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## On the Edge

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### Do Alternative Fee Arrangements Have a Place for Chapter 11 Counsel?



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Today, many privately owned middle-market companies have been acquired by investment funds that are more sophisticated purchasers of legal services and are looking for alternatives to hourly fees. When these companies begin to experience financial stress, management is more likely now than in the past to explore engaging counsel on a fixed or flat fee to minimize the administrative expenses involved in filing a chapter 11 case.

#### Flat Fees, State Law and Bankruptcy

Flat-fee agreements, also known as fixed-fee or advance-payment agreements (all, a "flat fee"), in the context of a chapter 11 case, are payments made by the debtor prior to the petition date in exchange for some or all of the legal services required by the debtor post-petition.<sup>1</sup> Under a flat fee, the entire payment is earned upon receipt, and title to the flat fee passes from the debtor to chapter 11 counsel.<sup>2</sup> Because the flat fee is property of chapter 11 counsel, it does not have to be segregated from chapter 11 counsel's general funds.<sup>3</sup> The debtor has no right to a refund of the flat fee unless chapter 11 counsel fails to perform the contracted legal services.<sup>4</sup>

This is in stark contrast with a security retainer agreement. It too is an advance payment by a debtor for services to be rendered by chapter 11 counsel in the future; however, a security retainer is not earned until chapter 11 counsel provides services to the debtor.<sup>5</sup> It is merely a source of funds against which chapter 11 counsel can draw upon as services are

performed.<sup>6</sup> Accordingly, the debtor retains ownership in any unearned funds in a security retainer.<sup>7</sup>

A flat fee can be very advantageous to both the debtor and chapter 11 counsel. These arrangements can help a debtor estimate its administrative professional fees and eliminate any uncertainty, anxiety and surprise that might arise when a debtor receives an invoice billed at an hourly rate.<sup>8</sup> Chapter 11 counsel could also benefit from a flat fee, as it rewards efficiency and an expedited reorganization, as well as provides certainty of payment at the beginning of the case.<sup>9</sup>

Even so, a flat fee may not be an option for chapter 11 counsel. Section 328(a) of the Bankruptcy Code provides that a debtor in possession may employ chapter 11 counsel "on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, on a fixed- or percentage-fee basis, or on a contingent-fee basis." Even though this section explicitly lists a fixed fee as being a reasonable term and condition of employment, a majority of courts have viewed a flat fee (and every advanced fee payment) as a retainer that must be held in trust pending court approval, and as such, a flat fee cannot be approved.<sup>10</sup> But the landscape appears to be shifting, as more recent decisions have noted that nothing in the Bankruptcy Code renders every advanced fee payment property of the estate.<sup>11</sup> In addition, adopting a *per se* rule that any advanced fee payment is property of the

6 See *In re Werry*, 2011 Bankr. LEXIS 3929 at \*23.

7 See *In re Wagers*, 514 F.3d 1021, 1028 (10th Cir. 2007).

8 See *In re ThreeStrands by Grace LLC*, 2012 WL 1986434 at \*3 (citing *In re Kendall*, 804 N.E.2d 1152, 1175 (Ind. 2004)); *In re Pineloch Enters. Inc.*, 192 B.R. 675, 678 (Bankr. E.D.N.C. 1996).

9 See *In re ThreeStrands by Grace LLC*, 2012 WL 1986434 at \*3 (citations omitted); *In re Pineloch Enterprises Inc.*, 192 B.R. at 678.

10 See *In re Prod. Assocs. Ltd.*, 264 B.R. 180, 187-88 (Bankr. N.D. Ill. 2001); *In re Pineloch Enters. Inc.*, 192 B.R. at 679.

11 See *Barron v. Countryman*, 432 F.3d 590, 595 (5th Cir. 2005); *In re Werry*, 2011 Bankr. LEXIS 3292 at \*21; *In re Prod. Assocs. Ltd.*, 264 B.R. at 189; *In re McDonald Bros. Const. Inc.*, 114 B.R. at 997.

1 See *In re Werry*, No. 11-01710-JDP, 2011 Bankr. LEXIS 3292 at \*22 (Bankr. D. Idaho Aug. 26, 2011).

2 See *In re ThreeStrands by Grace LLC*, No. 12-00756-JKC-11, 2012 WL 1986434 at \*2 (Bankr. S.D. Ind. June 1, 2012); *In re Blackburn*, 448 B.R. 28, 38 (Bankr. D. Idaho 2011); and *In re SVI Media Inc.*, Nos. 07-82762, 07-82763, 2008 Bankr. LEXIS 3587 at \*6-7 (Bankr. C.D. Ill. Oct. 31, 2008).

3 See *In re ThreeStrands by Grace LLC*, 2012 WL 1986434 at \*2.

4 See *id.* at \*3.

5 See *id.*; and *In re McDonald Bros. Constr. Inc.*, 114 B.R. 989, 999 (Bankr. N.D. Ill. 1990).

estate would render § 328 superfluous.<sup>12</sup> Instead, these courts turn to state law to determine whether the debtor's estate has any interest in the advanced fee payment in question.<sup>13</sup>

When determining whether a flat fee is authorized under state law, chapter 11 counsel must consider case law as well as state ethical rules and regulations.<sup>14</sup> A complete review is paramount, as the concept of flat fees passing title to the attorney upon receipt and the absence of a need to segregate the attorney may violate state ethical rules.<sup>15</sup>

## Documenting a Flat Fee Engagement

Assuming that state law allows chapter 11 counsel to be engaged pursuant to a flat fee, state law will also dictate how such an engagement should be memorialized. For example, Illinois law provides that a flat fee should be used sparingly and only when necessary to accomplish some purpose for the client that cannot be obtained by using a security retainer.<sup>16</sup> In addition, the retention agreement must use the exact term of a flat fee, advise the client of the option to use a security retainer (the choice of retainer is the client's alone), and set forth the special purpose of the retainer and why a flat fee is advantageous to the client.<sup>17</sup> This is in contrast with Indiana law, which encourages flat fees and merely suggests that any flat-fee agreement state that the flat fee is nonrefundable unless the attorney fails to perform the agreed upon legal services.<sup>18</sup> Whatever the retention agreement, it is the substance—not the title—that will control whether the agreement is a flat fee or a security retainer.<sup>19</sup>

As flat fees and security retainers are both advances in anticipation of future services, the distinguishing feature is whether the debtor retains an interest in the retainer. If the debtor retains any interest in the retainer, it is a security retainer and is considered property of the estate under § 541 of the Bankruptcy Code.<sup>20</sup> If there is no reversionary interest, then it is a flat fee, which is property of chapter 11 counsel and is not part of the estate.<sup>21</sup>

## Obtaining Court Approval of a Flat Fee Agreement under § 328(a)

Whether a debtor has an interest in chapter 11 counsel's retainer has significant bearing on the application and compensation process. If a debtor has an interest in the retainer, then any payment made to chapter 11 counsel during the case will come from the estate and will be reviewed by the court after work is complete through fee applications submitted pursuant to §§ 330 and 331 of the Bankruptcy Code.<sup>22</sup> If the

debtor has no interest in the retainer, §§ 330 and 331 are inapplicable because there are no payments from the estate to review.<sup>23</sup> Instead, the entirety of the flat fee is reviewed under § 328(a) at the outset of the engagement.<sup>24</sup> If an engagement agreement is ambiguous as to the type of retainer, courts generally treat the retainer as a security retainer.<sup>25</sup>

A flat fee engagement under § 328(a) must still contain terms and conditions that a court finds reasonable. Noting the implications of an approved flat fee under § 328(a), one court has held that a flat fee will be approved “only after reviewing the circumstances of each case with a high level of scrutiny.”<sup>26</sup> Considerations include (1) the stated reasons for the flat fee; (2) the parties' understanding of the flat fee; (3) the source of funds used to pay the flat fee; (4) the amount of the flat fee given the facts, issues and complexities of the case; and (5) the ability of chapter 11 counsel to repay some or all of the flat fee if warranted.<sup>27</sup>

Courts have also modified the terms of a flat fee before approving the engagement under § 328(a). Such judicially imposed conditions include (1) quarterly and final applications showing fees and expenses to allow the court to ensure that the flat fee was not improvident and does not exceed the reasonable value of the services provided;<sup>28</sup> (2) requiring segregation of the flat fee and creating three intervals in which chapter 11 counsel would be deemed to have “earned” the funds;<sup>29</sup> and (3) reserving the right to review the flat fee under the reasonableness standard of § 330.<sup>30</sup>

## Review under the “Improvident” Standard

Assuming that chapter 11 counsel can obtain an order authorizing a flat fee under § 328(a), and assuming that the order does not fundamentally change the nature of the flat fee, what further oversight does the court have over chapter 11 counsel's fees? The answer lies further on in § 328(a).

Section 328(a) provides that a court may alter the terms and conditions of a flat fee “if such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions.” However, modification under § 328(a) “is severely constrained,” and any motion seeking to modify such terms “has a high hurdle to clear.”<sup>31</sup> Unanticipated circumstances are not enough to satisfy the improvident standard; rather, the developments and circumstances requiring modification must not have been capable of anticipation in order for the court to revisit a flat fee approved under § 328(a).<sup>32</sup> As such, modification of a flat fee has been rejected where (1) a contingency-fee case was settled after 2.7 hours of work, equating to an hourly rate of \$1,235;<sup>33</sup> (2) the divergent positions of the debtor and unsecured creditors resulted in the rejection of multiple settle-

23 *In re ThreeStrands by Grace LLC*, 2012 WL 1986434 at \*5-6; *In re McDonald Bros. Const. Inc.*, 114 B.R. at 1002.

24 *In re Citation Corp.*, 493 F.3d at 1318; *Barron v. Countryman*, 432 F.3d at 596 and 596 n. 5; *In re ThreeStrands by Grace LLC*, 2012 WL 1986434 at \*4-6.

25 See *In re Werry*, 2011 Bankr. LEXIS 3292 at \*13-14.

26 *In re ThreeStrands by Grace LLC*, 2012 WL 1986434 at \*4.

27 *Id.*

28 *Id.*

29 *In re Pineloch Enters. Inc.*, 192 B.R. at 679.

30 *In re Citation Corp.*, 493 F.3d at 1316.

31 *In re SmartWorld Technologies LLC*, 552 F.3d 228, 234-35 (2d Cir. 2009).

32 *Id.* at 232; *In re Asarco LLC*, 457 B.R. 575, 581 (S.D. Tex. 2011); *In re Gilbertson*, No. 06-C-610, 2007 WL 43096 at \*2 (E.D. Wis. Feb. 4, 2007).

33 *Id.* at \*5.

12 See *In re Prod. Assocs. Ltd.*, 264 B.R. at 189.

13 See *Butner v. U.S.*, 440 U.S. 48, 54 (1979); see also *In re Wagers*, 514 F.3d at 1028, and *In re ThreeStrands by Grace LLC*, 2012 WL 1986434 at \*2.

14 *In re Werry*, 2011 Bankr. LEXIS 3292 at \*25; *In re E-Z Serve Convenience Stores Inc.*, 299 B.R. 126, 130 (Bankr. M.D.N.C. 2003).

15 Compare *In re ThreeStrands by Grace LLC*, 2012 WL 1686434 at \*2 (Indiana law recognizes flat fee); *In re SVI Media Inc.*, 2008 Bankr. LEXIS 3587 at \*6-7 (Illinois law recognizes flat fee); and *In re E-Z Serve Convenience Stores Inc.*, 299 B.R. at 130 (North Carolina law recognizes flat fee in limited circumstances); with *In re Danner*, No. 11-00651-TLM, 2011 Bankr. LEXIS 2077 at \*13-15 (Bankr. D. Idaho May 26, 2011) (flat fee may be in contravention of Idaho law); and *In re NBI Inc.*, 129 B.R. 212, 222 (Bankr. D. Col. 1991) (noting that flat fee was contrary to Colorado disciplinary decisions).

16 *In re SVI Media Inc.*, 2008 Bankr. LEXIS 3587 at \*7 (citing *Dowling v. Chicago Options Assocs. Inc.*, 875 N.E.2d 1012 (Ill. 2007)).

17 *Id.* (citations omitted).

18 *In re ThreeStrands by Grace LLC*, 2012 WL 1986434 at \*3.

19 *Id.* at \*2; *In re Werry*, 2011 Bankr. LEXIS 3292 at \*23.

20 *In re Wagers*, 514 F.3d at 1028; *In re Sheridan*, 215 B.R. 144, 146 (Bankr. N.D. Ill. 1996).

21 *Barron v. Countryman*, 432 F.3d at 596; *In re McDonald Bros. Constr. Inc.*, 114 B.R. at 1002.

22 *In re Citation Corp.*, 493 F.3d 1313, 1318 (11th Cir. 2007).

ments;<sup>34</sup> (3) the law firm received instructions from both the officers and shareholders of the debtor;<sup>35</sup> (4) litigation was unusually long and protracted;<sup>36</sup> and (5) the law firm proved to be an obstacle—not an asset—to ultimate settlement.<sup>37</sup> In contrast, the following four factors, when combined, were deemed incapable of anticipation: (1) length of proceeding where initial engagement was to be for one month culminating in a sale; (2) significant unforeseen debtor management and reporting deficiencies; (3) the debtor's chief financial officer was replaced twice in the first months of the case; and (4) the lack of leadership of debtor, which had always taken instructions from a nondebtor parent.<sup>38</sup>

## Practical Considerations When Considering Flat-Fee Retainers

There are several practical issues for chapter 11 counsel to consider prior to seeking engagement pursuant to a flat fee. To accurately gauge the costs of a chapter 11 case, counsel must, prior to filing, estimate (1) the length of the case, (2) the litigiousness of creditors, (3) cash use/post-petition financing issues and (4) possible operational issues. Furthermore, the flat fee cannot be too high, or chapter 11 counsel risks running afoul of Model Rule of Professional Conduct 1.5(a)'s requirement that an attorney not make an agreement for an unreasonable fee. Nor should the flat fee be too low, as chapter 11 counsel must meet the improvident standard for any upward adjustment. Finally, even if chapter 11 counsel can formulate a reasonably accurate cost estimate, does the debtor have the financial wherewithal to pay the proposed flat fee?

A number of cases cited herein show that there are some occasions where an alternative fee arrangement in the form of a flat fee might be appropriate for chapter 11 counsel. However, given the difficulty in quoting a flat fee and the heavy burden required to modify a flat fee, such arrangements appear to have limited application. **abi**

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<sup>34</sup> *In re SmartWorld Technologies LLC*, 552 F.3d at 235.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> *In re Asarco LLC*, 457 B.R. at 582-585.