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Whether Section 327 Professional Persons' Legal Fees are the Cost of Doing Business in a Chapter 11 Bankruptcy

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Introduction

When a debtor attempts to reorganize under chapter 11 of title 11 of the United States Code (the "Bankruptcy Code"), the debtor typically remains "in possession"¹ and retains all the rights of the trustee, including the right to administer the bankruptcy estate "as a fiduciary for the estate's creditors" in a chapter 11 bankruptcy case.²

Importantly, a debtor-in-possession and a trustee are empowered to employ third parties to carry out their duties. Section 327 of the Bankruptcy Code deems these individuals "professional persons."³ A professional person may be compensated upon submission of a fee application to the court.⁴ The "scant"⁵ jurisprudence on the extent of permissible payments to professional persons has been the subject of discussion among the bankruptcy community.

¹ 11 U.S.C. § 323 (2012).

² See *Baker Botts L.L.P. v. ASARCO, L.L.C.*, 135 S. Ct. 2158, 2158 (2015). The court is also empowered to appoint a trustee under limited circumstances. 11 U.S.C. § 1104 (2010).

³ 11 U.S.C. § 327 (2012).

⁴ 11 U.S.C. § 330 (2012).

⁵ See *In re Walker Land & Cattle, L.L.C.*, 535 B.R. 348, 352 (Bankr. D. Idaho 2015).

Professional persons are oftentimes subpoenaed or deposed to discuss their particular findings and expertise. In addition to subpoenas and depositions, professional persons must submit fee applications to the court for compensation for services. Understandably, professional persons may hire outside counsel to represent them in both instances. While section 330 of the Bankruptcy Code allows payment of “actual, necessary expenses” for professional persons,⁶ the issue of whether these legal fees apply to the statute remains unclear.

This article examines whether a professional person may successfully receive reimbursement for hiring an attorney to represent him or her in a chapter 11 bankruptcy case. Part I analyzes the relevant Bankruptcy Code provisions that govern the employment of professional persons. Part II discusses four approaches to the legal issue of a professional person’s reimbursement for legal fees under the Bankruptcy Code. Part III discusses the implications of the split of authority with respect to such reimbursements to professional persons.

I. Employing Professional Persons Under the Bankruptcy Code

Bankruptcy cases require the court’s role as a regulatory body and contain built-in procedural mechanisms to “guard against diversion of a bankruptcy estate’s scarce resources to payment of unnecessary or excessive professional expenses.”⁷ Section 327 of the Bankruptcy Code authorizes a trustee to hire “attorneys, accountants, appraisers, auctioneers, or other professional persons.”⁸ The Bankruptcy Code further mandates court approval for employment of professional persons in chapter 11 cases.⁹ The Bankruptcy Code requires timely applications,

⁶ 11 U.S.C. § 330 (2012).

⁷ See *In re Walker Land & Cattle, L.L.C.*, 535 B.R. at 358.

⁸ 11 U.S.C. § 327 (2012).

⁹ *Id.*; see also *In re Crafts Retail Holding Corp.*, 378 B.R. 44, 48 (Bankr. E.D.N.Y. 2007) (stressing “it is therefore essential that the bankruptcy formally approve an [professional person’s] employment before that [professional person] renders services compensable by the estate.”).

notice to interested parties, and bankruptcy court approval of any proposal to employ a professional.¹⁰ Typically, a debtor will file an employment application with the court before the professional person can render services for the trustee.¹¹ To be approved, the professional must be disinterested¹² and “not hold or represent any interest adverse to the estate.”¹³ In essence, professional person’s services must benefit the estate.¹⁴

The Bankruptcy Code mandates procedural safeguards for compensation of professional persons. Section 330 of the Bankruptcy Code provides statutory avenues of recovery for professional persons.¹⁵ In addition to compensation for the services rendered to the trustee,¹⁶ section 330 allows for professional persons to seek “reimbursement for actual, necessary expenses.”¹⁷ Expenses are deemed “actual” if they are not incurred as a result of “guesswork, formula or pro rata allocation,”¹⁸ and, instead, attributable to the bankruptcy client. Courts have generally defined “necessary” in two ways. An expense is necessary if it “was required to accomplish proper representation of the client.”¹⁹ Additionally, an expense is necessary if “required to accomplish properly the task for which the professional was employed.”²⁰

¹⁰ See *In re Walker Land & Cattle, L.L.C.*, 535 B.R. at 351.

¹¹ *Id.* at 349.

¹² 11 U.S.C. § 327 (2012).

¹³ See *In re Borders Grp., Inc.*, 456 B.R. 195, 201 (Bankr. E.D.N.Y. 2007).

¹⁴ See *Max Rouse & Sons, Inc. v. Specialty Plywood Inc.*, 160 B.R. 627, 632 (B.A.P. 9th Cir. 1993) *opinion withdrawn*, 166 B.R. 153 (B.A.P. 9th Cir. 1994).

¹⁵ 11 U.S.C. § 330 (2012).

¹⁶ 11 U.S.C. § 330(a)(1)(a) (2012). Section 330 lists several factors a court may take into consideration to determine reasonable compensation such as: time spent on the services, the rate charged, and the professional person’s experience in the bankruptcy field. *Id.*

¹⁷ 11 U.S.C. § 330(a)(1)(b) (2012).

¹⁸ See 3 COLLIER ON BANKRUPTCY ¶ 330.04-1 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009).

¹⁹ See *Max Rouse & Sons, Inc. v. Specialty Plywood Inc.*, 160 B.R. 627, 632 (B.A.P. 9th Cir. 1993) *opinion withdrawn*, 166 B.R. 153 (B.A.P. 9th Cir. 1994).

²⁰ See *In re Borders Grp., Inc.*, 456 B.R. at 210.

Fundamentally, expense reimbursements must bear a reasonable relationship to the likely amount of the professional's compensation.²¹ The burden lies on the professional person to prove reimbursement for expenses.²²

II. Four General Approaches to Reimbursement of Legal Fees Under Section 330

Bankruptcy courts continue to grapple with the issue of whether employed professional persons may recover legal fees as a reimbursement expense under section 330. Courts have described the existing case law to be “conflicting”²³ and “not easily reconciled.”²⁴ The holdings on this legal issue have been described as “not uniform in either their outcome or analytical approach.”²⁵ On balance, since the retained professionals' fees in chapter 11 cases may be substantial, “it is understandable that courts are reluctant to augment these already substantial costs by adding reimbursement for the professionals' outside counsel.”²⁶ The developing jurisprudence has produced four varying approaches to this legal issue. The analytical approaches discussed below reflect a study of the case law and in no way are meant to represent how the courts may categorize them.

a. *A Professional Person's Outside Counsel was not Properly Employed under Section 327*

One approach with considerable support on the issue of professional person's reimbursement of legal fees has been to “strictly observe” the Bankruptcy Code.²⁷ If the professional person's outside counsel did not comply with section 327, no recovery is allowed. For example, in *In re Crafts Retail Holding Corp.*, a New York bankruptcy court unequivocally

²¹ See *In re Borders Grp., Inc.*, 456 B.R. at 207.

²² See *In re Am. Preferred Prescription*, 218 B.R. 680, 686 (Bankr. E.D.N.Y. 1998).

²³ See *In re Borders Grp., Inc.*, 456 B.R. at 207.

²⁴ *Id.*

²⁵ See *In re Walker Land & Cattle, L.L.C.*, 535 B.R. at 352.

²⁶ See *In re Borders Grp., Inc.*, 456 B.R. at 207.

²⁷ See *In re Crafts Retail Holding Corp.*, 378 B.R. at 48.

held that section 330 is a *per se* bar to reimbursement of non-retained professionals' fees as expenses.²⁸ In that case, a court-approved financial advisor was retained by the debtors in a chapter 11 case. The financial advisor engaged a law firm to finalize its retention with the debtors and subsequently included the law firm's fees in its application to the court.²⁹ Upon ruling against the financial advisor, the court noted that the law firm was not properly retained pursuant to section 327 and, therefore, "not included within the class of persons eligible for compensation"³⁰ under the Bankruptcy Code. The "strong policy reasons" behind the Bankruptcy Code proved dispositive in the court's analysis.³¹ In particular, the court relied on the Honorable Late Judge Learned Hand's observation that the Bankruptcy Act was adopted to "control serious abuses and [is] to be strictly observed; without an order of the court ... not only may he not be retained, but he can recover nothing."³²

Similarly, in *In re Auto Parts Club*, a California bankruptcy court denied a fee application by a court-approved real estate consultant for legal fees incurred by the consultant.³³ In that case, the court strictly adhered to the statute's purpose to allow the court to "control administrative expenses and avoid intervention by unnecessary participants."³⁴ Absent court authorization under section 327, there can be no recovery of fees under section 330.³⁵ In particular, the court noted there was no substantive difference between services directly rendered to the debtor and services rendered to the professional person. For the court, "[e]ither way the estate bears the expense."³⁶

²⁸ See *In re Crafts Retail Holding Corp.*, 378 B.R. at 48.

²⁹ *Id.* at 47.

³⁰ *Id.* at 48.

³¹ *Id.*

³² *Id.* at 48. (citing *In re Eureka Upholstering Co., Inc.*, 48 F.2d 95, 95 (2d Cir. 1931)).

³³ See *In re Auto Parts Club*, 191 B.R. 848, 851 (Bankr. S.D. Cal. 1996).

³⁴ *Id.* at 850.

³⁵ *Id.* at 851.

³⁶ *Id.* at 850.

Therefore, the debtor must initiate the employment of additional professional help, not the professional.³⁷

b. *Outside Counsel Fees are not “Necessary” Expenses*

The Ninth Circuit has denied recovery of legal fees as a reimbursement expense by adopting a strict definition of “necessary.”³⁸ In the eyes of the Ninth Circuit, if the expense at issue does not benefit the debtor’s estate, there can be no recovery under section 330.³⁹ For example, in *Max Rouse & Sons, Inc. v. Specialty Plywood Inc.*, the Ninth Circuit strictly defined “necessary” to disallow a professional person’s reimbursement for outside counsel.⁴⁰ In that case, a court-approved auctioneer sought compensation for services rendered to the debtor. However, the debtor objected to the amount charged by the auctioneer and refused to pay. The auctioneer hired an attorney to prepare a fee application to the court and included the attorney’s legal fees in the application.⁴¹ In ruling against the auctioneer, the court adhered to the strict procedures of the Bankruptcy Code and held that the auctioneer’s attorney was not employed as a professional person and therefore could not recover such legal fees as “actual, necessary expenses.”⁴² Importantly, the court defined “necessary” as “required to accomplish properly the task for which the professional was employed.”⁴³ Since the fees sought did not pertain to the auction itself, the auctioneer could not recover the legal fees as a necessary expense under section 330.⁴⁴

³⁷ See *In re Auto Parts Club*, 191 B.R. at 850.

³⁸ See *Max Rouse & Sons, Inc. v. Specialty Plywood Inc.*, 160 B.R. 627, 632 (B.A.P. 9th Cir. 1993) *opinion withdrawn*, 166 B.R. 153 (B.A.P. 9th Cir. 1994).

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.* at 627.

⁴² *Id.* at 632. The case was later settled. See *Max Rouse & Sons, Inc. v. Specialty Plywood Inc.*, 166 B.R. 153, 153 (B.A.P. 9th Cir. 1994).

⁴³ See *Max Rouse & Sons, Inc. v. Specialty Plywood Inc.*, 160 B.R. 627, 632 (B.A.P. 9th Cir. 1993) *opinion withdrawn*, 166 B.R. 153 (B.A.P. 9th Cir. 1994).

⁴⁴ *Id.* at 633.

This definition of “necessary” was adopted in *In re Walker Land & Cattle, L.L.C.*, where an Idaho bankruptcy court barred a court-approved accountant from recovering legal fees from the debtor.⁴⁵ In *In re Walker Land & Cattle, L.L.C.*, the chapter 11 debtor requested permission to use cash collateral. Upon the request of creditor, Wells Fargo Bank, the court required the debtor to provide audited financial statements. The court approved the employment of accountant Judith K. Brower (“Brower”) to conduct the audit.⁴⁶ After the audit, the creditor issued a notice to depose Brower and a subpoena for Brower to testify at the debtor’s confirmation hearing.⁴⁷ Brower retained counsel for both the deposition and hearing and subsequently sought \$7,735 for reimbursement of her attorney’s fees from the debtor.⁴⁸ In denying Brower’s request, the court ruled that Brower’s retention of outside counsel was not a necessary expense under section 330. Outside counsel was not required to accomplish the purpose for which Brower was employed, performing the audit. Therefore, Brower could not recover legal fees as reimbursement expenses.⁴⁹

c. Professional Persons May Recover Legal Fees for Fee Applications Only

An alternative approach to professional person’s recovery of outside counsel legal fees balances the policy considerations of the Bankruptcy Code with contractual arrangements made between the professional persons and outside counsel. In *In re Borders Group, Inc.*, a New York bankruptcy court allowed a court-approved compensation consultant to recover reimbursement of legal fees in limited circumstances.⁵⁰ Pursuant to an engagement agreement, retained

⁴⁵ See *In re Walker Land & Cattle, L.L.C.*, 535 B.R. at 358.

⁴⁶ *Id.* at 349.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.* at 358.

⁵⁰ See *In re Borders Grp., Inc.*, 456 B.R. at 213.

professionals that hire counsel for purposes of fee applications may be reimbursed for reasonable expenses and the counsel need not be employed under section 327.⁵¹

In that case, the debtor engaged the compensation consultant to render services to the bankruptcy estate. Pursuant to an engagement agreement, the debtor agreed to allow the consultant to recover legal fees.⁵² Upon seeking reimbursement for fees and expenses for services performed, the parties objected to the legal fees incurred.⁵³ In granting the consultant's application, the court noted the absence of statutory authority in the Bankruptcy Code that "counsel retained to represent a retained professional in connection with its retention or fee applications should or even could be retained under section 327."⁵⁴ The court ultimately concluded that existing case law supported recovery of legal fees only on a narrow basis, for the retention or preparation of fee applications.⁵⁵

d. *Professional Persons May Recover Outside Counsel Fees on Fundamental Fairness Grounds*

Notably, two bankruptcy courts have rationalized a carve-out exception for a professional person's recovery of legal fees under the grounds of "fundamental fairness." Although both courts use the exception in different contexts, the courts agree that the Bankruptcy Code does not provide explicit language that encompasses the legal issue at bar and, therefore, may utilize fundamental fairness in granting recovery to the professional person.

In *In re American Preferred Prescription*, a New York bankruptcy court granted a court-approved accountant's request for reimbursement of legal fees under the theory of "fundamental

⁵¹ See *In re Borders Grp., Inc.*, 456 B.R. at 213.

⁵² *Id.* at 200.

⁵³ *Id.* at 202.

⁵⁴ *Id.* at 207.

⁵⁵ *Id.* at 213.

fairness.”⁵⁶ In that case, the debtor accused the accountant of a conflict of interest and filed a motion to disqualify the accountant as a professional person. The accountant then retained an attorney.⁵⁷ In requesting reimbursement expenses, the accountant included the legal fees incurred from litigating the motion.⁵⁸ The court ultimately allowed for recovery of such fees because the debtor’s own actions caused the professional person to incur “defense costs.”⁵⁹ The court recognized the legal fees were necessarily incurred in connection with the work performed.⁶⁰ Moreover, the fact that the legal fees were “incidental costs” to the professional person did not change the court’s analysis.⁶¹ The court defined “necessary” as “incurred because it was required to accomplish the proper representation of the client.”⁶² Since the professional person needed legal assistance to litigate the debtor’s baseless accusations, the legal fees were an “actual, necessary expense.” The court found it significant to make the accountant “whole as a matter of fundamental fairness.”⁶³

Similarly, in *In re Geneva Steel Co.*, a Utah bankruptcy court granted a financial advisor’s recovery of legal fees on the grounds of fundamental fairness.⁶⁴ In that case, the parties approved a financial advisor to render services to the bankruptcy estate.⁶⁵ During the period of employment, the financial advisor submitted a series of fee applications to the court. Particularly, on the second, third, and fourth applications, the parties objected to the professional person’s

⁵⁶ See *In re Am. Preferred Prescription*, 218 B.R. at 687.

⁵⁷ *Id.* at 684 (finding that the accusation was “baseless” and ultimately denying the debtor’s motion).

⁵⁸ *Id.* at 685.

⁵⁹ *Id.* at 687.

⁶⁰ *Id.* at 686.

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.* (citing *Reading Co. v. Brown*, 391 U.S. 471, 479 (1968), as dictating the result in this case).

⁶⁴ See *In re Geneva Steel Co.*, 258 B.R. 799, 803 (Bankr. D. Utah 2001).

⁶⁵ *Id.* at 800.

fees.⁶⁶ The financial advisor retained counsel to litigate the objections and subsequently sought reimbursement expenses for the legal fees from the debtor.⁶⁷ In holding in favor of the professional person, the court recognized that there was no Bankruptcy Code provision “for a professional appointed pursuant to Section 327 to seek appointment of another professional to represent its interests at a fee hearing.”⁶⁸ Therefore, the court ruled that it was fundamentally unfair to allow a non-attorney professional to suffer the financial costs of defending multiple fee applications without being reimbursed.⁶⁹

III. Implications of the Split of Authority

From the perspective of the bankruptcy community, the varying approaches to a professional person’s right to legal fees implicate an inevitable circuit split. For every fee application involving legal fees, a bankruptcy court must reconcile the “sparse”⁷⁰ and “scant”⁷¹ existing case law. This will inevitably result in a cherry-picking approach. Admittedly, courts openly recognize the existing case law is oftentimes difficult to apply.⁷²

One particular difficulty that courts have left unresolved is the definition of “necessary” under section 330. As illustrated above, courts have defined “necessary” as either “required to accomplish the task for which the professional was employed”⁷³ or “required to accomplish the proper representation of the client.”⁷⁴ The courts’ inability to reconcile the two standards contributes to the split in the law.

⁶⁶ See *In re Geneva Steel Co.*, 258 B.R. at 800.

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.* at 803.

⁷⁰ See *In re Borders Grp., Inc.*, 456 B.R. at 203.

⁷¹ See *In re Walker Land & Cattle, L.L.C.*, 535 B.R. at 352.

⁷² See *In re Auto Parts Club*, 191 B.R. at 849.

⁷³ See *In re Borders Grp., Inc.*, 456 B.R. at 202.

⁷⁴ *Id.*

Notwithstanding that the courts have created a means of recovery for professional persons, the strong policy reasons against extending legal fees to professionals as reimbursement fees in a chapter 11 bankruptcy case bears considerable attention. The Bankruptcy Code is a comprehensive and exclusive system of allowances for services and expenses.⁷⁵ By “morphing ... attorney compensation into a garden variety expense,” a court essentially circumvents the statutory requirement of pre-appointment court approval by simply shifting the terminology.⁷⁶ Courts rationalize that the statutory nature of the Bankruptcy Code primarily seeks to protect the bankruptcy estate, not provide a “license to hire other professional persons without court approval.”⁷⁷ This rationale ensures avoidance of intervening, unnecessary participants⁷⁸ with “subcontracting arrangement[s]”⁷⁹ that determine who should render professional services for the estate. Thus, if a professional person desires legal assistance, the professional person should simply request the bankruptcy court to employ outside counsel.

On balance, courts on the opposite end of the spectrum voice a troublesome concern about the status of non-attorney professionals. The court in *In re Geneva Steel Co.* expressed this very concern. “To expect ... a non-attorney professional, to ... absorb the cost of representation itself is fundamentally unfair.”⁸⁰ Since non-attorney professionals do not have the benefits of legal knowledge, they are ill-equipped to represent themselves at fee hearings.⁸¹ Further, courts continue to deny fee applications despite recognizing that professional persons are “justified to

⁷⁵ See *In re Crafts Retail Holding Corp.*, 378 B.R. at 51.

⁷⁶ *Id.* at 50 (advocating against “morphing of attorney compensation into a garden variety expense”).

⁷⁷ *Id.*

⁷⁸ See *In re Auto Parts Club*, 191 B.R. at 850.

⁷⁹ See *In re Borders Grp., Inc.*, 456 B.R. at 209 (warning such arrangement would “eviscerate the protections of section 327(a)”).

⁸⁰ See *In re Geneva Steel Co.*, 258 B.R. at 803.

⁸¹ *Id.*

hire a lawyer.”⁸² Despite this recognition, section 327 non-attorney professional persons such as financial advisors, accountants, and consultants now take the risk of a reduced paycheck. The compensation professional persons expect to receive for service rendered will be reduced from the fees of hiring an attorney. Bankruptcy attorneys have now warned professional persons of the existing case law’s rulings on fees. Professional persons are urged to understand the risks associated with litigating this issue.⁸³

Conclusion

The recovery of expenses for professional persons pursuant to section 330 of the Bankruptcy Code has produced four different analytical approaches. First, bankruptcy courts in New York and California have ruled that section 330 prohibits professional persons from seeking reimbursement for legal fees because the attorneys were not approved under section 327.⁸⁴ Second, the Ninth Circuit and an Idaho bankruptcy court have ruled that professional persons may not recover outside legal fees because such fees are not “necessary expenses” under section 330.⁸⁵ Third, a New York bankruptcy court held that professional persons may recover legal fees for retention and preparation of fee applications only.⁸⁶ Lastly, bankruptcy courts in New York and Utah have allowed professional persons to recover legal fees under section 330 on

⁸² See *In re Walker Land & Cattle, L.L.C.*, 535 B.R. at 358.

⁸³ See George Klidonas, *Practice & Procedure, Fees on Fees Prohibited by the Supreme Court: The Aftershock*, 35-1 AM. BANKR. INST. J., Jan. 2016 at 14, 15. The United States Supreme Court’s recently held in *Baker Botts L.L.P. v. ASARCO L.L.C.*, 135 S. Ct. 2158, 2158 (2015)), that attorney professionals cannot recover for legal fees in litigating a fee application under section 330(a).

⁸⁴ See *In re Crafts Retail Holding Corp.*, 378 B.R. at 48; see also *In re Auto Parts Club*, 191 B.R. at 851.

⁸⁵ See *Max Rouse & Sons, Inc. v. Specialty Plywood Inc.*, 160 B.R. 627, 632 (B.A.P. 9th Cir. 1993) *opinion withdrawn*, 166 B.R. 153 (B.A.P. 9th Cir. 1994); see also *In re Walker Land & Cattle, L.L.C.*, 535 B.R. at 358.

⁸⁶ See *In re Borders Grp., Inc.*, 456 B.R. at 213.

fundamental fairness grounds.⁸⁷ Since the four approaches lack uniformity, lower courts will likely apply their own individual analysis and arbitrarily use the persuasive authority that supports their own rulings.

⁸⁷ See *In re Am. Preferred Prescription*, 218 B.R. at 687; see also *In re Geneva Steel Co.*, 258 B.R. at 803.