SECTIONS 327 THROUGH 330: RECENT DEVELOPMENTS IN THE LAW OF EMPLOYMENT AND COMPENSATION OF BANKRUPTCY PROFESSIONALS

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I. Introduction

Sections 327 through 330 of the Bankruptcy Code[1] provide the rules and standards that govern the employment and compensation of bankruptcy professionals. While each Code provision governs separate aspects of the employment and compensation of professionals, taken as a whole, and with certain related Federal Rules of Bankruptcy Procedures,[2] these sections comprehensively govern employment issues in bankruptcy cases. This article reviews and discusses some of the noteworthy developments in this area from 2018.

Section 327 of the Bankruptcy Code[3] governs the trustee or debtor in possession's[4] ability to retain professionals. Section

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[1]Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, 11 U.S.C.A. §§ 101, et seq. (2012) (hereinafter "the Code" or "the Bankruptcy Code").

[2]See, e.g., Fed. R. Bankr. P. 2014.

[3]Section 327 reads:

> **(a)** Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

327 requires both court approval of any retention and that the proposed professional is disinterested and does "not hold or represent an interest adverse to the estate . . ."[5] Section 327 of the Bankruptcy Code governs hiring estate professionals "to represent or assist" the *debtor* in carrying out its duties under the Bankruptcy Code.[6] While seemingly conventional estate professionals—such as "attorneys, accountants, appraisers, [and] auctioneers"—are set out in the Bankruptcy Code, who may fall into those categories and their obligations are often left to the courts to decide.[7]

First, this article discusses recent developments regarding who is a "professional" under section 327. Next, this article analyzes recent decisions regarding duties owed by professionals under section 327, including with respect to other professionals and compensation.

(b) If the trustee is authorized to operate the business of the debtor under section 721, 1202, or 1108 of this title, and if the debtor has regularly employed attorneys, accountants, or other professional persons on salary, the trustee may retain or replace such professional persons if necessary in the operation of such business.

(c) In a case under chapter 7, 12, or 11 of this title, a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest.

(d) The court may authorize the trustee to act as attorney or accountant for the estate if such authorization is in the best interest of the estate.

(e) The trustee, with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed.

(f) The trustee may not employ a person that has served as an examiner in the case.

11 U.S.C.A. § 327.

[4]See 11 U.S.C § 1107(a) ("[A] debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all the functions and duties, except the duties specified in sections 1106(a)(2), (3), and (4) of this title, of a trustee serving in a case under this chapter.").

[5]See 11 U.S.C.A. § 327(a).

[6]See 11 U.S.C.A. § 327(a).

[7]See 11 U.S.C.A. § 327(a).

II. When is a Professional a "Professional"? —Recent Decisions Concerning Retention Under Sections 363 v. 327

A. Retention of Liquidators—*Heritage Home* and *Brookstone*

In two cases decided within just days of each other—*In re Heritage Home Grp. LLC*[8] and *In re Brookstone Holdings Corp.*[9]—two Delaware bankruptcy judges held, in the face of objections from the United States Trustee, that the retention of liquidators[10] under sections 363 and 365 of the Bankruptcy Code was appropriate. Liquidators are commonly retained by chapter 11 retail debtors, providing "valuable services to debtors relating to disposition and monetization of inventory, real estate, intellectual property and other estate assets."[11] Liquidators (like Hilco, Gordon Brothers, Great American, Tiger Capital, and SB360) commonly enter into a services contract with a debtor, who seeks to engage the liquidator in bankruptcy pursuant to sections 363(b) and 365(a) of the Bankruptcy Code.[12]

In both *Heritage Home* and *Brookstone*, the United States Trustee argued that the debtors' chosen liquidators needed to be retained pursuant to section 327 of the Bankruptcy Code, which provides that a debtor "may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons."[13] In both cases, the United States Trustee argued that the liquidators were either "auctioneers" or "other professional persons" such that they were required to be retained under section 327, and thus could not be retained

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[8] *In re Heritage Home Group LLC*, 66 Bankr. Ct. Dec. (CRR) 70, 2018 WL 4684802 (Bankr. D. Del. 2018) (Gross, J.).

[9] *In re Brookstone Holdings Corp.*, 592 B.R. 27, 66 Bankr. Ct. Dec. (CRR) 81 (Bankr. D. Del. 2018) (Shannon, J.).

[10] In *Heritage Home*, the liquidator was SB360 Capital Partners, LLC and in *Brookstone*, the liquidator was a joint venture of Gordon Brothers Retail Partners, LLC and Hilco Merchant Resources, LLC.

[11] Brookstone, 592 B.R. at 28.

[12] 592 B.R. at 28.

[13] 11 U.S.C.A. § 327(a).

pursuant to sections 363(b) and 365(a).[14] In both cases, the bankruptcy courts were easily able to conclude that the liquidators were not auctioneers. Noting that the Bankruptcy Code does not define "auctioneer," both courts looked to the common usage of the term, which involves calling for bids during either a public or private auction.[15] Rather than conducting any semblance of an auction, the liquidators were selling inventory "in a manner typical of a retail store," and thus were not "auctioneers" under section 327 of the Bankruptcy Code.[16]

Just like "auctioneer," "professional" is a term left undefined in the Bankruptcy Code, and "courts have struggled to identify clear principles to use to determine whether a given employee is an 'other professional' which must be retained under § 327(a)."[17] However, both Judge Shannon and Judge Gross looked to the *First Merchants*[18] decision for guidance. Indeed, Judge Shannon cited to Judge Gross' summary of the *First Merchants* standard: "What is clear in *First Merchants* is that a 'professional' is limited to those occupations which control, purchase or sell assets that are important to reorganization, is negotiating the terms of a plan of reorganization, [and] has discretion to exercise his or her own personal judgment . . ."[19]

In both cases, the court focused on the advisory nature of the services provided by the liquidator; while the liquidators had the ability to suggest pricing strategy and "going out of business" sale timing, the debtors retained complete control

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[14]Brookstone, 592 B.R. at 32; *In re Heritage Home Group LLC*, 66 Bankr. Ct. Dec. (CRR) 70, 2018 WL 4684802, *2–3 (Bankr. D. Del. 2018).

[15]Brookstone, 592 B.R. at 33; Heritage Home, 2018 WL 4684802, at *3.

[16]Brookstone, 592 B.R. at 33.

[17]592 B.R. at 34.

[18]*In re First Merchants Acceptance Corp.*, 1997 WL 873551 (D. Del. 1997).

[19]Brookstone, 592 B.R. at 29 (citing Heritage Home, 2018 WL 4684802, at *3). Both cases recognize that one of the *Heritage Home* factors is whether the purported professional has "some degree of special knowledge or skill," but downplay such factor's importance, with Judge Shannon going so far to say in "all candor" that such prong is "entirely unhelpful" because "literally all business and service activities require 'specialized knowledge or skill' on the part of the provider." Brookstone, 592 B.R. at 37.

over whether to implement such suggestions.[20] Additionally, Judge Shannon noted in *Brookstone* that while the liquidator had an important role in the debtors' bankruptcy cases, "there is considerable distance between Hilco's assistance in inventory disposition, and the negotiation and implementation of a reorganization strategy that will be embodied in a plan."[21] Thus, both Judge Gross and Judge Shannon found that the liquidators were not "professionals" within the meaning of section 327 of the Bankruptcy Code, and therefore could be retained pursuant to sections 363 and 365.

Judge Shannon candidly noted the reason why debtors almost invariably seek to retain liquidators under sections 363 and 365, as opposed to section 327. "[I]nformed by decades of experience with the potential pitfalls of even the most promising retail restructurings, Hilco and the Debtor left open and expressly contemplated that Hilco might be called upon or invited to play other roles in the case as circumstances may require, such as buying estate assets or even serving as a lender."[22] However, if a liquidator is a professional retained under section 327 of the Bankruptcy Code, "it would likely be precluded from engaging in further transactions with the Debtor" because of the disinterestedness standard contained within that Bankruptcy Code section.[23]

B. Yes, A Debtor Can Still Retain Management Consultants Under Section 327—*Nine West*

On occasion, a chapter 11 debtor will seek to retain a firm as a management consultant, often to provide the debtor with interim officers. In *Nine West*,[24] the debtors sought to retain Alvarez & Marsal North America, LLC ("A&M") pursuant to section 363(b) of the Bankruptcy Code to provide the debtors with an interim CEO, Ralph Schipani, and other personnel as

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[20] Brookstone, 592 B.R. at 36–37; Heritage Home, 2018 WL 4684802, at *3–4.

[21] Brookstone, 592 B.R. at 37; see also Heritage Home, 2018 WL 4684802, at *3(stating that the liquidator "is not at the center of Debtors' reorganization").

[22] Brookstone, 592 B.R. at 31–32.

[23] 592 B.R. at 33.

[24] *In re Nine West Holdings, Inc.*, 588 B.R. 678, 65 Bankr. Ct. Dec. (CRR) 240 (Bankr. S.D. N.Y. 2018).

necessary. The United States Trustee objected, claiming that A&M could only be retained pursuant to section 327.

In a strongly-written opinion, Judge Chapman not only held that it was appropriate for the debtors to retain A&M and Mr. Schipani pursuant to section 327 of the Bankruptcy Code, but that the United States Trustee's objection to their retention amounted to a direct contradiction of "the U.S. Trustee's national policy over the last 14 years of explicitly assenting to retention applications for management consultants pursuant to section 363(b) in similar circumstances."[25] Specifically, Judge Chapman was referring to the so-called Jay Alix Protocol,[26] which began as a settlement agreement between the United States Trustee and a management consultancy firm, but that "has developed into a national policy adopted by the U.S. Trustee whereby the U.S. Trustee assents to—indeed, directs—the retention of distressed management consultants by a debtor pursuant to section 363 of the Code so long as the firm complies with certain requirements contained in the Protocol."[27]

1. Management Consultants and the Jay Alix Protocol

The Jay Alix Protocol began in 2004 as a settlement agreement between the United States Trustee and Jay Alix & Associates, a management consultant.[28] At its core, the Protocol has four requirements: (1) the firm must only serve in one capacity (i.e. financial advisor, crisis manager, claims agent, or investor); (2) the retention application must be filed under section 363 of the Bankruptcy Code, but must also disclose relationships with interested parties; (3) the firm must file monthly staffing reports; and (4) retention of persons furnished by the firm must be approved by and act under the direction of independent directors.[29] The Protocol is therefore "designed to avoid the 'inherent conflict' between an advisor's duty to a debtor and its own business interests where the advisory firm serves both as a financial advisor retained pursu-

[25]Nine West, 588 B.R. at 683.

[26]Or, the "Protocol."

[27]588 B.R. at 688.

[28]588 B.R. at 688.

[29]588 B.R. at 688.

ant to section 327 of the Bankruptcy Code and as a crisis manager with firm staff serving as officers of the debtor corporation."[30]

The effect and importance of the Protocol is that "companies approaching financial distress have been able to meet their needs for operational resources by engaging management consultancy firms to run the day-to-day management of such companies and, at times, to serve as their interim officers."[31] If the United States Trustee's objection to A&M's retention in *Nine West* was sustained, Judge Chapman noted, it would "disrupt company management" because if section 327 was the only means of retention available, "firms that previously provided firm personnel to fill necessary management roles would be jettisoned when the company files for chapter 11 by virtue of the fact that, having served as officers of the debtor, the firm and its personnel are arguably not disinterested."[32]

In overruling the United States Trustee's objection, the *Nine West* court noted that the Trustee not only fails to mention the Protocol, but found that its position "ignores [its] prior position with respect to section 363 retentions . . . implying that there was clear error in every case in which a bankruptcy court has in the past approved an A&M retention pursuant to section 363(b)."[33] To that end, the court found that "the purpose of the protocol . . . has not been violated here"[34] and to allow the United States Trustee to reverse course with respect to its application of the Protocol would be "starkly inequitable."[35]

2. Management Consultants as "Professional Persons"

Although Judge Chapman found that A&M was properly retained under section 363(b) of the Bankruptcy Code, she did also discuss whether A&M was a "professional person" under section 327. In the Second Circuit, the court noted that " 'professional persons' are defined to include firms or indi-

[30] 588 B.R. at 688.

[31] 588 B.R. at 691.

[32] 588 B.R. at 691.

[33] 588 B.R. at 689.

[34] 588 B.R. at 689.

[35] 588 B.R. at 690.

viduals who have been 'hired for the purpose of reorganizing the corporation or otherwise assisting it through the Chapter 11 bankruptcy process."[36] This, the court noted, is in contrast to "officers responsible for the day-to-day business of the debtor."[37] In *Nine West*, the court noted that the services that A&M provided "have remained largely unchanged" since it was retained four years prior to the bankruptcy filing, "albeit augmented by certain bankruptcy-related responsibilities."[38] In other words, A&M and A&M personnel have been in the "role of managing the daily operations of the Debtors' business" and "any services it has performed relating to the Debtors' chapter 11 processes have been services that could have been performed by existing company personnel . . . had the necessary resources been available within the company."[39] Thus, the *Nine West* court found that because A&M's services were focused on running the Debtors' business, separate and apart from its bankruptcy-specific professionals, A&M was not a "professional person" within the meaning of section 327 of the Bankruptcy Code.[40]

III. Duties and Disclosure Under Section 327

A. Counsel for the Debtor Does Not Owe Duties to Other Estate Professionals

Counsel for the debtor often assists other estate professionals with submitting retention applications, fee applications, and other pleadings. Such accommodations, however, may implicate section 327 of the Bankruptcy Code, particularly where a dispute arises. For example, in *Jackson v. GSO Business Management, LLC (In re Jackson)*,[41] the court held that counsel for the debtor did not owe any duties to the debtor's former accountant. There, GSO served as the debtor's business managers and accountants until terminated postpetition

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[36] 588 B.R. at 693 (quoting *In re SageCrest II, LLC*, 2011 WL 134893 (D. Conn. 2011)).

[37] 588 B.R. at 693 (cleaned up).

[38] 588 B.R. at 694–95.

[39] 588 B.R. at 694.

[40] 588 B.R. at 695.

[41] *In re Jackson*, 2018 WL 3218097 (Bankr. D. Conn. 2018).

by the debtor.[42] Prior to its termination, GSO was an estate professional. Counsel for the debtor, Neligan LLP,[43] drafted, filed, and resolved objections to GSO's retention application.[44] After the debtor terminated GSO, Neligan and GSO worked on a number of drafts of GSO's fee application.[45] GSO's fee application was never filed.

Subsequently, the debtor commenced an adversary proceeding against GSO, alleging, among other things, that GSO failed to make a tax election on behalf of the debtor and his estate and wrongfully paid itself fees during the pendency of the case without court approval.[46] GSO then filed a complaint against Neligan, asserting a claim for indemnification.[47] GSO argued that Neligan was negligent in performing a duty it owed to GSO to file a fee application in the main case, and thus Neligan must indemnify GSO for any liability it may have to the debtor.[48] Neligan moved to dismiss, arguing that "Neligan could not have owed a duty to GSO as a matter of law, and consequently could not have been negligent regarding the [f]ee [a]pplication."[49]

The court was not willing to accept GSO's allegation "that in seeking assistance with the preparation of [its retention application] it imposed a duty on Neligan[] to prepare and file the fee application on behalf of GSO . . ."[50] The court noted that Neligan was retained as counsel for *only* the debtor under section 327 of the Bankruptcy Code, and therefore could not be counsel to GSO as well.[51] Indeed, section 327 of the Bankruptcy Code requires that professionals hired by the debtor "must: (1) be disinterested; and, (2) not hold or represent any interest adverse to the estate," and that "[c]ounsel for a chapter 11 debtor owes a fiduciary duty of loyalty and

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[42] 2018 WL 3218097 at *2.

[43] Hereinafter "Neligan."

[44] 2018 WL 3218097 at *2.

[45] See 2018 WL 3218097 at *2.

[46] See 2018 WL 3218097 at *1.

[47] See 2018 WL 3218097 at *1.

[48] See 2018 WL 3218097 at *1.

[49] 2018 WL 3218097 at *1.

[50] 2018 WL 3218097, at *3.

[51] 2018 WL 3218097 at *3.

care to his client, which is the debtor-in-possession, not the debtor's principals."[52] Based on those standards, the court reasoned that if the "debtor's counsel [was] to be an advisor or agent to a party in interest in a debtor's case other than the debtor, that would be a conflict of interest violating the two prongs of section 327(a)."[53] Therefore, the court declined to find that counsel for the debtor had, or could have, a duty to a party in interest, let alone a duty to GSO that would give rise to a claim for indemnification.

B. "Buyer's Premiums"

Chapter 7 trustees often seek to retain auctioneers under section 327 of the Bankruptcy Code in order to liquidate a debtor's assets. Over the past several years, it has become common for auctioneers to charge a "buyer's premium" as part of their overall compensation.[54] "Simply stated, [a buyer's premium] is adding [a] sales commission as an obligation to the buyer after the bid."[55] For example, if the winning bid is $100, and the buyer's premium is 10%, the winning bidder's final invoice would be $110.[56] Notably, a buyer's premium is often in addition to sales commissions generally charged by auctioneers. While the appropriateness of buyer's premiums in the bankruptcy context is subject to debate,[57] they should be disclosed at the outset.

In *In re THR & Assocs.*, the court consolidated two cases where the same auctioneer sought approval of compensation that was not fully disclosed when the auctioneer was retained. In both cases, the chapter 7 trustee filed an application to

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[52]2018 WL 3218097 at *4 (internal quotation omitted) (citing *In re Angelika Films 57th, Inc.*, 227 B.R. 29, 39, 33 Bankr. Ct. Dec. (CRR) 535 (Bankr. S.D. N.Y. 1998), opinion aff'd, 246 B.R. 176 (S.D. N.Y. 2000)).

[53]2018 WL 3218097 at *4.

[54]See *In re THR & Associates, Inc.*, 65 Bankr. Ct. Dec. (CRR) 28, 2018 WL 279741, *2 (Bankr. C.D. Ill. 2018).

[55]Leslie H. Miles Jr., Buyer's Premium, 18-Oct Am. Bankr. Inst. J., 26 (Oct. 1999).

[56]See Miles, supra n. 55.

[57]*In re THR & Associates, Inc.*, 65 Bankr. Ct. Dec. (CRR) 28, 2018 WL 279741, *2 (Bankr. C.D. Ill. 2018) (noting "while the charging of buyer's premiums has become increasingly common, the use and impact of the buyer's premium in auctions is still a subject of debate and confusion, even within the industry." (citation omitted)).

employ the auctioneer to sell vehicles. The proposed compensation was described in the retention applications as a 5% commission on the sale price, plus transporting fees. In only one of the cases, the retention application included a statement that that the auctioneer "charges a buyer's premium of 5% for all auctions other than for the sale of agricultural equipment."[58] However, both retention applications did state that all proceeds would be turned over to the trustee and that the auctioneer did not have an adverse interest to the respective estates. In both cases, the auctioneer's fees and costs were subject to court approval.[59] After the auctions, the auctioneer filed fee applications, seeking its commissions and reimbursement of expenses. Neither fee application disclosed the amount of the buyer's premiums, but stated that the amounts were not paid by the estates. Notably, in response to an inquiry from the court in the second case, the trustee stated that the buyer's premium was mistakenly not included in the retention application and the amount was refunded to the winning bidder.

In ruling on the fee applications, the court stated at the outset that "[r]egardless of whether hiring auctioneers who charge buyer's premiums is a wise choice, trustees and auctioneers cannot ignore the requirements of the Code and Rules related to the employment and compensation of professionals."[60] Indeed, the trustee did not argue that undisclosed fees should be paid, and cited cases that make clear that a buyer's premium must be disclosed at retention.[61] The court reasoned that an interest adverse to the estate under section 327 of the Bankruptcy Code has been described as an

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[58] 2018 WL 279741 at *1.

[59] See 2018 WL 279741 at *1.

[60] 2018 WL 279741 at *3.

[61] See 2018 WL 279741 at *3–4 (citing *In re Carpenter*, 392 B.R. 97, 107 (Bankr. D. Vt. 2008), subsequent determination, 2008 WL 3060739 (Bankr. D. Vt. 2008); *In re Driller*, 2004 WL 1661981, *5 (Bankr. D. Idaho 2004); *In re Deliverance Christian Church*, 2013 WL 5954686, *4 (Bankr. N.D. Ohio 2013) ("A buyer's premium is a material term that must be explicitly included in the [sale] order if it is desired to be in effect."); *In re Remote Operating Systems, Inc.*, 238 B.R. 656, 658, 660 (Bankr. N.D. Tex. 1999) (noting that the United States Trustee's guidelines require disclosure and court approval at the time of employment for an auctioneer to charge a buyer's premium)).

interest "that would tend to lessen the value of the bankruptcy estate,"[62] and if professionals "were free to make undisclosed compensation arrangements with third parties related to the work that they were doing for the bankruptcy estate, then it would be impossible to police the requirement that such professionals have no interests adverse to the estate."[63] Based on the above, and the disclosure requirements in the Bankruptcy Code and rules, the court denied the fee application in the first case for including costs inconsistent with the court-approved terms of employment.

The court also considered the reasonableness of the compensation under section 330 of the Bankruptcy Code. The trustee argued that the fees were not property of the estate, and thus not subject to review. The court disagreed, noting that "the weight of authority holds that amounts charged, retained, or collected as a buyer's premium are property of the bankruptcy estate" under section 541 of the Bankruptcy Code.[64] Moreover, Rule 2016(a) requires that fee applications include "a statement as to what payments have . . . been made or promised to the applicant . . ."[65] Even though "it is compensation from the estate that must be approved by the court, compensation paid or promised from all sources is undeniably relevant to determining the reasonableness of compensation sought from the estate by a professional" under section 330 of the Bankruptcy Code.[66] The court denied both fee applications without prejudice, reminding professionals of the importance of full and continuing disclosure in bankruptcy.

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[62] *In re THR & Associates, Inc.*, 65 Bankr. Ct. Dec. (CRR) 28, 2018 WL 279741, *3 (Bankr. C.D. Ill. 2018) (quoting *In re Crivello*, 134 F.3d 831, 835, 31 Bankr. Ct. Dec. (CRR) 1258, 39 Collier Bankr. Cas. 2d (MB) 213, Bankr. L. Rep. (CCH) P 77603 (7th Cir. 1998) (quotation omitted)).

[63] *In re THR & Associates, Inc.*, 65 Bankr. Ct. Dec. (CRR) 28, 2018 WL 279741, *3 (Bankr. C.D. Ill. 2018).

[64] 2018 WL 279741 at *4.

[65] Fed. R. Bankr. P. 2016(a).

[66] *In re THR & Associates, Inc.*, 65 Bankr. Ct. Dec. (CRR) 28, 2018 WL 279741, *5 (Bankr. C.D. Ill. 2018).