

THE ABI CHAPTER 11 FEE STUDY:
MOVING FORWARD ANALYSIS

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I. History of the ABI Professional Fee Study.

A. How the Fee Study Began.¹

The ABI has always had a commitment to the study of compensation of professionals in bankruptcy proceedings. Between 1989 and 1991, the ABI conducted the National Report on Professional Compensation (“Report on Compensation”), which was the first comprehensive survey of professional fees in bankruptcy.²

The concept for conducting a new study of professional fees awarded by bankruptcy Courts in chapter 11 cases (“Fee Study”) first came about due to the ABI’s historical commitment to this issue and from discussions of chapter 11 compensation of professionals between then ABI president Bettina Whyte, Al Togut and Deirdre Martini, then the Region 2 U.S. Trustee. These discussions led to the presentation of a proposal to the ABI for a new empirical study of professional compensation in bankruptcy proceedings. Thereafter, a Fee Study Steering Committee, initially comprised of Michael P. Richman, John Penn, Chip Bowles, Deirdre Martini, Judge Steven Rhodes, Judge Wesley Steen, Bettina Whyte and Judge Gregg Zive, was formed. The Steering Committee has been since augmented by the addition of ABI President’s Reginald W. Jackson and John Ames. The Steering Committee’s charge was to further evaluate the feasibility of commissioning a new empirical study of professional fees in bankruptcy, develop guidelines for that study and find an eminent law professor to act as the Fee Study’s reporter.

During the summer and fall of 2004, the Steering Committee met and considered the parameters of the Fee Study and considered several prominent academics for the post of Fee Study Reporter (“Reporter”). After refining the study proposal and meeting with other various candidates the Steering Committee recommended and the ABI selected Prof. Stephen J. Lubben³ as the Reporter. The ABI also agreed to fund the Fee Study

¹ A full copy of the Fee Study can be obtained from the ABI at www.abiworld.org.

² For a more detailed history of the Report on Compensation, see Gerdano, [ABI Funded Fee Study Launched](#) February 2005 ABI Law Journal Director’s Column; Bowles & Lubben, [The ABI chapter 11 Professional Fee Study. An Update](#) April 2006 ABI Law Journal Endowment News (hereinafter Bowles & Lubben, [Fee Study](#)).

³ Professor Stephen Lubben is the Daniel J. Moore Professor of Law at Seton Hall University. Prior to coming to Seton Hall, he was an associate with Skadden, Arps, Slate Meacher & Flom in its New York and Los Angeles offices. Professor Lubben has concentrated his legal research in the areas of chapter 11 business reorganizations and Court-appointed professionals’ fee issues. Professor Lubben has published three major pieces on professional fee issues: Lubben, [Microeconomics of chapter 11](#), 4 Int’l Corp. Rescue 31 (Part 1) and 4 Int’l Corp. Rescue 31 (Part 2) (2007). Lubben, [The Direct Costs of Corporate](#)

through a \$350,000 grant (“FSG”) from the ABI and its endowment fund.⁴ The Fee Study was also supported by a \$10,000 grant from the National Conference of Bankruptcy Judges. This grant was the largest grant ever made by the ABI and the ABI endowment fund.

After the Reporter was selected, then-ABI President Michael Richman, with input from the Steering Committee and ABI Executive Director Sam Gerdano, formed the Practitioner Advisory Panel (“PAP”) to provide practical insight and advice on professional compensation issues to Prof. Lubben, as well as critical logistical support to the fee study. The PAP was chaired by Chip Bowles and initially consisted of Geoffrey Berman, Joseph Bodoff, Rudy Cerone, Terri Gardner, Laura Davis Jones, Melissa Kibler Knoll, Richard Meth, Neil Olack, Trish Redmond, Thomas Salerno, James Sprayregen, James Sweet, Al Togut, Bruce White and Mark Williams. James T. Markus, Robert G. Burns and Lisa G. Laukitis were later added to the PAP. A Study Advisory Panel was also established, whose members include Judge Barbara Houser, Richard Levin, Prof. Robert Lawless, Prof. Edward Morrison, Prof. Nancy Rapoport and Prof. Robert Rasmussen.

After the Fee Study began, it was decided that the Fee Study would be supplemented by an analysis of professional fee data from selected large chapter 11 cases (“Big-Case Sample”). The Big-Case Sample would use the same data collection model as the random sample of Fee Study. However, unlike the main Fee Study, which is based on a sample of randomly selected chapter 11 cases from jurisdictions across the country, the Big-Case Sample focused on professional compensation issues in large chapter 11 cases.

The Fee Study’s data was gathered by members of the Steering Committee and the PAP who downloaded and transmitted hundred of thousand of pages of documents to the Reporter. These documents were then input into an extensive database and reviewed by the Reporter.

B. Overview of the Fee Study’s Methodology.

The Fee Study main sample (“Random Sample”) was comprised of a sample of up to 40 chapter 11 cases randomly selected from each of 33 judicial districts, three districts from each numbered circuit. One district was selected from the state with the highest population in the circuit, one from the lowest population state, and one district

Reorganization: An Empirical Examination of Professional Fees in Large chapter 11 Cases, 74 Am. Bankr. L. J. 509 (2000), and Cook and Lubben, Retention, Payment Ethical and Other Obstacles for Non-Legal Professionals in chapter 11 Reorganizations, 769 PLI/Comm 549 (1999).

⁴ The ABI Endowment Fund was established in 1989 to provide resources for research and education related to bankruptcy issues and related matters. The ABI Endowment Fund is currently directed by Anthony N.H. Schnelling of Bridge Associates LLC, ABI Vice President of Development. For more information about the Endowment Fund and your various giving opportunities, please [see www.abiworld.org](http://www.abiworld.org) and click on “About ABI” or contact Kathy Sheehan at either 703-739-0800 or endowment@abiworld.org.

from the median population state in the circuit.⁵ Due to several districts not having 40 chapter 11 cases filed in the time period covered by this Fee Study, 945 cases constitute the Random Sample. As noted above, the main sample is supplemented by a Big-Case Sample that is comprised of 81 additional large chapter 11 cases that were not captured by the original sampling rules. The total number of chapter 11 cases reviewed by the Fee Study was 1,026.

The Fee Study's sample size is substantially larger than any prior study of bankruptcy professional fees.⁶ In particular, the Fee Study examined the costs incurred by these debtors while in chapter 11. Information on professionals, fee examiners, fee committees, committees and various measures of the complexity of a case were collected by the Steering Committee and PAP. The use of holdbacks, ordinary-course professional procedures and other similar devices is also examined in the Fee Study.

II. Important Fee Study Findings and Issues.

The results of the Fee Study are impressive from both scholarly and practical standpoints. Of scholarly interest is an impressive amount of basic information about the characteristics of chapter 11 cases including:

Economic Data.

- The average debtor in the Random Sample had assets of between \$13.3 million and \$28.9 million and liabilities of between \$23 million and \$50 million. The median debtor in the Random Sample had assets of \$818,000 and liabilities of about \$1.2 million.
- The average debtor in the Big-Case Sample had assets of \$423.4 million and liabilities of more than \$775.7 million. The median debtor in the Big-Case Sample had assets of \$13.7 million and liabilities of approximately \$50.2 million.

⁵ Hurricane Katrina, which made landfall in New Orleans on Aug. 29, 2005, just before the start of data entry, necessitated the modification of the selection rules in the Fifth Circuit. In particular, the Northern District of Mississippi was substituted for the Southern District. Similarly, the Western District of Louisiana was substituted for the Eastern District. These changes were made both to avoid the need to work with Courts whose operations were tremendously disrupted by the storm and to avoid any skewing effects on the Random Sample that the devastation in these two districts might have had.

⁶ See, e.g., LoPucki, Prof. Lynn M. and Doherty, Joseph W., The Determinants of Professional Fees in Large Bankruptcy Reorganization Cases, 1 J. Empirical L. Stud. 111, 140 (2004) (reporting that the average ratio of fees and expenses to assets in a sample of 48 chapter 11 cases was 2.2 percent); Lubben, Prof. Stephen J., The Direct Costs of Corporate Reorganization: An Empirical Examination of Professional Fees in Large chapter 11 Cases, 74 Am. Bankr. L.J. 509, 540 (2000) (finding that professional fees averaged 2.5 percent of assets if prepackaged cases were excluded from the sample); Weiss, Lawrence A., Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims, 27 J. Fin. Econ. 285, 286 (1990) (reporting professional fees of 3 percent of assets, based on a sample of 31 publicly traded firms that filed for bankruptcy in the early 1980s). Cf. Warner, Jerold B., Bankruptcy Costs: Some Evidence, 32 J. Fin. 337, 340 (1977) (discussing a sample of eleven railroad cases filed under § 77 between 1933 and 1955).

- The average debtor in the Random Sample had operating income of between \$2.2 million and \$7.6 million. The median debtor in the Random Sample had operating income of \$575,514.00. The average debtor in the Big-Case Sample had operating income of between \$36.5 million and \$442.8 million. The median debtor in the Big-Case Sample had operating income of \$6,144,000.00.
- In the Random Sample, cases took less than a year, on average, to reach resolution (mean = .91 years). If the cases that were still pending when data entry was completed are omitted, the length drops to 0.85 years. Approximately a quarter of the cases in the Random Sample ended in a confirmed plan, and a similar number of cases converted to chapter 7. Dismissal of the chapter 11 case was the most common outcome, with more than forty-five percent of the cases in the Random Sample leaving chapter 11 via dismissals.
- In the Big-Case Sample, confirmed chapter 11 plans were the norm with 70 of the 99 cases ending in confirmation. Conversions and dismissals were relatively rare. Cases in the Big-Case Sample took an average of 1.08 years to complete. If the still pending cases are ignored the cases take just under a year to complete (0.98 years).
- In the Random Sample, the debtor's lead counsel billed an average of 1,725.5 hours per case. In the Big-Case Sample lead counsel billed an average of 5,026.7 hours per case.
- Courts appointed committees in about 20% of the chapter 11 cases in the Random Sample and approximately 66% of the Big-Case Sample. However, this did not always mean that the committee retained professionals. In 22% of the cases in the Random Sample, committees retained no professionals.

Fee Data.

- Objections to proposed retention of professionals in chapter 11 cases are fairly rare. 16.5% of the cases in the Random Sample had retention objections filed and in the Big-Case Sample 34% of the cases had a retention objection. Courts rarely deny retention applications – just 2% of retention applications in both the Random and Big Cases Samples were rejected. However, motions to revoke or disqualify retained professionals, when filed, were generally granted.
- In the Random Sample, the debtor's lead counsel's fee applications resulted in formal objections in about 10% of the cases. The United States Trustee objected to the lead counsel's fee application in just over 3% of the cases. In the Big-Case Sample, fee objections are more common, with the U.S. Trustee objecting to lead counsel's fee

applications in more than 13% of the cases and all parties objecting in slightly fewer than 20% of the cases.

- Almost 35% of the cases in the Random Sample resulted in no payment whatsoever to the professionals. These are typically smaller cases that are often converted to chapter 7 or dismissed outright but still demonstrate that chapter 11 practice is risky.
- Total professional fees awarded in either dataset of chapter 11 cases average a total of about 4% to 4.5% of the sum of assets and debts of the debtor. It is important to note that these professional fees include fees which debtors would have incurred even if no bankruptcy was filed as well as fees related directly to the bankruptcy filing.
- Unlike prior studies of professional fees in bankruptcy, the Fee Study found that time spent in chapter 11 seems to have very little independent effect on the costs of the case. Factors like the size of the debtor, the number of professionals retained, the presence of “first day motions” and whether a committee is appointed play much bigger roles. It appears that the significance of time spent in chapter 11 discussed in previous studies was actually the result of case outcome and complexity factors that are now represented elsewhere in the Fee Study.
- Based upon the results of the Fee Study, the Reporter has developed models to project chapter 11 professional fees for case in both the Big-Case Sample or the Random Sample.

Of more immediate importance to Bankruptcy Professionals are some of the implications which could be drawn from the study’s results.⁷

A. Who and Where, No, What Yes: Fee Structures Matter.

For years it has been suggested that the debtor’s employment of certain firms and filing of chapter 11 cases in venues such as Delaware and Southern District of New York (“SDNY”) could lead to increased professional fees in chapter 11 cases. The Fee Study found that the selection of either Skadden Arps or Weil Gotshal as lead counsel for the debtor did not have an impact on fees. Further, filing of cases in either SDNY or Delaware also did not impact professional fees in those chapter 11 cases. The five main variables that the Fee Study found impacted professional fees were: (i) debtor size (assets plus debts); (2) whether the debtors employed three or more professionals; (3) whether a committee was appointed; (4) the highest hourly rate of the debtors lead counsel; and (5) whether there were first day motions filed in the case.

⁷ The opinions as to the implications of the Fee Study’s data are solely those of the author and do not reflect the opinions of the Fee Study Reporter, ABI or any other person or entity.

These variables appear to be indications of the complexity of issues and sophistication of the representation required of a chapter 11 case, and not independent causes of increased professional fees. Therefore it appears that the who and where of a case is not be a major factor in fees. However, while Delaware and SDNY venues and the selection of specific large law firms as debtors counsel are not causes of higher fees, the fee structure of professionals is a factor which impacts professional fees in chapter 11 cases. As noted above the highest hourly rate of lead debtor counsel has an impact on fees. Therefore, a factor which should be considered by debtors in choosing professionals is the fee structure which will be used in the engagement.

This fact does not mean that there should be an attempt to return to “economy of the estate” billing of the Bankruptcy Act which kept fees in bankruptcy unfairly and uneconomically low. Rather it indicates that smaller professional firms should be able to complete on an economic basis for employment in chapter 11 cases by offering better terms to debtors if their inherent fee structure is lower than their competitors for the engagement.

B. Monthly Compensation and Ordinary Course Counsel are Becoming Accepted.

Although relatively common in large cases, there was little hard evidence that Courts were approving monthly compensation programs for chapter 11 professionals or ordinary course counsel employment and payment procedures in a wider range of cases. The Fee Study showed that a significant number of Courts are approving both of these procedures, although they have not been universally adopted in all chapter 11 cases.

C. Fee Examiners are Not Silver Bullets.

One of the more unusual findings of the Fee Study is the apparent lack of impact which the appointment of a fee examiner has on professional fees in chapter 11 cases. This finding does not mean that, in appropriate cases, fee examiners will not be a valuable mechanisms for controlling costs in chapter 11 cases. Rather, it seems to indicate that fee examiners should not be appointed in all large chapter 11 cases as a routine matter. Further investigation of the scope of fee review services may also be warranted to determine whether more administrative fee review services could relieve Bankruptcy Courts of the almost overwhelming administrative burden of having the sole responsibility of reviewing professional fees in larger chapter 11 cases.

D. Facts Do Matter: Individual Issues in Fees.

Finally, as important as the Fee Study has been in developing a model for professional fees in chapter 11 cases, the Fee Study also demonstrates that individual characteristics of a chapter 11 proceeding will ultimately control fees in a case. Indeed, one group of over 100 cases reviewed in the Fee Study had their professional’s fee statistics skewed by the fees in a single case where a trustee, examiner and special criminal litigation counsel were appointed. This shows that while their Fee Study

projections can be a valuable tool in suggesting a range of professional fees in cases, it should not be viewed as a controlling formula for professional fees in any given case.

III. The Law Here and Now: Key Case Law under 11 U.S.C. §§ 328 and 330.

A. Important Circuit Caselaw Under 11 U.S.C. § 330

First Circuit

In re Iannochino, 242 F.3d 36 (1st Cir. 2001) (discussing impact of final award of fees and factors to be reviewed in determining fees under § 330).

In re Spillane, 884 F.2d 642 (1st Cir. 1989) (Chapter 13 case noting lodestar is proper standard for awarding fees under 11 U.S.C. § 330).

Boston and Maine Corp. v. Sheehan, Phinney, Bass & Green P.A. 778 F.2d 890 (1st Cir. 1985) (Noting lodestar may not be only basis for awarding professional fees in bankruptcy).

Second Circuit

In re Keren Ltd. Partnership, 189 F.3d 86 (2nd Cir. 1999) (Discussing limits on nunc pro tunc retention and that 11 U.S.C. § 503 cannot be used to avoid requirements of 11 U.S.C. §§ 327 and 330).

In re Ames Dept. Stores, Inc., 76 F.3d 66 (2nd Cir. 1996) (Although overruled on Lamie issue, contains good discussion about 11 U.S.C. § 330 policy for awards of fees).

Third Circuit

In re Federal Mogul-Global, Inc., 348 F.3d 390 (3rd Cir. 2003) (Discussing relationship between fees awarded under 11 U.S.C. §§ 330 and 328).

Zolfo, Cooper & Co. v. Sunbeam-Oster Company, Inc., 50 F.3d 253 (3rd Cir. 1995) (Discussing appropriate hourly rates to use under lodestar analysis).

In re Busy Beaver Building Centers, Inc., 19 F.3d 833 (3rd Cir. 1994) (Leading case on how professional fees should be analyzed under 11 U.S.C. § 330).

Fourth Circuit

In re Computer Learning Centers, Inc., 407 F.3d 656 (4th Cir. 2005) (Discussing impact on interim awards of fees and use of Lodestar method to award claims).

Fifth Circuit

In re Cahill, 428 F.3d 536 (5th Cir. 2005) (Noting Lodestar is traditional method of calculating fees under 11 U.S.C. § 330).

In re Coho Energy, Inc., 395 F.3d 1988 (5th Cir. 2004) (Discussing 11 U.S.C. § 330 vs. § 328 fee awards).

Sixth Circuit

In re Big Rivers Elec. Corp., 355 F.3d 415 (6th Cir. 2004) (Discussing in general use of 11 U.S.C. § 330 in awarding reasonable fees).

In re Boddy, 950 F.2d 334 (6th Cir. 1991) (Chapter 13 case discussing use of Lodestar in awarding fees under 11 U.S.C. § 330).

Seventh Circuit

Matter of Taxman Clothing Co., 49 F.3d 310 (7th Cir. 1995) (Reviewing award of fees under Lodestar Standard and discussing in detail limits on use of Lodestar).

Matter of UNR Industries, Inc., 986 F.2d 207 (7th Cir. 1993) (Discussing policy behind 11 U.S.C. § 330 and the award of fees in bankruptcy).

Eighth Circuit

Stalnaker v. DLC Ltd., 376 F.3d 819 (8th Cir. 2004) (Holding Lodestar is appropriate method for calculating fees in bankruptcy cases under 11 U.S.C. § 330).

In re Apex Oil Company, 960 F.2d 728 (8th Cir. 1992) (Discussing non-contractual fee enhancements under 11 U.S.C. § 330).

Ninth Circuit

In re Eliapo, 468 F.3d 592 (9th Cir. 2006) (Noting “customary” method for awarding fees under 11 U.S.C. § 330 is Lodestar, but holding it is not only method of determining fees).

Unsecured Creditors Committee v. Puget Sound Plywood, Inc., 924 F.2d 955 (9th Cir. 1991) (Noting departure from Lodestar standard in awarding fees was not an abuse of discretion).

In re Manoa Finance Company, Inc., 853 F.2d 687 (9th Cir. 1988) (Discussing awards of non-contractual fee enhancements under 11 U.S.C. § 330).

Tenth Circuit

In re Commercial Financial Services, Inc., 427 F.3d 804 (10th Cir. 2005) (Noting that in Tenth Circuit an adjusted Lodestar analysis is used to determine reasonableness of fees under 11 U.S.C. § 330).

In re Miniscribe Corp., 309 F.3d 1234 (10th Cir. 2002) (Comparing common fund vs. Lodestar analysis in context of award of Trustee fees under 11 U.S.C. § 326).

In re Lederman Enterprises, Inc., 997 F.2d 1321 (10th Cir. 1993) (Discussing benefit to estate analysis under 11 U.S.C. § 330).

Eleventh Circuit

In re Citation Corporation, 493 F.3d 1313 (11th Cir. 2007) (Noting that Lodestar analysis is appropriate to use in determining professional fees where employment not approved under 11 U.S.C. § 328).

Grant v. George Schumann Tire & Battery Co., 908 F.2d 874 (11th Cir. 1990) (Discussing hourly rates under Lodestar and fee enhancement issues).

D.C. Circuit

In re AO V Industries, Inc., 797 F.2d 1004 (D.C. Cir. 1986) (Discussing Lodestar as a method of determining fees under 11 U.S.C. § 330 and reductions from Lodestar amounts for conflicts of interest).

B. Important Circuit Caselaw Under 11 U.S.C. § 330

First Circuit

In re Independent Engineering Co., Inc., 197 F.3d 13 (1st Cir. 1999) (Discussing court authority under 11 U.S.C. § 328(c) to “revisit” order employing professional).

Rome v. Braunstein, 19 F.3d 54 (1st Cir. 1994) (Discussing disgorgement issues under 11 U.S.C. § 328(c)).

Boston and Maine Corp. v. Sheehan, Phinney, Bass & Green, P.A., 778 F.2d 890 (1st Cir. 1985) (Addressing the approval of contingency fee agreements under 11 U.S.C. § 328).

Second Circuit

Bernheim v. Daman and Morey, LLP 2007 WL 1858292 (2nd Cir. 2007) (Noting under 11 U.S.C. § 328(c) that courts may deny compensation for conflict of interest).

Third Circuit

In re Federal Mogul-Global, Inc., 348 F.3d 390 (3rd Cir. 2003) (Discussing Discretion of Court in approving terms of employment under 11 U.S.C. § 328(a)).

United Artists Theatre Co. v. Walton., 315 F.3d 217 (3rd Cir. 2003) (Discussing standards for approval of indemnity agreements under 11 U.S.C. 328).

Zolfo, Cooper & Co. v. Sunbeam – Oster Co., Inc., 50 F.3d 253 (3rd Cir. 1995) (Reviewing precise language for order approving terms of employment under 11 U.S.C. § 328).

Fourth Circuit

In re J.W. Knapp, 930 F.3d 386 (4th Cir. 1991) (Refusing to allow trustee’s counsel to be compensated as professionals for performing work statutorily required of trustee).

Fifth Circuit

In re Coho Energy Inc., 395 F.3d 198 (5th Cir. 2004) (Discussing consideration fee award under 11 U.S.C. § 328(a) standards).

In re Barren, 325 F.3d 690 (5th Cir. 2003) (Reviewing standards for approval of employment under 11 U.S.C. § 328 and what constitutes circumstances incapable of being anticipated at time employment was approved).

Matter of Texas Securities, 218 F.3d 443 (5th Cir. 2000) (Holding lodestar review could not be used where employment and hourly rate were approved under 11 U.S.C. § 328).

Sixth Circuit

In re Airspect Air Inc., 385 F.3d 915 (6th Cir. 2004) (Setting forth standards for approval of employment under 11 U.S.C. § 328).

In re Federated Dept. Stores, Inc., 44 F.3d 1310 (6th Cir. 1995) (Discussing disgorgement of fees under 11 U.S.C. § 328(c)).

Seventh Circuit

In re Crivello, 134 F.3d 831 (7th Cir. 1998) (Reviewing in detail disallowance of fees under 11 U.S.C. § 328(c)).

Eighth Circuit

In re Farmland Industries, Inc., 397 F.3d 647 (8th Cir. 2005) (Addressing proper way to calculate “success fee” approved under 11 U.S.C. § 328).

In re Mahendra, 131 F.3d 750 (8th Cir. 1997) (Discussing court discretion to reduce professional fees under 11 U.S.C. § 328(c)).

Ninth Circuit

In re Circle K Corp., 279 F.3d 669 (9th Cir. 2002) (Reviewing standards for employment and review of fees under 11 U.S.C. § 330 vs. employment and review of fees under 11 U.S.C. § 328).

In re B.U.M. Intern., Inc., 229 F.3d 824 (9th Cir. 2000) (Court reviews standards for approval of employment under 11 U.S.C. § 328. Order approving retention, but reserving right to review final fee application for reasonableness and benefit to the estate, did not approve employment under 11 U.S.C. § 328).

In re Reimers, 972 F.2d 1127 (9th Cir. 1992) (In depth analysis of approval of retention under 11 U.S.C. § 328 and scope of court review of fees under 11 U.S.C. § 328(a)).

Tenth Circuit

In re Commercial Financial Services, Inc., 427 F.2d 804 (10th Cir. 2005) (Discussing that lodestar analysis of fees would be required where professional not retained under 11 U.S.C. § 328).

In re Miniscribe Corp., 309 F.3d 1234 (10th Cir. 2002) (Discussing trustee compensation where trustee hires firm as professional under 11 U.S.C. § 328(b)).

Eleventh Circuit

In re Citation Corp., 493 F.3d 1313 (11th Cir. 2007) (Reviewing standard for approval of retention and fee structure under 11 U.S.C. § 328 at time of employment.)

U.S. v. Ruff, 99 F.3d 1559 (11th Cir. 1996) (Discussion of approval under 11 U.S.C. § 328 of fee structure of professional in connection with IRS levy of fees from trustee).

D.C. Circuit

No Circuit cases.

See David & Hagner, P.C. v. DHP, Inc., 171 B.R. 429 (D.D.C. 1994) (Discussing approval of guarantee of fees by non-debtor third party under 11 U.S.C. § 328).

IV. Fees Under Lodestar and 11 U.S.C. § 330.

In general, awards of attorney fees and other professional fees are governed by 11 U.S.C. § 330.⁸ 11 U.S.C. § 330(3)(A) provides that:

In determining the amount of reasonable compensation to be awarded, 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 on such services; (b) the rates charged for such services; (c) whether the services were necessary to the administration of, or beneficial at the time at which the service was rendered toward the completion of, a case under this title; (d) whether the services were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed; and (e) whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.

While this provision of the Bankruptcy Code sets forth a few key factors for Courts to consider, the factors set forth in §330(3) are by no means exhaustive. See generally Johnson v. Georgia Highway Express, Inc., 488 F.2d 714 (5th Cir.1974) (setting forth 12 factors to be considered in determining reasonable hourly rates and reasonable hours for an award of professional fees).

The main test used by Courts in determining an award of fees under 11 U.S.C. § 330 is the Lodestar Test. “The Lodestar method calculated as the number of hours reasonable expended multiplied by a reasonable hourly rate is the appropriate calculation of fees [under 11 U.S.C. § 330]” Stalaker v. DLC Ltd., 376 F.3d 819, 825 (8th Cir. 2004). See also, In re Busy Beaver Building Centers, 19 F.3d 833 (3rd Cir. 1994). While the reasonable hours times reasonable rates formula of Lodestar is well known and has been extensively adopted by Courts, the more difficult question of what factors are used to determine reasonable rates of compensation and reasonable hours expended has not received as extensive judicial review.⁹ As a determination of reasonableness under Lodestar in a given case is a factual, rather than a legal inquiry,¹⁰ there is no exact or universal answer to this great philosophical question. However, there are certain factors which generally should be considered in the reasonableness of each component of Lodestar.

⁸ See generally, Blum v. Stensen, 465 U.S. 886 (1984) (non-bankruptcy fee shifting case; In re Apex Oil Co., 960 F.2d 728 (8th Cir. 1992).

⁹ See In re Atwell, 148 B.R. 483, 488 (Bkrtcy. W.D.Ky 1993) (“While the Lodestar Standard is easy to articulate defining its two key terms is not so simple.”); see also, In re Fleming Components, Inc., 304 B.R. 85 (Bkrtcy. D. Del. 2003) (discussing appropriate hourly rates).

¹⁰ See generally: Stalaker v. DLC, Ltd., 376 F.3d at 825; Matter of Taxman, 49 F.3d 310 (7th Cir. 1995).

One of the broadest analysis of the components of Lodestar is found in the case of In re Atwell,¹¹ where the Court attempted to devise a conceptual framework for resolving these questions by formulating a set of factors to be used in determining: (1) reasonable hourly rates; 2) reasonable hours expended on the tasks in question; and (3) whether there should be global modifications to the requested professional fees.

A. Let's See, the Moon is in the Seventh House, so This Year's Hourly Rate is. . .

Atwell identifies six factors to be considered in determining what constitutes a reasonable rate of compensation. The first and the most important of these factors is what is the customary hourly rate charged by the professional in question.¹² In litigating any objection to fees this is the starting point of determining reasonable hourly rates. Professionals seeking to defend their fee requests should consider providing general billing records for the professionals or fee applications in other bankruptcy cases to establish their hourly rates.

The second factor which should be established in litigation involving the reasonableness of a professional's rates is whether the rate charged by the professional is commensurate with rates charged by other similar professionals. The principal issues which will arise under this factor are: (1) do you compare the professional's rates to other bankruptcy professionals only or to all similar professionals regardless of their specialty;¹³ and (2) do you compare the professional's rates to the rates charged where the bankruptcy is pending or the local where the professionals generally practice.¹⁴ In situations such as this, parties should consider using expert witnesses or studies of similar hourly rates to support their positions.¹⁵

A third factor to be considered in determining the reasonableness of fees is the skill of the attorney and quality of legal services provided. This is one of the most subjective elements of the consideration concerning the reasonableness of rates, as it goes not to an attorney's general billing rate or a comparable rate of compensation in an appropriate market, but to how well the attorney performed his tasks in the case. This issue will generally be resolved by a review by the Court of the professional's

¹¹ 148 BR at 483 – In support of full disclosure the author had the honor as serving as the Law Clerk for the Honorable Henry H. Dickinson when he authored the Atwell opinion.

¹² For a discussion of customary hourly rates See Bowles Are All Attorneys Created Equal? 23 Am Bankr L.J. 32 (Mar. 2004); See also In re Busy Beaver Building Centers, 19 F.3d 833 (3rd Cir. 1994) (Professional fees should be awarded in bankruptcy cases on the same economic basis as fees are paid by non-bankruptcy clients); Matter of Taxman Clothing Co., 49 F.3d 310, 315-316 (7th Cir. 1995); In re Atwell, 148 B.R. 483, 488-89 (Bkrcty. W.D. Ky 1993).

¹³ See In re Fleming Companies, Inc., 304 B.R. 85 (Bkrcty. D.Del. 2003).

¹⁴ See generally In re Farly Inc., 156 B.R. 203 (Bkrcty. N.D. Ill. 1993) (counsel location of general practice governs fees); In re Grimes, 115 B.R. 639 (Bkrcty. D.S.D. 1990) (local rates may prevail if matter could be handled by local counsel).

¹⁵ See Matter of River Landings Inc., 180 B.R. 701 (Bkrcty. S.D. Ga. 1995) (Discussing use of expert testimony on fees).

performance in the case. See generally, In re Maxine's Inc., 304 B.R. 245 (Bkrcty. D. Md. 2003).

The fourth factor in determining the reasonableness of hourly rates is the difficulty and novelty of the issues presented in a case or particular matter. This consideration goes to issues of the level staffing of specific issues in a case. Counsel should work to establish that the staffing and rates charged in the case generally were appropriate for the importance and complexity of the matters involved.¹⁶

A fifth issue controlling reasonable hourly rates concerns whether the tasks performed by a professional would be considered “clerical” duties which would either be considered part of a professional’s overhead (and not compensated on an hourly rate basis) or work which should be compensated at much lower rates. While it is well established in bankruptcy and non-bankruptcy settings that paraprofessionals are compensated for their work on an hourly basis rather than as a form of expense or overhead, there is still a great deal of discussion as to the appropriate rate for such billings and as to what matters should be performed by paralegal professionals or by attorneys.¹⁷

A sixth factor which should also be reviewed by Courts in determining the reasonableness of hourly rates is the terms of the professional’s engagement agreement and the use of reasonable billing judgment by the professional in charging its clients under that contract. A billing agreement if approved by the Court as part of the professional’s retention, will govern how the debtor should be billed, although unless specific billing terms are approved under 11 U.S.C. § 328, they will generally be subject to 11 U.S.C. § 330 review. Further as noted by the Supreme Court,¹⁸ attorneys must exercise billing judgment in reducing the hourly rates charged on a matter where appropriate. At all times professionals should disclose in their fee applications how they exercised their billing judgment as opposed to just providing after the fact evidence of the care with which the professional reviewed its bills in any hearings over fee objections.

B. It’s About Time, . . . uh Yeah It Is.

The second component of the Lodestar calculation of an appropriate professional fee is the determination of the reasonable hours expended in all matters in a bankruptcy case. This portion of the Lodestar analysis is generally given stricter scrutiny than the reasonable rate component as Courts seek to ensure that professionals are not

¹⁶ See In re McClanahan, 137 B.R. 73, 75 (Bkrcty. M.D. Fla. 1992) (Hourly rates requested by counsel in a routine consumer chapter 13 case exceeded rates charged at that time by attorneys in complex chapter 11 cases and would be denied).

¹⁷ See generally In re Busy Beaver Bldg. Centers Inc., 19 F.3d at 833.

¹⁸ In Hensley v. Eckerhort, 461 U.S. 424, 103 S.Ct. 1933, 76 L.Ed.2d 40 (1983): the Supreme Court noted: “[attorneys] should make a good faith effort to exclude from a fee request hours that are excessive, redundant or otherwise unnecessary; just as a lawyer in private practice ethically is obligated to exclude such hours from his fee submission. ‘In the private sector, “billing judgment” is an important component in fee setting. It is no less important here.’”

compensated for either inefficiency or for spending time on projects which are not beneficial to the estate.¹⁹

The initial factor in determining what constitutes reasonable hours expended in a case, concerns the nature of the issues involved in the proceeding. The more difficult, unusual or complicated issues in a case, the more time that will be spent by the professional. Further the size and magnitude of a particular issue will also be important in determining the reasonableness of the hours expended in a matter. Unfortunately, as noted by the Atwell Court, the size, importance and difficulty of the issues in dispute in a bankruptcy case are purely factual questions which can only be resolved on a case by case determination.²⁰

The second factor important to determining what constitutes a reasonable amount of time spent on matters in a case is the amount of time spent on comparable matters in similar cases by comparable counsel. This factor is more often applied in an analysis of chapter 13 fees, where numerous routine pleadings often make up the bulk of a professional's fees. However, such a review can also be applied in chapter 11 cases.²¹

A third element to be used in evaluating the reasonable hours expended by a professional in a bankruptcy case is the nature and characteristics of the debtor in a particular case. A debtor with a simple debt structure, which is in the process of selling its assets or has terminated its operations will generally have fewer legal and factual issues in dispute than, an operating chapter 11 debtor with several viable, but different potential business models which could be adopted, a complex debt structure and significant pending litigation.

The fourth factor which must be considered in determining whether the hours claimed by the professional are reasonable, is the degree to which matters have to be litigated. While professionals compensated under 11 U.S.C. § 330 should not be compensated for causing needless litigation²² professionals should not be penalized by having the actual time spent on a matter reduced solely because they were faced with zealous or perhaps overly zealous opposition which lead to what would otherwise be an excessive amount of time spent on a matter. See Stalnaker v. DLC Ltd., 376 F.3d 819 (8th Cir. 2004) (Court awarded trustee's counsel its requested fees even though defendant settled case and paid all creditors in full after 4 years of litigation on a fraudulent conveyance suit that only became moot after the defendant's payment to creditors).

A fifth factor to be reviewed by Courts in determining reasonable time expended in a case, is the amount of time spend in preparing attorney fees applications. While most

¹⁹ See Matter of Taxman Clothing Co., 49 F.3d 310, 313 (7th Cir. 1995); In re Atwell, 148 B.R. at 491.

²⁰ 148 B.R. at 491.

²¹ See Matter of Taxman Clothing Co., 49 F.3d 310, 314-315 (discussing comparison of typical preference litigation with the litigation at issue in the case).

²² Id. at 316 (Denying \$78,000 of an \$85,000 fee awarded for engaging in a preference lawsuit that could only have resulted in a \$33,000.00 judgment for the bankruptcy estate).

Courts²³ permit reimbursement of at least some professional fees for the preparation of fee applications in Lodestar cases, the amount of time allowed on preparing fee applications is generally limited. Further, it is an open question as to whether any professional fees will be awarded for the defense of, as opposed to the preparation of, a fee application although the recent trend seems to support awards of attorney fees for litigation related to fee award.²⁴

The final factor generally used in determining the amount of reasonable hours in a case is once again an analysis of the billing judgment used by the professional requesting its fees. In order to prove that a bill has been properly reviewed by a professional, “counsel in their fee request should set forth what time has been written off.” In re Automobile Warranty Corporation, 138 B.R. 72 (Bkrtcy. D.Col. 1991) in order to demonstrate the proper use of billing judgment.

C. Judicial Eye for the Fee. . . Persons: Global Modifications of Professional Fees Under Lodestar.

Finally, the Atwell Court lists 5 additional factors which should be considered in whether a fee should be modified either up or down, taking the fee request as a whole rather than by adjusting specific rates or hours charged on a particular motion. These factors are: (1) compliance with employment and fee application requirements including ethical requirements; (2) opportunity costs in the time the engagement has taken away from other potential matter; (3) the undesirability of the case; (4) the potential contingent nature of the compensation; and (5) the results obtained by the professionals. In re Atwell, 148 B.R. at 492-493.

In briefly discussing these factors the Atwell Court stressed that factors 2, 3 and 4 of the global modifications would only be used to modify fees in the rarest and most unusual cases.²⁵ The Atwell Court also noted that factor (1) would generally be used to globally reduce fees²⁶ while factor (5) would generally be considered in cases where a fee enhancement was requested²⁷ although in extreme cases it could also be used to reduce fees.²⁸

V. Non-Lodestar Fee Structures and Provisions.

As noted above, unless another method of billing is provided for in a professional’s engagement agreement and is approved by the Court, 11 U.S.C. § 330 and

²³ See generally Coulter v. Tennessee, 805 F.2d 146 (6th Cir. 1986) (3% limit on fee application time).

²⁴ In re Wind N’ Wave, ___ F.3d. ___ 2007, W.L. 4226146 (9th Cir. December 3, 2007).

²⁵ For a full discussion of non-contractual fee enhancements, see In re El Paso Refinery LP, 257 B.R. 809 (Bkrtcy. W.D. Tx. 2000).

²⁶ See generally, Freeman, Current Issues in Bankruptcy Ethics 091803 ABI-CLE 265 (September 18-21, 2003) for a discussion of the problems in failing to comply with the provisions of the Bankruptcy Code, Bankruptcy Rules and applicable local rules in seeking employment or requesting awards of fees.

²⁷ See Protopopas, Fee Enhancements; How Do You Get One, Parts I and II 20 Am. Bankr. Inst J. 1 (June 2001) and 20 Am Bank Inst J. 12 (Aug. 2001).

²⁸ See generally Matter of Taxman Clothing Co., 49 F.3d at 310.

the Lodestar standard will be employed in evaluating the fees to be awarded to professionals. See generally Blum v. Stensen, 465 U.S. 886 (1984); In re Apex Oil Co., 960 F.2d 728 (8th Cir. 1992).

However, many professionals have fee structures both in and out of bankruptcy engagements which are not based on the Lodestar model. Regardless of what fee structure a professional may use in an engagement with a debtor, or Trustee or Committee, the professional should seek in its Retention Application to have its fee structure approved by the Court under the provisions of 11 U.S.C. § 328.

A. Approval of Fee Structures Under 11 U.S.C. § 328.

11 U.S.C. § 328(a) as amended by BAPCPA provides:

(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.

The most important provisions of 11 U.S.C. § 328(a) provide that a Bankruptcy Court may approve, as a part of the retention of a professional, “any reasonable terms and conditions of their employment, including on a retainer, on an hourly basis, on a fixed or percentage fee basis or on a contingent fee basis.” Compare In re Circle K Corporation, 279 F.3d 669 (9th Cir. 2002) (approving a Bankruptcy Court's review of reasonableness of a professional's fees under 11 U.S.C. § 330 and requiring submission of hourly fee records to a professional employed on a flat fee basis where initial employment was not approved under 11 U.S.C. § 328) with Matter of Barron, 225 F.3d 583 (5th Cir. 2000) (reversing Bankruptcy Court, which reviewed contingent fee arrangement for reasonableness under 11 U.S.C. § 330 where original contingent fee basis for fees had been approved under 11 U.S.C. § 328).

The importance of Court approval of a fee structure under 11 U.S.C. § 328 as part of an employment application concerns how fees are reviewed for final allowance by a Court. If a professional's fee structure is approved under 11 U.S.C. § 328 as part of the order approving the professional's retention, the Professional's fees can only be reconsidered by the Court, if the Court finds that the terms and conditions of the fee structure “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.” 11 U.S.C. § 328(a). However, if the fee structure was not approved by the Court under 11 U.S.C. § 328, then a professional's final fee application may be reviewed under the standards of 11 U.S.C. § 330 to see if the compensation requested is reasonable. A Court may require detailed time records for this Lodestar based determination to support any claimed fees. See generally In re Circle K Corp., 294 B.R. 111, 120-123 (Bkrtcy. D.Az. 2003) (discussing how to determine fees for reasonableness under 11 U.S.C. § 330 where professional's flat fee structure was not approved under 11 U.S.C. § 328 and the professionals did not keep time records).

As a general rule, in order for the more limited fee review provisions of 11 U.S.C. § 328 to govern a fee award, the application for retention and the Order approving retention must expressly and unambiguously provide for approval of the retention under section 328. Otherwise, Courts will be able to review fees for reasonableness under 11 U.S.C. § 330.²⁹ Although the Sixth Circuit³⁰ allows a less restrictive “totality of the circumstances” test to determine whether retention of a professional was approved under 11 U.S.C. § 328, this appears to be a minority position. Therefore, professionals should seek specific retention under section 328 and approval of their employment under 11 U.S.C. § 328 in the order approving their employment or run the significant risk having to justify their fees under 11 U.S.C. § 330.

B. Types of Fee Structures.

As can be noted above, there is no statutory limitation as to the type of fee structure which a Court can approve under 11 U.S.C. § 328. However, any fee structure which could be approved must constitute “reasonable terms and conditions of employment”. See In re Insilco Technologies, Inc., 291 B.R. 628 (Bkrtcy. D.Del. 2003) (approving “Evergreen” retainer structure). Below are a few of the more common types of non-Lodestar fee structures which have been approved by Courts under 11 U.S.C. § 328(a).

1. Contingent Fees.

In numerous cases, Courts have approved a compensation arrangement for professionals on a “contingent fee” basis. In fact, contingent fee arrangements are the most common non-Lodestar based forms of compensation for attorneys approved by Courts. See Matter of Barron, 225 F.3d 583 (5th Cir. 2000); Matter of Texas Securities, Inc., 218 F.3d 443 (5th Cir. 2000). Under these fee arrangements, professionals are generally awarded a percentage of the recovery made on behalf of the bankruptcy or Committee. In these cases, professionals must clearly spell out the circumstances under which the contingent fee award will be made. It is important to note the contingent fee awards can be made in addition to an hourly based fee structure, although the Court would have to review the structure of such a fee package, as part of the approval of the

²⁹ See In re Circle K Corp., 279 F.3d 669, 671 (9th Cir. 2002); Zolfo, Cooper & Cov. Sunbeam-Oster Co., Inc., 50 F.3d 253, 26-62 (3rd Cir. 1995).

³⁰ In re Airspect Air, Inc., 385 F.3d 915 (6th Cir. 2004).

professional's retention, under 11 U.S.C. § 328 for reasonableness, and the hourly component of the fee structure would be reviewed under Lodestar standards and 11 U.S.C. § 330 in any fee application filed by the professional.

2. Flat Rate Fees.

Increasingly, it is becoming common for non-attorney professionals to be paid on some form of a "flat-rate" basis. In several high-profile bankruptcy cases, financial advisors to an Estate or Committee have been paid a flat monthly fee for their work in a bankruptcy proceeding.

While flat fee arrangements are clearly permissible under the Bankruptcy Code, unless they are clearly approved by the Court under the provisions of 11 U.S.C. § 328, they are subject to review by the Court under 11 U.S.C. § 330 and will be challenged if the Lodestar calculation for the actual work done by the Professional is less than the flat fees that were charged by the debtors. In the cases of In re Citation Corporation, 493 F.3d 1313 (11th Cir. 2007); In re Commercial Financial Services, Inc., 427 F.3d 804 (10th Cir. 2005) and In re Circle K Corporation, 279 F.3d 669 (9th Cir. 2002), professionals, who had been hired on a flat fee basis and were paid several hundred thousand dollars per month, had their final fees successfully challenged and were forced to prove the amount of time spent and hourly rates of the professionals working on the debtors' cases under Lodestar before they were awarded any fees. In the Circle K, Citation and Commercial Financial cases, the Courts noted that if the initial engagement of these professionals been approved under 11 U.S.C. § 328, the final review of the reasonableness of their fees under 11 U.S.C. § 330 would not have been permissible, unless the Court had determined that the fee structure originally approved had been "improvident in light of the developments not capable of being anticipated at the time the fee structure was approved." It is interesting to note that Courts are willing to approve flat rate fees in chapter 11 for attorneys even though such fees would ordinarily be subject to a Lodestar review under 11 U.S.C. § 330. See also In re Pineloch Enterprises, Inc., 192 B.R. 675 (Bkrcty. E.D. N.C. 1996) (flat rate approved for attorney fees in chapter 11 case).

3. Success or Transaction Fees.

Recently, many professionals, both in and out of bankruptcy cases, are negotiating success or transaction fees, in addition to other fee structures as compensation for engagements. These transaction fees are usually a form of a contingent payment which will be earned if certain financial goals are met. These fees are calculated in a wide variety of ways, and often involve extremely complex financial models negotiated between the parties. See In re Farmland Industries, Inc., 296 B.R. 188 (8th Cir. BAP 2003) (success fee for Committee Professionals approved by Court, amounting to one percent of all distributions made to Committee's constituents). There is another form of success fees which have been approved in chapter 11 cases which involves non-contractual success fees or fee enhancements awarded for exceptional performance in those cases. Non-contractual success fees are becoming increasingly rare and, therefore, professionals seeking any form of success fee or enhancement of their hourly rates or other base fee structure should contract for these success fees and have these fees

approved by the Court under 11 U.S.C. § 328. Even in cases where tremendous results are achieved by the financial professional, the lack of a contractual provision may prevent a Court from awarding a success fee. See generally, Protopapas, Fee Enhancements: How Do You Get One? Parts I and II, at footnote 27.

4. “Lodestar” Fee Structure Approval.

Finally, even if a professional’s agreement is to be paid under Lodestar, the professional should have its hourly rates and other terms of the employment agreed to by the bankruptcy estate or Committee approved under 11 U.S.C. § 328. Without such approval, it is possible that a Court could “modify” under section 330 the retention agreement and change either the hourly rates charged or the method of payment to a different calculation. In the case of Unsecured Creditors Committee v. Puget Sound Plywood, Inc., 924 F.2d 955 (9th Cir. 1990), the Ninth Circuit upheld the Bankruptcy Court changing the method of compensation of an attorney from a Lodestar basis to a percentage-recovery basis, noting that the Court did not approve the hourly-based fee arrangement between the attorney and the Committee as a part of his retention application.

In summary, is highly important to avoid a “hindsight” reassessment of fees or retention agreement, except under the limited provisions of 11 U.S.C. § 328(a), by obtaining approval of the structure of a professional's compensation in the order approving the professional retention. However, it should be noted that 11 U.S.C. § 328 can, in rare cases, be used to assist professionals in the event the compensation provided for in the original agreement with a bankruptcy estate or Committee turns out to be improvidently too low, in light of factors unknown at the time they were initially retained. In the case of In re Home Express, Inc., 213 B.R. 162 (Bkrcty. N.D. Cal. 1997), the Court allowed professionals who sought an amendment of their prior fee orders to increase their “flat fee” arrangement in light of post-petition components that were unknown at the time of their retention.

C. Indemnification Provisions.

As with compensation provisions, other provisions of a professional's retention agreement should be approved under 11 U.S.C. § 328(a) in order for the Professional to be properly retained and compensated in bankruptcy proceedings. One of the critical issues that should be approved under 11 U.S.C. § 328 are issues related to indemnification of professionals and similar provisions in their retention agreements (“Indemnification Provisions”).

The leading case discussing Indemnification Provisions in bankruptcy is In re United Artist Theatre Company v. Walton, 315 F.3d 217 (3rd Cir. 2003). In this case, the Third Circuit Court of Appeals ruled that such Indemnification Procedures were not, per se, prohibited by the provisions of either 11 U.S.C. §§ 327 or 328 and could be approved on a case-by-case basis. However, the Third Circuit cautioned that the indemnification provisions would have to be reasonable and that broadly-written provisions, which would eliminate most of a professional's liability, would not be found to be reasonable and

would be disallowed by Courts. Further, the United Artists Theatre Court held that indemnification provisions would be strictly construed by the Court, against the professional in question. Therefore great care should be made in their drafting and approval by Courts in connection with employment applications. See generally In re Baltimore Emergency Services II, LLC, 291 B.R. 382 (Bkrtcy. D.Md. 2003) (rejecting indemnity provisions in question and holding that indemnity agreement, which indemnified professional from gross negligence and willful misconduct, provided indemnification for all contractual disputes between the professional and the debtors and did not specifically exclude from its provisions breaches of loyalty or of conflict of interest by the professional was, per se, unreasonable). For an additional discussion of the United Artists case on the question on availability of indemnification provisions in bankruptcy cases, see Bowles, “Now Playing at a Theater Near You: In re United Artists Theatre Co. v. Walton, 315 F.3d 217 (3rd Cir. 2003)”, which was originally published in 2003 No. 5 Norton Law Advisor 2 (May 2003).

VI. Professional Fees in Involuntary Cases.

Involuntary bankruptcy proceedings and the fee problems faced by professionals representing parties faced with an involuntary petition during the period between the filing of the involuntary bankruptcy petition and the adjudication or consent to the entry of the order of relief in a bankruptcy case (“Gap Period”) have always posed particularly difficult challenges to bankruptcy professionals.³¹ Fee issues related to representing parties subject to involuntary bankruptcy proceeding (“Potential debtors”) arise from the lack of certainty as to how professional fees accrued representing Potential debtors during the Gap Period are treated in a subsequent bankruptcy.

A. Can Anyone Tell Me What the Ordinary Course of Business Is?

In a voluntary bankruptcy proceeding, the Bankruptcy Code offers a clear, if not particularly precise, statutory framework as to how and when the debtor’s professional can be hired to represent the bankruptcy estate.³²

In involuntary bankruptcies, 11 U.S.C. § 327 does not govern the appointment of a debtor’s professionals during the Gap Period.³³ Instead, the process for being paid while representing a Potential debtor facing an involuntary bankruptcy petition is governed directly or indirectly by four separate statutes. 11 U.S.C. §§ 303(f), 502(f), 507(a)(3) and 549.

The primary section of the Bankruptcy Code addressing how a debtor may hire and pay professionals during the Gap Period is 11 U.S.C. § 303(f) which authorizes a Potential debtor to operate its business and use, acquire and dispose of its property as if

³¹ See 11 U.S.C. §§ 303 and 502(f).

³² See 11 U.S.C. § 327.

³³ See 11 U.S.C. § 327; In re McNair, Inc., 116 B.R. 746 (Bkrtcy. S.D. Cal. 1990) (Order approving employment of counsel for Potential Debtor not required under either 11 U.S.C. § 327 or 329).

an involuntary case had not been commenced, unless a Court orders otherwise.³⁴ This provision generally permits a debtor to continue to operate in the ordinary course of its business under the guidelines of 11 U.S.C. § 363 which requires Court authorization for the sale, use or lease of property of the debtor other than in the ordinary course of its business.³⁵

The ability of a debtor to operate its business, however, is also limited by the provisions of 11 U.S.C. §§ 502(f) and 507(a)(3) which governs the allowance of claims during the Gap Period between the filing of involuntary bankruptcy petition and the appointment of either an interim trustee or the entry of an order of relief.³⁶ Section 502(f) allows claims “arising out of the ordinary course of the debtor’s business or financial affairs,” during the Gap Period to be allowed as a pre-petition claim in a bankruptcy case. 11 U.S.C. § 507(a)(3) grants claims allowed under 502(f) a second priority status, behind administrative expenses. Read together, Sections 502(f) and 507(a)(3) mean that unsecured claims which arise in the ordinary course of the debtors’ business during the Gap Period are entitled to a third priority status unsecured claims. Claims which do not arise in the ordinary course of the debtor’s business during the Gap Period, if allowed at all, will be treated only as general unsecured claims.³⁷

Finally, 11 U.S.C. § 549 provides a final limitation on the payment of professional fees during the Gap Period. 11 U.S.C. § 549³⁸ provides that the trustee may avoid the transfer of property that occurs after the commencement of a bankruptcy case, including an involuntary proceeding whether the transfer is only authorized under Section 303(f), unless said transfer is: (1) made after the commencement of the involuntary case; (2) before the entry of an order of relief; and (3) to the extent of any value of goods or services rendered to a debtor after the commencement of the case.³⁹ The “safe harbor”

³⁴ See 11 U.S.C. § 303(f) Provides: “Notwithstanding section 363 of this title, except to the extent that the Court orders otherwise, and until an order for relief in the case, any business of the debtor may continue to operate, and the debtor may continue to use, acquire or dispose of property as if an involuntary case concerning the debtor had not been commenced.”

³⁵ See 11 U.S.C. § 363.

³⁶ See 11 U.S.C. § 502(f) Provides: If an involuntary case, a claim arising in the ordinary course of the debtor’s business or financial affairs after the commencement of the case but before the earlier of the appointment of a trustee and the order for relief shall be determined as of the date such claim arises, and shall be allowed under subsection (a), (b) or (c) of this section or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition. 11 U.S.C. § 502(f) expenses have priority under 11 U.S.C. § 507(a)(3) (**designated 11 U.S.C. § 507(a)(2) prior to BAPCPA**).

³⁷ See *In re Manufacturer’s Supply Co.*, 132 B.R. 127 (Bkrcty. N.D. Ohio 1991) (claims which arise in the Gap Period which do not arise in the ordinary course of a debtor’s business are general unsecured claims).

³⁸ See 11 U.S.C. § 549(a)(b) provides in part: “Except as provided in subsections (b) or (c) of this section, the trustee may avoid a transfer of property of the estate: (1) made after the commencement of the case; and (2)(a) that is authorized only under section 303(f) or 542(c) of this title; or (b) that is not authorized under this title or by the Court. In an involuntary case, the trustee may not avoid under subsection (a) of this section a transfer made after the commencement of such case but before the order for relief to the extent any value, including services, but not including satisfaction or securing of a debt that arose before the commencement of the case, is given after the commencement of the case in exchange for such transfer, notwithstanding any notice or knowledge of the case that transferee has.”

³⁹ *Id.*

provisions of 11 U.S.C. § 549(b) does not include providing security or the payment of any debt that arose before the commencement of the case.

Based on this patchwork quilt of statutes, it appears that if a Potential debtor ultimately files bankruptcy, any professional fees earned or paid during the Gap Period are at risk. Unless a Court is willing to approve nunc pro tunc to the beginning of the Gap Period the application of a chapter 11 debtor's professionals, then that professional will be entitled to at best a third level priority expense, for any services rendered, "in the ordinary course of the debtor's business." Courts are generally split as to whether amounts paid professionals during the Gap Period are paid "in the ordinary course" of a day's business.

B. Since When Is an Involuntary Bankruptcy Ordinary?

Although there is little direct case law on the subject, Courts have still managed to split on the issue of whether payments or accrual of Gap Period professional fees related to the involuntary bankruptcy arise in the ordinary course of a Potential debtors' business.

One line of bankruptcy cases, holds that generally the professional fees accrued or paid by a debtor during the Gap Period do not arise in the ordinary course of business and are not entitled to priority under 11 U.S.C. § 507(a)(3). One leading case under this line of authority is In re: Hanson Industries, Inc.⁴⁰ In Hanson, counsel for the Potential debtor applied in the Potential debtor's bankruptcy for an award of attorney's fees, both as administrative expense under 11 U.S.C. § 507(a)(1) or as a second priority administrative expense under 11 U.S.C. § 507(a)(2) under pre BAPCPA law. The services for which the attorney sought reimbursement primarily were related to "virtually every possible defense for filing an involuntary petition."⁴¹ In reviewing the fee application, the Court ultimately found that the actions of debtor's counsel were at best of extremely doubtful value to the bankruptcy estate, and at worst, an obstruction to the bankruptcy trustee's efforts to administer the estate. The Bankruptcy Court, ultimately determined that most of the debtor's counsel's work was not beneficial to the estate and denied \$48,000.00 of the \$60,000.00 fee application made by debtor's counsel. The Court noted that, "creditors would not ordinarily and reasonably expect a company with virtually no assets and no business to expend more than \$60,000.00 over a period of 11 weeks in litigation of any sort." Thus, while some reasonable amount of attorney's fees might be expected to minimally keep certain of the claims of the company alive, sums in the amount and of the nature involved, and efforts as zealous and determined as these, are not reasonably justified.⁴² The Court went on to find that where the debtor failed to voluntarily convert to a chapter 11, or agree to an adjudication of bankruptcy, that the attorney fees and expenses did not arise in the ordinary course of the debtor's business.⁴³

⁴⁰ 90 B.R. 405 (Bkrty. D. Minn. 1988).

⁴¹ Id. at 408.

⁴² Id. at 408 n.2.

⁴³ Id. at 414.

Perhaps the most troubling portion of the Hanson decision is its discussion of why Hanson was distinguishable from the case of In re: Sun Spec Industries⁴⁴ which found professional fees earned during the Gap Period did arise in the ordinary course of a debtor's business and were entitled to priority status. The Hanson Court distinguished Sun Spec by noting "the debtor chose to voluntarily convert to a chapter 11 and option this debtor rejected." This dicta is problematic as it seems to indicate that professionals are more likely to get paid if a Potential debtor voluntarily enters bankruptcy.

The Hanson decision was based on a number of similar rulings, including the case of In re: Kenval Marketing Corporation,⁴⁵ and In re: J.V. Knitting Service, Inc.,⁴⁶ both of which held, that professionals working for Potential debtors that opposed an involuntary petition, would not be awarded either an administrative expense of their 11 U.S.C. § 507(a)(1) or an administrative expense under 11 U.S.C. § 507(a)(2) for their work during the Gap Period. Hanson based its decision on the cases of Kalin v. Litas,⁴⁷ and In re: Peninsula Roofing & Sheet Metal, Inc.⁴⁸ Debtors have also prevailed against professionals on preference actions for fees paid prior to a bankruptcy filing which were found not to have been paid in the ordinary course of a debtor's business.

The rationale behind the Hanson line of cases is that payments made to attorneys during the Gap Period, especially payments made to contest an involuntary bankruptcy petition, rarely arise in the ordinary course of business and, that such services were not valuable to the debtor's bankruptcy estate. These cases take a rather strict approach as to the concept of the ordinary course of business and make it difficult for an attorney representing a Potential debtor to be assured of being paid or even having a priority claim for fees earned during the Gap Period, unless the Potential debtor agrees to convert to a chapter 11 or is successful in opposing the involuntary bankruptcy.

C. Since When is it Not Ordinary to Hire an Attorney to Fight a Lawsuit?

Other Courts have rejected the reasoning of Hanson and have allowed professionals to be paid, or at least be awarded a priority claim, for their services during the Gap Period. Perhaps the most liberal position on this matter is taken by the Court in In re: Rundlett.⁴⁹ In Rundlett, the law firm was paid during the Gap Period the sum of \$50,000.00 to represent the Potential debtor in the involuntary chapter 7 petition filed against her. Approximately three weeks after they were retained, the debtor converted her case to a chapter 11 proceeding and moved to employ the law firm as her chapter 11 counsel. The proposed employment application permitting the law firm to retain the \$50,000.00 retainer paid to them during the Gap Period.

⁴⁴ 3 B.R. 703 (Bkrcty. S.D. N.Y. 1980).

⁴⁵ 84 B.R. 32 (Bkrcty. E.D. Pa. 1988).

⁴⁶ 22 B.R. 543 (Bkrcty. S.D. Fla. 1982).

⁴⁷ 47 B.R. 977 (N.D. Ill. 1985), rev'd on other grounds, 790 F.2d 574 (7th Cir. 1986).

⁴⁸ 9 B.R. 257 (Bkrcty. W.D. Mich. 1981).

⁴⁹ 137 B.R. 144 (Bkrcty. S.D. N.Y. 1992).

Shortly after the employment application was filed, the involuntary chapter 11 was converted to a chapter 7 proceeding and the debtor's estate was liquidated. Certain bank creditors of the debtor objected to the \$50,000.00 retainer and moved that it be returned to the bankruptcy estate for distribution to creditors. The Bankruptcy Court rejected this motion, holding that the payment was authorized under 11 U.S.C. §§ 303(f) and 329 and subject only to a review of the reasonableness of the retainer, and any fees charged by debtor's counsel during the Gap Period under provisions of 11 U.S.C. § 329(b). The Court, held that it had no duty or authority to regulate the payment to professionals during the Gap Period. The Court ruled against the creditors, finding that they had not proven that either the retainer or the fees were excessive or improper under the provisions of 11 U.S.C. § 329(b).⁵⁰ No discussion was made by the Court of the priority of the fees under 11 U.S.C. § 507(a)(3) or of the possibility of having any of the retainer avoided under the provisions of 11 U.S.C. § 549.

The Rundlett standard, has not been fully adopted by other Courts. Instead, the majority of Courts which find Gap Period professional fees should be entitled to priority treatment have adopted a "flexible standard"⁵¹ for determining whether Gap Periods are entitled to priority treatment under 11 U.S.C. § 507(a)(3). In the cases of In re: May Lumber Co.,⁵² In re: Shah International, Inc.,⁵³ and In re: McNair, Inc.,⁵⁴ bankruptcy Courts held that professionals were entitled to retain compensation and/or retainers paid⁵⁵ by Potential debtors to those professionals during the Gap Period. These Courts however held that all fees billed and paid during the Gap Period were subject to review by the bankruptcy Court in the event a debtor "wound up" in bankruptcy.⁵⁶ These Courts recognize the importance of a Potential debtor being allowed to hire competent counsel to either defend itself against an involuntary petition or, ultimately, to guide it through a chapter 11 proceeding. As noted by the Shah International Court:

"For a debtor to be successful in chapter 11, it is imperative that the debtor have skilled legal counsel. As was stated in *In re Martin*, 817 F.2d 175, 181, "It will sometimes be

⁵⁰ Id. at 148.

⁵¹ See In re May Lumber Co., 135 B.R. 368 (Bkrcty. W.D. Mo. 1992); In re Shah International, Inc., 94 B.R. 136 (Bkrcty. E.D. Wisc. 1988).

⁵² 135 B.R. at 368.

⁵³ 94 B.R. at 136.

⁵⁴ 16 B.R. 746 (Bkrcty. S.D. Cal. 1990). See also In re Matter of Sun Spec Industries, 3 B.R. 703 (Bkrcty. S.D. N.Y. 1980); In re Labrum & Doals, LLP, 1998 WL 34 1933 (Bkrcty. E.D. Pa. June 25, 1998).

⁵⁵ In Shah International, the debtor's counsel were permitted to retain mortgages as a retainer for their fee, although the Court held that the mortgages secured all administrative claims in the chapter 11 cases, not just the attorney fees of the debtor's counsel. 94 B.R. at 138-139.

⁵⁶ The May Lumber Court explained the "flexible standard" as follows:

1. A gap debtor may engage counsel of choice;
2. A gap debtor may pay counsel of choice what is mutually agreeable between debtor and counsel;
3. The aforesaid payment is subject to the test of reasonableness under the circumstances, if the debtor winds up in bankruptcy;
4. The bankruptcy judge is (hopefully) an expert in the area of reasonableness and thus, all fees are subject to his tender mercies.

difficult to obtain competent counsel in anticipation of a bankruptcy proceeding unless the lawyer's financial well-being can be assured to some extent." Equitable principles govern the exercise of bankruptcy jurisdiction (*Bank of Marin v. England*, 385 U.S. 99, 103, 87 S.Ct. 274, 277, 17 L.Ed.2d 197 (1966)), and legal counsel have rights, as do other persons in the case. One right is a reasonable opportunity to be paid in a bona fide case, whether commenced by a voluntary or an involuntary petition. A putative debtor should not be prevented from obtaining skilled counsel solely because the debtor is in bankruptcy only because creditors succeeded in filing an involuntary petition prior to the time the debtor filed a voluntary petition.⁵⁷

The May Lumber line of cases represent the middle ground between the strict limitations on employment of counsel in Hanson and the virtually unfettered discretion of Potential debtors enjoyed under the Rundlett case. May Lumber places reasonable limits on a Potential debtor's ability to direct professionals to guard against the overzealous advocacy decried in Hanson, yet still permits the Potential debtor the right to seek competent counsel to defend itself or guide it through a bankruptcy in the event it must enter a chapter 11.

D. What's a Poor debtor's Attorney To Do?

Given the wide divergence of case law, professionals for a Potential debtor must carefully weigh their options before deciding to represent a Potential debtor. The best of all worlds would be to receive a fair retainer from the Potential debtor and apply that retainer against all fees earned during the Gap Period prior to entering bankruptcy. Even the Hanson line of cases, which decries the payment of professional fees during the Gap Period, do not discuss requiring the return of professional fees or a retainer, except in the context of preference litigation. However, this course of action does have the drawback of possibly presenting a Potential debtor's bankruptcy counsel, with an adverse interest, should the case ultimately be converted to a chapter 11 unless counsel seeks and obtains approval of payments as part of the employment application. However, this risk is not different from the risk all chapter 11 attorneys run every day by accepting any fee payment in the 90 days prior to the bankruptcy filing, which could be challenged in any chapter 11 proceeding.

Second, in a particularly hotly contested case, the Potential debtor's counsel could move for approval of their fees under the provisions of 11 U.S.C. § 363 of the Bankruptcy Code. Under 11 U.S.C. § 303(f), in unadjudicated involuntary cases, 11 U.S.C. § 363 still prohibits the sale, use or transfer of a debtor's assets outside the ordinary course of business. If there is a question as to the payment of a retainer or fees

⁵⁷ 94 B.R. at 137-38.

during the Gap Period, a Bankruptcy Court could authorize the payment to the debtor's counsel under 11 U.S.C. § 363 during this Gap Period, thereby giving Potential debtor's counsel some assurance of being paid for its work during the Gap Period. Unfortunately, this is a rather cumbersome and untried procedure which, given the nature of a hotly contested involuntary proceeding, may get lost in the shuffle and become just another bargaining chip concerning the fate of the entire involuntary case.

Finally, in the event that the involuntary case ultimately becomes a chapter 11 proceeding, debtor's counsel can petition the Court either for approval of employment nunc pro tunc, to the date the involuntary petition was actually filed, thereby converting the Gap Period fees to ordinary professional fees under 11 U.S.C. §§ 330 and 331. As an alternative, professionals could also seek implicit approval of all payments made during the Gap Period by full disclosure in their employment application. This final option is apparently one of the most often used by counsel in involuntary cases, and offers a fair degree of protection. The Court will be apprized of all payments of Gap Period fees at the time the application is made for employment thereby fulfilling a professional disclosure requirement. The Court and all creditors-in-interest can object to those payments as part of the employment application, and if they fail to do so, could be estopped from contesting the payment at a later date. However, absent a specific finding in a Bankruptcy Court's order employing counsel that the payments made during the Gap Period were made in the ordinary course of a debtor's business and are entitled to priority under 11 U.S.C. § 507(a)(3), the issue of any Gap Period retainer or payments could still remain in doubt despite the implied approval.

VII. Disgorgement of Fees in Administratively Insolvent Cases.

“Counsel is a gambler in [bankruptcy] proceedings like every other administrative creditor” Specker Motor Sales Co. v. Eisen, 393 F.3d 659, 664 (6th Cir. 2004).

With those somewhat chilling words the Sixth Circuit concluded its opinion in Specker Motors. Although a relatively small case involving the redistribution of \$9,026.59 from a \$10,000.00 retainer in a former chapter 11 case converted to a chapter 7 proceeding, Specker Motors is an extremely important case as it raises the question of what, if anything, can bankruptcy professionals do to protect their fees against disgorgement in the event of administrative insolvency.

A. Specker Motor's History.

In Specker Motors, the debtor filed its chapter 11 petition in March of 1997. At the time of the filing the debtor's counsel was paid a retainer of \$10,000.00. The retainer and the debtor's employment were approved by the Court on April 21, 1997. During the course of the case the Court approved fees of \$17,343.10 for debtor's counsel, but did not permit the debtor's counsel to apply the retainer to these fees.⁵⁸

⁵⁸ In re Specker Motor Sales Company, 289 B.R. 870, 871 (Bkrtcy. W.D.Mich 2003).

During the course of the chapter 11 the debtor operated its business and incurred unpaid chapter 11 administrative expenses of \$194,799.74⁵⁹ in addition to the \$17,343.10 unpaid administrative expense claim of the debtor's counsel for fees. In June of 1997 the debtor sold its assets. In September of 1997 the debtor's case was converted to a chapter 7 proceeding.

After the case was converted and administered by the chapter 7 Trustee, only \$1,494.67 was left to pay the chapter 11 administrative fees. The chapter 7 Trustee proposed in his final report that the debtor's counsel disgorge \$9,026.59 of his pre-petition retainer, which would result in debtor's counsel receiving \$973.41, his pro-rata share of his chapter 11 administrative expenses or a 5.6% distribution on his allowed chapter 11 fees, the same distribution as received by other unpaid chapter 11 administrative creditors, rather than the 57.9% "distribution" he would realize if no disgorgement occurred. No other creditors were to be required to disgorge any post-petition administrative expense payments.

The Bankruptcy Court approved the Trustee's final accounting and approved the distribution and disgorgement set forth without objection.⁶⁰ The debtor's counsel filed a timely motion for reconsideration⁶¹ which the Bankruptcy Court overruled.⁶² The Bankruptcy Court did not discuss the impact, if any, of the debtor's counsel's holding of a retainer paid to him pre-petition by the debtor.

On appeal the District Court applied the discretionary disgorgement standard of the Sixth Circuit Bankruptcy Appellate Panel's decision in In re Unicast Inc., and rejected the debtor's counsel's argument that the Bankruptcy Court should not have ordered disgorgement by the debtor's counsel. In its decision, the District Court held that disgorgement of the retainer was mandatory under 11 U.S.C. § 726(b) in the case of administrative insolvency.⁶³ The District Court also ruled that if the retainer was not disgorged, debtor's counsel would get an improper "super priority" claim.⁶⁴ The only discussion the District Court had concerning the fact the disgorgement came from the debtor's counsel's pre-petition retainer was footnote three of its opinion where the District Court stated:

The Court also notes a retainer is the property of the estate until awarded as compensation. In re Downs, 103 F.3d 472, 478 (6th Cir. 1996). Therefore, the money paid to

⁵⁹ The administrative expenses included unpaid U.S. Trustee fees and unpaid state and federal taxes.

⁶⁰ Specker Motor Sales Co., 300 B.R. 687, 690 (W.D.Mich. 2003).

⁶¹ 289 B.R. at 871 Strangely, the Debtors chapter 11 Counsel did not originally object to the proposed disgorgement and filed its motion for reconsideration in the name of the debtor, not as an administrative creditor. These technical issues did not impact the Court of Appeals' decision in this matter. See Specker Motor Sales v. Eisen, 393 F.3d 659, 662 (6th Cir. 2004).

⁶² The Bankruptcy Court rejected Unicast holding that "§726(b) requires disgorgement of interim compensation in every case of administrative insolvency in order to achieve the "pro-rata" distribution."

⁶³ 300 B.R. at 390.

⁶⁴ Id. at 391.

counsel in this action still belongs to the estate and for all intents and purposes cannot be claimed by counsel.⁶⁵

Debtor's counsel appealed to the Sixth Circuit Court of Appeals. There the Court affirmed the lower Courts, overruled Unicast and rejected the debtor's counsel's primary argument that disgorgement of professional fees was discretionary under 11 U.S.C. § 726(b) in order to achieve the pro-rata distribution required by that section.⁶⁶ The Sixth Circuit agreed with the District Court that permitting discretion on disgorgement of fees was both contrary to the statute and would give professionals a Court created "super-category" administrative priority. The Sixth Circuit also rejected the debtor's counsel's public policy arguments against mandating disgorgement of professional fees in administratively insolvent bankruptcy cases.⁶⁷ The Sixth Circuit did not address what impact if any, the approval of the retainer had on the issue of disgorgement other than to note, under its previous decision of In re Downs, 103 F.3d 472 (6th Cir. 1996) that retainers paid to professionals constitute property of the estate.⁶⁸

B. Disgorgement: The Ultimate 4 (well 12) Letter Word in the World of Bankruptcy Professional Fees.

The only issue raised to and directly decided by the Sixth Circuit was whether disgorgement of professional fees is required⁶⁹ when necessary to provide for pro-rata distributions under 11 U.S.C. § 726(b)⁷⁰ or whether disgorgement of professional fees is discretionary.⁷¹ Here the Sixth Circuit, relying primarily on the clear and unambiguous language of 11 U.S.C. § 726(b),⁷² found that the "shall be made pro-rata among claims of the kind specified in each such paragraph" language of section 726(b) required disgorgement to the extent necessary to allow a pro-rata distribution⁷³ to similarly situated creditors. This decision, although it overruled a prior BAP decision from the

⁶⁵ Id. at 390 n. 3.

⁶⁶ 393 F.3d at 663.

⁶⁷ Id. at 664.

⁶⁸ 393 F.3d at 662. Although the author was unable to review the briefs filed in the Court of Appeals from a review of the briefs filed in the District Court it is clear that the only issue raised by the parties was whether disgorgement was mandatory or discretionary under 726(b).

⁶⁹ In re Kingston Turf Farms, Inc., 176 B.R. 308 (Bankr. D.R.I. 1995); In re Groffena, 175 B.R. 386, 392 (Bankr. D.Mont. 1994).

⁷⁰ See generally Metropolitan Elec. Supply Corp., 185 B.R. 505 (Bankr. E.D. Va. 1995).

⁷¹ In re Unicast, Inc., 219 B.R. 741 (BAP 6th Cir. 1998); In re Anolik, 207 B.R. 34 (Bankr. D.Mass. 1997).

⁷² Payment on claims of a kind specified in paragraph (1), (2), (3), (4), (5), (6), (7), or (8) of section 507(a) of this title, or in paragraph (2), (3), (4), or (5) of subsection (a) of this section, shall be made pro rata among claims of the kind specified in each such particular paragraph, except that in a case that has been converted to this chapter under section 1009, 1112, 1208, or 1307 of this title, a claim allowed under section 503(b) of this title incurred under this chapter after such conversion has priority over a claim allowed under section 503(b) of this title incurred under any other chapter of this title or under this chapter before such conversion and over any expenses of a custodian superseded under section 543 of this title.

⁷³ An interesting question, not addressed by either the Sixth Circuit or this article is whether 11 U.S.C. § 726(b) requires either the Debtor in possession or Trustees to seek the disgorgement of all administrative payments made during a case and not just payments to professionals. See In re Kingston Turf Farms, Inc., 176 B.R. 308 (Bankr. 1995).

Sixth Circuit, was fairly straight forward and represents the majority view on this issue of law.

C. The Issue That Was Not There: Retainers and Professionals Interests in Them.

However, it is not the important, but narrow, determination of the appropriate interpretation of 11 U.S.C. § 726 as it concerns disgorgement of professional fees which should interest professionals. Rather the treatment (or lack thereof) by the Sixth Circuit of the issue of whether a retainer paid either pre or post-petition to a professional is subject to disgorgement in an administratively insolvent case is the most interesting issue not decided in Specker. Although all Specker Courts uniformly ordered the disgorgement of most of the debtor's counsel's pre-petition retainer, these Courts were not presented with this issue and did never addressed it.

Generally, Courts which have reviewed the questions of retainers paid pre-petition to professionals have generally found that there are four general types of retainers permitted by state law: (1) classic retainers which are paid to secure an attorney's services and earned upon receipt regardless of whether any services are actually performed for the client;⁷⁴ (2) security retainers where the retainer is given to the attorney as security for the payment of future services by the attorney;⁷⁵ (3) advance fee retainers (a type of security retainer) where some or all of the retainer is deemed earned and title to that portion of the retainer passes to the professional on payment of the retainer for services to be performed by the professional;⁷⁶ and (4) evergreen retainers which contemplate that the original retainer will remain intact throughout the case either by being constantly replenished throughout the engagement or by current fees being paid by the client.⁷⁷ In most bankruptcy proceedings, pre-petition retainers are considered to be security retainers where the estate retains an interest in the retainer, but the retainer is security for an attorney's future fees.⁷⁸

In the majority of decisions where Courts have actually considered the potential disgorgement of pre-petition retainers due to the administrative insolvency of the case, Courts have held that professionals do not have to return retainers for redistribution due to the professional's security interest in the retainer.⁷⁹ This position seems to be

⁷⁴ See In re Pan American Hospital Corporation, 312 B.R. 706, 709 (Bkrcty. S.D.Fl. 2004); In re McDonald Bros. Construction, Inc., 114 B.R. 989 (Bkrcty. N.D.Ill. 1990).

⁷⁵ 312 B.R. at 709; In re Production Associates Ltd., 264 B.R. 180, 185 (Bkrcty. N.D. Ill. 2001); In re Printcrafters, Inc., 233 B.R. 113, 118 (D.Col. 1999); In re North Bay Tractor, Inc., 191 B.R. 186, 187 (Bkrcty. N.D. Cal. 1996).

⁷⁶ 114 B.R. at 1000.

⁷⁷ In re Benjamin's-Arnolds, Inc., 123 B.R. 839, 842 (Bkrcty. D. Minn. 1990). See also In re Cottrell International LLC EIN, 2000 WL 1180282 (Bkrcty. D. Col. July 19, 2000).

⁷⁸ In re Printcrafters, Inc., 233 B.R. at 118 and cases cited therein.

⁷⁹ In re Printcrafters, Inc., 233 B.R. at 120; In re Pennebaker Custom Cabinet Corp., 198 B.R. 453 (Bkrcty. M.D.Pa. 1996); In re North Bay Tractor, Inc., 191 B.R. 186 (Bkrcty. N.D. Cal. 1996). See also, In re Cottrell International, 2000 WL 1180282 at *4; In re Printing Dimensions, Inc., 153 B.R. 715 (Bkrcty. M.D. Md. 1993).

appropriate under the Bankruptcy Code's priority rules although there are decisions such as Specker Motors, where Courts have ordered the turnover of retainers without discussion of the professional's security interest.⁸⁰

D. Removing the Specker of Disgorgement: Possible Measures To Take In Light of Specker.

While hopefully a remote problem, there are at least two (reasonably) simple steps that professionals can take to protect retainers and other approved payments from disgorgement.

1. 11 U.S.C. § 328: It's not just for non-attorneys now!

As previously discussed by this author⁸¹ 11 U.S.C. § 328 can and should be used by professionals in obtaining Court approval of the terms and fee structure of employment agreements with a debtor, trustee or committee. In light of Specker Motors, attorneys and other professionals should, as part of their employment application, seek approval of their retainers and of a related security interest in these retainers as part of their employment applications. This requested relief should be highlighted in any employment application filed by a professional.

However, before taking this step, proposed professionals for chapter 11 debtors in possession, trustees or committees should carefully review the controlling law of jurisdiction to ensure the case law permits the approval of such a security interest in the retainer because a minority of Courts have held that such security interests are improper.⁸² Further, care must be taken not to overreach in developing such a security interest in retainers.⁸³

2. Whit'n to Protection: Carveouts.

Another manner in which professionals can protect their post-petition fees is through Court approval of professional "carveouts" in cash collateral and post-petition financing orders. Simply stated,⁸⁴ carveouts are agreements by secured creditors to permit a portion of their collateral to be used to pay certain administrative expenses in a

⁸⁰ See In re Rittenhouse, 76 B.R. 610 (Bkrcty. S.D. Ohio 1987).

⁸¹ Bowles, Faith, Hope and Clarity, 23 ABI J.22 (Nov. 2004); Bowles, Ethical Trilogy: Something Old, Something New, Something Borrowed, 22 ABI J.18 (June 2003).

⁸² See In re Printcrafters, 233 B.R. at 119 discussing that Bankruptcy Court refused to find that debtor's professional had security interest in retainer because such a security interest would make professional "not disinterested" for purposes of the Bankruptcy Code.

⁸³ See In re W&W Protection Agency, Inc., 200 B.R. 615 (Bkrcty. S.D. Ohio 1996) (Bankruptcy Court refused to approve employment application which included a \$30,000.00 super-priority lien on the Debtor's real estate as a retainer, treatment of the Debtor's counsel compensation as a superpriority administrative claims and a \$5,000.00 on evergreen retainer). See also Miller, The Three Deadly D's – Disclosure, Disinterestedness & Disgorgement presented at 2006 ABI Annual Spring Conference, discussing recent disgorgement decisions.

⁸⁴ For an excellent discussion of carveouts see Levin, Almost All You Ever Wanted To Know About Carve Out, 76 Am' Bkr L.J. 445 (2002). See also In re U.S. Flow, 332 B.R. 92 (Bkrcty. W.D. Mich. 2005).

chapter 11 case. In negotiating these carveouts, professionals may wish to include appropriate language in both the motions and orders containing carveout agreements, which provide that carveouts for professional fees made under the carveout agreement are made solely to pay the professional fees for which the carveouts are granted, and that if they are not used for those purposes they shall be returned to the creditor granting the carveout. This can be done by providing that the specific carveout will have priority over the priority granted to secured lenders in DIP and Cash Collateral Orders. While such strict designations may not be approved by Courts,⁸⁵ if approved they should resolve the problems raised by In re Ben Franklin Retail Store, Inc.,⁸⁶ which ruled that consensual carveouts are general estate property and not directed payments to the designated administrative creditors.⁸⁷ Secured Creditors should also be in favor of such precise wording of carveouts as if such language is approved they will not have to give the carveout funds to the estate to be used to pay general administrative expenses.⁸⁸ See generally, U.S. Flow Corporation, 332 B.R. 792 (Bkrcty. W.D. Mich. 2005).

E. Summary.

While administratively insolvent bankruptcy estates are fortunately rare, the ruling in Specker Motors to disgorge a pre-petition retainer raises the somewhat disheartening prospect that retainers will become nothing more than administrative conveniences, rather than security for at least a portion of a professional's fees. While it is clear that the Specker Motors Courts never considered the nature of the retainer in making their decision, it is equally true that the Sixth Circuit did order the disgorgement of a pre-petition retainer, holding that disgorgement of a professional's interim compensation was required to make pro-rata distributions under 11 U.S.C. § 726(b).

VIII. Final Fee Awards.

Being a professional for a chapter 11 debtor has never been an easy job. Between the extensive and ever expanding conflict checks, increasing initial disclosures⁸⁹ requirements, extensive fee applications, Court supervision and fiduciary duties,⁹⁰ on top of the very real problems of getting paid by a financially distressed company, a chapter 11 debtor's counsel has perhaps the most difficult job of any attorney in civil litigation

⁸⁵ See generally In re Channel Master Holdings Inc., 309 B.R. 855, 860 (Bkrcty. D.Del. 2004) (Questioning whether Court should honor separate carveout limits for debtor and committee professionals); In re Scott Cable Communications, 287 B.R. 1 (Bkrcty. D.Conn. 2002) (carveout may be subject to disgorgement).

⁸⁶ 210 B.R. 315 (Bkrcty. N.D. Ill. 1997).

⁸⁷ For cases approving designation of carveout funds to certain creditors which cannot be disgorged See In re Debbie Reynolds Hotel & Casino, Inc., 255 F.3d 1061 (9th Cir. 2001); In re Nuclear Imaging Systems, Inc., 270 B.R. 365 (Bkrcty. E.D. Pa. 2001).

⁸⁸ See generally In re Blackwood Associates, L.P., 153 F.3d 61 (2nd Cir. 1998) (Secured Creditor unsuccessfully sued to disgorge adequate protection payments in order to fund unpaid carveouts).

⁸⁹ See generally, Seider, Getting Retained and Keeping the Money, A.J. Bankr. L. & Prac. 231 (2000); Cook and Lubben, Retention, Payment, Ethical and Other Obstacles for Non-Legal Professionals in chapter 11 Reorganization, 66 PLI/NY 175 (1999).

⁹⁰ Rapport & Bowles, Has the DIP's Attorney Become the Ultimate Creditors' Lawyer in Bankruptcy Reorganization Cases?, 5 Am. Bank. Inst. L.R. 47 (1997).

can face. Making this task more unpleasant has been the increasing trend for debtors,⁹¹ trustees⁹² or creditor representatives⁹³ to bring malpractice suits against debtor's professions for their actions during a chapter 11. However, a growing body of Circuit level case law addressing: (1) whether such suits are precluded by a Bankruptcy Court's final approval of a professional's fees; and (2) whether state Courts or the Bankruptcy Court has jurisdiction over such suits, may provide some relief to chapter 11 debtor's counsel.

A. It's not over till its over.

1. Issue⁹⁴ and claim⁹⁵ preclusion.

In four Court of Appeals decisions, Grausz v. Englander, 321 F.3d 467 (4th Cir. 2003) (Grausz); In re Iannochino, 242 F.3d 36 (1st Cir. 2001) (Iannochino), Matter of Southmark Corp., 163 F.3d 925 (5th Cir. 1999) (Southmark) and Matter of Intelogic Trace, Inc., 200 F.3d, 382 (5th Cir. 2000) (Intelogic Trace), the Courts addressed the issue of whether the final approval of a professional's final fee application would prevent a malpractice suit against the professional under either the doctrines of claim preclusion (res judicata) or issue preclusion (collateral estoppel).

In the earliest case, Southmark, the debtor filed a malpractice suit against the examiner's accountant for malpractice and breach of fiduciary duty in a Texas state Court ("State Court Suit"). The State Court Suit arose from allegations that the examiner's accountant failed to fully disclose the full extent of its relationship with Drexel Burnham Lambert Inc. ("Drexel") and improperly downplayed the viability of the debtor's causes of action against Drexel which ultimately resulted in the debtor not pursuing its claims in Drexel's own chapter 11 proceedings.

Prior to filing the State Court Suit, the debtor filed a motion to require the accountant to disgorge all of its fees previously awarded in the Southmark bankruptcy proceeding ("Disgorgement Suit"). On April 4, 1995, the Bankruptcy Court ordered the accountant to pay the debtor \$585,042.48 for the violation of their fiduciary duty by

⁹¹ Grausz v. Englander, 321 F.3d 467 (4th Cir. 2003); In re Iannochino, 242 F.3d 36 (1st Cir. 2001); Matter of Southmark Corp., 163 F.3d 925 (5th Cir. 1999); Mager v. Charmoy, 26 Conn. L. Rptr. 407, 2000 WL 175, 763 (Slip op. Conn. Super. 2000).

⁹² In re Merry-Go-Round Enterprises, Inc., 244 B.R. 327 (Bkrcty. D. Md 2000); In re Merry-Go-Round Enterprises, Inc., 222 B.R. 254 (D. Md. 1998).

⁹³ In re Seven Fields Development Corporation, 505 F.3d 237 (3rd Cir. 2007); In re Robotic Vision Systems, Inc., 343 B.R. 393 (Bkrcty. N.H. 2006); In re R & C Petroleum Inc., 236 B.R. 355 (Bkrcty. E.D. Tx. 1999).

⁹⁴ Issue preclusion, also known as collateral estoppel, applies when the following elements are met: (1) the issue at stake must be identical to the one involved in the prior action; (2) the issue must have been actually litigated in the prior action; and (3) the determination of the issue in the prior action must have been a part of the judgment in that earlier action.

⁹⁵ The test for claim preclusion also known as res judicata, has four elements: (1) The parties are identical or in privity; (2) the judgment in the prior action was rendered by a Court of competent jurisdiction; (3) the prior action was concluded to a final judgment on the merits; and (4) the same claim or cause of action was involved in both actions. Id. at 934, citing, Swate v. Hartwell, 99 F.3d 1282, 1286 (5th Cir. 1996).

failing to make proper disclosure. However, the Bankruptcy Court also ruled that the accountant did not cause the debtor to fail to file a claim in the Drexel bankruptcy. The Bankruptcy Court refused to order the disgorgement of all of the accountant's fees and this decision was not appealed.⁹⁶

Shortly after the State Court Suit was filed, the accountant removed the case to Bankruptcy Court, which refused to abstain and return the case to the state Court.⁹⁷ The Bankruptcy Court ultimately granted the accountant's motion for summary judgment on the grounds that the debtor's claims were barred by both issue and claim preclusion. The District Court affirmed and the matter was appealed to the 5th Circuit.

In its opinion, the 5th Circuit initially held that the Bankruptcy Court properly exercised its discretion in refusing to abstain and remand the case to state Court. It then addressed the question of whether the debtor's lawsuit was barred by either issue or claim preclusion due to its ruling in the Disgorgement Suit.

On the matter of issue preclusion, the Court found that the State Court Suit was barred by issue preclusion. The Court held that the issues actually litigated and decided in the Disgorgement Suit were the same as the issue raised by the State Court Suit. In reaching this decision, the 5th Circuit noted that the debtor failed to appeal the Bankruptcy Court's decision in the Disgorgement Suit and ruled that this failure to appeal prevented it from re-litigating these issues.⁹⁸

The Southmark Court's discussion of claim preclusion was far less clear.⁹⁹ After noting that its discussion was dicta designed to address the bankruptcy and District Court "reliance on claim preclusion,"¹⁰⁰ the Court stated that due to the Bankruptcy Code's "truncated procedures," claim preclusion doctrine was more limited than in other federal Court proceedings.¹⁰¹

The 5th Circuit would shortly get the chance to address whether approval of final fee applications would bar subsequent malpractice suits under the doctrine of claim preclusion. In January of 2000, the case of Matter of Intelogic Trace Inc., 200 F.3d 382 (5th Cir. 2000) was decided by the Court.

In Intelogic, the debtor filed its first chapter 11 in August of 1994 and obtained confirmation of its plan in December of 1994. On January 8, 1995, the debtor's accounting firm filed its final application for professional fees in the first bankruptcy

⁹⁶ See Id. at 928.

⁹⁷ The Fifth Circuit noted the oddity of a chapter 11 Debtor attempting to keep litigation of the Bankruptcy Court stating: "It is somewhat disingenuous for Southmark to pry these claims out of their bankruptcy setting." Id. at 931.

⁹⁸ Id. at 933, n. 11.

⁹⁹ Matter of Intelogic Trace, Inc., 200 F.3d 382, 390 (5th Cir. 2000) (discussing the confusion arising from the Southmark Court reserving judgment as to whether claims preclusion could apply to bankruptcy proceedings).

¹⁰⁰ 163 F.3d at 934.

¹⁰¹ Id. at 935.

case. At the time of this filing, the debtor was aware that the accounting firm may have committed malpractice related to its projections of the debtor's cashflow and working capital requirements. Rather than object to the accounting firm's fee application or bring a malpractice suit at that time, the chapter 11 debtor decided to use its complaints to negotiate a \$37,000.00 reduction in the accounting firm's fees. On January 25, 1995, with the support of the debtor, the accounting firm's final fee application was approved. No appeal of this order was taken.

Unfortunately, the debtor's financial problems continued and in March of 1995, it had to file a second chapter 11 which was ultimately converted to a chapter 7 proceeding. After the accounting firm filed a claim for its unpaid fees from the first chapter 11 case, the chapter 7 trustee filed a suit against the accounting firm for malpractice and other related claims in Texas state Court, which was ultimately removed to the Bankruptcy Court by the accounting firm.

The accounting firm moved for summary judgment on the grounds that the trustee's suit was barred by the doctrines of claim preclusion, issue preclusion and waiver. The motion was granted by the Bankruptcy Court on the grounds that the trustee's claims were barred by the doctrine of claim preclusion. The District Court affirmed the Bankruptcy Court's order, In re Intelogic Trace, Inc., 226 B.R. 382 (W.D. Tx. 1998),¹⁰² and this decision was appealed to the 5th Circuit by the trustee.

Unlike its Southmark decision, the 5th Circuit's decision in Intelogic was based on the doctrine of claim preclusion. The only issue before the 5th Circuit¹⁰³ as to whether the claim preclusion doctrine applied was whether the same causes of action were involved in the litigation related to the accounting firm's final fee applications and the chapter 7 trustee's state court malpractice lawsuit.

Under the Restatement Second of Judgment's test adopted by the Fifth Circuit¹⁰⁴ for determining whether the final fee application and the malpractice lawsuit involved the same causes of action, the Court had to determine whether the two actions were based on the same nucleus of operative fact. The Intelogic Court held that in order for claim preclusion to apply, a plaintiff must have: (1) had a sufficient general awareness of the potential for claims against the defendant at the time of the first proceeding; and (2) the procedures of the first proceeding must provide the claimant an opportunity to litigate its claims.¹⁰⁵

Employing this test, the Intelogic Court found that the trustee's malpractice suit was barred by the doctrine of claim preclusion. First, the Court found that the fee

¹⁰² The Intelogic case District Court decision was reviewed by John D. Penn in his "Last In Line" column in the February, 1999 issue of the ABI Journal. Penn, "speak now, or forever hold your peace (and give them a release)" 18 ABIJ 38 (1999).

¹⁰³ 200 F.3d at 386 ("The critical issue under the determination is whether the two actions under consideration are based on the same nucleus of operative facts.").

¹⁰⁴ Id.

¹⁰⁵ Id. at 387-388.

application involved the same operative facts as the legal malpractice suit. The Fifth Circuit held that fee applications involve nucleus of a finding of the quality and value of the accounting firm's services. These issues are the same issues as those raised in the malpractice suit. This ruling is important as technically all fee application hearings invokes such determinations.

Second, the Court determined that, under the facts of this case, the claimant¹⁰⁶ had actual knowledge of its claims against the defendant. The Court based its conclusion on the fact that the chapter 11 debtor used its knowledge of potential claims to obtain reduction in fees from accounting firms.

Finally, the Court held that a Bankruptcy Court could hear a legal malpractice claim in connection with a fee application hearing.¹⁰⁷ Therefore, the claimant had the opportunity to litigate its claim in the first proceeding.

Shortly after Intellogic Trace was decided, the First Circuit addressed the issues of issue and claim preclusion in the context of a final fee application in a chapter 13 case in the Iannochino case. In Iannochino the debtor's chapter 13 case was ultimately converted to a chapter 7 case. After the conversion the debtor's counsel filed a final fee application for fees earned during the chapter 13 which was ultimately approved without objection by the individual debtors.

Two years later the individual debtors filed suit in state Court against their counsel for malpractice. The case was removed to Bankruptcy Court which dismissed the case due to the res judicata effect of the order approving the chapter 13 counsel's final fees. The District Court affirmed the bankruptcy Court's decision and the matter was appealed to the First Circuit.

In Iannochino, after finding the fee award was an award of fees under 11 U.S.C. § 330 and a final judgment, the Court adopted the analysis of the Fifth Circuit in Intellogic Trace and held that the individual debtors had to raise their malpractice claims at the time of their chapter 13 counsel's final fee application and that their failure to do so precluded a subsequent action to raise that issue.

Some two years after Iannochino was decided, the Fourth Circuit, in Grausz v. Englander, 321 F.3d 467 (4th Cir. 2003). Grausz was an individual chapter 11 case, where the debtor sued his former chapter 11 counsel after that counsel had obtained final approval of its chapter 11 fees. The Grausz Court adopted the reasoning of both Iannochino and Intellogic Trace and dismissed this action due to the failure of the individual debtor to either object to the final fee application of the chapter 11 counsel or raise the malpractice claim as a counterclaim to that final fee application. The Fourth Circuit, as the Fifth and First Circuits did before it, found that the final allowance of fees included an inquiry by the Bankruptcy Court as to the nature and quality of legal services

¹⁰⁶ The chapter 7 Trustee was charged with the knowledge of the chapter 11 Debtor in the proceeding. Id. at 384-386.

¹⁰⁷ Id. at 389-390.

provided by the professional in question and that therefore the doctrine of claim preclusion prohibited a later malpractice suit.

B. Where am I?

An important, related issue to the doctrines of claim and issue preclusion is the question of whether state or federal Courts should hear malpractice suits against a bankruptcy estate's professionals. Fortunately, for post BAPCPA cases, under 28 U.S.C. § 1334(e)(2) Federal District Courts have exclusive jurisdiction in any malpractice claims involving "construction of section 327 of title 11, United States Code, or rules relating to disclosure requirements under section 327." This provision will require a large number of potential claims against bankruptcy professionals, whose employment was approved under 11 U.S.C. § 327, to be filed in Federal Court or be subject to dismissal for lack of jurisdiction. However, if a malpractice or other related claim does not involve issues related to 11 U.S.C. § 327, or any related disclosure provisions, then a state Court could still arguably still have jurisdiction over such malpractice cases.

Initially, it is important to note that Federal Courts do not, by statute, have exclusive jurisdiction over all professional malpractice claims arising from bankruptcy cases.¹⁰⁸ However, it is also important to note that Federal Courts have a strong basis for asserting jurisdiction over such malpractice suits due to the fee oversight provisions of the Bankruptcy Code. The Fifth Circuit has noted that "a malpractice claim . . . involves the nature of the services performed for the debtor's estate and the fees awarded under the superintendence of the bankruptcy Court . . .,"¹⁰⁹ and refused to remand¹¹⁰ the malpractice case to state Court. Nevertheless the Fifth Circuit did not hold that State Courts lacked jurisdiction over such claims.¹¹¹

However, if a malpractice suit is filed in State Court which relates to fees awarded on a bankruptcy case, a defendant has the right to remove the action to Federal Court.¹¹² If the case is removed to Federal Court,¹¹³ the opposing party may either move to remand the case under 28 U.S.C. §1452 or have the Bankruptcy Court abstain from hearing the case.¹¹⁴ A determination to either abstain or remand is discretionary with the Bankruptcy Court and involves similar factors.¹¹⁵ However, Bankruptcy Court rulings on abstention

¹⁰⁸ See generally Matter of Southmark Corporation, 163 F.3d 925 (5th Cir. 1999); In re Merry-Go-Round Enterprises, Inc., 222 B.R. 254 C.D. Md. 1998); Magee v. Charmoy, 26 Conn. L. Rpt. 407, 2000 W L 175763 (Sup. Conn. 2000).

¹⁰⁹ Matter of Southmark Corporation, 163 F.3d at 931.

¹¹⁰ Id. at 932.

¹¹¹ In fact of the cases cited in this article, only in In re R & C Petroleum, Inc., was the malpractice lawsuit originally brought in the bankruptcy Court. None of these cases ever questioned a state Court's jurisdiction to trial malpractice cases against estate professionals.

¹¹² See 28 U.S.C. §1452.

¹¹³ Under 28 U.S.C. §1452, cases are technically removed to the district Court and transferred to the bankruptcy Court via the district Court's standing order of reference.

¹¹⁴ In re Merry-Go-Round Enterprises, Inc., 222 B.R. 254, 256 (D Md. 1998).

¹¹⁵ Id.

cannot be appealed to Courts of Appeal or to the Supreme Court¹¹⁶ and therefore parties seeking to return to State Court should always seek to have a case remanded, as well as request the Bankruptcy Court to abstain from hearing the malpractice suit, in order to preserve the possibility of full appellate review of these issues.

Although, the case law is sparse, two cases illustrate the problems bankruptcy professionals face in malpractice suits brought against them in State Courts. In Magee v. Charmoy, 26 Conn. L. Rptr. 307 (Conn. Super. 2000), an individual who filed a chapter 11 case, which was converted to a chapter 7 proceeding, was permitted to maintain a malpractice suit against his former chapter 11 counsel¹¹⁷ even though the Bankruptcy Court had overruled the plaintiff's objections to its fee applications. The Court rejected the bulk of the Interlogic and Southmark decisions holding that the plaintiff did not have either an adequate opportunity to litigate his malpractice claims or the adequacy of the chapter 11 counsel's legal performance in the hearings on counsel fees¹¹⁸ in the Bankruptcy Court.

Of even greater concern is the Merry-Go-Round malpractice settlement. As discussed, the Bankruptcy Court's decision¹¹⁹ upholding a contingent fee award to the bankruptcy trustee in special counsel, a major national accounting firm paid \$185,000,000 to settle a malpractice and fraud suit arising out of its activities in a failed chapter 11 case.¹²⁰ Although of little precedential value, this settlement demonstrates the heightened risk of massive damage awards in cases argued before State Court juries.

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¹¹⁶ See 28 U.S.C. §1334(d).

¹¹⁷ Magee v. Charmoy, 2000 W.L. 17576 at *2. It is interesting to note that the state Court never discussed the issue of whether the malpractice claim was property of the bankruptcy estate.

¹¹⁸ Id. at *3.

¹¹⁹ In re Merry-Go-Round Enterprises Inc., 244 B.R. 327 (Bkrtcy. D. Md. 2000).

¹²⁰ Id. at 330.