Avoiding Pitfalls in the Retention Process

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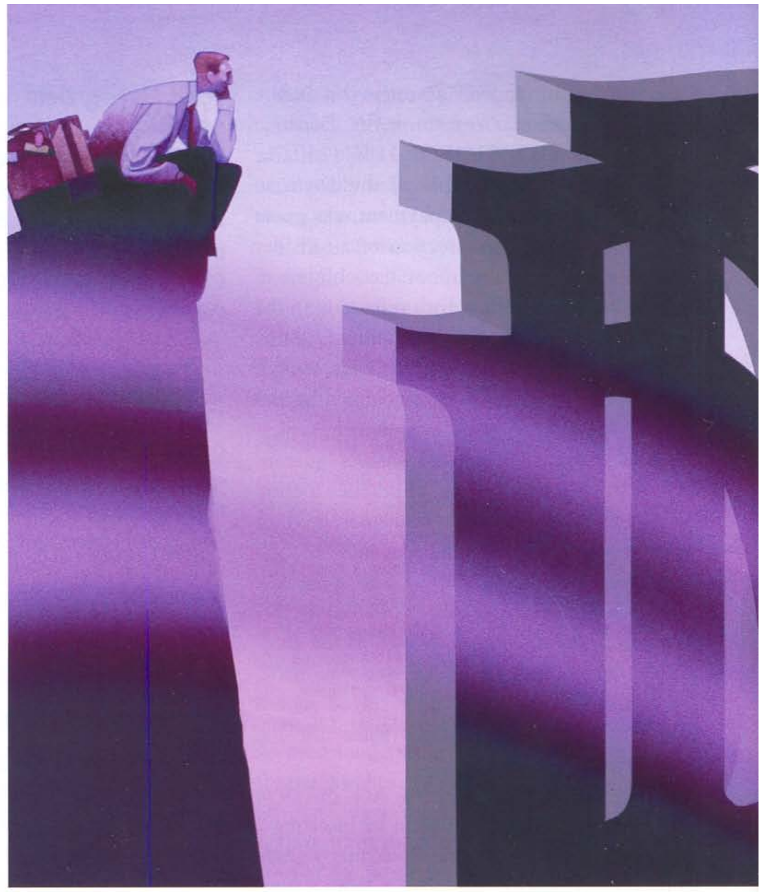

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Retention applications often are not given the attention they merit, despite the fact that the order approving retention is important to the debtor to ensure that it retains its restructuring professionals and imperative to your firm for obvious financial reasons. In that regard, retention applications frequently are adjourned to deal with more pressing concerns in a case. For a firm that has failed to implement adequate measures to ensure its continued engagement by the debtor, however, the result can be disastrous.

This article provides guidance regarding retention pitfalls governed by the "three Ds" for retention — disinterestedness, disclosure, and diligence. Attention to the three Ds can protect a firm from time-consuming and potentially expensive litigation and exposure in the bankruptcy retention process.

Disinterestedness

U.S. Bankruptcy Code Section 327(a) authorizes a trustee or debtor in possession to employ attorneys, accountants, appraisers, auctioneers, or other individual professionals only if they (1) do not hold or represent an interest adverse to the estate, and (2) are "disinterested," as defined in Section 101(14) of the code.

Although an "interest adverse to the estate" is not defined in the Bankruptcy Code, the phrase has been interpreted to mean "to possess or assert any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate is a rival claimant" or "to possess a predisposition under circumstances that render such a bias against the estate." [1] "Disinterested person," on the other hand, is defined by the Bankruptcy Code as someone who, among other characteristics, "[i]s not a creditor, an equity security holder, 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 an investment banker…." [2] The most common disinterestedness difficulties for professionals under 327(a) are (i) being characterized as a "creditor" and (ii) being exposed as the recipient of a preferential payment.

To be found disinterested, a professional must not be a creditor of the debtor. Bankruptcy Code Section 101(10)(A) defines a creditor as an "entity that has a claim against the debtor that arose at the time of or before the [the petition date]." A claim is defined in Section 101(5)(A) as a right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured. Read together, Sections 327(a) and 101(5)(A), (10)(A) and (14)(A), provide that, for a professional to be retained to represent the debtor, a professional must not, among other things, have a claim against the debtor's estate.

The most effective means to avoid creditor status is to obtain an adequate (or substantial) retainer. In addition, prior to the petition date, a professional should invoice the debtor regularly. To the extent possible, the periods between invoices should be predetermined by the debtor and should remain consistent. Upon invoicing and receiving approval for the invoice by the debtor, a professional should immediately allocate or draw down on the retainer the amount then outstanding. At all times, the fees earned and expenses incurred should not exceed the amount of the retainer.

A sufficient retainer and regular invoicing should minimize a professional's "interestedness." However, as the petition date approaches, the ability to invoice a debtor accurately decreases, especially for fees earned and expenses incurred during the days immediately preceding the filing of a petition. There is at least one approach that has been used successfully by professionals to avoid becoming a "creditor" in the period leading up to a Chapter 11 filing.

It requires that a debtor and professional agree, preferably in writing, that the professional will record fees and expenses as accurately as possible and, in addition, that the professional's fees and expenses immediately prior to the Chapter 11 filing will be estimated. The estimate must constitute payment in full, whether over or under, for all fees earned and expenses incurred prior to the petition date. To the extent the fees earned and expenses incurred exceed the estimate, the professional must waive those amounts to avoid holding a claim against the estate.

In many instances, to ensure that a professional does not hold a claim against the debtor and its estate, a debtor will satisfy all outstanding invoices just before initializing its Chapter 11 filing. Such payment in advance of a bankruptcy filing may have a direct impact on the Bankruptcy Code's disinterestedness requirement.

A professional who receives prepetition payment(s) from the debtor and who does not hold a security or other retainer may be liable for a preference under Section 550. Section 547, together with Section 550, empowers a trustee to avoid a transfer of the debtor's interest in property that (1) is made to or for the benefit of a creditor, (2) on account of antecedent debt, (3) made within 90 days of the petition date, (4) made while the debtor was insolvent, and (5) enabled the creditor to receive more than it would in a Chapter 7 liquidation had the transfer not been made. The existence

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of a facially preferential payment may render a professional not disinterested.[3]

To avoid the potentially disqualifying stigma of a preferential transference, in addition to insulating the professional from creditor status, it is essential that a professional obtain a sufficient retainer from the debtor well in advance of the filing and that the amount of the retainer at all times exceed the amount of fees earned and expenses outstanding.

Disclosure

Chapter 11 disclosure requirements stem from the Bankruptcy Code's disinterestedness requirement and Bankruptcy Rule 2014, which requires that a professional seeking employment under Section 327 must disclose all "connections" he has with a debtor. The irony of the requirement is that disclosure is required at the beginning of the case, but its impact may not be known until the end of the case.[4] The disclosure required under Rule 2014 extends beyond identifying disqualifying conflicts; a professional must disclose all connections, not merely those that rise to the level of conflicts.

Under Rule 2014, an application to employ must state the following: (1) specific facts showing the necessity for the employment, (2) the name of the person to be employed, (3) reasons for the selection of the professional, (4) professional services to be rendered, and (5) the proposed arrangement for compensation. In addition, the application must state, to the best of the applicant's knowledge, all of an applicant's connections with the debtor, creditors of the debtor, any other parties in interest, and the U.S. Trustee and anyone employed in that office (collectively, the "2014 Parties"). Connections subject to Rule 2014 disclosure generally fall into three categories: financial, business, and personal.[5]

While an abundance of case law is available on this issue, courts generally have evaluated connections on a case-by-case basis.[6] The penalty for failing to disclose relationships, connections, and interests can be extremely severe, including disgorgement of all fees and expenses earned during the pendency of a debtor's Chapter 11 proceeding. To avoid the potentially devastating consequences of a failure to disclose under Bankruptcy Rule 2014, professionals should:

- Describe all of the steps that were taken to investigate connections.
- Disclose any connections they have with "major" parties—debtor, debtor's employees, and any parties who had an impact on approval of employment, such as a lender, stalking horse bidder, companies on the list of largest creditors, significant holders of debt/equity, and affiliates.
- Describe connections in detail (*i.e.,* don't state you "represent various creditors of the debtor in other non-related matters...") to put the court and parties on notice of the issues that are the subject of the connection.
- Update and supplement the disclosures at least quarterly or more frequently as the facts of the case or the business of the debtor change and as their firms are engaged by new clients who may be connected with the debtor. Examples include strategy changes from reorganization to sale and vice-versa, filings of preference actions or claim objections, the entry of new lenders or equity/debt participants, or the filing of significant causes of action.

The most practical and helpful advice relating to disclosure under Rule 2014 is when in doubt, disclose. While the penalties for failing to disclose are severe — reduction of fees, disgorgement, and disqualification — they are entirely avoidable.

Diligence

The final "D" of retention pitfalls is more an exercise in common sense than in legal knowledge, but it often is overlooked. A professional must be diligent in drafting an application and related documents, as well as in negotiating and adjudicating any objections to them.[7] Before filing their applications, professionals must be sure that they and their firms have reviewed all connections with the 2014 parties and prepared a short description of each. They also must be diligent in filing supplemental disclosures. Time invested in the process at the beginning will save professionals and their firms time and money in the end.

Issues raised by an objecting party should be addressed quickly or narrowed and scheduled for hearing as soon as possible to avoid the potential downside of being disqualified months after a case has been filed. Professionals all too often put off adjudication of

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professional retentions until more pressing administrative/restructuring matters have been resolved. This can be a huge mistake that affects not only a professional's firm, but also a debtor in its effort to operate through the restructuring process and maximize value for its estate and creditors. Professionals should seek to have the matter considered by the court as quickly as possible.

If an objection to a firm's retention has been filed and the matter ultimately is scheduled for hearing, the affected professional must be absolutely certain that counsel is prepared to make a substantial evidentiary record to support the retention and to address any issues raised in objections. For a court to approve a retention, it must have facts/information necessary to rule in a professional's favor.[8]

Smooth Process

Adherence to the three Ds can help ensure that the retention process for the professional and the debtor proceeds as smoothly as possible. In a worst-case scenario, adherence to these guidelines will help a professional to be well prepared to address objections and present a court with an adequate record. In the best-case scenario, a court enters the retention order without objection, and the debtor and its professional are free to focus on more important issues in the bankruptcy. CR

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1 *In re Gelsinger,* Civ. No. 99-3264 U.S. Dist. LEXIS 1026 at *4-5 (E.D. Pa. Feb. 7, 2000).

2 11 U.S.C. Section 101(14)(A), (E).

3 *In Staiano v. Pillowtex, Inc. (In re Pillowtex, Inc.),* the 3d U.S. Circuit Court of Appeals held that when there is a facially plausible claim of a substantial preferential transfer, the court cannot grant retention conditioned on a later review of the claim. The appellate court also held that to the extent a debtor's attorney receives preferential transfers, the debtor's attorney has an actual conflict of interest that renders the attorney not disinterested. *In re Pillowtex,* 304 F.3d 246, 252 (3d Cir. 2002).

4 *E.g. In re Big Rivers Electric Corp.,* 284 B.R. 580 (W.D. Ky. 2002), affirmed 2004 WL 34848 (6th Cir. Jan. 8 2004) (denying all fees for failing to disclose a potential success fee); see, *e.g., In re Maximus Computers, Inc.,* 278 B.R. 189 (9th Cir. BAP 2002) (denying all fees for special counsel's failure to disclose a dual representation in the bankruptcy).

5 C.R. "Chip" Bowles, Jr., Fighting Nazgul, Trolls and Orcs is Easy; Disclosing Under Rule 2014 is Hard: Disclosing Connections and Relationships Under Current Bankruptcy Rule 2014: Part II, 22-3 Am. Bankr. Inst. J. 24 (2003).

6 *In re Park Helena Corp.,* 63 F.2d 877 (9th Cir. 1995); *In re Big Rivers Electric Corp.,* 284 B.R. 580 (W.D. Ky. 2002), affirmed 2004 WL 34848 (6th Cir. Jan. 8 2004); (3) *In re Maximus Computers, Inc.,* 278 B.R. 189 (9th Cir. BAP 2002); *Halbert v. Yousif,* 225 B.R. 336 (E.D. Mich. 1998); (5) *Bezanson v. Thomas (In re R & R Associates of Hampton),* 2003 WL 1233047 (D. N.H. Jan. 31, 2003); *In re Molten Metal Technology, Inc.,* 289 B.R. 505 (Bankr. D. Mass. 2003) *In re Bennett Funding Group, Inc.,* 226 B.R. 331 (Bankr. N.D.N.Y. 1998); *In re Begun,* 162 B.R. 168 (Bankr. N.D. Ill. 1993).

7 See *In re ACandS, Inc.,* 297 B.R. 395 (Bankr. D. Del. 2003) (denying retention and ordering disgorgement of all fees for failure to seek retention until nine months post-petition).

8 See *In re Dailey International, Inc.,* No. 99-1233 (Bankr. D. Del. Jul 1, 1999) (Walsh, J.) (letter opinion) (record fails to provide sufficient "evidence to support [the professional's] contention"); see also *In re Stations Holding Co., Inc.,* No. 02-10882 (Bankr. D. Del. Aug. 18, 2004) (Walrath, J.) (denying fees based on brief descriptions of the services provided that were insufficient).

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