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***Ouch – Administrative Insolvency and
Disgorgement of Fees – Case Strategies***

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*Protecting Professional Fees From Disgorgement: Obtaining Carve-Outs from Secured Creditors to Safeguard Against Uncertainties*²

Disgorgement Revisited³

¹ These materials are also being used in connection with a presentation to the 20th Annual Northwest Bankruptcy Institute, entitled "Navigating the Complex Web of Ethical Issues in Business Bankruptcies: Conflicts of Interest, Disclosure, Disinterested and Disgorgement," on April 27, 2007 in Vancouver, British Columbia.

² This article was previously presented at the Joint Presentation before the Ethics, Investment Banking and Professional Compensation Committees at the Annual Spring Meeting of the American Bankruptcy Institute in Washington, D.C., held April 20-23, 2006, and thereafter was published in two parts in the June and July/August Editions of the American Bankruptcy Journal.

³ A prior version of this article was previously presented at BAPCPA: One Year Later, A Columbus Day Seminar, in Novi, Michigan on October 9, 2006. This article has been updated to take into consideration new developments and recent case law.

Introduction

Notwithstanding the amendments to the Bankruptcy Code set forth in Bankruptcy Abuse Prevention Consumer Protection Act (“BAPCPA”), the Code provisions governing retention and compensation emerged relatively unscathed. Nevertheless, in many instances, case law continues to evolve with little clarity or predictability when it comes to these areas of concern, particularly when an estate is rendered administratively insolvent.

The materials that follow attempt to delineate, set forth and expand upon various issues that a professional should consider at the onset of a case in order to attempt to avoid the pitfalls that might otherwise be avoided in this factual context. Recognize, however, that there is no guarantee that any specific course of action will provide the professional with the comfort sought.

Standards for Retention of Counsel

I. Standard for Retention of Debtor's Counsel

A. Section 327 sets forth the standard for retention of debtor's counsel. To be retained, the professional must be disinterested and not hold an interest that is adverse to the estate. Section 327(a) states, in relevant part, as follows:

. . . the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent and assist the trustee in carrying out the trustee's duties under this title.

Not surprisingly, there is an overlap between the "adverse interest" and "disinterestedness" prongs of Section 327. Courts have recognized that the prongs "form one hallmark with which to evaluate whether professionals seeking court-approved retention (or to remain retained by the estate) meet the absence of adversity requirements embodied in the Bankruptcy Code." Collier's on Bankruptcy (15th Rev. Ed.), ¶ 327.04[2] at 327-31.

B. "Disinterested person" is defined in Section 101(14) of the Bankruptcy Code to mean a person that:

- (A) is not a creditor, an equity security holder, or an insider;
- (B) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and
- (C) does not hold an interest materially adverse to the interest of the estate or any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in the debtor, or for any other reason.

The definition of "disinterestedness" was amended by BAPCPA and eliminated from inclusion in "disinterested persons" those individuals and entities that had served as investment bankers or

counsel for investment bankers within the 2 year period preceding the filing of the Chapter 11 petition.

C. “Adverse interest” is not defined by the Bankruptcy Code, however the term has generally has been interpreted to mean: “any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute” or “a predisposition under circumstances that render such bias against the estate.”

See *In re American Printers & Lithographers, Inc.*, 148 B.R. 862, 864 (Bankr. N.D. Ill. 1992); *Kravit, Gass & Weber, S.C. v. Michel (In re Crivello)*, 134 F.3d 831, 835 (7th Cir. 1998). Examples of circumstances under which courts have found “adverse interests” are: where the professional person represented the debtor corporation’s officers; served as an officer and director of the debtor within two years of the petition date; was a prepetition creditor of the debtor’s estate; was actually acting on behalf of a major equity holder of the estate and co-owned land with the debtor. *Collier’s on Bankruptcy* (15th Rev. Ed.), ¶ 327.04[2][b] at 327-43-44.

D. In addition to the definitions set forth above, the distinction between the “interest adverse” and “disinterested” is that the “interest adverse” prong “forbids persons who represent interests adverse to the estate from also being employed by the trustee under section 327(a); in contrast, the “disinterestedness” prong does not forbid persons who represent interests adverse to creditors or equity security holders from also representing the estate.” *Collier’s on Bankruptcy* (15th Rev. Ed.), ¶ 327.04[2][b] at 327-43.

II. Standard for Retention of Creditors’ Committee Counsel

A. Standard for retention of committee counsel is governed by 11 U.S.C. § 1103(a) that provides:

[A] committee appointed under section 1102 of this title with the court’s approval . . . may select and authorize the employment of such committee of one or more attorneys . . . to represent or perform services for such committee.

See also *In re Enron Corp.*, 2002 WL 32034346 at *6 (Bankr. S.D.N.Y. 2002), *affd sub. nom.*, *Exco Resources, Inc. v. Milbank, Tweed, Hadley & McCloy LLP (In re Enron Corp.)*, 2003 WL 223455 (S.D.N.Y. 2003). Accord, *Halbert v. Yousif*, 225 B.R. 336, 346, n.17 (E.D. Mich. 1998).

B. The only statutory limitation on a committee's right to select counsel of its choice is Section 1103(b), which provides that an attorney employed to represent a committee may not, while employed by the committee, represent any other entity having an adverse interest in connection with the case. Thus, a firm is not disqualified from representing a committee as a result of any representation that (i) predates its employment by the committee, (ii) does not relate to the bankruptcy case at issue, or (iii) is not adverse to the committee's interests. See *In re Heck's Inc.*, 83 B.R. 410, 423 (S.D. W.Va. 1988); *In re Firstmark Corp.*, 132 F.3d 1179, 1182-83 (7th Cir. 1997) (attorney not disqualified from representing a committee when represented both committee and debtor's former senior executive who also received a preferential transfer, and such representation of the executive was unrelated to case at issue); *In re Enron Corp.*, 2003 WL 223455 at *5 (S.D.N.Y. 2003) (Section 1103(b) is not violated if counsel represented an entity with an adverse interest in a matter unrelated to the bankruptcy case or in a matter that pre-dates proposed committee representation); *Daido Steel Co. v. Official Comm. of Unsecured Creditors*, 178 B.R. 129, 132 (N.D. Ohio 1995) (committee counsel not disqualified despite firm's representation of actual purchaser of debtor's assets in matters unrelated to bankruptcy case); *In re Nat'l. Century Fin. Enters., Inc.*, 298 B.R. 112, 117 (Bankr. S.D. Ohio 2003) (U.S. Trustee's objection to retention of counsel for committee overruled; court held that neither prior representation of debtor nor continued representation of individual committee members were disqualifying conflicts).

C. Section 1103(b) does not require committee counsel to be disinterested. See *United States v. Schilling (In re Big Rivers Elec. Corp.)*, 355 F.3d 415, 439 (6th Cir. 2004) (professionals employed by committees need not be disinterested); *In re Firstmark Corp.*, 132 F.3d at 1183; *Halbert v. Yousif*, 2255 B.R. 336, 346, n.17 (E.D. Mich. 1998) (standards for retention of professions under Section 327(a) are different from the standards for the retention of professionals under Section 1103(b)); *United Steelworkers of Am. v. Lampl (In re Mesta Mach. Co.)*, 67 B.R. 151, 157 (Bankr. W.D. Pa. 1986) (Section 1103(b) does not require that committee counsel be “disinterested persons”); *In re Jensen-Farley Pictures, Inc.*, 47 B.R. 557, 579 (Bankr. D. Utah 1985). See also H.R. Rep. No. 595, 95th Cong., 1st Sess. 104-5, 1978 U.S. Code Cong. & Admin. News 5787 at 5963, 6357 (1978) (“[Code] requires that an attorney for a creditors’ committee cease representation of creditors in connection with the case. It does not require the attorney to cease representation of the creditors in matters unrelated to the case.”).

D. Committee counsel must comply with Federal Rule of Bankruptcy Procedure 2014 and make disclosure of “all connections.” Failure to promptly and timely make full and adequate disclosure, and to update same, as and when required, could result in the imposition of sanctions, including disgorgement of fees.

III. Standard for Retention of Special Counsel

A. Section 327(e) governs the retention of special counsel, and provides, in relevant part, as follows:

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

Unlike the standard contained in Section 327(a), special counsel are not required to demonstrate that they are “disinterested” because of the limited scope of employment: rather, they only need to demonstrate that they do not hold an interest adverse to the estate.

B. As one court has stated “where employment is sought only for specific limited purposes, subsection (e) of § 327 not only eliminates the disinterestedness requirement for a professional who has formerly represented the debtor, but also narrows the conflict of interest issue to one of factual evaluation of actual or potential conflicts only as related to the particular matters for which representation is sought.” Collier’s on Bankruptcy (15th Rev. Ed.), ¶ 327.04[9] at 327-63 (citing *In re Statewide Pools, Inc.*, 79 B.R. 312, 314 (Bankr. S.D. Ohio 1987)).

IV. Retention of Professionals Under Section 328(a) of the Bankruptcy Code

Normally most professionals engaged in a Chapter 11 case are retained under Sections 327 or 1103 of the Bankruptcy Code on an hourly fee basis (and sometimes also with retainers that are approved by the court). In such circumstances, the professional must file interim and final fee applications with the bankruptcy court pursuant to Sections 330 and 331 of the Bankruptcy Code, upon notice and opportunity, to have their fees and expenses reviewed, approved and blessed by the court. In reviewing the applications, courts must determine the reasonableness of the compensation to be awarded to the professional and must consider the nature, extent and the value of the services, taking into consideration such factors as: (i) the time spent for such services; (ii) the rates charged for such services; (iii) whether the services were necessary and beneficial to the estate; (iii) 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; (iv) whether the professional is board certified or otherwise demonstrated skill and expertise in the bankruptcy field; and (v) whether the compensation is

reasonable based on the customary compensation charged by comparatively skilled practitioners in cases other than cases under the Bankruptcy Code. See 11 U.S.C. § 330(a)(3).

However, Section 328(a) also provides an alternative basis by which to retain certain professionals who, instead of receiving fees on an hourly basis, may request and receive fees on a fixed fee basis. Section 328(a) provides, in relevant part, as follows:

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.

11 U.S.C. § 328(a).

Questions have arisen recently regarding the court's ability to review fixed or contingent fee compensation proposed to be awarded to a professional retained under Section 328(a) on the basis of reasonableness and the other factors delineated under Section 330(a)(3). It appears that, in large part, the determination of whether a court can, or will, undertake such a review in these limited circumstances will depend on the manner in which the professional was initially retained by the court.

In *F.V. Steel and Wire Company v. Houlihan Lokey Howard & Zukin Capital, L.P. (In re F.V. Steel and Wire Company)*, 350 B.R. 835 (D. Wis. 2006), the Committee retained Houlihan Lokey as its investment banker pursuant to Sections 328(a) and 1103. The proposed retention provided for a monthly advisory fee and a transaction fee. When Houlihan Lokey filed its final fee application, the debtor objected to the transaction fee, arguing that it had been wrongly calculated because it included retiree recoveries as part of unsecured recoveries (the basis

provided for the formula utilized in calculating the transaction fee). In response, Houlihan Lokey responded that (i) because Section 328(a) governed its retention, the court could modify the pre-approved compensation arrangement only if it proved to be improvident in light of developments that could not have been anticipated, and (ii) it had properly calculated the transaction fee. In ruling on this matter, the Bankruptcy Court rejected Houlihan Lokey's first argument, stating that it "would strip the court of the ability to review the reasonableness of professional fee requests." *Id.* at 838. Ultimately, the Bankruptcy Court found the transaction fee to be properly calculated and the fees sought to be reasonable. The debtor appealed this ruling.

On appeal, the District Court affirmed the ruling, but not the reasoning, of the Bankruptcy Court and, in doing so, made some interesting observations about the ability of a court to review pre-approved compensation for professionals retained under Section 328(a). According to the court, "[w]hether a bankruptcy court can be said to have pre-approved a professional's request for compensation under § 328(a) depends on the documents governing the professional's retention." *Id.*, citing *In re Circle K. Corp.*, 279 F.3d 669, 671 (9th Cir. 2002) (which held that unless a professional's retention application unambiguously specifies that it seeks approval under Section 328, it is subject to review under Section 330 of the Bankruptcy Code and thus, as a matter of good practice, the retention order should explicitly confirm same; however, the court also held that the absence of a specific reference to this section would not automatically *per se* override that the retention was governed by Section 328(a), thereby leaving the bankruptcy court free to determine whether Section 330 is applicable); *contra Donaldson, Lufkin & Jenrette Corp. v. National Gypsum Co. (In re National Gypsum Co.)*, 123 F.3d 861 (5th Cir. 1997) (unless the retention application and court's order authorizing the retention explicitly

provide that the retention is governed by Section 328(a), the court retains the right to review the professional fees for reasonableness under Section 330).

After evaluating the rulings of the Ninth and Fifth Circuit Courts of Appeal, the District Court held:

I agree with the Ninth Circuit that a professional seeking to have her fees reviewed under § 328(a) should make sure that the engagement letter, the retention application and to the extent possible the retention order, specify that review under such section is intended. I also agree with the Ninth Circuit that even if the engagement letter and/or retention application expressly contemplate review under § 328(a), a bankruptcy court may in its retention order specify that it will review the fee application under § 330. However, if the retention documents indicate that review under § 328(a) is intended, a bankruptcy court may not review a fee application for reasonableness under § 330 unless it unambiguously states in the retention order that it intends to do so. A professional has a right to know the standard under which her fee application will be reviewed at the time she is retained.

F.V. Steel and Wire Company v. Houlihan Lokey Howard & Zukin Capital, L.P., 350 B.R. at 840. In this case, because the engagement letter, the retention application and the retention order all expressly contemplated that Section 328(a) governed the retention, without any reference to Section 330, and further provided that the court could modify the terms and conditions only if they later proved to be improvident in light of developments not anticipated, the District Court held that the Bankruptcy Court could not thereafter review the fees for reasonableness under Section 330. Moreover, the District Court found that inclusion of language in the retention order, indicating that it had final review over Houlihan Lokey's fees, "was insufficient to authorize the court to review Houlihan's compensation under § 330." *Id.* Furthermore, the District Court stated:

If the court intended to reject § 328(a) review in favor of reasonableness review under § 330, it should have done so explicitly. Because it failed to do so, it could subsequently review Houlihan's fee application only under the improvident standard in § 328(a). By reviewing it for reasonableness under § 330, the court erred.

Id.

See also, *In re Chewning & Frey Security, Inc., f/k/a McLaughlin-Frey Security, Inc.*, 328 B.R. 899 (Bankr. N.D.Ga. 2005) (special counsel for trustee, retained on a contingent fee basis, was forced to have its contingent fee reduced in order to provide for a *pro rata* distribution among chapter 7 administrative creditors, consistent with the mandatory priority scheme contained in Section 726(b); equitable considerations did not permit the court to exercise its discretion to grant a fee enhancement or to otherwise vary from the distribution scheme contained under Section 726(b), as provided in *Specker Motor Sales Co. v. Eisen*, 393 F.3d 659 (6th Cir. 2004); administrative insolvency was not deemed to be a circumstance that permitted the court to modify the terms and conditions under which the professional had been initially retained under Section 328(a) but rather a risk that all professionals undertake at the beginning of an engagement; and special counsel could not assert a post-petition charging lien on the property recovered for the benefit of the estate because to do so in this case would violate the automatic stay provisions that prohibit, among other things, any act to create, perfect or enforce any lien against property of the estate under Section 362(a)(4)).