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Joint Committee Meeting of:
Financial Advisors Committee
Professional Compensation Committee
Investment Banking Committee

Emerging Issues in the Retention and Compensation of Professionals - Is the Playing Field Changing?

- **Hon. James D. Gregg, Moderator**
U.S. bankruptcy Court, W.D. Mich.; Grand Rapids
- **Richard A. Chesley**
Jones Day
- **Richard M. Cieri**
Kirkland & Ellis
- **Peter S. Fishman**
Houlihan Lokey Howard & Zukin

**Featuring a discussion of Retention of Professionals under
Sections 328 and 330 of the Bankruptcy Code and an update on
recent decisions regarding Disgorgement of Fees.**

ABI Winter Leadership Conference
Joint committee meeting Financial Advisors and Professional Compensation

Emerging Issues in the Retention and Compensation of Professionals - Is the Playing Field Changing?

Is getting retained and paid becoming so difficult that professionals need to think twice before accepting an engagement? Are changes hurting the Companies that most need the assistance of good financial and legal advisors? Is there a bigger risk of fee collection difficulties in bankruptcy than out-of-court? Is it fair?

Getting retained

- Is there a new standard for retention under BAPCPA?
- How is retention different than outside of bankruptcy and does it make bankruptcy work less attractive?

Disclosure

- Is it becoming harder to meet the disclosure requirements under BAPCPA?
- Is it fair to put at risk fees earned if a disclosure problem occurs later in the case (i.e., disgorgement v.s. firing)?

Getting paid

- Is the value of carve-outs and retainers being diminished?
- Are Fee Auditors being used more?
- Is getting paid harder in bankruptcy cases than non-bankruptcy work: i.e., no holdbacks, less risk of disgorgement, no fee auditors to second guess?

Keeping what you are paid

- Is the risk of disgorgement in administratively insolvent cases (i.e., Midway Airlines) a new risk?
- Should bankruptcy professionals be able to charge an additional risk premium to compensate for this risk?
- Is there a difference between bankruptcy and non-bankruptcy work in terms of indemnification?
- Is there a bigger risk of fee collection in Bankruptcy?
- Is there greater scrutiny of professional fees as the total amount of fees in large bankruptcy cases continues to increase?

Are differences between bankruptcy work and non-bankruptcy work hurting the companies that most need the assistance of good financial and legal advisors?

- Have professionals left the bankruptcy field for greener pastures?
- Is the quality of service to Debtors hurt by some leaving for investment banking or private equity work?

**RETENTION OF PROFESSIONALS UNDER
SECTIONS 328 AND 330 OF THE BANKRUPTCY CODE**

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I. Applicable Bankruptcy Code provisions regarding retention of professionals

A. Section 327(a): “[T]he trustee, with the court’s approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee’s duties under this title.”

B. Section 1103(a): A committee appointed under section 1102 may “with the court’s approval ... select and authorize the employment by such committee of one or more attorneys, accountants, or other agents, to represent or perform services for such committee.”

C. Section 328(a): “The trustee, or a committee appointed under section 1102 of this title, with the court’s approval, may employ or authorize the employment of a professional person under section 327 or 1103 of this title, as the case may be, on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, on a fixed or percentage fee basis, or on a contingent fee basis. Notwithstanding such terms and conditions, the court may allow compensation different from the compensation provided under such terms and conditions after the conclusion of such employment, if such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions.”

D. Section 330(a): “After notice to the parties in interest and the United States Trustee and a hearing, and subject to sections 326, 328, and 329, the court may award to a ... professional person employed under section 1103 (A) reasonable compensation for actual, necessary services rendered by the ... professional person, or attorney and by any paraprofessional person employed by such person; and (B) reimbursement for actual, necessary expenses.”

II. History and evolution of sections 328 and 330

A. Bankruptcy Act

1. Under former Bankruptcy Rule 219, professional persons were entitled to award of “reasonable compensation” for services
2. No provision authorizing compensation agreements
3. Compensation determined by court on *quantum meruit* basis

4. Overriding principle: “spirit of economy,” which required court to consider (i) conservation of the estate and (ii) return to creditors

5. Private agreements, including contingent fee arrangements, were improper

B. Bankruptcy Reform Act of 1978

1. Allowed private compensation agreements under sections 328 and 330

2. Attorneys and other professionals compensated at same rate as in non-bankruptcy cases

3. Legislative history: “[n]otions of economy of the estate in fixing fees are outdated and have no place in the bankruptcy code”

4. Recognition that capable professionals must be paid comparably to non-bankruptcy engagements or would leave bankruptcy field

C. Bankruptcy Reform Act of 1994

1. Section 328 not directly amended

2. Section 330 significantly changed

a. Section 330(a)(3): increases factors courts would consider in determining “reasonableness” (discussed below)

b. Section 330(a)(2): allows court to award compensation less than amount requested upon motion of party in interest or *sua sponte*

c. Section 330(a)(4)(A): prohibits compensation in certain circumstances

d. Section 330(a)(5): provides that compensation reduced by amount of interim compensation awarded under section 331, and if interim compensation exceeds amount awarded under section 330, excess compensation may be disgorged

e. Section 330(6): allows compensation for time spent preparing fee application

D. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

1. Section 328(a) amended to clarify that compensation may be approved on a fixed or percentage fee basis

2. Section 330(a)(3) amended to add another factor to consider in “reasonableness” determination

III. Retention under section 330

A. Professionals may be employed only “for actual, necessary services” under section 330(a)(1)(A)

1. Test of necessity of service is whether services were “reasonably likely to benefit the estate” and “necessary to the administration of the estate (*See* sections 330(a)(4)(A)(ii)(I)-(II)

a. Determined from perspective of the time that services were rendered, not based on hindsight

b. Services must benefit estate, not just the constituency for which services performed

2. Compensation not allowed for duplicative services under section 330(a)(4)(A)(i)

B. Professional’s compensation must be “reasonable”

1. Under sections 330(a)(3)(A)-(F), “the court shall consider the nature, the extent, and the value of such services, taking into account all relevant factors, including”

a. the time spent

b. rates charged

c. whether services necessary or beneficial to administration of case

d. whether services performed within reasonable amount of time, taking into account complexity, importance and nature of task

e. whether professional is board certified or otherwise has demonstrated skill and experience in bankruptcy field

f. whether compensation is reasonable based on customary compensation by comparably skilled practitioners

2. Courts determining reasonable compensation often apply “lodestar” analysis, in which court determines reasonable number of hours spent and multiplies by appropriate billing rate

IV. Retention under section 328(a)

A. Under section 328(a), the court assesses the reasonableness of the terms and conditions of employment *at beginning* of engagement, usually *before* the professional has rendered services

1. “If the most competent professionals are to be available for complicated capital restructuring and the development of successful corporate reorganization, they must know what they will receive for their expertise and commitment.” *In re Nat’l Gypsum Co.*, 123 F.3d 861, 862-63 (5th Cir. 1997)

2. Section 328(a) allows approval for contingent or “success” fees. *See, e.g., In re Texas Sec. Inc.*, 218 F.3d 443, 445-46 (5th Cir. 2000) (approving contingent fees under section 328(a)); *In re Merry-Go-Round Enters., Inc.*, 244 B.R. 327, 336-37 (Bankr. D. Md. 2000) (same).

B. Initial “reasonableness” determination

1. Burden is on trustee or committee seeking to employ professional to show that terms and conditions are reasonable

2. Courts may consider number of factors to determine whether terms and conditions are reasonable under section 328(a), *See In re Federal Mogul-Global, Inc.*, 3348 F.3d 390, 396-97 (3d Cir. 2003); *In re Insilco Techs., Inc.*, 291 B.R. 628, 634 (Bankr. D. Del. 2003) , including:

- a. Skills and qualifications of professional
- b. Commitment required to fulfill engagement
- c. Complexity of engagement
- d. Cost of comparable services
- e. whether parties are sophisticated business entities with equal bargaining power who engaged in arms-length negotiation
- f. whether retention is in best interests of estate
- g. whether there is opposition to retention
- h. whether plan provides appropriate level of “risk minimization” in light of existence of any other “risk minimization” devices, such as an administrative order or carve-out

3. Court “may eliminate, modify, or impose additional terms and conditions to satisfy the requirement of reasonableness.” *In re High Voltage Eng’g*

Corp., 311 B.R. 320, 333 (Bankr. D. Mass. 2004); *In re Federal Mogul-Global, Inc.*, 3348 F.3d 390, 397 (3d Cir. 2003).

a. “Bankruptcy Court may approve some of the terms and conditions proposed in an employment application while rejecting others.” *In re Federal Mogul-Global, Inc.*, 3348 F.3d 390, 398-99 (3d Cir. 2003).

b. Court “is not compelled to accept a professional’s employment under section 328 merely because the application cites that statutory provision. The bankruptcy court is free to make clear that it is only conditionally approving the professionals’ retention application such that section 330 is applicable.” *F.V. Steel & Wire Co. v. Houlihan Lokey Howard & Zukin Capital, L.P.*, 350 B.R. 835, 839 n. 2 (E.D. Wisc. 2006)

C. Effects of “pre-approval” under section 328(a)

1. Once a court approves the terms and conditions of employment under section 328(a), the court may change the pre-approved terms and conditions only “if such terms and conditions prove to have been *improvident* in light of developments *not capable of being anticipated* at the time of fixing of such terms and conditions” (emphasis added)

2. Determination of whether employment was, in fact, approved under section 328(a) depends on documents governing retention

a. Ideally, the engagement letter, retention application, and retention order should clearly state that retention is pursuant to section 328(a)

b. However, courts employ different standards when ambiguity exists as to whether employment was approved under section 328(a) or section 330

(i) Some courts have held that “unless a professional’s retention application unambiguously specifies that it seeks approval under section 328, it is subject to review under section 330.” See *In re Circle K Corp.*, 279 F.3d 669, 671 (9th Cir. 2002); *F.V. Steel & Wire Co. v. Houlihan Lokey Howard & Zukin Capital, L.P.*, 350 B.R. 835, 839-40 (E.D. Wisc. 2006). Similarly, other courts have held that “[i]f the order does not expressly and unambiguously state specific terms and conditions (e.g., specific hourly rates or contingency fee arrangements) that are being approved pursuant to ... section 328(a),” then the court’s review of such terms is under section 330, not section 328. *Zolfo, Cooper & Co. v. Sunbeam-Oster Co., Inc.*, 50 F.3d 253, 261 (3d Cir. 1995).

(ii) Other courts have adopted a more lenient view that determines whether approval was under section 328 based on “the totality of circumstances, looking at both the application and the bankruptcy court’s order.” *In re Airspect Air, Inc.*, 385 F.3d 915, 922 (6th Cir. 2004); *In re Nat’l Gypsum Co.*, 123 F.3d 861, 862-63 (5th Cir. 1997) (approving professional’s employment pursuant to section 328 even though the retention application did not specify section 328).

3. Court cannot engage in *post hoc* reasonableness analysis if approved under section 328(a). *See, e.g., In re Federal Mogul-Global, Inc.*, 348 F.3d 390, 397 (3d Cir. 2003); *In re B.U.M. Int'l, Inc.*, 229 F.3d 824, 829 (9th Cir. 2000); *In re Texas Sec. Inc.*, 218 F.3d 443, 445-46 (5th Cir. 2000); *In re Merry-Go-Round Enters., Inc.*, 244 B.R. 327, 344 (Bankr. D. Md. 2000); *Houlihan Lokey Howard & Zukin Capital, Inc. v. Northwestern Corp. (In re Northwestern Corp.)*, 332 B.R. 534, 536-37 (D. Del. 2005); *F.V. Steel & Wire Co. v. Houlihan Lokey Howard & Zukin Capital, L.P.*, 350 B.R. 835, 840 (E.D. Wisc. 2006).

4. “Improvident” standard

a. “Demanding” standard to show that terms and conditions are improvident under section 328(a). *See F.V. Steel & Wire Co. v. Houlihan Lokey Howard & Zukin Capital, L.P.*, 350 B.R. 835, 841 (E.D. Wisc. 2006); *In re Yablon*, 136 B.R.88, 92 (Bankr. S.D. N.Y. 1992)

b. Not enough that developments that made plan improvident were merely unforeseen; they must have been incapable of being anticipated. *See In re Barron*, 325 F.3d 690, 693 (5th Cir. 2003); *In re Airspect Air, Inc.*, 288 B.R. 464 (6th Cir. BAP 2003).

c. Thus, the court cannot reduce fees that were pre-approved under section 328(a) even if fees are for services duplicative of those provided by another professional if the potential for duplication was not unforeseeable. *Houlihan Lokey Howard & Zukin Capital, Inc. v. Northwestern Corp. (In re Northwestern Corp.)*, 332 B.R. 534, 537 (D. Del. 2005).

d. Likewise, a professional is bound by the terms of its engagement as described in the application and cannot seek a fee enhancement unless it can meet the “improvident” standard. *In re Nucentrix Broadband Networks, Inc.*, 314 B.R. 574, 579-81 (Bankr. N.D. Tex. 2004) (even though financial advisor “ably served” Debtors who sold their assets for three times original stalking horse bid, because its retention was approved under section 328, no upward departure for professional’s fees because “possibility of increased bid was certainly capable of being anticipated”).