UNITED STATES BANKRUPTCY COURT
DISTRICT OF MINNESOTA
THIRD DIVISION

In Re: CHAPTER 11

Pappy's Foods Company, Inc.,

Debtor. Bky. 3-91-6486

ORDER

This matter was heard February 11, 1993, on application of Rider, Bennett, Egan & Arundel (Rider) for final allowance of fees and expenses in connection with its former representation of the Debtor in the case; and, on motion of the Debtor for an order requiring disgorgement by Rider of all fees and expenses previously awarded and paid. Appearances are as noted in the record. The Court, having reviewed the voluminous material submitted by the parties in the form of pleadings, affidavits, depositions and exhibits, and being fully advised in the matter, now makes this ORDER pursuant to the federal and local Rules of Bankruptcy Procedure.

I.

Rider's employment by Pappy's Foods Company, Inc. commenced in the Fall of 1991 following the law firm's representation of Pappy's majority holders, Keith and Patty Warner. Donald Backstrom, a senior partner at Rider, received a referral of the Warners from Dorsey & Whitney. The Dorsey firm determined that it had a conflict of interest arising out of a contemplated capitalization effort for Pappy's that involved common clients of Dorsey & Whitney. Rider initially represented the Warners as shareholders of Pappy's, whose control of the company apparently was being challenged by minority holders.

Early in Rider's involvement with the Warners, it became apparent that the financial condition of Pappy's was a core problem that needed resolution in order to successfully address the Warners' concerns and to protect their interests. The Warners were guarantors of a substantial portion of Pappy's debt, and the company was in serious trouble. Poor financial condition of Pappy's led to the capitalization effort and threatened the Warners' continued control of the company.

Consequently, shortly after Rider became involved, its representation shifted from the Warners to Pappy's itself. Although initial efforts were directed at raising additional

capital and restructuring major debt without judicial process, the specter of reorganization under 11 U.S.C. Chapter 11 existed from the outset. Mr. Backstrom is a business attorney, who has had limited bankruptcy experience, and so with a shift in representation, Steven Kluz, another Rider partner, became active in the case. Mr. Kluz specializes in bankruptcy matters.

Pappy's was incorporated in 1982 and is in the business of producing frozen dough products for wholesale distribution to bakeries and for retail sale to the public through food stores. Pappy's expanded over the years through a series of acquisitions, including a purchase in 1991 from Super Valu of its bakery that had serviced Super Valu stores in the territory covered by what that company referred to as its Minneapolis region. As part of the transaction, Super valu entered into a separate agreement with Pappy's wherein it committed the Minneapolis region to purchase $3,000,000 per year of Pappy's product for three years following the sale of the bakery.

When Mr. Backstrom began representing the Warners in the Fall of 1991, he became aware of the Super Valu transaction, and he learned that Super Valu was $1.7 million short of its purchase commitment with Pappy's. Mr. Kluz also learned this when he became involved. Both Mr. Backstrom and Mr. Kluz knew that Rider represented Super Valu at that time on matters unrelated to Pappy's, pursuant to an historical attorney-client relationship of several years.

Neither the capitalization effort nor the informal debt restructuring attempt was successful. Pappy's filed for relief under 11 U.S.C. Chapter 11 on November 26, 1991. Rider applied for and received approval of employment as attorney for the Debtor-in-Possession shortly after the case was filed. The firm failed to disclose its attorney-client relationship with Super Valu in the application.

Initially, Keith Warner personally dealt with Super Valu management, seeking a business solution to the shortfall situation. Rider did not become openly involved in the matter until October 15, 1992. On that day, during a meeting with Super Valu senior management, Mr. Warner produced a letter addressed and written to him, at his request, by Ms. Julie Becker, a Rider associate. In the letter, dated October 14, Ms. Becker outlined the Debtor's fiduciary duties to the estate regarding the Super Valu dispute, including the obligation to litigate the matter if other reasonable attempts failed to produce a satisfactory resolution. Ms. Becker stated in the letter that, should litigation be necessary, special counsel would be required to represent Pappy's because Rider represented Super Valu in unrelated matters.

The letter was not well received by Super Valu. Among other responses, Super Valu questioned Rider's involvement in light of its own attorney-client relationship with the firm. Rider requested and received an opinion from the Minnesota Board of Professional Responsibility regarding its continued representation of Pappy's and concluded that it should withdraw as counsel for the Debtor. In the meantime, the Debtor retained its present counsel.

The Debtor seeks an order disallowing all fees and expenses to Rider, and requiring disgorgement of all compensation and reimbursement received from Rider's initial representation of Pappy's pre-petition through termination of its employment as attorney for the Debtor-in-Possession in the Chapter 11 case. The request is premised upon allegations that: Rider represented an interest adverse to the estate, due to Rider's attorney-client relationship with Super Valu, and was disqualified from employment under 11 U.S.C. Section 327; Rider failed to make the disclosures required by Rule 2014 of the Rules of Bankruptcy Procedure in connection with the application for employment; and, that circumstances warrant an order for disgorgement of post-petition receipts under 11 U.S.C. Section 328(c), and pre-petition receipts under 11 U.S.C. Section 329. Additionally, the Debtor seeks an award of $10,000 in damages, representing its costs in obtaining forced substitution of counsel.

Rider seeks allowance of final compensation, and review and approval of all fees and expenses previously awarded to it in the case. The firm argues that: its relationship with Super Valu did not disqualify Rider from representing the Debtor-in-Possession under 11 U.S.C. Section 327; failure to disclose pursuant to Rule 2014 was inadvertent and immaterial; and, with the possible exception of Ms. Becker's preparation and delivery of the October 14, 1992, letter, Rider carefully and appropriately conducted itself during the case to avoid any conflict that might have otherwise arisen from its attorney-client relationship with Super Valu.

III.

11 U.S.C. Section 327 provides that, with court approval, a debtor-in possession:

> [M]ay employ one or more attorneys . . . that do not hold or represent an interest adverse to its estate, and that are disinterested persons, to represent or assist the [debtor-in-possession] in carrying out the [debtor-in-possession's] duties under this Title.

Rule 2014 reads:

> An order approving the employment of attorneys . . . pursuant to Section 327 . . . shall be made only on application of the [debtor-in-possession]. . . The application shall state the specific facts showing the necessity of the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, the proposed arrangement for compensation, and to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, and any other party in interest [and their respective attorneys and accountants] . . .
>
> Fed. R. Bankr. P. 2014 (emphasis added).

The purpose of the statute is to preclude from employment on behalf of an estate, professionals who, either by their own direct relationship with the estate or their representation of others,

would have a conflict of interest as a result of the employment. The purpose of the Rule is to allow for the timely consideration and determination of conflict issues that might reasonably arise from an applicant's connections with a debtor or other parties who have an interest in a debtor or an estate.

The existence of a present attorney-client relationship with a party against whom the estate has a substantial claim, is a relationship that must be disclosed by an applicant under the Rule. Furthermore, such a relationship ordinarily constitutes the representation of an interest adverse to the estate, disqualifying an applicant from employment under 11 U.S.C. Section 327, even where the applicant does not represent the party in the matter relating to the estate.(Ftn1) See: In re Humble Place Joint Venture, 936 F.2d 814 (5th Cir. 1991).

Rider treats the Super Valu dispute as if it was a minor distraction in a much larger event.(Ftn2) Mr. Kluz claims that Mr. Warner was informed that Rider could not represent the Debtor regarding the matter and that Mr. Warner chose to represent the Debtor himself rather than retain special counsel.(Ft3) A $1.7 million dollar shortfall in the first year of a three-year annual $3 million dollar purchase commitment was a substantial problem for Pappy's.(4) The company sought relief under Chapter 11 because its operations did not positively cash flow and it had no significant reserves to cover the deficiency.

Rider's inability to represent the Debtor in the Super Valu matter sharply reduced the ability of Rider to represent the Debtor in the overall reorganization effort. Employment would not have been appropriate in the case, even if 11 U.S.C. Section 327 did not automatically preclude it.(5) Such employment was simply not in the best interests of the estate. Moreover, application of 11 U.S.C. Section 327, Rule 2014, and these other considerations should have been apparent to experienced business and bankruptcy counsel. Unfortunately, for some reason, these things were apparently overlooked. That is difficult to understand; so is Rider's apparent attitude in this proceeding.

Rider treats the actions and omissions of its senior and controlling partners in the matter as insignificant, and focuses the blame for this unfortunate situation on a junior associate and on a principal of the Debtor.(6) In its Memorandum in Support of Application, filed January 25, 1993, Rider points to Ms. Becker and Mr. Warner as the persons responsible for whatever might have gone wrong in Rider's representation of the Debtor. Rider relates the following:

> Although he understood Rider Bennett's position regarding Super Valu and had been advised of the need for separate attorneys, on October 12, 1992, Mr. Warner contacted Ms. Becker and asked her to attend a meeting with representatives of Super Valu for the limited purpose of answering any questions of Super Valu's representatives regarding the status of the bankruptcy proceeding and the duties and obligations of a debtor in possession and creditors' committee. She initially agreed and then

> decided, and Mr. Kluz agreed, that she could not. She immediately called Mr. Warner back and told him in no uncertain terms that she could not attend. He requested that she write a letter to him, generally describing the duties of the debtor in possession and creditors' committee with respect to claims, duties which she and Mr. Kluz had previously described to him generally. She prepared such a letter (perhaps erroneously, but in good faith) believing that she could do so as long as she did not evaluate or express any legal opinions on the claims against Super Valu. The letter described generally the nature of the duties and powers of a trustee, and indicated that a creditors' committee might assert a claim if the debtor did not. She also stated that the matter involving Super Valu should be resolved fairly soon and that litigation should be commenced if it could not be resolved amicably. She made it clear that she was not expressing an opinion on the merits of the claim and that Rider Bennett would not represent Pappy's. In doing so, she was conscientiously attempting to provide assistance to a debtor in possession without representing the debtor against another client of the firm. She fully expected that if the matter was not resolved by negotiation separate attorneys would be retained, as had previously been discussed.
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> Rider Mem., p.8.

Later, in the Memorandum, Rider, speaking of actual conflict of interest, argues:

> If an actual conflict of interest did arise in this case, it probably arose around the time of the October 15, 1992 meeting between debtor and Super Valu, soon after which, because of the way the matter developed, Rider Bennett withdrew from representing debtor.
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> Rider Mem., p.16, ftn. 3.

Rider seems to be arguing that, if there was a conflict problem in this case, it was created by Ms. Becker in writing and delivering the October 14, 1992, letter to Mr. Warner; and, by Mr. Warner in bringing the letter to the table at his negotiating session with Super Valu on October 15.(7) In fact, Rider, by its employment in the case, created an untenable situation for Ms. Becker, and, at best, left Pappy's without effective representation.(Ftn8)

Ms. Becker, as junior associate, had a right to rely on the judgment and direction provided by senior attorneys, and to act consistent with her understanding of that judgment and direction, unless she had reason to know that a particular course of action was improper. Nothing in the October letter is improper. In fact, a lawyer obviously has a duty in the ordinary course to provide a client the information requested of and provided by Ms. Becker in her letter. A lawyer who cannot furnish such information to a client has an irreconcilable conflict of interest that disqualifies the lawyer from representing the client. Obviously, if it is proper to furnish such information to a client, the client's publication of the information and its source, in seeking to

further and protect the client's own interests, is also proper.

Writing and delivering the October letter was not an improper act on Ms. Becker's part. The action was required by the attorney-client relationship Rider had with Pappy's. The advice and counsel provided in the letter might have been problematic in light of Rider's attorney-client relationship with Super Valu. But that unfortunate circumstance was the result of a conflict of interest created by Ms. Becker's superiors, not by her. Rider's representation of the Debtor was inappropriate. The letter simply served as the instrument of discovery by Super Valu of Rider's conflict of interest. Rider's employment in the case compromised the position of its associate, and left the Debtor without adequate representation regarding a major aspect of Pappy's reorganization.

11 U.S.C. Section 328 (c) provides, in pertinent part:

> The court may deny allowance of compensation for services and reimbursement for expenses of a professional person employed under Section 327 . . . of this Title, if at any time during such professional person's employment under Section 327 . . . of this Title, such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed.

This provision presents the specter of grave consequences to professionals for failure to consider and appropriately address conflict issues that arise in the context of prospective employment by a bankruptcy estate. Harsh as the sanction is, disallowance and disgorgement of fees and costs have been used without hesitation or qualification by numerous courts over the years to assure maintenance of the highest standards of conduct, both real and perceived, by fiduciaries. See: Woods v. City Nat'l Bank, 312 U.S. 262 (1941); In re Humble Place Joint Venture, 936 F.2d 814 (5th Cir. 1991); In re Leeway Holding Co., 100 B.R. 950 (Bankr. S.D. Ohio 1989); In re Vann, 136 B.R. 863 (D. Colo. 1992); In re Sixth Ave. Car Care Ctr., 81 B.R. 628 (Bankr. D. Colo. 1988); In re Hathaway Ranch Partnership, 116 B.R. 208 (Bankr. C.D. Cal. 1990); In re Nedig Corp., 113 B.R. 696 (D. Colo. 1990); In re Diamond Mortgage Corp. of Ill., 135 B.R. 78 (Bankr. N.D. Ill. 1991).

In this case, Rider either overlooked or ignored its responsibilities and its disqualification under Rule 2014 and 11 U.S.C. Section 327. The allegations, acrimony and recriminations in this proceeding alone provide substantial measure of the resulting harm to all parties, including Rider.(Ftn9) Yet, it is in addressing the resulting harm to the process itself where the Court, regrettably, finds the application of this harsh sanction necessary. Rider must be held accountable under 11 U.S.C. Section 328 (c) to preserve and assure adherence to the highest standard of conduct by fiduciaries. Accordingly, all fees and expenses for post-petition services rendered by Rider must be disallowed; and, all such compensation previously received must be disgorged.

The Debtor seeks disallowance and disgorgement of pre-petition fees and expenses paid by Pappy's to Rider as well. 11 U.S.C. Section 329 provides, in pertinent part:

> (a) Any attorneys 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 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, or 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 return of any such payment, to the extent excessive...

Pre-petition services rendered by Rider, beginning with Mr. Kluz' involvement on behalf of Pappy's, were services "in contemplation of or in connection with the case" within the scope of the statute. See: In re Creative Restaurant Mgt., Inc., 139 B.R. 902, 917 (Bankr. W.D. Mo. 1992). Accordingly, compensation received for those services is reviewable.

However, scope of review under the statute is limited to consideration of the reasonable value of services rendered. Section 329 (b) is aimed solely at overreaching. See: Creative Restaurant Mgt., Inc.; In Re McDonald, 114 B.R. 989, 995 (N.D. Ill. 1990); and, In Re Office Products of Am., 136 B.R. 964, 970-972 (W.D. Tex. 1992). The statute is intended to assure that a debtor who is sliding into bankruptcy does not pay too much, by way of retainer or otherwise, to an attorney for pre-filing legal advice.

It does not appear from the relevant statements recording the pre-petition services rendered and compensation charged in this matter, that the compensation exceeded the reasonable value of the services rendered. No other evidence of overreaching was offered or argued by the Debtor. Accordingly, the record provides no basis for disallowing and requiring disgorgement of pre-petition compensation under the statute.

Finally, Rider should be held accountable for the Debtor's cost of obtaining substitute counsel, which was in the undisputed amount of $10,000.

IV.

Accordingly, it is hereby ORDERED: Rider, Bennett, Egan & Arundel shall be disallowed all post-petition fees and expenses for services rendered to or on behalf of Pappy's Foods Company, Inc., and shall, within thirty days from the entry of this Order, return all fees and expenses previously received for and in connection with the firm's post-petition representation of the Debtor. Additionally, Rider shall pay to Pappy's, the sum of $10,000, for the cost to the Debtor of obtaining substitute counsel in the case.

Dated: May 17, 1993. By The Court:

DENNIS. D. O'BRIEN
U.S. BANKRUPTCY JUDGE

(Ftn1) The allegations, recriminations, inferences, and innuendos that permeate the materials submitted in this proceeding are cogent evidence of the wisdom, and need, of both the Statute and the Rule.

(Ftn2) Mr. Backstrom and Mr. Kluz state that they became aware of the Super Valu dispute as "incidental information."

(Ftn3) Mr. Warner claims that Mr. Kluz regularly advised Mr. Warner on strategy matters regarding Super Valu and, at one point, advised him not to retain special counsel but to raise with Super Valu the threat of a lawsuit by the unsecured creditors committee.

(Ftn4) Pappy's total sales for the first fiscal year to which the Super Valu agreement applied, were $10,593,500. Super Valu is a large customer of Pappy's, not limited to the Minneapolis region. Pappy's operated four facilities when the bankruptcy was filed, one in Minnesota, two in Illinois, and one in Iowa. According to the Debtor, Super Valu accounted for 47% of its total sales nationwide, notwithstanding the shortfall in Super Valu's Minneapolis region.

(Ftn5) Rule 1.7 of the Minnesota Rules of Professional Conduct is instructive in this regard. The Rule provides, in pertinent part:

> (b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:
>
> (1) the lawyer reasonably believes the representation will not be adversely affected; and
>
> (2) the client consents after consultation When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.

Comment to Rule 1.7 reads:

> Loyalty to a client is also impaired when a lawyer cannot consider, recommend or carry out an appropriate course of action for the client because of the lawyer's other responsibilities or interests. The conflict in affect forecloses alternatives that would otherwise be available
>
> to the client. Paragraph (b) addresses such situations.
>
> A possible conflict does not itself preclude the representation. The critical questions are the likelyhood that a conflict will eventuate and, if it does, whether it will materially interfere with the lawyer's

> independent professional judgment in considering alternatives or foreclosure courses of action that reasonably should be pursued on behalf of the client. Consideration should be given to whether the client wishes to accommodate the other interest involved.

(Ftn6) That is the apparent attitude of Mr. Backstrom and Mr. Kluz in their deposition testimony.

(Ftn7) Ms. Becker testified that Mr. Kluz authorized the letter. Mr. Kluz testified that he had no recollection of discussing the matter with Ms. Becker beforehand. Mr. Warner testified that Ms. Becker authorized him to give the letter to Super Valu. Ms. Becker testified she did not authorize delivery of the letter to Super Valu and that she did not understand that such was Mr. Warner's intention.

(Ftn8) In his deposition of February 3, 1993, Keith Warner said:

> Rear vision is always 20/20, and as I look back on this whole scenario, if there is anything missing, it was that there was never a legal contact made, a formal or informal basis of legal counsel representing Pappy's to the legal counsel at Super Valu. I'm not saying there should have been a lawsuit laid out, but I'm naked as a jay bird through this whole thing. Warner Dep., p. 177.

Rider argues that Pappy's did not ask for representation regarding the Super Valu dispute; did not expect Rider to represent the Debtor in the matter; and, in any event was informed that Rider could not represent Pappy's in the dispute. These assertions are disputed. Even if true, however, such facts did not relieve Rider of responsibility. Whether Pappy's specifically asked for representation or expected representation in the matter, clearly Pappy's needed representation regarding the Super Valu problem. At a minimum, the representation required was investigation, analysis from a reorganization perspective, and counseling regarding remedial alternatives consistent with the overall strategy of the reorganization effort. Experienced business and bankruptcy counsel should have readily foreseen that. Furthermore, the inability of Rider to represent Pappy's in this important aspect of the reorganization effort, was Rider's problem, not Pappy's. Special counsel was not the answer. Disqualification of Rider as Debtor's counsel was. Rider brought nothing unique to the reorganization effort, except its inability to represent the Debtor regarding a major problem that jeopardized its ability to reorganize.

(Ftn9) The state of the record does not facilitate the making of detailedfindings regarding many of the important allegations. The numerous affidavits, depositions, and documentary exhibits produce conflicting, contradictory and inconsistent versions of material relevant facts regarding the parties' conduct. Neither the Debtor nor Rider wished to pursue the matter through evidentiary hearing. Unfortunately, this somber state of affairs is a natural result of an environment created and maintained in disregard of the proscriptions of 11 U.S.C. Section 327.

END FN