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

By Steven Golden[*] and Raff Ferraioli[**]

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 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 2019.

First, this article discusses recent developments regarding "disinterestedness" in modern chapter 11 practice. Second, this article discusses a recent case applying and extending *ASARCO* to fees incurred by a chapter 7 trustee in defending his fees.

II. Disinterestedness and Chapter 11 Practice

Section 327 of the Bankruptcy Code[3] governs the trustee or

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[*]Steven Golden is an associate at Pachulski Stang Ziehl & Jones LLP. Steve received his J.D. from Georgia State University and LL.M. in Bankruptcy from St. John's University School of Law.

[**]Raff Ferraioli is an associate at Morrison & Foerster LLP. Raff received his J.D. and LL.M. in Bankruptcy from St. John's University School of Law. The authors would like to thank Professor Richard Lieb for his guidance on this project.

[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:

debtor in possession's[4] ability to retain professionals. Section 327 requires both court approval of any retention and that the proposed professional is disinterested[5] and does "not hold or represent an interest adverse to the estate . . ."[6] Courts

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(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.

(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]Pursuant to 11 U.S.C.A. § 101(14), a disinterested person "does not have an interest materially adverse to the interest of the estate or 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 for any other reason." 11 U.S.C.A. § 101(14).

[6]See 11 U.S.C.A. § 327(a); see also *In re WorldCom, Inc.*, 311 B.R. 151, 163, 43 Bankr. Ct. Dec. (CRR) 61 (Bankr. S.D. N.Y. 2004); see also *In re Project Orange Associates, LLC*, 431 B.R. 363, 370, 53 Bankr. Ct. Dec. (CRR) 114 (Bankr. S.D. N.Y. 2010) (citing *In re AroChem Corp.*, 176 F.3d 610, 622–23, 41 Collier Bankr. Cas. 2d (MB) 1647, Bankr. L. Rep. (CCH) P 77933 (2d Cir. 1999); *In re Innomed Labs, LLC*, 2008 WL 276490, at *2 (S.D. N.Y.

exercise their discretion when evaluating a proposed retention, taking into account "the particular facts and circumstances surrounding each case and the proposed retention before making a decision."[7] In the case of debtor's counsel, one example of potential "disinterestedness" includes representation of investors of the debtor-company.[8]

Distressed debt investors are active players in "mega"[9] chapter 11 cases.[10] Like large companies seeking chapter 11 relief, these investors are often represented (both in and out of bankruptcy) by large law firms. Although these relationships are common in the marketplace, they can present hurdles for law firms seeking to be retained by debtors in chapter 11. A recent example in *In re Stearns Holdings, LLC* illustrates the issue.

Stearns, a leading, independent mortgage company, filed for chapter 11 protection in the United States Bankruptcy Court for the Southern District of New York on July 9, 2019.[11] Stearns' bankruptcy was precipitated in part by rising inter-

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2008); *In re Granite Partners, L.P.*, 219 B.R. 22, 33, 32 Bankr. Ct. Dec. (CRR) 331 (Bankr. S.D. N.Y. 1998)).

[7] Arochem, 176 F.3d at 621 (internal quotation and citation omitted).

[8] See 3 Collier on Bankruptcy ¶ 327.04 (16th ed. 2020) (citing *In re Envirodyne Industries, Inc.*, 150 B.R. 1008, 23 Bankr. Ct. Dec. (CRR) 1762, 28 Collier Bankr. Cas. 2d (MB) 747, Bankr. L. Rep. (CCH) P 75186 (Bankr. N.D. Ill. 1993)).

[9] The Administrative Office of the United State Courts defines a "mega" bankruptcy case as "an extremely large case with: (1) at least 1,000 creditors; (2) $100 million or more in assets; (3) a great amount of court activity as evidenced by a large number of docket entries; (4) a large number of attorneys who have made an appearance of record; and (5) regional and/or national media attention." Administrative Office of the United States Courts; Judicial Conference of the United States, Guide to Judiciary Policies and Procedures, § 19.01.

[10] See Activist Investors, Distressed Companies, and Value Uncertainty, 22 Am. Bankr. Inst. L. Rev. 167, 178 ("Most commentators and practitioners agree that funds are increasingly present at the negotiating table in chapter 11 cases."); Eric B. Fisher & Andrew L. Buck, Hedge Funds and the Changing Face of Corporate Bankruptcy Practice, 25 Am. Bankr. Inst. J. 24, 24 (2007) (noting hedge fund involvement in chapter 11 cases has become active).

[11] See In re Stearns Holdings, LLC, Case No. 19-12226 (SCC) [Docket No. 1].

est rates.[12] Stearns entered chapter 11 as a private company, and funds managed by Blackstone's[13] private equity group held approximately 70% of the interest in the debtors.[14] Before the bankruptcy filing, Stearns and Blackstone worked to develop restructuring proposals that culminated with Blackstone serving as a stalking horse plan sponsor.[15] The proposed restructuring transaction provided, in part, that Blackstone would acquire 100% of the debtors' equity in exchange for a $60 million investment.[16]

As is common at the outset of a chapter 11 case, proposed counsel for the debtors—in *Stearns*, Skadden, Arps, Slate, Meagher & Flom LLP—filed a retention application.[17] In its Retention Application, proposed counsel for Stearns disclosed that it represented Blackstone in a number of matters, and, among other things, in particular Blackstone's 2015 acquisition of 70% indirect ownership interest in the debtors.[18]

The United States Trustee for Region 2[19] filed an objection to the Retention Application, seeking to disqualify proposed counsel.[20] The U.S. Trustee noted at the outset that proposed counsel for the debtors represented Blackstone in connection with their acquisition of a controlling stake in the debtors, and continues to represent Blackstone in a variety of undis-

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[12] See Declaration of Stephen Smith, President and Chief Financial Officer of Stearns Lending, LLC in Support of Chapter 11 Petitions and First Day Pleadings, ¶ 20, In re Stearns Holdings, LLC, Case No. 19-12226 (SCC) (the "Smith Decl.") [Docket No. 3].

[13] "Blackstone" refers to The Blackstone Group L.P. and its affiliates.

[14] See Smith Decl. ¶ 13.

[15] See Smith Decl. ¶¶ 32–33.

[16] See Smith Decl. ¶ 32.

[17] See Debtors' Application for Order Authorizing Employment and Retention of Skadden, Arps, Slate, Meagher & Flom LLP as Counsel to the Debtors Nunc Pro Tunc to the Petition Date, In re Stearns Holdings, LLC, Case No. 19-12226 (SCC) (the "Retention Application") [Docket No. 122].

[18] See Retention Application ¶¶ 13–16.

[19] The "U.S. Trustee."

[20] Objection of the United States Trustee to the Application of the Debtors for Authority to Employ and Retain Skadden, Arps, Slate, Meagher & Flom LLP as Counsel to the Debtors, In re Stearns Holdings, LLC, Case No. 19-12226 (SCC) (the "U.S. Trustee's Objection") [Docket No. 122].

closed matters.[21] According to the U.S. Trustee, counsel's relationship with Blackstone gave the appearance of impropriety, and caused potential, if not actual, conflicts of interest.[22] Specifically, the U.S. Trustee asserted that the decision to pursue the proposed equity sale would be rewarding to Blackstone, and could raise questions surrounding counsel's impartiality given the fact that Blackstone was a client of the law firm.[23]

The debtors filed a reply in further support of counsel's retention.[24] The debtors maintained that the work performed for Blackstone in connection with the equity acquisition was not adverse to the debtors, and that after the transaction, counsel began representing the debtors.[25] The Debtors also argued that "there is nothing unusual or improper in a firm representing the subsidiary of a private equity client, including in bankruptcy, and a per se bar to such representation, as the U.S. Trustee advocates, would hobble debtors and prevent them from retaining counsel who are best suited to serve them."[26] The debtors maintained that proposed counsel did not assert or possess any economic interest against the debtors, the U.S. Trustee could not establish that counsel was biased against the debtors' estates in any way, and that representing Blackstone in connection its equity acquisition was not adverse to the debtors.[27]

The Court overruled the U.S. Trustee's Objection and

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[21] See U.S. Trustee's Objection at 1. Blackstone was represented by separate counsel in the *Stearns* case. See Notice of Appearance filed by Elisha D. Graff on behalf of Blackstone Family Investment Partnership VI-NQ ESC L.P., Blackstone Capital Partners VI NQ/NF L.P. [Docket No. 47]; Notice of Appearance filed by Jamie Fell on behalf of Blackstone Capital Partners VI NQ/NF L.P., Blackstone Family Investment Partnership VI-NQ ESC L.P.. [Docket No. 48].

[22] See U.S. Trustee's Objection at 1–2.

[23] See U.S. Trustee's Objection at 9–10, 11.

[24] See Debtors' Reply Objection of the United States Trustee to the Application of the Debtors for Authority to Employ and Retain Skadden, Arps, Slate, Meagher & Flom LLP as Counsel to the Debtors, In re Stearns Holdings, LLC, Case No. 19-12226 (SCC) (the "Debtors' Reply") [Docket No. 171].

[25] See Debtors' Reply ¶ 2.

[26] Debtors' Reply ¶ 4.

[27] See Debtors' Reply ¶ 9–10.

granted the Retention Application on the record of the hearing. The Court applied the standard set forth in *Bank Brussels Lambert v. Coan (In re AroChem Corp.)*,[28] which defines holding or representing an adverse interest to the estate as "either an actual or potential dispute in which the estate is a rival claimant; or (2) to possess a predisposition under circumstances that render such a bias against the estate,"[29] and noted that "the test is not retrospective."[30] In reciting the principle that "the adverse interest test is objective and excludes 'any interest or relationship, however slight, that would even faintly color the independence and impartial attitude required by the Code and Bankruptcy Rules,' "[31] the Court noted: "But make no mistake . . . the insertion of the words 'however slight' does not mean that common sense should not be applied in a given case, particularly when a court is obligated to assess the totality of the circumstances."[32]

The Court ultimately found that there was no actual conflict of interest,[33] and that the U.S. Trustee's argument that the proposed transaction could prove financially rewarding to Blackstone was baseless.[34] In support of its holding, the Court pointed out, among other things, that an independent committee of the debtors' board of directors was running the equity sale process pursuant to court-approved bid procedures, and was being closely scrutinized by interested parties.

Aside from its findings in support of approving the Retention Application, the Court also discussed the policy point raised by the debtors; namely, that a per se rule barring law

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[28] *In re AroChem Corp.*, 176 F.3d 610, 622–23, 41 Collier Bankr. Cas. 2d (MB) 1647, Bankr. L. Rep. (CCH) P 77933 (2d Cir. 1999)

[29] *In re AroChem Corp.*, 176 F.3d 610, 623, 41 Collier Bankr. Cas. 2d (MB) 1647, Bankr. L. Rep. (CCH) P 77933 (2d Cir. 1999).

[30] See In re Stearns Holdings, LLC, Case No. 19-12226 (SCC) July 31, 2019 Hearing Transcript ("Hr'ng Tr.") [Docket No. 232].

[31] *In re Project Orange Associates, LLC*, 431 B.R. 363, 370, 53 Bankr. Ct. Dec. (CRR) 114 (Bankr. S.D. N.Y. 2010) (citing In re Granite Partners, 219 B.R. at 33; see also *In re Angelika Films 57th, Inc.*, 227 B.R. 29, 38, 33 Bankr. Ct. Dec. (CRR) 535 (Bankr. S.D. N.Y. 1998), opinion aff'd, 246 B.R. 176 (S.D. N.Y. 2000) ("The determination of adverse interest is objective and is concerned with the appearance of impropriety.")).

[32] Hr'ng Tr. 79:19–22.

[33] Hr'ng Tr. 80:11–12.

[34] Hr'ng Tr. 80:21–81:7.

firms that previously represented private equity sponsors from serving a debtors' counsel "would hobble debtors and prevent them from retaining counsel who are best suited to serve them."[35] The Court agreed with the debtors' contention, and further observed that if any such per se rule were adopted, "a debtor in the throes of financial distress would be unable to retain the law firm which likely possesses the greatest amount of institutional knowledge, and they would instead spend time and resources getting new, unfamiliar counsel up to speed."[36] Indeed, sidelining counsel that previously represented a private equity sponsor would increases the costs of administering the chapter 11 case.[37]

By rejecting a per se rule, *Stearns* recognizes the practical reality that there may be some overlap in chapter 11 practice given the role investors play in the market. As long as there is no conflict, and proper safeguards are in place (i.e., independent directors, robust marketing procedures, and proper ethical walls, to name a few), law firms should not be disqualified for having represented a private equity sponsor of the debtors before bankruptcy. That said, the particular facts and circumstances will control the outcome of each case, so law firms should be mindful of disclosing any past relationships with interested parties and evaluate at the outset of an engagement whether a conflict may exist or arise.

III. Section 330: *ASARCO* is Still Good Law and Also Applies to Chapter 7 Trustees

In *Baker Botts L.L.P. v. ASARCO LLC*, 576 U.S. 121, 135 S. Ct. 2158, 192 L. Ed. 2d 208, 61 Bankr. Ct. Dec. (CRR) 41, 73 C.B.C. 1017, Bankr. L. Rep. (CCH) P 82811 (2015), the Supreme Court faced whether, under sections 327 and 330 of the Bankruptcy Code, a law firm could be compensated from a debtor's estate for the time it expended defending its own fee application. Holding that such compensation was impermissible, the Supreme Court held that "Congress did not expressly depart from the American Rule to permit compensation for fee-defense litigation by professionals hired to assist

[35] Debtors' Reply ¶ 4.

[36] Hr'ng Tr. 84:22–85:2.

[37] Hr'ng Tr. 85:3–9.

trustees in bankruptcy proceedings."[38] The American Rule, a "bedrock principle," provides that "[e]ach litigant pays his own attorney's fees, win or lose, unless a statute or contract provides otherwise."[39] The Supreme Court's decision in *ASARCO* focused on Congress' use of the word "services" in section 330(a)(1)(A), finding that litigating a contested fee request is not a "service" rendered to the bankruptcy estate under such Code section, a prerequisite to compensation.[40] Since *ASARCO* was decided, lower courts have been tasked with applying its holding in practice. Recently, in *In re Morreale*,[41] *ASARCO* was extended to chapter 7 trustee fees.

In re Morreale, arises out of a "difficult and lengthy Chapter 7 liquidation" in which all general unsecured creditors were paid in full.[42] The issue facing the bankruptcy court in *Morreale* was whether the chapter 7 trustee's counsel was entitled to compensation for defending its own prior fee application as well as the chapter 7 trustee's fee application. Relying on *Baker Botts L.L.P. v. ASARCO LLC*, the court answered in the negative.

After going through a lengthy recitation of the litigation surrounding the parties' prior fee applications, the court stated that its "job is easier because the United States Supreme Court recently addressed virtually the exact fees for fee defense issue" in *ASARCO*, and what the chapter 7 trustee and his counsel were seeking "is completely foreclosed" thereby.[43]

In an attempt to distinguish *ASARCO*, the chapter 7 trustee's counsel proffered three arguments. First, counsel noted that the chapter 7 debtor and the United States Trustee objected to payment of fees for defending its fee applications, as opposed to the administrator of the bankruptcy estate (i.e. the chapter 7 trustee himself). The court was unconvinced, noting that "[t]he great majority of courts interpreting

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[38] 135 S. Ct. at 2164.

[39] 135 S. Ct. at 2164, citing *Hardt v. Reliance Standard Life Ins. Co.*, 560 U.S. 242, 252–53, 130 S. Ct. 2149, 176 L. Ed. 2d 998, 49 Employee Benefits Cas. (BNA) 1001 (2010).

[40] 135 S. Ct. at 2167.

[41] *In re Morreale*, 2019 WL 3385163 (Bankr. D. Colo. 2019).

[42] 2019 WL 3385163 at *1.

[43] 2019 WL 3385163 at *8.

ASARCO in the last few years . . . do not limit the holding to circumstances in which a 'bankruptcy administrator' has objected."[44] And, the court noted, "[e]ven in circumstances where bankruptcy debtors or trustees do not object, fee defense fees are still not compensable."[45]

Second, counsel argued (and the court rejected) that "fee objections based on attacks on the Trustee's administration of a case create an opportunity to collect fees for fee defense."[46] Although the court noted that the chapter 7 debtor was "quite aggressive" in his objection, it found that the nature of a party's objection "does not somehow magically result" in being able to collect fees for fee defense.[47] Finally, counsel asked the court to "avoid *ASARCO* because of unfairness and unfortunate policy results."[48] (internal quotations omitted). The court declined this invitation, noting that the Supreme Court considered and rejected this very argument in *ASARCO*.[49]

With respect to fees incurred by the chapter 7 trustee's counsel for defending the chapter 7 trustee's fee applications, which counsel did at the chapter 7 trustee's request, the court found that the legal analysis was the same and was also governed by *ASARCO*.[50] The bankruptcy court found that the "Bankruptcy Code does not contain any authorization for a trustee to recover additional fees for defending his or her own application for compensation."[51] Paralleling the Supreme Court's language, the court noted that "[a] trustee simply is not rendering a 'service' to a bankruptcy estate by defending his own application."[52]

Counsel, though, argued "that Chapter 7 trustees are entitled to counsel, and that if Chapter 7 trustees are not able to use estate funds to pay counsel when complex legal issues

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[44] 2019 WL 3385163 at *9 (citing cases).

[45] 2019 WL 3385163 at *9.

[46] 2019 WL 3385163 at *10 (cleaned up).

[47] 2019 WL 3385163 at *11.

[48] 2019 WL 3385163 at *11.

[49] 2019 WL 3385163 at *11.

[50] 2019 WL 3385163 at *12.

[51] 2019 WL 3385163 at *12.

[52] 2019 WL 3385163 at *12 (citing ASARCO, 135 S. Ct. at 2167).

arise in connection with their fee applications then trustees will face the prospect of paying for their defense out of pocket or will have to go without counsel just when counsel's assistance is required."[53] The court did not find this argument compelling because, it stated, challenges to trustee fee applications are "extremely rare" because they are usually a matter of "simple mathematical calculation."[54] And, in the rare circumstance where an objection is not a matter of an easily-resolved mathematical miscalculation, if an objection is "spurious," a court retains the right to impose sanctions.[55]

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[53] 2019 WL 3385163 at *13.

[54] 2019 WL 3385163 at *13.

[55] 2019 WL 3385163 at *13.