UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NORTH CAROLINA
CHARLOTTE DIVISION

In Re:	)	**Case No. 95-30796**
	)	**Chapter 7**
KOLORTEX CORP.	)	
	)	
Debtor.	)	
	)	

ORDER

This matter comes before the Court upon the revised Fee Application filed by Special Tax Counsel for the Debtor, Richard Marsh ("Marsh"), dated December 7, 1995 and the Objections thereto by the Bankruptcy Administrator and the Trustee for the Chapter 7 Debtor. An evidentiary hearing was held on September 20, 1996. Based on that hearing and the record, the Court makes the following findings of fact and conclusions of law:

FINDINGS OF FACT

Kolortex, Inc. prior to its shutdown in July, 1995, operated a textile dye and finishing plant in Charlotte, N.C. Kolortex is owned by Hans O. Keilhack ("Keilhack"). Keilhack has numerous other connections to this Debtor. He is its President. At the date of the Debtor's bankruptcy, he owned the real estate (The "Horseshoe Lane property") where the Debtor and Keilhack's other companies operated. Keilhack and his wife, Peggy Keilhack, also have asserted secured claims against the Debtor in this case.

Kolortex filed a voluntary Chapter 11 case in this Court on June 1, 1995. Due to an insufficient cash flow and lack of liquid assets, Kolortex was able to operate as a Debtor-in-Possession only for a brief time. The Bankruptcy Administrator moved on June 28,

1995 to either dismiss this case, convert it to Chapter 7 or appoint a Trustee. After several emergency hearings, and just prior to the July 4, 1995 holiday, the business was shut down. On July 28, 1995, a Chapter 11 Trustee, P. Wayne Sigmon, was appointed to manage the Debtor's affairs. The Court's decision to appoint the Trustee was attributable not only to the Debtor's financial problems, but also to the discovery of a previously undisclosed foreign bank account of the Debtor, and a repeated failure of Kolortex' management to abide by Orders requiring that postpetition payroll taxes be escrowed before payrolls were made. The case was converted to Chapter 7 on September 15, 1995, with Sigmon continuing to serve as Trustee.

From early on, a sale of this business had been sought. A prospective purchaser, Joseph Callahan, had appeared at several hearings and stated his interest in buying the Company assets. However, an agreement to purchase those assets, which consisted principally of textile machinery and equipment, was not immediately forthcoming. Finally, under the threat of an auction by the Trustee of Kolortex' assets, a private sale was secured. By Order dated November 5, 1995, the Trustee sold the bulk of the Debtor's assets to Callahan. On the same date, Callahan purchased the Horseshoe Lane property from Keilhack, who was also in bankruptcy in this Court in a Chapter 11 case filed on March 20, 1995 (Case No. 95-30375).

Prior to its bankruptcy, Kolortex had been represented by Richard E. Marsh, Jr. P.A. ("Marsh"). At the times relevant to these

proceedings, Marsh also represented Keilhack; Peggy Kielhack; the Debtor's affiliates Kieltex, T.D. Sportswear, Skieltex, and Skantex; the Debtor's financial consultant, Ron Schuster; and Salvista Trading Company, a European concern which helped to finance the sale to Callahan.

When it filed its Chapter 11 petition, Kolortex hired a second law firm, Rayburn, Moon and Smith, to represent it in the bankruptcy case. That firm was appointed counsel for the Debtor on June 5, 1995.

In addition to counsel to handle the Chapter 11 case, Kolortex felt it needed special tax counsel. On June 8, 1995, the Debtor filed an Application to hire Marsh as "Special Tax Counsel" under Sections 1107 and 327(e) of the Code. Richard Marsh filed a verified statement to support his firm's Application. His affidavit discloses that the firm represented Keilhack and Kieltex in tax matters, but made no mention of his other related clients and their relationships to this Debtor. As the Debtor had not filed its Schedules, this information was not available to parties in interest. An Order was entered appointing Marsh Special Tax Counsel to the estate on June 13, 1995.

After the Trustee had been appointed and the case converted to Chapter 7, on October 30, 1995, Marsh filed a fee application seeking $8,381.75 ($8,261.25 fees; $120.50 expenses)for his work as Special Tax Counsel. Both the Bankruptcy Administrator and Trustee objected to this Application. On December 7, 1995, Marsh filed a Revised Fee Application reducing the fee request to

$7,820.75 ($7,700.25 fees; 120.50 expenses). This revision also drew objections by the Bankruptcy Administrator and Trustee. After a number of continuances, a hearing on the merits was held on September 20, 1996.

CONCLUSIONS OF LAW

The Bankruptcy Administrator and Trustee raise two primary objections about Marsh's Revised Application. First, they contend that Marsh seeks compensation for services beyond the scope of his appointment as Special Tax Counsel. Second, they argue that Marsh represented parties having interests adverse to the Debtor and its creditors in contravention of Section 327(e) of the Code and that for these matters he is not entitled to payment. [While other points were raised by these Objections, they were resolved by the revisions to the Application and the testimony presented.]

Bankruptcy Code Section 327 authorizes the trustee, with court approval, to employ counsel to represent him in the conduct of a bankruptcy case. A debtor in possession holds many of the powers of a trustee, including the right to hire counsel. 11 U.S.C. § 1107.

Generally, the Trustee and therefore debtors-in-possession may hire only attorneys who are "disinterested" as defined at Section 101 and who neither hold nor represent any interest adverse to the estate. 11 U.S.C. § 327(a); Collier on Bankruptcy, 15th Ed., § 327.01, p.327-3. Because the trustee (or debtor-in-possession),

is a fiduciary for creditors, these standards are rigidly enforced. Collier, Section 327.03, p. 327-31.

An exception to this rule permits the Trustee to hire counsel who may not be "disinterested" and could not generally represent the debtor in the case to perform limited services:

> The trustee, with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed. 11 U.S.C. 327(e).

While Special counsel need not be "disinterested" he may not hold or represent adverse interests in the matters on which he is employed.

In the present case, Marsh was appointed "Special Tax Counsel" for the Kolortex estate under Section 327(e). He is entitled to be compensated for his **tax** law services to the Debtor-in-Possession, which were reasonably likely to benefit the estate and were necessary to the administration of its case(11 U.S.C. 330), **provided** that he did not represent any interests adverse to the Debtor with regard to those matters. Said another way, Marsh can be paid in this case only for tax work, and then only if he did not have a conflict of interest as to that work.

Marsh introduced at hearing a document analyzing his application wherein he breaks his time into two general categories: (1) "Legal Services Rendered at Request of Lead Counsel and on Behalf of Estate " (totaling $2,257.35 of the fee request) and (2) "Legal Services Rendered as Special Tax Counsel" (totaling $5,442.90).

As to the former, Marsh acknowledges that the work billed under the heading "Legal Services Rendered at Request of Lead Counsel and on Behalf of Estate" is outside the scope of tax advice, but attempts to justify these fees as being necessary services which he performed at the request of the Debtor's bankruptcy counsel.

This argument fails. It is well settled law that special counsel for a Debtor-in-Possession may not undertake a general representation of the Debtor, and may not be compensated for services beyond the scope of their retention. Appointments under section 327(e) of the Code are to be construed narrowly. In re Vladic Corp., 104 B.R. 599 (Bkrtcy. Ct. N.D. Tex. 1989); Collier § 327.03 at 327-87.

Section 327(e) expressly precludes an attorney serving as special counsel from performing general counsel duties: "This subsection does not authorize the employment of the debtor's attorney to represent the estate generally or to represent the trustee in the conduct of the . . . case." H.R. Rep. No. 595, n.11 supra at 328. As a leading authority on Bankruptcy law opines, "an attorney retained as special counsel may receive compensation only for those services directly related to the limited scope of retention and not for services rendered generally to the debtor in connection with its bankruptcy case." Collier on Bankruptcy, vol. 2, pg. 327-87.

Marsh' argument that he performed these tasks at the request of general counsel does not change this result. Even if Kolortex'

general counsel had requested this work (Rayburn, Moon & Smith were not present at this hearing), what is prohibited by the Code cannot be authorized by a Debtor-in-Possession's lead counsel. Section 327(e) protects not only the Debtor, but its creditors as well.

Further, one may not excuse the breach by claiming that the estate benefitted from the services. The work may have been necessary and beneficial; however, equally important is that it be performed by persons whose full allegiance is to the Estate. Congress foresaw the mischief that could arise where those working for an Estate have divided loyalties. It enacted a strict rule to prevent this problem and Courts have so interpreted it.

Marsh could not have been appointed to represent the Debtor generally in this bankruptcy case due to his representation of the Debtor's shareholders/creditors and its affiliates. Due to their interests as creditors of Kolortex(Keilhacks); shareholders, whose personal tax liabilities would be affected by this Debtor's actions(both Keilhacks); potentially, debtors of this estate (Keiltex and this Debtor hold putative claims against one another); and financiers of the buyer (Salvista), Marsh' clients' interests would preclude his ever being able to generally represent this Estate. Marsh cannot back into such authority by simply performing the work under the name of special counsel.

As a result, Marsh will not be compensated from this estate for any work he performed which falls outside the scope of his appointment as special **tax** counsel. This includes all of the work represented by the $2,257.35, which he calls "Legal Services

Rendered at Request of Lead Counsel and on Behalf of Estate, and much of the services which he considers to be tax work.

Referring back to his worksheet, Marsh seeks to recover for some $5,442.00 of work which he characterizes as "Legal Services Rendered as Special Tax Counsel." A review of the time entries show that very little of this work was tax work. Entries include preparing the Debtor's bankruptcy schedules, seeking appointment of a business consultant for the debtor, researching public real property records, reviewing creditor records, negotiating a sale of the Debtor's business, and preparing the Debtor's plan of reorganization.

These are functions of general bankruptcy counsel and not special tax counsel. This is particularly true in as much as the Debtor in this case is a Subchapter S Corporation, and, as such, has no liability for taxes. In S Corporations, and unlike C Corporations, tax liabilities pass through to the shareholders, in this case, Mr. Keilhack.

Marsh attempts to justify this work by suggesting that to secure a sale of the Debtor's assets, it was necessary to first determine its tax effects on the Debtor's shareholder, Mr. Keilhack. Why? Because Keilhack held a secured claim against this estate, and in order to make the Callahan sale work, it was necessary that Keilhack agree to subordinate his claim to the debts of other creditors. Conflict of interest concerns aside, this theory doesn't hold water for several reasons.

First, even if tax ramifications were a consideration in the sale, what was being done here went well beyond tax work and into negotiating a sale of the Debtor's assets. This is not a case of giving tax opinions to the Debtor or its general counsel about tax effects of a proposed deal. For example, on June 29-30, Marsh bills the estate for discussions about potential loans to the Debtor, the collateral for those loans, and seeking a dismissal of the bankruptcy case. This is the work of general counsel, not special counsel. As noted above, as special counsel Marsh was only able to perform tasks directly related to tax work. This was not tax work.

Second, even if it had been advantageous that Marsh perform these tasks, from a notice perspective, it was incumbent upon Marsh and the Debtor-in-Possession to come forward to seek that additional authority before expanding the scope of his retention.

A third problem with Marsh's theory is that only beneficial and necessary services may be compensated under Section 330. This record fails to disclose any reason why an S Corporation, would need tax advice at all, although the reasons why Hans Keilack, as its shareholder, would want this advice are well documented. [It should be noted that Marsh was appointed prior to the Debtor filing its Bankruptcy Schedules. As such, neither the tax status of the corporation nor much of the conflict of interest information was available to parties in interest at the time he was appointed.]

But even if the services Marsh performed were both within the scope of his retention and necessary and beneficial to the Estate,

he cannot be compensated if a conflict existed between the Debtor and his other clients.

For the tax matters on which Marsh worked, indeed on most matters that he handled in this case, he also was representing or had previously represented, persons having interests adverse to this estate. Marsh represented Keilhack, whose conflicts with this estate included being a shareholder, major secured creditor and landlord of the Debtor. This conflict was actual, not theoretical. For example, Marsh bills the Debtor for attempting to ensure that the Debtor's 401K plan was not disqualified by the Internal Revenue Service. This work was entirely adverse to the Debtor's estate. A disqualification of the 401K plan would bring that property into the bankruptcy estate, for the benefit of creditors. Keilhack as the largest plan participant, would be severely prejudiced if this were to occur.

In like measure, compensation was sought for work done regarding Keilhack's use of a company car, and for problems in Keilhack and others getting their mail after the Debtor's shutdown. Such work clearly benefitted insiders, not the Debtor. Finally, much of the application pertains to Marsh's work relating to efforts to sell the Debtor's business.

As to that sale it is impossible to determine whose interests were served--the Debtor's, or Keilhack's (whose building was being sold to the same buyer), or that of others, such as Salvista (the purchaser's financing group), or even Keiltex (which was still operating in the premises). Perhaps all profited. One cannot, at

this point, untangle the snarl of conflicting interests to determine whether or not Kolortex suffered as a result of these conflicting allegiances, and if so, to what extent. It was precisely because of the difficulty in sorting out these conflicting loyalties and the prospect that advantage could be taken of the estate, that Section 327(a) so jealously restricts appointment of professionals to those not having competing masters.

However, this record makes it clear that in almost every regard, as to the work performed by Marsh, he had another client having an interest in the transaction. As such, he may not be compensated.

Marsh makes a final argument in support of his fee request. He points out that he does not regularly practice in Bankruptcy Court and is not familiar with the Bankruptcy Code. He suggests that he should not be held to the same level of scrutiny that would apply to attorneys regularly practicing in this Court.

The short answer to this argument is it contradicts the Affidavit which Marsh filed with his retention application. In it, he states: that he is "disinterested" within the meaning of Section 327 and neither holds nor represents adverse interests in the matters in which he is to provide services. If counsel had any questions as to what this means, the Affidavit references the pertinent statute. Ignorance of the law is rarely, if ever, an excuse, and certainly not for an attorney who can recite the operant Code section in his application.

Because the work, for which compensation is sought, either fell outside the scope of his appointment, was not beneficial to the estate, and/or were on matters for which his other clients held conflicts of interest with this estate and its creditors, this Court must deny all compensation for the Applicant.

IT IS THEREFORE ORDERED:

1. Special Counsel's Fee Application dated October 30, 1995, and his Revised Fee Application Fee dated December 7, 1995, are DENIED, except as to reimbursement of his out-of-pocket expenses in the amount of $120.50 which are allowed.

2. In view of the prior interim disbursement of the applied for fees, Marsh will disgorge to the Debtor's bankruptcy estate all sums previously received of this estate over this amount, payable to the Trustee.

This is the 5th day of November, 1996.

J. Craig Whitley

United States Bankruptcy Judge