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SECTIONS 327 THROUGH 331—RECENT DEVELOPMENTS IN THE LAW OF EMPLOYMENT AND COMPENSATION OF BANKRUPTCY PROFESSIONALS

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I. Introduction

Sections 327 through 331 of the Bankruptcy Code establish standards for the employment and compensation of professionals such as attorneys, financial advisors, investment bankers, and accountants who help administer bankruptcy cases. This article reviews notable cases from 2011 that pertain to each of these Bankruptcy Code provisions.

The featured decisions address the appropriate standard of review regarding particular aspects of Bankruptcy Code sections 327 through 331. Two decisions dealing with section 327 grapple with conflicts of interest that arise when debtor's counsel has relationships with creditors of the bankruptcy estate.[1] The section 328 decision teaches that parties should carefully draft fee arrangements because their ability to alter terms approved under section 328 later in a case likely will be strictly limited to circumstances that are "improvident" and "incapable of anticipation."[2] The decision pertaining to section 329 identifies when prebankruptcy services provided by an attorney fall within the scope of the Bankruptcy Code's disgorgement remedies.[3] The section 330 decision clarifies that the recent U.S. Supreme Court decision in

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[1]*In re Harris Agency, LLC*, 451 B.R. 378, 381, 54 Bankr. Ct. Dec. (CRR) 226 (Bankr. E.D. Pa. 2011), aff'd, 462 B.R. 514, Bankr. L. Rep. (CCH) P 82109 (E.D. Pa. 2011); *In re Lewis Road, LLC*, 2011 WL 6140747 (Bankr. E.D. Va. 2011).

[2]*In re ASARCO LLC*, 457 B.R. 575, Bankr. L. Rep. (CCH) P 82063 (S.D. Tex. 2011).

[3]*In re Garcia*, 456 B.R. 361, Bankr. L. Rep. (CCH) P 81995 (N.D. Ill. 2011).

Perdue v. Kenny A.[4] does not alter the lodestar method employed by bankruptcy courts to calculate reasonable fee awards.[5] Lastly, the section 331 decision explains that postpetition fee retainers are permissible only in rare cases and are often inadvisable because they place a professional in a priority position above other administrative creditors.[6]

II. Close Connections Between Debtor's Counsel and Estate Creditors Create Impermissible Conflicts of Interest Under Section 327

Section 327 of the Bankruptcy Code authorizes the employment of professionals to the extent they "do not hold or represent an interest adverse to the [bankruptcy] estate" and are "disinterested" as that term is defined in section 101 of the Bankruptcy Code.[7] To assist courts in determining a professional's eligibility for employment, Rule 2014(a) of the Federal Rules of Bankruptcy Procedure requires professionals to submit a verified statement "setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee."[8]

Each year bankruptcy professionals test the limits of the appropriate levels of disclosure and permissible connections to interested parties in a case. In 2011, two noteworthy decisions dealt with conflicts of interest that arose between debtor's attorneys and creditors of the estate.

In *In re Harris Agency, LLC*,[9] the Bankruptcy Court for the Eastern District of Pennsylvania reviewed the standard for identifying conflicts of interest under section 327 of the Bankruptcy Code. There, counsel for the debtor (the "Firm") failed to disclose payments that it received from the debtor's creditors during the bankruptcy case and that it represented a creditor of the estate, Union One Insurance Group, LLC ("Union One"), in a

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[4] *Perdue v. Kenny A. ex rel. Winn*, 130 S. Ct. 1662, 176 L. Ed. 2d 494, 109 Fair Empl. Prac. Cas. (BNA) 1, 93 Empl. Prac. Dec. (CCH) P 43877 (2010).

[5] *CRG Partners, LLC v. U.S. Trustee*, 445 B.R. 667 (N.D. Tex. 2011).

[6] *In re USHC, LLC*, 456 B.R. 304, 55 Bankr. Ct. Dec. (CRR) 140 (Bankr. W.D. Ky. 2011).

[7] 11 U.S.C. § 327(a).

[8] Fed. R. Bankr. P. 2014(a).

[9] *In re Harris Agency, LLC*, 451 B.R. 378, 381, 54 Bankr. Ct. Dec. (CRR) 226 (Bankr. E.D. Pa. 2011), aff'd, 462 B.R. 514, Bankr. L. Rep. (CCH) P 82109 (E.D. Pa. 2011).

lawsuit pending in federal district court. The litigation involved a loan obligation that the debtor owed to a third party as to which the debtor and Union One were co-obligors.[10] The Firm claimed that it misunderstood that it was required to disclose payments from creditors.[11] It also argued that its participation in the district court action was "necessary to protect the Debtor" and that the debtor's interests were aligned with those of Union One.[12] Moreover, the Firm maintained that its representation of Union One did not amount to a material conflict because the Firm had "little involvement" in the litigation.[13]

The court explained that an "adverse interest" usually means "any economic interest that would tend to lessen the value of the bankruptcy or that would create either an actual or potential dispute in which the estate is a rival claimant."[14] The court observed, in contrast, that an actual conflict of interest is "defined largely on a case-by-case basis by examining the specifics of the facts of a given situation."[15] According to the court, "[a] conflict is deemed actual, and per se disqualifying, if 'it is likely that a professional will be placed in a position permitting it to favor one interest over an impermissibly conflicting interest.' "[16]

Applying this standard, the court disqualified the Firm on two independent bases. First, the court found that the Firm's receipt of undisclosed, postpetition payments from creditors of the estate without court approval created an actual conflict of interest with the debtor's estate. The court found unavailing the Firm's excuse that it held a "mistaken belief" that it was only required to disclose postpetition payments received from the debtor.[17]

Second, the court ruled that an actual conflict existed due to the Firm's concurrent representation of Union One in pending litigation. The court ruled that the Firm could not be a loyal advocate for the debtor and Union One at the same time because

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[10] *Id.* at 386.

[11] *Id.* at 384.

[12] *Id.* at 388.

[13] *Id.*

[14] *Id.* at 389 (citing *In re eToys, Inc.*, 331 B.R. 176, 189, 45 Bankr. Ct. Dec. (CRR) 117 (Bankr. D. Del. 2005)).

[15] 451 B.R. at 389 (citing *In re BH & P, Inc.*, 949 F.2d 1300, 1315, 22 Bankr. Ct. Dec. (CRR) 541, 26 Collier Bankr. Cas. 2d (MB) 37, Bankr. L. Rep. (CCH) P 74356 (3d Cir. 1991)).

[16] 451 B.R. at 389 (citing *In re Pillowtex, Inc.*, 304 F.3d 246, 251, 40 Bankr. Ct. Dec. (CRR) 62, Bankr. L. Rep. (CCH) P 78744 (3d Cir. 2002)).

[17] *Id.* at 384.

their interests were not identical. Their interests diverged because the debtor could have benefitted from a successful suit against Union One in which Union One was held responsible to pay the debt for which it is a co-obligor with the debtor.[18]

In addition, court reasoned that the Firm's representation of Union One and the debtor prevented it from having an undivided loyalty to the debtor and from taking steps that would have benefited the debtor's interests. Although the interests of the debtor and Union One may have been aligned at times, the court explained, the Firm's loyalties were impermissibly divided because it would have to choose between what was best for all creditors of the estate or remaining loyal to the interests of the Debtor's owners.[19]

Further, the court dismissed the Firm's argument that its representation of Union One did not involve enough time or money to create a conflict of interest. The court explained that "as soon as a professional's loyalties are actually improperly divided, it is irrelevant how much they are divided. The issue is qualitative, not quantitative; bankruptcy counsel simply cannot have or represent interests adverse to the estate."[20] As a result, the court disqualified the Firm as of the date it entered an appearance in district court on behalf of Union One. Moreover, the court ordered the Firm to disgorge fees it had already received, and ordered every attorney at the Firm to complete six hours of continuing legal education dealing specifically with conflicts of interest.[21]

The Bankruptcy Court for the Eastern District of Virginia addressed a similar conflict of interest in *In re Lewis Road, LLC*.[22] There, debtor's counsel possessed several competing interests with the estate. The law firm concurrently represented a creditor in connection with the bankruptcy case; a member of the law firm owned a participation interest in a secured loan to the debtor; and the law firm was a creditor of the estate due to prepetition attorney fees and expenses it incurred representing a creditor to enforce its rights against the company.[23]

The law firm attempted to justify its concurrent representation of the debtor and a creditor on the grounds that both clients

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[18] *Id.* at 391.

[19] *Id.* at 392.

[20] *Id.* at 394.

[21] *Id.* at 398.

[22] *In re Lewis Road, LLC*, 2011 WL 6140747 (Bankr. E.D. Va. 2011).

[23] *Id.* at *26–27.

waived the conflict and based on the exception provided in section 327(c) of the Bankruptcy Code, which does not require the automatic disqualification of a party "solely because of such person's employment by or representation of a creditor."[24]

The court rejected the law firm's arguments for two reasons. First, the court found that the law firm's conduct did not create a "potential conflict" waivable under the state rules of professional conduct. Instead, an actual conflict existed due to the law firm's concurrent representation of two parties with competing interests in the same case.[25] Second, the court held that even if the conflict was waivable under state rules of professional conduct, the law firm failed to independently satisfy the requirements of section 327 by giving written notice of the waiver to all interested parties and obtaining bankruptcy court approval.[26] Because the law firm did not adequately disclose its connections to interested parties and failed to obtain court approval of the conflict waivers, the court refused the firm any compensation.

III. Section 328 Strictly Limits Modifications to Fee Agreements

With court approval, Bankruptcy Code section 328 authorizes the employment of professionals on any reasonable terms and conditions, including the use of a retainer, as well as hourly, fixed, percentage and contingent fee bases.[27] Once employed pursuant to section 328(a), the terms and conditions may be modified by the court after the conclusion of the employment if the compensation agreement proves to be "improvident in light of developments which could not have been anticipated at the time of the agreement."[28]

In *In re ASARCO, LLC*,[29] the U.S. District Court for the Southern District of Texas reviewed the standard in the Fifth Circuit for modifying the compensation of professionals approved under section 328. The district court observed that the Fifth Circuit has interpreted section 328 as "strictly limiting the power of the bankruptcy court to alter the compensation of profession-

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[24] *Id.* at *24 (citing 11 U.S.C. § 327(c)).

[25] *Id.* at *24.

[26] *Id.*

[27] 11 U.S.C. § 328(a).

[28] *Id.*

[29] *In re ASARCO LLC*, 457 B.R. 575, Bankr. L. Rep. (CCH) P 82063 (S.D. Tex. 2011).

als approved under it."[30] This standard "requires that circumstances actually be 'incapable of anticipation, not merely unanticipated' . . .."[31]

In *ASARCO*, Barclays Capital Inc. ("BarCap") was the investment banker and financial advisor to the debtor. Following confirmation of the debtor's plan of reorganization, BarCap requested a fee enhancement for "unanticipated services" performed by Lehman Brothers Inc. ("Lehman"), whose assets BarCap purchased during the course of the bankruptcy, and additional discretionary fees for the successful outcome of the case.[32] The bankruptcy court granted BarCap $975,000 for Lehman's "unanticipated services" pursuant to section 328(a), but denied the other fee enhancements. Counter-appeals ensued and were consolidated before the district court. On the one hand, the debtor and its parent (the "Parent") appealed the award of $975,000 for Lehman's unanticipated services. On the other hand, BarCap appealed the denial of the additional discretionary fees.

With respect to the bankruptcy court's award of $975,000 for unanticipated services, the district court considered whether the bankruptcy court applied the "incapable of anticipation" standard to the fee enhancement, or merely an "unanticipated" standard as alleged by the Parent. The district court ruled that although the bankruptcy court's order included the phrase "[n]o one foresaw the length and complexity of this case" and awarded fees for "unanticipated services," it applied the proper "incapable of anticipation" standard pursuant to section 328.[33] Moreover, the district court held that ample evidence existed in the record to support the bankruptcy court's conclusions that the length and complexity of the bankruptcy were incapable of anticipation when Lehman executed its engagement letter with the debtor.[34] The district court recognized that the bankruptcy court identified findings of circumstances that Lehman did not know at the time it entered into the engagement that would make its arrangement improvident, including: (i) the debtor and Lehman expected the restructuring to take the form of a quick sale when they entered into their original engagement; (ii) Lehman's review of industry information about the debtor indicated that a quick liquidation

[30] *Id.* at 581.

[31] *Id.* (quoting *In re Barron*, 325 F.3d 690, 693, 41 Bankr. Ct. Dec. (CRR) 31, Bankr. L. Rep. (CCH) P 78825, 13 A.L.R. Fed. 2d 815 (5th Cir. 2003)).

[32] *Id.* at 585.

[33] *Id.* at 584.

[34] *Id.* at 585.

was reasonable; (iii) since the debtor was a nonpublic subsidiary of a foreign company, Lehman could not have known that the debtor had deficiencies in its internal management capabilities and reporting systems; and (iv) no one could have anticipated that the chief executive officer and board would be replaced within the first months of the case.[35] Finally, the district court observed that the bankruptcy court record reflected that Lehman performed tasks beyond the scope of its engagement letter and the expected tasks of an investment banker, which demonstrated to the district court that the contracted fees were below market rate and improvident.[36] As a result, the district court affirmed the bankruptcy court's award of $975,000.

The district court then considered the bankruptcy court's denial of BarCap's request for a $2 million discretionary fee for "the overall success of the Chapter 11 cases" (the "Success Fee").[37] BarCap argued that the bankruptcy court should have analyzed the propriety of the Success Fee under the reasonableness test set forth in section 330, even though BarCap's employment application emphasized that its fee applications "shall be subject to review pursuant to the standards set forth in Section 328(a) of the Bankruptcy Code and not subject to the standard of review set forth in Section 330 of the Bankruptcy Code."[38] BarCap maintained that the section 330 standard applied because the terms of its fee arrangement did not specify an amount for the Success Fee.[39]

The district court disagreed and held that the bankruptcy court correctly considered BarCap's request under the terms of its engagement letter because it was approved under section 328. Given that section 328 "seriously limits the power of a bankruptcy court to award compensation that departs from the terms that have been approved," the specific agreed-upon fee arrangements could be altered by the court only under the "incapable of anticipation" standard.[40] According to the district court, the fact that BarCap's engagement letter did not establish a specific

[35] *Id.* at 582.

[36] *Id.*

[37] *Id.* at 586.

[38] *Id.* at 586–87.

[39] *Id.* at 578–88.

[40] *Id.* at 589.

amount for the Success Fee did not change its analysis.[41] Therefore, the district court affirmed the bankruptcy court's decision to apply the criteria established by the engagement letter rather than the section 330 standard.

IV. A Subjective Test of the Debtor's State of Mind Determines the Scope of Section 329

Section 329(a) establishes disclosure requirements for a debtor's attorney with respect to any compensation paid or agreed to be paid "for services rendered or to be rendered in contemplation of or in connection with the [bankruptcy] case."[42] In addition, section 329(b) authorizes a court to disgorge attorneys' fees "[i]f such compensation exceeds the reasonable value of any such services."[43]

In *In re Garcia*,[44] the U.S. District Court for the Northern District of Illinois reviewed the standard for determining whether the services of an attorney who had represented a debtor before he filed for bankruptcy were "in contemplation" of the bankruptcy filing. The question arose because a Chapter 11 individual debtor, Mr. Garcia, filed a motion pursuant to section 329(b) to disgorge fees he paid to an attorney, Ms. Miller, prior to his bankruptcy filing.[45]

The debtor and attorney offered different views regarding the scope of the attorney's employment. Whereas Garcia claimed that he employed Miller for the purpose of defending him in foreclosure suits and to restructure his debts, Miller countered that she was hired to assist with the short sale of one of Garcia's properties and that she learned of his financial troubles and need for bankruptcy protection only after representing him for a number of months. The parties did not dispute, however, that Miller helped Garcia locate another attorney to represent him in his bankruptcy filing and that, without Miller's knowledge or consent, one of her assistants provided Garcia's bankruptcy counsel with certain data included in Garcia's bankruptcy petition.[46]

The bankruptcy court ruled that Miller was beyond the scope of section 329. The court emphasized that Miller did not serve as

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[41] *Id.*

[42] 11 U.S.C. § 329(a).

[43] 11 U.S.C. § 329(b).

[44] *In re Garcia*, 456 B.R. 361, Bankr. L. Rep. (CCH) P 81995 (N.D. Ill. 2011).

[45] *Id.* at 362.

[46] *Id.* at 363.

Garcia's bankruptcy counsel, and expressed concern that enforcing section 329 due to Miller's sharing of information with Garcia's bankruptcy counsel would discourage prepetition attorneys from disclosing information to a debtor's bankruptcy attorney.[47]

On appeal, the district court disagreed and remanded the case because the bankruptcy court applied an incorrect legal standard. The district court held that "a subjective test of the debtor's state of mind is used in determining if a transaction is subject to Section 329."[48] Services rendered to prevent bankruptcy fall within the ambit of section 329, yet nonbankruptcy services must bear " 'more than a casual relationship to the bankruptcy proceeding.' "[49]

The district court ruled that the bankruptcy court's emphasis on whether Miller could be considered one of Garcia's bankruptcy counsel was not the appropriate test for determining whether she was subject to the requirements of section 329. "Instead, the [bankruptcy] court should determine whether Garcia's transactions with Miller were for the purpose of avoiding bankruptcy or were motivated by the imminence of bankruptcy."[50] The district court tasked the bankruptcy court on remand with making factual determinations regarding Garcia's state of mind and the purpose of Miller's services in order to assess whether Miller was retained for the purpose of restructuring Garcia's debt or simply for short-selling a single property as Miller suggested.[51]

V. The U.S. Supreme Court Decision in *Perdue v. Kenny A.* Does Not Apply to Fee Enhancement Requests Under Section 330

Bankruptcy Code section 330 provides the statutory authority and standards for compensating services and reimbursing expenses of professionals and officers of a bankruptcy estate. Under section 330(a)(1)(A), a court may award reasonable compensation and reimbursement to professionals.[52]

A number of bankruptcy courts employ the lodestar method to

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[47] *Id.* at 364.

[48] *Id.*

[49] *Id.* (quoting *Matter of Swartout*, 20 B.R. 102, 106, 9 Bankr. Ct. Dec. (CRR) 313 (Bankr. S.D. Ohio 1982)).

[50] *Id.* at 365.

[51] *Id.*

[52] 11 U.S.C. § 330(a)(1)(A).

calculate the precise amount of a reasonable fee award. The lodestar amount is calculated "by multiplying the number of hours reasonably expended by the prevailing hourly rate in the community for similar work."[53] Although the lodestar may be adjusted upward or downward based on various factors, upward adjustments generally are proper only in rare and exceptional cases.[54]

In *CRG Partners, LLC v. United States*,[55] the U.S. District Court for the Northern District of Texas considered whether a different compensation standard explained in the U.S. Supreme Court's decision in *Perdue v. Kenny A.*,[56] governed fee-enhancement requests in bankruptcy cases. The issue arose when CRG Partners Group, LLC ("CRG"), the chief restructuring advisor for the debtor, filed a request for a $1 million fee enhancement based on a successful outcome in the case.[57]

The bankruptcy court ruled that the decision in *Perdue*, a civil-rights case involving a fee-enhancement request under 42 U.S.C. § 1988, governed fee-enhancement requests in bankruptcy cases and denied CRG's fee request based on that determination.[58] *Perdue* addressed whether the calculation of an attorney's fee under federal fee-shifting statutes based on the lodestar may be increased due to superior performance and results. The Supreme Court articulated "six important rules" and established a framework for assessing fee enhancement requests that differed

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[53]*Matter of Fender*, 12 F.3d 480, 25 Bankr. Ct. Dec. (CRR) 292, Bankr. L. Rep. (CCH) P 75711 (5th Cir. 1994); *see also Hensley v. Eckerhart*, 461 U.S. 424, 433, 103 S. Ct. 1933, 76 L. Ed. 2d 40, 31 Fair Empl. Prac. Cas. (BNA) 1169, 32 Empl. Prac. Dec. (CCH) P 33618 (1983); *Grant v. George Schumann Tire & Battery Co.*, 908 F.2d 874, 879, 23 Collier Bankr. Cas. 2d (MB) 708, Bankr. L. Rep. (CCH) P 73577 (11th Cir. 1990).

[54]*In re Fender*, 12 F.3d at 487; *Matter of UNR Industries, Inc.*, 986 F.2d 207, 210, 23 Bankr. Ct. Dec. (CRR) 1678, Bankr. L. Rep. (CCH) P 75138 (7th Cir. 1993); *Shipes v. Trinity Industries*, 987 F.2d 311, 320, 66 Fair Empl. Prac. Cas. (BNA) 375, 61 Empl. Prac. Dec. (CCH) P 42198, 25 Fed. R. Serv. 3d 1390 (5th Cir. 1993).

[55]*CRG Partners, LLC v. U.S. Trustee*, 445 B.R. 667 (N.D. Tex. 2011).

[56]*Perdue v. Kenny A. ex rel. Winn*, 130 S. Ct. 1662, 176 L. Ed. 2d 494, 109 Fair Empl. Prac. Cas. (BNA) 1, 93 Empl. Prac. Dec. (CCH) P 43877 (2010).

[57]445 B.R. at 668.

[58]*Id.* at 668.

from the standard that had been used in Texas bankruptcy cases.[59]

On appeal, the district court reviewed several decisions that did not extend *Perdue* beyond fee-shifting statutes and highlighted restrictive language in *Perdue* that limited the scope of the decision.[60] As a result, the district court concluded that the Supreme Court did not intend for *Perdue* to apply outside the context of federal fee-shifting statutes. The district court thus reversed the bankruptcy court decision and remanded the case for consideration under the previous state of the law in bankruptcy cases.

VI. Postpetition Fee Retainers Are Permissible in Rare Circumstances

Section 331 of the Bankruptcy Code explicitly authorizes a trustee, an examiner, an attorney or any professional person

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[59] *Id.* at 670 (citing *Perdue*, 130 S. Ct. at 1672–73). The Supreme Court explained:

> First, "reasonable" fee is a fee that is sufficient to induce a capable attorney to undertake the representation of a meritorious civil rights case. Section 1988's aim is to enforce the covered civil rights statutes, not to provide "a form of economic relief to improve the financial lot of attorneys."
>
> Second, the lodestar method yields a fee that is presumptively sufficient to achieve this objective. Indeed, we have said that the presumption is a "strong" one.
>
> Third, although we have never sustained an enhancement of a lodestar amount for performance, we have repeatedly said that enhancements may be awarded in " 'rare' " and " 'exceptional' " circumstances.
>
> Fourth, we have noted that "the lodestar figure includes most, if not all, of the relevant factors constituting a 'reasonable' attorney's fee," and have held that an enhancement may not be awarded based on a factor that is subsumed in the lodestar calculation. We have thus held that the novelty and complexity of a case generally may not be used as a ground for an enhancement because these factors "presumably [are] fully reflected in the number of billable hours recorded by counsel." We have also held that the quality of an attorney's performance generally should not be used to adjust the lodestar "[b]ecause considerations concerning the quality of a prevailing party's counsel's representation normally are reflected in the reasonable hourly rate."
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> Fifth, the burden of proving that an enhancement is necessary must be borne by the fee applicant.
>
> Finally, a fee applicant seeking an enhancement must produce "specific evidence" that supports the award. This requirement is essential if the lodestar method is to realize one of its chief virtues, *i.e.*, providing a calculation that is objective and capable of being reviewed on appeal.

Perdue, 130 S. Ct. 1672–73 (quoting *Pennsylvania v. Delaware Valley Citizens' Council for Clean Air*, 478 U.S. 546, 565–66, 106 S. Ct. 3088, 92 L. Ed. 2d 439, 24 Env't. Rep. Cas. (BNA) 1577, 16 Envtl. L. Rep. 20801 (1986), opinion supplemented, 483 U.S. 711, 107 S. Ct. 3078, 97 L. Ed. 2d 585, 26 Env't. Rep. Cas. (BNA) 1091, 45 Fair Empl. Prac. Cas. (BNA) 1750, 17 Envtl. L. Rep. 20929 (1987); citations omitted).

[60] *Id.* at 671–72.

employed under section 327 or section 1103 to apply to the court for interim compensation and reimbursement of expenses. Section 331 establishes a general rule that a professional may apply to the court for interim compensation every 120 days, but it also authorizes the court to permit more frequent applications.[61]

In large cases that involve extensive legal work, courts often permit professionals to apply for compensation more frequently than every 120 days.[62] Another deviation from the customary interim compensation procedure involves requests for special retainers during a bankruptcy case.[63] The U.S. District Court for the Western District of Kentucky addressed this type of request in *In re USHC, LLC*,[64] where the debtor's counsel sought to obtain a $2,000 monthly retainer during the bankruptcy case so that funds would be available to pay the debtor's counsel on a regular basis (the "Security Retainer").

There, the debtor applied to employ its bankruptcy counsel pursuant to sections 327 and 1107 of the Bankruptcy Code. The application stated that the debtor had paid the law firm a $30,000 retainer and further provided that "[i]n anticipation that the aforementioned retainer will not be sufficient to pay for all services and expenses incurred, the following provisions for additional payment(s) have been agreed to by client and counsel: escrowing with counsel an additional $2,000 per month. Any fees would be paid upon approval by the United States Bankruptcy Court."[65]

In response to an objection from the U.S. Trustee, an attorney from the proposed counsel's law firm testified in support of the Security Retainer that in his experience, "0% of the retainers collected have paid for the full cost of a case and in 98% of the cases in which his law firm represents Chapter 11 debtors, attorney

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[61] 11 U.S.C. § 331.

[62] *See, e.g., In re Mariner Post-Acute Network, Inc.*, 257 B.R. 723, 730–731, 36 Bankr. Ct. Dec. (CRR) 281, 45 Collier Bankr. Cas. 2d (MB) 922 (Bankr. D. Del. 2000); *In re Bennett Funding Group, Inc.*, 213 B.R. 227, 232 (Bankr. N.D. N.Y. 1997).

[63] *See, e.g. In re Pan American Hosp. Corp.*, 312 B.R. 706, 712, 43 Bankr. Ct. Dec. (CRR) 110, 52 Collier Bankr. Cas. 2d (MB) 842 (Bankr. S.D. Fla. 2004); *In re W & W Protection Agency, Inc.*, 200 B.R. 615, Bankr. L. Rep. (CCH) P 77175 (Bankr. S.D. Ohio 1996).

[64] *In re USHC, LLC*, 456 B.R. 304, 55 Bankr. Ct. Dec. (CRR) 140 (Bankr. W.D. Ky. 2011).

[65] *Id.* at 306.

fees are owed when the case is confirmed."[66] Moreover, he observed that although the U.S. Trustee gets paid in full and creditors get paid under the debtor's plan, debtor's counsel sometimes must wait a year or longer to be paid.[67]

The court assessed the reasonableness of the Security Retainer based on factors set forth in *In re Knudsen Corp.*,[68] and considered whether "rare" circumstances existed to justify a departure from typical fee arrangements in Chapter 11 cases. In *Knudsen*, the Bankruptcy Appellate Panel for the Ninth Circuit held that a fee retainer may be authorized in "the rare case" where the court makes the following findings: (1) the case is unusually large and an exceptionally large amount of fees accrue monthly; (2) waiting an extended period for payment would place an undue hardship on counsel; (3) the court is satisfied that counsel can respond to any reassessment of its fees; and (4) the fee retainer procedure itself is the subject of a noticed hearing before any payment.[69]

After considering the *Knudsen* factors, the court concluded that the Security Retainer was unwarranted. According to the court, the case was not unusually large, counsel had not demonstrated an undue hardship from having to wait an extended period for payment, and there was no evidence that the law firm could not respond to a reassessment on the fees.[70]

The court recognized the financial constraints placed upon Chapter 11 debtors' counsel with respect to the payment of fees, but ruled that the customary interim compensation procedures and the priority status afforded to professional fees under the Bankruptcy Code minimized the fee risk.[71] Moreover, the court expressed concern that the Security Retainer would serve as collateral for payment of the attorney's allowed fees and therefore transform the attorney into "a secured creditor with a possessory perfected security interest in the funds to the extent the retainer covers fees approved by the Court."[72] The court concluded that the Retainer was not in the best interest of the estate because it would require the debtor's use of creditors' cash collateral and

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[66] *Id.*

[67] *Id.*

[68] *In re Knudsen Corp.*, 84 B.R. 668, 17 Bankr. Ct. Dec. (CRR) 790 (B.A.P. 9th Cir. 1988).

[69] *Id.* at 672–73.

[70] *In re USHC, LLC*, 456 B.R. at 307.

[71] *Id.* at 308.

[72] *Id.* (citations omitted).

place the debtor's attorney in a priority position above other administrative claimants.[73] The court therefore denied the Retainer but otherwise approved the application to employ debtor's counsel in accordance with normal section 331 interim compensation procedures followed in the district.[74]

VII. Conclusion

These cases offer cautionary tales for bankruptcy professionals. Prepetition nonbankruptcy attorneys could face disgorgement if their clients retain them for the purpose of avoiding bankruptcy or are motivated by the imminence of bankruptcy. Once employed by a bankrupt debtor, professionals face the threat of disgorgement if they fail to disclose connections that call into question their loyalty to the debtor and its estate. And if unanticipated circumstances arise during a case, professionals may be held to otherwise unreasonable compensation terms if their employment was approved pursuant to section 328 of the Bankruptcy Code.

In the coming years, the compensation of bankruptcy professionals will receive greater scrutiny. In November 2011, the United States Trustee Program ("USTP") published proposed guidelines for reviewing applications for attorney compensation in large Chapter 11 cases in which a debtor's scheduled assets and liabilities exceed $50 million (the "Proposed Guidelines").[75] The USTP invited public review of and comment on the Proposed Guidelines, and received twenty-two comments before the comment period ended on January 31, 2012. The Proposed Guidelines aim to improve transparency in the billing practices and increase client and constituent accountability for overseeing fees and billing practices of professionals. However, a number of professionals, academics and professional organizations have criticized the Proposed Revisions. One comment letter submitted on behalf of 119 law firms, in particular, expressed "major concerns" with the Proposed Revisions and argued that the changes "threaten to undermine a linchpin of the domestic and international restructuring services that have developed in the United States and the infrastructure needed to save jobs through successful

[73] *Id.* at 308–09.

[74] *Id.* at 309.

[75] A complete copy of the Proposed Guidelines can be accessed online at: http://www.justice.gov/ust/eo/rules__regulations/guidelines/docs/proposed/proposed__guidelines__and__exhibits.pdf.

reorganizations."[76] Given the extensive feedback on the Proposed Guidelines and calls for meetings with USTP officials, bankruptcy professionals should expect heated debate in 2012 regarding their employment and compensation.

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[76]The comments from the 119 law firms can be accessed online at: http://www.justice.gov/ust/eo/rules__regulations/guidelines/docs/proposed/119__Law__Firms__Comments.pdf.