Restructuring Professionals - Is it time to rewrite your retention agreements?

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Monday, July 25, 2016

It is almost article of faith among professionals in the restructuring field that the best and possibly only way to satisfy the "disinterestedness" test under the Bankruptcy Code – and thereby qualify to be retained in a bankruptcy case – is to hold a retainer that always exceeds the amount of fees owed by the client. Two recent cases have put that faith to test. Both have suggested that holding a retainer may not be enough – that only specific types of retainers, structured a certain way, will suffice. More ominously, the cases suggest that a professional with a retainer arrangement not properly structured will be found to be not disinterested, and thereby disqualified from being engaged.

The issue arises because of the rather strict requirements for retention of professionals embedded in the Bankruptcy Code. To be retained, a professional must be a "disinterested person." A disinterested person is defined as a person that is, among other things, not a creditor. The Bankruptcy Code and the case law make clear that a professional owed money on the date of a bankruptcy is a creditor and not a disinterested person. Similarly, a professional who was paid preferential payments prior to the bankruptcy filing likewise is not a disinterested person.

To avoid being a creditor and/or being paid preferential payments, almost all professionals utilize "replenishing retainers," pursuant to which the client pays an initial retainer prior to the work

commencing. Thereafter, as fees are incurred, a portion of the retainer is applied, and the client replenishes it to the original amount. Such arrangements were thought to be a sure way to insure a determination that the professional would be a disinterested person.

In a case out of the Middle District of Pennsylvania – *In re Thompson Waterproofing* – the court held that a firm holding a retainer that serves as security for future, court-approved fees has a security interest in the debtor's assets that renders the firm "not disinterested." (2016 WL 94176, Case No. 14-01273 (Bankr. M.D. Pa. Jan. 7, 2016) at 3.) As often happens, bad facts make bad law. In *Thompson Waterproofing*, debtor's counsel filed an application that was deficient on a number of fronts, including failing to include any engagement agreement. Moreover, the Chapter 11 case went very poorly, primarily because of the alleged use of the debtor's funds by the debtor's principal to pay said principal's gambling debts. Finally, there were allegations of illegal activity involving a member of the debtor's counsel's firm, as well as threats by debtor's counsel to sue the trustee.

When the debtor's counsel sought approval of its fees, the trustee objected, arguing that, without a retention agreement, debtor's counsel had no interest in the retainer. The bankruptcy court ultimately denied the fee request. In doing so, it ruled that a security retainer results in the professional having an interest in the debtor's assets that is in conflict with interests of the debtor. As a result, the professional is not disinterested.

In the second case – *In re Caesars Entertaining Operating Co.* – the result worked to the debtor's counsel's favor, and provided some guidance on how retainers should be structured. The court overruled an objection to counsel's retention. In doing so, it described the three types of retainers – security retainer; classic retainer; and advance payment retainer. The court held that counsel's retainer, while called a classic retainer, was in fact an advance payment retainer. As a result, it created no adverse interest. But the court made clear that, had the retainer been a security retainer, the court would have found counsel to be not disinterested.

So – what to do?

Review your retention agreement – Better yet, have an expert review it. The distinctions among the various types of retainers can be subtle and confusing. The intent of the parties is not controlling; the language is. Make sure the form you use for your engagements has the correct language.

Know your jurisdiction – The rules regarding retainers vary by state. At the front end of the engagement, consider in which court the client would file if bankruptcy becomes necessary. Then, make sure your retention agreement complies, as close as possible, to the rules of that or those possible jurisdictions.

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