Recent Case Law Developments Concerning the Retention and Compensation of Professionals in Chapter 11 Cases

By:

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- and -

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This article is prepared in connection with the panel discussion *Getting Hired and Getting Paid – An Overview of Recent Issues in Chapter 11 Retention and Compensation* at the 49th Annual Southeastern Bankruptcy Law Institute Conference, and seeks to provide a brief discussion of certain topics related to professional retention and compensation in chapter 11 cases. While there are myriad issues that can arise in connection with the retention and compensation of professionals in a chapter 11 case, this article does not seek to be exhaustive; rather, it seeks to touch upon select recent opinions from courts around the country analyzing certain important issues. This article will examine retention issues such as the Bankruptcy Code's disinterestedness standards as they relate to professional ethical rules, claims between debtors, and subchapter v cases, as well as penalties for non-compliance with such disinterestedness requirements. This article further examines recent authority for seeking compensation and for revisiting compensation arrangements previously approved under section 328(a).

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I. Disinterestedness of Estate Professionals

Section 327(a) of title 11 of the United States Code (the "Bankruptcy Code") permits a debtor or debtor in possession to retain a professional if such professional does "not hold or represent an interest adverse to the estate, and that [they] are disinterested persons . . . ."[2] Although the Bankruptcy Code does not define "interest adverse," it does define "disinterested person" as one "who is not a creditor . . . or an insider . . . and does not have an interest materially adverse to the interest of the estate or of 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."[3] To evaluate whether a proposed professional holds any 'adverse interest' and whether a professional is 'disinterested,' Rule 2014(a) of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules") provides for the following disclosure requirements in retention applications:

> The application shall state the specific facts showing the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, to the best of the applicant's knowledge, all of 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. The application shall be accompanied by a verified statement of the person to be employed 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.[4]

Section 327(c) provides that a professional's employment should not be disqualified solely by virtue of such professional's representation of a creditor, unless there is an actual conflict and the U.S. Trustee or a creditor objects.[5] In addition, section 328(c) provides that where a professional

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2 11 U.S.C. § 327(a).
3 11 U.S.C. § 101(14).
4 FED. R. BANKR. P. 2014(a).
5 11 U.S.C. § 327(c).

holds an adverse interest or is not disinterested, a bankruptcy court may deny such professional's request for compensation and reimbursement of expenses from the debtor's bankruptcy estate.[6]

A. The Bankruptcy Code's 'Adverse Interest' and Disinterestedness Requirements are Distinct from Professional Ethical Obligations

The adverse interest and disinterestedness requirements of the Bankruptcy Code are unique and distinct from state professional ethical requirements and guidelines, an issue which was recently examined by the United States Court of Appeals for the Third Circuit. In *In re Boy Scouts of Am.*, 35 F.4th 149 (3d Cir. 2022), the debtors were initially represented by Sidley Austin LLP ("Sidley") as their general bankruptcy counsel.[7] At the same time that they represented the debtors, Sidley represented affiliates of Chub Ltd.—Century Indemnity Co., Westchester Fire Insurance Co., and Westchester Surplus Lines Insurance Co. (collectively "Century")—in obtaining reinsurance for insurance policies they issued to the debtors (but not with respect to the policies Century issued to the debtors), and the debtors retained separate counsel with respect to such insurance policies.[8] Additionally, a formal ethics screen was placed between the Sidley attorneys working on the reinsurance issue and those working on the debtors' restructuring.[9] Century objected to the debtors' application to retain Sidley, asserting that Sidley was prohibited from being retained by the debtors because it was conflicted under Rule 1.7(a) (concerning obligations owed to current clients) and Rule 1.9 (concerning obligations owed to former clients) of the Delaware Rules of Professional Conduct. Ultimately, Sidley resigned from its representation of Century prior to the filing of its objection and later from representation of the debtors after the relevant restructuring team moved to a different law firm.

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6 11 U.S.C. § 328(c).

7 One of the authors of this article, Paul J. Labov, is a partner with the New York, New York office of the law firm of Pachulski Stang Ziehl & Jones LLP ("PSZJ"). PSZJ represented the official committee of tort claimants in the chapter 11 cases of *In re Boy Scouts of Am., et al.*

8 *Boy Scouts of Am.*, 35 F.4th at 154.

9 *Id.* at 155.

In evaluating the Century's objection on appeal, the Third Circuit declined to implement a requirement that a bankruptcy court examine applicable professional ethical rules which "impose independent obligations," from those under the Bankruptcy Code, where the inquiry "is focused primarily on the interest of the estate" and "whether [a professional] could effectively represent [a debtor] in its bankruptcy case."[10] As such, the Third Circuit determined that "[t]he relevant issue in our case is thus whether a possible conflict implicates the economic interest of the estate and might lessen its value."[11] The Third Circuit affirmed both the bankruptcy and district courts that approved Sidley's retention because Century did not meaningfully challenge on appeal the bankruptcy court's finding that Sidley did not have a bias in favor of a non-debtor and did not hold an adverse interest.[12] In making its determination, the Third Circuit took into account that the debtors retained independent insurance counsel.[13] Additionally, the Third Circuit explained that Century never identified why any of Sidley's positions in its reinsurance representation were adverse to any of the debtors' interests or why any violation of the professional ethical rules would impede Sidley's representation of the debtors.[14] The Third Circuit acknowledged that Century may hold legitimate concerns under the ethical rules, but that those concerns could be addressed outside the bankruptcy process.[15] The Third Circuit continued on that a court could similarly exercise its discretion under its inherent disciplinary power and local rules to disqualify a professional, taking into account a number of factors, but that the bankruptcy court was within its discretion to decline to do so in this case.[16]

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10 *Id.* at 158, 161.
11 *Id.*
12 *Id.* at 159 (citation omitted).
13 *Id.*
14 *Id.*
15 *Id.* at 161
16 *Id.* at 160.

B. Intercompany Claims and Interests Among Debtors and Non-Debtors

While *Boy Scouts* makes clear that for purposes of the Bankruptcy Code a court's inquiries are focused on any prejudice to the economic interests of a bankruptcy estate, a recent opinion from the United States Bankruptcy Court for the Eastern District of Washington recognizes that where there are multiple debtors and estates involved, the question of what constitutes an 'adverse interest' can become more complicated. In *In re Easterday Ranches, Inc.*, two related-debtors filed for chapter 11 relief, and, concerned about potentially divergent interest between the two debtors' estates, the U.S. Trustee appointed separate creditors' committees for each debtor.[17] The debtors were managed by substantially the same management team and were operated as complementary businesses in many respects—one debtor focused on raising cattle and the other debtor focused on growing crops to feed such cattle and to be sold to third parties. Raising similar objections it had asserted to the debtors' application to employ PSZJ as their general bankruptcy counsel that were previously overruled by the bankruptcy court, the U.S. Trustee objected to PSZJ's final fee application with respect to fees incurred in connection with the preparation and filing of two proposed chapter 11 plans (together, the "Offending Plans") which the U.S. Trustee contended impermissibly subordinated the interest of one debtor to another, giving rise to an actual conflict between the estates.[18] The U.S. Trustee asserted that under section 328(c) of the Bankruptcy Code, PSZJ's fees with respect to the Offending Plans should be denied. The bankruptcy court disagreed.

In overruling the U.S. Trustee's objection, the bankruptcy court acknowledged that the Bankruptcy Code was generally designed for single debtor cases, which reveals "gaps and

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[17] *In re Easterday Ranches, Inc.*, No. 21-00141-WLH11, 2022 Bankr. LEXIS 3319, *4-*5 (Bankr. E.D. Wash. Nov. 23, 2022). One of the authors hereof, Paul J. Labov, is a partner with the New York, New York office of PSZJ and represented the debtors in the *Easterday* chapter 11 cases.

[18] *Id.* at *9.

uncertainties" with respect to intercompany rights when complex multi-debtor companies file for chapter 11.[19] The bankruptcy court continued that representation of affiliated debtors with potential intercompany claims against one another was not a categorical bar to approving the retention of common professionals, but that courts should consider the factual circumstances surrounding the representation.[20] In the context of the fee dispute at issue, and citing to sections 327(c) and 328(c), the bankruptcy court determined that "courts in the compensation context similarly should analyze whether a potential intercompany conflict ever rose to the level of an 'actual conflict' while also balancing on a case by case basis, the benefits to the bankruptcy estate and creditors against the effects of an actual conflict."[21] The bankruptcy court continued on that courts should consider the duty that professionals owe to the estate, which is generally a duty to maximize the estate's value, and that such duty is owed to all residual stakeholders generally, but not to any one stakeholder specifically.[22] Moreover, the bankruptcy court stated that professionals satisfy their duties "when acting in good faith to pursue a strategy reasonably designed to maximize the estate after accounting for the attendant costs, risks, and time," and that such strategy could be adverse or hostile "to a given stakeholder or class thereof."[23]

In the dispute at issue, the bankruptcy court noted that chapter 11 plans can be filed with a host of proper motivations so long as they are not facially unconfirmable or asserted for an improper purpose, and that the Offending Plans were part of a complex negotiation and confirmation process at the heart of chapter 11. The bankruptcy court continued that under relevant Ninth Circuit authority, pursuing a joint plan that advances the common good of all debtors to

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19 *Id.* at *1.
20 *Id.* at *11-*12.
21 *Id.* at *13.
22 *Id.* at *14.
23 *Id.* at *16-*17.

avoid limiting the collective interest of a group of debtors was permissible.[24] Moreover, the bankruptcy court found that under the framework of section 327(c), "no actual conflict arises unless it becomes apparent that the claims among the affiliated debtors cannot be resolved through negotiation" because the plan negotiation process that settles or otherwise resolves claims differs substantively and procedurally from affirmative litigation.[25] As a result, the bankruptcy court overruled the U.S. Trustee's objection, as well as made an alternative determination that penalization of debtors' counsel was unwarranted under section 328(c).[26]

Similarly, in *Aearo Technologies*, a bankruptcy court overruled the objections of the U.S. Trustee and two official tort claimants committees to the retention of Kirkland & Ellis LLP ("Kirkland") as the debtors' general bankruptcy counsel.[27] While no opinion was issued, the objecting parties generally asserted that Kirkland held an adverse interest to the Debtors' estates because Kirkland concurrently represented a non-debtor parent in tort litigation that was the impetus for the debtors' chapter 11 filing and because Kirkland initially assisted with the drafting of a funding agreement with this same non-debtor parent that would cover the plan recoveries and administrative costs of the debtors' chapter 11 cases.[28] The objectors asserted that the debtors' implementation of a conflicts committee of two independent directors and retention of separate conflicts counsel, as well as the non-debtor parent's retention of separate counsel with respect to the debtors' chapter 11 cases, was insufficient to cure Kirkland's purported conflicts.

The bankruptcy court disagreed, stating that Kirkland only assisted on the initial draft of the funding agreement, which was changed significantly since Kirkland's involvement, and that

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24 *Id.* at *24-*25.

25 *Id.* at *25 (quoting 3 Collier on Bankruptcy ¶ 327.04[5][b] (16th ed. rev. 2022)) (alteration in original and internal marks omitted).

26 *Id.* at *25-*29.

27 *In re Aero Technologies LLC,* Case No. 22-02890-JJG-11 (Bankr. S.D. In. Nov. 17, 2022) (order approving retention).

28 *Id.* (Oct. 20, 29022) (U.S. Trustee objection); *id.* (Nov. 2, 2022) (official tort committee objections).

the debtors' and non-debtor parent's interests were aligned under the funding agreement with respect to the payment of claims.[29] The bankruptcy court also pointed to the existence of the conflicts committee and conflicts counsel in approving Kirkland's retention, but observed that the interest of the non-debtor parent and the debtors could diverge, at which time Kirkland's retention would be revisited.[30]

C. Denial of Retention and Fee Applications Where the Professional holds an Adverse Interest and Fails to Promptly and Accurately Disclose Such Interest

Where a professional holds an adverse interest or fails to promptly and accurately disclose such interest, bankruptcy courts routinely deny such professional's retention and fee requests. For example, in *In re NIR West Coast, Inc.*, 638 B.R. 441, 445 (Bankr. E.D. Cal. 2022), a law firm concurrently represented a debtor in possession as well as the debtor's sole shareholder, who was also a guarantor and co-obligor on certain of the debtor's debts, the recipient of preferential transfers, a creditor of the debtor, and a co-defendant in a settled class action lawsuit in which the debtors' proposed bankruptcy counsel represented both the shareholder and debtor pre- and post-petition. Despite these highly interwoven connections, the debtor's proposed bankruptcy counsel did not disclose its representation of the shareholder in its retention application, which was approved by the bankruptcy court.[31] Subsequently, one of the debtor's attorneys referenced the shareholder as a client in passing on a phone call and was advised by the debtor's subchapter v trustee that an appropriate disclosure should be made.[32] However, rather than promptly disclose the connections, debtor's counsel waited six months to make any disclosure with the bankruptcy

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[29] Rick Archer, *Kirkland to Represent 3M Unit in Ch. 11, For Now* (Nov. 10, 2022), https://www.law360.com/articles/1548568/kirkland-clear-to-represent-3m-unit-in-ch-11-for-now.

[30] *Id.*

[31] *NIR West Coast, Inc.*, 638 B.R. at 445.

[32] *Id.*

court, and in doing so demonstrably misrepresented the timeframe in which the debtors' counsel purportedly first learned of the shareholder representation.[33]

These disclosure issues came to a head in the context of the law firm's first interim fee application, which the bankruptcy court denied.[34] In considering the application, the bankruptcy court determined that the law firm's concurrent representation of the shareholder was an actual conflict of interest because the economic interests of the shareholder and the debtor were directly adverse in certain instances, such as in the class action litigation and in formulating a chapter 11 plan, entitling the bankruptcy court to exercise its discretion under section 328(c) to deny the fee application.[35] The bankruptcy court further found that under its inherent authority and Bankruptcy Rule 2014, it had authority to remedy non-compliance with Bankruptcy Rule 2014's strict and ongoing disclosure requirements by denying the fee application.[36]

Similarly, in *In re Black & White Stripes, LLC*, 623 B.R. 34, 45-46 (Bankr. S.D.N.Y. 2020), the debtors' two largest creditors and the U.S. Trustee objected to the debtors' proposed retention of general bankruptcy counsel on the basis that, *inter alia*, the law firm had previously briefly represented the debtors and their principals in prepetition litigation related to claims on which the debtors and their principals could be found co-liable and because the debtors' estates also appeared to hold substantial claims against such principals.[37]

The bankruptcy court determined that while courts only look to present interests under section 327(a) to determine if a professional holds an 'adverse interest,' the law firm's previous representation of both the debtors and their principals created a *potential* conflict and that the law

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[33] *Id.* at 445-46.
[34] *Id.* at 451.
[35] *Id.* at 447-48.
[36] *Id.* at 449-50.
[37] *Black & White Stripes, LLC*, 623 B.R. at 45-46.

firm had made inconsistent disclosures with respect to such representation.[38] Moreover, the bankruptcy court was concerned that in pursuing its retention, the law firm minimized the estates' claims against the principals, for which some concerning evidence had already been adduced and where such claims were substantially similar to those brought in the prepetition litigation in which the law firm jointly represented the debtors and the principals.[39] As a result, the bankruptcy court determined that the law firm fell short of the 'determining factor' of "whether [the] counsel sought to be retained can proceed faithfully on behalf of the [d]ebtors and in the best interests of the estate."[40]

D. Disinterestedness and Compensation in Subchapter V Chapter 11 Cases

In chapter 11 cases proceeding under subchapter v, section 1195 of the Bankruptcy Code expressly modifies section 327(a)'s disinterestedness requirements to permit the retention of professionals with a pre-petition claim against the debtor of up to $10,000.00.[41] In addition, a subchapter v trustee is appointed in all such cases, who must either be a standing trustee or a "disinterested" person selected by the U.S. Trustee to act as the subchapter v trustee in a particular case, sometimes referred to as a "non-standing" subchapter v trustee.[42] Currently, the compensation of subchapter v trustees varies depending on whether they are a standing or non-standing trustee.[43] Under section 326(b) of the Bankruptcy Code, standing subchapter v trustees are compensated through a percentage of plan disbursements in accordance with 28 U.S.C. § 586 in the same manner as standing chapter 12 or 13 trustees.[44] Non-standing subchapter v trustees,

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38 *Id.* at 50-51.
39 *Id.* at 51-52
40 *Id.* at 51.
41 PAUL W. BONAPFEL, A GUIDE TO THE SMALL BUSINESS REORGANIZATION ACT OF 2019 101 (June 2022 ed.).
42 11 U.S.C. § 1183(a); *see also* Bonapfel, *supra* note 41, at 51-52 (discussing the U.S. Trustee's appointment of subchapter v trustees on a case by case basis in contrast to appointing standing trustees).
43 *See* Bonapfel, *supra* note 41, at 64-70 (discussing subchapter v trustee compensation).
44 *See id.* at 64-65.

however, generally receive compensation for actual and necessary services rendered and expenses incurred under Bankruptcy Code section 330 (discussed below), consistent with U.S. Trustee guidelines, although the Bankruptcy Code is somewhat unclear on this point.[45] The bankruptcy court in *In re 218 Jackson LLC*, 631 B.R. 937 (Bankr. M.D. Fla. 2021), recently had opportunity to examine not only the requirement that non-standing subchapter v trustees be disinterested, but also the unique role subchapter v trustees play in such cases.

There, a subchapter v trustee was appointed who, prepetition, represented a third party in litigation against the debtor's indirect equity-holder and another entity and then also represented that same third party in a subsequent bankruptcy filing by such entity. When the debtor's largest secured creditor moved to dismiss the bankruptcy filing as a bad faith filing, the trustee actively supported the dismissal and continued to take actions adverse to the reorganization of the debtor's estate, including by objecting to the debtor's proposed plan that proposed to pay creditors in full.

The *218 Jackson* court found that by representing an entity directly adverse to the debtor's indirect equity-holder, the subchapter v trustee held an interest materially adverse to the debtor's estate.[46] The *218 Jackson* court also found that subchapter v trustees have a unique role unassigned to any other bankruptcy trustee to "facilitate the development of a consensual plan of reorganization."[47] Finding this unique role significant, the *218 Jackson* court determined that a subchapter v trustee was intended to be less adversarial than other trustees and to "act[] more like a mediator than an adversary."[48] While noting that a subchapter v trustee might properly move to dismiss or oppose a plan, the *218 Jackson* court determined that the subchapter v trustee here did

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45 *See id.* at 65-69 (summarizing non-standing trustee compensation and discussing potential legislative drafting issues giving rise to the differing treatment of standing and non-standing subchapter v trustees and the technical argument that nothing in the Bankruptcy Code authorizes the compensation of a non-standing trustee).

46 *218 Jackson LLC*, 631 B.R. at 945-46.

47 *Id.* at 947 (quoting 11 U.S.C. § 1183(b)(7)).

48 *Id.*

not work as a mediator-facilitator of a consensual plan, which was at odds with his duties.[49] As a result, the *218 Jackson* court removed the subchapter v trustee under section 324 of the Bankruptcy Code, denied the subchapter v trustee's request for fees and expenses, and ordered disgorgement of any interim amounts already paid therefor.[50]

II. Compensation of Estate Professionals

Once successfully retained, the Bankruptcy Code provides certain requirements for and limitations upon the compensation of estate professionals. Most commonly, estate professionals will seek approval of their compensation and reimbursement of expenses under Bankruptcy Code section 330, as discussed below. Additionally, compensation arrangements can also be approved at the time of retention under section 328(a) of the Bankruptcy Code, which is commonly found to be appropriate with respect to non-hourly professionals, such as those who are paid on a contingency fee or other percentage basis like brokers. However, as discussed below, once such an arrangement is approved, changing it later is a tall order.

A. Compensation Standards under 11 U.S.C. § 330

Section 330(a)(1) of the Bankruptcy Code provides that "[a]fter notice to the parties in interest and the United States Trustee and a hearing, and subject to sections 326, 328, and 329, the court may award to . . . a professional person employed under section 327 or 1103—(A) reasonable compensation for actual, necessary services rendered . . . and (B) reimbursement for actual, necessary expenses."[51] As initially enacted in the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, 2564 (1978), section 330(a) provided little guidance for courts required to

[49] *Id.* at 948-49.
[50] *Id.* at 949.
[51] 11 U.S.C. § 330(a)(1).

determine the amount of reasonable compensation, stating only that courts must consider "the time, the nature, the extent, and the value" of the services and the cost of "comparable services."[52]

Absent further statutory guidance, some courts applied the factors set forth in *Johnson v. Georgia Highway Express, Inc.*, 488 F.2d 714 (5th Cir. 1974), a case arising under Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e *et seq.* The *Johnson* factors included (1) the time and labor required; (2) the novelty and difficulty of the questions; (3) the skill requisite to perform the legal service properly; (4) the preclusion of other employment by the attorney due to acceptance of the case; (5) the customary fee; (6) whether the fee is fixed or contingent; (7) time limitations imposed by the client or the circumstances; (8) the amount involved and the results obtained; (9) the experience, reputation, and ability of the attorneys; (10) the "undesirability" of the case; (11) the nature and length of the professional relationship with the client; and (12) awards in similar cases.[53] Various courts applied these factors in the bankruptcy context.[54]

Other courts, including the Eleventh Circuit in *Grant v. George Schumann Tire & Battery Co.*, 908 F.2d 874 (11th Cir. 1990), followed the "lodestar method." Under that method, the court "arrives at a fee by multiplying the attorney's reasonable hourly rate by the number of hours reasonably expended."[55] As explained by the Eleventh Circuit, "[a] calculation of the reasonableness of the rates and hours usually involves consideration of the twelve *Johnson* factors."[56] As the Fourth Circuit put it, the bankruptcy court "must expressly calculate the lodestar amount" and "may exercise its discretion to consider other factors such as the novelty and difficulty of the issues, the special skills of counsel, the results obtained, and whether the fee

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52 *In re Village Apothecary, Inc.*, 45 F.4th 940, 944 (6th Cir. 2022).
53 *Johnson*, 488 F.2d at 717-19.
54 *See, e.g., Harman v. Levin*, 772 F.2d 1150, 1152 n.1 (4th Cir. 1985).
55 *Id.* at 879.
56 *Id.*

awarded is commensurate with fees for similar professional services in non-bankruptcy cases in the local area."[57]

In the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106, 4130-31 (1994), Congress codified most, but not all, of the *Johnson* factors in section 330. Specifically, section 330(a)(3) states as follows:

> (3) In determining the amount of reasonable compensation to be awarded to . . . [a] professional person, the court shall consider the nature, the extent, and the value of such services, taking into account all relevant factors, including—
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> (A) the time spent on such services;
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> (B) the rates charged for such services;
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> (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;
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> (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;
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> (E) with respect to a professional person, whether the person is board certified or otherwise has demonstrated skill and experience in the bankruptcy field; and
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> (F) whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.[58]

The 1994 amendments also categorically excluded fees for "(i) unnecessary duplication of services; or (ii) services that were not—(I) reasonably likely to benefit the debtor's estate; or (II) necessary to the administration of the case."[59]

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[57] *In re Boddy*, 950 F.2d 334, 338 (6th Cir. 1991) (citing *Harman*, 772 F.2d at 1152 n.1).
[58] 11 U.S.C. § 330(a)(3).
[59] 11 U.S.C. § 330(a)(4)(A).

In *In re Village Apothecary, Inc.*, 45 F.4th 940, 944 (6th Cir. 2022), the Sixth Circuit addressed whether bankruptcy courts may consider, for purposes of determining the reasonableness of fees under section 330(a)(3), the *Johnson* factors that were not codified in 1994, such as the "results obtained." The debtor in *Village Apothecary* was a Michigan pharmacy that filed for Chapter 7 bankruptcy. The trustee hired a law firm to investigate potential causes of action, and the law firm determined that the pharmacy had a potential $1.6 million claim against its president for breach of fiduciary duty. The trustee eventually settled with the president for $38,000.00, which comprised the bulk of the estate's assets totaling $40,710.87. The law firm filed a fee application under section 330 seeking about $37,000.00, or over 90.6% of the estate's assets. After a hearing and two appeals to the district court, the bankruptcy court ultimately reduced the law firm's fees by half based in part on the "results obtained" *Johnson* factor. In the bankruptcy court's view, the law firm essentially obtained no results, as its requested fees would leave almost nothing for creditors. The district court affirmed the bankruptcy court's decision.

On appeal, the Sixth Circuit likewise affirmed. First, the court considered whether section 330 and Sixth Circuit precedent permit bankruptcy courts to consider *Johnson* factors, such as "results obtained," not explicitly enumerated in section 330(a)(3).[60] The court found that the statute unambiguously permits such unenumerated factors to be considered. In particular, section 330(a)(3) instructs bankruptcy courts to "tak[e] into account all relevant factors" and introduces the list of enumerated factors with the word "including," both of which indicate that the list is nonexhaustive. In the court's view, "[w]ere the factors listed in § 330(a)(3) meant to be exhaustive, then the directive to consider 'all relevant factors' would be meaningless."[61] Additionally, section 330(a)(1) gives bankruptcy courts discretion to award fees, as evidenced by its language that the

[60] *See e.g.*, *In re Boddy*, 950 F.2d 334, 338 (6th Cir. 1991).
[61] *Village Apothecary, Inc.*, 45 F.4th at 948.

court "may award" compensation, and thus "reading the list of factors as merely illustrative better fits the structure of the text."[62]

To no avail, the law firm argued that the "results obtained" *Johnson* factor conflicted with the factor enumerated in section 330(a)(3)(C), whether the service was "beneficial at the time at which the service was rendered[.]" The Sixth Circuit found "no inconsistency in having courts look at both factors" because courts can "compensate for services that were reasonably beneficial at the time they were performed and benefitted the estate" *or* "compensate a professional even if the services did not benefit the estate."[63] The phrase "beneficial at the time" in section 330(a)(3)(C) "ensures that bankruptcy courts do not automatically bar fees for attorneys when they are not ultimately successful."[64]

Likewise, the Sixth Circuit rejected the law firm's argument that the "results obtained" factor effectively revives the defunct "spirit of economy" policy. Under that policy, it was believed that "attorneys assisting the trustee in the administration of a bankruptcy estate are acting not as private persons but as officers of the court" and thus should receive less compensation than private attorneys.[65] Courts agree that Congress rejected the spirit of economy policy in section 330.[66] But, in the Sixth Circuit's view, "considering 'results obtained' does not revert the system back to the 'spirit of economy' framework" because section 330 provides compensation to attorneys in bankruptcy cases commensurate with fees for comparable services in non-bankruptcy cases, where "results obtained" is one of the factors commonly considered in awarding fees.[67]

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62 *Id.* at 949.
63 *Id.*
64 *Id.*
65 *Id.* (quoting *In re First Colonial Corp. of Am.*, 544 F.2d 1291, 1299 (5th Cir. 1977)).
66 *Id.* (citing *Boddy*, 950 F.2d at 337).
67 *Id.* at 950.

Having decided this threshold issue under section 330(a)(3), the Sixth Circuit found that the bankruptcy court did not abuse its discretion in reducing by half the law firm's fees. The court cited persuasive Ninth Circuit precedent for the proposition that a 50% reduction in fees is permissible under section 330(a)(3).[68] The Sixth Circuit found that the fee reduction was appropriate in this case for two reasons: first, the law firm obtained only $38,000.00 on a $1.6 million claim, and second, "had the bankruptcy court awarded the law firm all its fees, it would have left virtually nothing for the estate."[69] The Sixth Circuit therefore affirmed.

Similarly, in *In re Beaulieu Group, LLC*, a bankruptcy court reduced the total amount of a transaction fee requested by the debtors' investment banker due to its lack of involvement in the debtors' sale process. In approving the debtors' retention of the investment banker, the bankruptcy court approved the investment banker's fee structure under section 328(a) (discussed below), subject to the filing of a final fee application and the bankruptcy court's, U.S. Trustee's, and official committee of unsecured creditors' right to object to the investment banker's fees under section 330 of the Bankruptcy Code.[70] Following the closing of the sale of substantially all of the debtors' assets, the investment banker filed its final fee application, which sought, *inter alia*, approval of monthly fees paid to it by the debtors and a 2% transaction fee, as reduced by the monthly fees and certain fees paid prepetition in accordance with an engagement agreement.

The official committee of unsecured creditors objected to the final fee application, asserting that, *inter alia*, the investment banker's requested compensation was unreasonable and the investment banker's services were not a benefit to the debtors' estates due to the investment

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68 *Id.* at 951 (citing *In re Strand*, 375 F.3d 854, 861 (9th Cir. 2004)).

69 *Id.*

70 *In re Beaulieu Group, LLC*, Case No. 17-41677-mgd (Bankr. N.D. Ga. Aug. 24, 2017) (order approving debtors' retention of investment banker). Prior to joining PSZJ, one of the authors hereof, Paul J. Labov, was among the Fox Rothschild LLP attorneys who represented of the official committee of unsecured creditors appointed in the *Beaulieu* chapter 11 cases.

banker's lack of involvement with the sale process, including lack of participation in sale updates, identification and engagement with the ultimate purchaser, and negotiation of definitive sale documentation.[71] Rather, the committee asserted that the majority of the sale efforts were conducted by the debtors' financial advisor and co-chief restructuring officers and that the only bids or other indications of interest received by the investment banker were lower, liquidating bids. The investment banker responded that, among other things, it was involved with every aspect of the sale process, including initially contacting the ultimate purchaser and preparing marketing materials and financial models, as well as assisting the debtors in generating competition among interested parties, without which the debtors would have been unable to generate as much value for their stakeholders.[72] Moreover, the investment banker noted that its level of involvement with the purchaser was limited because the purchaser required that negotiations take place on a principal to principal basis and that the sale proceed as a private sale.

The bankruptcy court determined that the full amount of the transaction fee was not reasonable in light of the level of involvement by the investment banker.[73] In particular, the bankruptcy court noted in its order that, through no fault of the investment banker, the purchaser's desire of principal only negotiations and a private sale process changed the parties' initial expectations that the investment banker would assist the debtors in conducting an auction process. As a result, the bankruptcy court approved approximately half the fees originally sought, calculated by looking to the approximate midpoint of the bids the investment banker solicited, less certain deductions and fees in accordance with the investment banker's engagement agreement.

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71 *In re Beaulieu Group, LLC*, Case No. 17-41677-mgd (Bankr. N.D. Ga. Nov. 29, 2017) (official committee of unsecured creditors' objection to investment banker's final fee application).

72 *In re Beaulieu Group, LLC*, Case No. 17-41677-mgd (Bankr. N.D. Ga. Jan. 12, 2018) (investment banker's reply in support if its final fee application).

73 *In re Beaulieu Group, LLC*, Case No. 17-41677-mgd (Bankr. N.D. Ga. Feb. 9, 2018) (order partially granting investment banker's final fee application).

B. Standards for Revisiting Compensation Agreements Approved under Section 328

Section 327(a) of the Bankruptcy Code provides that, with certain exceptions, "the trustee, with the court's approval, may employ one or more . . . professional persons . . . to represent or assist the trustee in carrying out the trustee's duties[.]"[74] Under section 328(a), the trustee "with the court's approval, may employ or authorize the employment of a professional person under section 327 . . . 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."[75] That provision goes on to state that "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."[76]

Two cases illustrate the difficulty of meeting this improvidence standard. First, in *In re Fundamental Long Term Care, Inc.*, 626 B.R. 51 (Bankr. M.D. Fla. 2021), an involuntary chapter 7 petition was filed against the debtor by the Estate of Juanita Jackson in 2011, and in 2014 the chapter 7 trustee filed a complaint against Troutman Sanders, LLP and two other defendants (the "Troutman Litigation"). In January of 2016, the trustee filed an application to employ Robert F. Elgidely ("Elgidely") and the law firm Genovese Joblove & Battista, P.A. (the "Genovese Firm") to represent her in the Troutman Litigation on a contingency basis. The employment application was supported by the Estate of Juanita Jackson and certain other estates (the "Probate Estates") and therefore was approved by the bankruptcy court, subject to section 328(a), in February of 2016. In December of 2016, Troutman Sanders, LLP agreed to settle the Troutman Litigation by

[74] 11 U.S.C. § 327(a).
[75] 11 U.S.C. § 328(a).
[76] *Id.*

paying $6.5 million to the trustee. The Probate Estates objected, but after a hearing the bankruptcy court granted the trustee's motion to approve the settlement.

The Probate Estates twice appealed the settlement order to the district court, and during the second appeal Elgidely left the Genovese Firm to join Fox Rothschild LLP (the "Fox Firm"). In November of 2019, the trustee filed an application to employ Elgidely and the Fox Firm to represent her in the second appeal. After an objection by the Probate Estates and a hearing, the bankruptcy court approved that employment application in April of 2020, ordering that the previously approved contingency fee be divided between the Genovese Firm and the Fox Firm. In September of 2020, the district court affirmed the settlement order. In March of 2021, the bankruptcy court granted the Genovese Firm's fee application for a total of $2,236,426.04 and the Fox Firm's application for a total of $734,014.01.

On request of the Probate Estates, the bankruptcy court issued findings of fact and conclusions of law in support of the fee awards. The court explained that once employment terms and conditions are approved, a bankruptcy court's "power to amend those terms is severely constrained."[77] A finding of improvidence is "a difficult determination to make."[78] Even the occurrence of an unexpected event such as a settlement or sale, the court stated, does not render a fee agreement improvident "as long as the event was capable of anticipation at the time the fee agreement was pre-approved."[79] The court in *Fundamental Long Term Care* found that the trustee's contingency fee agreement with the Genovese Firm and the Fox Firm was not improvident because the firms successfully completed their work in settling the Troutman

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77 *Fundamental Long Term Care, Inc.*, 626 B.R. at 58 (quoting *In re Smart World Tech., LLC*, 552 F.3d 228, 232 (2d Cir. 2009)).

78 *Id.* (quoting *In re XO Comms., Inc.*, 323 B.R. 330, 339 (Bankr. S.D.N.Y. 2005)).

79 *Id.* (citing *In re Clark*, No. 12-30716-KKS, 2014 WL 10250672, at *3 (Bankr. N.D. Fla. July 28, 2014)).

Litigation and defending that settlement on appeal, the $6.5 million settlement significantly benefited the bankruptcy estate, and no unanticipated events occurred in the case.[80]

In the second case, *In re LATAM Airlines Group S.A.*, 643 B.R. 773 (Bankr. S.D.N.Y. 2022), the debtors filed chapter 11 petitions on May 26, 2020, after the onset of the COVID-19 pandemic. They continued to operate their businesses as debtors-in-possession, and their cases were jointly administered. The debtors employed PJT Partners LP ("PJT") as investment banker, as reflected in a May 20, 2020 engagement letter, which capped PJT's fees at $25 million and contemplated "all required services to file and consummate a potential U.S. chapter 11 case."[81] On June 30, 2020, the bankruptcy court granted the debtors' application to employ PJT on the terms and conditions set forth in the engagement letter.

During the pendency of the case, PJT helped the debtors obtain DIP financing, developed and negotiated a plan, and explored exit financing alternatives. The debtors' reorganization, however, proved more complex than originally anticipated, and PJT reached the fee cap of $25 million in October of 2021. The debtors' plan of reorganization was not confirmed until June 18, 2022. PJT filed a supplemental application to modify the terms of employment by raising the fee cap from $25 million to $37 million, citing the severity of the pandemic and other purportedly unforeseen events. The United States Trustee objected, arguing that the complexity and duration of the case should not have been unexpected given the scope of services listed in the engagement letter.

The bankruptcy court agreed with the U.S. Trustee. As the court explained, "[i]t is a high hurdle under section 328(a) for a movant seeking to revise the terms governing a professional's

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80 *Id.* at 58-59.

81 *LATAM Airlines Group S.A.*, 643 B.R. at 780.

compensation."[82] The party seeking revision of terms has the burden of proof under section 328(a).[83] As in *Fundamental Long Term Care*, the court emphasized that the movant "is tasked with the weight[y] burden of proving that the subsequent developments were incapable of being anticipated at the time the engagement was approved."[84] A court that revises a compensation agreement under section 328(a), the *LATAM Airlines* court stated, "must explain with specificity why the subsequent developments were 'incapable of being foreseen.'"[85]

Applying the "weighty" improvidence standard, the court found that the debtors failed to carry their burden under section 328(a). At the outset, the court noted that the only evidence of the parties' expectations came from the May 20, 2020 engagement letter. As noted, that letter provided that PJT would provide "all required services to file and consummate" a Chapter 11 case. In the court's view, professional services contemplated under an engagement letter are, by definition, capable of being anticipated for purposes of section 328(a).[86] Rejecting the debtors' arguments pertaining to COVID-19, the court found that "the severity and potential duration of the Pandemic were within the realm of possible outcomes when the Debtors retained PJT," as evidenced by repeated warnings issued by the World Health Organization at that time.[87] The court was likewise unmoved by the debtors' insistence that the $25 million cap was unreasonably low given prevailing market rates, stating that "this is not a basis for the Court to enhance fees under section 328(a)."[88] The court explained that section 328(a) allows professionals to exchange future flexibility for certainty, and once retained, "a professional subject to a fee cap must live with the possibility that

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82 *Id.* at 784 (citing *Smart World Tech., LLC*, 552 F.3d at 234-35).
83 *Id.* (citing *In re Yablon*, 136 B.R. 88, 91 (Bankr. S.D.N.Y. 1992)).
84 *Id.* (citing *Daniels v. Barron (In re Barron)*, 325 F.3d 690, 693 (5th Cir. 2003)).
85 *Id.* at 785 (quoting *Barron*, 325 F.3d at 693).
86 *Id.* at 785.
87 *Id.* at 786.
88 *Id.* at 789.

the value of its services exceeds the cap."[89] For these reasons, the court sustained the U.S. Trustee's objection and denied the supplemental fee application, leaving the fee cap at $25 million.

III. Conclusion

While this article was not intended to be a comprehensive examination of all possible issues arising with respect to the retention and compensation of professionals in chapter 11 cases, the cases discussed herein provide helpful guidance from recent authority to practitioners in evaluating such issues. In particular, the cases discussed herein provide additional clarity in evaluating a professional's disinterestedness as well as the consequences for a professional's failure to be disinterested. In addition, the cases discussed provide additional color on the requirements for seeking compensation in chapter 11 cases, including subchapter v cases, as well as revisiting professional compensation arrangements already approved by a bankruptcy court under section 328(a) of the Bankruptcy Code.

[89] *Id.*