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Third-Party Payments to Estate Professionals: Avoiding the Traps

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Many debtors who need chapter 11 relief inevitably lack the cash to file a case, but for those lawyers who are unable to contribute their time *pro bono*, getting paid is important. In addition to the debtor's assets or income, a distressed chapter 11 debtor might have third-party sources for payment to debtor's counsel. There are at least three hurdles or traps involving third-party sources of payment, however: disclosure of third-party payment, court approval of employment where payment will be made from a third party, and court approval of payment by a nondebtor third party.

Disclosure

An attorney representing a debtor must disclose the compensation paid or agreed to be paid within one year before the bankruptcy filing for services in connection with the bankruptcy case, as well as the source of compensation.[1] The disclosure is due within 14 days after the order for relief and must be supplemented within 15 days of any payment or agreement not previously disclosed.[2] The debtor in possession's (DIP) application for employment of counsel must disclose the proposed arrangement for compensation and all relevant connections,[3] and the professional must verify the relevant connections.[4] A third party's promise to pay, as well as the fact of any payments, are within the required disclosures.[5]

Approval of Employment

Like other estate professionals, debtor's counsel must have bankruptcy court approval to represent the DIP.[6] This is true even if the lawyer does not intend to seek compensation from the estate.[7] An argument that the estate is not responsible for the fees is undermined if the third party intends to seek reimbursement for the fees paid.[8] Where the payment is from a nondebtor subsidiary, the payment reduces the value of the estate's interest in the subsidiary.[9]

Approval of Payment

Counsel seeking court approval of payment must proceed under §§ 330 and 331. The statutes do not specify whether or not the request for compensation seeks payment from the estate. Most courts find that counsel for the DIP must obtain prior court approval of payment, whether from the estate or a third party.[10] An early California case authorized the use of interim fee statements provided to the U.S. Trustee with follow-up interim fee applications.[11]

There is at least one jurisdiction that does not require bankruptcy court approval of third-party payment (as opposed to disclosure).[12] Even such a rule, however, does not avoid review of the reasonableness of fees charged under § 329.[13]

1 11 U.S.C. § 329(a); *see also* Question 16 on the Statement of Financial Affairs for Individuals Filing Bankruptcy (Form B107); Question 11 on the Statement of Financial Affairs for Non-Individuals Filing for Bankruptcy (Form B207).
2 Fed. R. Bankr. P. 2016(b).
3 Fed. R. Bankr. P. 2014(a).
4 *Id.*
5 *Land v. First Nat'l Bank of Alamosa (In re Land)*, 116 B.R. 798, 806 (D. Colo. 1990); *In re Metro. Envtl. Inc.*, 293 B.R. 871, 888-92 (Bankr. N.D. Ohio 2003) ($6,500 payment disgorged and administrative expense denied for nondisclosure); *In re Greco*, 246 B.R. 226, 229-30 (Bankr. E.D. Pa. 2000) (counsel to chapter 7 debtor required to disclose third-party payment and, under Local Rules, file fee application if fee charged is more than $500).
6 *See* 11 U.S.C. § 327(a).
7 *Ferrara & Hantman v. Alvarez (In re Engel)*, 124 F.3d 567, 571 (3d Cir. 1997) ("Even if compensation is to come from some source other than the estate, employment of an attorney by the [DIP] must still be approved by the bankruptcy court."); *In re Land*, 116 B.R. at 805; *Christopher v. MIR (In re BOH! Ristorante Inc.)*, 99 B.R. 971, 972 (B.A.P. 9th Cir. 1989); *In re W.T. Mayfield Sons Trucking Co.*, 225 B.R. 818, 823 (Bankr. N.D. Ga. 1998).
8 *In re Land*, 116 B.R. at 805.
9 *See In re W.T. Mayfield Sons Trucking Co.*, 225 B.R. at 826-27.
10 *In re Land*, 116 B.R. at 806; *In re Valladares*, 415 B.R. 617, 625 (Bankr. S.D. Fla. 2009) (counsel ordered to disgorge $120,000 paid by third-party affiliates of debtor to debtor's bankruptcy trustee); *In re Hathaway Ranch P'ship*, 116 B.R. 208, 218 (Bankr. C.D. Cal. 1990) (retainer must be disclosed and court approval must be obtained before payment from retainer is permitted).
11 *In re Lotus Props. LP*, 200 B.R. 388, 396-98 (Bankr. C.D. Cal. 1996).
12 *See, e.g., David & Hagner PC v. DHP Inc.*, 171 B.R. 429, 436-37 (D.D.C. 1994), *aff'd*, 70 F.3d 637 (D.C. Cir. 1995) (no bankruptcy court approval of third-party payments required).
13 *See In re Key Largo Land Inc.*, 158 B.R. 883, 884 (Bankr. S.D. Fla. 1993) (court has power to review payments under § 329).

Mistakes Can Be Costly

Failing to surmount the hurdles, particularly of disclosure and court approval, can lead to real pain.[14] In a recent Florida case, special counsel failed to disclose more than $38,000 in third-party payments, which exceeded sums disclosed in the DIP's monthly operating reports. Upon the U.S. Trustee's motion for sanctions under Fed. R. Bankr. P. 2017(b), the court noted that the failure to comply with the disclosure requirements warranted forfeiture of all fees. In the exercise of discretion, the court disallowed only $1,250 as a sanction on an application for about $48,000.[15] The lawyer was lucky, as many courts (particularly in the Sixth Circuit) would impose total disgorgement as the sanction.[16]

In a Nebraska case, although counsel disclosed that the source of a $25,000 retainer was the debtor, it was, in fact, an affiliate, so debtor's counsel further failed to disclose an additional $109,000 paid by the debtor, $309,000 paid by another affiliate and $65,000 paid by the affiliate that provided the retainer. The court found that the substantial, undisclosed third-party payments also indicated undue influence over debtor's counsel by the funder as opposed to the client (the DIP). The court ordered that the retainer and all third-party payments be disgorged, along with a fee reduction due to services that were not beneficial to the estate and that were also the subject of a more than $1 million malpractice judgment.[17] Thus, on a $545,000 fee application, the firm was allowed to retain only $109,000 paid by the debtor and was liable for the malpractice award.

In contrast, in a Philadelphia case, after objections were filed and testimony was taken at a hearing, debtor's counsel belatedly disclosed almost $78,000 in third-party payments in connection with a $115,000 interim fee application. The bankruptcy court did not sanction the lawyer for nondisclosure, finding that the omission was in good faith,[18] nor did the court feel compelled to impose any sanction for failure to obtain court approval of the third-party payment, a finding that § 330 applies only to payments from the estate, not third parties.[19]

Finally, in an Idaho dairy chapter 12 case, debtor's counsel disclosed a $10,000 retainer from the debtor, but it was in fact advanced by a third party via a check to the manager of the third-party entity and endorsed to the lawyer. Due to the lack of disclosure of the retainer's source, counsel was ordered to disgorge the $10,000, but was allowed to keep post-confirmation chapter 12 plan payments of more than $29,000, as those were appropriately approved by the court.[20]

Conflicts

An estate professional may not represent an interest that is adverse to the estate, and must be a disinterested person.[21] In addition, lawyers must avoid conflicts of interest or obtain appropriate waivers,[22] and may accept payment from a third party for representation of a client only with the client's informed consent where "there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship," and if client confidential information under Model Rule 1.6 is appropriately protected.[23]

Bankruptcy courts recognize that a third-party guaranty of payment creates at least a potentially conflicting interest.[24] Some allow waivers with disclosure and other requirements;[25] others prohibit such representation of an estate professional on a *per se* basis.[26] Without disclosure, the third-party guaranty or other promise of payment is likely to result in a denial of fees.[27] With disclosure, the court, U.S. Trustee and other interested parties will consider whether the third-party source of payment either creates a conflict or renders counsel not disinterested.[28] How the third party characterizes the advance might impact the conflict question. A third-party advance to the debtor of capital earmarked to pay the lawyer might not pose a conflict, whereas a third-party advance characterized as a loan to the debtor might be a concern.[29]

In the Philadelphia case, where the court did not punish nondisclosure of third-party payments, the court nevertheless found a conflict when the DIP's lawyer drafted a plan providing for capitalization of the reorganized debtor by the third party, which was also a large unsecured creditor. The court disqualified counsel and directed that the work on preparation of the plan and disclosure statement would not be compensable.[30] The lawyer was fortunate that the court did not impose a more severe sanction for the undisclosed conflict.[31]

Where the source of the retainer is a third party but the circumstances require additional investigation, the lawyer is at additional risk. In a New York case, counsel for 11 related DIPs disclosed that a $100,000 retainer was funded by a third party. After the cases were dismissed, the retainer was determined to have been provided by one of the debtors under circumstances that suggested that the payment violated state court restraining orders and was likely an avoidable transfer. The lawyer's application for retention was retroactively denied, and the fee application was also denied, requiring the lawyer to disgorge all of the retainer (which the lawyer claimed to have spent without court approval).[32]

14 *See In re W.T. Mayfield Sons Trucking Co.*, 225 B.R. at 829 (counsel ordered to disgorge $93,000 secretly paid to counsel by debtor's subsidiary).
15 *In re Howard Ave. Station LLC*, 568 B.R. 146, 154 (Bankr. M.D. Fla. 2017).
16 *See, e.g., In re Stone*, 401 B.R. 897, 899 (Bankr. W.D. Ky. 2009) (payments by debtor's father required to be disgorged); *Limor v. Hancock (In re Innovative Entm't Concepts Inc.)*, No. 304-01633, 2007 WL 5582055 at *7 (Bankr. M.D. Tenn. 2007) (retainer funded by debtor's principal's mother disgorged upon conversion to chapter 7 and disclosure); *cf. Henderson v. Kisseberth (In re Kisseberth)*, 273 F.3d 714, 720 (6th Cir. 2001), *opinion clarified sub nom. Henderson v. Kisseberth*, 24 F. App'x 539 (6th Cir. 2002) (disgorgement justified by lack of disclosure).
17 *In re Sandpoint Cattle Co. LLC*, 556 B.R. 408, 428 (Bankr D. Neb. 2016).
18 *In re Harris Agency LLC*, 468 B.R. 702, 707-08 (Bankr. E.D. Pa. 2010).
19 *In re Harris Agency LLC*, 468 B.R. at 708-09.
20 *In re Silva Dairy LLC*, 552 B.R. 847, 854 (Bankr. D. Idaho 2016).
21 11 U.S.C. § 327(a).
22 *See* Rule 1.7, Model Rules of Professional Conduct (Model Rules).
23 Model Rule 1.8(f).
24 *See In re Metro. Envtl. Inc.*, 293 B.R. at 884.
25 *See In re EZ Links Golf LLC*, 317 B.R. 858, 863 (Bankr. D. Colo. 2004); *In re Lotus Props. LP*, 200 B.R. 388, 393-94 (Bankr. C.D. Cal. 1996); *In re Kelton Motors Inc.*, 109 B.R. 641, 658 (Bankr. D. Vt. 1989).
26 *In re Bergdog Productions of Haw. Inc.*, 7 B.R. 890, 891 (Bankr. D. Haw. 1980); *In re Senior G & A Operating Co.*, 97 B.R. 307 (Bankr. W.D. La. 1989); *In re Nat'l Distribs. Warehouse Co.*, 148 B.R. 558, 561-62 (Bankr. E.D. Ark. 1992) (payment by third party creates conflict unless interests of estate and third party are identical); *In re Hathaway Ranch P'ship*, 116 B.R. at 219, 220-21.
27 *United States v. Schilling (See In re Big Rivers Elec. Corp.)*, 355 F.3d 415, 436 (6th Cir. 2004) (creditors' undisclosed promise to pay examiner success fee warranted disgorgement of all sums paid to examiner and counsel); *In re Metro. Envtl. Inc.*, 293 B.R. 871, 891 (Bankr. N.D. Ohio 2003).
28 *See In re EZ Links Golf LLC*, 317 B.R. at 864 (retention application denied); *In re Metro. Envtl. Inc.*, 293 B.R. at 886 (counsel disqualified upon execution of undisclosed third-party guaranty of payment).
29 *See In re Lotus Props. LP*, 200 B.R. at 395 (rejecting *per se* requirement that advance be capital contribution to debtor).
30 *In re Harris Agency LLC*, 468 B.R. at 709-11.
31 *Cf. In re Nat'l Distribs. Warehouse Co.*, 148 B.R. at 562-63 (disqualifying counsel for conflict due to third-party payment and finding that joint representation of third party with conflicting interest justified disgorgement).
32 *In re Parklex Assocs. Inc.*, 435 B.R. 195, 213-14 (Bankr. S.D.N.Y. 2010).

Conclusion

The law of third-party payments is not uniform and can vary among districts and even judges. At a minimum, accepting payment from a third party in consideration of a lawyer's representation of the DIP requires (1) identification and avoidance of conflicts of interest; (2) complete, contemporary filed disclosure; (3) court approval of the employment; and (4) likely either contemporaneous notice or court approval of payments. abi

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