REPRINTED FROM
THE JOURNAL OF CORPORATE RENEWAL

COMPENSATION ISSUES

Professional Compensation Is a Gamble in Chapter 11

Checklist Designed to Improve the Odds

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When a turnaround results in a Chapter 11 bankruptcy, getting paid becomes much more complicated for the professionals involved. At least one judge has described a bankruptcy professional hoping to be paid as a "gambler."[1]

Obtaining proper compensation for professional bankruptcy services involves much more than doing good work and sending a fair bill. It is, in fact, the result of a process that must be planned and executed carefully to ensure that financial expectations are attained.

This article offers a practical checklist of the major compensation considerations for turnaround professionals acting on behalf of a debtor in possession, committee, or trustee. Abiding by this checklist will help professionals — defined by U.S. Bankruptcy Code Section 327 as attorneys, accountants, appraisers, auctioneers, or other professionals — to at least better their odds of getting paid.

1 Learn the Ropes

Sections 327 to 331 and 1103 of the U.S. Bankruptcy Code and Federal Bankruptcy Rules 2014, 2016, and 6005 govern the retention and payment of the professionals representing debtors in possession, committees, and trustees in bankruptcy cases. The office of the United States Trustee also has issued guidelines for professionals requesting compensation.[2]

In addition, all bankruptcy courts and many individual judges have established their own local rules, which often set forth supplemental regulations that must be followed by professionals seeking retention and compensation. A professional who is considering an engagement that may entail a bankruptcy proceeding must become familiar with all of these statutes, rules, guidelines, and procedures from the outset.

2 Lawyer Up

Equally important as the law and procedural rules are the practices and protocols of the district in which a case is filed and the bankruptcy judge to whom it is assigned (a pre-filing uncertainty in many larger districts). Attitudes and predilections of bankruptcy judges, as well as those of U.S. Trustees, tend to vary across a wide spectrum, from the strictly unbending to the somewhat laid back.

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Some bankruptcy courts are very sensitive to the criticism that professional fees often exceed initial — or even reasonable — expectations. As a result, they carefully scrutinize professional fee applications for issues such as the bunching of time entries, excessive interoffice conferences, the cost of meals, copying charges, and the cost of travel. Other courts are more sensitive to conflict of interest issues. Generally speaking, a thorough consultation with local counsel provides a turnaround professional with needed insight and advice. Whether working for the debtor, a committee, or the trustee, professionals should avail themselves of their clients' local counsel. If there is no local counsel, professionals seriously should consider retaining their own local bankruptcy attorneys.

3 Ponder Payment Possibilities

Bankruptcy Code Section 328 permits retention of professionals "on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, or on a contingent fee basis." Depending on the circumstances, a professional should consider each of these alternatives and various combinations of them.

Another common alternative fee arrangement involves a restructuring professional acting as a corporate officer of the debtor.[3] Some jurisdictions have allowed such arrangements under Bankruptcy Code Sections 105 and 363. This method of retention is often preferable because it may permit the professional to avoid some of the more burdensome retention and compensation requirements of Code Sections 327 to 331, such as the need to file a fee application to get paid.

In addition, professionals always should consider negotiating a results-based success fee during the initial stages of the relationship. However, other interested parties may be critical of and object to success fees, and professionals sometimes must defend a performance-based compensation arrangement. Professionals also can request a fee enhancement if their work is of superior quality and brings exceptional results to the administration of the case.[4]

4 Seek Secure Payment Source

As mentioned earlier, one whose paycheck is to come from a bankruptcy estate is to some degree a gambler. If a debtor's bankruptcy restructuring strategy fails, the bankruptcy estate may become administratively insolvent, with insufficient funds to pay all parties in full, including the professionals. Hence, whatever the pre-bankruptcy relationship is, the specter of Chapter 11 requires that professionals reexamine and secure their sources of payment.

The appeal of cash retainers is self-evident, but getting money up front does not guarantee that a professional will be allowed to keep it. In the case of an administratively insolvent debtor,

continued on page 2

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COMPENSATION IS A GAMBLE

continued from page 1

courts may require disgorgement of a retainer.[5] Carve-outs from lenders are also beneficial. Guaranties from principals are another, though less desirable, alternative. Professionals who do not carefully evaluate and secure their payment sources prior to filing risk financial disaster.

5 Get It in Writing

Once the source of payment is identified and secured, the exact terms of the professional's appointment should — and in many districts must — be specifically memorialized in an engagement letter. Too often, during the honeymoon phase of a new project, the engagement letter is neglected. Then, when it is time for payment, the parties realize that they were not on the same page regarding the terms of the engagement. That can leave professionals in the position of having their own clients object to their fees.

The ideal engagement letter is signed before work starts and clearly sets forth all obligations of the parties, especially compensation. It should spell out hourly rates, retainers, security, frequency of payment, any anticipated success or performance fees, and contingencies.

That the letter must set forth all terms of a professional's engagement cannot be overstressed. There can be no undisclosed side deals. When a professional enters into side arrangements and fails to disclose them to the bankruptcy court and other interested parties, the consequences can be financially painful. In at least one case, a bankruptcy court forced a professional to disgorge his paid fee of nearly $1 million. Upholding the court's disgorgement order, the appellate court declared that the amount of fees disgorged "represents the price of disloyalty." [6]

Finally, any engagement letter entered into at a time when the parties do not foresee bankruptcy must be reexamined — and almost always revised — before the troubled entity files for bankruptcy and the professional must seek court approval for appointment.

6 Tell It to the Judge

Without exception, the retention of a professional by a debtor, committee, or trustee in a bankruptcy case requires bankruptcy court approval. Until they receive that approval, professionals truly are working without a net.

Court approval requires the submission of a detailed retention application that sets forth all aspects of the proposed engagement, discloses any engagement letter, and includes detailed disclosures of all past and present connections and relationships of any nature between the professional and any party interested in the case. This should be done at the very beginning of the proceeding, preferably as a part of first-day orders. Some courts, however, will not consider professional applications until a committee is formed or at least until the U.S. Trustee's office has had a chance to comment.

Districts vary on the extent to which prior notice to creditors is required before an appointment is made. Some districts allow appointments on an *ex parte* basis, as long as the application is submitted within the first several weeks post-filing. But they require prior notice to all creditors if the application is not filed within that period. In any event, bankruptcy courts and U.S. Trustees take a very dim view of professionals who neglect the appointment process in the early stages of the case. A drastic but not atypical consequence of a professional's failure to be properly appointed is nonpayment and/or disgorgement of earned fees.

7 Pass Muster

Employment of a professional by a debtor or trustee, even as an employee, is subject to two key conditions under Bankruptcy Code Section 327. First, a professional must be a "disinterested person," which code Section 101(14) says excludes:

- Creditors.
- Equity holders or insiders.
- An investment banker for any outstanding security of the debtor within the preceding three years and its counsel.
- A person who was a director, officer, or employee of the debtor within the preceding two years.
- An investment banker of the debtor.
- Someone who has an interest materially. adverse to that of the estate.

Second, a professional may not "hold or represent an interest adverse to the [bankruptcy] estate," which generally encompasses any set of facts that would constitute a conflict of interest. Attorneys have elaborate rules and developed case law to help them avoid conflicts of interest. Many other professionals do not. If a professional has an actual or apparent conflict of interest, the bankruptcy court may refuse to appoint the person. However, a professional person is not disqualified for employment by a debtor in possession solely because of employment by or representation of the debtor before commencement of the case.[7]

In addition, code Section 327 provides that in a case under Chapter 11, a person is "not disqualified for employment…solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such appointment if there is an actual conflict of interest." Under certain circumstances, a waiver by the adverse party or disengagement from further representation of that party may solve the problem.

Other frequent sources of conflicts of interest arise if a professional is a creditor or has received an avoidable preferential payment before filing, which usually arises when a professional does not give the pre-filing payment schedule sufficient attention.[8] The elimination of this problem generally requires waiver of the pre-filing receivable and/or disgorgement of the preferential payment. Unfortunately, the latter may often not be a remediable circumstance and may leave the professional out of the case. As a cautionary measure, when dealing with a client facing the prospect of bankruptcy, a professional should also consider consulting with bankruptcy counsel to protect payments received before filing.

Lastly, when structuring the engagement of a turnaround management company and considering potential conflicts, turnaround professionals should give serious consideration to the widely known and accepted retention policy referred to as the "Jay Alix Protocol." [9]

8 Disclose, Disclose, Disclose

One principal purpose of the appointment process is to allow a Bankruptcy Court and other interested parties to determine whether a professional is disinterested and has no adverse interest. This is accomplished through Bankruptcy Rule 2014(a), which requires disclosure of "all of the [professional'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."

Turnaround professionals are routinely sanctioned for failing to disclose potential or actual adverse relationships and conflicts of interest. Failing to disclose such information

continued on page 3

continued from page 2

deprives the U.S. Trustee and creditors of their right to object in a timely manner to the appointment of that professional. As a result, bankruptcy courts are left with few options other than to order that the professional not be paid.

If hired by a debtor in possession, professionals also must disclose the nature of the pre-petition services rendered and the amounts paid for those services.[9] The consequences for failure to disclose can be nonpayment, disgorgement, and, at the extreme, jail.[10]

Additionally, disclosure is a continuing requirement. Especially in an era when claims trading is pervasive, all professionals should periodically update their conflicts checks and file supplemental disclosures where appropriate.

9 Document Carefully

Following their retention under code Section 327, professionals are responsible for convincing the Bankruptcy Court of the value they brought to a bankruptcy estate. Unless hired under Bankruptcy Code Section 363, a professional must submit a fee application and obtain court approval to be paid. Under the U.S. Trustee guidelines, fee applications must contain information about the applicant and the application, the case status, a summary sheet, and all time and service entries arranged in the project categories enumerated by the guidelines.

Citing code Section 330, the U.S. Trustee guidelines state that in evaluating fees for professional services, it is relevant for the court to consider: the time spent, the rates charged, whether the services were necessary to the administration of, or beneficial to the completion of, the case at the time they were rendered; whether the services were performed within a reasonable time commensurate with the complexity, importance, and nature of the tasks; and whether compensation is reasonable based on the customary compensation charged by comparably skilled practioners in non-bankruptcy cases.

Despite this published guidance, bankruptcy courts routinely criticize and sanction professionals for failing to keep adequate time records and for submitting otherwise deficient fee applications. Professionals should also be aware that some jurisdictions now pay professionals pursuant to the "lodestar" calculation, which requires the court to multiply the number of hours expended on a particular task by a reasonable hourly rate. The court then adjusts that figure by selecting a multiplier, which can be either positive or negative, based on the results of the professional's work.

In addition, code Section 331 provides that applications can be made only once every 120 days, unless the court orders otherwise. Recognizing that such lengthy intervals can cause hardships, many courts reduce the required time between fee applications or allow professionals to be paid a set amount or percentage of their fees on a regular interim basis. These measures are subject to final court approval following an application filed at a later date.

10 Don't Be Greedy

Professionals should always keep in mind the economics of bankruptcy. Most, if not all, parties involved already have lost money or soon will. No matter how big the case or how spectacular the results, a professional who is found to be taking advantage of the situation or "beating up the file" can be punished by a bankruptcy judge for overreaching. While a bankruptcy court's order can always be appealed, the likelihood of getting such a decision modified is miniscule.

Moreover, because professional fees paid in bankruptcy proceedings are a matter of public record, news organizations, trade journals, academics, and competitors may be eager to publicize the denial or reduction of a professional's fees.

A Good Bet

Careful preparation and follow-through will greatly enhance a professional's ability to get paid in bankruptcy cases. Generally speaking, bankruptcy judges acknowledge and appreciate the value that careful and conscientious professionals bring to their Chapter 11 cases. By following these rules, a "gambler" can greatly increase the odds of getting paid in a bankruptcy case. CR

[1] *Specker Motor Sales v. Sail Eisen,* 300 B.R. 687 (W.D. Mich., 2003).

[2] 28 CFR Part 58, Appendix. See www.usdoj.gov/ ust/guidlins.htm.

[3] See, for example, *In re: Bush Industries, Inc.,* Index No. 04-12295 (W.D.N.Y. 2004), *In re: Laidlaw USA, Inc.,* (W.D.N.Y. 2001) and *In re: Adelphia Communs. Corp.,* Index No. 02-41729 (S.D.N.Y. 2002).

[4] See, for example, *In re Nucentrix Broadband Networks, Inc.,* 314 B.R. 574 (Bankr. N.D. Tex., 2004).

[5] See for example, *Specker Motor Sales v. Sail Eisen,* 300 B.R. 687 (W.D. Mich., 2003).

[6] *In re Big Rivers Electric Corp.,* 355 F.3d 415 (6th Circuit, 2004).

[7] Code Section 1107.

[8] See, for example, *In re: Pillowtex, Inc.,* 304 F.3d 246 (3rd Cir., 2002).

[9] *In re: Safety-Kleen Corp.,* Index No. 00-02303, Docket Number 2825 and *In re Harnischfeger Industries, Inc.,* Index No. 99-02171, Docket Number 11741.

[10] *In re: Smitty's Truck Stop,* 210 B.R. 844 (10th Cir., 1997).

[11] See, for example, the media surrounding the bankruptcy case of *Bucyrus International, Inc.*

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