Navigating the Roads of Retention in a Post-*ASARCO* World: Conflicts, Compensation and Other Conundrums

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I. Fee Applications After *ASARCO*

A. Brief Summary of *Baker Botts LLP v. ASARCO LLC*, 135 S.Ct. 2158 (2015):

The U.S. Supreme Court held that § 330(a)(1) of the Bankruptcy Code does not permit bankruptcy courts to award fees that § 327(a) professionals incur in defending their own fee applications. The Court first emphasized the well-known American Rule: "Each litigant pays his own attorney's fees, win or lose, unless a statute or contract provides otherwise." The Court reiterated that it recognizes departures from the American Rule only in specific and explicit provisions for the allowance of attorneys' fees under selected statutes. The Court then stated that Congress did not expressly depart from the American Rule to permit compensation for fee-defense litigation by professionals hired to assist trustees in bankruptcy proceedings. Section 330(a)(1) provides compensation for all manner of work done in service of the estate administrator, but the Court concluded that "[t]ime spent litigating a fee application against the administrator of a bankruptcy estate cannot be fairly described as . . . 'disinterested service to' . . . that administrator."

B. Subsequent Cases Interpreting *ASARCO*:

Following *ASARCO*, some professionals have sought to work around the prohibition outlined by the Supreme Court. These "work arounds" have been met with, at best, mixed results.

1. **Delaware Cases:**

   a. *In re Boomerang Tube, Inc*., 548 B.R. 69 (Bankr. D. Del. 2016).

      Background: Boomerang Tube, LLC and its affiliates filed chapter 11 petitions. The United States Trustee appointed the Official Committee of Unsecured Creditors (the "Committee"), which retained Brown Rudnick, LLP and Morris, Nichols, Arsht & Tunnel, LLP as counsel (collectively "Committee Counsel"). Committee Counsel sought approval under section 328(a) of the Bankruptcy Code, of a provision in their retention applications entitling them to compensation from the debtors' estates for any fees, costs or expenses arising from the successful defense of their fees, subject to approval by the Court pursuant to sections 330 and 331. The United States Trustee objected to the fee defense provisions in the retention applications, arguing that they were precluded by *ASARCO*. The United States Trustee further argued that the fee defense provisions were outside the scope of employment and unreasonable.

Issue: Can retention agreements provide an American Rule exception for allowing bankruptcy professionals to receive compensation for fees and costs arising from the successful defense of fee applications?

Holding: Judge Walrath held that retention agreements do not provide an exception to the American Rule for bankruptcy professionals to receive compensation for fees and costs arising from the successful defense of fee applications.

In reaching its conclusion, the Court acknowledged that section 328(a) is an exception to section 330(a). However, like section 330(a), section 328(a) does not explicitly authorize awarding fees to a prevailing party in the context of an adversarial action. The Court concluded that, because the text of section 328(a) does not refer to the award of defense fees, it does not provide a statutory exception to the American Rule, which still applies. The Court further found it significant that the Bankruptcy Code does contain certain express exceptions to the American Rule and identified six bankruptcy provisions explicitly providing this exception.

The Court agreed that the contract exception to the American Rule is not precluded by *ASARCO* and that "the Supreme Court in *ASARCO* did not hold that section 330 prohibits the allowance of defense fees and merely held that it did not expressly authorize them." However, the Court agreed with the United States Trustee's position that parties cannot violate another provision of the Bankruptcy Code by contracting around it. Accordingly, the Court held that any contractual exception to the American Rule must be consistent with the other provisions of the Bankruptcy Code.

The Court stated that retention agreements are contracts, but noted that they are not bi-lateral contracts because they are subject to objection by other parties and ultimately subject to approval and modification by the Court. Further, a contract must provide "contractual exceptions" to the American Rule. The Court held that the retention agreement did not provide such an exception, because such agreements were not a contract between two parties providing that each will be responsible for the other's legal fees if it loses a dispute between them. Instead, the retention agreement provided that the estate, which is a third party to the agreement, shall pay the defense costs. Thus, the Court explained, the contract could not bind the estate, which was a non-party. The Court concluded that the retention agreements were not contractual exceptions to the American Rule. Furthermore, and even if they were, the Court would still be obligated to determine if the contractual exception was permissible under the Bankruptcy Code.

Finally, the Court viewed the retention agreement as a contract that was subject to court modification and approval under the Bankruptcy Code. The Court found that the fee defense provisions were not reasonable terms for the employment of Committee Counsel under section 328(a) because they proposed compensation for fee-defense which, after *ASARCO*, is not a "disinterested" "service" for which compensation can be owed. Rather, it would be a service performed by Committee Counsel in their own interests and therefore not a reasonable term of employment. This calculation does not change when a party agrees to the provision if the agreement conflicts with the Bankruptcy Code.

The Court concluded that the outcome would not be different if the fee defense was an "expense" rather than a "fee," as both are subject to the American Rule and the ruling in *ASARCO*.

b. *In re New Gulf Resources, LLC, et al.*, Case No. 15-12588 (Bankr. D. Del. March 16, 2016).

Background: New Gulf Resources, LLC and its affiliates filed chapter 11 petitions on December 17, 2015. In its application to represent New Gulf, Baker Botts proposed a modified fee structure to serve as lead debtors' counsel. The application provided a conditional premium fee that would be triggered if a reorganized, post-bankruptcy New Gulf decided to challenge Baker Botts' baseline rates. The Bankruptcy Court for the District of Delaware approved Baker Botts' application, but reserved judgment on the firm's fee proposal, which was opposed by the United States Trustee.

Issue: Is a "fee premium," payable in the event of litigation over fees, allowed following *ASARCO*?

Holding: In a letter ruling, Judge Shannon held that structuring a fee premium that is triggered by fee litigation runs afoul of the holdings in both *ASARCO* and *Boomerang Tube*. In so ruling, Judge Shannon found that there was no meaningful distinction between the fee premium proposed by Baker Botts and the matters considered and ruled upon in *Boomerang Tube*.

c. *In re Samson Resources Corporation* (Case No. 15-11934) (Bankr. D. Del. Feb. 8, 2016)

Background: Samson Resources Corporation and its affiliates filed chapter 11 petitions (collectively, "Samson"). In its application to represent Samson, Kirkland & Ellis, LLP, Kirkland & Ellis International, LLP and Klehr Harrison Harvey Branzburg, LLP requested approval of certain provisions regarding reimbursement of

fees and expenses incurred in connection with fees and claims related to legal services. Judge Sontchi approved the retention applications, but stated that the application provisions permitting reimbursement for fees and expenses would not be effective until further order of the court.

Issue: Is a "reimbursement" of fees and expenses incurred in connection with litigation of claims related to legal services allowed following *ASARCO*?

Holding: In a letter ruling, Judge Sontchi agreed with the ruling in *Boomerang* and held that the reimbursement provisions were not allowed, because "the provisions are not statutory or contractual exceptions to the American Rule and are not reasonable terms of employment of professionals." Judge Sontchi stated that the reimbursement provisions were substantially similar to the provisions at issue in *Boomerang* and noted that this outcome is equally applicable to professionals retained by the debtor as it is with counsel retained by a creditors' committee.

2. **Other Jurisdictions:**

In re 29 Brooklyn Avenue, LLC, __ B.R. __ 2016 WL 1714123 (Bankr. E.D.N.Y. 2016).

Background: Brooklyn Avenue, LCC (the "Debtor") filed a voluntary chapter 11. The debtor was a single-member LLC. Prior to the filing date, a bank initiated a foreclosure action with respect to certain property (the "Property") belonging to the Debtor. A receiver appointed in the foreclosure action came into possession of the Property and managed it until the petition was filed. The debtor filed a proposed chapter 11 plan that did not provide for payment of the receiver's outstanding expenses or commissions. The receiver filed an objection which was withdrawn when the Debtor agreed to escrow funds sufficient to pay his claim. The Plan was confirmed and the Property was sold with the Debtor ultimately retaining $1,367,454.00. The Plan provided for 100% payment of all administrative expenses and all allowed claims.

The receiver turned over possession of the Property after the filing date and filed a proof of claim in the amount of $80,757.22. The claim encompassed pre-petition paid and unpaid expenses of the Property, as well as the receiver's commission and legal fees incurred up to that point. The debtor filed an objection to the receiver's proof of claim. Following extensive discovery and an eight-day trial, the Court allowed the receiver's proof of claim in the amount of $72,223.86. The receiver then filed a motion seeking allowance of attorneys' fees incurred in the

bankruptcy case in the amount of $355,953.25. The debtor objected to the fee application.

Issue: Does section 503(b)(4) allow for the award of fees incurred in defending a receiver's application for compensation under section 503(b)(3)(E)?

Holding: The Court held that the receiver's counsel was entitled to reasonable compensation for services rendered to the receiver, including the extensive litigation with the debtor over the receiver's expenses and compensation under section 503(b)(4), and that *ASARCO* does not require a different result.

At the outset, the Court explained that the Bankruptcy Code defines a receiver as a "custodian" and provides for reimbursement for his expenses and compensation from the bankruptcy estate under section 543(c)(2), which is entitled to administrative priority under section 503(b)(3)(E). In addition, section 503(b) allows compensation for a custodian's attorney and section 503(b)(4) grants reasonable compensation for professional services rendered by an attorney for an entity whose expenses are allowable under certain subparagraphs of section 503.

The Court found that section 503(b)(4) is "unquestionably a fee-shifting statute" that allows for fee-shifting for a receiver and for his counsel for services related to the process of turning over property of the estate and providing a required accounting. The Court noted that the Bankruptcy Code also contemplates additional legal services being incurred in preparing the custodian's application for payment.

The Court discussed *ASARCO* and found the facts of the subject case to be distinguishable. The Court found that the legal services in question were rendered to the client and the litigation over the fee application by the receiver's counsel was "labor performed for" and "disinterested service" to the receiver. The Court further held that section 503(b)(4) was an explicit fee shifting statute, and thus it differed from section 330(a) because it only allows compensation for the attorney of an entity whose expense is allowable under section 503(b)(3), thus avoiding the risk that an attorney may receive a fee award for unsuccessfully defending an application for compensation.

The Court noted that the plan in this case paid all creditors 100% of their claims and the litigation was only between the debtor, a single-member LLC, and the receiver. The Court found this to be, in essence, litigation with the debtor's equity holder rather than the debtor, and that neither the debtor's estate nor the creditors would be prejudiced by an award of fees. Consequently, the fiduciary concerns of *ASARCO* were not present.

The Court evaluated the request for attorneys' fees under section 503(b) and held that all of the requirements were met. The Court found that the litigation was necessary, the receiver substantially prevailed, the debtor's efforts to disallow the proof of claim were misplaced and misunderstood the legal standard, there was no indication that the litigation was pursued to incur fees, and the expenses were unavoidable because the litigation was the only avenue to receive the compensation.

The Court noted that the receiver did not ask to be a part of the bankruptcy case and was appointed prior to the bankruptcy. Rather, it was the debtor that perpetuated the multi-year litigation effort. The Court noted that the proposition found in cases decided prior to *ASARCO* that "fees may be awarded to counsel for a debtor in possession or trustee for defending a fee application against objections interposed by a representative of the bankruptcy estate . . . [has] been overruled by *ASARCO*," but that "[t]he Supreme Court did not hold that legal fees incurred in defending a fee application are *per se* unrecoverable."

The Court rejected the argument that the receiver's actions had to benefit the estate, finding that the fees sought fell under section 503(b)(4) and not section 503(b)(3). The Court concluded that, since the receiver's services benefitted the estate and the fees incurred in defending the proof of claim were necessary, the fees were allowable under section 503(b)(4). The Court made a determination as to the reasonableness of the fees requested and determined that most of the fees were reasonable under the circumstances. Therefore, it granted the fee application in the amount of $234,206.25, plus actual and necessary expenses of $5,533.30.

C. United States Trustee Program's Position Regarding *ASARCO:*

The Office of the United States Trustee has published official "guidance" on fee applications post-*ASARCO*. Their relevant positions are summarized below:

1. Objection to Defense Fees: The United States Trustee Program ("USTP") has taken the position that, after *ASARCO*, there are no applicable judicial exceptions for receiving attorneys' fees for defending objections to applications for compensation that have been filed in court. Fees are *per se* prohibited because section 330 does not expressly alter the American Rule against fee shifting.

2. Fee Applications: The USTP will not rely on *ASARCO* to object to fees incurred in preparing fee applications, which it states are understood to be a service rendered to the estate administrator under section 330(a)(1), because fee applications are not required of lawyers practicing in areas other than bankruptcy as a condition to get paid.

3. Negotiations and Explaining Fee Applications: The USTP will generally not object to defense fees incurred in negotiating or explaining fee applications before an objection is filed in court. These may be viewed as an extension of fee application preparation. However, the outcome will depend on the facts and circumstances of each case. One of the factors the USTP will consider is whether defense fees appear to be for the professional's benefit or the client's.

4. Pre-approved term of employment permitting fees-on-fees: The USTP will object to professionals seeking approval of retention terms permitting fees-on-fees. The USTP explains that this outcome is governed by sections 328 and 330.

5. Bankruptcy Premium: The USTP will object to enhanced compensation or a bankruptcy premium based on the purported risk of non-payment for future fee litigation and resulting dilution of bankruptcy compensation, which the USTP finds to be inconsistent with *ASARCO*. The USTP further suggests that a dilution risk is minimal and that the facts of *ASARCO* were "exceedingly rare", noting that generally the USTP is the only objecting party and that others will be discouraged from making frivolous objections because of the objecting parties' own costs and the risk of Rule 9011 sanctions.

6. Billing for Invoice Preparation: The USTP will object to fees for preparing invoices, stating that there is no statutory authorization for granting these fees, since routine billing activities are not compensable outside of bankruptcy.

7. Non-legal professionals: The USTP will use standards analogous to those applied to attorneys seeking compensation for fee defense-related services.

D. Practical Impact:

Given the decisions in *ASARCO* and its progeny, some experts have predicted that the market's response will be pressure to increase hourly rates. Other experts also predict that some smaller firms handling midsize or smaller bankruptcy matters will be exiting the industry, as they cannot make a profit if forced to defend a fee application.

II. Disclosure of Potential Conflicts of Interest and "Connections"

A. Section 327(a) of the Bankruptcy Code requires that an attorney appointed to represent a trustee be a "disinterested person[ ]." A "disinterested person" is defined, in relevant part, as a person who "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 specified in

subparagraph (B) or (C) of this paragraph, or for any other reason." 11 U.S.C. § 101(14)(E).

B. Federal Rule of Bankruptcy Procedure 2014 requires all professionals to disclose to the court facts related to actual or potential conflicts of interests. FRBP 2014 provides, in pertinent part:

(a) *Application for and Order of Employment*. An order approving the employment of attorneys, accountants, appraisers, auctioneers, agents, or other professionals pursuant to §327, §1103, or §1114 of the Code shall be made only on application of the trustee or committee. The application shall be filed and, unless the case is a chapter 9 municipality case, a copy of the application shall be transmitted by the applicant to the United States trustee. The application shall state the specific facts showing the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, **to the best of the applicant's knowledge, all of the person'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**. The application shall be accompanied by a verified statement of the person to be employed setting forth the person'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. [(Emphasis supplied.)]

C. Courts' Interpretations of Rule 2014:

1. Disclosure of "Connections"/Simultaneous Representation/Conflict of Interest

a. *In re Frascella Enterprises, Inc.*, 2006 WL 1530256 (Bankr. E.D. Pa. 2006): In support of an employment application, an attorney disclosed that he had "represented the Debtor prior to the institution of these Proceedings." After being pressed by third parties who objected to the application, the attorney filed an Amended Application, which disclosed more about the prepetition representations and the fact that he had minimally represented other creditors in a related matter. The Court held that "professionals cannot pick and choose which connections are irrelevant or trivial" and the duty of disclosure is mandatory. The Court denied the application for two reasons: (1) failure to disclose all potential conflicts; and (2) the existence of both an actual and potential conflict.

b. *In re Sundance Self-Storage-El Dorado LP*, 482 B.R. 613 (Bankr. E.D. Cal. 2012).[2]

In response to an order to show cause directing the debtor's attorney to show cause why the court should not reconsider a previously approved fee award in his favor and why he should not be sanctioned for violating Bankruptcy Rule 9011(b), the court held that counsel held a materially adverse interest and was not disinterested as a result of his concurrent representation of both debtor Sundance (as a D-I-P) and debtor's principal in his individual Chapter 13 case. The court went on to say that the attorney should never have been allowed to represent both debtor and the principal for the two-year period in which the dual representation took place. (NOTE: "The court unearthed the fact of Counsel's representation of Smith on its own immediately before the .. . . continued hearing on the OSC." Counsel's multiple Declarations were woefully deficient in numerous other ways, as well.) A conflict of interest occurred when, in an effort to safeguard a source of income necessary to his own Chapter 13 plan, the principal caused Sundance's chief asset to be transferred to another company controlled by principal. However, counsel also failed to disclose disqualifying connections - either actively or revealed them in such a perfunctory manner "as to render them meaningless" − so as to warrant disallowance of all fees.

c. *In re Jade Management Services*, 386 Fed.Appx. 145 (3d Cir. 2010)[3]:

The Third Circuit held that the Bankruptcy Court did not abuse its discretion (i) in determining that there was only a remote possibility that potential conflict of interest, arising out of attorney's simultaneous representation of corporate Chapter 11 debtor and its sole shareholder in their separate bankruptcy cases, would ever ripen into actual conflict, and (ii) in approving attorney's employment as counsel to corporate debtor. While the shareholder had personally guaranteed corporate debtor's secured debt, the value of the corporation's encumbered assets far exceeded the value of the secured claims that shareholder guaranteed, such that it appeared substantially certain that all secured claims would be paid in full and the shareholder would never be called upon to honor her guarantee. Furthermore, the principal never filed a claim against the corporate debtor. The dual representation was known to all concerned and the assigned judge regularly heard both matters together. Therefore, the remote possibility of a potential conflict of interest and the full disclosure all pertinent facts from the onset of the bankruptcy filing resulted in the dual representation being authorized.

[2] Summary from published materials previously prepared by Richard M. Meth.
[3] Summary from published materials previously prepared by Richard M. Meth.

2. Rule 2014 As Applied to Financial Advisors

a. *In re Alpha Natural Resources*, Case No. 15-33896 (Bankr. E.D. Va. June 28, 2016)

In this case, McKinsey RTS was approved as a financial advisor to the debtor. On the eve of plan confirmation, McKinsey's disclosures under Rule 2014 were challenged based on allegations that McKinsey had failed to fully disclose connections with potential buyers of the debtor's assets. Specifically, a creditor and the Office of the US Trustee alleged that McKinsey had not disclosed the names or nature of its connections to debtor's lenders, creditors and competitors as required by Rule 2014. McKinsey opposed further disclosure because, among other reasons, they alleged that the challenge was brought for an improper purpose – to "force McKinsey out of the Chapter 11 restructuring business." They alleged that the creditor was only challenging based on anti-competitive reasons in order to force McKinsey to disclose its clients. The challenge was brought after McKinsey had already preformed extensive work, and after the Court had approved more than $16 million worth of fee applications over a nine month period. Moreover, the challenge was brought by an entity, Mar-Bow, that was owned by a competitor of McKinsey (*i.e.*, Alix Partners).

Judge Huennekens required that McKinsey make more detailed disclosures, including disclosing a list containing the name of 121 undisclosed connections that were raised by the debtor at the hearing on the matter. However, Judge Huennekens required the disclosures in camera and with confidentiality provisions that would protect McKinsey's business interests.

b. *In re Caesars Entertainment Operating Co., Inc., et al.*, Case No. 15 B 1145 (Bankr. N.D. Ill. March 16, 2016).

The Court preliminarily decided to deny in its entirety the application for compensation of the debtors' financial advisory firm, based upon an initially undisclosed close inter-personal relationship between a principal of the firm and a professional representing a party with an adverse interest to the debtors. However, in lieu of the Court making a final ruling with respect to their application, the advisory firm chose to withdraw their application in its entirety.

D. The "One Percent Rule":

Some courts have held that law firms should disclose if a secured creditor accounts for more than 1 percent of its annual revenues pursuant to Rule 2014. The rationale is that less than 1 percent revenue is considered *de*

minimus and should not be considered when determining a conflict of interest. *See, e.g., In re Rockaway Bedding, Inc*., No. 04-14898, 2007 WL 1461319, at *4 (Bankr. D.N.J. May 14, 2007) (holding that no actual conflict of interest occurred when a secured creditor accounted for less than 1% of a Duane Morris' revenues).

But, for a large law firm, one percent of its annual revenues can be a substantial amount of money. Some critics have thus said that one percent, without more context, is really just a number in a vacuum and does not provide any "real insight into whether the legal team working on the debtor's or committee's case would likely be influenced, nor does it provide insight into whether the team working on the chapter 11 case is likely to be influenced." *See* "The 1 Percent Rule Needs Fixing," Kenneth A. Rosen, Esq. Those criticizing this "rule" advocate that more information should be disclosed in retention papers, in order to determine the true significance of the relationship. This information should include the size of the case, the number of active parties involved, the amount of the secured creditor's claim, when the secured loan was made, what law firm documented the loan, what issues are likely to arise regarding the secured creditor's claim, the actual revenues that the secured lender represents to the firm, the size of the firm, and who at the firm provides legal services on behalf of the secured creditor.

E. Items that Rule 2014 Does Not Specifically Address:

1. The Rule does not provide a definition of "connection."

2. The Rule does not limit the extent of disclosure of a professional's connections with (a) the debtor, (b) any creditors of the debtor, (c) other parties in interest, (d) attorneys for the debtor, creditors, and parties in interest, (e) accountants for the debtor, creditors, and parties in interest, and (f) the United States Trustee and persons employed by the US Trustee's office.

F. Proposed Rule 2014:

The American Bankruptcy Institute's National Ethics Task Force proposed a revised Rule 2014 in April 2014. That rule would have significantly expanded the required disclosures, while at the same time clarifying the types of "connections" that needed to be disclosed.

Specifically, it would have forced applicants to describe "Relevant Connections," as defined by the proposed Rule, with the debtor, creditors of the estate, known or anticipated post-petition creditors of the estate, equity security holders of the debtor or of affiliates of the debtor, officers and directors of the debtor, parties that are insiders of the debtors or that were insiders of the debtor within 2 years before the date of the filing of the petition, any investment banker for any outstanding security of the debtor, the

United States Trustee, customers of the debtors or vendors to the debtor whose transactions with the debtor as of the petition date constitute a material portion of the debtor's business, parties to executory contracts and unexpired leases, utility service providers, government units and officials and employees thereof, committee members, any identified potential asset purchasers, and any professional employed by any of the foregoing entities.

G. Status of the Proposed Rule Change:

The Subcommittee on Attorney Conduct and Healthcare of the Advisory Committee on Bankruptcy Rules considered the amendment of Bankruptcy Rule 2014, and specifically considered the ABI's proposed rule, but rejected implementing any changes in August 2015. In doing so, the Subcommittee noted that such proposals could be implemented as best practices by the US Trustee, courts or practitioners without a rule amendment or official form.