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Chapter 11 - 101 The Nuts and Bolts of Chapter 11 Practice: A Primer

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Professional Retention and Compensation

Editors' Note: *This is the seventeenth of 22 installments that are being published here, with permission from the American Bankruptcy Institute. The series, read consecutively, will give the reader a broad overview of the Chapter 11 bankruptcy process. The installments are chapters from a CD-Rom that is available for purchase for $50 ($20 to ABI members) through the ABI. For more information, you can call the ABI at (703) 739-0800 or go to www.abiworld.org. The authors welcome your comments and questions as well, and you may feel free to contact them. Jonathan Friedland is a member of the ABI Board of Directors as well as a member of NACM Oregon.*

Some, but not all, lawyers in a bankruptcy case need court approval before they can represent their client and get paid for doing so. We begin by noting a few who do not need court approval. Then we move on to those who do.

First, if you are going to represent a Chapter 7 debtor (filing the petition and schedules, showing up at the meeting of creditors, and whatever else) you don't need court approval to take on the case or to take a fee. This is conceptually intuitive once you recall that a lawyer who represents a Chapter 7 debtor represents only the debtor and not the estate, whereas, a Chapter 11 debtor's attorney represents the debtor company *and* its estate. The court can, however, second guess your fees and make you disgorge money later if it thinks your fee was too high. In just about every district, there is a "rack rate," and if you come in at or below that rate, you won't run into much trouble. Remember, though, that you must get paid up front *and* in advance for your pre-petition work to avoid being a preference holder or merely a general unsecured creditor of the estate.

Second, if you represent a creditor in a bankruptcy case, then for the most part, your retention and compensation is a matter between you and your client. Unless you are: (1) seeking payment of your fees from the estate for "substantial contribution" under § 503(b)(3)(D) (we say a bit more about this topic below); or (2) seeking payment of the fees from the estate that would otherwise be paid to you by your client as the fees of an oversecured creditor under § 506(b). If you represent another party that is not going to be paid from estate funds (such as an investor or asset purchaser, a trade vendor, an employee, etc.), you are free—subject to the ordinary ethics rules—to make your deal with the client, without court involvement. The only exception here is the need to disclose multiple creditor representations, pursuant to Bankruptcy Rule 2019.

But none of these is our primary concern. Rather, we consider here those cases where you want to get your fees directly out of the bankruptcy estate. Here you are very much under court control.

Debtor's Bankruptcy Counsel

Section 327(a) says that "the trustee, with the court's approval, may employ one or more attorneys … to represent or assist the trustee in carrying out the trustee's duties under this title."

In practice, it works like this: among the papers that prospective debtors' counsel prepares at the beginning of the case is an "Application to Employ Counsel." It is filed, not in counsel's name, but in the name of the client. It says, for example, that "Dawson Debtor, the debtor and debtor-in-possession in this case, hereby requests authorization to employ the firm of Ayer, Bernstein, Friedland, & Kuney to represent it as debtor's counsel in this case."

Conflicts Basics

Now, let's go back and take a second look at § 327(a). It provides that "the trustee…may employ one or more attorneys," but it imposes two limitations. One, the attorney must not "hold or represent an *interest adverse* to the estate." And two, she must be a "*disinterested person*."

No Adverse Interest

"Adverse interest" is not defined in the Code. In our

view, to understand it, you start with what you know about conflicts outside of bankruptcy. For starters, you can't represent both plaintiff and defendant in a (nonbankruptcy) lawsuit; so also, you can't represent both creditor and DIP in the bankruptcy case.

So far, so good. The trouble is that bankruptcy isn't quite like nonbankruptcy litigation, and there are problems for which nonbankruptcy principles offer no analog. Most important: how aggressively may you support the interests of the old equity owners in fighting off the depredations of creditors?

There is no easy answer to this one; the best we can do is to say you can represent them some, but not too much. As DIP counsel, one of our favorite cases would be *Casco Northern Bank v. DN Associates*, 3 F.3d 512 (1st Cir. 1993), where the court allowed payment for a DIP counsel whose main contribution to the case appears to be that he induced senior creditors to pay prior creditors. Among our least favorite cases would be *In re Kendavis Industries Intern., Inc.*, 91 B.R. 742 (Bankr. N.D. Tex. 1988), where the court came close to saying that anything you do other than simply paying off creditors is improper. Then again, the facts in *Kendavis* were extreme: the old equity owners seem to have taken the position that if they were going down, then they would be perfectly happy to take the creditors down with them—and whatever the law allows, we would concede it's probably not that.

Disinterestedness Requirement

So much for "adverse interest." But recall that the court must also find that counsel is a "disinterested person." Unlike "adverse interest," it turns out that "disinterested person" is a defined term, and the definition is stringent: *See* § 101(14). It provides (among other things) that a "disinterested person" is one who "is not an equity security holder" and "is not…a director, officer, or employee of the debtor…" If the debtor's pre-bankruptcy corporate counsel is (a) a two percent stockholder, and/or (b) the corporate secretary, he may be the person best equipped to represent the estate, yet on the face of things, he is disqualified. The 2005 amendments to the Bankruptcy Code deleted the per se non-disinterested person status of pre-petition investment bankers. Thus, in appropriate cases, the debtor's pre-petition investment banker may serve as an estate professional.

Pity the law firm that is owed money for pre-bankruptcy work and that seeks to represent the debtor. It is a creditor and therefore not a "disinterested person" under § 101(14). These are difficult waters to navigate. The usual approach is to get prepaid for your work during the 90 days before bankruptcy, and then draw down the advance retainer as you incur fees, so that you are not a preference recipient and also not a creditor as of the petition date. Unfortunately, filings cannot always be timed that well, the debtor does not always have the ability to pay in advance, and the amount of fees cannot always be predicted—so it's worth careful planning, but it doesn't always work.

Some courts have cooked up "*de minimis*" exceptions and such, to get around the disinterestedness rule, which is often viewed as unduly restrictive. We are happy to be on the receiving end of such largesse, but would not recommend relying on it. If you are a creditor as of the petition date, most courts will allow you to become a "disinterested person" by waiving the claim.

Pillowtex

The Third Circuit in *In re Pillowtex*, 304 F.3d 246 (3d Cir. 2002), provided a fair amount of guidance on steps that a debtor's counsel should take (from early on) to avoid disqualification for allegedly holding an interest adverse to the debtor as a result of being a pre-petition creditor. In *Pillowtex*, the company paid $1 million in fees to its law firm in the 90-day period preceding its Chapter 11 filing (apparently constituting an avoidable preferential transfer). As a potential defendant to an avoidance action, the law firm was a potential creditor, and thus did not meet the disinterestedness requirement of § 327. As a result, the law firm was disqualified from the case, and all of the fees it had earned became subject to disgorgement.

A couple of guidance points here. First, do not allow accounts receivable to get past due. *Pillowtex* suggests that a law firm is at risk if it brings a past-due account receivable current during the 90 days prior to the petition date or even if it is simply collecting fees in due course prior to filing, since, in either case, payments would be made on account of an antecedent debt. Bringing a past-due account current certainly poses far less risk when done more than 90 days before the petition date. However, as noted above, the timing of a Chapter 11 petition is not entirely predictable.

The best solution is this: obtain a sufficient pre-petition advance payment retainer before commencing bankruptcy work. It appears that the common practice of obtaining, and drawing against, a retainer remains acceptable. Certainly, drawing against a retainer should pose no preference issue because such draws are not "on account of an antecedent debt." Therefore, one method of protection against a *Pillowtex*-like scenario is to obtain a sufficiently large

retainer, frequently draw earned fees from that retainer, and then simultaneously request that the client replenish the retainer.

Approval of Retention Application

Absent conflict issues, approval of an employment application is usually pretty routine. This approval comes in the form of an order authorizing employment of counsel. Strictly speaking, only then are you allowed to represent the DIP in the case—but everybody recognizes there is a bit of slippage in the early hours or days, and you are likely to get paid for the work that you do prior to entry of the approval order, so long as your application is timely filed and does in fact get approved in due course.

To facilitate this, employment orders are typically entered to be effective as of the petition date or the date on which the employment application was filed. Some judges will enter an interim order approving the employment application, and then set the matter for a final hearing a few weeks later, to give parties more time to review and address any concerns (including, potentially, those of a committee, which may not have been appointed until a several weeks into the case). This approach allows a more careful review of an employment application, while protecting the professionals for necessary work that is done while that review is ongoing.

Disclose, Disclose, Disclose

The application must be accompanied by an affidavit signed by the professional, in accordance with Bankruptcy Rule 2014, setting forth, among other things, all of the professional's connections, with the debtor, creditors, other parties-in-interest, their attorneys and accountants and the UST. This disclosure is made so that other parties, and the court, can evaluate whether there are disqualifying conflicts. Although the Bankruptcy Rules do not prescribe the exact form that the affidavit should take, the affidavits all tend to look fairly similar.

In a large case, preparing the disclosures can entail a lot of work. It is worthwhile to do this work carefully, to make sure your disclosures are complete, and to err on the side of over-disclosure. The consequences for incomplete or misleading disclosures may include disqualification, loss of compensation, and sometimes worse.

Conducting the Conflicts Search

We've seen that you cannot represent the DIP if you have certain kinds of conflicts. But you can't deal with conflicts if you don't know about them. In a big case (or a big firm—or both), just identifying conflicts can be a major undertaking. Here we offer a protocol designed to make sure you identify conflict problems.

At the outset of the representation, you should obtain lists from the company of its top creditors and other conventionally adverse parties. The scope of the search categories can be narrowed, within reason, by using parameters such as "Top 50" or "in the last three years," depending upon the circumstances. These categories may include, but are not necessarily limited to, any or all of the following: (a) present and former directors and officers, (b) landlords and tenants; (c) key customers; (d) primary vendors; (e) largest unsecured creditors; (f) secured creditors; (g) other professional services firms; (h) insurers; (i) major securities holders; (k) litigation counterparties; and (l) parties to key contracts.

As the data comes in from the company, you'll then need to cross-reference it against your client database, and generate a report that reflects your search results.

When a name is identified as a current client of your firm, the usual course of action is to disclose the client-relationship in general terms on the disclosure exhibit to your retention affidavit. The disclosure usually goes something like "Ayer, Bernstein, Friedland & Kuney represents Acme Tire Company, a key vendor of the debtor, in corporate and transactional matters unrelated to the debtor."

Of course, the appropriate level of detail for each disclosure will vary based upon the circumstances. For instance, where a particular client relationship is more suspect and more likely to become adversarial (*e.g.*, where the law firm represents the nondebtor parent or significant equity-holder), it is a good idea to address the issue in detail in the actual text of the affidavit (as opposed to a cursory two-line statement in an exhibit).

As the bankruptcy case progresses, it is important to remember that, as debtor's counsel, you'll have a duty of continuing disclosure. This means that if a potentially adverse relationship between the debtor and another client was either unknown to you at the time you submitted the original retention affidavit or later developed as a result of unforeseen events, you should file a supplemental affidavit that discloses the existence of such relationship. As with the initial disclosures, this supplemental disclosure should be viewed as an opportunity to get everything out on the table and avoid the appearance of impropriety that might otherwise

arise if the relationship was uncovered by another party.

Handling Actual Conflicts of Interest

With that said, it is important to understand that debtor's counsel is not prohibited from the ongoing representation of key parties in interest. What is prohibited is representing such parties in matters adverse to the debtor (*e.g.*, filing a proof of claim in the debtor's bankruptcy case).

In these situations, one preferable fix is to retain conflicts counsel to represent the DIP in matters where the actual conflict of interest exists between the DIP and one of your firm's other current clients. Conflicts counsel is then available to handle one-off matters (*e.g.*, claims objections, avoidance actions) that will be brought against your other clients by the DIP. If local counsel has been retained in the case, such firm often serves this dual capacity as well. When you're drafting your retention affidavit, it is usually best to expressly note that your firm will not represent such clients in any matters adverse to the DIP (and vice versa) and that, should such matters arise, conflicts counsel will represent the DIP in such regard.

An additional point of note is that often times when a holding company files for Chapter 11, some of its subsidiaries and affiliates will file along with it. In such cases, retention applications often contemplate that the professionals will be representing all of the debtors, not just one. This raises obvious questions as to conflicts of interest (*e.g.*, holding company debtor is largest creditor of subsidiary debtor). We don't have the space here to give this issue its due, but the bottom line is that most courts understand that in the absence of an actual conflict, a single firm can adequately represent multiple debtors. This is also the logical result when one thinks about the expense that would be involved if the baseline rule were that each debtor in a multi-debtor enterprise be represented by separate counsel.

Getting Paid

Obtaining approval of the employment application is a good start; but it is not the end. There is still the matter of fees. The statute allows "(a) reasonable compensation for actual, necessary services rendered…and (b) reimbursement for actual, necessary expenses." *See* § 330(a)(1). So even though authorized to represent the estate, you need to make a separate application to get paid. The statute specifies that "the court may allow compensation different from the compensation (provided for in the employment application) if [those terms] prove to have been in provident light of developments not capable of being anticipated at the time of employment approval. *See* § 328.

Fee Applications

Given these constraints, getting a fee award is far from automatic. We all know about the public complaints against allegedly excessive bankruptcy fees. We are acquainted also with the defense from lawyers who argue that they add value and should be well compensated, in order to attract talented professionals to the bankruptcy practice. We won't get into that mare's nest here. Suffice it to say that anyone who wants to get paid for representing the DIP had better be prepared to keep full and accurate time records (usually in tenth of an hour increments), and to be able tell a plausible story as to why his services are in fact worthy of reward.

In filing a fee application, you should review the court's local rules and UST's guidelines to make sure you provide the information the court requires in the proper format and that you don't seek fees or expenses of a kind that the court does not permit. Local rules vary, but some courts have limits on fax charges, meal expenses, billing travel time, compensation for time spent preparing fee applications, and other sorts of expenses.
See http://www.usdoj.gov/ust/guidlins.htm (providing downloadable access to the ____________, including suggested billing categories and sample summary sheet).

In § 330(a)(3), there is a list of "factors" that the court may consider in setting fees. The statute lists six factors, and specifies that list is not exclusive. Some court decisions have listed more factors; a much-cited classic list is in *Johnson v. Georgia Highway Exp., Inc.*, 488 F.2d 714, 717 (5th Cir. 1974). It is often a good idea to address these factors in your fee application, although the list of factors should not constrain you from telling the story of how your work benefited the estate.

Any party in interest can object to an interim or final fee application. USTs tend to be particularly active in this area, perhaps believing that other lawyers in the case may not be sufficiently vigilant in policing each other's fees. Even without objections, judges may raise issues and concerns of their own.

Interim Payment

In a simpler time, at least in smaller cases, you had to wait until the end of the case and take your fees out of the final distribution. Maybe that is still true today

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somewhere, but we know of no such place. Courts typically permit some sort of mechanism for "interim fees." This is contemplated by § 331, which provides for interim fee applications once every 120 days, or more often if the court permits. In large cases, even the 120-day delay can be a burden on professionals. As a result, many courts will enter orders permitting monthly payment of undisputed fees and expenses, subject to a holdback (a typical arrangement might be 80-85% of fees and 100% of expenses). You still need to file interim and final fee applications, but the monthly compensation orders help with the cash flow issues.

"Local" vs. "National" Rates

In recent years, professional service firms with national reputations and extensive experience representing debtors in large Chapter 11 cases have captured a large share of the market. When a bankruptcy case is filed in a city where a local professional typically charges lower hourly rates than national firms charge, an issue arises whether such national firms may be compensated at their customary hourly rates. This is known in the business as the "national rate vs. local rate" debate. For the most part, however, this debate appears to be coming to a close, with most bankruptcy courts and USTs recognizing that compensation should be based on the customary rates the retained firm typically charges. If you look at the legislative history, you will see that it supports this result.

Nonetheless, it is important to be aware that certain courts to this day will enforce the local rate rule. And, if you find yourself considering filing in one such jurisdiction, it would behoove you to be well-versed in the relevant case law and prepare to support your compensation as "reasonable," in the event that such a challenge arises.

Priority of Payment

The bad news is that you have to jump through all of these hoops to get paid. The good news is that when your fees do get approved, in a business case you are at or very near the head of the queue. The Bankruptcy Code provides for a schedule of priorities in distribution: § 507(a)(2) provides that priority goes to "administrative expenses" over all other unsecured claims other than those of domestic support obligations or trustee fees. Your allowed fees for services in representing the DIP count as an "administrative expense."

Beware of Conversion

However, the administrative expense priority is not necessarily the end to all your troubles. One hundred percent of nothing is still nothing, and you get your priority payment only if there is enough to pay administrative expenses. Here is a nightmare: the Chapter 11 collapses into Chapter 7. Administrative expenses for the Chapter 7 trump the administrative expenses for Chapter 11, so you may find that the estate is administratively insolvent—there's not enough money to pay all Chapter 11 administrative expenses in full—or sometimes at all. It is typical (and usually quite prudent) for the DIP's counsel to get a pre-petition retainer in order to deal with this risk. This is a good idea, although it usually just limits, rather than eliminates, the risk.

Obtaining the Carve Out

Another risk may be even more common—that the estate's only assets will be fully encumbered by a secured creditor's (or DIP lender's) first priority lien. If the secured creditor is undersecured, there will be nothing left to pay professional fees. To deal with this risk, professionals usually negotiate a "carve out" to provide for payment of their allowed fees. The carve out is essentially an agreement by the secured creditor to subordinate its lien and claim to certain allowed professional fees, permitting such fees to come first in line in terms of payment from the estate's assets.

The carve out may be subject to a dollar amount cap and also to restrictions on the services that can be paid from the carve out (*i.e.*, usually one cannot use the carve out to sue the secured lender who agreed to it). As a practical matter, the secured lender usually agrees to the carve out because otherwise nobody will represent the debtor (or committee) and the case will fall apart, further diminishing the overall value of the secured lender's collateral. These carve outs are very common, but they are not automatic. Make sure you negotiate a carve out up front, and obtain proper court approval through the applicable first-day financing motion (*e.g.*, motion to approve cash collateral stipulation). Otherwise, you may find, at the end of the case, that you did a lot of free work, mostly for the benefit of the secured creditor.

Bankruptcy Code § 503 and Substantial Contribution

There is another route to compensation via § 503, the section that governs administrative expenses. Bankruptcy Code § 503(b)(3)(D) allows compensation to "a creditor" who makes "a substantial contribution" to a Chapter 11 case. Bankruptcy Code § 503(b)(4) allows compensation for his attorney. But don't count on it in lieu of a proper retention. What is a "substantial contribution" in your eyes may not appear so to others

who believe you were merely protecting your client's interests.

Special Counsel

Bankruptcy Code § 327(e) authorizes the trustee to appoint a firm as special counsel for a particular purpose. The typical example would be the case where debtor's counsel is in the midst of litigation on the debtor's behalf when the Chapter 11 begins. The debtor wants to use that same counsel to complete the litigation. The appointment still needs court approval, but the conflict rules are less stringent. Just as before, counsel must have no "adverse interest," but in this case only "with respect to the matter on which such attorney is to be employed." There is also no "disinterestedness" requirement.

It is thus much easier to qualify under § 327(e) than under § 327(a). But courts have been alert to prevent counsel from using § 327(e) as an end run around § 327(a): you can't be "special counsel" for the purpose of "generally representing the DIP." By its language, § 327(e) also seems only to apply to lawyers, and not to, say, accountants who cannot satisfy the disinterestedness standard, but may have a special role they are particularly well qualified to play. On occasion, a judge will "bend" this rule to permit a non-lawyer to be retained under § 327(e).

Non-Lawyers and Bankruptcy Code § 327(a)

When lawyers talk about § 327(a), the conversation tends to focus on the matter of fees for counsel who represent the DIP. Its scope is broader than that. In fact, § 327(a) speaks of "attorneys, accountants, appraisers, auctioneers or other professional persons." Not surprisingly, there is a good deal of activity relating to the employment of these other professionals, and other professionals. Some of this concerns what sort of people are "professionals" who need court approval to be retained. We have seen, for example, real estate brokers end up working for free because nobody told them to seek approval of their retention in advance. A court may sometimes stretch to approve compensation for someone who was not retained in advance, perhaps through retroactive retention order or on a quantum meruit basis—but, again, don't count on it.

In large cases where a debtor employs many professionals, the court will sometimes enter an order authorizing the employment of "ordinary course" professionals, in order to avoid having to consider a multitude of employment applications for professionals who perform routine services. Typically these are subject to a monthly compensation cap (both for each individual professional and for all such professionals in the aggregate), to assure that any of the substantial professional retention are approved by the court on an individual basis.

Potential Retention and Fee Payment Alternatives for Financial Advisors and Investment Bankers

Another issue with respect to § 327(a) retention involves investment bankers and financial advisors, who typically don't like to keep records in quarter or tenth of an hour increments and also often charge flat monthly fees plus success fees rather than hourly fees. Some courts resist this, in part because it is difficult for the court to evaluate the work performed and the "value" conferred without time records and in part because the fees are sometimes enormous.

In addition, financial advisors are often employed by distressed companies prior to the bankruptcy filing, sometimes in the capacity of corporate officers. This has caused problems when the filing takes place and the DIP seeks to employ the same advisor via § 327(a).

In such cases, some DIPs will file a motion pursuant to § 363 seeking to approve a post-petition engagement agreement with the financial services firm. Bankruptcy Code § 363 does not have § 327(a)'s disinterestedness and no adverse interest requirements. Technically, the motion need only be shown to be in the best interests of the estate. Nevertheless, to hedge against likely objections from the U.S. Trustee that the DIP is attempting an end run of § 327(a), most DIP's will submit supporting affidavits from the financial advisor similar to those required in § 327(a) retentions, disclosing the nature of the past and present relationship, and any potentially adverse interests. In addition, such § 363 retentions are not subject to fee application requirements—the avoidance of which, as noted above, is usually an important objective of financial advisors.

The likelihood of success of this alternative approach will depend, in large part, upon the particular court and corresponding region for the UST where the case is located. Higher traffic jurisdictions such as S.D.N.Y. and Delaware are more familiar with such § 363 motions and, as a result, tend to be more agreeable to their use.

Using Bankruptcy Code § 328 for Locking in Approval of Success Fees

In some cases, financial advisors and investment banking firms, in particular, will try to utilize § 328 to obtain approval of lump-sum success or transaction fees. Section 328 authorizes the employment of a professional person under § 327 "on any reasonable

terms and conditions of employment, including a retainer, on an hourly basis, on a fixed or percentage fee basis or on a contingency fee basis." Unlike the standard § 327 retention, if a fee arrangement has been approved under § 328, a court cannot "reduce the resulting fee unless the terms of the court's approval 'prove to have been improvident in light of developments not capable of being anticipated' when approved."

This predictability of compensation makes § 328(a) very attractive to a financial advisor if the fee arrangement involves incentive based compensation. Some courts will accept this. Others may be resistant to any effort by a professional to limit the court's ability to evaluate the value of services rendered with the benefit of hindsight.

Committee Professionals

Paralleling § 327, § 1103 provides that a creditor's committee in a Chapter 11 case may appoint counsel and other professionals. Bankruptcy Code §§ 328 and 330 specify that the committee's professional fees, too, will be a charge against the estate. The same sort of adverse interest rules apply, with a notable exception—the disinterestedness requirement does not apply, just the adverse interest test. And, because the most obvious candidate for committee counsel may be a lawyer who previously represented an individual creditor, § 1103 specifies that representation of one or more individual creditors will not be an adverse interest that per se prevents the lawyer from representing the committee. It does, however, provide that he cannot represent the individual creditor at the same time that he is representing the estate.

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Watch for next month's issue!