown in Table 1, the almost universal practice was for the court to approve the employment first and receive the verified statements later. Thus the courts entered orders based on affidavits not yet received.

Only a single court required that the professionals send their invoices to anyone other than the debtors who would pay them; no one else may ever have seen the invoices. Although the funds from which debtors paid those invoices must have been estate funds, the professionals did not make the legally required fee applications.[39] The judges did not receive or review fee

and accompanying text. Although the sample is not ultimately random, once we selected a case for investigation, the case remained in the study. We have no reason to think that the selection process was biased, or that these cases are not representative of the population from which we drew them.

[39] "An entity seeking interim or final compensation for services . . . from the estate shall file an application . . . ." Fed. R. Bankr. P. 2016(a).

HeinOnline -- 83 Am. Bankr. L.J. 431 2009

applications, or even invoices. Nor did the judges determine "the amount of reasonable compensation to be awarded"[40] or enter orders awarding that compensation, as required by Bankruptcy Code § 330(a).[41]

The courts typically defined an "ordinary course professional" as a professional who would be paid less than a fixed amount in a given month. As shown in Appendix 1, the limits ranged from $7,500 to $100,000 per month, with most in the range of $25,000 to $35,000 per month. The Pacific Gas order was unlimited in amount. Under it, Latham and Watkins received $29 million.[42]

The monthly limits are deceptive. First, many of the orders allowed professionals earning more than the limit in a given month to accept payment of the excess in a later month without losing their ordinary-course status.[43] Thus, a professional firm that earned three times the monthly limit in a given month could retain its ordinary-course status by agreeing to take payment over three months. Second, some of the orders allowed the debtors to pay fees in amounts that exceeded the monthly limits if the debtors notified certain parties and none of those parties objected.[44]

Because (1) most of these limits are only monthly limits, (2) cases can go

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[40]"After notice . . . and a hearing . . . the court may award to . . . a professional person employed . . . reasonable compensation for actual, necessary services rendered by the . . . professional person." 11 U.S.C. § 330(a)(1) (2006).

[41]11 U.S.C. § 330(a) (2006).

[42]Order on Final Application by Pacific Gas and Electric Company for Authority to Pay Compensation and Reimbursement of Expenses to Special Counsel to Debtor in Possession on Non Bankruptcy Matters, *In re* Pacific Gas & Electric Company, No. 01-30923, (Bankr. N.D. Cal. Sept. 14, 2004) (docket No. 15774) (hereinafter Pacific Gas Payment Order) (showing $29,142,742.48 payable to Latham & Watkins).

[43]*E.g.*, Order Authorizing the Employment of Professionals Utilized in the Ordinary Course of the Debtor's Business at 3, *In re* XO Communications, Inc., No. 02-12947 (Bankr. S.D.N.Y. June 18, 2002) (docket No. 25) ("[I]t is further ORDERED, that monthly amounts in excess of $25,000 shall be carried to the following month, provided, however, that as set forth in the preceding paragraph no monthly amount in excess of $25,000 may be paid to an Ordinary Course Professional without further order of the Court . . ."); Order Authorizing Retention and Payment, Nunc Pro Tunc, of Professionals Used By Debtors in Ordinary Course of Business at 4, *In re* CP Acquisition, No. 03-11258 (Bankr. D. Ariz. Oct. 21, 2003) (docket No. 197) ("The Debtors are authorized to make monthly payments up to $7,500 per month for each Ordinary Course Professional, for fees and expenses (on an average, rolling basis as described in the Motion) . . . .").

[44]For example, the order in Oglebay Norton provided:

> To the extent that the average monthly fees and expenses of any Ordinary Course Professional exceed $25,000 . . . the Ordinary Course Professional shall . . . file with the Court a statement setting forth the aggregate amount of fees and expenses requested . . . and a brief description of the services provided (a "Compensation Statement") and . . . serve such Compensation Statement [on the Notice Parties]. . . . If no Notice of Objection is filed, the fees and expenses set forth in a Compensation Statement shall be deemed allowed and payable without any further action by the parties or the Court.

Order Authorizing Debtors and Debtors in Possession to Retain, Employ and Pay Certain Professionals in

HeinOnline -- 83 Am. Bankr. L.J. 432 2009

on for years,[45] and (3) hundreds of ordinary-course professionals can be employed in a single case, the total amounts paid to ordinary-course professionals in the aggregate can far exceed the monthly limit. In Mirant, for example, the total paid to ordinary course professionals was "approximately $11 million."[46]

Debtors frequently move to add more professionals to the ordinary-course list as the bankruptcy case progresses. The court enters an order approving each addition.

Because ordinary-course professionals do not file their invoices with the court, the public record does not show what information was furnished to the debtor before payment. Although anyone theoretically could object to the fees, no one but the debtor may ever have seen the invoices. As shown in Appendix 1, some courts do not require the debtor to publicly divulge even the amounts paid. Other courts require that the debtors file, at 90 or 120 day intervals, lists of the payments made to the professionals. But even when ordered to file lists, the debtors routinely failed to file them for the entire period from the court's order to plan confirmation. As shown in Appendix 1, the reporting of payments was complete through confirmation for only three of fourteen cases (21%).

B. Illegality of the Practice

Bankruptcy Rule 2016(a) requires that:

> An entity seeking interim or final compensation for services, or reimbursement of necessary expenses, from the estate shall file an application setting forth a detailed statement of (1)

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the Ordinary Course of Business at 2-3, *In re* Onco Investment Company, No. 04-10558 (Bankr. D. Del. Mar. 24, 2004) (docket No. 252). The order in U.S. Airways provided:

> Each . . . Ordinary Course Professional that exceeds the $45,000 monthly limit . . . shall, on or before the 30th day of the month following the month for which compensation is sought (the "Monthly Statement Date"), submit a monthly statement (the "Monthly Statement") to . . . the Interested Parties . . . . If any of the Interested Parties object to the payment of those fees and expenses and such objection cannot be resolved within twenty (20) days after the Fee Objection Deadline, then the Key and/or Ordinary Course Professional whose Monthly Statement was objected to will be required to submit a formal application for compensation to the Court . . . .

Order Authorizing Retention of Professionals Utilized by Debtors in the Ordinary Course of Business Pursuant to 11 U.S.C. §§ 105(a), 327(e) and 331 at 3-4, *In re* U.S. Airways, Inc., No. 04-13819 (Bankr. E.D. Va. Sept. 15, 2004) (docket No. 126).

The term "Interested Parties" misleadingly suggests that anyone expressing an interest is included. The orders typically define "the Interested Parties" as specific parties. They include the debtor, the creditors' committee, and the United States trustee. *See, e.g. id.* at 3-4 (defining "Interested Parties").

[45]The average time from filing to plan confirmation in the 102 cases we studied was a little under fifteen months. Six (6%) remained pending for more than three years.

[46]*In re* Mirant Corp., 354 B.R. 113, 123 (Bankr. N.D. Tex. 2006).

HeinOnline -- 83 Am. Bankr. L.J. 433 2009

> the services rendered, time expended and expenses incurred, and (2) the amounts requested.[47]

An ordinary course professional who sends an invoice to the debtor is certainly "an entity seeking . . . compensation for services." Funds to pay the invoice could come only from the estate, because large, public companies rarely, if ever, have funds that are not property of the estate.[48] It follows that ordinary course professionals must file interim and final fee applications.

The "reasonably detailed statements" sent to the debtor pursuant to the Ordinary Course Practice do not satisfy this requirement because they are not "filed" with the court. Nor is it likely that those secret statements comply with the second sentence of Rule 2016(a), which provides:

> An application for compensation shall include a statement as to what payments have theretofore been made or promised to the applicant for services rendered or to be rendered in any capacity whatsoever in connection with the case, the source of the compensation so paid or promised, whether any compensation previously received has been shared and whether an agreement or understanding exists between the applicant and any other entity for the sharing of compensation receive or to be received for services rendered in or in connection with the case.[49]

If the ordinary course professionals filed fee applications that complied with Rule 2016(a), the courts would have to consider the applications, rule on them, and enter orders awarding or declining to award the fees. Bankruptcy Code § 330(a)(1) provides:

> After notice to the parties in interest and the United States Trustee and a hearing . . . the court may award to a . . . professional person employed under section 327 or 1103 –
>
> (A) reasonable compensation for actual, necessary services rendered by the . . . professional person or attorney . . . .[50]

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[47]Fed. R. Bankr. P. 2016(a).

[48]11 U.S.C. § 541(a)(1) (2006) provides:

> [T]he commencement of a [bankruptcy] case . . . creates an estate. Such estate is comprised of all of the following property, wherever located and by whomever held:
>
> (1) [A]ll legal or equitable interests of the debtor in property as of the commencement of the case. . . .
>
> (6) Proceeds, product, offspring, rents, or profits of or from property of the estate . . . .

[49]Fed. R. Bankr. P. 2016(a).

[50]11 U.S.C. § 330(a)(1) (2006).

HeinOnline -- 83 Am. Bankr. L.J. 434 2009

Because the court must consider certain information contained in the fee application, the court can make the award only after the court receives the application. Section 330(a)(3) requires:

> In determining the amount of reasonable compensation to be awarded to . . . a professional person, the court *shall* consider the nature, the extent, and the value of such services, taking into account all relevant factors, including -
>
> (A) the time spent on such services . . . [and]
>
> (D) whether the services were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue or task addressed . . .[51]

The court's consideration of the debtor's application to employ the ordinary course professionals cannot qualify as the required process because the services have not yet been performed, the court knows hardly anything about the services to be performed, and the court does not "determine the amount" that is "reasonable."

No provision of the Bankruptcy Code or Rules authorizes the courts to excuse compliance with Rule 2016(a) or Bankruptcy Code § 330(a). Although ordinary-course applications and orders often refer to Bankruptcy Code § 105(a), which empowers the bankruptcy court to enter "any order . . . that is necessary and appropriate to carry out the provisions of this title,"[52] the Supreme Court has twice held that § 105 does not authorize bankruptcy courts to make exceptions from Bankruptcy Code provisions.[53] Most recently, the Court stated that "[o]bviously, however, neither [§ 105(a) or the bankruptcy court's inherent power] authorizes a bankruptcy court to contravene the Code. On the contrary, a bankruptcy court's general and equitable powers must and can only be exercised within the confines of the Bankruptcy Code."[54]

C. Purported Legal Justifications

As with any other motion, a debtor filing a motion to establish an Ordinary-Course-Professionals Practice in a given case must cite authority for the practice. The motions generally list Bankruptcy Code §§ 105, 327, 330, and

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[51]11 U.S.C. § 330(a)(3) (2006) (emphasis added).

[52]11 U.S.C. § 105(a) (2006).

[53]Marrama v. Citizens Bank, 549 U.S. 365 (2007); Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988).

[54]Marrama v. Citizens Bank, 549 U.S. 365, 382 (2007) (quoting Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988)).

HeinOnline -- 83 Am. Bankr. L.J. 435 2009

331 and occasionally include § 328.[55] Some set forth the full text of the statutes. But with the exception discussed in the next paragraph, none of the applications we examined even tried to assemble an argument from the language of those sections.

Instead, nearly half of the applications made the bogus argument that the persons the debtors sought to employ - most of whom were attorneys - were not "'professionals' within the meaning of § 327." Here, for example, is how Skadden Arps phrased the argument in the Kmart case:

> 35. Because the nature of the work performed by the Ordinary Course Professionals is only indirectly related to the type of work carried out by the Debtors, because the degree of discretion afforded the Ordinary Course Professionals in performing such work is marginal, and because the Ordinary Course Professionals will not be involved in the administration of these chapter 11 cases, the Debtors do not believe that the Ordinary Course Professionals are "professionals," within the meaning of section 327 of the Bankruptcy Code, whose retention must be approved by the Court. See *In re* First Merchants Acceptance Corp., Case No. 97-1500, 1997 Bankr. LEXIS 2245, at 8-9 (Bankr. D.Del.Dec. 15, 1997). . . .
>
> 37. Nevertheless, out of an abundance of caution, the Debtors seek the relief requested herein to avoid any subsequent controversy as to the Debtors' employment and payment of the Ordinary Course Professionals during the pendency of these chapter 11 cases.[56]

Skadden did not say why it should matter whether "the Ordinary Course Professionals are 'professionals' whose retention must be approved by the Court." The probable reason is that § 330, which requires that fees be awarded, applies to "a professional person employed under section 327." [57] Skadden's argument might be that no order is needed to employ an ordinary course professional, so an ordinary course professional doesn't need to file a fee application.

The § 327 employment requirement is not, however, limited to a professional persons who will "be involved in the administration of the estate." Section 327(e) requires court approval to hire *attorneys* who will *not* be involved in the administration of the estate. Viewing the two relevant provi-

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[55]The motions are posted at http://lopucki.law.ucla.edu/RoutineIllegalityDocuments/.

[56]Motion for an Order Pursuant to 11 U.S.C. §§ 105(a), 327(a) and 331 Authorizing Retention of Professionals Utilized by Debtors in the Ordinary Course of Business at 14-15, *In re* Kmart Corp., No. 02-B02474, (Bankr. N.D. Ill. Jan. 22, 2002) (docket No. 31) (hereinafter Kmart Ordinary Course Application).

[57]11 U.S.C. § 330(1)(1) (2006).

HeinOnline -- 83 Am. Bankr. L.J. 436 2009

sions of § 327 together reveals the problem with the *First Merchants Acceptance* argument:

> (a) Except as otherwise provided in this action, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, . . . to represent or assist the trustee in carrying out the trustee's duties under this title.
>
> (e) The trustee, with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor . . . .[58]

Ordinary course professionals are not covered by section (a) because they are not assisting with the bankruptcy case. But ordinary course professionals who are attorneys are covered by (e). Orders are necessary to employ them, so they must seek fee awards.

The large majority of all Ordinary Course Professionals are attorneys, and so covered by subsection (e). For example, the Kmart application in which Skadden made the *First Merchants Acceptance* argument sought authority to employ thirty-six professionals. Thirty-two of them (89%) were attorneys.[59] Thus, the *First Merchants Acceptance* argument falls far short of justifying the Ordinary-Course-Professionals Practice.

Another flaw in the *First Merchants Acceptance* argument is that it proves too much. The argument does not distinguish among ordinary course professionals or provide any basis for the court to distinguish among them. The argument leads to the conclusion that ordinary course professionals cannot be employed under § 327, and so are ineligible for fee awards under §§ 330(a) or 331 - regardless of the amounts of the fees involved.[60] The argument does not reach the conclusion necessary to justify the Ordinary Course Professionals Practice: the court has discretion to decide which professionals must make fee applications.

Debtors made the *First Merchants Acceptance* argument in six of the fourteen Ordinary Course Professionals cases we surveyed.[61] (The only other argument regularly made for entry of the ordinary course orders was

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[58]11 U.S.C. § 327 (2006).

[59]Kmart Ordinary Course Application, *supra* note 56, at 8-14 (listing "Description of Services" for 32 of 36 ordinary course professionals as "legal") .

[60]Acceptance of the argument would exclude all ordinary course professionals from the coverage of 11 U.S.C. § 327. Because they were not employed under that section, the court could not award them compensation under 11 U.S.C. § 330(a) or 11 U.S.C. § 331. Both those sections apply only to persons employed under § 327.

[61]The cases are Conseco, Crown Pacific, Hayes Lemmerz, Kmart, Ultimate Electronics, and US Airways (2004).

HeinOnline -- 83 Am. Bankr. L.J. 437 2009

that bankruptcy courts had approved "similar orders" in other cases.) That an argument so clearly insufficient is the best the lawyers can come up with is a tribute to the drafting of Rule 2016(a) and Code § 330(a). Law is rarely so clear.

D. Purported Practical Justifications

Defenders of the Ordinary-Course-Professionals Practice argue that (1) the fee application procedure is too expensive when applied to small applications (the "Expense and Inefficiency argument"), (2) some ordinary-course professionals will refuse to work for the estate if they must comply with the application requirement (the "Refusal to Work argument"), and (3) fee applications are redundant because the debtors are already monitoring the fees (the "Redundancy argument"). These arguments typically appear as only single sentences in ordinary-course applications. None of the arguments is tenable.

1. *Expense and Inefficiency*

The Expense and Inefficiency argument is nearly always directed against a straw man: the supposed necessity, in its absence, for a separate application to employ each professional. Bankruptcy Rule 2014(a) does not, however, require separate applications. Nor does Rule 2016(a) require separate fee applications filed by each professional. To the contrary, Rule 2016(a) specifically contemplates that a fee application may be made by an entity other than the attorney: "The requirements of this subdivision shall apply to an application for compensation for services rendered by an attorney or accountant even though the application is filed by a creditor or other entity." That other entity can be the debtor, filing a single application on behalf of dozens or hundreds of professionals.

Pacific Gas and Electric did precisely that. That is, it complied with the requirement for the filing of final fee applications by attaching a Rule 2016(a)-compliant affidavit executed by each of the attorneys on whose behalf Pacific Gas applied.[62] To comply with Rule 2016(a), such an affidavit need not be much different from the "reasonably detailed invoices" required by Ordinary Course Orders.[63] The essential differences between fee applications and detailed invoices are that (1) the fee applications are filed with the court, and (2) the fee applications must disclose this additional information:

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[62]Notice of Submission of Declarations of Special Counsel in Support of Final Application by Pacific Gas and Electric Company for Authority to Pay Compensation and Reimbursement of Expenses to Special Counsel to Debtor in Possession on Non-Bankruptcy Matters, *In re* Pacific Gas & Electric Co., No. 01-30923 (Bankr. N.D. Cal. July 9, 2002) (docket No. 15513) (submitting declarations for 89 special counsel in support of the debtor's final application to pay those special counsel).

[63]The words "reasonably detailed invoices" or substantial equivalents were used in eleven of the fourteen cases surveyed (79%). *See supra* Table 1.

HeinOnline -- 83 Am. Bankr. L.J. 438 2009

> An application for compensation shall include a statement as to what payments have theretofore been made or promised to the applicant for services rendered or to be rendered in any capacity whatsoever in connection with the case, the source of the compensation so paid or promised, whether any compensation previously received has been shared and whether an agreement or understanding exists between the applicant and any other entity for the sharing of compensation received or to be received for services rendered in or in connection with the case, and the particulars of any sharing of compensation or agreement or understanding therefor, except that details of any agreement by the applicant for the sharing of compensation as a member or regular associate of a firm of lawyers or accountants shall not be required.[64]

We think an affidavit like this hypothetical one would comply with the Rule:

> I was paid $4,962 on September 20, $970 on October 20, and $9,556 on November 20. No other payments have been made to me for services in connection with the bankruptcy case. The debtor has promised to pay me fees in accord with the attached retainer agreement. No other person has promised to pay me for services rendered in connection with the bankruptcy case. I have not previously shared any of this compensation and have no agreement or understanding to share any compensation received or to be received in, or in connection with the case, except as a member of my firm.

Such filings would not be expensive. Whether they would be "efficient" depends on what they would disclose or deter.

If a fee application is in excess of $1,000, the clerk, or some other person, must give creditors and indenture trustees at least twenty days notice of the hearing.[65] Again, no unreasonable expense need be involved. If all required fee applications are filed by the deadline, a single mailing can provide notice of all of them.

Nor would Rule 2016 fee applications place any greater burden on the United States trustee or the courts than they chose to accept. The law does not require the United States trustee to review every fee application. The United States trustee's duty is to review fee applications "whenever the United States trustee considers it to be appropriate" and only in accord with

[64]Fed. R. Bankr. P. 2016(a).

[65]Bankruptcy Rule 2002(a)(6).

HeinOnline -- 83 Am. Bankr. L.J. 439 2009

the United States trustees' own guidelines "which guidelines shall be applied uniformly by the United States trustee except when circumstances warrant different treatment."[66] Checking only a small percentage of ordinary-course applications would probably provide the greatest benefit per hour of United States trustee time.

Judges would likely respond to ordinary course attorneys' fee applications in the same way they respond to other fee applications. They approve dozens of applications in a single "omnibus" order,[67] and are involved with individual applications only when some party raises a dispute. Limiting review to those applications that draw objections may violate § 330(a).[68] But advocates who support the minimal-review practice with respect to large applications should not be heard to argue that the practice is illegal and its illegality prevents its use with respect to small applications.

At bottom, the Expense and Inefficiency argument is an assertion that the ordinary course professionals' fees applications are too small to warrant their processing. That argument proves too much. It probably would excuse most fee applications filed in ordinary Chapter 11 cases. Most Chapter 11 fee applications in ordinary cases are for amounts lower than the limits in most ordinary course professionals orders.

In a study of 945 randomly selected 2004 Chapter 11 cases, Professor Stephen Lubben found that, ignoring the largest 5% of cases, the average, *total* fees and expenses paid to all the debtors' professionals per case was $62,823.42.[69] That is less than $6,000 a month[70] - and substantially less than the $25,000 to $35,000 *per-month per-professional* limits typical for the

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[66]28 U.S.C. § 586(a)(3)(A) (2006).

[67]*See, e.g.*, Order Granting Interim and Final Allowance of Compensation and Reimbursement of Expenses at 1-2, *In re* Northwest Airlines Corp., No. 05-17930 (Bankr. S.D.N.Y. Sept. 14, 2007) (docket No. 7633) (approving final compensation for 33 listed professionals in a single order).

[68]*In re* Busy Beaver Bldg. Centers, Inc., 19 F.3d 833, 841 (3d Cir. 1994) ("[W]e think the bankruptcy court has a *duty* to review fee applications, notwithstanding the absence of objections by the United States trustee ("UST"), creditors, or any other interested party, a duty which the Code does not expressly lay out but which we believe derives from the court's inherent obligation to monitor the debtor's estate and to serve the public interest."); *In re* Armstrong World Industries, Inc., 366 B.R. 278, 280 (D. Del. 2007) ("Upon receipt of such fee applications submitted pursuant to § 330(a), the bankruptcy court not only has the power, it also has the *duty* to independently scrutinize them to ensure that such fee applications comport with § 330(a)."); *see also* McGuirl v. White, 86 F.3d 1232, 1236 (D.C. Cir. 1996) (citing *Busy Beaver* with approval and noting that "[c]reditors rarely object to fee applications, perhaps because each individual creditor has only a 'modest interest in each dollar the estate saves' and a 'creditor's reward for fighting that battle may be a smaller distribution due to its indirect obligation to pay a proportionate share of the fee applicant's fees ascribable to the defense of his or her fee request.'").

[69]Stephen J. Lubben, *Corporate Reorganization & Professional Fees*, 82 AM. BANKR. L.J. 77, 100 (2008).

[70]We have assumed that ordinary Chapter 11 cases are 11 months in duration. Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11*, 107 MICH. L. REV, 603, 607-08, 626 (2009) (reporting the results of a study of 1,422 Chapter 11 bankruptcy reorganizations in 1994 and 2002 that "[t]he median time spent in Chapter 11 is about eleven months").

HeinOnline -- 83 Am. Bankr. L.J. 440 2009

Ordinary-Course Professionals Practice.[71] If ordinary course applications are too small to process, then so are most fee applications in ordinary Chapter 11 cases. The Expense and Inefficiency argument is really just an attack on the fee-control system itself.

2. *Refusal to Work*

Some motions assert that without the Ordinary-Course-Professionals Practice, some ordinary-course professionals would refuse to represent the estate. Such refusals would put the estate to the expense of hiring substitute counsel or perhaps even result in the loss of estate cases. For example, Skadden Arps argued in Kmart that "While generally the Ordinary Course Professionals with whom the Debtors have previously dealt wish to represent the Debtors on an ongoing basis, many might be unwilling to do so if they may be paid only through a formal application process."[72] Skadden continued that "if the expertise and background knowledge of certain of these Ordinary Course Professionals . . . are lost, the estates undoubtedly will incur additional and unnecessary expenses because the Debtors will be forced to retain other professionals without such background and expertise."[73] Similarly, in the Conseco case, Kirkland and Ellis argued that "Some of the Ordinary Course Professionals might be unwilling to work with the Debtors if these requirements are imposed."[74] None of the applications that made this argument asserted that any ordinary course professional had actually threatened to withdraw.

Nor could most ordinary-course attorneys properly withdraw from representation for the reasons suggested. Under the Rules of Professional Conduct, attorneys may withdraw only if "withdrawal can be accomplished without material adverse effect on the interests of the client," continuing "will result in an unreasonable financial burden on the lawyer or has been rendered unreasonably difficult by the client," or some other "good cause" exists.[75] Thus, the Refusal to Work argument rests on a complete absence of evidence, combined with an assumption that ordinary course attorneys would act unethically.

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[71]The limits in a sample of cases are shown in Appendix 1.

[72]Kmart Ordinary Course Application, *supra* note 56, at 8.

[73]*Id.*

[74]Application for Entry of an Order Pursuant to Sections 1107(a) and 1108 of the Bankruptcy code Authorizing the Debtors to Employ and Compensate Certain Professionals Utilized in the Ordinary Course of the Debtor's Business at 4, *In re* Conseco, Inc., No. 02-49672 (Bankr. N.D. Ill. Dec. 17, 2002) (docket No. 23). In Boston Chicken, the argument was subtler. *See* Debtors' Motion for Authority to Employ and Compensate Professionals Utilized in the Ordinary Course of Business at 5, *In re* BCE West, L.P., No. 98-12547 (Bankr. D. Ariz. Oct. 7, 1998) (docket No. 42) ("Clearly, it is in the best interest of all the parties and the creditors to avoid any disruption in the professional services rendered by the Ordinary Course Professionals in the day to day operation of the Movants' business.").

[75]ABA MODEL RULES OF PROF'L CONDUCT, R. 1.16(b).

HeinOnline -- 83 Am. Bankr. L.J. 441 2009

Attorneys who charge reasonable fees for necessary work have no reason to avoid the fee application system. The attorneys would have to do some extra work in connection with their employment and fee applications.[76] But they would be entitled to be paid for that extra work - at their regular hourly rates.[77] If the ordinary course attorneys did not know how to file fee applications, the debtors' attorneys could assist them.

3. *Redundancy*

Lastly, debtors' attorneys argue that the employment and fee application process is redundant because the debtor is vetting the ordinary-course professionals. Thus, in Grand Union, Weil Gotshal argued:

> [A]lthough some of the Ordinary Course Professionals may hold small amounts of unsecured claims against the Debtor in respect of prepetition services rendered, the Debtor does not believe that any of the Ordinary Course Professionals has an interest materially adverse to the Debtor, its creditors, or other parties in interest, and thus none would be retained who does not meet, if applicable, the special counsel retention requirement of section 327(e) of the Bankruptcy Code.[78]

Weil Gotshal used substantially the same language in Lehman Brothers.[79]

The fallacy is obvious. If debtors could be trusted to vet professionals and their fees, the entire fee control apparatus mandated by Bankruptcy Code §§ 327-330 would not be necessary. The apparatus exists because Congress recognized that bankrupt debtors pay their professionals with other people's

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[76]For example, attorneys who are not accustomed to keeping hourly time records might be required to do so.

[77]*E.g.*, *In re* Nucorp Energy, Inc., 764 F.2d 655 (9th Cir. 1985) (holding that bankruptcy counsel are entitled to compensation for time and effort spent preparing fee applications).

[78]Application of the Grand Union Company Pursuant to Sections 105(a), 327, 328, and 330 of the Bankruptcy Code for Authorization to Employ Professionals Utilized in the Ordinary Course of Business at 9, *In re* The Grand Union Company, No. 98-27912 (Bankr. D. N.J. June 24, 1998) (docket No. 23).

[79]The application stated:

> Although certain of the Ordinary Course Professionals may hold unsecured claims against the Debtors for prepetition services rendered to the Debtors, the Debtors do not believe that any of the Ordinary Course Professionals have an interest materially adverse to the Debtors, their creditors or other parties in interest that should preclude such professional from continuing to represent the Debtors, and thus, all of the Ordinary Course Professionals proposed to be retained meet the special counsel retention requirement under section 327(e) of the Bankruptcy Code.

Debtors' Motion Pursuant to Sections 105(a), 327, 328, and 330 of the Bankruptcy Code for Authorization to employ Professionals Utilized in the Ordinary Course of Business Nunc Pro Tunc to the Commencement Date at 8, *In re* Lehman Brothers Holdings Inc., No. 08-13555 (Bankr. S.D.N.Y. Oct. 13, 2008) (docket No. 901).

HeinOnline -- 83 Am. Bankr. L.J. 442 2009

money. The fee control system exists to address "the temptation of a failing debtor to deal too liberally with his property in employing counsel."[80]

III. THE PRIOR-PAYMENT-DISCLOSURE PRACTICE

In nearly all large, public company bankruptcies, the professionals file fee applications that omit some of the information required by Bankruptcy Rule 2016(a) and the courts make fee awards based on the applications.[81] One required item of information routinely omitted from the final fee applications of debtors' lead bankruptcy attorneys is the amounts of money the debtors paid those attorneys prior to filing in connection with the cases.

A. THE LEGAL REQUIREMENT

Bankruptcy Rule 2016(a) specifies what every fee application must contain.

> An entity seeking interim or final compensation for services, or reimbursement of necessary expenses, from the estate shall file an application setting forth a detailed statement of (1) the services rendered, time expended and expenses incurred, and (2) the amounts requested. *An application for compensation shall include a statement as to what payments have theretofore been made . . . to the applicant for services rendered or to be rendered in any capacity in connection with the case . . . .*[82]

The italicized language requires inclusion of payments made by the debtor to the applicant prior to the filing of the case if those payments are made "in connection with the case."

Although the phrase "in connection with the case" has not been construed by the courts as it appears in Rule 2016(a), the phrase is a term of art used in several sections of the Bankruptcy Code and Rules.[83] For example, Bankruptcy Code § 329(a) provides:

> Any attorney representing a debtor in a [bankruptcy] case, or in connection with such a case, whether or not such attor-

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[80] *In re* Whitman, 51 B.R. 502, 506 (Bankr. D. Mass. 1985) (quoting *In re* Wood & Henderson, 210 U.S. 246, 253 (1908)).

[81] The courts granted each of the faulty applications listed in Appendix 2.

[82] Fed. R. Bankr. P. 2016(a) (emphasis added).

[83] 11 U.S.C. §§ 329(a), 330(a)(4)(B), 1129(a)(4) (2006); Fed. R. Bankr. P. 1006(b)(1). Although no court has construed the phrase "in connection with the case" as it appears in Rule 2016(a), COLLIER ON BANKRUPTCY, a leading treatise in the field, takes the position that the phrase means the same thing in Rule 2016(a) as it does in Code § 329(a), which is implemented through Rule 2016(b): "Rule 2016(a) requires that an application for compensation disclose all payments previously received by the applicant in connection with the case. This would include payments disclosed pursuant to Rule 2016(b) . . . ." 9 COLLIER ON BANKRUPTCY, 2016.09 [2] (2008).

HeinOnline -- 83 Am. Bankr. L.J. 443 2009

> ney applies for compensation [from the estate] shall file with the court a statement of the compensation paid . . . if such payment . . . was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or *in connection with the case* by such attorney . . . .[84]

Because this section specifically refers to payments made before the filing of the petition, it is impossible to construe the phrase "in connection with the case" as not including them.

The courts have uniformly held and specifically noted that the language "in connection with the case" includes payments made prior to the filing of the case.

> [T]he "in connection with" language used in § 329 extends the scope of the court's review to compensation paid by the debtor to an attorney at any time after one year prior to the commencement of the debtor's bankruptcy case, whether or not the court can make a subjective determination that the debtor was contemplating bankruptcy, if it can be objectively determined that the services rendered or to be rendered by the attorney have or will have an impact on the bankruptcy case.[85]

Numerous courts have held debtors attorneys obligated to report under § 329 - and thus under Rule 2016(b) - payments received prior to bankruptcy for work done prior to bankruptcy.[86] No court has ever held pay-

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[84]11 U.S.C. § 329(a) (2006) (emphasis added)

[85]*In re* Rheuban, 121 B.R. 368 (Bankr. C.D. Cal. 1990).

[86]For example, the court in *In re* Ostas, 158 B.R. 312, 321 (N.D.N.Y. 1993) stated:

> Certainly the $1,600 compensation appellant Cohn received for legal services rendered by him to obtain the stay of foreclosure was work "in connection" with the debtors' bankruptcy, as that phrase has been construed by the courts. . . . While it is true that there was no Chapter 13 case pending when the appellant obtained the stay of foreclosure, the foreclosure action clearly was inextricably intertwined with the reopening of the debtors' second Chapter 13 proceeding.

Id. at 321-22. Other examples include *In re* Command Services Corp., 85 B.R. 230, 232 (Bankr. N.D.N.Y. 1988) ("While Sheehan's services pre-petition may not have been rendered in contemplation of the Chapter 11 case, they clearly were rendered in connection with it . . . ."); *In re* Mayeaux, 269 B.R. 614, 624 (Bankr. E.D. Tex. 2001) ("the court finds that the services provided by the Debtor's counsel prior to and during this case were rendered both 'in contemplation of' and 'in connection with' the Debtor's bankruptcy case . . . ."); *In re* Campbell, 259 B.R. 615, 626 (Bankr. N.D. Ohio 2001) ("The scope of the phrase 'in connection with the case' is broad. . . . The phrase may include services related to the precipitating cause of the bankruptcy . . . ."); *In re* Keller Financial Services of Florida, Inc., 248 B.R. 859, 878 (Bankr. M.D. Fla. 2000) (quoting *Rheuban* that "the language used in § 329 extends the scope of the court's review to compensation paid by the debtor to an attorney any time after one year prior to the commencement of the debtor's bankruptcy case . . . ."); *In re* Bartmann, 320 B.R. 725, 747-48 (Bankr. N.D. Okla. 2004)(holding

HeinOnline -- 83 Am. Bankr. L.J. 444 2009

ments excludable because made prior to filing. Moreover, the phrase "in connection with the case" is also used in other sections of the Bankruptcy Code[87] and Rules[88] and in bankruptcy fee practice generally[89] to include payments made prior to the filing of the case. Thus, the payments a professional must reveal to satisfy Rule 2016(a) include payments made prior to the filing of the bankruptcy case for services performed prior to the bankruptcy case - if the payments are "in connection with the case."

B. Description of the Practice

The routine practice in large, public company cases is to receive prepetition payments in connection with the cases, to report them in Statements of Financial Affairs or § 329 disclosures, but not to report them in final fee applications. Final fee applications disclose only payments received from the bankruptcy estate during the bankruptcy case - that is, from the filing of the case to the closing date of the final fee application period.

To document the illegal practice, we examined the final fee applications filed by the debtors' lead bankruptcy attorneys in twenty-nine[90] cases ran-

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that the debtor's attorney was obligated under the "in connection with the case" language of § 329 to disclose prepetition compensation he received from the debtor).

[87]*E.g.*, 11 U.S.C. § 1129(a)(4) (2006) ("The court shall confirm a plan if all of the following requirements are met: . . . (4) Any payment made . . . for services . . . in or in connection with the case . . . has been approved by . . . the court as reasonable."); *In re* Congoleum Corp., 2009 WL 499262 (Bankr. D. N.J. 2009) (rejecting a settlement that allowed attorneys to retain prepetition payments made to them in connection with a prepackaged case because the settlement did not permit review of those payments as required by § 1129(a)(4)).

[88]Bankruptcy Rule 1006(b)(1), which requires that an application for permission to pay the filing fee in installments must be accompanied by the debtor's representation that the debtor has "neither paid any money nor transferred any property to an attorney for services in connection with the case." Because the application is filed with the petition and its purpose is to avoid the requirement of payment of a filing fee as a prerequisite to the filing of the petition, the payments "in connection with the case" disclaimed by the application cannot be payments made during the case. The case does not yet exist when the application is filed. *In re* Bost, 341 B.R. 666, 692 (2006) ("Mr Angeleri violated this rule by accepting payment prior to paying the filing fee . . . .").

[89]*In re* Golf Augusta Pro Shops, Inc., 2003 Bankr. LEXIS 2024 at 3(Bankr. S.D. Ga. Aug. 28, 2003) ("In determining the true nature of a 'retainer' agreement, absent an understanding between the debtor and debtor's attorney that the payment to the attorney made prior to the filing of the Chapter 11 case was a flat fee for all services provided in connection with the bankruptcy petition, the money paid is a payment to secure the payment of past and future services rendered by the attorney in connection with the case."); *In re* Dees Logging, Inc., 158 B.R. 302, 306 (Bankr. S.D. Ga. 1993) ("[B]arring a clear expression of an understanding between the debtor and the debtor's attorney that the payment to the attorney made prior to the filing of a Chapter 11 bankruptcy petition and in contemplation of that peitition is a flat fee for all services to be rendered by the attorney in connection with the bankruptcy proceeding, the funds paid will be construed by this court as a payment to secure the payment of past and future services rendered by the attorney in connection with the case . . .").

[90]We examined the fee applications filed by the debtor's lead bankruptcy attorneys in thirty cases. In one, Genuity, Inc., the debtor's lead bankruptcy attorney did not commence work on the case until shortly after it was filed.

HeinOnline -- 83 Am. Bankr. L.J. 445 2009

domly selected from among the 102 cases studied,[91] omitting the forty cases for which fee applications were not available on Pacer. The results are shown in Appendix 2. Only two of the twenty-nine applications (7%) complied with the requirement of Rule 2016(a) by disclosing the prepetition payments received "in connection with the case."[92] Five additional applications (17%) arguably complied by disclosing payments received prepetition without certifying that they were all received "in connection with the case."[93] Such a statement complies with Rule 2016(a) only if one assumes that (1) the attorneys would not disclose some prepetition payments without disclosing all of them[94] and (2) the language "in connection with the case" is thus not needed for compliance. The final fee applications in the remaining twenty-two of the twenty-nine cases (76%) disclosed only payments the attorneys received during the case.[95]

We know that each of the sixty-two debtor's lead bankruptcy attorneys eligible for inclusion in our study had received payments from the debtor in the year prior to filing either "in connection with the case"[96] or "for consultation concerning debt consolidation, relief under the bankruptcy law or preparation of a petition in bankruptcy"[97] because the attorneys disclosed that

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[91]We used the random number generator at http://www.randomizer.org to generate thirty random numbers from 2 to 63 (to correspond with the row numbers on a spreadsheet). These are the numbers, in the order generated: 61, 37, 56, 63, 38, 39, 52, 57, 32, 3, 43, 12, 53, 41, 33, 21, 50, 20, 11, 51, 9, 24, 30, 59, 34, 27, 2, 19, 60, 62. With the database arranged alphabetically on an Excel spreadsheet by the amount of the prepetition payment received by the attorney, we selected the records with these numbers, and then read the final fee application associated with each record. We read in the order in which the numbers were generated. If a fee application was not available on Pacer, we omitted that record from the study. We continued reading until we read thirty final fee applications.

[92]The two cases were Mirant and Bethlehem Steel.

[93]The five cases were Flag Telecom Holdings, Friedman's Inc., Pacific Gas & Electric, US Airways (2002), and US Airways (2004).

[94]Assume, for example, that an attorney received two payments from the debtor prior to bankruptcy for work done prior to bankruptcy. One payment was in the amount of $500,000, the other in the amount of $300,000. In the final fee application, the attorney stated that it received a payment in the amount $500,000 from the debtor for work done prior to bankruptcy. Such a statement, although not wrong, would be highly misleading. From that conclusion, one might argue that, in the context of a fee application, the statement one received $500,000 should be taken to mean one received *only* $500,000. If one accepts that latter conclusion, it follows that the attorney has revealed all payments made for prepetition work. Provided that the attorney has separately revealed the retainers it holds as of the filing of the case, the two disclosures necessarily add up to disclosure of all payments made before the filing of the case.

[95]*See infra* Appendix 2.

[96]That is, each was reported as receiving payments "in connection with the case" in the debtor's application to employ the attorney. About two-thirds of the applications to employ these 62 DIP lead bankruptcy attorneys reported the payment of retainers or the payment of legal fees to those attorneys prior to the filing of the case, in connection with the case.

[97]That is, each was listed as having received payments in the year prior to bankruptcy in response to question 9 on the Statement of Financial Affairs filed by the debtor in the bankruptcy case, Bankruptcy Rules, Official Form 7. Question 9 of the Statement of Financial Affairs requires that the debtor "List all payments made or property transferred by or on behalf of the debtor to any persons, including attorneys,

HeinOnline -- 83 Am. Bankr. L.J. 446 2009

information at some time during the case. We also know that each performed services prior to the filing of the case in connection with the case, because each filed the petition and numerous other documents with the court on the day they filed the petition. The attorneys filing those documents necessarily prepared them prior to filing. For their own protection, the attorneys had to either apply the payments to the prepetition services or hold the payments as security for those services. If an attorney did neither, the attorney would be an unsecured creditor of the debtor for the price of the services at the moment of filing, and ineligible to continue representing the debtor after filing.[98] Thus, we can be confident that each of the attorneys received prepetition payment for all or substantially all of the prepetition services they rendered "in connection with the case," but did not report those payments in their final fee applications, as required by Rule 2016(a).

Several of the non-complying applications did reveal the amounts of retainers paid to the attorneys prior to the filing of the case or held by the attorneys as of the filing of the case. Such statements are still non-complying because, as is illustrated by the following paragraph from the debtor's application to employ Weil Gotshal in Grand Union, the amount of the retainer bears no necessary relationship to the amount of the payments.

> 18. Within one year prior to the Commencement Date, WG&M received from the Debtor an aggregate of $2,200,000 for professional services performed relating to general corporate affairs, the potential restructuring of the Debtor's financial obligations and the potential commencement of this chapter 11 case. WG&M also has received a retainer fee and an advance against expenses for services to be performed in the preparation for and prosecution of this chapter 11 case, in the sum of $400,000 and $50,000, respectively, which will be applied to such post petition al-

for consultation concerning debt consolidation, relief under the bankruptcy law or preparation of a petition in bankruptcy within one year immediately preceding the commencement of this case."

[98]A debtor's attorney who holds an unsecured claim against the debtor for an unpaid prepetition fee is not "disinterested," 11 U.S.C. § 101(14) (2006). That renders the attorney ineligible to represent the debtor during the bankruptcy case, 11 U.S.C. § 327(a) (2006) (professional persons must be "disinterested" to qualify for employment). To avoid disqualification, debtors' attorneys insist on prepetition retainers sufficient to cover the fees. If the retainers are inadequate, they waive the balance owing. Application for Authority to Retain Skadden, Arps, Slate, Meagher & Flom LLP as Lead Restructuring and Bankruptcy Counsel to the Debtors at 12, *In re* Winn-Dixie Stores, Inc., No. 05-11063 (Bankr. S.D.N.Y. Feb. 21, 2005) (docket No. 6) ("In the event of a deficiency in the Retainer after application to prepetition fees and expenses, Skadden, Arps has agreed to waive any resulting prepetition claim against the Debtors.").

HeinOnline -- 83 Am. Bankr. L.J. 447 2009

> lowances of compensation and reimbursement of expenses, respectively, as may be granted by the Court.[99]

The temporal order of these retainers and other payments is not shown in the court file. But under the standard practice, Weil Gotshal could have obtained the retainers first, performed work, billed for the work without applying the retainers, repeated the process until payments totaled $2.2 million, and still held the retainers at the time the bankruptcy was filed. Thus, an application that reveals only the amounts of the retainers received, does not reveal the "payments . . . made . . . to the applicant for services rendered . . . in connection with the case."[100]

C. The Need for Disclosure

There are three apparent purposes for requiring that payments previously disclosed be disclosed again in each fee application. The first is to enable the judge, the United States trustee, and parties in interest to be aware of the prepetition payments as they assess the reasonableness of a requested post-petition payment.[101] Professionals already paid for prepetition work are familiar with the documents, the people, and the law involved in the case. They should take less time than new professionals to perform the same tasks post-petition. The second reason for the required repetition is that, even though the attorney need not seek allowance of the prepetition payment, if the court determines it to have been excessive, the court can require the professional to disgorge it.[102] The court needs to see the amount of the prepetition payment in context to make this decision. The third is to make available in the court file the total amount of compensation paid to the professional to date in connection with the case.

Because the practice is not to disclose prepetition payments in the applications, fee reviewers must proceed without that information, or search the court file for another document, such as the Rule 2016(b) statement, that contains the same information. That search can be a formidable task in a large public company bankruptcy. The court file is likely to contain

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[99]Application of the Debtor Pursuant to Section 327(a) of the Bankruptcy Code for Authorization to Employ Weil, Gotshal & Manges LLP as Attorneys for the Debtor at 8, *In re* Grand Union Company, No. 98-27912 (Bankr. D. N.J. June 24, 1998) (docket No. 11).

[100]Bankruptcy Rule 2016(a). Grand Union's application to employ Weil Gotshal revealed sufficient information to comply with Rule 2016 if that information had been contained in Weil Gotshal's final fee application. But in accord with the standard practice, the information was not in the fee application.

[101]Promoting such awareness is an express purpose of the United States trustee's professional fee guidelines. 28 C.F.R. pt. 58, app. A ("The fee application should also contain sufficient information about the case and the applicant so that the Court, the creditors, and the United States Trustee can review it without searching for relevant information in other documents.").

[102]11 U.S.C. § 329(b) (2006) (permitting the court to order return of prepetition payments in connection with the case if they are "excessive").

HeinOnline -- 83 Am. Bankr. L.J. 448 2009

thousands of documents,[103] many of the documents are poorly labeled,[104] and Rule 2016(b) statements are often incorporated into other documents.[105] The United States trustee's Guidelines for Reviewing Fee Applications specifically acknowledge the need for convenient access by providing that "[t]he fee application should also contain sufficient information about the case and the applicant so that the Court, the creditors, and the United States Trustee can review it without searching for relevant information in other documents."[106]

IV. THE DISBURSE-FIRST PRACTICE

Nearly all courts processing large, public company bankruptcies authorize the disbursement of 80% of the fees sought by professionals before the court has reviewed the fees or decided their reasonableness. Most of those courts authorize such disbursements before the professionals have even filed fee applications. In a practice that evokes the Red Queen's "sentence first, verdict afterwards,"[107] the courts acknowledge that applications are necessary, but think it sufficient that the applications be filed after the fees are paid. Thus, the courts disburse the fees first and decide later whether to award them. In the Southern District of New York, the Disburse-First Practice has been codified in the form of a General Order with which all Disburse-First orders filed in the District must comply.[108] The early disbursements violate the fee application requirement of Rule 2016(a) and the "allow and disburse" requirement in Bankruptcy Code § 331.[109]

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[103]The median number of documents listed on the docket sheet through plan confirmation in the cases we studied was 1,330. The average was 2,725. The maximum was 19,758. A document often consists of numerous subdocuments and documents continue to be filed after confirmation, so the total numbers of documents is much higher than the numbers listed here.

[104]The name of a document on the Pacer docket seldom matches the name of the document as it appears on the document itself.

[105]In some cases, the Rule 2016(b) statement is not a separate document, but is included in some other document, such as an application to employ the attorney. *See, e.g.*, Affidavit of Weil, Gotshal & Manges LLP and Disclosure Statement Pursuant to Bankruptcy Code Sections 327, 328(a), 329 and 504 and Federal Rules of Bankruptcy Procedure 2014(a) and 2016(b) at 2, *In re* Bethlehem Steel Corporation, No. 01-15288 (Bankr. S.D.N.Y. Oct. 15, 2001) (docket No. 17) ("I submit this affidavit in connection with the application dated October 15, 2001 (the Application) for approval of the Debtors' retention of WG&M as attorneys . . . and to provide disclosure required under Rules 2014(a) and 2016(b) of the Federal Rules of Bankruptcy Procedure (the Bankruptcy Rules).") This document is attached to an application to employ Weil Gotshal. The docket entry makes no mention of it, Rule 2016(b), or Bankruptcy Code § 329 - making it virtually impossible to discover by electronic search.

[106]28 C.F.R. pt. 58, app. A (2007).

[107]LEWIS CARROLL, ALICE'S ADVENTURES IN WONDERLAND 187 (William Morrow & Co., Inc. 1992) (1866).

[108]Amended General Order M-219, (Bankr. S.D.N.Y. Mar. 21, 2008), *available at* http://www.nysb.uscourts.gov (Choose Local Rules/Orders/Guidelines, Administrative Orders, General Orders by Subject).

[109]11 U.S.C. § 331 (2006) ("After notice and a hearing, the court may allow and disburse to such applicant such compensation or reimbursement.").

HeinOnline -- 83 Am. Bankr. L.J. 449 2009

Whether the professionals can be compensated monthly is not the issue. Most bankruptcy professionals charge by the hour, the month, or the specific transaction. Bankruptcy Code § 331 permits any professional to "apply to the court not more than once every 120 days . . . or more often if the court permits" to receive payment "for services rendered before the date of [the professional's] application." The legislative history adds that "[t]he court may permit more frequent application if the circumstances warrant, such as in very large cases where the legal work is extensive and merits more frequent payments."[110] This provision authorizes the court to permit monthly fee applications, enter monthly orders, and pay monthly fees in large cases.[111]

What stood in the way of monthly payment under § 331 was that the judges were unwilling to review fees monthly.[112] The Disburse-First Practice was adopted to reconcile the judges' desire to avoid reviewing fees monthly with the professionals' desire to be paid fees monthly.[113] As one court candidly admitted

> The administrative fee order permitting monthly payment of undisputed fees subject to quarterly review and hearing by the court . . . also eases the administrative burden on the court that results when fee applications in large or complex cases must, in the interests of justice, otherwise be heard monthly.[114]

A. Description of the Practice

The Practice is for the debtor to apply for, and the court to enter, an

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[110]Senate Report No. 95-989, 95th Cong., 2d Sess. (1978) at 330.

[111]*In re* International Horizons, Inc., 10 B.R. 895, 898 (Bankr. N.D. Ga. 1981) (authorizing monthly compensation on the basis of Bankruptcy Code § 331).

[112]As one court wrote:

> Another factor we consider relevant is the effect of the proposed procedure on the ability of the Court to adequately review professional fee applications. In large cases, it is often difficult for the Court to assess whether services rendered by a professional were necessary or performed within a reasonable time when the Court only has one month's worth of time to review. The Court often has to review several months of fee applications to determine whether a specific task was performed in a reasonable amount of time and provided a benefit to the estate. Thus, quarterly fee applications make it easier for the Court to perform this function.

In re Mariner Post-Acute Network, Inc., 257 B.R. 723, 731 (Bankr. D. Del. 2000).

[113]*E.g.*, Motion for Administrative Order Under 11 U.S.C. §§ 105(a) and 331 Establishing Procedures for Periodic Compensation and Reimbursement of Expenses of Professionals at 9, *In re* National Steel Corporation, No. 02-08699 (Bankr. N.D. Ill. Mar. 6, 2002) (docket No. 28) ("To eliminate the burdens placed on the Court by a requirement that the Court hear uncontested monthly fee applications . . . the Debtors request that the Court establish procedures . . . for compensating . . . such court-approved Professionals.").

[114]*In re* Pittsburgh Corning Corp., 255 B.R. 162, 164 (Bankr. W.D. Pa. 2000).

HeinOnline -- 83 Am. Bankr. L.J. 450 2009

order that (1) authorizes the professionals to request fees without filing Rule 2016(a) fee applications and (2) authorizes the debtor to pay 80% of the fees requested without further court order.[115] To determine the extent and precise nature of the Practice, we conducted a small empirical study. The study consisted of downloading and reviewing all of the applications and orders that established the monthly payment procedures in the random sample of thirty cases previously drawn for the Prior-Payment-Disclosure Study.[116] The principal results of this Disburse-First Study are shown in Appendix 3.

We found that court entered an order establishing a monthly payment procedure in twenty-eight of the thirty cases (93%). The two cases without a procedure were Grand Union and Salant. At 35 and 108 days respectively from filing to plan confirmation, those two cases were the shortest in the study. In neither case was an application made. The probable reason was that the parties did not expect the cases to last long enough for monthly payment to make much difference. In twenty-one of the twenty-eight cases in which the court did establish a monthly payment procedure (75%), the court entered the order authorizing the Disburse-First Practice within thirty-five days of the filing of the bankruptcy case.[117]

As previously noted, Bankruptcy Code § 331 confers on the bankruptcy courts the discretion to permit the monthly payment of professional fees. In all twenty-eight cases, however, the orders establishing the procedure did more than authorize monthly payments. All were Disburse-First orders. That is, by a single order entered in each case before the work was done, the court authorized the monthly disbursement of 80% of the fees requested for the remainder of the case, without further order.

The procedure employed uniformly in Delaware required that, before each disbursement, the professional file a Rule 2016 application.[118] The other courts' procedures uniformly eschewed the word "application." Most required a "detailed statement" of the fees sought, although one required a "bill" and another required a "cover sheet."[119] Of the twenty-two orders that did not require an application, five (23%) did require that the substitute document be filed with the court.[120] The remaining seventeen (73%) did not.

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[115]General Order M-219 (Bankr. S.D.N.Y. Jan. 24, 2000), available at http://www.nysb.uscourts.gov ("At the expiration of the thirty-five (35) day period, the Debtors shall promptly pay eighty percent (80%) of the fees . . . to which no objection has been served . . .").

[116]*See supra* note 910, and accompanying text (describing the methodology).

[117]*See infra* Appendix 3.

[118]*E.g.*, Administrative Order Establishing Procedures for Interim Compensation and Reimbursement of Expenses of Professionals at 3, *In re* Onco Investment Company, No. 04-10558 (Bankr. D. Del. Mar. 22, 2004) (docket No. 225) ("All Monthly Fee Applications will comply with the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure, . . . applicable Third Circuit law and the Local Rules.").

[119]Appendix 3.

[120]*Id.* These cases are marked "filed" in column (5).

HeinOnline -- 83 Am. Bankr. L.J. 451 2009

Some of the twenty-two orders specified, in varying levels of detail, what information had to be in the fee request. But none of the twenty-two required that the document contain all of the information required by Bankruptcy Rule 2016. Thus, all twenty-two authorized disbursement of fees to professionals without a Rule 2016 application. In doing so, they authorized an illegal practice.

All, or substantially all, of the twenty-eight orders required fee requesters to "serve" copies of their requests on the debtor and other specified parties in interest. If any party in interest objected to particular fees, the orders in nineteen of twenty-eight cases (68%) required that party to serve its objections and seek to resolve them by agreement.[121] Those nineteen orders did not, however, require the parties to file their objections with the court unless the objections remained unresolved for some stated period of time. In the remaining nine cases (32%), the order required that the objection be filed with the court.[122] So long as an objection remained pending, the debtor was not authorized to disburse the questioned fees without a further order. The Disburse-First orders invariably recited that fees paid under them were subject to disgorgement if not ultimately allowed.

In all but five instances, the disbursements authorized were of 80% of the fees requested. The five orders that deviated did so by authorizing higher levels of disbursement.[123] As a result of the Disburse-First Practice, the estates in these cases probably disbursed more than 80% of all fees in response to requests that the courts had neither reviewed nor approved at the time of payment.

Participation in the Disburse-First Practice was voluntary for professionals in twenty-five cases, and mandatory in three.[124] The orders almost invariably required that if a professional opted to receive monthly payments, the professional was required to make interim fee applications for those payments at three to six month intervals.[125] Thus, to the extent that the attorneys "applied" for the fees prior to disbursement, the order required that they apply for the fees again. The result was particularly ironic in Delaware, where the professionals who sought monthly payment had to file interim monthly fee applications, interim fee applications at three month intervals, and then final fee applications at the end of the case. All three sets of applications covered precisely the same fees. Professional dissatisfaction with the procedure's redundancy is undoubtedly mitigated by the fact that profession-

[121] *See infra* Appendix 3, column (6) (cases marked "Serve").

[122] *Id.*, column (6) (cases marked "File").

[123] *Id.*, column (9) (showing two cases with 15% holdbacks, two cases with 10% holdbacks and one case with zero holdback).

[124] *Id.*, column (4) (cases marked "required").

[125] The precise intervals are shown in Appendix 3. *Id.*, column (10).

HeinOnline -- 83 Am. Bankr. L.J. 452 2009

als are entitled to payment, at their regular hourly rates, for time spent preparing all three sets of fee applications.[126]

B. ILLEGALITY OF THE PRACTICE

The Disburse-First Practice is illegal in two respects. First, the law requires that applications be made before fees are paid. Second, the law requires that the court consider the applications and award the fees before payment.

1. *Payment without Application*

Disbursement of fees without the filing of a fee application violates Bankruptcy Rule 2016(a). That rule provides

> An entity seeking interim or final compensation for services . . . from the estate shall file an application setting forth a detailed statement of (1) the services rendered, time expended and expenses incurred, and (2) the amounts requested. An application for compensation shall include [specific recitals and information].[127]

A professional person who bills the estate for services monthly is certainly "an entity seeking interim or final compensation . . . from the estate" and so is required to file a fee application. Bankruptcy Code § 331 points to the same conclusion. After authorizing the court to permit interim applications, that section authorizes the court to "allow and disburse" only to an "applicant" and so does not authorize payment in response to other requests.[128]

The legislative history of § 331 is in accord: if a court chooses to permit more frequent payment, it must require more frequent application. The Senate Report states that "[t]he court may permit *more frequent applications* if the circumstances warrant, such as in very large cases where the legal work is extensive and merits *more frequent payments*."[129] Thus the Disburse-First Practice variant that does not require an application, filed with the court, that contains the information required by Bankruptcy Rule 2016, violates § 331.

2. *Disbursement before Allowance*

All of the Disburse-First Practice variants, including Delaware's, also vio-

[126]*In re* 14605, Inc., 2007 WL 2745709 at 9 (Bankr. D. Del. 2007) (stating that "[c]learly the statute contemplates that fees will be allowed for preparation of fee applications in bankruptcy cases" and citing numerous cases).

[127]Fed. R. Bankr. P. 2016(a).

[128]11 U.S.C. § 331 (2006).

[129]Senate Report No. 95-989, 95th Cong., 2d Sess. (1978), at 330 (emphasis added).

HeinOnline -- 83 Am. Bankr. L.J. 453 2009

late § 331 because that section does not authorize disbursement except after, or in conjunction with, court approval. Section 331 provides:

> A . . . professional person . . . may apply to the court not more than once every 120 days . . . or more often if the court permits, for such compensation for services rendered before the date of such an application . . . as is provided under section 330 . . . . After notice and a hearing, the court may allow and disburse to such applicant such compensation . . . .[130]

The order of events specified in the statute is clear. First, the professional must render the services.[131] Second, the professional must make an application for the services.[132] Third, notice must be given and a hearing held if one is requested.[133] Only "*after* notice and a hearing" may the court "allow and disburse" the compensation. "Allow and disburse" is unambiguous as to the act contemplated: entry of the standard order stating that the compensation sought is awarded and that the debtor is authorized and directed to pay it from the estate.[134] Thus, the Disburse-First Practice is illegal because the Practice authorizes the disbursement of fees without allowing them.[135]

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[130]11 U.S.C.§ 331 (2006).

[131]The application is for "services rendered before the date of such an application."

[132]What the court is permitted to do is "disburse to such applicant." If no application has been made, the disbursement would not be to an "applicant."

[133]"After notice and a hearing" is defined in 11 U.S.C. § 102(1) (2006) to mean "after such notice as is appropriate in the particular circumstances, and such opportunity for a hearing as is appropriate in the circumstances; but . . . authorizes an act without actual hearing if such notice is given properly and if . . . such a hearing is not requested timely by a party in interest . . . ." The act authorized in the absence of a hearing is "to allow and disburse" not simply to disburse. *But see In re* Mariner Post-Acute Network, Inc., 257 B.R. 723, 728-29 (Bankr. D. Del. 2000) (concluding that the "'notice and a hearing' requirements of section 331 have been met by [a disburse-first] Procedure").

[134]An order in the Worldcom case contains the language typically employed to "allow and disburse." Third Supplemental Order Granting Interim and Final Compensation and Reimbursement of Expenses at 2-3, *In re* Worldcom, Inc., No. 02-13533 (Bankr. S.D.N.Y. Apr. 15, 2005) (docket No. 15848) ("[I]t is hereby ORDERED that final compensation is approved as set forth in Exhibit 'A' attached hereto . . . , the Reorganized Debtors are directed and authorized to pay the 'Total Fees Allowed' and 'Total Expenses Allowed' . . . to the extent that such amounts have not already been paid pursuant to a prior order of this Court, or otherwise.").

[135]*See, e.g., In re* Haven Eldercare, LLC, 382 B.R. 180, 184 (Bankr. D. Conn. 2008) ("Although Section 331 permits a Court to award compensation on a time interval more frequent than every 120 days, there exists no statutory authority permitting compensation to be 'advanced' without court approval."); *In re* Chapel Gate Apartments, Ltd., 64 B.R. 569, 573 (Bankr. N.D. Tex. 1986) ("Any payment to counsel before the closing of the case is by definition interim compensation, and to allow counsel to receive payments . . . without notice to the creditors and approval by the Court, is blatantly inconsistent with the statute . . . ."); *but see In re* Kaiser Steel Corp., 74 B.R. 885, 892 (Bankr. D. Colo. 1987) ("In the Court's view, Section 331 does not prohibit the adoption of such [disburse-first] procedures so long as it is clear that the monthly payments made are subject to recapture from the professionals . . . .").

HeinOnline -- 83 Am. Bankr. L.J. 454 2009

The Congressional history confirms that § 331 was not intended to alter the sequence of events in the fee award process:

> The court is authorized to allow and order disbursement to the applicant of compensation and reimbursement that is otherwise allowable under section 330. *The only effect of this section* is to remove any doubt that officers of the estate may apply for, and the court may approve, compensation and reimbursement during the case, instead of being required to wait until the end of the case, which, in some instances, may be years.[136]

C. Purported Legal Justifications

The practice begins with a motion for an order establishing procedures for interim compensation. Most courts require that the motion to establish a Disburse-First Practice in a case explain the legal basis for the Practice and provide authority. Nearly all of the twenty-eight motions studied cited §§ 105(a) and 331 of the Bankruptcy Code,[137] and mentioned that orders "similar" to the one sought had been entered in other cases in the district. Eleven of the applications (39%) cited International Horizons,[138] three (11%) cited Knudsen,[139] and two (7%) cited Mariner Post-Acute Network.[140] None of this authority provides legal justification for the practice.

1. *Sections 105(a) and 331*

Of the twenty-eight applications for Disburse-First orders, all but two[141] cited Bankruptcy Code § 105(a) as authority. That section provides in relevant part that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."[142] As previously explained, however, "neither [11 U.S.C. § 105(a) or the bankruptcy court's inherent power] authorizes a bankruptcy court to contravene the Code. On the contrary, a bankruptcy court's general and equitable powers must and can only be exercised within the confines of the Bankruptcy

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[136]Senate Report No. 95-989, 95th Cong., 2d Sess. (1978), at 41 (emphasis added).

[137]11 U.S.C. §§ 105(a) and 331 (2006).

[138]*In re* International Horizons, Inc., 10 B.R. 895 (Bankr. N.D. Ga. 1981). The cases citing *International Horizons* were aaiPharma, Allied Holdings, Crown Pacific, Geneva Steel, Focal Communication, Foamex, Friedman's, National Steel, Ultimate Electronics, US Airways (2002), US Airways (2004).

[139]Knudsen Corp. v. U.S. Trustee (*In re* Knudsen Corp.), 84 B.R. 668 (9th Cir. B.A.P. 1988). The cases citing *Knudsen* were Boston Chicken, Oglebay Norton, and Pacific Gas & Electric.

[140]*In re* Mariner Post-Acute Network, Inc., 257 B.R. 723, 726 (Bankr. D. Del. 2000). The cases citing *Mariner* were aaiPharma and Oglebay Norton. Motions in other cases cited the Mariner order as an example of an order in which the court granted the relief requested, but did not cite the Mariner opinion.

[141]The two applications were in Oglebay-Norton and Pacific Gas & Electric.

[142]11 U.S.C. § 105(a) (2006).

Code."[143] Thus, an order issued under § 105 cannot change the procedure required by § 331. None of the twenty-six applications mentioned this limitation on § 105(a) or sought to explain why the limitation did not apply.

2. In re *International Horizons*

International Horizons is the case most frequently cited in support of the practice of paying interim fees without application and disbursing those fees prior to their allowance.[144] The court did not approve either practice in that case, or write any dicta suggesting that it would in future cases.

In *International Horizons*, the court authorized the debtors to employ professionals "under a general retainer"[145] - a practice clearly authorized in Bankruptcy Code § 328.[146] But when "the debtors filed an application for authority to pay a retainer" to the professionals, creditors objected "on the grounds that both attorneys and accountants should be paid only for services actually rendered."[147] The court sustained the objection and denied the application:

> The Court finds that the retainer arrangement is inappropriate because it would require the debtors to pay for services which had not yet been rendered. The Court also notes that under a retainer arrangement there may be a tendency for the amount of services required to grow in order to consume the amount of funds available. Therefore, the Court denies the applications of [the professionals] for retainers.[148]

The Court continued "the Court does not wish to require that the attorneys for the debtor in possession fund this reorganization proceeding. In order to avoid this result, the Court finds that it should award the attorneys for the debtors in possession reasonable compensation for their services . . . ."[149] But the fees the Court allowed were fees for services already performed and for which application had already been made: "Both [professionals] have fully documented the extent of services performed . . . . The Court finds on review of the evidence that the services set forth in the application are actual and necessary services rendered by the attorneys in the administration of these cases."[150]

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[143]Marrama v. Citizens Bank, 549 U.S. 365, 382 (2007) (quoting Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988)).

[144]*See supra* note 138 and accompanying text.

[145]*In re* International Horizons, Inc., 10 B.R. 895, 895-96 (Bankr. N.D. Ga. 1981).

[146]"The trustee . . . with the court's approval may employ . . . a professional person . . . on any reasonable terms and conditions of employment, including on a retainer." 11 U.S. C. § 328(a) (2006).

[147]*In re* International Horizons, Inc., 10 B.R. 895, 896 (Bankr. N.D. Ga. 1981).

[148]*Id.* at 897.

[149]*Id.*

[150]*Id.* at 898-99.

HeinOnline -- 83 Am. Bankr. L.J. 456 2009

Thus, *International Horizons* did not authorize disbursements without application or prior to allowance. To the contrary, the court established a decide-first-then-disburse procedure:

> Each professional employed by the debtors or the Creditors' Committee may submit, during the first five days of each month, applications for compensation for services rendered in the preceding month. A hearing on these applications shall be scheduled for a convenient date toward the end of the month and notices of that hearing sent to all interested parties. After hearing on notice to interested parties, the court shall allow further compensation as it deems appropriate.[151]

3. In re *Knudsen*

Knudsen is a different story. In *Knudsen,* an appellate panel composed of three bankruptcy judges upheld an order that authorized "a procedure whereby professionals employed by the debtor and its creditors' committee would be paid each month without prior court approval of billing statements."[152] Although *Knudsen* is cited infrequently in the cases we studied,[153] most published opinions authorizing disburse-first practices rely upon it.

Knudsen's reasoning is deeply flawed and does not actually lead to its conclusion.

> We agree with the Trustee that allowance and disbursement of fees is permitted only in accordance with sections 330 and 331. We disagree, however, that sections 330 and 331 absolutely prohibit the transfer of funds to professionals prior to compliance with those sections. Section 328(a) specifically states that a bankruptcy court may authorize a retainer as part of a compensation agreement. A retainer contemplates payment of a lump sum at the beginning of a case or periodically thereafter. Periodic retainer payments could be either set amounts or a percentage of fees incurred in prior months. *Legal fees and costs may then be deducted from the retainer as they accrue and are allowed by the court.* It makes little sense that the court could allow payment of a lump sum or peri-

[151]*Id.* at 898.

[152]Knudsen Corp. v. U.S. Trustee (*In re* Knudsen Corp.), 84 B.R. 668, 669 (9th Cir. B.A.P. 1988).

[153]*See supra* note 139 and accompanying text.

HeinOnline -- 83 Am. Bankr. L.J. 457 2009

> odic retainer before fees are earned, but not after.[154] (emphasis added)

It is the court's analysis, however, that makes little sense.[155] Section 328(a) authorizes *employment* on a retainer basis; it does not purport to authorize *disbursement* of a retainer. Retainers are of two basic types, "classic" and "special." A classic retainer is a payment to the attorney, not for any work, but to guarantee the attorney's availability to work.[156] Classic retainer agreements are ineffective in the bankruptcy context.[157] In any event, Disburse-First payments purport to be for actual services rendered, and so are not classic retainers.

To the extent that Disburse-First payments are retainers at all, they are special retainers. That is, they are advance payment of fees not yet allowed. Under the law of most states, the attorney who receives such an advance payment must place the fees in the attorney's trust account and draw them only when earned.[158] Under bankruptcy law, such an advance payment remains property of the estate, even if the payment is made prior to filing and is expressly agreed to be non-refundable.[159]

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[154]*Id.* at 670.

[155]As one court noted:

> the language in *Knudsen* is somewhat contradictory [i.e., "legal fees may then be deducted from the retainer as they *accrue and are allowed* " and "fees must not be finally allowed (i.e., they must be subject to repayment) until a detailed application is filed, an opportunity for objection has been provided, and the court has reviewed the application"].

In re Act Mfg., Inc., 281 B.R. 468, 477 (Bankr. D. Mass. 2002).

[156]*In re* Bressman, 214 B.R. 131, 140 (Bankr. D.N.J. 1997) (describing a classic retainer as "intended to remunerate counsel for being deprived, by being retained by one party, of the opportunity of rendering services to another and receiving pay from him. The payment of such fee, in the absence of an express understanding to the contrary, is neither made nor received in payment of the services contemplated.").

[157]*Id.* at 140 ("'Earned retainers' are unreasonable in a bankruptcy case because they impermissibly circumvent the explicit and implicit requirements of the Bankruptcy Code and Rules pertaining to compensation of professionals, particularly debtor's counsel."); *In re* Chapel Gate Apartments, Ltd., 64 B.R. 569, 574 (Bankr. N.D. Tex. 1986) ("Describing the retainer as 'fully earned and nonrefundable' does not make it so, as the Court, and only the Court, has the power and duty to determine whether, and to what extent, any sum has been earned or should be returned.").

[158]*E.g., In re* Blanchard, 144 P.3d 286, 295 (Wash. 2006) (six-month suspension was appropriate sanction for attorney's misconduct in failing to deposit clients' advanced fees into a trust account and other wrongdoing); *In re* Gelden, 739 N.W. 2d 274, 276 n.6 (Wis. 2007) (referring to a former Supreme Court Rule requiring that "Unearned fees and advanced payments of fees shall be held in trust until earned by the lawyer . . . ."); *In re* Mayrand, 723 N.W. 2d 261, 266 (Minn. 2006) ("Mayrand violated . . . Board Opinion 15 (placement of advanced fees in trust account) by failing to place retainer fees from R.C. and J.H. into a client trust account.").

[159]*In re* Bressman, 214 B.R. 131, 140-41 (Bankr. D.N.J. 1997)(although "ownership of the funds is clearly intended by the parties to vest immediately . . . such 'advance payment retainers' have been held by a *majority* of courts to be property of the estate"); *In re* Chapel Gate Apartments, Ltd., 64 B.R. 569, 574 (Bankr. N.D. Tex. 1986) ("Describing the retainer as 'fully earned and nonrefundable' does not make it so, as the Court, and only the Court, has the power and duty to determine whether, and to what extent, any

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The retainers discussed in *Knudsen* are special retainers. As the *Knudsen* court recognized, in a bankruptcy case, the professional who receives a special retainer must obtain court approval to draw on the funds after performing the services: "Legal fees and costs may then be deducted from the retainer as they . . . are allowed by the court."[160] Thus, what follows from the *Knudsen* court's argument is not the court's conclusion that the debtor can be authorized to pay professionals absolutely prior to allowance. What follows is that the debtor can be authorized to pay fees into the professionals' trust accounts to be disbursed to the professionals when the courts allow the fees.[161] The difference is fatal to the Disburse-First Practice. The professionals want monthly *payments* so they can spend the money. Under the Disburse-First Practice, that is what they get. Monthly *retainers* that must remain in the professionals' trust accounts until the court awards the fees and authorizes their disbursement would not be an acceptable substitute.

4. In re *Mariner Post-Acute Network*

In *Mariner*, the bankruptcy court addressed both the application and prior-court-approval issues. After the debtor obtained court approval of an interim fee procedure, the debtor sought to amend it in two relevant respects. First, the procedure initially adopted authorized "fee applications on a monthly basis."[162] The debtor sought to reduce the requirement to "detailed monthly fee statements" before disbursement and "similarly detailed fee applications on a quarterly basis" - the latter presumably after disbursement.[163] The court holds that the detailed statement plus the later application are together a sufficient basis for allowance of the fees. This is the entirety of the court's explanation:

> 2. Formal fee application
>
> To permit adequate review to determine if the services performed by a professional are necessary and the fees requested reasonable, the professional must file a detailed fee applica-

sum has been earned or should be returned."); *In re* Kinderhaus Corp., 58 B.R. 94, 96 (Bankr. D. Minn. 1986) ("A prepetition retainer taken by a debtor's attorney for services to be rendered and costs to be incurred during the pendency of a bankruptcy case is held in trust, except to the extent that attorney's fees are allowed by the Court and ordered paid pursuant to 11 U.S.C. §330 and §331.").

[160]Knudsen Corp. v. U.S. Trustee (*In re* Knudsen Corp.), 84 B.R. 668, 670 (9th Cir. B.A.P. 1988). Accord, *In re* Chapel Gate Apartments, Ltd., 64 B.R. 569, 575 (Bankr. N.D. Tex. 1986) ("Any attorney who unilaterally draws against a retainer while representing a debtor in bankruptcy is plainly in violation of the strictures of the Code.").

[161]*In re* Act Mfg., Inc., 281 B.R. 468, 477 (Bankr. D. Mass. 2002) ("There is no doubt that security retainers, the most common form of retainer employed in bankruptcy, remain property of the estate and cannot be drawn upon absent court authorization.").

[162]*In re* Mariner Post-Acute Network, Inc., 257 B.R. 723, 726 (Bankr. D. Del. 2000).

[163]*Id.* at 728.

HeinOnline -- 83 Am. Bankr. L.J. 459 2009

> tion. As stated by the Court of Appeals for the Third Circuit: "We do not doubt the applicant's duty to submit fee applications with enough detail to enable the court to reach an informed decision - one necessarily grounded in complete, coherent information - as to whether the requested compensation is justified." In re Busy Beaver Bldg. Ctr., Inc., 19 F.3d 833, 845 (3d Cir. 1994).
>
> The Modified Compensation Procedure does provide for the preparation of detailed monthly fee statements, as well as the filing of similarly detailed fee applications on a quarterly basis. Thus, the proposed procedure complies with the requirements of the Code for sufficient detail of the services rendered to permit review and evaluation by the other interested parties in the case and the Court.[164]

The court cannot have intended to derive from *Busy Beaver* that any statement with "enough detail to enable the court to reach an informed decision"[165] is sufficient as a fee application even if it does not contain other information specifically required to be in a fee application. If the court had, the court would have engaged in the logical fallacy that if every fee application must be a sufficiently detailed statement then every sufficiently detailed statement is a fee application. Moreover, the *Busy Beaver* quote requires the information in the fee application to be *complete*, not just *detailed*. The Delaware bankruptcy court may have held that a court can authorize disbursement under § 331 without the application required by Rule 2016, but the court provided no logical argument for that proposition. The Delaware court has since abandoned this position. That court requires a fee application prior to disbursement.[166]

The second amendment sought in *Mariner* was to permit disbursement of fees prior to court approval. The court began by noting a split among the reported opinions, repeated portions of the *Knudsen* analysis[167] and concluded: "We agree with the rationale and conclusion of the *Knudsen* decision that § 328 permits a court to approve a procedure which allows monthly conditional interim payments to be made to a professional without prior Court approval, subject to later review and disgorgement."[168] Thus, *Mariner*

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[164]*Id.*

[165]*Id.*

[166]*See* Appendix 3, column (5) (showing that all six disburse-first orders in Delaware required fee applications as a prerequisite to payment).

[167]*Id.* at 730.

[168]*Id.*

HeinOnline -- 83 Am. Bankr. L.J. 460 2009

adds nothing to the argument for the legality of the Disburse-First Practice, except the court's agreement with it.

E. Purported Practical Justifications

Despite the illegality of the Disburse-First Practice, bankruptcy attorneys argue and some judges apparently agree that it is beneficial because it streamlines the fee award process, relieves professionals from having to finance the reorganization process, improves the monitoring of professional fees, and enables judges to review fees more effectively. Defensively, they argue that the practice does no harm because the court must ultimately approve all fees, and because, even after payment, fees remain subject to disgorgement. We address each of these arguments separately.

1. *Streamlining the fee award process.*

None of the attorneys who argued that disbursing first streamlined the professional fee process elaborated on what they meant.[169] As shown in column (6) of Appendix 3, courts that adopted the Disburse-First Practice invariably established a system for objections to the requests and resolution of those objections. As shown in column (10), with the sole exception of Mirant, those courts required the already-paid professionals to apply for the same fees at three to six month intervals and thus undergo another objection process. Instead of streamlining the professional fee process, the Disburse-First Practice roughly fattened it by half.

2. *Relieving professionals from necessity to finance the reorganization.*

The most frequently asserted justification for the Disburse-First Practice is that the monthly payment of fees relieves professionals from the necessity to finance the reorganization.[170] As one court explained:

> The provision for hearings every 120 days was intended to - and did - put bankruptcy counsel on essentially the same payment schedule as other lawyers. In 1978, when the Code was enacted, attorneys customarily billed their clients on a

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[169]*E.g.*, Motion of Debtors for an Order Pursuant to 11 U.S.C. §§ 105(a) and 331 Establishing Procedures for Interim Compensation and Reimbursement of Professionals at 12, *In re* Foamex, No. 05-12685 (D. Del. Sept. 27, 2005) (docket No.80) ("Such an order will streamline the professional compensation process . . . ."); Motion of Debtors for Administrative Order, Under 11 U.S.C. §§ 105(a) and 331, Establishing Procedures for Monthly Compensation and Reimbursement of Expenses of Professionals at 6, *In re* Flag Telecom, No. 02-11732 (Bankr. S.D.N.Y. June 4, 2002) (docket No. 126) ("Such an order will streamline the professional compensation process . . . ."). Other cases in which the "streamline" claim was made were Allied Holdings, Friedman's, Oakwood Homes, Ultimate Electronics, US Airways (2002), US Airways (2004), and WHX .

[170]*In re* Commercial Consortium of California, 135 B.R. 120, 123 (Bankr. C.D. Cal. 1991) ("The essential purpose of [§ 331] is to relieve counsel and other professionals of the burden of 'financing' lengthy bankruptcy proceedings.").

HeinOnline -- 83 Am. Bankr. L.J. 461 2009

> quarterly basis. Times have changed. Lawyers now run their practices in a more business-like fashion. Computerization has simplified and speeded the billing process. As widely documented in the legal press, the billing cycle has shifted to monthly statements.[171]

Another court noted:

> A 1992 guide to managing bankruptcy mega-cases which was produced by the Federal Judicial Center noted the unique pressures that large bankruptcy cases place on professionals: "In a large case, it is likely that the professionals appointed under section 327 are investing huge quantities of time, and therefore receiving payment only once every four months may impose an intolerable burden on them and may place them at a significant economic disadvantage to the professionals retained by the creditors." (citation omitted)
>
> The pressures are felt not only by the professionals, but also by debtors. Debtors often prefer a monthly payment schedule for professional fees in order to permit them to better manage their cash flow. Such arrangements should also abrogate the necessity to pay large pre-petition retainers to debtors' professionals thereby assuring that debtors will be in a better financial condition at the beginning of the reorganization process.[172]

Such arguments are beside the point. They prove at most the necessity for monthly payment. The language of § 331 clearly contemplates monthly payments, but specifically leaves in place the requirements of application and allowance prior to disbursement. It is the removal of those safeguards, not the monthly payment of fees, that requires justification.

3. *Improving fee monitoring.*

The second most frequently made argument for the Disburse-First Practice is that it improves the monitoring of professional fees. For example, one judge concluded that "requiring monthly payment of professional fees may alert the parties, and the Court, to an administratively insolvent debtor earlier than in the case where fees are allowed and paid less frequently."[173]

No one disputes that *required* monthly billing of professional fees could alert debtors to an approaching cash-flow problem. But monthly billing was

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[171] *Id.*

[172] *In re* Mariner Post-Acute Network, Inc., 257 B.R. 723, 727-29 (Bankr. D. Del. 2000).

[173] *Id.* at 728.

HeinOnline -- 83 Am. Bankr. L.J. 462 2009

not required in twenty-five of twenty-eight Disburse-First orders (89%).[174] Optional monthly billing results in a running total that may grossly underestimate the amount of fees incurred as of any given time. This effect is illustrated dramatically in the Monthly Operating Report filed by the debtor in Lehman Brothers for the period ending January 31, 2009.[175] In every one of the five months listed, most professionals are shown as not receiving a disbursement. That could be either because they didn't work, they didn't bill, they billed but the debtor didn't pay, or the debtor paid but didn't record the payment on the report. For example, Weil Gotshal was listed in the January 31 Monthly Operating Report as receiving no disbursement in any of the five months. On April 13, 2009 - two and a half months later - Weil Gotshal sought approval of $55 million in fees paid to Weil during the same five months.[176] Because it omitted most of the fees paid, the *Lehman Brothers* report obviously could be of no practical use in monitoring the solvency of Lehman's estate.

The improvements in fee monitoring that would come from monthly billing are available without the Disburse-First Practice. That is, the courts could order monthly billing without permitting disbursement prior to review - or without permitting monthly disbursement at all. Disbursement prior to review must be justified some other way.

4. *Improving judicial review.*

Specifically addressing the necessity for the Disburse-First Practice, one judge held that fee reviewers need more information than is contained in a single month's bill:

> In large cases, it is often difficult for the Court to assess whether services rendered by a professional were necessary or performed within a reasonable time when the Court only has one month's worth of time to review. The Court often has to review several months of fee applications to determine whether a specific task was performed in a reasonable amount of time and provided a benefit to the estate. Thus,

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[174]*See infra* Appendix 1, column (4).

[175]Monthly Operating Report, January 1, 2009 to January 31, 2009 at C-4, *In re* Lehman Brothers Holdings, Inc., No. 08-13555 (Bankr. S.D.N.Y. Mar. 10, 2009) (docket No. 3030) (Schedule of Professional Fee Disbursements).

[176]First Application of Weil, Gotshal & Manges LLP, as Attorneys for the Debtors, for Interim Allowance of Compensation for Professional Services Rendered and Reimbursement of Actual and Necessary Expense Incurred from September 15, 2008 through January 31, 2009 at 47, *In re* Lehman Brothers Holdings, Inc., No. 08-13555 (Bankr. S.D.N.Y. Apr. 13, 2009) (docket No. 3343) (seeking fees of $55,140,791.25 and expense reimbursements of $1,336,880.60 for the period September 15, 2008 through January 31, 2009).

HeinOnline -- 83 Am. Bankr. L.J. 463 2009

> quarterly fee applications make it easier for the Court to perform this function.[177]

Another judge concurred:

> Quarterly, rather than monthly review of fee applications by the court gives the court a better sense of the progress and direction of the case as well as a better framework for the necessary determination of whether or not the fees requested are reasonable and were incurred for actual and necessary services.[178]

These analyses, however, abandon the roots of the argument for monthly payment. Those roots are the premise that professionals should be paid in bankruptcy as they are paid outside bankruptcy. Outside bankruptcy, the argument goes, fees are paid monthly, not quarterly, so the practice in bankruptcy should be the same. But outside bankruptcy, market actors do not pay fees prior to review.[179] Lawyers bill monthly[180] and those bills are on average paid more than four months after billing.[181] Monthly bills are reviewed singly outside bankruptcy,[182] so there is no apparent reason they cannot be reviewed singly in bankruptcy.

Although the court protests that it cannot effectively review monthly bills singly, the court authorizes a process that apparently presumes that the debtor, the United States trustee, the creditors' committee, and others will do so. The judge might respond that, under Delaware's procedures at least, no one is *required* to review the monthly applications, and failure to object to them is not a waiver of objections. In Delaware, the three-month interim fee

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[177]*Mariner Post-Acute Network*, 257 B.R. at 731.

[178]*In re* Pittsburgh Corning Corp., 255 B.R. 162, 164 (Bankr. W.D. Pa. 2000).

[179]Although lawyers are sometimes paid in advance, we could find no reference in the literature to any practice outside bankruptcy of paying lawyers after they bill but before the bill was reviewed.

[180]*See, e.g.*, CAROLE BASRI & IRVING KAGAN, CORPORATE LEGAL DEPARTEMENTS (Practicing Law Institute 3d ed. 1997) ("Normally, law departments like to have statements submitted on a monthly basis.").

[181]EDWARD POLL, ATTORNEY AND LAW FIRM GUIDE TO THE BUSINESS OF LAW 199 (2ND 2002) (noting that "the average national accounts receivable cycle for lawyers' services is 4.3 months. What this means is that it will take, on average, about four and one-half months from the date any bill is received by the client for you to receive the funds.")

[182]One authority provides this description of the process:

> From the moment the bill arrives until a check is mailed to the firm, numerous people work on it: opening, copying, and filing it; checking it for accuracy and appropriateness; entering its information into a computer; calling outside counsel about it; responding to letters and calls from outside counsel about it; adding information to it; initialing it; occasionally thinking about it; and - after absolutely all other avenues have been tried - paying it.

REES W. MORRISON, LAW DEPARTMENT BENCHMARKS 155 (2nd ed. 2001).

HeinOnline -- 83 Am. Bankr. L.J. 464 2009

review process is mandatory for all who have been paid monthly,[183] so nobody has to review fees monthly. But to the extent that the defense of monthly review and payment is that monthly review will not actually occur, the true nature of the Disburse-First Practice is revealed: the disbursement of fees without prior review by anyone.

5. *Lack of harm.*

Defenders of the Disburse-First Practice argue that the practice does no harm. They note that the professionals must still make interim and final applications for their fees and the courts must still review and allow them.[184] Although 80% will have been paid prior to review, those payments are subject to disgorgement to the extent the court finds them excessive.[185] Rarely will the courts cut fees to an extent that requires disgorgement, and rarely will a professional firm ordered to disgorge fail to do so. In the end, they argue, the results in a disburse-first system are pretty much the same as the results in a decide-first system.

L. Tersigni Consulting, P.C. (hereinafter "LTC") recently perpetrated a fraud on the bankruptcy courts that provides evidence to the contrary. LTC was paid $45 million in professional fees in more than twenty asbestos bankruptcies[186] and received at least some of the money pursuant to Disburse-First orders.[187] The fraudulent portion of LTC's billings was estimated to be as high as $10 million.[188] The fraud consisted of billing for more hours than the firm worked. When the fraud was discovered, LTC filed bankruptcy,

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[183]*See infra* Appendix 3, column (10).

[184]*In re* Circle K Corp., 191 B.R. 426, 432 (1996) ("Fees are not finally allowed, i.e., they are subject to disgorgement, until a detailed final application is filed, noticed, an opportunity for objection and hearing is provided, and the court reviews and approves the application.").

[185]*Id. See generally* Steve H. Nickles, *Disgorgement of Fees Paid to a Professional Person in Bankruptcy*, 102 COMM. L.J. 380, 388 (1997) ("An interim award of fees is, by name and nature, not final. Even a final award can be undone that is based on mistake or fraud, or if other good reason exists.").

[186]Motion for Order Approving Compromise of Claims Against L. Tersigni Consulting CPA, P.C. at 2, *In re* L. Tersigni Consulting CPA, P.C., No. 07-50702 (Bankr. D. Conn. Oct. 22, 2008) (docket No. 305) (hereinafter "Motion to Approve Tersigni Settlement") ("Beginning in 2001, LTC was retained in more than twenty bankruptcy matters, including some of the largest asbestos-related bankruptcy actions in recent years. . . . LTC was paid in the aggregated, pursuant to approved fee applications, more than $45 million.").

[187]For example, Federal Mogul was one of the twenty asbestos cases in which Tersigni perpetrated its fraud. A Disburse-First order was in effect in that case. Administrative Order Under 11 U.S.C. §§ 105(a) and 331 Establishing Procedure for Interim Compensation and Reimbursement of Expenses for Professionals at 2, *In re* Federal-Mogul Global Inc., No. 01-10578 (Bankr. D.N.J. Nov. 9, 2001) (docket No. 357) ("Upon expiration of the Objection Deadline, each professional may file a certificate of no objection . . . after which the Debtor is authorized to pay each Professional an amount . . . equal to . . . 80 percent of the fees . . . requested in the Fee Application . . . .").

[188]*Financial advisor settles claims*, 51 BANKR. CT. DECISIONS, Issue 7, Mar. 17, 2009, at 7 (referring to the overbilling claim as being "as much as 23 percent - or more than $10 million in total").

HeinOnline -- 83 Am. Bankr. L.J. 465 2009

and its estate ultimately proved to be administratively insolvent.[189]

The asbestos estates were able to recover $2.6 million of their losses only because Loreto Tersigni's probate estate had liability - a source that was available only because of the unusual circumstance that Loreto Tersigni had personal liability for the overpayments.[190] The settling estates simply lost the remainder. The amount of the loss was never determined because LTC's accounts with the defrauded asbestos estates were never reconciled. Two of those estates are continuing to pursue disgorgement claims totaling more than $5 million.[191] To the extent that Disburse-First orders were in effect in LTC's cases, and the scandal broke before interim fee approval, those orders contributed to actual losses.

LTC also demonstrates why opponents of the Disburse-First Practice can rarely provide evidence of actual losses. Once fees have been paid to an insolvent professional firm, the payments are, as a practical matter, unrecoverable. Because the fees are unrecoverable, no one has any incentive to review the fees, object to their allowance, and press for the necessary disgorgement order. Without a disgorgement order, critics cannot prove the bankruptcy estate actually suffered a loss.

What we can prove is the likelihood that actual losses occurred. Numerous professional firms have failed while working in large, public company bankruptcies. Prominent examples include Arthur Anderson,[192] Dreier LLP,[193] and Heller Ehrman.[194] The risk of the kinds of misconduct that

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[189]Motion for Order Dismissing Case of L. Tersigni Consulting CPA, P.C. at 6, *In re* L. Tersigni Consulting CPA, P.C., No. 07-50702 (Bankr. D. Conn. Jan. 6, 2009) (docket No. 332) ("In any event, it is clear that the LTC Bankruptcy Estate is administratively insolvent . . . .").

[190]Motion to Approve Tersigni Settlement, *supra* note 186, at 5 ("The aggregate settlement payments to Asbestos Debtors, which are being funded by the Tersigni Probate Estate, are approximately $2,550,000.").

[191]*Id.* at 5-6.

[192]Arthur Andersen was employed in 20 of the 102 cases we studied (20%). That firm's demise was sudden:

> In 2001, Andersen was the fifth-largest auditing firm in the world by worldwide revenue. It employed 85,000 people in 84 countries and reported revenues of $9.3 billion ($4.3 billion in the United States alone) . . . After Enron reported a $638 million third-quarter loss on October 16, 2001, a series of accounting irregularities related to Enron and Andersen were revealed to the market. . . . On December 12, 2001, Andersen's CEO admitted before Congress it had made an error in its Enron audit. . . . [A] criminal indictment against the company was handed down on March 15. Finally, Andersen was barred from conducting audits after August 2002.

Stephanie Rauterkus & Kyojik Roy Song, *Auditor's Reputation and Equity Offerings*, 34 FIN. MGMT. 121, 124-25 (2004).

[193]Dreier LLP served as special counsel to the debtors in Adelphia Communications, one of the 102 cases we studied (1%). Dreier's financial problems surfaced in October, 2008. Nathan Koppel, Justin Scheck, & Steve Stecklow. *Fast Living, Bold Ambitions Drove Lawyer's Rise and Fall*, WALL ST. J. (Eastern ed.), Dec. 19, 2008, at A1 ("[I]n October [2008] . . . a hedge fund that was considering buying some promissory notes was puzzled by the documents' fine print. Seeking more detail, the fund, Whippoorwill

HeinOnline -- 83 Am. Bankr. L.J. 466 2009

would warrant a disgorgement order is probably high among such firms, both because the firms may be desperate for cash and because those submitting the firms' bills may know the firms are judgment proof.

The Disburse-First Practice is essentially money lending.[195] The court opinions that approve the practice acknowledge the necessity to determine whether the professional firms to whom this credit is extended are credit-worthy.[196] None of the Disburse-First applications or orders we surveyed, however, mentioned any actual effort to determine the credit-worthiness of any professional firm.[197] In one case, the court excused itself from the effort, stating:

> [T]he professionals involved in this case are known to the court either through their prior appearances before us or by reputation and there is no question that any of them would be able to comply with a disgorgement order in the unlikely event that one would be entered.[198]

Ironically, one of those professionals was LTC.[199] LTC filed bankruptcy while the case was pending and could repay no part of the ensuing disgorgement order.[200] In another reported case, a more cautious court refused to

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Associates Inc., got in touch with the auditor whose name was on the documents - and learned they had been forged . . . ."). Dreier filed bankruptcy on December 16, 2008. *In re* Dreier LLP, No. 08-15051 (Bankr. S.D.N.Y. 2008).

[194]Heller Ehrman was employed in 4 of the 102 cases we studied (4%). That firm failed suddenly in 2008. Nathan Koppel, *Recession Batters Law Firms, Triggering Layoffs, Closings*, WALL ST. J., Jan. 26, 2009, at A1 (describing the collapse of Heller Ehrman: "In late September [2008], Heller Ehrman . . . [j]ust two years after its most profitable year ever . . . expired, closing its doors after 118 years in business."). Heller filed bankruptcy on December 29, 2008. *Id.*

[195]Interim fee awards are money-lending as well. But interim fee awards are money-lending authorized by law and the loans are secured by court-awarded fees. Neither mitigation is present in the Disburse-First Practice.

[196]For example, in *Knudsen*, the court stated:

> The ability to recover fees may be assured by a variety of methods including, without limitation, the following: retainer payments are for only a percentage of the amount billed so that the likelihood or necessity of repayment is minimal; counsel can post a bond covering any possible reassessment; counsel's financial position makes it certain that any reassessment can be repaid; funds paid prior to allowance are held in a trust account until a final or interim fee allowance is made.

In re Knudsen Corp. 84 B.R. 668, 672 (9th Cir. B.A.P. 1988).

[197]*But see, e.g.*, *In re* Haven Eldercare, LLC, 382 B.R. 180, 185 (Bankr. D. Conn. 2008) (denying motion for a Disburse-First order and noting that "none of the Professionals have offered to provide any alternative method of assurance, such as, e.g., the posting of a bond or, in the case of attorneys, the placing of fee/expense payment in a trust account until such time as they are finally allowed").

[198]*In re* Pittsburgh Corning Corp., 255 B.R. 162 (Bankr. W.D. Pa. 2000).

[199]Motion for Order Approving Compromise of Debtor's Claims Against L.Tersigni Consulting CPA, P.C. A/K/A Tersigni Consulting, P.C., *In re* Pittsburgh Corning Corp., No. 00-22876 (Bankr. W.D. Pa., Nov. 7, 2008) (docket No. 6281) (describing LTC's participation in the case).

[200] *See supra* notes 188-191 and accompanying text.

authorize disbursement prior to allowance because it considered the necessary inquiry into the professional firms' financial conditions to be impractical.[201]

Even disbursements to solvent professional firms have the potential to harm estates. Payments are harder to reverse than prevent. Once the professional firm receives the money and distributes it to members of the firm as compensation, the firm will be more willing to fight to retain the money than the firm would have been to fight to receive it in the first place. This "endowment effect" may be irrational, but behavioral economics research leaves no doubt that it is real.[202] Willingness to fight plays a major role in litigation outcomes.

The Disburse-First Practice also undermines the fee control system in other ways. First, the practice excludes all but a small group of insiders from what may be the only meaningful stage of the fee review process - the new, secret stage added at the beginning. Professionals serve their fee requests only on a short list of "notice parties." They do not place those requests in the court file.[203] Objectors do the same with respect to their objections.[204] Under most procedures, negotiation of the objections is mandatory. Because of the secrecy, however, participation is effectively limited to the parties who receive notice. Excluded parties have the opportunity to participate at later stages, but only after minds have been made up.

Second, when courts excuse the filing of fee requests, they authorize payments that do not show up in the court file until months later. That prevents all but the small group of notice parties from monitoring the requests for payment and the payments as they are made. To mitigate this problem, some Disburse-First orders require that the debtors' monthly operating reports contain the names of the professionals paid and the amounts paid to them. Other courts, however, do not.[205] Even in courts that order debtors

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[201] *In re* Bread and Chocolate, Inc, 148 B.R. 81, 82 (Bankr. Dist. Col. 1992) ("[A]s recent law firm bankruptcies suggest, the task of ascertaining a law firm's condition may not be performed with certitude.").

[202] Charles R. Plott & Kathryn Zeiler, *The Willingness to Pay-Willingness to Accept Gap, the "Endowment Effect," Subject Misconceptions, and Experimental Procedures for Eliciting Valuations*, 95 AM. ECON. REV. 530, 531 (2005) (quoting the conclusion in Jack L. Knetsch, Fang-Fang Tang & Richard H. Thaler, *The Endowment Effect and Repeated Market Trials*, 4 EXPERIMENTAL ECON. 257, 257 (2001): "people commonly value losses much more than commensurate gains.").

[203] *See infra* Appendix 3, column (5). If the Disburse-First order required filing of a fee application, the case is marked "Yes" on Appendix 3, column (5). If the court did not require filing of a fee application, but did require filing of the request for payment, the case is marked "filed" in that column. Nineteen of thirty cases (63%) are marked neither "Yes" nor "filed."

[204] *See infra* Appendix 3, column (6).

[205] Examples of cases in which the courts did not order disclosure of the amounts paid are Crown Pacific, Genuity, U.S. Airways (2002), and U.S. Airways (2004).

HeinOnline -- 83 Am. Bankr. L.J. 468 2009

to report the payments, the debtors sometimes ignore the orders.[206] At any given time, the court file will substantially understate the amounts requested and paid.[207]

Third, payment of most or all of the fees in advance reduces the professionals' incentives to make the required fee applications later. The court files show instances in which professional firms have applied for interim fees, obtained orders allowing those fees, presumably received payment, but not made the required application for final fee approval.[208] Boston Chicken illustrates the potential. In that case, the court entered the usual order authorizing monthly disbursements to "ordinary course professionals" but imposed the unusual condition that the professionals file fee applications at the end of the case. In relevant part, the order provided:

> IT IS FURTHER ORDERED that Debtors are authorized to compensate Ordinary Course Professionals whose employment is authorized by this Order in the same manner as Debtors' general and local counsel and accountants pursuant to the Knudsen Order *provided, however, that: . . . (d) the Ordinary Course Professional files a final fee application* at the earlier of (i) the termination of Debtors' employment of the Ordinary Course Professional, or (ii) the closing of the Debtors' bankruptcy cases.[209]

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[206]Worldcom and Contifinancial are examples of cases in which the debtors simply ignored orders to disclose their payments to professionals. *Compare* Order Pursuant to Sections 105(a) and 331 of the Bankruptcy Code Establishing Procedures for Interim Monthly Compensation and Reimbursement of Expenses of Professionals at 5, *In re* Worldcom, Inc., No. 02-13533 (Bankr. S.D.N.Y. Aug. 13, 2002) (docket No. 616) ("[I]t is further ORDERED that the Debtors shall include all payments to professionals on their monthly operating reports, detailed so as to state the amount paid to each professional . . .") *with* Monthly Operating Statement for the Period from November 1, 2002 to November 30, 2002, *In re* Worldcom, Inc., No. 02-13533 (Bankr. S.D.N.Y. Jan. 29, 2003) (docket No. 3240) (monthly operating report containing no list of payments to professionals). *Compare* Order Pursuant to 11 U.S.C. §§ 105(a) and 331 Establishing Procedures for Monthly Compensation and Reimbursement of Expenses of Professionals at 5, *In re* Contifinancial Corp., No. 00-12184 (Bankr. S.D.N.Y. June 21, 2000) (docket No. 87) ("[I]t is further ORDERED that the Debtors shall include all payments to professionals on their monthly operating reports, detailed so as to state the amount paid to each professional . . .") with Monthly Operating statement for the Period October 1 to October 31, 2000, *In re* Contifinancial Corp., No. 00-12184 (Bankr. S.D.N.Y. Nov. 22, 2000) (docket No. 410) (monthly operating report containing no list of payments to professionals).

[207]*See, e.g.*, notes 175-76 and accompanying text (discussing the discrepancy in Lehman Brothers).

[208]*See, e.g.*, Order Granting Fourth Quarterly Application for Compensation and Reimbursement of Expenses of Huron Consulting Services LLC as Financial Advisors to the Debtors, *In re* ATA Holdings Corp., No. 04-19866 (Bankr. S.D. Ind. May 5, 2006) (docket No. 4091). This, and previous orders, granted interim compensation totaling $4,540,447. As of March 31, 2009 - almost three years after Huron's last interim fee award - we can find no application by Huron for final approval of these fees and no order awarding them.

[209]Order Granting Debtors' Amended Motion for Authority to Employ and Compensate Professionals

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The debtor listed fifty-two ordinary course professionals[210] and, presumably, paid them monthly. But ten years later, the court file does not appear to contain even a single final application by any of the ordinary course professionals - nor any evidence of efforts to compel disgorgement of fees.

Lastly, the Disburse-First Practice increases the direct costs of the fee control system. Even as established by Congress, the system was redundant. Professionals had to file, and the system had to process, both interim and final applications for the same fees. The Disburse-First Practice leaves those requirements in place and adds a third layer of request-and-object. The professional firms are entitled to compensation for their work in all three layers of review, so the cost of this third layer is borne by the debtor and may or may not be passed along to the creditors.

V. OTHER ILLEGAL PRACTICES

We found evidence of many other illegal fee practices in large, public company cases. For example, Rule 2016(a) requires that fee applications include a statement

> whether any compensation previously received has been shared and whether an agreement or understanding exists between the applicant and any other entity for the sharing of *compensation received or to be received* for services rendered in or in connection with the case.[211]

The provision is apparently designed to flush out referral fees paid by the professionals to obtain the work. In their fee applications, at least some attorneys change this required recital to a recital that no such agreement or understanding exists with respect to fees *to be received*,[212] thus avoiding making the required representation with respect to fees *already received*.

Bankruptcy Code § 331 authorizes interim allowances and disbursements to a "trustee, an examiner, a debtor's attorney, or any professional per-

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Utilized in the Ordinary Course of Business, *In re* BCE West, L.P., No. 98-12547 (Bankr. D. Ariz. Jan. 26, 1999) (docket No. 506) (emphasis added).

[210]*See infra* Appendix 1.

[211]Fed. R. Bankr. P. 2016(a) (emphasis added).

[212]Final Application of Pachulski, Stang, Ziehl, Young, Jones & Weintraub P.C. for Compensation for Services Rendered and Reimbursement of Expenses As Counsel to the Debtors at 5, *In re* Focal Communications Corp., No. 02-13709 (Bankr. D. Del. July 31, 2003) (docket No. 1030) ("There is no agreement or understanding between PSZYJ&W and any other person, other than members of the Firm, for the sharing of compensation to be received for services rendered in these cases."); Fourth and Final Fee Application of Kronish Lieb Weiner & Hellman LLP, Counsel for the Debtors, for Final Compensation and Reimbursement of Expenses at 17, *In re* MetroMedia Fiber Network, Inc., No. 02-22736 (Bankr. S.D.N.Y. Oct. 14, 2003) (docket No. 2178) ("No agreement or understanding exists between Applicant and any other entity for the sharing of compensation to be received for services rendered in or in connection with these Chapter 11 cases.").

HeinOnline -- 83 Am. Bankr. L.J. 470 2009

son . . . ."[213] It does not authorize the interim allowance and disbursement of the expenses of the creditors committee's members.[214] It appears, however, that most courts authorize such interim allowances and disbursements anyway.[215]

Bankruptcy Code § 330(a)(3) requires that, "in determining the amount of reasonable compensation to be awarded to . . . [a] professional person, the court shall consider . . . the time spent on such services."[216] The court can only do that if the professional keeps and submits time records. In what now appears to be a routine practice, judges excuse investment bankers from keeping time records.[217] Other judges authorize the payment of multi-million dollar fees to investment bankers from assets of the estate without any fee applications at all.[218]

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[213]11 U.S.C. § 331 (2006).

[214]*In re* Haven Eldercare, LLC, 382 B.R. 180, 183 (Bankr. D. Conn. 2008) (holding that § 331 does not authorize reimbursement of expenses to members of creditors' committees).

[215]Order Pursuant to Sections 331 and 105(a) of the Bankruptcy Code Establishing Administrative Procedures for Interim Compensation and Reimbursement of Expenses of Professionals and Committee Members at 5, *In re* aaiPharma Inc., No. 05-11341 (Bankr. D. Del. June 3, 2005) (docket No. 139) ("[I]t is hereby ORDERED that each member of a Committee, if one or more is appointed, may request payment of expenses by submitting statements thereof and supporting vouchers to his or her respective Committee counsel (if and when appointed), and that such counsel is authorized to collect and submit such requests for payment in accordance with the foregoing procedures; provided. however, that approval of these procedures does not authorize payment of such expenses to the extent that such authorization does not exist under the Bankruptcy Code . . . ."); Order Pursuant to Sections 105(a) and 331 of the Bankruptcy Code Establishing Procedures for Interim Monthly Compensation and Reimbursement of Expenses of Professionals at 4-5, *In re* MetroMedia Fiber Network, Inc., No. 02-22736 (Bankr. S.D.N.Y. June 5, 2002) (docket No. 96) ("The attorney for any statutory committee may, in accordance with the foregoing procedure for monthly compensation and reimbursement of professionals, collect and submit statements of expenses, with supporting vouchers, from members of the committee he or she represents . . . .").

[216]11 U.S.C. § 330(a)(3) (2006).

[217]Order Under 11 U.S.C. §§ 327 and 328 and Fed. R. Bankr. P. 2014 and 2016 Authorizing the Employment and Retention of Houlihan Lokey Howard & Zukin Capital as Financial Advisor, at 4, *In re* McLeodUSA Incorporated, No. 02-10288 (Bankr. D. Del. Feb. 28, 2002) (docket No. 110) ("Houlihan shall file interim and final fee applications . . . provided, however, that Houlihan shall not be required to maintain detailed time records."). *See also*, Application Pursuant to Bankruptcy Rule 2014(a) and Sections 327(a) and 328(a) of the Bankruptcy Code for Authorization to Employ and Retain Greenhill & Co., LLC as Investment Banker for the Debtors, *In re* Chrysler LLC, No. 09-50002 (Bankr. S.D. N.Y. May 6, 2009) (docket No.424) ("While in some instances Greenhill has maintained time records in bankruptcy cases, Greenhill believes in this case it should be excused from this requirement given the nature of the services to be provided and the size, complexity, and scope of the case.").

[218]For example, the court in Enron authorized Blackstone to take fees estimated at more than $36 million from estate funds, without making fee applications:

> 15. In addition to [the fees applied for] Blackstone has earned Divestiture/Merger Transaction Fees . . . where Blackstone has . . . acted as the Debtors' exclusive financial advisor. . . . Pursuant to the terms of the Amended Engagement Agreement [approved by the court at the time of employment], the receipt by Blackstone of Divestiture/Merger Transaction Fees did not require "further application to the Court."

E.g., Final Application of the Blackstone Group L.P., as Financial Advisor to the Debtors and Debtors-In-

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We have not examined the scope of these practices. As a result, we do not know if they qualify as "routine."

VI. CONCLUSIONS

In this Article we have demonstrated the existence, in large public company bankruptcies, of three routine fee practices that violate the applicable statutes or rules. First, the courts are permitting supposedly "small"-fee attorneys to fly under the radar of the fee control system. The courts excuse ordinary course attorneys from filing fee applications and sometimes failed even to require public disclosure of the amounts ultimately paid to them.[219]

Second, debtors' lead bankruptcy attorneys routinely fail to include in their final fee applications the amounts of the payments they received in connection with the case prior to its filing. The effect is to make it difficult for fee reviewers to discover how much an applicant seeks to receive for the entire case. The courts sign orders awarding fees based on those inadequate applications.[220]

Third, the courts authorize debtors to disburse fees to professionals before the professionals have even filed fee applications. Disbursement prior to allowance violates the statute governing interim allowances.[221]

We also noted the existence of many other illegal fee practices. As to those practices, we have not investigated sufficiently to know if they are routine.

The illegal practices discussed in this Article have two things in common. The first is that they reduce the workload of judges by excusing the keeping of time records, the filing of fee applications, or the review of fee applications that have been filed. The second is that the illegal practices favor the managers and professionals - the people who can bring future cases to the court. The managers get greater freedom to pay the professionals when and how much the managers choose. The professionals get higher fees, paid more quickly, with minimal oversight.[222]

The illegal practices delay, fragment, obscure, and sometimes excuse entirely, the reporting of the aggregate amounts and patterns of professional fee disbursements. That, in turn saves the judges, the professionals and the man-

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Possession for Allowance of Compensation for Necessary Services Rendered, *In re* Enron Corp., No. 01-16034 (Bankr. S.D.N.Y. Nov. 1, 2004) (docket No. 21753). In addition to the $14,731,414.73 referred to in paragraph 15, Blackstone estimates future fees for which no application would be made at $22,000,000 million. *Id.* at 1.

[219]*Supra* Part II.

[220]*Supra* Part III.

[221]*Supra* Part IV.

[222]LoPucki & Doherty, *Professional Overcharging*, *supra* note 2, at 985 (reporting an empirical finding that "[p]rofessional fees and expenses are 32 percent higher in forum-shopped cases").

HeinOnline -- 83 Am. Bankr. L.J. 472 2009

gers the public embarrassment that would flow from court transparency.[223]

Defenders claim that these practices are necessary. Bankruptcy judges, they claim, do not have time to review small or monthly fee applications and such review would not be cost-effective anyway. That defense goes only to the Ordinary-Course-Professionals and the Disburse-First Practices. As to them, the defense would ring truer if the judges had tried to streamline their awkward procedures within the bounds of the law before going outside those bounds. Instead, fee applications continue to consist of lengthy, free-form narratives with "background" sections cut and pasted from other documents and free-form sentences that fail to track the statutory requirements for specific disclosures. Data-enabled pdf forms that could automate some, and facilitate other, fee application processing have been available, and recommended to the courts by the Judicial Conference, for years.[224] To our knowledge, no court has even begun adapting them to the fee application review process.

The truth is that it is not in the interests of the competing courts to control fees. A court that succeeded at fee control would no longer get large cases. Other courts would welcome those cases, and continue the illegal practices.

As mandated by Congress, the bankruptcy fee-control system is far from perfect. Vigorous debate over possible improvements is needed. But to consider the routine illegalities presented here as merely the occasion for such debate would be to miss the point. Over seventy years, Congress has repeatedly held the debates, made the decisions, and embodied those decisions in the statutes and rules. In large, public company bankruptcies, the courts are simply ignoring Congress' decisions.

If we are right about the root cause of this routine illegality, changing the statutes and rules will not help. The courts will not enforce the new legislation for the same reasons they are not enforcing the existing legislation.

Competition for large cases has played a major role in making illegal fee practices routine. When one side in litigation can choose the judge and the judge wants to be chosen, the judge's integrity is tested. Most judges will resist the temptation. But the integrity of a system that puts its judges in a competition to attract cases can have only the integrity of its weakest judge. If even a few judges succumb, the cases flow to them and their illegal practices become ubiquitous. The only way to assure the integrity of the bankruptcy courts is to end the competition.[225]

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[223]Lynn M. LoPucki, *Court System Transparency*, 94 IOWA L. REV. 481, 494-95 (2008) (discussing the role of transparency in exposing and reducing corruption); *id.* at 508 (discussing the potential for embarrassment of officials).

[224]*Id.* at 487-88 n.4 (2008) (describing data-enabled pdf forms); U.S. Trustee Program, Data Enabled Form Standard, http://www.usdoj.gov/ust/eo/bapcpa/defs/index.htm (last visited Mar. 19, 2009).

[225]Essentially two means exist for ending the bankruptcy court competition. Both would require

amendments to the bankruptcy venue statute, 11 U.S.C. § 1408(a). The first would require companies to file in their local bankruptcy courts. The second would designate three or four regional bankruptcy courts to hear large cases and require large companies to file in their regional bankruptcy courts. LoPucki, Courting Failure, *supra* note 10 at 251-54 (describing and recommending these changes).

HeinOnline -- 83 Am. Bankr. L.J. 474 2009

APPENDICES

APPENDIX 1. ORDINARY-COURSE PROFESSIONALS PRACTICE						
Case name	Order date Court	Individual limits	Aggregate limits	Number of professionals	Total amount reported paid	Payment reporting requirement
1. Conseco	1/14/2003 Chicago	$50,000 per month	No aggregate limit	662	$10,366,089	Total for each professional at 90 day intervals; stopped 2-3 months before confirmation
2. Worldcom	7/22/2002 New York	$100,000 per month $500,000 in total	$2,000,000 per month	602	Not reported	None
3. Kmart	1/25/2002 Chicago	$25,000 per month	No aggregate limit	237	$8,310,336	Total for each professional, at 120 day intervals; one of four reports was missing
4. Mirant	7/14/2003 Dallas	$50,000 per month	No aggregate limit	168	About $11,000,000	None. Total disclosed in court's opinion
5. Grand Union (1998)	6/24/1998 Newark	$30,000 per month	No aggregate limit	93	Not reported	None
6. Hayes Lemmerz	12/12/ 2001 Wilmington	$30,000 per month, $300,000 per year	No aggregate limit	92	$2,252,539	Total for each professional at 90 day intervals; stopped 5-6 months before confirmation
7. Pacific Gas & Electric	8/16/2001 San Francisco	No fixed dollar limit	No fixed dollar limit	90	$55,695,537	Total for each professional at 120 day intervals; complete reporting in Order on Final App.
8. US Airways (2004)	9/15/2004 Richmond	$45,000 per month	No aggregate limit	76	$2,895,224	Total for each professional at 120 day intervals; stopped 2-3 months before confirmation
9. Boston Chicken	10/7/1998 Phoenix	$30,000 rolling six-month total	No aggregate limit	52	Not reported	Court ordered professionals to file final fee statements but none did

Case name	Order date Court	Individual limits	Aggregate limits	Number of professionals	Total amount reported paid	Payment reporting requirement
10. Oglebay Norton	3/24/2004 Wilmington	$25,000 per month on average	$120,000 per month until notice	45 listed, 14 paid	$209,073	Total for each professional at 120 day intervals; stopped 1-2 months before confirmation
11. Ultimate Electronics	2/14/2005 Wilmington	$30,000 per month, $300,000 in total	No aggregate limit	15	$165,796	Total for each professional at 120 day intervals; stopped 3-4 months before confirmation
12. XO Communications	6/18/2002 New York	$25,000 per month, $300,000 per year	No aggregate limit	15	Not reported	None
13. aaiPharma	6/3/2005 Wilmington	35,000 per month	No aggregate limit	14	$550,629	Total for each professional at 90 day intervals; complete reporting
14. Crown Pacific	10/21/2003 Phoenix	$7,500 per month	$25,000 per month	7	$257,610	Total for each professional at 120 day intervals; stopped 2-3 months before confirmation

HeinOnline -- 83 Am. Bankr. L.J. 476 2009

APPENDIX 2. DISCLOSURE IN FINAL FEE APPLICATIONS OF FEES PAID TO DEBTORS' LEAD BANKRUPTCY ATTORNEYS PRIOR TO BANKRUPTCY IN CONNECTION WITH THE CASE								
Case name	Date confirmed	Court City	Attorneys	Fee judge	Rule 2016(a) compliance?	Fees and expenses paid prior to filing	Fees and expenses paid after filing	Percent of fees and expenses paid prior to filing
Mirant	12/9/2005	Fort Worth	White Case	Lynn	Yes	$11,873,538	$85,685,761	12%
Bethlehem Steel	10/22/2003	New York	Weil Gotshal	Lifland	Yes	969,685	12,985,930	7%
US Airways (2002)	3/18/2003	Alexandria	Skadden Arps	Mitchell	Arguably	2,620,799	19,840,430	12%
US Airways (2004)	9/16/2005	Alexandria	Arnold Porter	Mitchell	Arguably	2,091,148	13,629,430	13%
Flag Telecom	9/26/2002	New York	Gibson Dunn	Gropper	Arguably	1,000,000	5,640,094	15%
Pacific Gas & Electric	12/22/2003	San Francisco	Howard Rice	Montali	Arguably	1,546,076	37,109,220	4%
Friedman's	11/23/2005	Savannah	Skadden Arps	Davis	Arguably	5,099,341	11,333,807	31%
National Steel	10/23/2003	Chicago	Piper Rudnick	Squires	No	335,690	4,087,024	8%
Metals USA	10/18/2002	Houston	Fulbright	Greendyke	No	152,649	3,985,106	4%
ATA Holdings	1/31/2006	Indianapolis	Baker Daniels	Lorch	No	165,638	4,952,021	3%
Grand Union (1998)	8/5/1998	Newark	Weil Gotshal	Winfield	No	2,200,000	338,370	87%
Allied Holdings.	5/18/2007	Newnan	Troutman Sanders	Mullins	No	1,035,508	7,010,736	13%
Guilford Mills.	9/20/2002	New York	Togut Segal	Lifland	No	666,195	1,423,011	32%
Delta Air Lines	4/25/2007	New York	Davis Polk	Hardin	No	11,891,493	40,198,302	23%
United Australia/ Pacific	3/18/2003	New York	Latham Watkins	Gerber	No	220,520	429,638	34%
Worldcom	10/31/2003	New York	Weil Gotshal	Gonzalez	No	1,900,000	38,763,962	5%
ContiFinancial	12/20/2000	New York	Dewey Ballantine	Gonzalez	No	4,448,755	2,993,987	60%
Salant (1998)	4/16/1999	New York	Fried Frank	Blackshear	No	490,018	1,214,334	29%
WHX	7/21/2005	New York	Jones Day	Gropper	No	601,108	1,028,567	37%
Crown Pacific	12/20/2004	Phoenix	Andrews Kurth	Haines	No	1,225,525	4,585,624	21%
Boston Chicken	5/15/2000	Phoenix	Akin Gump	Case	No	1,082,975	3,227,163	25%
Geneva Steel	12/8/2000	Salt Lake City	Cadwalader	Clark	No	500,000	2,295,605	18%

HeinOnline -- 83 Am. Bankr. L.J. 477 2009

Case name	Date confirmed	Court City	Attorneys	Fee judge	Rule 2016(a) compliance?	Fees and expenses paid prior to filing	Fees and expenses paid after filing	Percent of fees and expenses paid prior to filing
Metromedia Fiber	8/21/2003	White Plains	Kronish Lieb	Hardin	No	300,000	7,656,440	4%
Ultimate Electronics	12/9/2005	Wilmington	Skadden Arps	Gross	No	900,000	3,356,596	21%
Oakwood Homes	4/16/2004	Wilmington	Morris Nichols	Walsh	No	203,000	4,958,353	4%
Oglebay Norton	11/16/2004	Wilmington	Jones Day	Baxter	No	850,000	6,727,219	11%
Focal Communications	6/19/2003	Wilmington	Pachulski Stang	Carey	No	171,580	2,988,673	5%
Foamex	2/1/2007	Wilmington	Paul Weiss	Gross	No	1,292,605	6,112,506	17%
aaiPharma	1/20/2006	Wilmington	Fried Frank	Sontchi	No	2,202,224	4,190,087	34%
Genuity	11/21/2003	New York	Skadden/Ropes	Beatty	Inapplicable	4,226,230	6,299,453	40%
TOTAL/ AVERAGE						$62,262,300	$345,047,449	15%

HeinOnline -- 83 Am. Bankr. L.J. 478 2009

APPENDIX 3. PROCEDURES FOR MONTHLY FEE PAYMENT									
(1) Case name	(2) Court city	(3) Date case filed	(4) Disburse-First monthly payment procedure?	(5) Fee application required?	(6) Objections required filed?	(7) Date procedure established	(8) Days until procedure established	(9) Hold-back	(10) Interim applications required?
US Airways (2002)	Alexandria	8/11/2002	yes	No, "statement"	Serve list	9/6/2002	26	15%	yes, 4 mo.
US Airways (2004)	Alexandria	9/12/2004	yes	No, "statement"	Serve list	10/14/2004	32	15%	yes, 4 mo.
National Steel	Chicago	3/6/2002	yes, required	No, filed "statement"	File	3/6/2002	0	10%	yes, 4 mo.
Mirant	Fort Worth	7/14/2003	yes, required	No, "statement"	Serve list	8/1/2003	18	20%	no, 4 mo.
Metals USA	Houston	11/14/2001	yes, required	No, "statement"	Serve list	12/5/2001	21	20%	yes, 4 mo.
ATA Holdings	Indianapolis	10/26/2004	yes	No, bill	Serve DIP	12/10/2004	45	0%	yes, 4 mo.
Salant (1998)	New York	12/29/1998	no	Not applicable		None			no, 4 mo.
ContiFinancial	New York	5/17/2000	yes	No, filed "statement"	Serve list	6/21/2000	35	20%	yes, 4-5 mo.
Bethlehem Steel	New York	10/15/2001	yes	No, "statement"	Serve list	10/15/2001	0	20%	yes, 3 mo.
Guilford Mills	New York	3/13/2002	yes	No, "statement"	Serve list	4/3/2002	21	20%	yes, 5 mo.
United Australia/ Pacific	New York	3/29/2002	yes	No, "statement"	Serve list	5/13/2002	45	20%	yes, 5 mo.
Flag Telecom	New York	4/12/2002	yes	No, "statement"	Serve list	6/13/2002	62	20%	yes, 4-5 mo.
Worldcom	New York	7/21/2002	yes	No, filed "statement"	Serve list	8/13/2002	23	20%	yes, 4-5 mo.
Genuity	New York	11/27/2002	yes	No, "statement"	Serve list	1/7/2003	41	20%	yes, 4-5 mo.

HeinOnline -- 83 Am. Bankr. L.J. 479 2009

(1) Case name	(2) Court city	(3) Date case filed	(4) Disburse-First monthly payment procedure?	(5) Fee application required?	(6) Objections required filed?	(7) Date procedure established	(8) Days until procedure established	(9) Hold-back	(10) Interim applications required?
WHX	New York	3/7/2005	yes	No, "statement"	Serve list	3/31/2005	24	20%	yes, 4-5 mo.
Delta Air Lines	New York	9/14/2005	yes	No, "statement"	Serve list	10/6/2005	22	20%	yes, 4-5 mo.
Grand Union (1998)	Newark	6/24/1998	no	Not applicable		None			no, 4 mo.
Allied Holdings	Newnan	7/31/2005	yes	No, "statement"	Serve list	8/24/2005	24	20%	yes, 4-6 mo.
Boston Chicken	Phoenix	10/5/1998	yes	No, "statement"	Serve list	10/27/1998	22	20%	yes, 4 mo.
Crown Pacific	Phoenix	6/29/2003	yes	No, filed "statement"	File	8/21/2003	53	20%	yes, 4 mo.
Geneva Steel	Salt Lake	2/1/1999	yes	No, "statement"	Serve list	6/14/1999	133	20%	yes, 4 mo.
Pacific Gas & Electric	San Francisco	4/6/2001	yes	No, filed "cover sheet"	File	7/26/2001	111	10%	yes, 4 mo.
Friedman's	Savannah	1/14/2005	yes	No, "statement"	Serve list	1/18/2005	4	20%	yes, 4 mo.
Metromedia Fiber	White Plains	5/20/2002	yes	No, "statement"	Serve list	6/5/2002	16	20%	yes, 4-5 mo.
Oakwood Homes	Wilmington	11/15/2002	yes	Yes	File	12/18/2002	33	20%	yes, 3 mo.
Focal Communications	Wilmington	12/19/2002	yes	Yes	File	1/23/2003	35	20%	yes, 3 mo.
Oglebay Norton	Wilmington	2/23/2004	yes	Yes	File	3/22/2004	28	20%	yes, 4 mo.
Ultimate Electronics	Wilmington	1/11/2005	yes	Yes	File	2/14/2005	34	20%	yes, 3 mo.
aaiPharma Inc.	Wilmington	5/10/2005	yes	Yes	File	6/3/2005	24	20%	yes, 3 mo.
Foamex	Wilmington	9/19/2005	yes	Yes	File	10/17/2005	28	20%	yes, 3 mo.

HeinOnline -- 83 Am. Bankr. L.J. 480 2009