Does "Improvident" Mean "Immutable"?
The Standard of Review for Advisors' Professional Fees

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Professional Fees of Investment Bankers and Financial Advisors

Investment bankers historically have sought retention under terms and conditions that fixed their compensation pursuant to 11 U.S.C. § 328(a). Their compensation usually consists of a fixed monthly fee and a "back-end" transaction fee, most often calculated based upon (i) the amount of post-petition financing made available to the debtor, (ii) the purchase price of assets in a sale or (iii) plan confirmation.[2] More recently, financial advisors, which now include turnaround and restructuring professionals, have moved from seeking compensation based upon hourly rates to requesting fixed monthly fees with a back-end transaction fee.[3] These compensation requests appear in the form of Engagement Letters between the debtor and the professional, annexed to an application to retain the professional.[4]

Section 330 requires that the court find that the compensation requested is "reasonable," and that determination is premised upon six factors set forth in the statute, many of which implicate hourly rates. As they have moved from seeking hourly rates, financial advisors have also attempted to alter the standards of section 330. When compelled to have their compensation reviewed under the reasonableness standard of section 330, they have attempted to limit the focus to only one of the factors set forth in that section. This article reviews and compares the standards of sections 328 and 330 and recent decisions interpreting them.

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[1] By statute, the United States Trustee Program has 21 regions. Region 2 includes all judicial districts in New York, Connecticut, and Vermont. Region 3 includes all judicial districts in Delaware, Pennsylvania, and New Jersey.

[2] *See, e.g., Houlihan Lokey Howard & Zukin Capital v. High River L.P.*, 369 B.R. 111, 117 (S.D.N.Y. 2007).

[3] This article does not address the distinction, if any, between investment bankers and financial advisors and whether financial advisors should seek compensation under section 328(a) rather than section 330.

[4] Fee agreements are a recent invention and under the Bankruptcy Act were not permitted. "Courts were emphatic that it was the duty of the court to determine compensation based on the services rendered. Private arrangements and contingent fee agreements were not proper in cases under the Act." 3 Collier on Bankruptcy ¶ 328.LH[2], p. 328-39 (15th ed. rev. 2005).

Sections 328 and 330

The difference between sections 328 and 330 affects not only the timing of court review and approval of fees, but also the process for that review and approval. Under section 328, the court may approve any reasonable terms and conditions of employment, including on a retainer or hourly, fixed or percentage fee, or contingent fee basis. After the conclusion of the professional's employment, however, the court may allow different compensation from the compensation provided under such terms and conditions, if the terms and conditions prove to have been "improvident" in light of developments incapable of being anticipated at the time the terms and conditions were approved.

In contrast, under section 330 the court may approve compensation only after the services have been rendered, applying the standard of "reasonable compensation for actual, necessary services." In determining the reasonableness of the fees and expenses, the court takes into account all relevant factors, including the six factors set forth in the statute.[5]

Procedural Developments

Over the years, investment bankers, financial advisers and the United States Trustees in Regions 2 and 3 (U.S. Trustees) have reached accommodations regarding certain provisions of retention orders. In the not-too-distant past, the retention applications of investment bankers and financial advisors not only sought section 328 approval but also included indemnification agreements. The U.S. Trustees filed objections to these agreements and to the pre-approval of compensation under section 328. Over time, the terms of indemnification acceptable to the U.S. Trustees were worked out. In addition, the U.S. Trustees for Regions 2 and 3 do not object if,

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[5] 11 U.S.C. § 330, governing compensation of officers, provides in pertinent part:

> (3) In determining the amount of reasonable compensation to be awarded to an examiner, trustee under chapter 11, or 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;
> > (B) the rates charged for such services;
> > (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;
> > (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;
> > (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
> > (F) whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.

after notice to all creditors, no other parties have objected to the retention under section 328, provided that the U.S. Trustee and the court are permitted to review the compensation at the end of the case under the standards set forth in section 330. In Region 2 this agreement is known as the Blackstone Protocol, and a sample Order is posted on the Region 2 Web site.[6]

Setting Compensation Under § 328(a) - What Constitutes Pre-Approval

A split exists in the courts of appeals regarding the showing that courts require to pre-approve reasonable terms and conditions of employment in accordance with section 328. The burden rests on the professional seeking to be retained "to ensure that the court notes explicitly the terms and conditions if the applicant expects them to be established at that early point." *Zolfo, Cooper & Co. v. Sunbeam-Oster Co.*, 50 F.3d 253, 262 (3d Cir. 1995) (*Zolfo Cooper*). In *Zolfo Cooper*, the bankruptcy court authorized the debtor to retain Zolfo Cooper consistent with the accounting services set forth in their retention affidavit. In reviewing this order, the Third Circuit determined that the language "only established the nature and range of services"; the language did not specify particular terms and conditions as required by section 328. *Id*. at 262. As a result, compensation was subject to review under section 330.[7]

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[6] Certain of the timing requirements of the Blackstone Protocol have been obviated by the amendments to Bankruptcy Rule 6003.

[7] Specificity in the retention application may also be critical to the standard of review that the court will apply when reviewing fees pursuant to section 330. For example, over the objection of the U.S. Trustee, the Bankruptcy Court for the District of Delaware approved a retention and specified that the "reasonableness" review under section 330 was to be evaluated "by comparing the transaction fees payable in these cases to fees paid to other investment banking firms offering comparable services in other Chapter 11 cases and shall not be evaluated on hourly or length-of-case based criteria." *See* Order Authorizing the Employment and Retention of Miller Buckfire & Co., LLC, as investment banker to the debtors dated December 6, 2006, in *Korth v. Dura Auto. Sys., Inc. (In re Dura Automotive Systems, Inc.)*, – B.R. –, 2009 WL 743324 (D. Del. 2009). This decision is at odds with the market-driven approach to fees established in both the Second and Third Circuits. *See In re Ames Dept. Stores, Inc.*, 76 F.3d 66 (2d Cir. 1996), *abrogated in part on other grounds by Lamie v. U.S. Trustee*, 540 U.S. 526 (2004), and *In re Busy Beaver Bldg. Ctrs.*, 19 F.3d 833 (3d Cir. 1994); *see also In re XO Communications, Inc.*, 398 B.R. 106, 114 (Bankr. S.D.N.Y. 2008) (certain enumerated factors in section 330 do not apply when conducting a section 330 review of fees tied to a specific result and the court should view the "nexus between the work done and the results achieved."); *In re Northwest Airlines Corp.*, 400 B.R. 393, 399 (Bankr. S.D.N.Y. 2009) (in determining the reasonableness of a transaction fee "in the absence of an actual determination prior to or at the time the services were rendered *of what* the marketplace would bear, the court must look at the nexus between what was achieved, *i.e.,* the restructuring of the debt, and the impact of the advisor's effort in that regard.") (citations omitted). *But see Miller Buckfire & Co., LLC v. Citation Corp. (In re Citation Corp.)*, 493 F.3d 1313 (11th Cir. 2007) (finding that four of the five factors in section 330 explicitly or implicitly require a bankruptcy court to examine the amount of time spent); *Houlihan, Lokey Howard & Zukin Capital v. Unsecured Creditors'*

The Ninth Circuit established a more specific test, holding that the applicant "must invoke the section [328] explicitly in the retention application" in order to ensure that it governs the review of the professional's fees. *Circle K. Corp v. Houlihan, Lokey, Howard & Zukin, Inc. (In re Circle K Corp.)*, 279 F.3d 669, 674 (9th Cir. 2002). In *Circle K*, neither the retention application nor the retainer agreement of the financial advisor specifically mentioned section 328, although the engagement did mention payment of a flat monthly fee. The court of appeals did not find the monthly fee reference adequate to assure section 328 approval, leaving the professional's fees subject to review under the section 330 reasonableness standard.

At the opposite end of the spectrum, the Sixth Circuit adopted a totality of the circumstances test in *Nischwitz v. Miskovic (In re Airspect Air, Inc.)*, 385 F.3d 915 (6th Cir. 2004). The debtor retained special litigation counsel under a contingency fee agreement. In determining whether the bankruptcy court had approved the contingent fee agreement pursuant to section 328, the Sixth Circuit eschewed the standards of both the Third Circuit and the Ninth Circuit, holding instead that the analysis rests on the totality of the circumstances, "looking at both the application and the bankruptcy court's order." *Id*. at 922. The Sixth Circuit held that the existence of a request for pre-approval, a determination of reasonableness of the fee in the order and an express reference to section 328 are among the factors that the court should consider in its analysis.

Recently, in *Riker, Danzig, Scherer, Hyland & Perretti v. Official Comm. of Unsecured Creditors (In re Smart World Technologies, LLC),* 552 F.3d 228 (2d Cir. 2009) (*Smart World)*, the Second Circuit rejected both the Ninth Circuit requirement that the retention application explicitly seek section 328 pre-approval and the Third Circuit standard that the order expressly state the terms and conditions of the professional's retention. Instead, the Second Circuit adopted the totality of the circumstances approach articulated by the Sixth Circuit in determining whether the applicant specifically requested fee pre-approval, whether the court assessed the propriety of the fee arrangement and whether the order or the retention application expressly invoked section 328.

Reviewing Compensation Under § 328(a) – What Constitutes 'Improvident'?

In *Smart World*, the debtor retained a law firm as special counsel under an agreement that, as modified, provided for a sliding-scale contingency fee based upon several factors, including the amount recovered and the length of the litigation (the agreement). The unsecured creditors' committee (the committee) twice presented a settlement of the litigation to the court for approval but both times special counsel objected, asserting that the committee undervalued the claim. The court approved the first settlement, but was reversed on appeal. The second settlement proposed by the committee was contained in a reorganization plan, which was filed by

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Liquidating Trust (In re Commercial Fin. Servs., Inc.), 427 F.3d 804 (10th Cir. 2005) (using an "adjusted lodestar analysis" in awarding fees to a financial advisor, the bankruptcy court did not err in considering the number of hours worked and comparing the compensation requested to the compensation of other financial advisors working in the same case).

the committee and confirmed by the court. Special counsel filed a fee application based upon the agreement. The court awarded less than the amount requested, finding that four factors were "incapable of being anticipated": (i) the divergence of positions between the debtor and its creditors, (ii) the fact that special counsel took its directions directly from the majority shareholders of the debtor who seemed to favor equity over the unsecured creditors, (iii) the unusually prolonged litigation, and (iv) the fact that special counsel was an obstacle to the settlement rather than an asset. *Smart World*, 383 B.R. at 877-78.

Special counsel appealed and the district court reversed, holding that the factors on which the bankruptcy court relied may have been unanticipated but were not "incapable of being anticipated." On appeal, the Second Circuit noted that there were surprisingly few cases on the "improvident" standard of section 328, but those cases made it clear it was a "high hurdle." Citing *In re Gilbertson*, No. 06-C-610, 2007 WL 433096 (E.D. Wis. Feb. 4, 2007), the court found that "none of the four developments cited by the bankruptcy court were *incapable* of being anticipated." *Smart World*, 552 F.3d at 235.

Moreover, the court noted that the "after-the-fact" reasonableness consideration under section 330 and the "severely constrained" ability to review the pre-approved compensation under section 328(a) are "mutually exclusive," as "'[t]here is 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 already has approved the professional's employment under 11 U.S.C. § 328.'" (citation omitted). *Id*. at 232. *See also In re Gilbertson*, 2007 WL 433096, at *5 (once approved under section 328, the court may not subsequently reform the compensation absent developments that could not have been anticipated at the time of approval.); *Houlihan, Lokey, Howard & Zukin Capital, Inc. v. Northwestern Corp. (In re Northwestern Corp.)*, 332 B.R. 534, 537 (D. Del. 2005) (district court reversed the bankruptcy court, finding that the lower court, having approved the retention under section 328(a), was constrained to apply the legal standard of section 328(a), and that because the potential for duplication was certainly not unforeseeable, the lower court abused its discretion by reducing the fee award.

Conclusion

The only court of appeals to have addressed the "improvident" standard of section 330 is the Second Circuit. The holdings in *Smart World* – that the inquiries under sections 328 and 330 are "mutually exclusive" and that pre-approved compensation may be re-visited only in light of developments incapable of being anticipated – raise two important questions. First, is the "carve-out" for U.S. Trustee review of the compensation under section 330 of any effect or would the court still be bound by the section 328(a) standard? Second, are there any circumstances "incapable of being anticipated"?

We can only speculate how other circuit courts will similarly find that fees pre-approved under section 328 are protected from review. However, if an end-of-case review is unlikely to change the compensation approved at the beginning of the case, then it would benefit all parties-in-interest, as well as the bankruptcy system as a whole, for the professional to provide adequate proof that it proposes to be retained under reasonable terms and conditions consistent with section 328(a). It therefore is incumbent on the debtor, the professionals, any committees, the

U.S. Trustee and the court to ensure that an application under section 328(a) is supported by credible evidence and not simply a boilerplate pleading. By way of example, the application might address (i) increased risk due to the debtor's debt load and (ii) a comparative analysis of fees based upon duration of the case, the amount of work needed to be performed and fees charged in other cases of similar duration and complexity.[8] In addition, other terms require close attention, including whether the "back-end" fee is transactional or restructuring in nature, is tied to a specific result, or is a fee enhancement or bonus, all of which affect the manner in which the compensation will be reviewed.

When a case is in its early stages, pre-approval of compensation should present a challenge to the courts to compel an adequate record to meet the high hurdle presented by section 328(a). Very often the debtor has not yet filed its schedules or statement of financial affairs.[9] Yet, this same debtor, who is apparently unable to determine basic facts about its economic condition for disclosure to the court, its creditors and interest holders, seeks to convince the court that the millions of dollars it proposes to pay for financial advisory services are reasonable. Such a debtor should be put to its proof before the compensation is approved – especially when hindsight offers little or no protection.

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[8] Forethought at the beginning of a case may also result in the professional being protected at the end of a case if it seeks to have its fees increased. *See, e.g., In re Hale-Halsell Co.,* 391 B.R. 459 (Bankr. N.D. Okla. 2008) (the court could not approve a settlement between committee counsel and the committee where retention was approved under section 328(a) at a blended hourly rate of $275 but the settlement would result in a higher blended hourly rate.); *In re Nucentrix Broadband Networks, Inc.,* 314 B.R. 574 (Bankr. N.D. Tex. 2004) (the financial advisor was denied a success fee due to constraints imposed by section 328).

[9] As noted by the court in *XO Communications*, in the case of a pre-packaged bankruptcy, most of the transactional work will have occurred pre-petition and, therefore, the court, the debtor and the parties-in-interest are often in a better position to judge the merits of a section 328 application. *XO Communications*, 398 B.R. at 106.