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Utilizing **Pre-Approved Retainers** Under Code **Section 328**

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With names like Madoff and Lehman part of our everyday vernacular, bankruptcies are now commonplace in American culture. While part of the mainstream, media coverage is often dedicated to the fees that professionals earn in these bankruptcy cases. The headlines often tell of eye-popping dollars that are doled out to these professionals, yet little coverage is dedicated to the procedure underlying those payments, and the different payment schemes contemplated by the Bankruptcy Code.

Approximately five years ago, the Second Circuit authored a decision entitled *Riker, Danzig, Scherer, Hyland & Perretti v. Official Committee of Unsecured Creditors (In re Smart World Technologies)*,[1] wherein a bankruptcy court's ability to reduce the fees of bankruptcy professionals that were retained under §328 of the Bankruptcy Code was significantly curtailed. This article will discuss: (i) a description of the retention of bankruptcy professionals under the Bankruptcy Code, (ii) the confusion among courts regarding §328 of the Bankruptcy Code leading up to *Smart World*, (iii) an analysis of *Smart World* and its impact on the fee requests of bankruptcy professionals retained under §328 of the Bankruptcy Code, and (iv) in light of *Smart World*, practical tips to those professionals seeking retention and payment under §328 of the Bankruptcy Code.

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Retention of Bankruptcy Professionals

Section 327 of the Bankruptcy Code authorizes a bankruptcy trustee, with the court's approval, to employ professionals to represent the trustee. Sections 328 and 330 establish a two-tiered system for judicial review and approval of the terms of the bankruptcy professional's retention.

Retention of professionals in bankruptcy cases are most commonly governed by §330 of the Bankruptcy Code, where a professional is paid on an hourly or lodestar basis. Section 330 authorizes the bankruptcy court to award the retained professional "reasonable compensation" based on an after-the-fact consideration of "the nature, the extent, and the value of such services, taking into account all relevant factors."[2] Professionals employed in bankruptcy cases often accept the uncertainty of not knowing what the court will consider "reasonable compensation" under

§330 of the Bankruptcy Code because the fees are subject to potential reduction if not deemed reasonable by the court.

As a result of commonplace reduction of professionals' fees under §330 of the Bankruptcy Code, Congress enacted §328 in 1978. Section 328 allows bankruptcy professionals to avoid the uncertainty of what is reasonable compensation by having their fee arrangements approved in advance by the court. Specifically, under §328, a debtor or bankruptcy trustee, with the court's approval, may employ a professional "on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, or on a contingent fee basis."[3] Even if the court "pre-approves" the terms of a professional's compensation pursuant to §328, "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."[4]

Section 328(a) permits a bankruptcy court to forgo a full post-hoc reasonableness inquiry if it pre-approves 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."[5] Where the court pre-approves the terms and conditions of the retention under §328(a), its power to amend those terms is severely constrained. The significance of pre-approval under §328(a) is that reasonableness of the fee and the basis of the fee is determined in advance of services being rendered. This is a strict standard in its application, requiring extraordinary and unforeseeable circumstances before a court can depart from the pre-approved compensation after services have been rendered.

Section 328 and 330 inquiries are mutually exclusive, as a bankruptcy court may *not* conduct a §330 inquiry into the reasonableness of the fees and their benefit to the estate if the court already has approved the professional's employment under 11 U.S.C. §328. Thus, there is a significant distinction between compensation awarded under §330 to a professional who has been employed under §327, and compensation awarded to a professional according to an arrangement previously approved under §328. Consequently, leading up to *Smart World*, courts were split about their ability under §328 to deviate from the terms of a professional's pre-approved contingency fee agreement at the time of that professional's fee application.

Circumstances Leading up to 'Smart World'

Prior to *Smart World*, the case law interpreting §328 was greatly muddled for several reasons. First, Congress's implementation of §328 was a departure from the general powers afforded to the court under §330. Courts struggled with the restrictions placed on their ability to control fees at the time of the professionals' fee applications.[6] It was this subtle, yet important, distinguishing characteristic of §328(a) from §330 that led to confusion because certain courts had addressed 328 fee applications under a §330 analysis in spite of Congress's intent to distinguish the two sections.

Second, other courts applied the correct §328 standard, but were befuddled when interpreting the language of §328(a). In certain circumstances, courts struggled with applying the term "improvident" as found in the latter half of 11 U.S.C. §328(a).[7] Even more concerning, in other circumstances, courts struggled to define the phrase "developments not capable of being anticipated" found in 11 U.S.C. §328. Such "developments" had proven troublesome for courts to identify.[8] Importantly, however, those developments must not have been capable of being anticipated *at the time* of the professional's retention. Yet, merely because a circumstance was not anticipated does not mean that it was not capable of being anticipated.[9] Certain other courts reached results-oriented decisions by finding that certain anticipatable developments met the legal standard of "developments not capable of being anticipated" and, in drawing such a conclusion, enabled the court the flexibility to reduce the professional's compensation in a results driven decision. It was those decisions that so muddied the legal standard created ambiguities for future courts adjudicating similar disputes, as was the case giving rise to *Smart World*.

In *Smart World*, the fight over attorneys' fees originated from an adversary proceeding in the *Smart World* bankruptcy case between Smart World and Juno Online Services. Riker Danzig Scherer Hyland & Perretti was retained to represent Smart World in an adversary proceeding commenced in the *Smart World* bankruptcy case, which dispute surrounded the valuation of a subscriber list that Smart World had sold to Juno. The parties ultimately agreed that Juno would pay $6.5 million to settle that adversary proceeding.

Given that settlement, Riker Danzig sought fees of $2.2 million based on the terms of its contingency agreement that the bankruptcy court had previously approved. Despite the agreement, the unsecured creditors committee and Smart World's principals objected to Riker Danzig's fee request, and a judge in the U.S. Bankruptcy Court for the Southern District of New York awarded Riker Danzig only $1.2 million. That judge had claimed that the reduction was justified by events incapable of being anticipated at the time that Riker Danzig was retained, such as disagreements between the debtor and creditors and an unusually prolonged procedural path of the adversary proceeding.

On appeal from the bankruptcy court, the U.S. District Court for the Southern District of New York reversed the bankruptcy court's decision and, on a question of first impression, the Second Circuit, affirmed the district court's reversal of the bankruptcy court. Agreeing with the district court, the Second Circuit found the bankruptcy judge's justification for the fee reduction lacking, asserting that the events described as "incapable of being anticipated" at the time of Riker Danzig's retention probably were anticipated and certainly anticipatable. "The

prospect of prolonged litigation always exists, and was clearly anticipated by the parties," the Second Circuit said, noting that Riker Danzig's fee agreement included contingencies based on the length of the litigation.[10] "Simply put, none of these developments were incapable of being anticipated at the time the bankruptcy court preapproved the terms of Riker Danzig's retention," the Second Circuit concluded, establishing a more rigorous standard for altering fee agreements that receive court approval pursuant to §328 of the Bankruptcy Code.[11]

Several decisions both within and beyond the Second Circuit have followed *Smart World*. For example, in 2012, the Fifth Circuit relied on *Smart World* in preventing a financial advisor from seeking an enhancement to its fees where the bankruptcy court had previously approved the terms of its retention pursuant to §328(a) of the Bankruptcy Code. Specifically, the Fifth Circuit found that the financial advisor could not demonstrate that developments during the course of the bankruptcy case were incapable of being anticipated at the time the advisor's retention which otherwise rendered improvident the terms of the advisor's retention.[12] Similarly, in 2010, the Eastern District of New York followed *Smart World*'s strict interpretation of §328(a) when reviewing an auctioneer's fee application and concluding that the default of the winning bidder at the bankruptcy auction was not a development that was incapable of being anticipated at the time of the auctioneer's retention that would have rendered the terms of that retention improvident.[13] In short, the effect of *Smart World* is that under §328 of the Bankruptcy Code, a party will be entitled to receive exactly what is provided for in its retainer agreement unless the movant seeking to alter payment different from those terms can show facts that were not anticipatable at the time of the retention that rendered those retention terms improvident.

Practical Tips

Most bankruptcy attorney fee agreements are made under section 330 of the Bankruptcy Code, in which attorneys are retained on an hourly basis. The court gets final approval of hours and fees claimed on a review utilizing a reasonableness standard. Although contingency and other section 328 fee agreements are not the norm for bankruptcy lawyers, *Smart World* is important for both companies entering bankruptcy and for attorneys and other professionals handling their cases. The professionals who enter into these types of arrangements need confidence that they are going to be honored.

Because the standard for compensation of professionals under section 328(a) is different than the standard under section 330(a), professionals should unambiguously state the basis for employment in their employment application before the bankruptcy court. If a professional desires to be compensated pursuant to section 328, the application to employ the professional should cite to section 328(a) of the Bankruptcy Code, explain the proposed fee arrangement, explain the scope of the proposed employment, and provide the reason or reasons that the movant believes justify such an arrangement. In addition, the movant should submit a proposed order that provides such information and approves the employment under section 328(a). For instance, a contingency fee might be proposed because the estate has little or no assets, and the proposed professional is taking a risk that he or she will not be paid. In other cases, compensation for the professional might be dependent on whether the professional is successful in recovering assets for the estate. Or the proposed professional might be called upon to perform services that are so specialized that hourly compensation would not be reasonable.

Smart World teaches estate professionals that seek to be retained under §328(a) two valuable lessons. First, when in doubt, retention applications must be abundantly clear that the applicant is seeking retention under §328(a) of the Bankruptcy Code. Any ambiguity in the language of the fee application will be construed against the fee applicant, most likely resulting a in a finding that the bankruptcy court retained the estate professional under §330 of the Bankruptcy Code and subjecting that professional's fees to a reasonableness review. Second, §328(a) of the Bankruptcy Code provides certainty to estate professionals who have been retained under this section. Since *Smart World*, it is more difficult for a court to award fees that deviate from what was previously approved in a section 328(a) retention order. Importantly, this, too, could have its drawbacks where an estate professional seeks a "fee enhancement" and believes that a reasonableness review under §330 of the Bankruptcy Code would result in granting fees that were in excess of that provided for in the retainer agreement. In short, if the estate professional wants fee certainty, §328(a) should be abundantly clear in that professional's retention application, and it must be comfortable with compensation based on those terms under any circumstance that might arise during the course of the bankruptcy case.

1. 552 F.3d 228 (2d Cir. 2009) (*Smart World*).
2. 11 U.S.C. §330(a).
3. 11 U.S.C. §328(a).
4. 11 U.S.C. §328(a).
5. 11 U.S.C. §328(a).
6. *In re Humbert*, 39 B.R. 643, 645 (N.D. Ohio 1984) (concluding that the 36 hours expended by special counsel to achieve favorable results did not warrant a contingent fee and the bankruptcy court had discretion to grant a fee different from the agreed upon §328(a) terms and conditions); *In re Churchfield Mgmt. & Inv.*, 98 B.R. 893, 899-900 (Bankr. N.D. Ill. 1989) (because there is no evidence to show that special counsel had any significant risk of failure and nonpayment in its pursued litigation, the court should use its discretion under §328(a) to reduce the allowance below the original contingent percentage because the contingent fee otherwise would "constitute not an award to counsel based on risk, but rather a bonanza not earned under §330 of the Bankruptcy Code").
7. See *In re Ashby*, No. 05-05779, 2006 Bankr. LEXIS 954, at *12 (Bankr. N.D. Iowa May 31, 2006) (refusing to find that the one-third contingency fee agreement was improvident under §328(a), but still reducing counsel's fees because counsel sought payment for carrying out duties that were the responsibility of the trustee).
8. *In re Gilbertson*, 340 B.R. 618, 622 (Bankr. E.D. Wis. 2006) (erroneously finding "that the contingency fee arrangement … has proven improvident in light of the unexpectedly early and easy resolution of this matter").
9. *In re Gilbertson*, Case No. 06-C-610, 2007 U.S. Dist. LEXIS 11734 (E.D. Wis. Feb. 4, 2007) vacated the bankruptcy court's order, noting that the fact that the bankruptcy professional "settled the claim quickly and easily was not a development 'not capable of being anticipated' at the time his application was approved." Id. at *15.
10. 552 F.3d at 235.
11. Id.
12. *Asarco v. Barclays Cap. (In re Asarco)*, 702 F.3d 250 (5th Cir. 2012).
13. *Liani v. Baker*, Nos. 09-CV-2651 (ILG), 09-CV-2652 (ILG), 2010 U.S. Dist. LEXIS 64785 (E.D.N.Y. June 28, 2010).

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