MARCH 2006

BANKRUPTCY

A supplement to

The Legal Intelligencer

PENNSYLVANIA LAW WEEKLY

ALM

Getting Retained and Getting Paid in the 3rd Circuit

A Review of 2005 Bankruptcy Issues and Outcomes

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Special to the Legal, PLW

While all professionals work tirelessly to keep abreast of decisions that may affect their current or prospective clients' interests, they often fail to maintain the same zeal with respect to their own interests, most times until it is too late. As a result, this article is directed to professionals practicing in the 3rd U.S. Circuit Court of Appeals and is intended to benefit their most longstanding and important client — their own firms. Below is a summary of issues and outcomes addressed by the federal courts in the 3rd Circuit, and a discussion of bumps in the road that should and can be avoided.

A NECESSARY PREREQUISITE

The first step toward getting paid is getting retained. Section 327 of the Bankruptcy Code authorizes a trustee (or debtor) to retain professionals, including attorneys, to provide general advice administering the estate and also authorizes retention of attorneys for a "specified special purpose." There are several recent decisions interpreting Section 327 and impacting the retention process.

Although attorneys are "professionals," as the term is used in Section 327, trustees and debtors often seek their advice before hiring other professionals/consultants. In order to ensure that another firm's fees will be paid, a debtor must determine whether the firm is, in fact, a professional within the meaning of the Bankruptcy Code and thus, whether its retention must be approved by the court under section 327.

In *In re American Tissue Inc.*, a firm provided services to a Chapter 7 trustee and sought payment of its fees as administrative expenses. The firm's business consisted of monitoring class action lawsuits and identifying potential claimants. The firm contacted the trustee because the estate had an interest in a lawsuit. After reaching an agreement with the trustee, the firm filed a claim in the lawsuit and, if the estate received a recovery, the firm would be compensated.

After receiving payment on the estate's claim, the trustee attempted to compensate the firm. The U.S. Trustee objected and argued that the firm was a "professional" and had not been properly retained. Finding that the services performed by the movant "neither involve[d] superior intellectual attainment or heightened education, nor the hightened public and commercial recognition," the Delaware Bankruptcy Court rejected the argument and held that the firm was not a professional. Therefore, the trustee was not required to file a retention application, and the firm's fees could be paid as administrative expenses.

In *In re Congoleum Corp.*, the 3rd Circuit denied a debtor's request to retain a law firm pursuant to Section 327(e) because the firm had an actual conflict of interest regarding matters for which it was being retained. In dicta, the court discussed the scope of services a Section 327(e) attorney may provide and stated that the scope cannot be too broad with respect to general bankruptcy services. As such, in addition to denying the retention due to the actual conflict, the court rejected the firm's argument that it was retained primarily for strategic advice on insurance issues, because the application also included a

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laundry list of bankruptcy related services.

In *In re Woodworkers Warehouse*, a decision predating *In re Congoleum*, a law firm originally sought retention as "general bankruptcy counsel" under Section 327(a), but the retention was rejected by the bankruptcy court. However, the Delaware District Court approved the firm's retention under Section 327(e) because it found the firm was retained for the limited "special purpose" of advising the debtor in connection with cash collateral, sales and a KEPP, and not general bankruptcy advice. The U.S. Trustee argued that in this instance, Section 327(e) retention circumvented the Bankruptcy Code. The district court rejected the argument because there was substantial precedent within the 3rd Circuit and the functions to be performed by "general bankruptcy counsel" and "special counsel" did not overlap.

In *In re eToys Inc.*, a law firm retained by the debtors failed to disclose actual conflicts of interest and "connections" until years after it discovered the potential for conflicts. Another firm retained by the committee failed to disclose "connections" with a restructuring executive it recommended to the debtors. The Delaware Bankruptcy Court held that both firms violated Bankruptcy Rule 2014 by failing to comply with their ongoing obligation to disclose "connections" to and relationships with parties-in-interest.

With respect to debtors' counsel, the court only ordered disgorgement of fees related to work done by the firm on matters involving its other clients. With respect to committee counsel, the court approved a settlement with the U.S. Trustee also requiring partial disgorgement. In both instances, although the court had discretion to disqualify the firms, the court believed the remedies were sufficient because both firms ultimately disclosed the connections. In so ruling, the court outlined an acceptable course of conduct — ongoing disclosure of connections through supplemental affidavits and retention of disinterested professional(s) to handle conflicted matters.

THE FRUIT OF RETENTION

Knowledge of the applicable statutory authority, an awareness of precedent interpreting it, and a willingness to conform internal practices and procedures to comply therewith will ease the fee approval process in any bankruptcy case. To that end, set forth below are recent decisions interpreting the Bankruptcy Code's compensation provisions.

In *In re Garden Ridge Corp.*, the Delaware Bankruptcy Court held that prior approval of a professional's employment is a necessary prerequisite to compensation under the Bankruptcy Code. Moreover, the court ruled that there is no exception under Section 503(b)(1)(A) for a professional who provided necessary and beneficial services to the estate, but whose retention was not approved.

In that case, the U.S. Trustee objected to the debtor's application for retention of a real estate professional. The application was withdrawn, but the professional nevertheless assisted the debtors until the court approved the retention of a new consultant. The real estate professional thereafter sought payment of fees and expenses incurred between the petition date and the date the new consultant's retention was approved, pursuant to Section 503(b)(1)(A), as "necessary and beneficial" to the estate. The court denied the request because the real estate professional's retention was not previously approved, even though the services may have been necessary and beneficial to the estate.

Whether compensation is sought pursuant to section 328 or 330, the court has discretion with respect to final allowance and payment of compensation. However, in *In re NorthWestern Corp.*, the Delaware District Court clarified that a court's review of fees approved pursuant to section 328 differs from traditional fee reviews under Section 330. Pursuant to Section 330, the court reviews fees and expenses after they are incurred by a professional to determine if they are reasonable.

On the other hand, under Section 328, the terms and conditions of a professional's retention are pre-approved and, once approved, those terms and conditions, including any fees, are *per se* reasonable for purposes of Section 330. As the district court made clear, fees approved pursuant to Section 328 may only be later disallowed if they "prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such [fees]," a higher standard of review than that required by Section 330.

Whether particular services and expenses are compensable under Section 330 of the Bankruptcy Code has been the subject of many recent decisions. In *Hennigan Bennett & Dorman LLP v. Goldin Associates L.L.C. (In re Worldwide Direct Inc.)*, the Delaware District Court held that a law firm may be compensated for fees and expenses incurred as a result of successfully defending against an objection to its fees. The court stated that to hold otherwise would be "contrary to the Third Circuit's instruction that bankruptcy professionals are to stand on an equal footing with their non-bankruptcy counterparts."

In a separate decision by the bankruptcy court in the *In re Worldwide Direct* Chapter 11 case, the court clarified certain specific billing issues and held that: clerical tasks, including "calendaring," maintaining the notice list, and preparing labels are not compensable, even if performed by paraprofessionals; attorneys may be compensated for legal research; and a law firm may be compensated for actual expenses incurred as a result of work performed by temporary attorneys and paralegals hired through an employment agency, but may not profit from such services.

Pursuant to sections 503(b)(3)(D) and (b)(4), a creditor, an equity security holder, an informal committee of either, or an indenture trustee may receive an allowed administrative claim for reasonable attorneys' fees incurred while providing a substantial contribution to a case.

In another decision, the *In re Worldwide Direct Inc.* Chapter 11 case, the Delaware Bankruptcy Court held that although a request for payment of attorneys' fees pursuant to Section 503(b)(4) does not require the filing of a formal fee application, Section 503(b)(4) does require the same level of documentation and substantiation as a request for compensation under Section 330. Because attorneys to an indenture trustee did not consistently provide detail of their services and expenses, the court could not determine whether all of the services and expenses provided a substantial contribution to the case and, accordingly, allowed in part certain fees and expenses. In allowing portions of the request, the court was persuaded by entry descriptions and summaries that indicated: whether and how the work benefited the estate; and whether the work was requested by the debtor, a committee or other estate representative, but was not duplicative of work otherwise performed. •

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