



Bankruptcy & Restructuring **ALERT**

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Second Circuit Clarifies Meaning and Application of Retention Provision Under Bankruptcy Code

On January 6, 2009, the United States Court of Appeals for the Second Circuit rendered a decision in the case of *Riker, Danzig, Scherer, Hyland & Perretti v. Official Comm. of Unsecured Creditors (In re: Smart World Tech., LLC)* that clarifies the implications of a bankruptcy court's "pre-approval" of the terms of a professional's retention by the bankruptcy estate under Sections 327 and 328 of the Bankruptcy Code. The decision also clarified the meaning of language in Section 328(a) of the Bankruptcy Code that allows a court to modify the terms of a professional's employment only if those terms "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." The *Smart World* decision illustrates the importance of obtaining clear retention orders and clarifies the Bankruptcy Code's limitations on the ability of bankruptcy courts to retroactively modify the terms of a professional's employment.

Section 327(a) of the Bankruptcy Code authorizes the retention of professionals by a bankruptcy estate. Section 330(a) of the Bankruptcy Code requires bankruptcy court approval of the fees paid to professionals by the bankruptcy estate and imposes a reasonableness standard on those fees. Section 328(a) addresses the terms on which professionals may be employed, stating that professionals may be employed "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." Section 328(a) also provides, however, that the court may allow compensation different from that provided under the terms by which a professional was retained "if such terms...prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms...."

Prior to filing bankruptcy and liquidating, Smart World and its affiliates provided dial-up Internet services to subscribing customers. During its bankruptcy proceedings, Smart World agreed to sell its subscriber list to Juno Online Services, Inc. Thereafter, a dispute arose

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between Smart World and Juno over the number of subscribers for which Juno was obligated to pay Smart World. In November 2000, the debtor sought to retain Riker Danzig as special counsel to pursue Smart World's claims against Juno on a contingency basis. Certain creditors objected to Riker Danzig's retention because those creditors were already engaged in settlement negotiations with Juno and were, therefore, concerned that Riker Danzig could obtain a windfall as a result of pre-existing settlement efforts.

On the record during the hearing on Riker Danzig's retention application, Riker Danzig agreed to modify the terms of its retention by agreeing to take a smaller fee if the dispute with Juno was resolved on an expedited basis. These modifications were subsequently memorialized in a letter sent by Riker Danzig to the debtor's counsel, which was incorporated into the bankruptcy court's order approving Riker Danzig's retention and was intended, though errantly not, to be attached as an exhibit to that order.

In February 2001, the bankruptcy court stayed the litigation between the debtor and Juno. In May 2003, the creditors of Smart World proposed a US\$5.5 million settlement with Juno, which Smart World opposed. The bankruptcy court approved that settlement, but was reversed on appeal to the Second Circuit by Smart World, through Riker Danzig. The bankruptcy court subsequently approved a plan of liquidation proposed by the creditors that contained a US\$6.5 million settlement between the estate and Juno.

Riker Danzig filed a fee application seeking approval of approximately US\$2.3 million in fees to which it was entitled under the terms of its retention agreement plus expenses. However, the bankruptcy court, with a different judge presiding, determined that four events occurred during the course of the litigation between Smart World's estate and Juno that were "not capable of being anticipated at the time" of Riker Danzig's retention, and, therefore, Riker Danzig's fee award was reduced to approximately US\$1.2 million plus expenses. These four events included (i) the divergence of opinion between Smart World and its creditors; (ii) the fact that Riker Danzig took instruction directly from the officers and majority shareholders of Smart World; (iii) the unusually prolonged litigation; and (iv) the fact that Riker Danzig was an obstacle, not an asset, to approval of the settlement. Riker Danzig appealed.

The Second Circuit first addressed the question of whether the bankruptcy court order approving Riker Danzig's retention was a pre-approval of the terms of Riker Danzig's retention under Section 328(a) of the Bankruptcy Code, including Riker Danzig's fees. If the order did not constitute a pre-approval, the bankruptcy court had the discretion under Section 330(a) of the Bankruptcy Code to modify the compensation received by Riker Danzig. The Second Circuit adopted a "totality of the circumstances" approach to determining whether a court order approving the retention of a professional constitutes pre-approval of the terms of a professional's retention, including fees. In this case, the Second Circuit concluded that the bankruptcy judge clearly pre-

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approved the terms of Riker Danzig's retention, including its fees, pursuant to the order approving Riker Danzig's retention under Section 328(a) of the Bankruptcy Code. The Second Circuit took particular note of the fact that the bankruptcy judge stated that he would not review Riker Danzig's time records upon an application to approve its fees because he was approving a contingency fee arrangement.

The Second Circuit then addressed the question of what constitutes "developments not capable of being anticipated at the time" a professional's pre-approval is obtained. Without providing a clear definition, the Second Circuit found that this is a "high hurdle to clear" and that none of the events cited by the bankruptcy court in reducing Riker Danzig's fees satisfied this requirement. Specifically, (i) there is always an expected amount of discord between the debtor and its creditor constituents; (ii) creditors and equity always seek to maximize their own share of the debtor's limited assets; (iii) the prospect of prolonged litigation always exists and was exacerbated by the bankruptcy court's own stay of the litigation; and (iv) Riker Danzig's appeal of the initial US\$5.5 million settlement resulted in a 20-percent increase in the ultimate amount of the settlement.

Smart World illustrates the importance of having clear language in retention orders providing that the approval order constitutes pre-approval of the terms and conditions of the retention of any professional. It also illustrates the limitations imposed upon the ability of bankruptcy court judges to subsequently review fees under the reasonableness standard of Section 330(a) where those fees are pre-approved under Section 328(a) when a professional is retained. While lawyers representing either the debtor or the creditors' committee as general bankruptcy counsel are rarely, if ever, retained on a contingency, other professionals, including special litigation counsel, investment bankers and brokers, frequently seek approval of both fixed fees and outcome-dependent bonuses or incentive payments. By obtaining pre-approval under Section 328(a), and ensuring that the professional's retention order contains clear language regarding pre-approval under Section 328 (a), these professionals may draw support from the *Smart World* decision to prevent second-guessing of pre-approved fees when the bankruptcy court considers final approval of the fees.

For further information, please contact one of the Squire Sanders lawyers listed in this alert.

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