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Locking in Professional Compensation in Bankruptcy Cases: Beware of §328(a)

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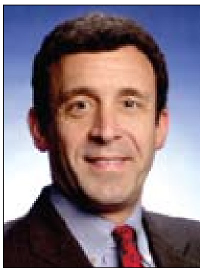
As bankruptcy practitioners, we are accustomed to the concept that professional compensation in a bankruptcy case is subject to approval and adjustment, if necessary, by the bankruptcy court. But this is not always the case, as the bankruptcy court's review of compensation may be substantially circumscribed if a professional is retained under §328(a) of the Code as opposed to §327(a). Because the case law indicates that slight nuances can mean the difference between review of compensation under the general reasonableness standards of §§330 and 331 and review under the more limited strictures of §328(a), practitioners should be alert to how one result or the other can be accomplished.



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Section 328(a) provides that a professional may be employed "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."[1] The section goes on to provide that, once approved on specific terms and conditions, a professional's compensation may only be altered at the time of fee allowance under limited circumstances. Specifically, it provides that:

> [N]otwithstanding such terms and conditions, the court may allow compensation different from the compensation provided under such terms and conditions after the conclusion of such employment, if such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions.[2]

About the Authors

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If a professional is retained on terms that are approved under §328(a), "the court cannot on the submission of a fee application instead approve a reasonable fee under §330(a), unless [it] finds that the original arrangement was improvident due to unanticipated circumstances as required by §328(a)."[3] Under this standard, the circumstances must not only have been "unanticipated," but "not capable of anticipation."[4]

The difference in results if one is considered retained under §328(a), or generally retained under §327(a),[5] can be quite dramatic. In *Riker, Danzig, Scherer, Hyland & Perreti LLP v. Official Committee of Unsecured Creditors (In re Smart World Technologies LLC)*, for example, the creditors' committee argued that special litigation counsel, which was retained on a contingency fee basis, should not receive any fees whatsoever because there was no demonstration that its services brought about the substantial litigation recovery that had been received by the estate.[6] The bankruptcy court reduced the contingency fee, but on appeal to the district court, the firm was awarded its full contingency fee of more than $2 million because it was retained under §328(a) and there were no circumstances that could not have been anticipated at the time of the retention.[7]

Feature

How to Become Retained under §328(a)

The courts have taken various approaches to determining whether a particular compensation arrangement will be considered "preapproved" under §328(a), and therefore subject to more limited review, or may be subject to later review for reasonableness and benefit to the estate under §330.

The strictest view has been espoused by the Third Circuit Court of Appeals in *Zolfo, Cooper & Co. v. Sunbeam-Oster Co.*[8] In

1 11 U.S.C. §328(a).

2 11 U.S.C. §328(a).

3 Peele v. Cunningham (In re Texas Sec. Inc.), 218 F.3d 443, 445-46 (5th Cir. 2000). See also In re Airspect Air Inc., 385 F. 3d 915, 920 (6th Cir. 2004) (Section "328 applies when the bankruptcy court approves a particular rate or means of payment, and §330 applies when the court does not do so."); Friedman Enter. v. B.U.M. Int'l Inc. (In re B.U.M. Int'l Inc.), 229 F. 3d 824, 829 (9th Cir. 2000) ("no question that a bankruptcy court may not conduct a §330 inquiry into the reasonableness of the fees and their benefit to the estate if the court has already approved the professional's employment under 11 U.S.C. §328."); Donaldson Lufkin & Jenrette Sec. Corp. v. National Gypsum Co. (In re National Gypsum), 123 F. 3d 861, 862 (5th Cir. 1997) (professional may avoid uncertainty of compensation under §330 by being retained under §328(a)).

4 Riker, Danzig, Scherer, Hyland & Perreti LLP v. Official Committee of Unsecured Creditors (In re Smart World Tech. LLC), 383 B.R. 869, 877 (S.D.N.Y. Mar. 20, 2008). See also In re Barron, 325 F. 3d 690, 692-93 (5th Cir. 2003) (to vary from compensation arrangement that has been approved under §328(a), "the intervening circumstances must have been incapable of anticipation, not merely unanticipated....").

5 11 U.S.C. §327(a) (trustee, with court's approval, "may employ one or more attorneys, accountants, appraisers, auctioneers or other professional persons...").

6 Smart World, 383 B.R. at 875 n. 2.

7 Id. at 878-79.

8 Zolfo, Cooper & Co. v. Sunbeam-Oster Co., 50 F.3d 253 (3d Cir. 1995).

Zolfo Cooper, the Third Circuit held that for a professional to be considered retained under §328(a), the bankruptcy court's order must "expressly and unambiguously state specific terms and conditions [of employment] that are being approved pursuant to the first sentence of §328...."[9]

Two more moderate approaches to this issue have been taken by the Ninth and Sixth Circuits. In the Ninth Circuit, it has been held that "unless a professional's retention application unambiguously specifies that it seeks approval under §328, it is subject to review under §330."[10] The absence of a specific reference to §328(a) in the retention order, however, "would not of itself automatically override the retention application's invocation of §328(a)."[11]

The Sixth Circuit takes an even less constrictive approach, employing a "totality of the circumstances" standard.[12] In determining whether a fee arrangement has been "preapproved" under this standard, a court should look at "both the application and the bankruptcy court's order," and should also consider "whether the debtor's motion for appointment specifically requested fee preapproval, whether the court's order assessed the reasonableness of the fee and whether either the order or the motion expressly invoked §328."[13] In *Airspect*, the Sixth Circuit also found it relevant that the retention order required the professional to submit applications for fees to the court for approval.[14]

At the other, more liberal end of the spectrum is the Fifth Circuit's decision in *National Gypsum Co. v. Donaldson, Lufkin & Jenrette Securities Corp. (In re National Gypsum Co.)*.[15] In *Gypsum*, the bankruptcy court's order authorized the retention of the debtor's financial advisors "upon the terms and conditions of that certain engagement letter," but ended with the condition that "[t]he court retains the right to consider and approve the reasonableness and amount of DLJ's fees on both an interim and final basis." Notwithstanding this caveat, and even though §328(a) was not mentioned in the application or order, the Fifth Circuit found that the retention was under §328(a) and, as a result, held that DLJ's compensation of $125,000 per month could not be reviewed under §330.[16]

In contrast to *Gypsum*, however, most courts seem to be in agreement that if a professional's retention order states that compensation is subject to review and approval by the court, the more open review process of §330 will apply.[17] There are exceptions to this apparent majority rule, however, when other circumstances indicate an unambiguous intention to retain a professional under §328(a).

For example, in *F.V. Steel and Wire Company v. Houlihan Lokey Howard & Zukin Capital C.P.,*[18] the creditors' committee sought to retain *Houlihan Lokey* as its financial advisors for $80,000 a month plus a percentage of the unsecured creditors' recoveries as a transaction fee.[19] The application specifically stated that the retention was pursuant to §§328(a) and 1103, and that compensation would be "subject to court approval, in accordance with §§328 and 330."[20] Moreover, the order signed by the bankruptcy court adopted the language of the proposed order that inartfully paraphrased the second sentence of §328(a),[21] but the court added language stating that "[a]ny and all compensation paid to Houlihan, including the Ttransaction Fee and monthly advisory fee, is subject to the final approval of this Court."[22]

The district court affirmed the bankruptcy court's ruling that the retention was pursuant to §328(a), reasoning that "the engagement letter, the retention application and the retention order all expressly contemplated that the bankruptcy court would review Houlihan's compensation under the §328(a) standard."[23] It also placed emphasis on the fact that the retention order cited §328(a) and stated that "the court could modify Houlihan's compensation arrangement only if it proved improvident in light of developments that could not have been anticipated."[24] As to the language added to the order by the bankruptcy court, to the effect that compensation would be subject to court approval, the district court found it to be "unremarkable" and not sufficient to allow a review of compensation under §330, particularly since no reference to §330 was made in the order.[25]

The recent decision in *Smart World* also appears to have adopted the "totality of circumstances" test, although not explicitly. In *Smart World*, the bankruptcy court's order did not expressly mention §328(a), but recited that compensation to special litigation counsel would be in accordance with its engagement letter, which was annexed to the order.[26] The engagement letter provided for a contingency fee that was to be calculated on a sliding scale.[27]

The district court held that special litigation counsel was retained pursuant to §328(a).[28] In reaching that conclusion, the court found it relevant that at the retention hearing, the trustee specifically objected to retention under §328(a), arguing that the fees should be reviewed instead under §§330 and 331.[29] The bankruptcy court, however, had rejected that argument.[30] The district court also considered it relevant that *Smart World's* retention application sought to retain special litigation counsel "pursuant to 11 U.S.C. §§327 and 328."[31]

Circumstances that Are Incapable of Anticipation—A Tough Standard

Courts have been reluctant to make a determination, after the fact, that a compensation arrangement has proven to be improvident based on circumstances that could not be anticipated at the time the arrangement was approved. In general, it has been noted that "[t]his is a difficult requirement to meet, and courts rarely alter a fee award on these grounds."[32]

A stark example of how difficult it can be to change compensation that has been preapproved under §328(a) is provided by the decision in *In re Merry-Go-Round Enterprises Inc*.[33] There, special litigation counsel sought approval of a 40 percent contingency fee of $71.2 million after it recovered a pretrial settlement for the estate in the amount of $185 million.[34]

The contingency fee had been approved

[9] Id. at 261. In Zolfo Cooper, the bankruptcy court reduced the hourly rate it would allow for the accounting firm from the hourly rate stated in the firm's employment application. Id. at 256. The Third Circuit refused to consider Zolfo Cooper's retention to have been under §328(a), which would have prevented any reduction, because the retention order simply authorized the employment to perform the services as set forth in the motion and accompanying affidavit.

[10] The Circle K. Corp. v. Houlihan, Lokey, Howard & Zukin Inc. (In re The Circle K Corporation), 279 F. 3d 669, 671 (9th Cir. 2001).

[11] Id.

[12] Nischwitz v. Miskovic (In re Airspect Air Inc.), 385 F.3d 915 (6th Cir. 2004).

[13] Id. at 922.

[14] Id.

[15] Donaldson Lufkin & Jenrette Sec. Corp v. National Gypsum Co. (In re National Gypsum Co.), 123 F.3d 861 (5th Cir. 1997).

[16] Id. at 862-63.

[17] See Friedman Enter. v. B.U.M. Int'l Inc. (In re B.V.M. Int'l Inc.), 229 F.3d 824, 830 (9th Cir. 2000); In re Northeast Express Reg'l Airlines Inc., 235 B.R. 695, 699 (Bankr. D. Maine 1999); In re Olympic Marine Servs. Inc., 186 B.R. 651, 652, 654 (Bankr. E.D. Mass. 1995). But see Lazard Freres & Co. v. Northwestern Corp. (In re Northwestern Corp.), 344 B.R. 40, 42, 43 (D. Del. 2006) (retention order approved engagement terms as reasonable, including $5.5 million restructuring fee, "subject to final review under 11 U.S.C. §§328 and 330;" court nevertheless held that retention was under §328(a)).

[18] F.V. Steel and Wire Co. v. Houlihan Lokey Howard & Zukin Capital LP, 350 B.R. 835 (E.D. Wis. 2006).

[19] Id. at 837.

[20] Id. at 838.

[21] The paraphrased language stated that "Houlihan's compensation is expressly subject to the provisions of the Bankruptcy Code, which provide that the court may allow compensation agreed to in the engagement letter or described in the application, if in light of developments in the case, the terms of the compensation later prove improvident." Id. at 838.

[22] Id.

[23] Id. at 840.

[24] Id.

[25] Id. The analysis employed by the district court in this case appears to follow the "totality of the circumstances" approach taken by the Sixth Circuit in Airspect.

[26] Smart World, 383 B.R. at 871-72.

[27] Id. at 872.

[28] Id. at 876.

[29] Id.

[30] Id.

[31] Id.

[32] Houlihan Lokey Howard & Zukin Capital v. High River Limited Partnership, 369 B.R. 111, 117 n. 8 (S.D.N.Y. 2007).

[33] In re Merry-Go-Round Enter. Inc., 244 B.R. 327 (Bankr. D. Md. 2000).

[34] Id. at 333.

at the outset of the engagement and, despite the fact that the fees requested were almost 20 times what they would be if compensation were on an hourly basis, the court refused to reduce the contingency fee.[35] The court based its ruling on the public policy consideration of attracting competent professionals to work on bankruptcy matters and its view that a pre-trial settlement of the magnitude that had been achieved was not incapable of being anticipated.[36]

Other courts have reached results similar to the outcome in *Merry-Go-Round*. As catalogued by the district court in *Smart World*,[37] courts have rejected attempts to reduce contingency fees because of a substantial or easier-than-expected recovery, or even a stipulated hourly fee to two financial advisors who were accused of duplication of services.[38] The common theme in these cases has been that the circumstances cited in support of a fee reduction were not considered unforeseeable.[39]

Conclusion

Whether it is to avoid unintended consequences or litigation at the time of fee allowance, careful attention should be paid to what language is used and specifically, what section of the Code is invoked, in retaining professionals in bankruptcy cases. To eliminate uncertainty, it should be made clear in both the retention application and order that a particular compensation arrangement is being preapproved under §328(a), if that is what is intended, or alternatively, that, notwithstanding a proposal to charge certain rates or work on other specified terms, a professional's retention is under §327(a) only, with a reservation that fees will be subject to review and approval under §§330 or 331.

Author's Note: *Following the submission of this article for publication, the Second Circuit Court of Appeals affirmed the district court's decision in* Smart World. See Riker, Danzig, Scherer, Hyland & Perretti v. Official Committee of Unsecured Creditors (In re Smart World Technologies LLC), *Docket No. 08-172-bk, 2009 WL 23341 (2d Cir. Jan. 6, 2009). In its affirmance, the Second Circuit adopted the Sixth Circuit's "totality of the circumstances" approach to determining whether the terms of a professional's retention will be considered pre-approved under §328(a). After affirming the district court's ruling on that issue, the Second Circuit then held that once the terms of an engagement are pre-approved under §328(a), they cannot be altered unless the later developments that are cited as making them "improvident" were "incapable of being anticipated" when the terms were approved..*

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35 Id. at 335, 344-45.
36 Id. at 337-38.
37 Smart World, 383 B.R. at 877.
38 Id.
39 See, e.g., Houlihan, Lokey, Howard & Zukin Capital Inc. v. Northwestern Corp. (In re Northwestern Corp.), 332 B.R. 534, 537 (D. Del. 2005) ("potential for duplication was certainly not unforeseeable").