

The Business Of Bankruptcy

I wish I had a dollar for every occasion upon which I have heard a lay person cynically comment upon the fact that, in a bankruptcy case, the attorneys' fees are treated as a first priority claim. The comment usually goes something like this: "Oh, of

NEAL L. WOLF

course, the lawyers pay themselves first!"

These days, I usually say nothing in response. I have given up trying to explain. Any response, no matter how rational and appropriate, is fruitless. The speaker's resentment of attorneys is usually so deeply imbedded that he will hardly listen to, much less try to understand, logic and reason.

The undeniable fact is -- if we are to have an effective bankruptcy system characterized by a high level of practice, professional fees *must* be treated as a priority expense. If they were not accorded that priority, no bankruptcy attorney would agree to represent a beleaguered debtor or a committee of creditors or shareholders in a chapter 11 case. As a former colleague of mine used to say to clients, "You would not want me as your attorney if I were stupid enough to add my name to your list of creditors." Indeed, many businessmen and women who would readily join in, if not initiate, the attorney-bashing would be the first to insist upon advance deposits and C.O.D. terms when dealing with insolvent customers.

Moreover, notwithstanding the priority treatment accorded such fees, bankruptcy lawyers all too commonly find themselves among the unhappy creditors who recover only a fraction of the amount owed to them at the end of the case. The statutory priority is not a guaranty of payment.

Professionals Entitled to Compensation from the Bankruptcy Estate

Attorneys are not the only professionals that are entitled to compensation from the Bankruptcy Estate. This class of professionals includes accountants, appraisers, financial advisors, investment bankers, and other kinds of experts who are employed to serve the debtor, a trustee or examiner (if one is appointed), and any official committee of creditors or shareholders that has

been appointed by the United States Trustee. Hence, while this article may focus on attorneys' fees, virtually everything that I say herein is equally applicable to these other kinds of professionals.

The employment of all such professionals, as well as the terms of their employment, must be approved by the Bankruptcy Court, upon application and notice to all interested parties, who may object on any relevant ground. Grounds for objection can include, without limitation, the need for such professional, any actual or potential conflicts of interest, the proposed professional's qualifications, and the reasonableness of the proposed fee arrangement.

Moreover, before the professional can receive compensation, he or she must apply for and receive a bankruptcy court order allowing both the amount and the payment of such fees. This application, also, is furnished to all interested parties, who may object and be heard on any relevant ground. Grounds for objection can include, without limitation, the quality of the work, the amount of time spent, and whether the work was within the professional's scope of employment or otherwise necessary.

The Assets from which Professional Fees Can be Paid before Bankruptcy

Needless to say, notwithstanding the high priority that is accorded a bankruptcy court award of attorneys' fees, the entitlement to such fees is absolutely worthless if the debtor has no funds with which to pay them. Moreover, even if the debtor has a sufficient liquidity otherwise to pay its allowed attorneys' fees, it may not be able to pay those fees if its cash is subject to the lien of a secured creditor.

These days, virtually every debtor has at least one, if not more, layers of debt that are secured by liens upon all of the debtor's assets. These liens typically extend to all of the debtor's cash. In the days and weeks before the debtor commences its chapter 11 case, it usually has control over its cash and can determine which creditors to pay, whether or not to provide prospective legal counsel with an advance retainer, etc. Typically, however, cash is very scarce at this time. The debtor is compelled to allocate very

limited resources among its employees and crucial suppliers (who, by then, have put the debtor on a COD basis or worse). If the debtor cannot pay either of these groups, the business necessarily dies an almost immediate and chaotic death. There may or may not be sufficient liquidity with which to furnish an appropriate retainer to bankruptcy counsel.

In some circumstances, however, even before the commencement of its bankruptcy case, the debtor has absolutely no control over its scarce cash resources. All of the debtor's cash receipts are funneled into a "lock box" that is tightly guarded by a secured lender pursuant to a revolving credit facility. In periods in which there is no default, the lender is required to re-advance cash collections pursuant to an agreed-upon formula under which the lender advances an amount equal to some percentage of qualifying accounts receivable and inventory. More often than not, however, during this critical period, the credit facility is in default. The lender has advanced more to the debtor than it was required to advance. In that circumstance, the lender may lawfully dictate the circumstances under which it will make additional "over-advances," or perhaps choose to make no additional advances (thus removing all "life support" from its borrower). While few lenders make the latter choice (preferring the sale or liquidation of a "going concern" over a fire sale of the assets of a lifeless business), most impose strict controls over the use by the debtor of any additional over-advances. Often, they will agree to lend against a budget that has been prepared by the debtor and submitted in advance to the lender. If the lender recognizes the need for and supports the commencement of a bankruptcy case, it may agree to fund a budget that provides for the employment of bankruptcy counsel and other necessary professionals. The lender may not agree to fund such a retainer, however.

The Assets from which Professional Fees Can be Paid after Bankruptcy

The rules change after a bankruptcy case has been commenced. Under the law, however plentiful or limited its cash may be, the debtor may not use the cash collateral of the lender without the express consent of the lender or, if the lender is unwilling to consent to the use of cash collateral, a bankruptcy court order. Often, again motivated by a self-interested

desire to preserve the going concern value of the business, the lender is willing to provide such consent, but only if the cash is used in strict compliance with a budget of which the lender has approved. The agreed-upon budget usually provides for the payment of attorneys' fees and other professional fees incurred by the debtor and the unsecured creditors committee. In such circumstances, the lender often imposes a wholly-inadequate ceiling or "cap" on such fees, the amount of which becomes the subject of negotiation between the lender, on the one hand, and counsel for the debtor and the unsecured creditors committee, on the other. The lender has the decided "upper hand" in any such negotiation however.

The lender generally imposes other restrictions on the use of such funds for the payment of attorneys' fees. One common restriction is that cash collateral may not be used to pay attorneys' fees incurred in the investigation and prosecution of any claims against the lender. This unsurprising restriction effectively converts the investigation and prosecution of such claims into a contingent fee case for the attorneys who are absolutely required, from the standpoint of professionalism and sound practice, to conduct such investigation and prosecute meritorious claims in any event.

Unless the agreed-upon budget is adequate (and it generally is not), the bankruptcy professionals must hope that the value of the company is sufficiently high that there are unencumbered assets, after payment in full of the secured lenders, available to pay allowed fees that exceed budgeted and approved amounts. In the average chapter 11 case, as distinguished from mega-cases involving entities like General Motors and Enron, the risk that there will be adequate unencumbered assets is exceedingly great. In short, the high statutory priority granted to payment of professional fees does not trump the claims of secured creditors.

Neal L. Wolf is a partner with Butler Rubin Saltarelli & Boyd LLP, a Chicago litigation and bankruptcy boutique. He is chair of firm's Business Reorganization, Bankruptcy and Insolvency practice group. The views expressed are personal to the author.



BUTLER RUBIN
excellence in litigation™