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The Use of Advance Fee Attorney Retainer Agreements in Bankruptcy: Another Special Law for Lawyers

Lester Brickman
Yeshiva University, Benjamin N. Cardozo School of Law

Jonathan Klein

THE USE OF ADVANCE FEE ATTORNEY RETAINER AGREEMENTS IN BANKRUPTCY: ANOTHER SPECIAL LAW FOR LAWYERS?

LESTER BRICKMAN*
JONATHAN KLEIN**

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* Professor of Law, Benjamin N. Cardozo School of Law. B.S. 1961, Carnegie Tech; LL.B. 1964, University of Florida; LL.M. 1965, Yale University.
** Attorney, Office of the General Counsel, Tele-Media Corporation. B.A. 1985, Middlebury College; J.D. 1991, Benjamin N. Cardozo School of Law.

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I. INTRODUCTION

From the time that the first lawyers set foot in what is now the United States, society has engaged in efforts to regulate lawyers' fees, including fees received from clients in bankruptcy[1] proceedings. Lawyers, in turn, have been engaged in continuing efforts to: secure their self-interests, aggrandize their role in society, be free of societally imposed constraints on their fees and activities, and carve out an ever larger area of exclusive domain. Although lawyers have not fared as well in their recent efforts to extend the scope of their monopoly by the use of statutes that prohibit the unauthorized practice of law[2] and may even be on the verge of seeing their monopoly erode,[3] they have been more successful in securing other aspects of their self-interest and in using their positions of authority to create rules exempting themselves from the reach of laws and doctrines that they, as lawyers, have been instrumental in establishing or enacting to regulate the conduct of others.[4]

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1. The term "bankruptcy" can be traced back to Roman law. In the Italian city-states "it was called *bankca rupta* after a medieval custom of breaking the bench of a banker or tradesman who absconded with property of his creditors." THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 1 (1986).

2. *See* Deborah L. Rhode, *The Delivery of Legal Services by Non-Lawyers*, 4 GEO. J. LEGAL ETHICS 209 (1990); *see also* Deborah L. Rhode, *Policing the Professional Monopoly: A Constitutional and Empirical Analysis of Unauthorized Practice Prohibitions*, 34 STAN. L. REV. 1 (1981) (advocating relaxation of unauthorized practice prohibitions in certain areas).

3. *See* Kathleen E. Justice, Note, *There Goes the Monopoly: The California Proposal to Allow Nonlawyers to Practice Law*, 44 VAND. L. REV. 179 (1991).

4. It's Christmastime [sic] for . . . lawyers. If a doctor is negligent in saving a human life, the doctor pays. If a priest is negligent in saving the spirit of a

Thus, lawyers have been instrumental in creating rules for evaluating the practice of medicine that are highly favorable to lawyers' incomes, but have avoided the application of those same rules to lawyer malpractice.[5] Lawyers also have created special rules that exempt themselves from liability to third parties while extending liability to other professionals such as accountants and doctors.[6] Lawyers also have been quite successful in their determined resistance to societal efforts to regulate their fees.[7]

> human, the priest pays. But if a lawyer is negligent in advising his client as to a settlement, the client pays. . . . Should we change the law so that non-lawyers can be judges?

Muhammad v. Strassburger, McKenna, Messer, Shilobod & Gutnick, 587 A.2d 1346, 1352-53 (Pa. 1991) (Larsen, J., dissenting).

5. *See* Lester Brickman & Lawrence A. Cunningham, *Nonrefundable Retainers: Impermissible Under Fiduciary, Statutory and Contract Law*, 57 FORDHAM L. REVIEW 149, 151 n.9 (1988).

6. *Id.* Consider how the rules regarding third-party liability, which are established by judges who are lawyers, would be different if they were written by judges who were accountants: "Should we change the law so that non-lawyers can be judges?" *Muhammad*, 587 A.2d at 1353.

7. Contingent fees, a source of enormous wealth to lawyers, are a prominent example. Contingent fees in personal injury cases alone yield $13 billion annually to lawyers. *See* Lester Brickman, *A Massachusetts Debacle:* Gagnon v. Shoblom, 12 CARDOZO L. REV. 1417, 1429 n.68 (1991) [hereinafter Brickman, *A Massachusetts Debacle*]. It is black letter law that courts have the inherent authority to monitor contingent fees and must closely superintend contingent fees to protect clients from being overreached by their lawyers. *See* Lester Brickman, *Contingent Fees Without Contingencies: Hamlet Without the Prince of Denmark?*, 37 UCLA L. REV. 29, 55-56 & n.97, 64-66, 73-74 (1989) [hereinafter Brickman, *Contingent Fees*]. When the American Bar Association first approved contingent fees in 1908, it stated that they "should be under the supervision of the court, in order that clients be protected from unjust charges." 33 REPORTS OF AMERICAN BAR ASSOCIATION: REPORT OF THE THIRTY-FIRST ANNUAL MEETING OF THE AMERICAN BAR ASSOCIATION 80 (1908) (adopting Canon 13 to the Canons of Ethics). Yet the need for judicial supervision is far greater today than in 1908. Contingent fee rates have escalated to the point that they often bear no relationship to the work to be performed or the risk assumed by the attorney. Indeed, when measured in constant dollars, contingent fee rates yield effective hourly rates of return that are five to eight times greater today than 25 years ago though the litigation risks borne by lawyers has declined significantly in that interval. *See* Brickman, *Contingent Fees*, *supra*, at 101.

Although it has been demonstrated (1) that ethical rules and fiduciary law mandate that contingent fees be used only when there are contingencies, *i.e.*, when there is risk; and (2) that if there is a realistic risk of nonrecovery, then the premium for assuming the risk, *i.e.*, the contingent fee, must be commensurate with the risk, *see id.* at 44-93, it is clear that lawyers are routinely violating the ethical admonitions of the Model Rules, the Model Code, and the correlative fiduciary right of clients not to be overreached in contingent fee settings, *see id.* at 54. As a consequence of the judiciary's abdication of its supervisory responsibility, the effective hourly rates of return from contingent fees in cases in which little or no risk is borne by the attorney often can exceed $1000 per hour. *See* Brickman, *Contingent Fees*, *supra*, at 33 n.12; Lester Brickman, *The Asbestos Liti-*

One fee matter in which success still eludes lawyers is the nonrefundable retainer—a payment in advance to a lawyer for work to be done later.[8] Although generally unsuccessful in creating a special rule—applicable only to lawyers—that would validate these contractual fee forfeiture provisions, some bar associations have issued opinions that have gained the imprimatur of several bankruptcy courts for their self-interested efforts to legitimate these professionally irresponsible fees.[9]

These efforts are part of a broader assault by lawyers on societal attempts to regulate their fees in bankruptcy proceedings. Not content with having surmounted fee restraints,[10] lawyers are seeking to use advance fee retainers to have their fees, and their fees only, exempted from the scrutiny of the bankruptcy courts. This Article critically examines such efforts.

Attorney fees paid from the bankruptcy estate are subject to regulation under the Bankruptcy Code and the Bankruptcy Rules, and disbursements from the estate for attorney fees are carefully supervised by the bankruptcy courts.[11] In reaction to these statutorily imposed procedures, the bankruptcy bar has posited several strategies to liberate attorney fees from the ambit of the Bankruptcy Code's fee application process and thus escape the scrutiny of the bankruptcy courts.

The dominant thread in these efforts has been the attorney's attempt to obtain fees for postpetition services *before* filing the debtor's petition for bankruptcy.[12] Once a petition is filed, all of the debtor's equitable and legal property interests are transformed into a new and

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gation Crisis: Is There a Need for an Administrative Alternative?, 13 CARDOZO L. REV. 1819, 1835 n.61 (1992); Lester Brickman, *Lawyers' Fee Frenzy*, WASH. POST, Aug. 16, 1991, at A29.

8. *See* Brickman & Cunningham, *supra* note 5, at 150-51 & n.1.

9. *See* cases cited *infra* note 16.

10. *See infra* notes 36-68 and accompanying text.

11. In a variety of situations, the Bankruptcy Code imposes on the judge the responsibility of measuring the propriety of the parties' fee requests. Other courts have this responsibility in some cases, but the important point may be the shift in the balance: in the ordinary case, control over fees may be the exception, while in bankruptcy it is the rule.

John D. Ayer, *How To Think About Bankruptcy Ethics*, 60 AM. BANKR. L.J. 355, 398 (1986).

12. The bankruptcy courts have held that only an attorney and not a lay person may file a petition for bankruptcy court protection when the debtor is not a natural person (for example, a corporation). *In re* Bellerive Springs Bldg. Corp., 127 B.R. 219, 220 (Bankr. E.D. Mo. 1991). Filing a petition for bankruptcy court protection is the practice of law and may be accomplished only by a duly licensed attorney. *In re* Video Sys. Design & Sales, Inc., 129 B.R. 196, 196 (Bankr. W.D. Mo. 1991); *see also In re* Global Constr. & Supply, Inc., 126 B.R. 573 (Bankr. E.D. Mo. 1991) (holding that the filing of a bankruptcy petition by a nonlawyer was the unauthorized practice of law).

separate legal entity: the bankruptcy estate. The statutory scheme laid out by Congress in the bankruptcy fee application procedure ensures that attorney fees paid from the bankruptcy estate are prudential. However, by requiring payment from the debtor prior to filing the petition for bankruptcy, attorneys receive their fees prior to the genesis of the bankruptcy estate. In this way, the attorney seeks to avoid the fee application process. If this method is successful, then merely through their own agreement, the attorney and the debtor can unilaterally redefine the property interests of the bankruptcy estate.

This Article argues that advance fees paid by the debtor on the eve of bankruptcy cannot escape the scrutiny of the bankruptcy courts, must be deposited in the attorney's client security account, and cannot be denominated as nonrefundable. It further argues that actions to the contrary are illegal because they violate fiduciary law, unethical because they are contrary to the Model Code of Professional Responsibility and the Model Rules of Professional Conduct, violative of the provisions and policies of the United States Bankruptcy Code,[13] and at odds with the public policies of both the states and the federal government.

The use of advance fees in bankruptcy to avoid the statutory fee application process is nothing less than professional hegemony. Authored by bar associations,[14] advocated by the bankruptcy bar,[15] and recently sanctioned by some bankruptcy courts,[16] attorneys have sought to elevate their interests above those of the intended beneficiaries of the bankruptcy process: the estate and its creditors.

This Article is intended to deliver a *coup de grace* to these nascent efforts to create another special rule for lawyers that circumvents both the letter and spirit of the Bankruptcy Code.

Part II of this Article is a brief primer on bankruptcy law as it pertains to bankruptcy fees. Part III examines the evolution of the bankruptcy attorney fee application process and how it operates to effectuate the broader goals of the Bankruptcy Code: a fresh start for the debtor[17] and creditor protection. Part IV outlines the mechanics of the

13. 11 U.S.C. §§ 101-1330 (1988 & Supp. II 1990).

14. The bankruptcy bar has relied on and cited to state bar association ethics opinions as authority in its attempts to legitimate prepetition payments from clients. *See infra* text accompanying notes 151-67, 235-58.

15. Jeffrey Krause, *Treatment of Prepetition Retainers*, 17 CAL. BANKR. J. 153 (1989).

16. *See In re In re* D.L.I.C., Inc., 120 B.R. 348 (Bankr. S.D.N.Y. 1990); McDonald Bros. Constr., Inc., 114 B.R. 989 (Bankr. N.D. Ill. 1990).

17. *E.g.*, *In re* Krohn, 886 F.2d 123, 125 (6th Cir. 1989); Eric W. Sleeper, Recent Development, *Discharge: Sections 727, 524 and 523*; 2 BANKR. DEV. J. 115, 115 (1985) (citing Slocum v. Wheeler (*In re* Wheeler), 38 B.R. 842 (Bankr. E.D. Tenn. 1984)).

Bankruptcy Code's fee application process. Part V presents an overview of general and special attorney retainer agreements including: (1) advance fee payments, (2) nonrefundable retainers, and (3) security retainers. Part VI examines the use of these various retainers in the bankruptcy context and then critically examines two recent cases that, through legal legerdemain, seek to create another special rule that benefits attorneys by sanctioning the use of advance payment retainers in a manner that insulates them from the Bankruptcy Code's fee application process.

II. Bankruptcy Law: A Primer

A. *Purpose of the Bankruptcy Laws*

Congress's objective in enacting the Bankruptcy Act of 1898[18] (the Act) and the Bankruptcy Reform Act of 1978[19] was to give debtors a fresh start while protecting the interests of unsecured creditors.[20] This idea was novel when the first Bankruptcy Act was passed and is still unique in the world. Under this bankruptcy law schema, insolvent debtors are not left to strain under the yoke of their debts for the rest of their lives.[21] Instead, debtors can petition[22] the United States Bank-

18. An Act to Establish a Uniform System of Bankruptcy Throughout the United States, ch. 541, 30 Stat. 544 (1898) (repealed 1978).

19. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (current version at 11 U.S.C. §§ 101-1330 (1988 & Supp. II 1990)). The 1978 Bankruptcy Reform Act repealed the Bankruptcy Act of 1898 and created the current Bankruptcy Code, which became effective on October 1, 1979.

20. *Krohn*, 886 F.2d at 127-28 (" 'The goals of bankruptcy are to provide an honest debtor with a fresh start and to provide for an equitable distribution to creditors.' ") (quoting bankruptcy court opinion, 78 B.R. 829, 833 (Bankr. N.D. Ohio 1987)); *see also* Grogan v. Garner, 111 S. Ct. 654, 659 (1991) (recognizing the fresh start policy of the Bankruptcy Code).

21. Handeen v. LeMaire (*In re* LeMaire), 883 F.2d 1373, 1380 (8th Cir. 1989) (" 'Having to live the rest of his life with a significant judgment which would forever accrue interest and result in endless garnishments against his wages and keep him from accumulating any property would be inimical to such a fresh start.' ") (quoting bankruptcy court opinion, No. 4-87-104, slip op. at 13 (Bankr. Minn. Nov. 12, 1987)), *rev'd en banc*, 898 F.2d 1346 (8th Cir. 1990).

22. A debtor who seeks bankruptcy court relief is deemed to have filed a "voluntary petition." 18 U.S.C. § 301 (1988). The bankruptcy court also protects unsecured creditors from both the debtor and rival creditors. When creditors of an insolvent individual or entity file a bankruptcy petition against a debtor, it is deemed an "involuntary petition." *Id.* § 303. The bankruptcy court supervises the bankruptcy estate to protect the creditors' and the debtor's interests. Judicial supervision reduces the chance of creditor loss due to fraud or mismanagement by the debtor. Bankruptcy also diminishes the incentive for creditors to race to the courthouse to collect their debts because the Code mandates the priority in which creditors can be paid. *See, e.g.*, *id.* §§ 362, 506-509, 725,

ruptcy Court for protection from their creditors under the Bankruptcy Code while they attempt to reorganize their businesses.[23]

B. Voiding Preferences of One Creditor over Those of Others

Section 547 of the Bankruptcy Code[24] seeks to treat all unsecured creditors equally in a bankruptcy proceeding by allowing the trustee to avoid, as an unlawful preference,[25] any transfer of an interest in the

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726.

23. If the bankruptcy reorganization plan is successful, the debtor will have reestablished its business and satisfied its creditor's claims under a court-approved plan. *See* 11 U.S.C. §§ 1121-1129, 1321-1330 (1988). If the reorganization fails, the case may be converted from a bankruptcy reorganization to a bankruptcy liquidation. *Id.* §§ 1112, 1307. An individual debtor with regular income will most likely attempt to file Chapter 13 bankruptcy, *id.* § 109(e), although such a debtor is not precluded from reorganizing under Chapter 11. *See* Toibb v. Radloff, 111 S. Ct. 2197 (1991). Under the Bankruptcy Code's liquidation provisions, 11 U.S.C. §§ 701-766 (1988), a trustee will supervise the orderly liquidation of the bankruptcy estate's remaining assets, which will be applied towards the satisfaction of any outstanding claims against the debtor's estate. A debtor may file for Chapter 7 relief without first attempting to reorganize under Chapters 11 or 13. *See id.* § 109(a)-(b).

24. 11 U.S.C. § 547 (1988). This section is a brief sketch of the applicable bankruptcy law in simplified form.

25. The trustee must show that a transfer meets five conditions before it can be deemed a preference and avoided.

> [T]he trustee may avoid any transfer of an interest of the debtor in property—
> (1) to or for the benefit of a creditor;
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
> (3) made while the debtor was insolvent;
> (4) made—
> (A) on or within 90 days before the date of the filing of the petition; or
> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; [Section 547(f) creates a rebuttable presumption that the debtor was insolvent on and during the 90 days immediately preceding the petition date] and
> (5) that enables such creditor to receive more than such creditor would receive if—
> (A) the case were a case under chapter 7 of this title;
> (B) the transfer had not been made; and
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547(b) (1988). Section 547(b) is the operative provision of § 547. Section 547(c) contains three exceptions to the general rule of § 547(b). Transfers coming under these exceptions cannot be set aside by the trustee as voidable preferences. Section 547(g) places the burden of proving avoidability under § 547(b) on the trustee and the burden of proving nonavoidability under § 547(c) on the creditor. Section 547(a) contains

debtor's property that would put one creditor in a better position than another.[26]

C. *Priority of Claims in Bankruptcy Estate Liquidation*

In drafting the Bankruptcy Code, Congress established the order of priority in which creditors' claims are to be satisfied from the bankruptcy estate upon its liquidation.[27] Under this schema claims against the debtor are grouped into classes for different treatment. Secured claims[28] are paid first.[29] Assets that remain are distributed pro rata to satisfy unsecured claims.

Within the class of unsecured claims, Congress has determined that some should be satisfied ahead of others and has selected eight types of unsecured claims for priority status.[30] They are, from highest to lowest priority[31]: (1) Administrative expenses, section 507(a)(1)[32]; (2) Involuntary case gap claims, section 507(a)(2)[33]; (3) Wages, salaries, or commissions, section 507(a)(3); (4) Contributions to an employee benefit plan, section 507(a)(4); (5) Claims of grain farmers and United States fishermen, section 507(a)(5); (6) Consumer layaway claims, section 507(a)(6); (7) Unsecured prepetition taxes, section 507(a)(7); and (8) Claims necessary to maintain the capital of an insured depository

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definitions of the terms "inventory," "new value," and "receivable," as they are to be understood for § 547's purposes. *Id.* § 547(a)(1)-(3).

26. Although preferring one creditor over another is perfectly acceptable in a nonbankruptcy proceeding, it is prohibited retroactively once a bankruptcy petition is filed.

27. *See* 11 U.S.C. §§ 507, 725, 726 (1988). *See generally* John C. Levy, *The Priority Provisions*, 1 BANKR. DEV. J. 282 (1984) (analyzing the priority provisions of the Bankruptcy Code).

28. If the value of the collateral is insufficient to satisfy a secured claim, then the unsatisfied portion becomes an unsecured claim. 11 U.S.C. § 506(a) (1988).

29. *Id.* § 725; *In re* A.J. Lane & Co., 113 B.R. 821, 824 (Bankr. D. Mass. 1990) (holding that secured creditor's claim to collateral is superior even to first priority claimants, including attorney fees).

30. 11 U.S.C. § 726(a)(1) (1988) (referring to § 507).

31. To a large extent each priority claim's relative position and the fact that a particular class of claims has a priority at all is a reflection of the favored class of claimants' lobbying efforts and political power in Washington. For example, Senator Robert J. Dole, whose home state of Kansas boasts many grain farmers, was influential in elevating the claims of grain farmers to priority status. *See* 130 CONG. REC. 20,083 (1984) (statement of Sen. Dole).

32. Only the "actual, necessary costs and expenses of preserving the estate" are granted a first priority. 11 U.S.C. § 503(b)(1)(A) (1988).

33. Gap claims are claims that arise in the ordinary course of the debtor's business after an involuntary petition is filed, but before a trustee is appointed or an order for relief is granted. *Id.* § 502(f).

institution, section 507(a)(8).[34] Claims of the highest priority, termed "administrative expenses," include all costs of administering the bankruptcy estate postpetition, including attorney fees incurred by the estate.[35] Therefore, attorneys (and other professionals) employed by the bankruptcy estate have a first priority claim among the unsecured creditors.

III. History of Regulation of Attorney Fees in Bankruptcy

A. *Regulation of Attorney Fees in the New World*[36]

Perhaps the first attempt in the New World to regulate attorney fees occurred in 1658 when Peter Stuyvesant, in response to abuses alleged to have been committed by various court officers, prohibited lawyers from charging excessive fees.[37] Stuyvesant's proclamation was said to have reduced the fees charged for various legal services from

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34. *Id.* § 507(a) (1988 & Supp. II 1990). The trustee begins the distribution of claims with priority by first satisfying all claims in the highest priority class. Only then may the claims from the next class of priority creditors be satisfied. As each class of claims is satisfied in full, the trustee then proceeds to the next subordinate class of claims. If there are insufficient assets to satisfy all the claimants in a given class, then each claimant is paid a pro rata share of what remains and the subordinate classes of claimants receive nothing. *Id.* § 726(b) (1988).

The general unsecured claims are subordinated to all eight priority unsecured claims. *Id.* § 726(a)(2)-(4). Although this is the numerical schema of priorities, Congress has allowed two types of claimants to come ahead of all eight enumerated classes of priority claimants. If a secured creditor is given adequate protection for a lien under § 362, 363, or 364, but the adequate protection ultimately proves deficient, the creditor will receive an administrative claim senior to all other administrative priority claims. *Id.* § 507(b). This is called a superpriority. *See In re* Colter, Inc., 53 B.R. 958 (Bankr. D. Colo. 1985); *In re* Callister, 15 B.R. 521 (Bankr. D. Utah 1981) (stating that administrative expenses include attorney fees, but they are inferior in priority to superpriorities), *appeal dismissed sub. nom* Callister v. Ingersoll-Rand Fin. Corp. (*In re* Callister), 673 F.2d 305 (10th Cir. 1982). *See generally* Smith v. Dairymen, Inc. (*In re* Smith), 75 B.R. 365 (W.D. Va. 1987) (discussing the requirements to obtain a superpriority claim). Sometimes the bankruptcy estate is strapped for cash and the trustee cannot find a lender willing to lend money postpetition on an unsecured basis. In such cases the bankruptcy court can, in return for new credit or debt, give the lender's claim priority over all other administrative claims, even a superpriority claim. 11 U.S.C. § 364 (1988).

35. *See* 11 U.S.C. § 507(a)(1) (1988).

36. Parts of this section on the history of attorney fees in Colonial America rely on an unpublished research paper prepared by Kenneth Churin, J.D., 1991, Cardozo School of Law.

37. *See* 1 Charles Z. Lincoln, The Constitutional History of New York 458 (1906) ("'It is then provided that the officers enumerated shall serve the poor gratis for God's sake, but may take from the wealthy the fee specified.'") (quoting proclamation issued by Peter Stuyvesant).

fifty to eighty-five percent.[38]

Although the original English laws in the Colony of New York (the Duke's Laws) made no particular reference to attorney fees, by 1693 the New York Colonial Assembly had published a catalogue of fees.[39] However, attorneys usually ignored the catalogue, and their charges generally exceeded the published amounts.[40] As a result, the Assembly promulgated another act in 1709 that not only reestablished a fee schedule but also required severe punishments for lawyers who charged in excess of the prescribed amounts.[41] However, the bar exerted such enormous pressure on the colonial government that the Act was repealed in December of the same year.[42] In 1710 the governor and council issued yet another ordinance regulating attorney fees, and this act, with minor alterations, remained in effect until 1768.[43]

Interestingly, the 1710 act raised fees only slightly above the rates authorized by the 1709 act.[44] Apparently, the only significant difference between the two acts was the omission from the 1710 act of the severe penalty provisions. Presumably, without a penalty provision, lawyers could safely ignore the act.[45] The bar's exercise of its power to force a change in the 1709 act[46] was merely a precursor of things to come.[47]

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38. 1 ANTON-HERMANN CHROUST, THE RISE OF THE LEGAL PROFESSION IN AMERICA 153 (1965).

39. *Id.* at 159.

40. *Id.*

41. *Id.* at 159-60 ("That if any Lawyer Or Attorney shall take or Exact any more or other fees than is Limited in This Act or Refuse to Serve any person for the aforesaid Fees not being Retained by the adverse party Shall fforfeit Fifty pounds Currant money of this Colony and for Ever be Debarred from Practising in any Court within This Colony.'") (quoting I COLONIAL LAWS OF NEW YORK 1638-53, at 653 (1894)).

42. *Id.* at 160.

43. *Id.*

44. *Id.* The 1709 statute allowed a maximum of fifty shillings while the 1710 statute allowed a maximum of four pounds.

45. "Disregard of law was commonplace in the eighteenth century, when governments freely enacted general legislation without succeeding in or even caring about enforcement in particular cases . . . . [T]he British Americans were possibly the least law abiding of all the more civilized European peoples." R. R. PALMER & JOEL COLTON, A HISTORY OF THE MODERN WORLD 324 (2d ed. 1962).

46. The bar's political power may have been a result of the unique conditions in eighteenth century New York when there were apparently few practicing attorneys in relation to the degree of commercial activity in the colony. The bar may have created this shortage to put upward pressure on fees. As early as 1695 an act was passed that prohibited a litigant from hiring more than two attorneys because the litigant could otherwise "fee" or hire all of the available attorneys and deprive the opponent of counsel. LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 87 (1973). In 1729 a group of New York lawyers formed an association "to supervise legal education, regulate practice, and control admission to the bar." *Id.* In 1756 they agreed not to take on any clerks (the method by which one learned the law and gained admittance to the bar) for the next

Lawyers in the other colonies also were beset by societal attempts to regulate their fees and also were quite successful in resisting those efforts. In 1787, after years of antilawyer sentiment on the part of the public, the Massachusetts Legislature twice tried and twice failed to pass an iron-clad fee schedule.[48] In 1777 Pennsylvania installed a new fee schedule that, because of inflation, doubled the fees previously set in 1752.[49] There is considerable evidence, however, that even the new fee schedule was not effective in regulating lawyers' fees.[50]

When New York emerged as a state, it did so replete with laws regulating lawyers' fees. Through 1813 these fee bills, as they were called, prescribed the total compensation to which a lawyer was entitled. These included proscriptions on attorney-client contract rates ("fees") and the litigation costs recoverable by the winning party ("costs").[51] Thus, the fee bill statutes purported to declare that the specified recoverable costs were the full measure of the lawyer's compensation.[52] Post-1823 New York fee bills did not seek to control what courts could allow as recoverable costs, but did prescribe what fees attorneys could charge their clients.[53]

Despite express statements in the fee bills that lawyers could not charge their clients more than the statutorily authorized amount, law-

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fourteen years, except for their sons. *Id.*

47. *See* Robert S. England, *Congress, Nader, and the Ambulance Chasers*, AM. SPECTATOR, Sept. 1990, at 18.

48. MAXWELL BLOOMFIELD, AMERICAN LAWYERS IN A CHANGING SOCIETY 1776-1876, at 56 (1976).

49. 2 CHROUST, *supra* note 38, at 257.

50. Despite the statute, the governor of Pennsylvania required in 1792 that:

> [A]ll attorneys "entitled to demand or receive fees" were required to "transmit to the governor of the commonwealth a particular statement of the several services for which they are entitled to demand and receive fees . . . and of the fees . . . which they respectively charge and receive . . . for the performance of their respective duties, together with the several particulars."

Id. (quoting ch. 1648, § 1, 14 STATUTES AT LARGE OF PENNSYLVANIA 1682-1801, at 329 (1909)).

The purpose of this demand was to allow the legislature to collect reliable data about the actual fees that attorneys were charging so that it could draft a new, and perhaps more realistic, act for regulating fees. *Id.* The lawmakers must have concluded that the prior regulations were not being observed. If the fee regulations were being seriously enforced, then the legislature need not have asked attorneys what they were actually charging for their various services. They need have consulted only the established schedule.

51. *See* 1813 N.Y. Laws ch. 83 ("[N]o officer . . . shall exact, demand or ask, or be allowed any fee greater than prescribed.").

52. *See* Davenport v. Ludlow, 4 How. Pr. 337, 338 (N.Y. Sup. Ct. 1850) (referring to function of fee bills prior to repeal).

53. *See, e.g.*, 1840 N.Y. Laws, ch. 386, §§ 1-4, at 11-41.

yers in fact did precisely that. In *Adams v. Stevens & Cagger*[54] the court stated:

> It is supposed, however, that as the fee-bill has fixed certain allowances for counsel fees, no greater compensation than is there specified can be recovered as between solicitor and client. But such has not been the construction of the law of this State, fixing a tariff of fees from time to time. The counsel fees specified in the statute have always been considered as merely fixing the rate of allowance of taxable costs, as between party and party . . . . The language of the former fee bills of 1789, of 1801 and of 1813, was much stronger than that which is contained in the Revised Statutes . . . . The courts, however, did not consider that as limiting the amount which the counsel was to receive from his own client, for trying or arguing his cause.[55]

The court continued:

> [W]here a party employs counsel, and agrees to give him a specific allowance for his services, or to pay him what those services shall be reasonably worth, I think, by the laws of this State, the counsel thus employed may receive from his own client a compensation beyond the nominal counsel fee specified in the fee bill, without subjecting himself to indictment for a misdemeanor, or rendering himself liable to the penalty of treble damages to the client . . . .[56]

In addition to disregarding the fee bills, lawyers also responded to the fee restraints in other ways. For example, the fee bills stated that a lawyer could charge two dollars for "[p]erusing and amending interrogatories"[57] and one dollar for "[d]rawing a demurrer or joinder in demurrer."[58] Thus, lawyer income became a function of court filings and "the prominence and practice of a lawyer was judged by the number of writs he sued out, or to which he appeared."[59] Because a lawyer's compensation depended on "the number or length of the proceedings,"[60] the fee bills encouraged "multiplication of the processes."[61] The

54. 26 Wend. 451 (N.Y. 1841).

55. *Id.* at 455-56.

56. *Id.* at 457. The two concurring opinions were even more emphatic. The concurrence of Senator Lee, an associate justice, stated, "In an experience of some forty years with the practice of the courts, I have never known counsel, in their claims on their clients, limited to the fee bill." *Id.* at 458. The concurrence of Senator Verplank, an associate justice, was a *tour de force* of construing away the plain meaning of the words of the fee bill. *See id.* at 461-66.

57. 1840 N.Y. Laws, ch. 386, § 2.

58. *Id.* § 3.

59. HENRY W. SCOTT, THE COURTS OF THE STATE OF NEW YORK 217-18 (1909).

60. FIRST REPORT OF THE COMMISSIONERS ON PRACTICE AND PLEADING, NEW YORK CODE OF PROCEDURE tit. X, at 205 (1848) [hereinafter FIRST REPORT].

61. *Id.*

proliferation of proceedings that ensued coupled with the inordinate procedural complexities that resulted from the dual systems of equity and law, which often denied meritorious claimants victory because of their archaic insistence on obsolete formalisms,[62] culminated in the Field Code of 1848.[63]

The Field Code abrogated the fee bill system[64] and declared:

> All statutes establishing or regulating the costs or fees of attorneys, solicitors and counsel in civil actions, and all existing rules and provisions of law, restricting or controlling the right of a party to agree with an attorney, solicitor or counsel, for his compensation, are repealed; and hereafter the measure of such compensation shall be left to the agreement, express or implied, of the parties.[65]

Thereafter, attorney fee regulation shifted to fiduciary concerns. This shift culminated in rules that allow clients to discharge retained lawyers in whom they have lost trust and confidence without incurring contract damages[66] and efforts to control rampant overreaching in contingent fee practice.[67] Like the fee bills, however, these modern regulations have atrophied substantially.[68]

B. Attorney Fee Regulation in Bankruptcy

1. Attorney Fees for Representing a Debtor in Bankruptcy Have Received Greater Scrutiny than Attorney Fees for Other Services

One area of fee regulation that has not atrophied, but rather has been periodically renewed, is attorney fees in bankruptcy. This area has evolved into a set of strong and tightly monitored rules. The legislative attention given to bankruptcy fee regulation is due to three factors.

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62. FLEMING JAMES, JR. & GEOFFREY C. HAZARD, JR., CIVIL PROCEDURE § 1.6, at 17-18 (3d ed. 1985).

63. *See* FIRST REPORT, *supra* note 60, at 204.

64. David Dudley Field strongly disfavored state regulation of lawyers' fee. *Id.* at 204-05. However, repealing the fee bills also may have served another goal. Because lawyers had invested heavily in the formalistic pleading system and would have had to devote considerable time to learning a new pleading system, many no doubt opposed Field's proposal. It is possible that the price for their political acquiescence was the abolition of the fee bills.

65. 1848 N.Y. Laws, ch. 379, tit. 10, § 258.

66. *See* Lester Brickman, *Setting the Fee When the Client Discharges a Contingent Fee Attorney*, 41 EMORY L.J. 367 (1992).

67. *See supra* note 7.

68. *See* Brickman, *supra* note 66, at 382-92; Brickman, *A Massachusetts Debacle*, *supra* note 7, at 1423-30.

a. *The Vesting of the Bankruptcy Power at the National Level*

Historically, attorney fees have been regulated by the colonial governments and their successors, the sovereign states. These regulatory attempts have been intermittent and generally unsuccessful.[69] However, the national government regulates attorney fees in bankruptcy pursuant to Congress's constitutional authority to "establish . . . uniform Laws[70] on the subject of bankruptcies throughout the United States."[71] Although as of 1788 the Constitution authorized Congress to enact a national bankruptcy law,[72] it was not until 1898 that the first bankruptcy statute of longstanding duration was enacted.[73] That legislation has become known as the Bankruptcy Act of 1898, or just the "Act."

b. *The Unique Purposes of the United States Bankruptcy Statutes*

The United States bankruptcy schema serves two major societal purposes. First, because the debtor may have its debts discharged and assume a fresh economic start, the debtor can resume its position as a functional cog in the economic wheel of our economy. Second, the protection of each creditor's interests from both the debtor and rival creditors strengthens the economy's credit system. Thus, although the general purpose of attorney fee regulation is to protect the client, in this

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69. *See supra* part III(A).

70. The importance of uniform bankruptcy laws to the framers of the Constitution is evidenced by the inclusion of the bankruptcy power—directly after the commerce clause and prior to the power to coin money—in the brief list of enumerated powers granted to the national government. U.S. CONST. art. I, § 8, cls. 3-5; *cf.* Thomas M. Clark, Note, *More Plenary Than Thou: A Post-*Welch *Compromise Theory of Congressional Power to Abrogate State Sovereign Immunity*, 88 COLUM. L. REV. 1022, 1038-39 (1988) (stating that the bankruptcy clause is one of Congress's limited powers to abrogate state law).

71. U.S. CONST. art. I, § 8, cl. 4. In those periods when our nation had no national bankruptcy law, state insolvency laws filled the void. However, national bankruptcy laws, once adopted, became preeminent over state insolvency laws. *See* Note, *Effect of National Bankruptcy Act on State Insolvency Statutes*, 49 YALE L.J. 1090 (1940).

72. The Constitution became legally effective upon the signing of the ninth state, New Hampshire, on June 21, 1788. MARTIN SHAPIRO, THE CONSTITUTION OF THE UNITED STATES AND RELATED DOCUMENTS xxvi (1973).

73. Congress was slow to exercise its authority and enact a national bankruptcy statute. When it finally did so, in 1800, the Act was short-lived; Congress repealed it in 1803. In fact, federal bankruptcy laws were in effect for only 15 years of our nation's first century. The three bankruptcy acts during this time were: Act of Apr. 4, 1800, ch. 19, 2 Stat. 19 (repealed 1803); Act of Aug. 19, 1841, ch. 9, 5 Stat. 440 (repealed 1843); Act of Mar. 2, 1867, ch. 176, 14 Stat. 517 (repealed 1878). None of these statutes directly addressed attorney fees. JACKSON, *supra* note 1, at 1 n.2.

case the debtor,[74] the bankruptcy schema is designed to protect creditors—third parties to the attorney-debtor contract—both from the usual menace of attorney overreaching as well as from debtors who might deal too liberally with their attorneys in an attempt to stave off creditors.

c. The Political Power and Organizational Skill of the Group Most Affected by the Bankruptcy Statutes: Creditors

The large stake creditors have in keeping the bankruptcy process efficient—to allow greater recovery for themselves—has resulted in their coordination of efforts to influence national bankruptcy legislation.[75]

2. Level of Compensation from the Bankruptcy Estate: Balancing Conservation of the Bankruptcy Estate with Attracting a Competent Bar

a. Attorney Fees Under the Bankruptcy Act of 1898

Under the Bankruptcy Act of 1898,[76] courts were parsimonious in their awards of attorney fees.[77] Indeed, the history of attorney fee regulation in bankruptcy is the saga of an ever-evolving struggle between two competing interests: (1) conserving the bankruptcy estate to allow the debtor a fresh start and creditors a maximum recovery, and (2) sufficiently compensating those who administer the estate—principally attorneys—to maintain a competent corps of bankruptcy professionals.[78] Under the Bankruptcy Act of 1898, the protection of the interests

74. *See* Dorr, Cooper & Hays v. Wyle (*In re* Pacific Far E. Line, Inc.), 644 F.2d 1290, 1293 (9th Cir. 1981); *In re* C & P Auto Transp., Inc., 94 B.R. 682, 687-88 (Bankr. E.D. Cal. 1988).

75. For example, three prominent consumer credit trade groups: the American Financial Services Association, the American Bankers Association, and the Consumer Bankers Association, each of which is in itself an amalgamation of numerous creditors, combined with other creditors to form the National Consumer Bankruptcy Coalition to more effectively lobby Congress for procreditor reforms of the Bankruptcy Code. Paul Starobin, *Distressed Debtors*, 23 NAT'L J. 2468, 2471 (1991). The National Consumer Bankruptcy Coalition currently is lobbying Congress to prohibit personal debtors from filing under Chapter 7 if they can meet a Chapter 13 debt-repayment plan. *Id.*

76. An Act to Establish a Uniform System of Bankruptcy Throughout the United States, ch. 541, 30 Stat. 544 (1898) (repealed 1978).

77. *See infra* notes 80-85 and accompanying text.

78. *See, e.g.,* Moshein v. Beverly Crest Convalescent Hosp., Inc. (*In re* Beverly Crest Convalescent Hosp., Inc.), 548 F.2d 817, 820 (9th Cir. 1976). Attorneys phrase their interest not in terms of satisfying their needs for compensation but rather in terms of

of creditors and the public was preeminent, and courts awarded compensation to bankruptcy professionals, including attorneys, in light of that objective.[79] In *Massachusetts Mutual Life Insurance Co. v. Brock*,[80] a case decided under the Bankruptcy Act of 1898, the court discussed the reasons for its prudence in the awarding of attorney fees.

> The public interest which is inherent in bankruptcy matters must be considered in awarding fees. The object is to draw a balance to the end that competent trustees and counsel are obtainable in matters of this kind because of the knowledge that they will be fairly compensated. They must not and cannot expect, however, to be overcompensated, for the court must exercise its discretion for the double purpose of fairly treating the trustee and his counsel while at the same time doing equity to the debtor and creditors.[81]

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attracting a competent bar for the benefit of both debtors and creditors. The ubiquitous view in the literature that advocates liberalizing the attorney payment schema for bankruptcy work is that, because of inadequate compensation, competent bankruptcy attorneys had or were about to abandon bankruptcy work. The inescapable conclusion, though not stated forthrightly in the literature, is that no attorneys, or only incompetent attorneys, would be left to handle bankruptcy work. Therefore, the efficiency of the entire bankruptcy process was at stake.

No reliable empirical data exists to support this conclusion. Indeed, one recent study of the bankruptcy bar noted: "Even while the Bankruptcy Reform Act was debated in Congress, no one had even a sound estimate of the number of lawyers practicing in the bankruptcy courts, how they were distributed across the country, how specialized their practices were, or what kinds of clients they represented." Lynn M. LoPucki, *The Demographics of Bankruptcy Practice*, 63 AM. BANKR. L.J. 289, 290 n.6 (1989).

While the bar seeks to bring to the attention of Congress and the public the danger of not compensating bankruptcy attorneys at the rate they could receive for doing nonbankruptcy work, it is interesting to note that the federal rules that govern the compensation of physicians who treat Medicare patients provide for a physician's fee that is less than that which a physician could earn if the physician treated nonMedicaid patients. *No More Smoke and Mirrors—Deficit Reduction Takes on Real Taxes and Real Cuts*, SEATTLE NEWS, Oct. 2, 1990, at A8 (editorial). There are several possible reasons for this discrepancy: (1) competent doctors are more likely to work for below-market wages than competent attorneys, (2) Congress believes that the protection of a debtor's right to competent legal counsel is more fundamental than a Medicaid recipient's right to competent medical care, (3) lawyers are better lobbyists than doctors, or (4) more lawyers than doctors serve in Congress.

79. Presumably it is in the public interest to promote efficient bankruptcy administration because it minimizes creditor losses and speeds the debtor's transition to a productive member of society. Scant attention has been given, however, to the study of the purposes of the bankruptcy power. "Bankruptcy scholars have been content to recite, without critical analysis, the two normative objectives of bankruptcy: rehabilitation of overburdened debtors and equality of treatment for creditors and other claimants." Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 155 (1989).

80. 405 F.2d 429 (5th Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).

81. *Id.* at 432-33.

Despite the amount of effort an attorney expends in representing a client in bankruptcy, the attorney's total compensation under the Act would have to bear some relationship to the size of the bankruptcy estate that the attorney seeks to maximize.[82]

Courts strove to come up with a general rule for determining what maximum amount of compensation an attorney should receive from the estate. One frequently cited yardstick was the annual salary of a federal district court judge.[83] The rationale for this standard was that the attorney was working as a fiduciary of the bankruptcy estate and, "being regarded as [a] public servant[]," should not expect to be paid the usual rate charged to private clients.[84] Additionally, the Act permitted payment to attorneys only at the conclusion of a case.[85]

Other fee regulation aspects of the Bankruptcy Act of 1898, particularly the fee disclosure and fee application provisions, have been refined over the past century and incorporated into the current Bankruptcy Code. The 1898 Act authorized bankruptcy courts to reexamine attorney fees paid by debtors in anticipation of bankruptcy. If the fees paid were intended to compensate the attorney for legal services to be *performed in the future*, a creditor could petition the court to reexamine the transaction. If the court found that the fee exceeded a reasonable amount, it could order that the excess be refunded to the estate.[86]

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82. "[I]n a reorganization proceeding, where the lawyers look for compensation to the debtor's estate which may belong, in equity, largely to others than those who have requested their services, they should have in mind the fact that the total aggregate of fees must bear some reasonable relation to the estate's value. Under these circumstances they cannot always expect to be compensated at the same rate as in litigation of the usual kind . . . ."

Id. at 433 (quoting Finn v. Childs Co., 181 F.2d 431, 435-36 (2d Cir. 1950)).

83. Official Creditors' Comm. of Fox Mkts., Inc. v. Ely, 337 F.2d 461, 465-66 (9th Cir. 1964) (citing Newton v. Consolidated Gas Co., 259 U.S. 101, 106 (1922)) (stating that the salary of a federal district court judge is a relevant factor in determining the reasonableness of compensation to an attorney), *cert. denied*, 380 U.S. 978 (1965).

84. York Int'l Bldg., Inc. v. Chaney (*In re* York Int'l Bldg., Inc.), 527 F.2d 1061, 1069 (9th Cir. 1975).

85. This forced attorneys and their law firms to finance overhead and other costs associated with bankruptcy work until the end of the case, which could last months or years, and there was never any certainty that the bankrupt estate would have sufficient assets to cover these costs. To circumvent this risk, attorneys sought to receive at least a part of their fee in advance. *See* Susan R. Boyle, *Economic Conditions Lead to Innovation in Practice; Care is Used to Avoid Fee Fights*, CRAIN'S CHI. BUS., Nov. 4, 1991, at 1.

86. The original attorney compensation regulation, adopted in 1898, read:

If a debtor shall, directly or indirectly, in contemplation of the filing of a petition by or against him, pay money or transfer property to an attorney and counselor at law, solicitor in equity, or proctor in admiralty for services to be rendered, the transaction shall be reexamined by the court on petition of the trustee or any creditor and shall only be held valid to the extent of a reasonable amount to be determined by the court, and the excess may be recovered by

Congress amended the Act in 1968 to give the court authority: (1) to reexamine attorney fees paid by a debtor for work *previously performed*, if done in anticipation of bankruptcy, and (2) to reexamine, on its own motion, attorney fees for both past and future services.[87] The 1968 amendment, in addition to expanding the court's authority to scrutinize fee payments, also authorized the court to reexamine the fee agreement and to strike it if unreasonable.[88]

b. *Attorney Fees Under the Bankruptcy Code of 1978*

The Bankruptcy Act was repealed in 1978 and replaced by the Bankruptcy Code.[89] The newly enacted Code *legislatively* liberalized the attorney compensation scheme in three significant ways: (1) It increased the rate of attorney compensation to market value, (2) it eliminated the cap on total attorney compensation, and (3) it formally allowed interim attorney compensation.

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the trustee for the benefit of the estate.

An Act to Establish a Uniform System of Bankruptcy Throughout the United States, ch. 541, § 60(d), 30 Stat. 544, 562 (1898) (repealed 1978).

87. The May 8, 1963 amendment substituted a new subsection as the operative language of the Act in regulating attorney fees:

> If a debtor shall, directly or indirectly, in contemplation of the filing of a petition by or against him, pay money or transfer property to an attorney at law, for services rendered or to be rendered, the transaction may be examined by the court on its own motion or shall be examined by the court on petition of the trustee or any creditor and shall be held valid only to the extent of a reasonable amount to be determined by the court, and the excess may be recovered by the trustee for the benefit of the estate.
>
> If, whether before or after filing, a debtor shall agree orally or in writing to pay money or transfer property to an attorney at law after the filing, the transaction may be examined by the court on its own motion or shall be examined by the court on petition of the bankrupt made prior to discharge and shall be held valid only to the extent of a reasonable amount to be determined by the court, and any excess obligation shall be canceled, or if excess payment or transfer has been made, returned to the bankrupt.

Act of May 8, 1963, Pub. L. No. 88-17, 77 Stat. 14, 14-15 (codified at 11 U.S.C. § 96d (Supp. V 1959-63)) (repealed 1978).

88. *Id.*

89. Bankruptcy Rules governing practice and procedure in Chapter XI cases became effective in 1974, and rules applicable in Chapter X cases became effective in 1975. The Rules were promulgated pursuant to 28 U.S.C. § 2075. The Bankruptcy Act of 1898, as amended, and the Bankruptcy Rules were repealed as of Oct. 1, 1979 by section 401 of the Bankruptcy Reform Act, Pub. L. No. 95-598, Tit. IV, sec. 401, 92 Stat. 2682 (1978).

Michael A. Gerber, *The Election of Directors and Chapter 11—The Second Circuit Tells Stockholders to Walk Softly and Carry a Big Lever*, 53 BROOK. L. REV. 295, 298 n.7 (1987). The Bankruptcy Code is currently codified as Title 11. 11 U.S.C. §§ 101-1330 (1988 & Supp. II 1990).

First, the enactment of the Code overturned the rule of the *Massachusetts Mutual* case. The amount an attorney could earn for performing bankruptcy services would now be that amount an attorney would earn if performing comparable nonbankruptcy services, without any reference to economy of the estate.[90] Second, the judge-made rule of *Moshein v. Beverly Crest Convalescent Hospital, Inc. (In re Beverly Crest Convalescent Hospital, Inc.)*[91] also was overturned, thus eliminating any caps on total attorney compensation for bankruptcy work.[92] Finally, the Code included a provision that created a formal mechanism for the compensation of attorneys on an interim basis, by application to the court every 120 days, so that attorneys would not have to wait for the conclusion of the case to receive compensation.[93]

Although Congress liberalized some aspects of attorney compensation in bankruptcy with the enactment of the Code, it carried forward many of the fee strictures that evolved from the earlier Bankruptcy Act. Principal among these are the Code's provisions for scrutinizing prepetition fee agreements.[94]

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90. Attorneys' fees in bankruptcy cases can be quite large and should be closely examined by the court. However bankruptcy legal services are entitled to command the same competency of counsel as other cases. In that light, the policy of this section is to compensate attorneys and other professionals serving in a case under title 11 at the same rate as the attorney or other professional would be compensated for performing comparable services other than in a case under title 11. . . . Notions of economy of the estate in fixing fees are outdated and have no place in a bankruptcy code.

124 CONG. REC. 32,394-95 (1978) (statement of Rep. Edwards); *see also* 11 U.S.C. § 330(a) (1988).

91. 548 F.2d 817 (9th Cir. 1976).

92. *See* 11 U.S.C. § 330(a) (1988); 124 CONG. REC. H11,901-02 (Sept. 28, 1978); CONG. REC. S17,408 (Oct. 6, 1978); *see also* Boddy v. United States Bankruptcy Court (*In re* Boddy), 950 F.2d 334, 337 (6th Cir. 1991) (establishing a fixed maximum fee for attorneys inconsistent with language of the Bankruptcy Code).

93. 11 U.S.C. § 331 (1988) (stating that an attorney can apply for interim compensation every 120 days during the case); BANKR. R. 2016(a).

94. Perhaps the Congress of 1978 feared the same type of human failing by the fiduciaries of bankruptcy estates (*i.e.*, overreaching) as the Congress of 1898 did. Thus, the 1978 Congress may have decided that more than honor was still necessary to protect the interests not only of the debtor, but also of creditors, and other third parties from self-interested contracts between the attorney and debtor that were struck on the eve of bankruptcy.

Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity . . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgement of this court.

Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, C.J.) (citation omitted).

Under the Code a prepetition agreement between a debtor and an attorney is always subject to review by the court on its own motion or on the motion of any party in interest.[95] Moreover, an attorney who seeks compensation from the bankruptcy estate carries the burden of proving that the fee is "reasonable compensation for actual, necessary services" that benefitted the estate.[96]

In addition, the Code has carried forward those provisions of the Act that require an attorney to disclose the terms of any agreement made with the debtor prior to petitioning for bankruptcy protection and that come within the court's jurisdiction. In enacting section 329 of the Code,[97] which requires attorneys to disclose their compensation agreements and allows the court to require attorneys to disgorge any unreasonable fees, Congress was cognizant of the problems inherent in allowing fiduciaries to set their own fees without court supervision.[98]

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95. BANKR. R. 2017.

96. 11 U.S.C. § 330(a)(1) (1988); *see In re* C & P Auto Transp., Inc., 94 B.R. 682, 686 (Bankr. E.D. Cal. 1988) (holding that the burden of proof is on the party that requests funds from the estate). "The compensation is to be reasonable, for actual necessary services rendered, based on the time, the nature, the extent, and the value of the services rendered, and on the cost of comparable services other than in a case under the bankruptcy code." H.R. REP. No. 595, 95th Cong., 2d Sess. 329-30 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6286.

97. 11 U.S.C. § 329 (1988).

98. In *In re* Senior G & A Operating Co., 97 B.R. 307 (Bankr. W.D. La. 1989), the court discussed the history of the regulation of advance fees paid to a debtor's attorney prior to bankruptcy and indicated that many of the disclosure requirements in the Code originated in the 1898 Bankruptcy Act.

> *Leiman v. Guttman* squarely held that Section 221(4) applied even to "fees incident to the reorganization but not payable out of the estate." Preferred stockholders had escrowed shares to give their attorneys "additional compensation" for their reorganization services. The Supreme Court reversed a bankruptcy court holding that it had no power to determine the amount to be paid under the agreement. Writing for the Court, Mr. Justice Douglas reviewed the history of Section 221 history [sic] and the evils it sought to remedy:
>
>> The control of the judge is not limited to fees and allowances payable out of the estate. Section 221(4) places under his control "all payments made or promised" (1) by "the debtor" or (2) "by a corporation issuing securities or acquiring property under the plan" or (3) "by any other person" for services rendered "in connection with" the proceeding or "in connection with" the plan and "incident to" the reorganization. The services of petitioners concededly met those requirements; and the committee against whom [sic] stock a lien is sought to be asserted would plainly be included within the words "any other person". [sic] Moreover, these petitioners are included in the classes of claimants to whom the judge is empowered to allow reasonable compensation. To lift petitioner's claim from Sec. 221(4) would therefore be to rewrite it or to hold that when extended so far it was unconstitutional. The latter has not even been intimated. The former is not permissible.

Hence, it paid close attention to the need for careful supervision of attorney fees.

This section, derived in large part from [former] Bankruptcy Act

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The aim of the expanded controls over reorganization fees and expenses is clear. The practice had been to fix them by private arrangement outside of court. The deposit agreement under which committees commonly functioned was viewed as a private contract, which granted the committee a lien on the deposited securities for its fees and expenses. By terms of the agreement the committee was normally the sole judge of their amount. This gave rise to serious abuses. There was the spectacle of fiduciaries fixing the worth of their own services and exacting fees which often had no relation to the value of services rendered. The result was that the effective amount received by creditors and stockholders under the plan was determined not by the court but by reorganization managers and committees.

Hence Congress instituted controls, controls which became more pervasive as Sec. 77B was evolved into Ch. X. Section 211 requires that a committee file with the court a statement disclosing specified information including the agreement under which it operates. The scrutiny clause of Sec. 212 gives the court power to set aside any of the provisions of such an agreement which it finds to be "unfair or not consistent with public policy". [sic] And Sec. 221(4) is written in pervasive terms—it applies to "all payments" for services "in connection with" the plan and "incident to" the reorganization, whoever pays for them.

Id. at 310 (citations omitted) (quoting Leiman v. Guttman, 336 U.S. 1, 5-8 (1948)). The *Senior* court further stated:

Just as a bankruptcy court cannot delegate fee review to another court or agency, *it cannot delegate fee review to the very persons whose fees would be affected, or to their clients who are often uninformed or not in a position to bargain.* Attorneys will in the vast majority of instances strenuously attempt to comport themselves with fairness. However, the judgement of our bankruptcy laws is that it is too much humanly to expect that these professionals can be entirely dispassionate judges of the value of their own services. Income not only buys material goods and services, but also tends to have psychic value. Some in our culture value themselves by how much they are paid, or view their income as a measure of what hard-earned effort contributes to society or the economy. Lawyers are not immune from powerful feelings such as these that make the task of fee review difficult for both the judge and the professional seeking fees.

The guaranty of the fees of attorneys for the Debtor may raise a question as to whom the attorneys are actually representing. Counsel's duty of undivided loyalty runs to the Debtor. That duty cannot be compromised by insiders who guaranty compensation. Insiders have been known to make prepetition transfers for personal benefit; to withdraw capital contributions under the guise of repayment of personal loans made to the debtor; to satisfy debts guaranteed by them in preference to non-guaranteed obligations; and to transfer business opportunities of a debtor to a new entity. By accepting a guaranty from an insider, a debtor's counsel may have created a potential conflict of interest.

Id. at 311 (citation omitted) (emphasis added).

> § 60d, requires the debtor's attorney to file with the court a statement of the compensation paid or agreed to be paid to the attorney for services in contemplation of and in connection with the case, and the source of the compensation. Payments to a debtor's attorney provide serious potential for evasion of creditor protection provisions of the bankruptcy laws, and serious potential for overreaching by the debtor's attorney, and should be subject to careful scrutiny.[99]

3. *The Current Issue of Bankruptcy Fees: Both the Bankruptcy Bar and the Number of Bankruptcy Cases Filed Have Grown Significantly Since the Enactment of the Code*

Because of the vastly increased number of bankruptcy cases handled today and because some of America's largest and best known companies have recently filed bankruptcy, the issues surrounding attorney fees in bankruptcy have become more prominent. Moreover, because of the current cyclical downturn in the economy[100] and in part because of a secular change in the way corporate America and the bankruptcy bar have made use of the bankruptcy laws,[101] the volume of bankruptcy

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99. H.R. REP. No. 595, 95th Cong., 2d Sess. 329 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6285; S. REP. No. 989, 95th Cong., 2d Sess. 39 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5825.

100. Real estate values have substantially depreciated, buyers are scarce, and bankers thus have had trouble in even establishing market prices. Adrienne Linsenmeyer, *The Worst Market Collapse in Decades, and Its Likely Repercussions*, FIN. WORLD, Nov. 12, 1991, at 26 ("[H]ow do you establish market value when there is no market?"). In 1991 two thirds of the wealth in the United States was in the form of real estate holdings. Thus, the possibility of defaults on large real estate loan portfolios threatens leading lending institutions and the United States economy. "Most of the big real estate loans made by the banks will be coming due over the next three years, and the regulators are pressuring the banks not to refinance them, but rather to take the hit immediately." *Id.* The inability of debtors to obtain new financing on delinquent loans will, of course, lead to more real estate loan defaults and a larger volume of bankruptcy filings.

101. For example, companies often use bankruptcy to (1) fend off tort claims and (2) avoid the contractual obligations owed to their unions. There is an "increasing tendency of companies to use the bankruptcy laws to cope with financial crises created by labour, health or environmental problems." *America's Corporate-Law Firms: LBO's Carrion Crows*, THE ECONOMIST, June 9, 1990, at 86.

> Manville was besieged by product liability suits on behalf of—so far—152,000 claimed victims of diseases caused by its asbestos dust. The company's prospects of survival were improved by a court-approved plan for it to set up a trust fund to compensate victims. A similar settlement was reached when the viability of A.H. Robins . . . was threatened by the claims of women injured by its Dalkon Shield contraceptive device. Continental Airlines used . . . the bankruptcy laws to win a labour dispute. A big issue in the LTV case is whether the company has to re-assume full liability for pension obligations that were assumed by the government when the company was unable to fulfill

filings has increased dramatically over the last decade.[102] This combination of increased attorney compensation for bankruptcy work and the larger number of entities seeking bankruptcy protection at a time of economic contraction and reduced corporate merger activity has led to a significant growth in the bankruptcy bar.[103]

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them.

Id.

Other possible reasons for the increased number of bankruptcies include easier credit for consumers and greater public awareness of bankruptcy law and the protections it offers to debtors. Mac Scott, *Bankruptcy's New Chapters*, ST. LOUIS BUS. J., Apr. 22, 1991, at 1B.

102. United States bankruptcy filings increased from 331,098 in 1980 to 782,960 in 1990. Miles Maguire, *Bankruptcy Buff Makes Book on Profiting From Others' Busts*, WASH. TIMES, June 27, 1991, at C1. This increased volume of bankruptcy filings includes some by the largest and best known companies in America: Eastern Air Lines, Pan Am, Continental Airlines, Trans World Airlines, Greyhound, A.H. Robbins, LTV, Federated Department Stores, R.H. Macy's, and Manville. These frequent filings have reduced the stigma of bankruptcy, much as the stigma of divorce has diminished over the last two decades. Ann K. Smith, *The Bankruptcy Boom*, U.S. NEWS & WORLD REP., June 4, 1990, at 72. In addition, debtors find it easier to file under the new Code, and "life after bankruptcy isn't always a credit-barren wasteland." *Id.* "Bankruptcy just doesn't mean what it used to mean." Scott, *supra* note 101, at 1B.

103. Law firms that formerly did not have a significant presence among the bankruptcy bar have added or greatly expanded their bankruptcy departments since the 1978 enactment of the Code. This appears to be a reflection of the increased volume of the business available and higher rates of return. "The new code also raised fees, making Chapter 11 much more lucrative, and large firms were lured into the practice." Nina Martin, *Boom Times for Bankruptcy*, A.B.A. J., Dec. 1991, at 83.

"[T]he recent tidal wave of bankruptcy work not only has strengthened the quality of bankruptcy lawyers in Houston, but it also has stimulated dramatic growth in the bankruptcy bar." Gary Taylor, *Bankruptcy Work Means Black Gold for Houston Bar*, LEGAL TIMES, Aug. 1, 1983, at 1.

The large number of law firms that have committed resources and personnel to do bankruptcy work has created a competitive environment in which bankruptcy attorneys compete against each other to represent clients in bankruptcy—particularly creditors. These contests have been termed "beauty contests," and the competition usually takes place at the first meeting of creditors. "It's not unusual for ten to fifteen law firms to show up and start elbowing each other. . . . Why at Carter Hawley Hale, there were fifteen to twenty law firms lined up with their brochures." Susan Beck, *The Anatomy of a Beauty Contest*, AM. LAW., Nov. 1991, at 46.

> Clients have used them for years to choose counsel for all sorts of work. But the bankruptcy arena generates a special breed of beauty contest. Unlike contests conducted through discreet, select interviews, creditors committee contests are, in fact, much like runway competitions. One after another, firms parade in to strut their stuff before the judging panel. . . . "It's somewhere between a trip to the dentist and trying to sell your house."

Id. at 48 (quoting interview).

> Law firms begin jockeying for position as soon as the petition for relief is filed. "There's a great deal of jockeying going on [before the creditors committee meeting] . . . . [F]irms try to line up "invitations" to the meeting or support

IV. THE MECHANICS OF PAYMENTS TO THE DEBTOR'S ATTORNEY

The mechanics of attorney[104] compensation under the Code are best understood by examining its six components.[105] The first is disclosure.[106] The Code's disclosure requirements are extraordinarily strict and contain harsh penalties for noncompliance.[107] The second and third are application for and approval of employment, respectively.[108] Although the debtor can negotiate an employment contract with an attorney, in bankruptcy only a judge may approve an attorney's contract for employment with the debtor in possession. Fourth, in order to be paid, the attorney must submit a statement to the court that details the work already performed.[109] Fifth, all payments to and agreements with the debtor's attorney must be approved by the court.[110] Finally, the Code sets out strict requirements for determining the appropriate level of compensation for attorneys who are paid out of estate funds.[111] All of these rules were agreed upon as part of a legislative compromise[112]: balancing the creditors' interests in conserving the estate's as-

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> from large creditors. . . . "One thing people do is, as soon as the case is filed, they absolutely run over [to the bankruptcy court] and get the list of the twenty largest creditors and run that list through their computer of client names to see if they have any contacts. They'll also send around a memo, saying, 'If you know anybody at XYZ Company, let me know.' "

Id. (some brackets in original) (quoting interview).

104. Because this Article concerns only the validity of prepetition asset transfers from debtors to their attorneys, we refer here, and throughout this section, only to the *debtor's attorney*, unless stated otherwise.

105. This is merely a sketch of the Bankruptcy Code's attorney payment mechanics as set out in 11 U.S.C. §§ 326-330, Bankruptcy Rules 2014-2017, and other miscellaneous sections. *See generally* Steven J. Carney, Comment, *Attorneys Fees in Bankruptcy*, 19 GONZ. L. REV. 333 (1983-84) (discussing in detail the attorney fee provisions of the Bankruptcy Code).

106. 11 U.S.C. § 329 (1988); BANKR. R. 2016.

107. 11 U.S.C. § 329 (1988).

> Proper and adequate notice is the most important element in all bankruptcy proceedings. In the context of an employment application, such notice, to be effective, requires disclosure. The disclosure must contain enough information as will reasonably convey the information required by 11 U.S.C. §§ 327 and 329 and Bankruptcy Rules 2014 and 2016.

In re Automend, Inc., 85 B.R. 173, 179 (Bankr. N.D. Ga. 1988); *see also In re* Kero-Sun, Inc., 58 B.R. 770 (Bankr. D. Conn. 1986) (denying compensation to debtor in possession's court-approved attorney for failure to disclose under § 329 the source and proper amount of fees received from major creditors).

108. 11 U.S.C. § 327 (1988); BANKR. R. 2014.

109. BANKR. R. 2016.

110. 11 U.S.C. §§ 328-329 (1988); BANKR. R. 4016.

111. 11 U.S.C. §§ 329(b), 330(a) (1988). This includes both prepetition and postpetition compensation if the payments are made with the debtor in possession's money.

112. "Section 330(a) contains the standard of compensation adopted in H.R. 8200 as

sets against the attorneys' interests in receiving fair remuneration.

A. Disclosure Requirements

Under section 327 of the Bankruptcy Code[113] the trustee or debtor in possession[114] is authorized to hire an attorney for the bankruptcy estate. However, the trustee must seek court approval before hiring the attorney.[115] Moreover, the attorney must not have or represent any interest adverse to the estate[116] and must be a "disinterested person."[117] If at any time the court determines that an attorney is not a "disinterested person," then it may deny the attorney compensation.[118] In addi-

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passed by the House rather than the contrary standard contained in the Senate amendment. Attorneys' fees in bankruptcy cases can be quite large and should be closely examined by the court." 124 CONG. REC. 32,394 (1978).

113. 11 U.S.C. § 327 (1988).

114. The terms "debtor in possession" and "trustee" are used interchangeably in this section. Both refer to the person charged by the bankruptcy court with overseeing the administration of the bankruptcy estate.

115. 11 U.S.C. § 327(a) (1988). Technically, attorneys who perform work prior to getting court approval are not entitled to compensation for that work. *In re* F/S Airlease II, Inc., 844 F.2d 99 (3d Cir. 1988). However, some bankruptcy courts have recently shown flexibility and held that nunc pro tunc appointments of bankruptcy professionals are within the bankruptcy court's equity power. Fanelli v. Hensley (*In re* Triangle Chems., Inc.), 697 F.2d 1280 (5th Cir. 1983).

116. 11 U.S.C. § 327(e) (1988).

117. *Id.* § 327(a). The attorney selected cannot be a relative of the judge who will have to approve the appointment; nor can the trustee hire a firm, partnership, or any other business entity in any way associated with the judge. BANKR. R. 5002(a).

The term "disinterested person" is defined in the Code as follows:

> "disinterested person" means person that—
>
> (A) is not a creditor, an equity security holder, or an insider;
>
> (B) is not and was not an investment banker for any outstanding security of the debtor;
>
> (C) has not been, within three years before the date of the filing of the petition, an investment banker for a security of the debtor, or an attorney for such an investment banker in connection with the offer, sale, or issuance of a security of the debtor;
>
> (D) is not and was not, within two years before the date of the filing of the petition, a director, officer, or employee of the debtor or of an investment banker specified in subparagraph (B) or (C) of this paragraph; and
>
> (E) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or an investment banker specified in subparagraph (B) or (C) of this paragraph, or for any other reason.

Id. § 101(14) (Supp. II 1990).

118. *Id.* § 328(c) (1988); *see also* Regina S. Kelbon et al., *Conflicts, The Appointment of "Professionals," and Fiduciary Duties of Major Parties in Chapter 11*, 8 BANKR. DEV. J. 349, 357-74 (1991) (discussing case law on the "disinterested" requirement).

tion, the trustee can be denied compensation for failing to make a diligent inquiry into the facts surrounding an attorney's apparent conflict of interest.[119]

After the petition is filed, an attorney who represents the debtor in possession must file a statement with the court disclosing all compensation "paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition."[120] If the court finds that the compensation received or to be received is excessive, it can order the agreement canceled and the consideration returned to the payor—including a party other than the debtor.[121]

As noted in *In re Senior G & A Operating Co.*,[122] the legislative history of the Code evidences that Congress enacted these strict disclosure requirements because of concern for attorney fees paid outside the Code's creditor protection provisions.[123] Congress therefore gave bankruptcy courts the authority to scrutinize attorney fees and the power to reject them if they are unwise or unreasonable.

Bankruptcy Rule 2016(b) implements the disclosure requirements of section 329(a). It requires the attorney for the debtor to file a disclosure document within fifteen days after the order for relief, and it requires subsequent disclosures within fifteen days of any modifications to the agreement or payments. The attorney also must disclose any fee sharing agreement and the amounts involved.[124] Fee splitting also is illegal.[125]

B. Employment of Attorney

1. Application to Court for Employment

The trustee must apply to the court for an order approving the employment of counsel. The application must contain the following: (1) the facts showing the necessity of employment, (2) the name of the attorney, (3) the reasons why the attorney was selected, (4) the services

119. 11 U.S.C. § 326(d) (1988).
120. *Id.* § 329(a).
121. *Id.* § 329(b).
122. 97 B.R. 307 (Bankr. W.D. La. 1989).
123. *Id.* at 308-09.
124. BANKR. R. 2016(b).
125. 11 U.S.C. § 504 (1988); Anderson v. Anderson (*In re* Anderson), 936 F.2d 199, 203 (5th Cir. 1991) (holding that fee splitting is prohibited without prior court approval). Congress intended that debtor's lawyers should not split fees. Lawyers should " 'attend to their duty as officers of the bankruptcy court.' " *In re* Matis, 73 B.R. 228, 231 (Bankr. N.D.N.Y. 1987) (quoting 3 COLLIER ON BANKRUPTCY ¶ 504.02, at 504-8 to -9 (Lawrence P. King et al. eds., 15th ed. 1986)).

the attorney will render, (5) the proposed compensation agreement, (6) all relationships that the attorney has with any parties in interest, and (7) a verified statement from the attorney that discloses the attorney's relationships with any party in interest and that party's professional employees.[126]

2. *Court Approval of Employment*

Once the trustee has submitted the attorney's name for approval and the attorney has disclosed all necessary information, the court must decide whether to approve the attorney's employment. No prior agreement between the trustee and attorney is binding on the court.[127] The judge has sole discretion to decide the matter and can set any reasonable terms of employment, including a retainer, a contingent fee, or an hourly rate[128]; if the terms of employment eventually prove unwise because of unanticipated circumstances, the court can remake the terms of employment.[129]

C. *Compensation of Attorney*

1. *Application for Compensation*

Under the Bankruptcy Act an attorney had to wait until the case was concluded to apply for compensation. Although case law under the Act established some circumstances in which interim compensation would be allowed,[130] section 331 of the 1978 Bankruptcy Code[131] made a dramatic change. Under section 331 an attorney can apply for interim compensation for services already rendered once every 120 days.[132]

When applying for either interim or final compensation, the attorney must file a fee application with the court that complies with Rule 2016. The application should contain a detailed account of: (1) services

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126. BANKR. R. 2014.

127. *See* 11 U.S.C. §§ 329-330 (1988); BANKR. R. 2017.

128. 11 U.S.C. § 328(a) (1988).

129. *Id.*; *see In re* Shah Int'l, Inc., 94 B.R. 136, 139 (Bankr. E.D. Wis. 1988) (holding that all fees remain subject to court approval despite prior agreement between debtors and their attorneys).

130. *See In re* Imperial "400" Nat'l Inc., 324 F. Supp. 582 (D.N.J. 1971). Interim compensation is any compensation received before the case is resolved.

131. 11 U.S.C. § 331 (1988).

132. *Id.*; *see* BANKR. R. 2016; Continental Ill. Nat'l Bank & Trust Co. v. Charles N. Wooten, Ltd. (*In re* Evangeline Ref. Co.), 890 F.2d 1312, 1321 (5th Cir. 1989) (holding that the Bankruptcy Code specially provides for interim compensation).

already rendered, (2) time spent, (3) expenses incurred, (4) the amount requested, (5) payments made or promised for services performed or to be performed, and (6) any fee sharing agreement.[133] All parties in interest must receive notice of the application.[134]

2. *Court Approval of Compensation*

After notice and a hearing the court can award compensation.[135] The court will review the attorney's application for payment in light of the compensation standards enumerated in section 330. It can award "reasonable compensation for actual, necessary services rendered."[136] This evaluation is based on the nature, extent, and value of the services rendered, the time spent, and a comparison with the cost of comparable nonbankruptcy services.[137] The court also may award "reimbursement for actual, necessary expenses."[138] These standards are a significant departure from the standards applicable under the Act.[139]

Despite these requirements some courts have approved advance fee payments in a manner that effectively allows attorneys to avoid the enumerated Code provisions which were enacted to protect the bankruptcy res and creditor interests.[140] These judicial circumventions of the letter and spirit of the Bankruptcy Code presumably seek to elevate attorney fee claims to an even higher status than that intended by Congress. Whether this is necessary to attract a competent bankruptcy bar because it eases attorneys' cash flow problems and assures that money will be available to pay their fees,[141] or whether it is simply

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133. BANKR. R. 2016.

134. 11 U.S.C. §§ 330(a), 331 (1988).

135. *Id.*

136. *Id.* § 330(a)(1).

137. *Id.*; *see also In re* Orthopaedic Technology, Inc., 97 B.R. 596, 601 (Bankr. D. Colo. 1989) (requiring detailed showing of attorney's expenses in reviewing request for compensation under § 330).

138. 11 U.S.C. § 330(a)(2) (1988).

139. *See* Boddy v. United States Bankruptcy Court (*In re* Boddy), 950 F.2d 334, 337 (6th Cir. 1991) ("[U]nder the pre-Code Bankruptcy Act . . . economy of the debtor's estate was a paramount concern. This notion that economy of the estate should govern the award of attorney's fees was expressly repudiated by the Code.").

140. *See In re* D.L.I.C., Inc., 120 B.R. 348 (Bankr. S.D.N.Y. 1990); *In re* McDonald Bros. Constr., Inc., 114 B.R. 989 (Bankr. N.D. Ill. 1990).

141. The bankruptcy bar complains loudly about the difficulty of being properly compensated for doing bankruptcy work. Barbara Rabinovitz, *Economic Conditions Lead to Innovation in Practice: Option Bypasses U.S. Bankruptcy*, MASS. LAW. WKLY., Nov. 4, 1991, at 1 (" 'It's like dentistry . . . . You've got to drill every tooth to get paid. It's the same in bankruptcy.' "). Bankruptcy attorneys complain about the lack of uniformity among bankruptcy judges on what services are compensable and what rate of pay applies to compensable services. Indeed, there are vast differences among the judi-

another special rule for lawyers[142] is an open question. Any attempt to answer this question, however, requires a firm grounding in the law of attorney retainer agreements.

V. RETAINER AGREEMENTS

A retainer agreement is an agreement to actually or potentially perform legal services for a client.[143] There are two types of retainer agreements: General retainers and special retainers.

A. *General Retainer Agreements*

A general retainer, sometimes called a classic retainer, is an agreement between the attorney and client in which the client agrees to pay a fixed sum in exchange for the attorney's promise to be available to perform, at an agreed price, any legal services that arise during a speci-

cial districts on which expenses must be borne by the lawyer as part of overhead, and which expenses the attorney can be reimbursed for. The American Bankruptcy Institute's recent survey of bankruptcy practitioners and judges confirms this lack of uniformity. AMERICAN BANKRUPTCY INSTITUTE, AMERICAN BANKRUPTCY INSTITUTE NATIONAL REPORT ON PROFESSIONAL COMPENSATION IN BANKRUPTCY CASES (G. Ray Warner rep., 1991). For example, judges were asked whether they grant requests for reimbursement for certain expenses, and the results were tabulated as follows: Ordinary Mail: ⅔ allow reimbursement, ⅓ disallow reimbursement, *id.* at 228; Express Mail: 90% allow reimbursement, 10% disallow reimbursement, *id.* at 230-31; Messenger Services: 75% allow reimbursement, *id.* at 231; Fax Transmission: 73% reimburse at cost, 11% reimburse at market rate, 16% disallow reimbursement, *id.* at 232; Photocopy Expenses: allowance ranges from 10 cents to 50 cents per copy, *id.* at 236-37; In Town Meals: 14% reimburse at cost, 5% reimburse at market rates, 81% disallow reimbursement, *id.* at 239; Paralegals: typically reimbursement is allowed for time spent on professional tasks, but denied for clerical tasks that are considered part of overhead (there are, however, many variations on what tasks the judges consider professional), *id.* at 249; General Secretarial Work: although this would seem to be a part of overhead, 31% of the attorneys that were surveyed reported being reimbursed for general secretarial work, *id.* at 246.

142. *See supra* notes 4-7 and accompanying text.

143. The term "retainer" is ambiguous because in actual practice it is used to refer to three distinct circumstances: The retainer agreement between the attorney and client; the consideration paid in advance to the attorney for work to be done under the agreement, that is, an advance fee payment, *see infra* text accompanying note 148; and a general retainer payment for availability, *see infra* text accompanying note 144. *See also In re* C & P Auto Transp., Inc., 94 B.R. 682, 686 (Bankr. E.D. Cal. 1988) ("The term 'retainer' has become inherently ambiguous. . . ."). When lawyers state that they have "accepted a retainer," they usually mean that the advance fee they have demanded and received is nonrefundable. This usage rarely is correct. For purposes of precision this Article will use the word "retainer" to refer to a special retainer advance fee payment, that is, to the fee paid in advance for specific services and not to either a general retainer payment or to the employment contract.

fied period.[144] Because the consideration for a general retainer is paid in exchange for availability, it is a charge separate from the fees incurred for services actually performed.[145]

Because general retainer fees are intended only to compensate an attorney for availability and not for actual legal services, they are regarded as earned in full upon receipt. Therefore, the fiduciary client discharge rule, which provides that an attorney discharged by the client before completion of the contract task cannot seek breach of contract damages but is limited to a recovery in quantum meruit,[146] does not apply to a general retainer.[147] Rather, the attorney is allowed the contract price as damages when a client breaches a general retainer agreement.

B. *Special Retainer Agreements*

A special retainer is an agreement in which an attorney promises to perform specific legal services. If a payment is made before the attorney performs the services, it is denominated as an advance fee payment.

1. *Advance Fee Retainers*

An advance fee is a contractually mandated payment made by a client to an attorney prior to the performance of the contemplated services. The attorney depletes the prepayment as the services are rendered. If the matter is completed or the attorney's work on the matter otherwise ends before the advance fee has been fully earned, the attorney is obligated to refund the balance of the advance payment to the client.[148] Advance fee payments must be deposited to the attorney's client security account because they are "funds of clients" until earned.[149] Although some bar association opinions provide that ad-

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144. Lester Brickman, *The Advance Fee Payment Dilemma: Should Payments Be Deposited to the Client Trust Account or to the General Office Account?*, 10 CARDOZO L. REV. 647, 649 n.13 (1989).

145. Brickman & Cunningham, *supra* note 5, at 158.

146. Martin v. Camp, 114 N.E. 46, 48 (N.Y. 1916); Brickman & Cunningham, *supra* note 5, at 155-56; *see* Brickman, *supra* note 66, at 367.

147. *Martin*, 114 N.E. at 48. The basis for this exception to the client discharge rule has been severely questioned. *See* Brickman & Cunningham, *supra* note 5, at 157-60.

148. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.5 cmt. (1983) ("A lawyer may require advance payment of a fee, but is obliged to return any unearned portion."); MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 2-110(A)(3) (1980); *see also* D.C. Bar Op. 113, at 1 (May 18, 1982); Wash. State Bar Ass'n Code of Professional Responsibility Comm., Formal Op. 173, *reprinted in* WASH. STATE BAR NEWS, Oct. 1980, at 50.

149. MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 9-102(A) (1980); *see also*

vance payments are not funds of the client but rather funds of the attorney and therefore are to be deposited in the general office account,[150] the majority view is to the contrary.

2. *Nonrefundable Retainers*

A nonrefundable retainer is a form of special retainer agreement between a lawyer and client that (1) provides for the payment of part or all of the fee in advance of the lawyer's performance, and (2) designates the advance payment as nonrefundable.[151] Under fiduciary law and ethical codes, most nonrefundable retainers are illegal and unethical.[152]

The majority of jurisdictions that have adopted the client discharge rule have not given nonrefundable retainers an imprimatur of validity.[153] In these jurisdictions fiduciary law imparts into the retainer agreement a provision that allows the client to terminate the agreement at will upon a loss of trust and confidence in the attorney.[154] The unfettered right to discharge requires the corollary right that the client cannot be compelled to pay contract damages upon termination.[155] Enforcing nonrefundable retainers would defeat the client discharge rule because, by designating advance fees as nonrefundable, the attorney effectively would be imposing a penalty upon the discharging client in contravention of the rule.

Even jurisdictions that reject the client discharge rule do not uphold nonrefundable retainers. Unless categorized by courts as sui generis, in order to create a special rule for lawyers, nonrefundable retainers, from a traditional contract perspective, are a form of liqui-

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MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.15 (1983); Brickman, *supra* note 144, at 648-49.

150. Brickman, *supra* note 144, at 650, 654-55 & nn.47-48. These opinions have been sharply criticized by the senior author as contrary to rules of ethics, fiduciary law, and public policy. *See id.* at 654-75.

151. Disputes over the validity of these agreements usually arise when the client terminates the lawyer's employment without legally sufficient cause before the lawyer completes the designated task and demands return of the unearned part of the fee. Because the client discharge rule precludes the attorney from obtaining contract damages, but instead relegates the attorney to quantum meruit, *see supra* note 146 and accompanying text, the only way in which the attorney can keep the unearned portion of the advance fee is to assert that the advance fee payment was designated nonrefundable and for a court to uphold the validity of that designation.

152. *See* Jennings v. Backmeyer, 569 N.E.2d 689 (Ind. Ct. App. 1991). *See generally* Brickman & Cunningham, *supra* note 5, at 150-57 (examining the legal and ethical validity of nonrefundable retainers).

153. *See* Brickman & Cunningham, *supra* note 5, at 150 n.4.

154. *See* Brickman, *supra* note 66, at 370-71, 376-79.

155. Martin v. Camp, 114 N.E. 46, 48 (N.Y. 1916).

dated damages clause. However, virtually all nonrefundable retainers fail to meet the test for liquidated damages and therefore are unenforceable penalties.[156]

A jurisdiction that rejects the fiduciary law-inspired client discharge rule and also exempts lawyers' retainer agreements from the reach of contract law's liquidated damages rule[157] may nonetheless contemplate upholding the validity of a nonrefundable retainer on the basis of statutory law. Many jurisdictions have adopted a version of New York's Field Code and its later codifications[158] which provide that attorney compensation is "governed by agreement, express or implied, which is not restrained by law."[159] Read literally, and in this instance wrongly, the statute appears to mean that if a lawyer contracts for a nonrefundable retainer, the retainer can be enforced.[160] Not so. The statute, both in its original form and in its recodifications, sought only to abolish the "fee bills," which regulated attorney fees by fixing allowable charges for attorney services.[161] Neither the Field Code nor its later codifications were intended to diminish the judiciary's role in superintending attorney-client agreements,[162] let alone create a special rule for lawyers that would exempt them from general contract law.

Although no court has countenanced nonrefundable retainers and the few that have considered the matter mostly have rejected their validity,[163] a few bar associations have opined that nonrefundable retainers are valid.[164] Discarding professional responsibility and opting for a more lucrative alternative, these bar association opinions represent the pinnacle of professional irony for a profession that claims to operate in

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156. For a detailed analysis of the contract law aspects of the nonrefundable retainer, see Brickman & Cunningham, *supra* note 5, at 176-89. There are rare instances when a nonrefundable retainer might be valid under contract law. *See id.* at 188-89.

157. The irony of this position, of course, is that such a jurisdiction not only rejects the fiduciary content of the attorney-client relationship but in fact turns that doctrine on its head. Instead of fiduciary law protecting the client, reverse fiduciary law deprives the client of even common-law contract protection.

158. For a partial list, see Brickman & Cunningham, *supra* note 5, at 170 n.137.

159. N.Y. JUD. LAW § 474 (McKinney 1983).

160. For a detailed analysis of the "unrestrained by law" statutes, their legislative history, and their historically accurate meaning, see Brickman & Cunningham, *supra* note 5, at 170-76.

161. *Id.* at 172-76.

162. *See* Barry v. Whitney, 3 Sand. 696, 698 (Super. Ct. City of N.Y. 1851) ("Before the [Field] [C]ode, the court had the general power of examining into [attorney-client] bargains . . . to see that they were not unreasonable or oppressive, and the power has not been taken away.").

163. *See* Brickman & Cunningham, *supra* note 5, at 150 n.4; *see also* Joel R. Brandes, P.C. v. Zigmond, 573 N.Y.S.2d 579 (Sup. Ct. 1991).

164. *See* Brickman & Cunningham, *supra* note 5, at 150 n.5.

the public interest.[165] Consider that these bar associations are validating the use of nonrefundable retainers, which usually amount to several thousand dollars each, in the teeth of contrary contract law and fiduciary law that imposes a non-self-interested and non-arms-length standard on the lawyer[166] and when nearly all jurisdictions have determined that in the arms-length commercial law sale-of-goods context the forfeiture of the nonrefundable retainer equivalent, an advance down payment, is limited to a reasonable amount or twenty percent of the value of total performance up to a maximum of $500.[167] Were it up to these bar associations, a purchaser of a used car who paid a $2000 nonrefundable down payment towards a purchase price of $5000 and then reneged on the purchase likely would be entitled to a return of $1500 (assuming that the seller's incidental and consequential damages totalled $500 or less), but a client who gave the same advance payment to a lawyer for legal services would not be entitled to any refund regardless of how little work the lawyer had done. It seems plausible to contend that the lawyer-fiduciary should at least be held to the same standard as the used car seller.

3. *Security Retainers*

Another purported form of special retainer, which apparently is used only in the bankruptcy context, is the security retainer. This retainer is "held by the attorneys to secure payment of fees for future services."[168] Although security retainers require a payment in advance for services to be rendered, "the money given to the debtors' attorneys is not present payment for the future services. Rather, the retainer remains the property of the debtor until the attorney 'applies' it to charges for services actually rendered; any unearned funds are turned over by the attorneys."[169]

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165. "The profession has a responsibility to assure that its regulations are conceived in the public interest and not in furtherance of parochial or self-interested concerns of the bar." MODEL RULES OF PROFESSIONAL CONDUCT Preamble (1983).

166. The lawyer-client relationship is not one at arms length, but rather is a fiduciary relationship based upon trust and confidence; fee arrangements between lawyer and client are not ordinary commercial contracts. *See* Brickman, *Contingent Fees, supra* note 7, at 64-66.

167. *See* U.C.C. § 2-718(1)-(2) (1966). Under the UCC the seller is entitled to damages for the buyer's breach. If damages are $500 or less, the buyer is entitled to restitution of the amount that the down payment exceeds 20% of the value of total performance or $500, whichever is less. If damages are more than $500, then this limitation would not decrease the buyer's entitlement to damages or to set off those damages against the down payment. *Id.* § 2-718(3).

168. *In re* McDonald Bros. Constr., Inc., 114 B.R. 989, 999 (Bankr. N.D. Ill. 1990).

169. *Id.*

The chimerical quality of the security retainer is immediately apparent from the prior statement: "[T]he money given to the debtors' attorneys is not present payment for the future services."[170] Of course, it is precisely that: it is present payment in advance for future services.[171]

In the context in which the term is used in bankruptcy, there is no such thing as a security retainer.[172] For a security retainer to exist,

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> "[T]he agreement should provide that: (1) the retainer is deemed a trust fund, subject to deposit in the firm's client trust account . . . ; (2) any interest accrual on the retainer amount are added to the retainer; (3) the firm has the right to apply against the retainer amount all accrued time charges and reimbursable costs on a monthly basis upon the submission to the client of detailed statements of such time charges and reimbursable costs . . . and (4) if either the client or the firm notifies the other party in writing of its decision to terminate the agreement, the balance of the retainer amount may be applied to all accrued but unpaid charges . . . and any remainder will be returned . . . ."

Id. (quoting STANLEY B. BERNSTEIN, COLLIER BANKRUPTCY COMPENSATION GUIDE, ¶ 203, at 2-13 (1989)).

170. *Id.*

171. The term "security retainer" is a shibboleth used by those seeking to flee from the requirements of §§ 330 and 331. However, the security retainer does not afford such refuge. "[B]ecause the debtor continues to hold an interest in security retainers, such a retainer is estate property, which can only be used by debtor's counsel upon compliance with the entire fee application process, including court approval." *Id.* at 1000.

172. In theory, one could devise a security retainer that would apply in the bankruptcy context. *See* STANLEY B. BERNSTEIN, COLLIER BANKRUPTCY COMPENSATION GUIDE ¶ 2.06[5], at 2-32 (1991). The process would begin with a prepetition payment to the attorney as cash collateral securing the payment of both prepetition and postpetition services. This retainer would be deposited to the lawyer's trust account. Prepetition services would be billed in a timely fashion and paid by the client upon receipt. Postpetition services would be billed and, upon court approval and after the requisite time interval, would be paid by the estate. *See* 11 U.S.C. § 331 (1988). The cash collateral on deposit in the trust account would secure these payments; hence the retainer would be a security retainer. Upon completion of services and payment, the security retainer would be returned to the client or to the estate. The lawyer could transfer some or all of the retainer to his or her own account only in the event of nonpayment and only upon court approval of the payment. However, in the bankruptcy context if the prepetition payment is in fact an advance fee payment (as it almost always is) and not a security device, it cannot be denominated as a security retainer. For a determination to the contrary that ignores all of these arguments, see *In re* Viscount Furniture Corp., 133 B.R. 360, 365 (Bankr. N.D. Miss. 1991).

A variation of the security retainer that is in actual use is for the advance fee payment to be held in the client trust account and applied against the final invoice with the client making monthly payments for the initial and middle phases of the representation. *See* BERNSTEIN, *supra*, at 2-33. This practice, referred to as an "evergreen retainer payment," was disallowed on the policy grounds that it created an incentive for generating unnecessary work. *In re* Fitzsimmons Trucking, Inc., 124 B.R. 556 (Bankr. D. Minn. 1991); *In re* Cal-Inland, Inc., 124 B.R. 551 (Bankr. D. Minn. 1991). It also has been approved. *In re* Benjamin's-Arnolds, Inc., 123 B.R. 839 (Bankr. D. Minn. 1990).

there must be some security[173] for payment of the lawyer's fee. An advance fee payment, however, being the payment for the service, is not therefore security for the payment obligation.[174] Nothing is being secured[175] by collateral.[176] The so-called security retainer does not secure the payment of compensation.[177] The payment of a security retainer is not intended to create a fall back asset, or secondary obligation[178] to which the attorney-creditor can look for satisfaction in the event of default. On the contrary, the typical so-called security retainer is an advance fee payment that secures nothing.[179] Indeed, it is better than

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173. Black's Law Dictionary defines security as:

> Protection; assurance; indemnification. The term is usually applied to an obligation, pledge, mortgage, deposit, lien, etc., given by a debtor in order to assure the payment or performance of his debt, by furnishing the creditor with a resource to be used in case of failure in the principle obligation. Collateral given by debtor to secure loan.

BLACK'S LAW DICTIONARY 1355 (6th ed. 1990).

174. It is the client—not the attorney—who has a security interest in the advance fee because the client can demand the return of any unused portion of the advance payment upon termination of the attorney's services.

175. "One 'secures' his creditor by giving him a lien, mortgage, pledge, or other security, to be used *in case the debtor fails to make payment.*" BLACK'S LAW DICTIONARY 1354 (6th ed. 1990) (emphasis added).

176. Collateral is defined as: "Property which is pledged as security for the satisfaction of a debt. Collateral is additional security for performance of principal obligation, or that which is by the side, and not in direct line." *Id.* at 261; *see also* Shaffer v. Davidson, 445 P.2d 13, 16 (Wyo. 1968) (citing several similar definitions of collateral).

177. The UCC definition of security interest is "an interest in personal property or fixtures which secures payment or performance of an obligation." U.C.C. § 1-201(37) (1966).

Because the advance payment is the actual payment, it does not "secure[] payment." *Id.* Moreover, unlike a performance bond, the advance payment does not secure the lawyer's performance of his obligation to render legal services. As for an argument that the performance being secured is that of the client, that obligation is, of course, to pay. Hence the phrase "secures payment" deals with the client's payment obligation, not the clause "secures . . . performance of an obligation." *Id.*

178. The *McDonald* court incorrectly found that a security retainer comes within the definition of a pledge. *In re* McDonald Bros. Constr., Inc., 114 B.R. 989, 999 (Bankr. N.D. Ill. 1990). A retainer fee, however, cannot be a pledge because a retainer fee does not secure any debt. The definition of a pledge is:

> A bailment, pawn, or deposit of personal property to a creditor *as security for some debt* or engagement. Personal property transferred to pledgee *as security* for pledgor's payment of debt or other obligation. A pledge, considered as a transaction, is a bailment or delivery of goods or property *by way of security for a debt* or engagement, or *as security* for the performance of an act. . . . A lien created by delivery of personal property by owner to another, upon express or implied agreement that it shall be *retained as security for existing or future debt.*

BLACK'S LAW DICTIONARY 1153 (6th ed. 1990) (citation omitted) (emphasis added).

179. Because the client's money is placed in a trust account over which only the

security for payment; it is payment.[180]

VI. Retainer Agreements Consummated in Anticipation of Bankruptcy

A. *The Use of General Retainers in Bankruptcy*

The Bankruptcy Code's fee application procedure applies only to property of the estate,[181] which is defined as "all legal or equitable interests of the debtor in property as of the commencement of the case."[182] Because a general retainer becomes property of the attorney upon receipt,[183] it has been held that a general retainer paid prior to commencement of the case is not part of the debtor's estate.[184]

Although an attorney must disclose the receipt of a general retainer payment pursuant to section 329,[185] the attorney is not subject to the more demanding requirements of section 330, especially the burden of proving, after notice and a hearing, that the fees were for actual and necessary services[186] that benefitted the estate.[187] By getting a gen-

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bankruptcy court, upon performance by the attorney in accordance with the terms of the retainer agreement, can release the monies, the relationship is more akin to an escrow agreement than a security agreement. Black's Law Dictionary defines escrow as:

> A legal document (such as a deed), money, stock, or other property delivered by the grantor, promisor or obligor into the hands of a third person, to be held by the latter until the happening of a contingency or performance of a condition, and then by him delivered to the grantee, promisee or obligee. A system of document transfer in which a deed, bond, stock, funds, or other property is delivered to a third person to hold until all conditions in a contract are fulfilled . . . .

BLACK'S LAW DICTIONARY 545 (6th ed. 1990).

180. Because both the so-called security retainer and the actual security retainer are payment in advance for services to be rendered, however, they are not "value" as used in § 548, 11 U.S.C. § 548 (1988), and it is possible that an advance payment can be attacked as a fraudulent transfer. *See infra* notes 198-203 and accompanying text.

181. *In re* McDonald Bros. Constr., Inc., 114 B.R. 989, 993-96 (Bankr. N.D. Ill. 1990).

182. 11 U.S.C. § 541(a)(1) (1988).

183. *See supra* notes 144-47 and accompanying text.

184. *McDonald*, 114 B.R. at 998-99.

185. The court can order the attorney to repay a general retainer if it exceeds a reasonable value. 11 U.S.C. § 329 (1988).

186. *Id.* § 330. Under § 330 an attorney can receive payment only after the services have been performed and the court is satisfied that the attorney has carried the burden of persuasion.

187. *In re* James Contracting Group, 120 B.R. 868, 872 (Bankr. N.D. Ohio 1990). "Examples of services which cannot be said to have benefitted the estate are where the work was performed for non-bankruptcy matters, where the services were rendered to benefit the debtor personally or where the services were actually in opposition to the

eral retainer from the debtor prior to filing the debtor's petition, attorneys can obviate their section 330 duty to go before the court and justify their fees. Thereupon, any party in interest who objects to the propriety of the fee would have to initiate the objection and carry the burden of persuasion.[188]

The use of general retainers in bankruptcy is problematic. Outside of the bankruptcy context, clients use general retainer agreements for a variety of reasons: to ensure the availability of a particular attorney, to secure an attorney who has unique skills or knowledge, to hedge against an expected contingency that might require a large team of legal specialists that would be difficult to assemble on short notice, or to deprive competitors or hostile suitors of a feared attorney's services.[189] These motives lose much of their force when the debtor is insolvent.

From the point of view of the attorney contemplating postpetition work for the soon-to-file debtor, the earned-upon-receipt aspect of the general retainer is most attractive. Not surprisingly, therefore, general retainers are used in the bankruptcy context. While the use of a general retainer agreement to assure postpetition availability can be legitimate, it is more likely that the attorney has denominated a special retainer advance fee as a general retainer in order to evade the bankruptcy court's scrutiny.[190] It is very rare that an advance fee is paid prepetition solely for availability and not as payment for legal services to be rendered postpetition; indeed, most attempts to disguise advance fees as general retainers fail. In discussing this pretextual subterfuge, one court has stated:

> [T]his Court questions whether any retainer deemed by the parties to be earned in advance of legal services, even the historically "classic retainer" paid in exchange solely for an attorney's promise of future availability and the necessary incidents to maintaining such availability, is ever a viable means of compensating counsel for a debtor-in-possession. Attorney compensation in a bankruptcy case is premised on performance of legal services which benefit the estate, not on mere availability for such purpose or promises to perform such services if

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estate's administration." *Id.; see also In re* Leff, 88 B.R. 105, 108-09 (Bankr. N.D. Tex. 1988), *aff'd sub nom.* Stewart v. Law Offices of Dennis Olson, 93 B.R. 91 (N.D. Tex. 1988), *aff'd*, 878 F.2d 1432 (5th Cir. 1989). These holdings under the Code are consistent with holdings under the Act. *See, e.g., In re* Walchef Dev. Corp., 388 F. Supp. 1064 (S.D. Cal. 1975).

188. BANKR. R. 2017; *In re* Saturley, 131 B.R. 509 (Bankr. D. Me. 1991).

189. *See* Brickman & Cunningham, *supra* note 5, at 158 n.50.

190. *Cf.* Jacobson v. Sassower, 452 N.Y.S.2d 981, 985 (Civ. Ct. 1982) ("[T]his retainer agreement is commonly used throughout the New York City Metropolitan area."), *aff'd*, 474 N.Y.S.2d 167 (Sup. Ct. 1983), *aff'd*, 483 N.Y.S.2d 711 (App. Div.), *aff'd*, 489 N.E.2d 1283 (N.Y. 1985); AMERICAN BANKRUPTCY INSTITUTE, *supra* note 141, at 91 (stating that in bankruptcy the "use of pre-petition attorney retainers is not uncommon").

necessary in the future.[191]

Moreover, from a policy perspective, the use of a general retainer in the bankruptcy context is inappropriate. It can lead attorneys to inflate the value of their availability. Any exaggeration of value, except the most egregious, would be difficult for a party in interest to uncover and inefficient to prosecute. Even if an exaggerated general retainer were challenged, putting a value on an attorney's availability could be difficult in a bankruptcy setting, although one bankruptcy court has forthrightly assessed that the value of such availability is negligible.[192]

Finally, the generally accepted view that general retainers are earned upon receipt and are therefore nonrefundable may not withstand bankruptcy law analysis. Under section 548 of the Bankruptcy Code,[193] the trustee can avoid any transfer of an interest of the debtor in which the debtor receives "less than a reasonably equivalent value in exchange for such transfer or obligation."[194] Value, for the purposes of section 548 "does not include an unperformed promise to furnish support to the debtor."[195] In the bankruptcy context general retainers entail an agreement by the attorney to be available to file a bankruptcy petition on behalf of the debtor client and to be available to perform postpetition legal work for the bankruptcy estate. Because availability, by definition, can be effectuated only in the future, the propriety of all prepetition general retainers under section 548 is questionable. Moreover, because there is no exchange of reasonably equivalent value, the trustee--who, if he is a debtor in possession, paid the fee to the lawyer—has a fraudulent transfer claim against the attorney. This creates a conflict of interest that is disqualifying for the lawyer.[196]

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191. *In re* NBI, Inc., 129 B.R. 212, 223 n.11 (Bankr. D. Colo. 1991).

192. A true earned upon receipt retainer is one paid to a lawyer for which the only consideration exchanged is the promise to represent the client and no other party in the particular matter. The consideration cannot include logically the provision of future services if the retainer is truly earned upon receipt. I find there is little or no value in a professional's mere promise to represent a debtor in possession and no other party in a bankruptcy case. The value of such a promise is negligible, absent extraordinary circumstances. The true value provided by the professional is the provision of actual, necessary and effective services.

In re Hathaway Ranch Partnership, 116 B.R. 208, 216 (Bankr. C.D. Cal. 1990) (citation omitted).

193. 11 U.S.C. § 548 (1988 & Supp. II 1990).

194. *Id.* § 548(a)(2)(A) (1988).

195. *Id.* § 548(d)(2)(A).

196. Further, this absence of an exchange of reasonably equivalent value gives rise to a claim for fraudulent transfer pursuant to 11 U.S.C. §§ 548 and 544. This would be a claim owned and asserted by a bankruptcy estate against its own lawyer. The existence of such a claim means counsel for a debtor in pos-

B. *The Use of Special Retainer-Advance Fee Payments in Bankruptcy*

There is an increasing tendency among bankruptcy attorneys to seek a substantial portion of their fees for postpetition work prepetition, that is, in advance of the performance of their services.[197] Two issues are raised when attorneys obtain these payments. First, are the payments permissible? Second, if they are permissible, are they subject to the supervision of the bankruptcy court?

1. *Are Advance Fees Unperformed Promises of No Value?*

Section 548 of the Code,[198] which is entitled fraudulent transfers

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> session is not a "disinterested person" and that said counsel would hold an interest adverse to that of the bankruptcy estate. 11 U.S.C. §§ 327(a) and 101(13)(E). Thus any lawyer who accepted a true earned upon receipt retainer would be disqualified from representing a debtor in possession.

Hathaway Ranch, 116 B.R. at 216. *But see In re* K & R Mining, Inc., 105 B.R. 394, 397 (Bankr. N.D. Ohio 1989) (quoting *In re* Martin, 817 F.2d 175, 180 (1st Cir. 1987)). Whenever an attorney does work for the debtor in possession, the attorney becomes a creditor of the estate. That creates a conflict of interest that is permitted under the Code because disqualifying the attorney would " 'virtually eliminate any possibility of legal assistance for a debtor in possession.' " *Id.* Therefore, becoming a creditor of the estate prior to doing any work for the estate, *i.e.*, prepetition, is also permissible. *Martin*, 817 F.2d at 180 n.5.

197. *See generally* Kraus, *supra* note 15. "[T]he vast majority of lawyers representing Chapter 11 debtors have received pre-petition retainers at least once . . . . [U]se of pre-petition attorney retainers is not uncommon." AMERICAN BANKRUPTCY INSTITUTE, *supra* note 141, at 91. For examples of cases in which attorneys charged prepetition retainers, see cases cited *infra* note 205.

198. 11 U.S.C. § 548 (1988 & Supp. II 1990).

> (a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily—
>
> (1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or
>
> (2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
>
> (B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
>
> (ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or
>
> (iii) intended to incur, or believed that the debtor would incur,

and obligations, allows the trustee to avoid any fraudulent transfer of an interest in the debtor's property if the transfer meets the conditions of section 548(a). Of the different avoiding powers available to the trustee, the fraudulent transfer provisions of the Code are of the most utility to a vigilant trustee in scrutinizing prepetition advance fee retainers.

Under section 548(a) the trustee can avoid two types of transfers. The first is a transfer of any interest in the debtor's property that was made with the actual intent to defraud, hinder, or delay a past or future creditor.[199] The second is any transfer of an interest in the debtor's property that was not made in exchange for reasonably equivalent value that (1) occurred at a time when the debtor was insolvent, or (2) caused the debtor to become insolvent, or (3) left the debtor with too little capital, or (4) was made by a debtor who intended to incur debts beyond the debtor's ability to repay.[200]

Congress defined the term "value" for purposes of section 548 so as to exclude "an unperformed promise to furnish support to the debtor."[201] This definition, if given effect by the bankruptcy courts rather than being ignored, would have a significant chilling effect on advance fee payments. A debtor's advance fee payment to a lawyer in return for a promise to perform legal services in the future would appear to be avoidable by the trustee as a fraudulent transfer because the debtor has not received "reasonably equivalent value" as defined in the Code.[202]

Bankruptcy courts have avoided any sua sponte challenges to advance fee payments to attorneys as unperformed promises, and therefore, fraudulent transfers. In the limited number of reported cases in which the bankruptcy courts have examined whether attorney fees are fraudulent transfers, they have not addressed the question of whether an attorney fee paid prior to performance of services is a transfer made for "an unperformed promise," and whether the attorney's promise is "less than a reasonably equivalent value." Thus, the validity of ad-

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> debts that would be beyond the debtor's ability to pay as such debts matured.

Id. § 548(a) (1988).

199. *Id.* § 548(a)(1).

200. *Id.* § 548(a)(2).

201. *Id.* § 548(d)(2)(A). The definition of value is: "property, or satisfaction or securing of a present or antecedent debt of the debtor, *but does not include an unperformed promise to furnish support to the debtor* or to a relative of the debtor." *Id.* (emphasis added).

202. *Id.* § 548(a)(2)(A). However, the attorney's interest in fees earned may be protected by § 548(c). Section 548(c) gives the transferee of a fraudulent conveyance who is not liable to the trustee under any other section and who gave value in good faith a lien on the transferred property to the extent of the value given. *Id.* § 548(c).

vance fee payments in the bankruptcy context remains unresolved.[203]

2. *Are Advance Fee Payments Subject to Court Supervision?*

Not surprisingly, attorneys who demand advance fee payments seek to treat these payments "as their own money—*i.e.*, to spend it—without first obtaining court approval of a fee application."[204] Overwhelmingly, bankruptcy courts, pursuant to sections 330 and 331, have rejected this importuning.[205]

The rationale for requiring court approval of a professional's compensation from the estate was set forth in *In re Ross*[206]:

> The funds of a bankruptcy estate are trust funds. The Court has a duty to see that these funds are administered in a manner consistent with the intent of the Bankruptcy Code. This duty exists independent of any objections that may be filed by parties in interest. Thus, an attorney for the trustee may only receive payment pursuant to a court order authorizing the trustee to disburse such funds.[207]

Despite the overwhelming rejection of attorneys' attempts to circumvent the fee superintendence required by the Bankruptcy Code, several recent opinions have countenanced such circumvention: *In re McDonald Brothers Construction, Inc.*,[208] followed quickly by *In re D.L.I.C., Inc.*[209] These courts have sought to create another special rule for lawyers; in the process they have misinterpreted the Code, misapplied state law, and rejected the clearly stated intent of Congress.

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203. There is no reported case in which a court has ruled on whether an advance fee paid to an attorney is "an unperformed promise to furnish support to the debtor" and therefore not "value" as defined in § 548(d)(2)(A).

204. *In re* McDonald Bros. Constr., Inc., 114 B.R. 989, 993 (Bankr. N.D. Ill. 1990).

205. *In re* NBI, Inc., 129 B.R. 212, 225 (Bankr. D. Colo. 1991); *In re* Doors & More, Inc., 127 B.R. 1001, 1004 (Bankr. E.D. Mich. 1991); *In re* K & R Mining, Inc., 105 B.R. 394, 398 (Bankr. N.D. Ohio 1989); *In re* Martin, 102 B.R. 653, 658 (Bankr. W.D. Tenn. 1989); *In re* C & P Auto Transp., Inc., 94 B.R. 682, 690 (Bankr. E.D. Cal. 1988); *In re* Wyslak, 94 B.R. 540, 542 (Bankr. N.D. Ill. 1988); *In re* Shah Int'l, Inc., 94 B.R. 136, 139 (Bankr. E.D. Wis. 1988); *In re* Structurlite Plastics Corp., 91 B.R. 813, 817-18 (Bankr. S.D. Ohio 1988); *In re* Tri-County Water Ass'n, 91 B.R. 547, 550-51 (Bankr. D.S.D. 1988); *In re* Burnside Steel Foundary Co., 90 B.R. 942, 944 (Bankr. N.D. Ill. 1988); *In re* Chicago Lutheran Hosp. Ass'n, 89 B.R. 719, 734 n.21, 735 (Bankr. N.D. Ill. 1988); *In re* Leff, 88 B.R. 105, 107 (Bankr. N.D. Tex. 1988), *aff'd sub nom.* Stewart v. Law Offices of Dennis Olson, 93 B.R. 91 (N.D. Tex. 1988), *aff'd*, 878 F.2d 1432 (5th Cir. 1989); *In re* Chapel Gate Apartments, Ltd., 64 B.R. 569, 573-75 (Bankr. N.D. Tex. 1986); *In re* Kinderhaus Corp., 58 B.R. 94, 97 (Bankr. D. Minn. 1986).

206. 88 B.R. 471 (Bankr. M.D. Ga.), *remanded on other grounds*, 94 B.R. 210 (M.D. Ga. 1988).

207. *Id.* at 475.

208. 114 B.R. 989 (Bankr. N.D. Ill. 1990).

209. 120 B.R. 348 (Bankr. S.D.N.Y. 1990).

a. In re McDonald Brothers

In *McDonald* the court addressed the applicability of the Code to a debtor's prepetition advance fee payment for postpetition work.[210] The court concluded that the advance fee paid to debtor's attorney was no longer property of the client upon payment and therefore, never became property of the bankruptcy estate. Because the advance fee was not estate property, the court found that it was not subject to the fee oversight provisions in sections 330 and 331,[211] but was subject only to the disclosure requirements in section 329.[212]

The court's analysis of the various kinds of advance fee payments is confusing to the point of obfuscation and tends to distract the eye from following the swiftly moving fee pea. A close examination of the *McDonald* court's movement of the fee pea from shell to shell reveals that the court inaccurately analyzed retainer agreements, ethical rules, state law, and the Bankruptcy Code.

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210. The debtor paid its attorneys $12,500 in contemplation of filing a bankruptcy petition. After the petition was filed, the attorneys sought an order from the court granting them "leave to apply" the "retainer." *McDonald*, 114 B.R. at 992. The court reasoned that because the transfer of property took place prior to the petition date, the entire $12,500 retainer was property of the attorneys. The attorneys, therefore, were not required to apply to the court for compensation. *Id.* at 1002-03.

211. 11 U.S.C. §§ 330-331 (1988). Fee application procedures, the court stated, apply only when an attorney seeks compensation from the estate.

> [T]he fee application procedure *only* applies when a professional is seeking an award payable from the estate. Nothing in the [Bankruptcy Code] authorizes a court to award compensation or reimbursement of expenses from a source other than the estate. . . . Thus, professionals who hold funds that do not belong to the estate need not, and should not, seek an award of those funds through the fee application process.

McDonald, 114 B.R. at 994.

212. Although the court held that the payment was subject to the monitoring function of § 329, which requires disclosure and allows avoidance if the compensation exceeds the reasonable value of the services, the court eschewed even that function pending a challenge by an interested party. *McDonald*, 114 B.R. at 995, 1003.

According to the Code the right to invoke §§ 547(b), 548(a), and 544(a) and (b) rests with the trustee. 11 U.S.C. §§ 544(a)-(b), 547(b)-(d), 548(b)-(c) (1988). However, case law has extended that right to creditors in some circumstances. In *In re* Xonics Photochemical, Inc., 841 F.2d 198 (7th Cir. 1988), the court stated that a creditor, who first demonstrates that the debtor in possession has abrogated its duty, can bring "a form of derivative suit" in the name of the debtor and invoke § 548(a) or § 544(b) to avoid a transfer. *Id.* at 203; *see* William B. Tanner Co. v. United States (*In re* Automated Business Sys., Inc.), 642 F.2d 200, 201 (6th Cir. 1981). However, the duty to invoke the avoiding powers belongs to the trustee or debtor in possession in the first instance. *Xonics Photochemical*, 841 F.2d at 203.

(i) *McDonald on Retainer Agreements*

The *McDonald* court posited three kinds of advance fee retainer payments: the general retainer, the "security retainer,"[213] and the "advance payment retainer."[214] The latter two, which are special retainers, are mutant progeny of the special retainer advance fee payment—merely titles into which an amalgam of disparate principles have been poured. The resulting security retainer and advance payment retainer are mere chimeras masquerading as legitimate forms of retainer payments that evanesce under close scrutiny.

As noted above there is no such thing as a security retainer as that term is typically used in the bankruptcy context.[215] As for the court's advance payment retainer, it is a conceptual transposition of the advance fee payment into a hybrid consisting of: (1) an advance fee payment that must be deposited into the lawyer's own account, rather than the client trust account, and (2) a nonrefundable retainer.[216] *McDonald* does not call an advance fee payment an advance fee payment as we have used that term because, according to the court, advance fee payments are nonrefundable.[217] Indeed, in an attempt to insulate advance fee payments from the Bankruptcy Code's fee application process, the *McDonald* court refused to acknowledge the existence of any refundable advance fee payment—even one deposited to the lawyer's account.

213. *McDonald*, 114 B.R. at 999-1000.

214. *Id.* at 1000-01.

215. *See supra* notes 171-80 and accompanying text.

216. *See McDonald*, 114 B.R. at 1000 ("[T]he debtor pays, in advance, for some or all of the services that the attorney is expected to perform . . . . This type of retainer differs from the security retainer in that ownership of the retainer is intended to pass to the attorney at the time of payment . . . .").

217. The court does not explicitly state that advance payment retainers are nonrefundable; nonetheless, it is clear that that is exactly how the court treated them. Both in terms of its usage and its reliance on authority, the *McDonald* court denoted the advance payment retainer as nonrefundable. Thus, in support of its analysis of the advance payment retainer, the court cited: (1) Illinois State Bar Ass'n Op. 722, at 16 (1981) as "approving *nonrefundable* advance payment retainers," *McDonald*, 114 B.R. at 1001 (emphasis added); (2) a 1987 Illinois case and implied therefrom that retainer contracts that contain "an explicit *non-refundability* provision" are not inappropriate, *id.* (emphasis added); (3) a 1986 bankruptcy court decision, which "set[] forth a retainer agreement in which it is stated that the retainer is 'fully earned and *nonrefundable* upon its payment and receipt,' " *id.* at 1000 (emphasis added), and indicated that the case's operative facts are similar to those *sub judice* (*i.e.*, both cases involved an advance payment retainer intended to cover only a part of the work to be performed); and (4) two Illinois cases about which the *McDonald* court observed: "If it were improper to accept any advance payment [nonrefundable] retainer, the courts would have no reason to consider whether retainers like the ones in [those cases] were excessive." *Id.* at 1001-02.

Moreover, although the court accurately describes the general retainer,[218] it apparently misapplied the term to the facts of the case.[219] Thus, it quoted from the applicants' brief that the advance fee paid was a general retainer " 'paid for purposes of obtaining their services [and therefore] was earned upon . . . receipt.' "[220] The court then stated that the applicants "confirmed their position that the retainer was an advance payment for services to be rendered in the case"[221] and "was, as they represent, an advance fee retainer."[222] These two positions are, of course, inconsistent. A general retainer is payment for availability, not "an advance payment for services to be rendered."[223] Because the court held that advance fee retainers are nonrefundable and because a general retainer is earned upon receipt and therefore is

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218. *McDonald*, 114 B.R. at 997-99.

219. The attorneys' own characterization of the retainer agreement is contradictory. They gave it attributes of both a general and a special retainer. *Id.* at 992. In fact, it was a special retainer and the court, in the end, so held. *Id.* at 1002-03.

When the debtor in possession first filed a Rule 2014(a) application to have the attorneys' employment approved by the court, it stated that "the attorneys would be employed 'under a general retainer.' " *Id.* at 992. Thereupon, the court approved the attorneys' employment. In their brief the attorneys stated that prior to entering into an employment contract, they negotiated an agreement with the debtor and told the debtor that " 'the $12,500.00 was a fee paid for purposes of obtaining their services and getting them involved in the case." *Id.*

However, the attorneys' brief went on to describe their understanding of the general retainer, and the description includes provisions that clearly are not within the scope of a general retainer. The attorneys proposed to:

> (1) "apply the said retainer for the time they have spent . . . and for further work that will be necessary in the future"; (2) "account to the Court for all time spent in and about the matter"; and (3) in the event the Court allows total fees in an amount less than the retainer, "turn over to the Debtor all such excess."

Id. During negotiations, the attorneys told the debtor that

> "if he wanted them to take his Chapter 11 case and devote their time, energies, and experience to the case, [the debtor] must pay them a retainer of $12,500.00 before they file the case," that "they undoubtedly would apply to the Court in the future for additional compensation," and that "the $12,500.00 was a fee paid for purposes of obtaining their services and getting them involved in the case."

Id.

The attorneys also asserted that the debtor knew that " '[w]hen the retainer was paid, it ceased to be the property of [the debtor] and therefore it is not property of Debtor's estate." *Id.* However, the court's opinion states that at an informal hearing the attorneys confirmed that "the retainer was an advance payment for services to be rendered in the case." *Id.* at 993. Therefore, the court appears to have treated the $12,500.00 payment as an advance fee for work to be done later.

220. *Id.* at 992.

221. *Id.* at 993.

222. *Id.* at 1002.

223. *Id.* at 993.

nonrefundable, it appears that lurking in the court's characterization of the advance fee retainer are elements of the general retainer.

(ii) McDonald*'s Arguments on Whether an Advance Fee Payment Is Subject to the Fee Application Process*

The essential feature of the *McDonald* opinion is its determination that the advance fee payment, which the court terms an "advance payment retainer," is not property of the estate. If so, then the estate has no legal or equitable interest in the funds advanced, and the retainer payment therefore is not subject to the Code's fee application process.[224] Each of the elements of the court's argument in this regard is analyzed below.

(1) Since "Funds of Clients" Equals Property of the Estate Then, by Corollary, Not "Funds of Clients" Equals Not Property of the Estate

As previously noted, both the Model Code and Model Rules mandate that advance fee payments be deposited to the attorney's client security account and withdrawn as earned.[225] Under the ethical rules advance fee payments are funds of the client.[226] The *McDonald* court held, however, that in Illinois advance payments are not funds of the client but rather funds of the attorney[227] and therefore for bankruptcy purposes advance payments are not funds of the estate because only advance fees that are funds of a client can be funds of the estate.[228] The court's syllogistic reasoning may be restated as follows: Since denominating an advance fee payment as "funds of clients" as that term is used in the ethical rules equates with "property of the estate" for bankruptcy law purposes, then finding that an advance payment is not "funds of clients" under the governing ethical regime leads to the conclusion that the payment is not property of the estate. The syllogism is incorrect.

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224. *Id.* at 1002.

225. *See supra* notes 148-50 and accompanying text.

226. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.15 & cmts. (1983); MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 9-102(A) (1980).

227. *McDonald*, 114 B.R. at 1001-02, 1002 n.17.

228. The court held that the client retains an interest in "security retainers," and therefore security retainer payments became property of the estate. *Id.* at 999-1000. According to the court, the client does not, however, retain any interest in an advance payment retainer, and advance retainer payments therefore do not become property of the estate. *Id.* at 1002.

Even if *McDonald*'s analysis of state law is correct,[229] it does not follow that the Bankruptcy Code's fee application process is therefore avoided. The term "funds of clients" in the ethical rules appears under the heading "Preserving Identity of Funds and Property of a Client"[230] and is a codification of an attorney's fiduciary obligation[231] to protect clients' funds both from the attorney's creditors and from the attorney's own temptation.[232] Under the ethical rules a lawyer who deposits an advance payment to the lawyer's personal account rather than to the client trust account is guilty of commingling.[233]

These ethical rules were not intended to constitute substantive law, let alone define what funds become part of the bankruptcy estate.[234] Whether a prepayment of fees for work to be done later is bankruptcy estate property is a matter of federal law to which the ethical rules do not speak. The conclusion, therefore, that a lawyer's fee delineated "not funds of clients" under ethical rules translates into "not property of the bankruptcy estate" under bankruptcy law is a *non sequitur.*

(2) Unearned Funds Must Be Returned to the Client

The *McDonald* court's attempt to import elements of the general retainer into the special retainer and to characterize advance fee payments as nonrefundable may reflect an intent to avoid the consequence of the ethical requirement that upon termination a lawyer must promptly refund any unearned portion of the advance fee payment.[235] Because a client has the right, derivative of fiduciary law, to terminate an employment contract with a lawyer without incurring contract damages,[236] the client retains an interest in an advance fee payment until it

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229. For the analysis of why it is not correct, see *infra* notes 241-48 and accompanying text.

230. MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 9-102 (1980); *see* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.15 (1983).

231. *See* Brickman, *Contingent Fees*, *supra* note 7, at 44 n.65.

232. *See* Brickman, *supra* note 143, at 652-54.

233. *See id.* at 647-48.

234. Thus, the Preliminary Statement to the Model Code states that it does not "undertake to define standards for civil liability of lawyers." MODEL CODE OF PROFESSIONAL RESPONSIBILITY Preliminary Statement (1980). The Scope to the Model Rules states that "[v]iolation of a Rule should not give rise to a cause of action . . . . The Rules are designed to provide guidance to lawyers and to provide a structure for regulating conduct through disciplinary agencies. They are not designed to be a basis for civil liability." MODEL RULES OF PROFESSIONAL CONDUCT Scope ¶ 6 (1990).

235. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.16(d) (1983); MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 2-110(A)(3) (1980).

236. This is true of most jurisdictions, including Illinois. *See* Rhoades v. Norfolk &

has been fully earned by performance.[237] That interest suffices to make the advance fee payment estate funds for purposes of bankruptcy law.[238] If the advance payments are denominated nonrefundable, however, the client does not retain any interest in them.[239] Hence, the essentiality of incorporating the concept of the nonrefundable retainer into the retainer fee construct becomes apparent if one is to insulate the advance fee payment from judicial scrutiny. As previously noted, however, nonrefundable retainers violate both contract and ethical laws.[240]

(3) Advance Payment Retainers Are Permitted Under Illinois Law

McDonald asserted that "[u]nder Illinois law . . . advance payment retainers are permitted, for several reasons."[241] Bearing in mind that *McDonald* denominated advance payment retainers as nonrefundable advance fee payments that are deposited to the lawyer's account, we can now examine each of the pillars on which the *McDonald* court's

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W. Ry., 399 N.E.2d 969, 974-75 (Ill. 1979); *see also Brickman, supra* note 66, at 367-68, 373 & n.37.

237. The client's interest includes the right to compel the attorney not to transfer the funds to the attorney's account if the client disputes the fee. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.15(c) (1983); MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 9-102(A)(2) (1980).

238. *See In re* Leff, 88 B.R. 105, 107-08 (Bankr. N.D. Tex. 1988) (holding that the entire retainer was property of the estate and rejecting the argument that the client's interest was a mere contingent reversionary interest); *cf.* United States v. Whiting Pools, Inc., 462 U.S. 198 (1983) (holding that property that a judicial lien creditor seizes is property of the estate even though the debtor had no possessory interest in the property at the time that the petition was filed).

239. *McDonald* states that in order for an advance fee retainer not to be property of the estate, the debtor must have no interest in the prepaid fee at the time the petition is filed. *In re* McDonald Bros. Constr., Inc., 114 B.R. 989, 996 (Bankr. N.D. Ill. 1990). Of course, the client's ability to recapture at least part of the advance fee by terminating the lawyer's employment is just such an interest. Moreover, even if the advance payment is denominated as nonrefundable, the bankruptcy court can still order some or all of it returned to the estate under § 329 if the compensation exceeds "the reasonable value of such services." 11 U.S.C. § 329 (1988). According to *McDonald*, however, "the possibility of this return does not give the debtor an interest in the transferred funds" but only a potential claim, and "[i]t is the recovery of the funds involved in an 'avoided' transfer, not the potential for recovery, that causes the funds to be considered part of the estate." 114 B.R. at 997.

240. *See supra* notes 152-64 and accompanying text; *see also* Brickman & Cunningham, *supra* note 5, 150-53 (stating that nonrefundable retainers are unethical and illegal); BERNSTEIN, *supra* note 172, ¶ 2.06[3], at 2-29 ("[A] provision in a written retainer agreement that defines the retainer amount as earned upon receipt by the debtor's counsel and nonrefundable upon a termination of the agreement is unenforceable.").

241. *McDonald*, 114 B.R. at 1001.

holding rests.

(a) In Illinois an Attorney May Contract for Any Retainer Agreement Without Restraint

"Illinois recognizes the general rule of freedom of contract with respect to attorney's fees."[242] Therefore, the *McDonald* court inferred that an attorney in Illinois can contract for an advance fee that is to be deposited into the lawyer's personal account and that is denominated nonrefundable.[243] In support of its analysis, the court cited *Estate of Harnetiaux v. Hartzell (In re Estate of Harnetiaux)*.[244] That case, which involved the propriety of a contingent fee in a wrongful death case, not only does not support the proposition for which the *McDonald* court cited it, but in fact stands in opposition to that proposition. Nowhere did the *Harnetiaux* court state or suggest that Illinois law recognizes a special rule for lawyers that validates nonrefundable retainers; nor did the court state or suggest that advance fee payments are not funds of the client that can be deposited to the lawyer's account. Furthermore, *Harnetiaux* neither stated nor suggested that the bargain between a lawyer and client ousts the court's authority to superintend attorney fees.[245] Indeed, Illinois law is to the contrary.[246] As

242. *Id.* (citing Estate of Harnetiaux v. Hartzell (*In re* Estate of Harnetiaux), 234 N.E.2d 81, 84 (Ill. App. Ct. 1968)).

243. The *McDonald* court's position that attorney fees are regulated according to general contract law and not fiduciary law is even less credible when applied to an attorney-client bargain for bankruptcy services. The about-to-be bankrupt client's need for fiduciary protection is paramount. The attorney can afford the time necessary to create a truly bargained-for agreement because the attorney's position is as strong on the first day of negotiations as it is on any hypothetical future date. By contrast, an insolvent debtor on the precipice of having his assets attached and petitioning the bankruptcy court for protection lacks the time to negotiate in earnest with the attorney. The debtor may not have the time necessary to screen the market for competitors that a plaintiff would have in a traditional contract or tort case in which the statute of limitations is measured in years. In this respect an insolvent party has the same problem in retaining counsel at a competitive rate that a trustee has in receiving market value at a bankruptcy liquidation sale. Attorneys, in the aggregate, are aware of the client's inability to search for other fee bids just as the bidders at a liquidation auction are aware that the trustee cannot delay the auction to seek additional bids. Although it is beyond the scope of this Article to explain the phenomenon, it is a maxim of the bankruptcy bar, and lay persons alike, that the trustee rarely realizes full value in a liquidation sale. In negotiations both parties have a time premium when they are in roughly equal bargaining positions. If one party's position will diminish considerably in a short time, however, and both the second party and other market participants know this, the party with the time premium will exact a better bargain than the first party would have yielded had the first party not been in an attenuated position.

244. 234 N.E.2d 81 (Ill. App. Ct. 1968).

245. The "freedom of contract with respect to attorney's fees," *McDonald*, 114 B.R.

noted in another opinion cited by the *McDonald* court, the freedom of contract provision does not oust the Illinois courts' authority to superintend attorney fees.[247] Moreover, the *Harnetiaux* court characterized the contingent fee contract in that case as "reasonable,"[248] thus indicating that it was superintending the fee and belying any argument that the general rule of freedom of contract displaces an Illinois court's inherent authority to regulate attorney fee agreements.

(b) The Illinois State Bar Association Has Approved Advance Payment Retainers

In addition to its misplaced reliance on Illinois case law, the *McDonald* court also relied on two opinions of the Illinois State Bar Association.[249] However, the opinions of the Illinois State Bar Association are not the law of Illinois; they are merely the self-interested statements of a trade association that represents lawyers, and they do not carry the imprimatur of either the state's legislature or its courts.

Illinois State Bar Association Opinion 703[250] provides that advance fee payments are not funds of the client under Disciplinary Rule 9-102

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at 1001, in Illinois is nothing more than a version of the recodified Field Code that repealed fee bills and allowed lawyers and clients to bargain over fees. As previously noted, the language used in repealing the fee bills was not intended to oust the courts' longstanding supervisory powers over lawyers' fees and lawyers' fiduciary responsibilities. *See supra* note 162 and accompanying text. For an analysis of the development of lawyers' fiduciary obligation to clients, see Brickman, *Contingent Fees*, *supra* note 7, at 45 n.66.

246. *In re* Teichner, 470 N.E.2d 972 (Ill. 1984) (holding that fees that are advanced to cover future work remain property of the client and must be kept separate from attorney funds and that the reasonableness of contingent fee contracts are always subject to the scrutiny of the courts) (citing ILLINOIS CODE OF PROFESSIONAL RESPONSIBILITY DR 2-106 (1970); Pocius v. Halvorsen, 195 N.E.2d 137 (Ill. 1964)), *cert. denied*, 470 U.S. 1053 (1985).

247. In *In re* Kutner, 399 N.E.2d 963 (Ill. 1979), the Illinois Supreme Court explained:

> Respondent's argument, as we interpret it, is that attorney-client fixed-fee agreements, when freely entered into, are not subject to scrutiny by a disciplinary committee and may not form the basis for disciplinary action against an attorney. Rather, respondent contends that any dispute over a fixed fee must be resolved based on traditional contract principles in a court of law. In support of this argument, respondent cites *Sokol v. Mortimer* (1967), 81 Ill.App.2d 55, 225 N.E.2d 496. The *Sokol* case, however, is inapposite. It merely stands for the proposition that attorney-client fee arrangements are not presumptively fraudulent.

Id. at 964.

248. *Harnetiaux*, 234 N.E.2d at 84.

249. *In re* McDonald Bros. Constr., Inc., 114 B.R. 989, 1001 (Bankr. N.D. Ill. 1990).

250. Illinois State Bar Ass'n, Op. No. 703 (Nov. 24, 1980).

unless they are expressly so designated in writing.[251] However, the Opinion also provides that "[i]f . . . a dispute should arise as to the fee payable, the funds should be kept segregated in the lawyer's special trust account."[252] This no doubt represents an attempt to accommodate to the protection afforded to the client in Disciplinary Rule 9-102(A)(2) of the Model Code, which allows the lawyer to withdraw funds that constitute the lawyer's fee from the trust account unless the fee "is disputed by the client, in which event the disputed portion shall not be withdrawn until the dispute is finally resolved."[253]

The inanity of Opinion 703 therefore is exposed. If a client pays a fee in advance, the Illinois attorney is to deposit it to the attorney's own account. But if a dispute arises over the fee, the attorney is required to keep the funds in the client trust account. If the funds are already in the lawyer's account, however, is the attorney to take the funds out and deposit them to the client trust account? If so, then the advance fees remain the functional equivalent of funds of the client despite their contrary characterization. If the attorney is not required to transfer the funds from the personal account to the trust account if the fee is disputed, then the "if . . . a dispute should arise" language of Disciplinary Rule 9-102(A)(2) is rendered nugatory.

Like Opinion 703, Illinois State Bar Association Opinion 722[254] is something less than a model of clarity and is self-contradictory. It stated that an advance payment can be denominated nonrefundable but only "as long as the fee is not excessive."[255] Under Illinois law a client who discharges an attorney can recover any part of an advance payment that the attorney has not earned by performance at the time of discharge.[256] Therefore, if the attorney seeks to keep the advance fee

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251. *Id.* at 3.

252. *Id.*

253. MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 9-102(A)(2) (1980). The Illinois rule in effect at the time provided: "The portion of funds deposited in accounts described in Rule 9-102(A) belonging to the lawyer or law firm may be withdrawn when due, after reasonable notice to the client of a intention to withdraw, unless the right of the lawyer or law firm to receive it is disputed by the client, in which event the disputed portion shall not be withdrawn until the dispute is finally resolved." Ill. S. Ct. R. 9-102.

254. Illinois State Bar Ass'n, Op. No. 722 (Apr. 30, 1981), *reprinted in* ILL. B.J., Aug. 1981, at 782.

255. *Id.*

256. *See* Simon v. Auler, 508 N.E.2d 1102 (Ill. App. Ct.), *appeal denied*, 515 N.E.2d 127 (Ill. 1987).

> A client who has executed a retainer contract and paid a substantial retainer fee to an attorney must be able to recover a portion of the retainer fee upon discharging the attorney after he has performed only a small amount of work. A contrary holding would seriously infringe upon the client's right to discharge the attorney at will and unjustly penalize the client for exercising that right.

Id. at 1004.

for work that the attorney has not done, the fee necessarily is excessive.[257] As if to emphasize its double speak, Opinion 722 stated:

> In ISBA Opinion 432, this Committee held that it is proper for a lawyer to make a contract for professional services which provides that a substantial retainer deposit with the lawyer may be retained no matter how much work the lawyer does in the case, provided the [retainer is not excessive]. . . .
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> . . . . . . [W]e also stated that a lawyer was not entitled to retain funds advanced by a client for time never spent by the law firm, even though the law firm might stand ready to perform.[258]

So in Illinois, the bar association has opined that it is ethical for a lawyer to provide that an advance fee payment is nonrefundable, but if the client discharges the lawyer before the work is completed, the *nonrefundable* advance fee payment is *refundable* to the extent of the uncompleted work. In short, according to the Illinois State Bar Association, nonrefundable retainers are refundable.

(4) State Law and a Uniform Federal Bankruptcy Law

Even if the *McDonald* court's characterization of Illinois law is correct, the court's opinion should still be rejected. According to the *McDonald* court, "there can be no uniform rule as to whether fee applications are required in order for debtors' counsel to use a pre-petition retainer."[259] Rather, whether an advance fee payment is subject to the requirements of sections 330 and 331 is a matter of "state law, rather than the Code."[260] Thus, the court argued, "It has long been recognized that 'Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law' and that 'state laws are . . . suspended only to the extent of actual conflict with the [bankruptcy] system.' "[261]

Although Congress has allowed states to strike different balances

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257. *See* Arens v. Committee on Professional Conduct, 820 S.W.2d 263 (Ark. 1991).

> If a lawyer charges a reasonable [nonrefundable] retainer and is retained for the purpose of providing specified services, but never performs those services, the fee charged would become unreasonable. Just as a lawyer cannot bill a client for work he has never performed in the past, a lawyer cannot bill a client for work he will never perform in the future.

Id. at 264.

258. Illinois State Bar Ass'n, Op. No. 722 (Apr. 30, 1981), *reprinted in* ILL. B.J., Aug. 1981, at 782, 786.

259. *In re* McDonald Bros. Constr., Inc., 114 B.R. 989, 996 (Bankr. N.D. Ill. 1990).

260. *Id.* at 997.

261. *Id.* at 996 (brackets supplied by court) (quoting Butner v. United States, 440 U.S. 48, 54 & n.9 (1979)).

between the interests of debtors and creditors,[262] it has not indicated an intent to permit variances among the states on whether sections 330 and 331 apply to advance fee payments to attorneys. To the contrary, congressional intent is clear: "Payments to a debtor's attorney provide serious potential for evasion of creditor protection provisions of the bankruptcy laws, and serious potential for overreaching by the debtor's attorney, and should be subject to careful scrutiny."[263] Thus, contrary to the *McDonald* court, the attorney fee regulatory scheme set forth in the Code is not subject to the vagaries of fifty states' law and the opinings of a hundred bar associations.

Because the debtor is vulnerable to overreaching by attorneys and because the debtor's attorney represents not only the interests of the debtor but also the interests of the estate's unsecured creditors, Congress does not allow attorneys to bargain freely with debtors, and bankruptcy courts have the authority to supervise and remake their fee agreements.[264] As one court stated:

> 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.
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> . . . .
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> . . . [F]ees in bankruptcy cases are not entirely a matter of contract between counsel and client, and by statute any such agreement, and therefore the terms of the [fee agreement], are subject to review, modification, and outright cancellation by the Court. Any such agreement is nothing more than a framework for an award by the Court, with whom decisions concerning extent and frequency of compensation are squarely and solely placed. Consequently, the terms of the [fee agreement] are determined by statute and by the sound exercise of the Court's discretion. The relevance and impact of any agreement

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262. For example, each state has its own exemption laws, including the ubiquitous homestead exemption, that exempt certain property from the claims of creditors.

263. H.R. REP. No. 595, 95th Cong., 2d Sess. 329 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6285; S. REP. No. 989, 95th Cong., 2d Sess. 39 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5825 (setting forth the legislative history of § 329).

264. Freedom of contract is necessarily limited in the bankruptcy context. Bankruptcy counsel and debtors are not at liberty to bargain away the rights and responsibilities of a debtor-in-possession, nor the protections afforded creditors and other parties in interest in a bankruptcy case, under the guise of freedom of contract. They cannot evade the jurisdiction of the Court by choice, nor limit exercise of the Court's discretion by fiat. They cannot negate or defer application of the Bankruptcy Code and Rules by design. A prepetition agreement between counsel and a prospective debtor-in-possession which purports to do any of these things cannot be considered reasonable and cannot be condoned as such in a Chapter 11 case.

In re NBI, Inc., 129 B.R. 212, 225 (Bankr. D. Colo. 1991).

between debtor and counsel are accordingly limited.[265]

By finding that an attorney and debtor can unilaterally contract for a compensation agreement that transfers the debtor's property prior to bankruptcy, the *McDonald* court has significantly departed from the spirit and the letter of the Bankruptcy Code. *McDonald* would allow parties, by contract, to circumnavigate the express intent of Congress.[266] Under section 330 of the Bankruptcy Code[267] attorneys must apply to the Court to receive compensation for services that they already have rendered. Congress enacted section 330 because it is only *after* the attorney has performed the services that a court can decide whether the fee charged was "reasonable" and whether the services performed were "actual, necessary services" that benefitted the bankruptcy estate.[268] Congress placed the burden of proving the reasonableness of the fee on the attorney.[269] By allowing the parties to contract out of the fee application process, the *McDonald* court sought to dispense with the requirements of section 330.

The only court scrutiny that an advance fee would receive under *McDonald* is an after-the-fact disclosure under section 329.[270] Under that section the court, on its own motion or on motion of any party,[271]

265. *In re* Chapel Gate Apartments, Ltd., 64 B.R. 569, 574-75 (Bankr. N.D. Tex. 1986). In *McDonald* the court could cite no cases that agreed with its logic or holding. However, in reaching its conclusion, the *McDonald* court rather disingenuously cited the *Chapel Gate* case for the proposition that it was "setting forth a retainer agreement in which it is stated that the retainer is 'fully earned and nonrefundable upon its payment and receipt' and that the client 'will be entitled to services to be provided by this firm at the hourly rates specified . . . up to the full amount of the retainer.'" *In re* McDonald Bros. Constr., Inc., 114 B.R. 989, 1000 (Bankr. N.D. Ill. 1990) (quoting *Chapel Gate*, 64 B.R. at 579). However, the *McDonald* court neglected to cite *Chapel Gate*'s holding in which the court stated, "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." *Chapel Gate*, 64 B.R. at 574.

266. The fact that § 328(a) of the Bankruptcy Code includes the term "retainer" does not mean that any fee agreement that an attorney and client agree upon and call a retainer is therefore reasonable and within the Code's parameters. *In re* NBI, Inc., 129 B.R. 212, 222 (Bankr. D. Colo. 1991). "The Court, in its discretion, must make this determination." *Id.* (citing *In re* Leff, 88 B.R. 105 (Bankr. N.D. Tex. 1988)).

267. 11 U.S.C. § 330 (1988).

268. *Id.*; *see also In re* James Contracting Group, Inc., 120 B.R. 868, 872 (Bankr. N.D. Ohio 1990) (holding that legal services must have benefitted the estate to be compensable).

269. "When a fee application comes before the court, the burden of proof of the reasonableness of the fee request is on the applicant. The standard of proof is 'preponderance of the evidence.'" *James Contracting*, 120 B.R. at 872 (citations omitted).

270. 11 U.S.C. § 329 (1988).

271. BANKR. R. 2017.

can review any fees paid[272] to the debtor's attorney during the year prior to the bankruptcy filing, and if a court finds the fee "excessive," it can order the fee returned to the estate or to the entity that paid it.[273]

The burden of proof is not on the attorney under section 329, as it is under section 330. Under section 329 the burden of proof is on the party who seeks to have the attorney fee struck as excessive. The burden on the moving party is a high one; some courts hold that the fee must "shock the conscience" of the court for it to be "excessive."[274]

(5) Section 329 Countenances Advance Fee Payments

A possible argument that *McDonald* did not advance in support of its position is contained in section 329:

> (a) Any attorney representing a debtor in a case under this title, or in connection with such a case, whether or not such attorney applies for compensation under this title, shall file with the court a statement of the compensation *paid* or *agreed to be paid*, if such payment or agreement 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, and the source of such compensation.
>
> (b) If such compensation exceeds the reasonable value of any such services, the court may cancel any such agreement, or order the return of any such payment, to the extent excessive . . . .[275]

Because section 329 addresses compensation for services "to be rendered," and provides for the cancellation or modification of agreements to render future services, it can be argued that advance fee payments are not within the parameters of sections 330 and 331. Indeed, section 329 can be read to infer that a payment in advance for services to be rendered is an exchange of "reasonably equivalent value," and therefore not avoidable under section 548.[276] It is possible and more plausible, however, to read section 329 in a manner that is consistent

272. The court also can examine promises to pay fees in the future that are made prior to the petition's filing. 11 U.S.C. § 329(a) (1988).

273. *Id.* § 329(b).

274. Moshein v. Beverly Crest Convalescent Hosp., Inc. (*In re* Beverly Crest Convalescent Hosp., Inc.), 548 F.2d 817, 821 (9th Cir. 1976) (stating that under the predecessor statute to the Act, the fee must "shock the conscience" of the court); York Int'l Bldg., Inc. v. Chaney (*In re* York Int'l Bldg., Inc.), 527 F.2d 1061, 1068-69 (9th Cir. 1975); *In re* D.L.I.C., Inc., 120 B.R. 348, 351 (Bankr. S.D.N.Y. 1990) (stating that the party who objects to the attorney fee has the burden of proof).

275. 11 U.S.C. § 329 (1988) (emphasis added).

276. *Id.* § 548(d)(2)(A); *see supra* notes 195-98, 200-05 and accompanying text.

with sections 330, 331, and 548. The critical phrases in section 329 are:

(1) "a statement of the compensation paid," or
(2) compensation "agreed to be paid,"
(3) "for services rendered," or
(4) for services "to be rendered."[277]

The proper reading of section 329, and one that is consistent with other Code sections, is that the attorney must provide a statement of (a) compensation paid for services rendered, (1) and (3) above, and (b) compensation agreed to be paid for future services, (2) and (4) above; and not (c) compensation paid for future services, (1) and (4) above. This reading rejects the conclusion that section 329 renders sections 330, 331, and 548 inapplicable to advance payments for future services.

b. In re D.L.I.C., Inc.

The court in *In re D.L.I.C., Inc.*[278] quickly accepted and exceeded the invitation-by-example that the *McDonald* court extended to fashion another special rule for lawyers. In *D.L.I.C.* unsecured creditors objected to a $17,000 advance fee payment.[279] *McDonald*, having vitiated sections 330 and 331, only partially vitiated section 329—leaving the option to challenge the excessiveness of the advance fee payment to any interested party but declining "in the absence of any challenge to . . . inquire further" sua sponte.[280] The *D.L.I.C.* court went a step further and did to section 329 what *McDonald* did to sections 330 and 331.

A closer look at the arguments of the *D.L.I.C.* court reveals incorrect interpretations of the Code, bar association opinions, and ethics laws, *ala* those of the *McDonald* opinion. In *McDonald* the court found that under state law the advance fee was to be deposited into the attorney's account rather than into the client security account; thus the advance fee was not funds of the estate for the purposes of sections 330 and 331.[281] The *D.L.I.C.* court held that this reasoning also applies to section 329 and therefore puts the issue of excessiveness as per section

277. 11 U.S.C. § 329(a) (1988).

278. 120 B.R. 348 (Bankr. S.D.N.Y. 1990).

279. This type of action, which was brought by the unsecured creditors rather than the debtor in possession, illustrates the inherent conflict of interest that is created when a debtor makes a prepetition advance payment. The debtor in possession, who, as the debtor, originally employed the attorney, is not likely to oppose the employment contract to which it was a party, even though the debtor in possession has this duty as a fiduciary of the bankruptcy estate.

280. *In re* McDonald Bros. Constr., Inc., 114 B.R. 989, 1003 (Bankr. N.D. Ill. 1990).

281. *Id.* at 1002.

329 beyond the purview of a bankruptcy court when the advance fee payment is found not to be funds of the estate.[282] Indeed, the court read the statute in a way that would never allow a challenge to an advance fee payment based upon excessiveness.[283]

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282. *D.L.I.C.*, 120 B.R. at 350. "The critical question in this case is whether or not the retainer which the debtor paid to its attorneys should be regarded as property of the estate as expressed in 11 U.S.C. § 329(b)(1)(A)." *Id.* The court dismissed the case because the objecting creditors offered insufficient evidence on the terms of the agreement and how the attorneys treated the payment for the court to determine whether the payment was property of the estate.

283. Before addressing whether the fee was excessive, the court concocted a threshold issue and stated that the creditors must show, as a prerequisite to an examination of the reasonableness of the fee, that the fee was in fact property of the estate. *Id.* at 351. The court stated that this requirement is necessary because § 329(b)(1)(A) allows return of the fee payment to the estate *only* if "the property transferred would have been property of the estate." 11 U.S.C. § 329(b)(1)(A) (1988). The court concluded that the advance payment must be "property of the estate," as defined in § 541, 11 U.S.C. § 541 (1988 & Supp. II 1990), before the court can examine it. Section 541(a) defines those property interests of the debtor that pass into the bankruptcy estate at the commencement of the case. The basic rule is that only those property interests that the debtor held as of the commencement of the case become property of the estate. *Id.* § 541(a)(1)-(2) (1988). However, § 541(a)(3) states that property of the estate also includes "[a]ny interest in property that the trustee recovers under section 329(b)." *Id.* § 541(a)(3).

Inexplicably, and in contravention of the statute, the court dismissed the unsecured creditor's challenge.

> [T]he court is unable to determine that the prepetition retainer which the debtor paid to its attorneys before the Chapter 11 case was commenced should be regarded as property of the estate within the meaning of 11 U.S.C. § 541.
>
> . . . [T]he objecting creditors have not presented sufficient facts for this court to sustain their objection, which is dismissed for lack of evidence as to whether or not the prepetition retainer should be regarded as property of the estate.
>
> . . . .
>
> . . . [T]he prepetition retainer which the debtor paid to its attorneys, which was disclosed in accordance with 11 U.S.C. § 329(a) may be refunded as excessive only if such retainer fee would have been property of the estate as stated in 11 U.S.C. § 329(b)(1)(a).
>
> Because the objecting creditors have not established that the prepetition retainer which the debtor paid to its attorneys should be regarded as property of the estate, within the meaning of 11 U.S.C. § 541, it follows that their objection on the ground of excessiveness is hereby dismissed.

D.L.I.C., 120 B.R. at 351-52.

The court required the objecting creditors to show that the fee was property of the estate, as defined in § 541 and which includes "[a]ny interest in property that the trustee recovers under section 329(b)." 11 U.S.C. § 541(a)(3) (1988). However, the court refused to allow the creditors to recover the fee under § 329 until they showed that the property was already within § 541. This is a problem of existential dimension because the *D.L.I.C.* court has established a circular argument under which there can never be a § 329 recovery.

Obviously, the statute was not designed to work this way; it otherwise would have no

Like *McDonald*, the *D.L.I.C.* court based its arguments on a faulty reading of state law—this time the law of New York rather than Illinois—and concluded that advance payments can be deposited into the attorney's account. As in *McDonald*, the *D.L.I.C.* court used a bar association opinion, Opinion 570 of the Committee on Professional Ethics of the New York State Bar Association,[284] as the basis for its determination of state law.[285] If Opinion 570 were merely a weak reed, the court's sole reliance on the opinion would be as objectionable as *McDonald*'s reliance on Illinois Bar Association Opinions. Opinion 570 is, however, a broken reed.[286] Its textual interpretations of the Code of Professional Responsibility are illogical, inconsistent with other Code of Professional Responsibility provisions, and irrelevant.[287] Opinion 570's policy goals were professionally irresponsible,[288] as was its rejection of fundamental principles of fiduciary law.[289]

In an attempt to rival *McDonald*, the *D.L.I.C.* court made its own contribution to the obfuscation of attorney-client retainer agreement law. Thus, it created another form of retainer agreement: The "flat fee retainer," which, according to the court, "covers all services to be rendered by the attorneys for the debtor in a bankruptcy case and [is] not

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effect at all. Section 329 merely requires that the judge review the fee for excessiveness. Section 329(b) was set up to ensure that the proper payor receives a refund if the fee payment is excessive. The structure of § 329(b) indicates that if an advance fee payment is judged excessive, the judge, in remedying the situation, can return the fee either to "the estate," *id.* § 329(b)(1), or to "the entity that made such payment," *id.* § 329(b)(2). The legislative history of § 329 states:

> Subsection (b) permits the court to deny compensation to the attorney, to cancel an agreement to pay compensation, or to order the return of compensation paid, if the compensation exceeds the reasonable value of the services provided. The return of payments already made are generally to the trustee for the benefit of the estate. However, if the property would not have come into the estate in any event, the court will order it returned to the entity that made the payment.

S. REP. No. 989, 95th Cong., 2d Sess. 39-40 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5825; H.R. REP. No. 595, 95th Cong., 1st Sess. 329 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6285-86.

284. New York Comm. on Professional Ethics, Op. 570 (June 7, 1985).

285. *D.L.I.C.*, 120 B.R. at 350-51.

286. It is doubtful that any bar association ethical opinion has ever been so thoroughly discredited in the literature as New York Opinion 570. *See* Brickman, *Advance Fees*, *supra* note 144, at 654-75. The senior author of this Article was a member of the committee that rendered New York Opinion 570.

287. *Id.* at 656-66.

288. *Id.* at 667-70.

289. *Id.* at 672-73. By virtue of its intense self-interestedness, New York Opinion 570 is strong support for the argument made in Part VI(B)(2)(a)(ii)(4) that the Bankruptcy Code should provide uniform treatment for advance fee payments and attorney fee applications. *See supra* notes 259-74 and accompanying text.

regarded as belonging to the debtor after payment is made."[290] By making the advance paid flat fee nonrefundable, the court apparently has imported elements of the general retainer into the flat fee potpourri. There is no such thing as the flat fee retainer drafted by the *D.L.I.C.* court. Of course, an attorney and a client can agree on a flat fee for certain work, rather than an hourly rate or contingent fee. However, if a flat fee is negotiated and paid in advance, it is really a special retainer advance fee payment and is therefore indistinguishable from a special retainer advance fee payment for work to be done on a hourly basis. A client who pays a flat fee is paying for actual legal services to be rendered and not merely for the attorney's availability as is the case under a true general retainer. The flat fee therefore is refundable. An attorney who has received an advance flat fee payment is relegated to quantum meruit if the client discharges the attorney before the attorney completes the services required by the contract.[291]

The *D.L.I.C.* court may have gone even further than simply holding that advance fee payments are substantially insulated from section 329 under New York law. Although its full effect is unclear, *D.L.I.C.* may have created a second unsustainable burden, not only in New York but in every state, for creditors or other parties in interest who contest the excessiveness of an advance fee payment under section 329. Consider the following language:

> In the instant case [when creditors are contesting the advance fee payment], there was no evidence as to whether or not the retainer agreement was written or verbal, nor was there any evidence as to what the parties intended when the debtor advanced the prepetition retainer funds to the attorneys for the debtor. Moreover, there was no evidence as to how the attorneys treated the funds, in which account they deposited the money, whether or not the objecting creditors challenged the debtor's attorneys' treatment of the retainer or that such treatment was improper. Accordingly, the court is unable to determine that the prepetition retainer which the debtor paid to its attorneys before the Chapter 11 case was commenced should be regarded as property of the estate within the meaning of 11 U.S.C. § 541.[292]

Because the information that the court found necessary to sustain the creditors' burden was solely in the possession of the attorney—a party adverse to the creditors' claims—and because the failure of the creditors to present this unavailable information to the court necessitated dismissal of their action, it appears that under *D.L.I.C.* general creditors cannot contest the excessiveness of advance fee payments.

290. *In re* D.L.I.C., Inc., 120 B.R. 348, 350 (Bankr. S.D.N.Y. 1990).
291. *See* Brickman & Cunningham, *supra* note 5, at 155-56.
292. *D.L.I.C.*, 120 B.R. at 351.

VII. CONCLUSION

The regulation of lawyers' fees in bankruptcy proceedings is following much the same pattern that other societal efforts to regulate attorney fees have followed: determined resistance from the bar followed by societal acquiescence. The Bankruptcy Code's adoption significantly vitiated the strict fee regulations of the Bankruptcy Act. The Code's regulatory scheme, embodied in sections 329 and 331, however, continues to require judicial superintendence of lawyer fees. These surviving regulatory provisions are now under attack from the bankruptcy bar, and in *McDonald* and *D.L.I.C.* the assault on regulation prevailed. According to these decisions, lawyers, and only lawyers, can use advance fee payments to escape judicial scrutiny of their fees.

This Article attempts to check the assault on the lawyers' fee regulatory apparatus. By engaging in a close analysis of the *McDonald* and *D.L.I.C.* decisions, and in particular the courts' tortured rendering of retainer law and misconstruction of relevant Bankruptcy Code provisions, our intent is to demonstrate not only the policy implications of these decisions but also the unacceptability of their analyses.

Putting the quietus to *McDonald* and *D.L.I.C.* may blunt the assault for a while, but the history of bar resistance to attorney fee regulation indicates that the assault likely will resume. Advance fee payments seem likely to be the centerpiece of any renewed effort to surmount the Code's regulatory scheme. In this Article we have suggested that the Bankruptcy Code may well prohibit advance fee payments.[293] Even if advance fee payments are not prohibited, however, their use raises significant policy questions.

A. *Advance Fee Payments Are Disfavored Under the Code*

It is evident from the structure and legislative history of the Bankruptcy Code that Congress prefers that bankruptcy courts measure the value of lawyer services and award attorney compensation after the attorney has performed the services because only after the attorney has rendered services can the worth of such services be known.[294] The use

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293. To recapitulate, accepting a prepetition retainer creates a potential § 548 fraudulent transfer. The debtor, in return for valid consideration, receives only a promise of future services. Unlike a contract for insurance that stretches into the future, an advance fee contract requires substantial future performance from the attorney. A prepetition retainer payment given in exchange for work that the attorney promises to do in the future would appear to be a transfer of the debtor's money for an "unperformed promise to furnish support in the future," and therefore not for "value." 11 U.S.C. § 548(d)(2)(A) (1988); *see supra* notes 193-96, 198-202 and accompanying text.

294. Under §§ 330 and 331, an attorney can receive compensation only after the

of advance fee payments works against this congressional goal and the spirit and letter of the Code.

B. Advance Fee Payments Are Inefficient

A bankruptcy schema that encourages debtors to pay their attorneys prior to a court award of compensation and later requires the court or other party to assert a claim against the attorney to recapture the payment wastes both the court's and the parties' resources. More than the parochial interests of attorney and client are at stake in adjudging the efficiency of advance fee payments in bankruptcy. It is detrimental to the economy to allow attorneys to carve out and set aside some of the debtor's assets prior to the attorney's performance of legal services and the genesis of a fixed claim against the estate's assets. Prepetition retainers sap vital capital from the debtor when it is most needed. Once the automatic stay takes effect, debtors should be able to use their capital to meet new obligations and should not have to worry about the satisfaction of prepetition obligations. If attorneys tie up that capital, however, it hinders the debtors' ability to meet the rigid payment requirements that suppliers often impose on insolvent customers and the new obligations incurred during the reorganization. The practice of quarantining debtor assets benefits only attorneys. The myriad other parties interested in the debtor's financial turnaround, including creditors, suppliers, and customers, are adversely affected by this practice.

C. Conflicts of Interest

Prepetition retainers create a host of conflict of interest problems. It is a maxim of the legal profession that an attorney and client must be united in interest. In the bankruptcy context the estate's attorney represents not only the debtor in possession but also the interests of the unsecured creditors. In order to fulfill the duty to maximize the estate's assets for the benefit of unsecured creditors, the attorney must act as an antagonist to parties that hold security interests in the debtor's property. The existence of a potentially fraudulent transfer

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work has been done. This is necessary because it is only at that time that the value of the attorney's services to the estate can be known and examined. The court can grant only "reasonable compensation for actual, necessary services." 11 U.S.C. § 330(a)(1) (1988). The court can grant interim compensation only for "services rendered before the date of" the application for interim compensation. *Id.* § 331; *see also* S. REP. No. 989, 95th Cong., 1st Sess. 40-42 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5826-28; H.R. REP. No. 595, 95th Cong., 2d Sess. 329-31, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6286-87 (describing factors used to determine reasonable compensation).

mandates that the estate's attorney pursue the property interest that is transferred. However, if the estate's attorney is the transferee, the attorney must counsel the debtor in possession or trustee on whether the bankruptcy estate should pursue a claim against the attorney's own property—an obviously untenable position. The conflict is acute because in practice the attorney is more than just an agent for the client. The debtor in possession, often a business with experienced management, must focus on winning back suppliers and customers. Debtors in possession rely on their attorneys to think for them on legal matters. The parties whose interests suffer are the unsecured creditors because although the debtor in possession wants to maximize the estate's assets, it rarely shares the zeal of the unsecured creditors—those who are most at risk.[295]

A similar conflict would arise if the attorney had a property interest that was *potentially* a claim under sections 329, 544, 547 or other similar provisions. The mere possibility of a valid claim is enough to create a potential conflict of interest and adversely affect the attorney's fiduciary duty to the client.

Moreover, if the applicable state law permits the deposit of unearned funds into the attorney's office account, the debtor's property becomes subject to the attorney's creditors. Considering the Bankruptcy Code's overwhelming concern for the interests of debtors and

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295. The debtor in possession (or trustee) has, in the first instance, the right to invoke § 548(a) or 544(b); this right belongs to the estate and not to any one creditor. Creditors may bring a derivative suit, but must first demonstrate to the court that the debtor/trustee has shirked his duty. *In re* Xonics Photochemical, Inc., 841 F.2d 198 (7th Cir. 1988).

In Chapter 11 cases the appointment of an unsecured creditors committee is mandatory. 11 U.S.C. 1102 (1988). However, in practice, there is often no creditors committee or no active creditors committee, particularly in small cases. 1 BANKR. LAW. EDITION § 41:9 cmt., at 9 (1987).

The primary duty of the creditors committee is to negotiate the terms of a plan of reorganization, not to involve itself with the day-to-day operations of the estate. *In re* Structurlite Plastics Corp., 91 B.R. 813 (Bankr. S.D. Ohio 1988). Creditors committees have been permitted to intervene in an adversary proceeding to bring an action to recover preferences and fraudulent transfers when it could be shown that the trustee had failed to do so. *In re* Philadelphia Light Supply Co., 39 B.R. 51 (Bankr. E.D. Pa. 1984) (holding that it is unreasonable to expect a debtor to zealously prosecute its own president to recover a preference).

The threshold issue for creditors committees under these circumstances is whether they have standing to proceed. Fuel Oil Supply & Terminaling v. Gulf Oil Corp., 762 F.2d 1283 (5th Cir. 1985). Once standing is established, the creditors committee may ask the court to require the trustee/debtor in possession to bring the preference or fraudulent transfer action or allow the committee to bring the action itself. *In re* Evergreen Valley Resort, Inc., 27 B.R. 75 (Bankr. D. Me. 1983); Official Creditors' Committee v. Alloy Automotive Co. (*In re* Wesco Prods. Co.), 22 B.R. 107 (Bankr. N.D. Ill. 1982).

creditors, it is inconceivable that those interests should be jeopardized for the benefit of attorneys.[296]

Finally, while we have stated that security retainers as described in *McDonald* do not exist, assuming arguendo that they are valid, conflicts of interest again arise. Because the attorney presumably takes a security interest in the advance payment—a concept that we have derided, the attorney becomes a secured creditor of the estate. As a fiduciary of the bankruptcy estate, the attorney must decide whether to commence proceedings against the holder of the equitable interest—the attorney.

If the court recognizes the validity of security retainers and therefore the validity of the attorneys' security interest in the estate, it would thereby enable attorneys to elevate their dissolution priority from an administrative claim to a secured claim. When a bankruptcy case is converted from a Chapter 11 reorganization to a Chapter 7 dissolution, the Code, in order to facilitate the orderly administration of dissolution, requires that the Chapter 7 attorneys be paid before the Chapter 11 administrative claimants.[297] This provision encourages attorneys to take the case by helping to ensure that they will be compensated first out of the remaining unsecured assets. By taking a prepetition security interest in the fee, the Chapter 11 attorney circumvents the Code[298] and is satisfied ahead of the Chapter 7 attorney.

The policy arguments in opposition to the use of prepetition advance fee payments must be balanced against lawyers' economic interests in their use for purposes other than circumventing the regulatory scheme of sections 329 and 330. Representing insolvent clients involves risk. Moreover, bankruptcy lawyers complain that bankruptcy court fee regulation is highly uneven and idiosyncratic.

Lawyer complaints about the fee application process, if true, raise legitimate complaints that fall into four categories: (1) Lack of uniformity among bankruptcy judges about what tasks are compensable, (2) lack of uniformity about the permissible rates for compensable services, (3) uncertainty about whether sufficient assets will be available to pay attorney compensation once it is awarded, and (4) the minimum

296. In addition, because the debtor maintains a reversionary interest in the fee to the extent that it has not been earned, the bankruptcy estate has a property interest in the attorney's assets. *See supra* note 174.

297. 11 U.S.C. § 726(b) (1988). This provision might be thought of as a requirement to pay the undertaker before the doctor.

298. *Contra In re* K & R Mining, Inc., 105 B.R. 394, 397 (Bankr. N.D. Ohio 1989) (holding that attorneys who receive security interests in advance fee payments are to be treated as any other secured creditor of the bankruptcy estate, and therefore they have priority over administrative claims such as Chapter 7 attorney expenses) (quoting *In re* Burnside Steel Foundary Co., 90 B.R. 942, 944 (Bankr. N.D. Ill. 1988)).

120 day period that attorneys must wait before they can receive any compensation.

Caprice in matters of bankruptcy compensation should be addressed on a national basis. Uniformity would help alleviate the forum shopping engaged in by debtors' attorneys for their own benefit.[299] Bankruptcy attorneys allege that tasks which are compensable at a paralegal's rate in one venue are compensable at an associate's rate in another venue, and indeed, variance exists from judge to judge within the same district.[300] Bankruptcy fee regulations should be set out in detail sufficient to preclude these types of inequities. Detailed regulations, if they established uniform compensation rules and possibly uniform rates within each venue, would significantly ameliorate the bankruptcy practitioners' fears of being inadequately compensated for work that already has been completed and therefore reduce the attorneys' incentive to circumvent court supervision through creative prepetition

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299. Typically, forum shopping is done to secure an advantage for the client, *e.g.*, seeking a more favorable state law or a more debtor-oriented bankruptcy court. However, unlike forum shopping for the benefit of the client, the textual reference is to forum shopping for the benefit of the lawyer. If forum shopping for the benefit of the client is frowned upon by the legal community and those who make public policy, forum shopping for the benefit of the advocate is particularly objectionable. Indeed, because preserving the estate is in the interest of the debtor and its employees, creditors, equity holders, and customers, as well as society at large, searching for a forum that will allow the highest cost attorneys to service the estate conflicts with basic bankruptcy policies.

The search by bankruptcy professionals for forums that allow high-cost reimbursement for bankruptcy services has been documented in the bankruptcy reorganizations of many large publicly held companies. *See* Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large Publicly Held Companies*, 11 WIS. L. REV. 11, 33, 36-37 (1991).

It is interesting to note that although large American companies often have relocated to areas with lower labor costs, they nevertheless choose to petition for bankruptcy court protection in venues in which the cost of attorneys is known to be among the highest in the nation.

> When forum shopping occurred, the destination of choice was usually New York City. Even though none of the companies studied had substantial operations in New York City, thirteen of the forty-three cases studied (thirty percent) proceeded in New York City. In two additional cases (five percent), parties filed petitions in New York City in unsuccessful attempts to proceed there.

Id. at 29. Cases filed in New York City remained pending nearly five months longer than cases in other districts, despite the fact that the New York City cases were "considerably smaller" in number of employees, sales, and assets than cases studied in other venues. *Id.* at 31-34, nn.68-69.

300. The authors of this Article were informed by an attorney who practices in a venue with two bankruptcy judges that the judges have divergent views on what services can be performed by a paralegal and what services must be performed by a lawyer. Therefore, in the early stages of any case, at least until the judge is assigned, the attorney is uncertain whether to assign particular tasks to associates or paralegals so as to avoid performing work that might go uncompensated or undercompensated.

retainer agreements.[301]

Recognizing the economic realities of conducting a law practice and easing the bankruptcy professional's cash flow problems also would reduce the incentive to use prepetition retainer agreements. When first employed by a debtor, the attorney needs time to evaluate the debtor's options before the attorney can recommend that the debtor file a petition for bankruptcy. If a petition eventually is filed, however, the attorney could remain uncompensated for these services until, at a minimum, 120 days after the order for relief is granted.[302] Accordingly, attorneys should not have to wait the statutorily provided 120 days to apply for compensation.[303] Particularly at the beginning of the case, attorneys should be able to seek compensation for prepetition work no later than thirty days after an order for relief has been entered, and at ninety-day intervals thereafter.

The validity of lawyers' complaints about the actions of bankruptcy judges in superintending fees, however, is not a valid reason for the functional elimination of sections 329, 330, and 331 of the Code. Even if the problems faced by bankruptcy practitioners were completely ameliorated by these proposals, attempts to evade judicial scrutiny of attorney fees would no doubt continue. Indeed, *McDonald* and *D.L.I.C.* can be viewed, in a historical context, as simply attempts—noteworthy mainly for their lack of success—to create another special law for lawyers while at the same time permitting bankruptcy courts to shed their responsibility to supervise lawyers' fees.[304]

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301. Fee guidelines for bankruptcy professionals are under active consideration by bankruptcy courts and the regional offices of the United States Trustee. Barbara Franklin, *Passing Fee Inspection*, N.Y. L.J., May 14, 1992, at 5, col. 2. More specificity in fee applications and more uniform treatment of disbursements have resulted from guidelines issued in July 1992 by the Southern District of New York. *Id.*

302. *See* 11 U.S.C. § 331 (1988). Lawyers' fees presumably include an interest component as compensation for anticipated time delay.

303. *Id.* Attorneys may apply for interim compensation every 120 days. However, even if compensation is awarded, the attorney may not receive it for several weeks or even several months.

See Rick Dower, *Creditor Objects to Omni's Legal and PR Expenditures*, SAN DIEGO BUS. J., Aug. 14, 1989, at 5 (stating that an attorney demanded a large advance fee and justified the fee because he would not be able to obtain payment for at least 120 days, whereas for nonbankruptcy work, a smaller advance fee was requested because it would only have to cover a 30-day period).

304. *Sed quis custodiet ipsos custodes*? (But who would guard the guards themselves?) Juvenal, VI Satires line 347, *quoted in* J. BARTLETT, FAMILIAR QUOTATIONS 122 (E. Beck 15th ed. 1980).