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Steven E. Seward

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CASENOTE

A World of Evergreen Fees? *In re Pan American Hospital* and Evergreen Retainers in Chapter 11 Reorganizations

*Why, this bond is forfeit; And lawfully by this [Shylock] may claim
A pound of flesh, to be by him cut off. Nearest the merchant's heart.*

—The Merchant of Venice¹

I. INTRODUCTION

A common refrain among bankruptcy judges and practitioners is this: it costs a lot of money to go bankrupt. While this statement on its face appears counterintuitive, the tidal wave of large-scale corporate reorganizations and liquidations has proved the truth of this proposition.² Yet in the context of these legal fees is the simple fact that these corporations that are reorganizing or liquidating are on highly tenuous financial grounds, and the lawyer must secure his or her own financial livelihood while simultaneously providing quality legal service.

This dilemma of the legal profession, that of providing legal services to corporations whose future existence is questionable (and therefore whose future ability to pay is also questionable), is hardly new or extraordinary, nor is it limited to bankruptcy.³ A lawyer is in a very different position from that of a third-party financier who provides post-petition financing to a reorganizing corporation.⁴ However, the risk-

1. WILLIAM SHAKESPEARE, *THE MERCHANT OF VENICE* act IV, sc. 1.

2. See, e.g., Jeff St. Onge, *Reorganization Billings Run Past \$514 Million for Enron*, CHI. SUN-TIMES, Nov. 17, 2003, at 56. As of May 2003, Enron's primary bankruptcy counsel had billed over \$87 million dollars worth of legal fees. *Id.* At that time, the total legal fees resulting from Enron's collapse were predicted to be \$880 million dollars by completion. *Id.*

3. Indeed, all lawyer compensation involves a conflict of interest. The client's preference would always be to get top notch legal counseling for free (which only exists in the limited context of pro bono work). These sorts of conflicts also exist in the structure of the representation itself; how a law firm bills its time and what risks it takes are different than what the client would prefer. Bankruptcy exacerbates these issues. Professor Westbrook notes that "in a circumstance of financial crisis there is a profound conflict between the lawyer's interest in assurance of payment and the client's interest in the application of scarce resources to other pressing needs." See Jay Westbrook, *Fees and Inherent Conflicts of Interests*, 1 AM. BANKR. INST. L. REV. 287, 297 (1993).

4. Post-petition financing is codified in bankruptcy law. See 11 U.S.C. § 364 (2000). A debtor's current lenders often have the most at stake and typically provide the source of post-

minimization of what would essentially be involuntary pro bono work is constantly evolving through the efforts of clever lawyers. This Note is devoted to a close examination of one such risk-minimization device, an "evergreen retainer," as recently discussed in the opinion of Judge A. Jay Cristol of the United States Bankruptcy Court for the Southern District of Florida in *In re Pan American Hospital Corp.*⁵ In short, an evergreen retainer is an agreement in which a law firm's retainer remains intact until after confirmation of the bankruptcy plan is complete, and the lawyer's compensation is paid from the debtor's operating capital.⁶ The problem derives from the fact that this agreement places burdens on the corporation's operating capital while simultaneously withholding the amount of the retainer until the reorganization is complete. All of this occurs against a backdrop of the court's determination of what *reasonable* compensation is under bankruptcy law, both in substance and form.⁷

In Part I, this Note will examine why this reasonableness component exists in the context of compensation for bankruptcy attorneys, and briefly introduces two seminal cases on evergreen retainers prior to *Pan American Hospital*. With the stage set, Part II will then carefully examine the facts and procedure behind *Pan American Hospital* and the bankruptcy judge's opinion itself. The Note will then scrutinize the validity of evergreen retainers as an appropriate tool to hedge risks, from both the perspective of a law firm and from that of the corporate debtor, in Part III. This section will also briefly look at a possible justification for using evergreen retainers in bankruptcy after the United States Supreme Court's recent decision in *Lamie v. U.S. Trustee*.⁸

This Note concludes that an evergreen retainer is an important risk-minimization device and should not be invalid per se, but that the terms of the evergreen retainer should be scrutinized at the outset to ensure that it provides fiscal security to the lawyers while simultaneously providing the liquidity of funds needed by the debtor corporation. Because an evergreen retainer is distinct from a traditional retainer in that it holds a sum of cash outstanding until the confirmation of the bankruptcy plan, and because correcting an unreasonable term in a compensation agreement with an attorney is difficult, this scrutiny is important at the outset

petition financing. The Code provides that post-petition financing will be allowable as an "administrative expense." *Id.* Administrative expenses have first priority among unsecured creditors. *See id.* § 503.

5. 312 B.R. 706 (Bankr. S.D. Fla. 2004).

6. However, outside of the bankruptcy context, evergreen retainers have been defined as "[requiring] clients to replenish the retainer fee as the money is drawn down by the law firm." Sandra Torry, *Recession Forces More Firms to Make Bottom Line a Top Priority*, WASH. POST, Feb. 18, 1991, at F5.

7. 11 U.S.C. § 329(b).

8. 540 U.S. 526 (2004).

of a bankruptcy case. While every Chapter 11 case is different, and courts can only rely upon general factors to provide guidance (necessarily precluding a bright-line approach), this scrutiny allows for risk-minimization superior to a typical retainer, while simultaneously ensuring that the evergreen retainer is a rational expense on the part of the corporation.

II. EVERGREEN RETAINERS: A PRIMER

A corporation's choices on who to retain as counsel, and upon what terms the retention is made, are generally within the "business judgment" of the firm, and are entitled to the wide judicial deference commonly associated with the business judgment rule.⁹ The business judgment rule is characterized as a doctrine of abstention,¹⁰ a sharp barrier preventing courts from inquiring into the wisdom of a board's decision making, provided the board complies with basic procedural requirements.¹¹ Thus, a challenge to the retention of counsel because the corporation violated its duty of care to shareholders is likely doomed to failure (even if the retention is made under outrageous and egregious terms),¹² unless the shareholder can prove procedural defects,¹³ or that the transaction violated a duty of loyalty.¹⁴

But when a corporation approaches insolvency, the scope of these "fiduciary duties" is altered. When a corporation becomes insolvent, or when insolvency is near, the fiduciary duties of the officers and directors

9. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 811-12 (Del. 1984).

10. See Stephen Bainbridge, *Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004). Professor Bainbridge cogently argues that the abstention view of the business judgment rule is the only view that provides proper deference to decisions made by the board of directors. *Id.* at 87-88. Because a court cannot increase accountability of a board of directors without a commensurate interference and derogation of the board's ability to exercise authority, courts must be reluctant to review such decisions absent evidence of self-dealing. *Id.* at 128-30.

11. See *Aronson*, 473 A.2d at 811-12.

12. See, e.g., *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). This case is perhaps the most extreme example of the application of the business judgment rule. Here, the Disney board was accused of breaching its fiduciary duty in approving an extravagant and wasteful employment agreement with former CEO Michael Ovitz, which ultimately resulted in Ovitz earning \$140 million dollars for approximately 14 months of work. *Id.* at 249-52. On August 9, 2005, the Delaware Court of Chancery reaffirmed the application of the business judgment rule to the *Disney* case, finding that although the board fell short of the best practices of business governance, the business judgment rule protected the board from monetary liability. *In re Walt Disney Deriv. Litig.*, 2005 WL 2056651, at *41, 51 (Del. Ch. 2005).

13. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

14. The duty of loyalty is distinct from the duty of care, and triggers a different standard of review. The standard of review for a duty of loyalty claim is designed to avoid the possibility of fraud and the temptation of self-dealing. If a plaintiff invokes a duty of loyalty claim, the defendant has the burden to prove the intrinsic fairness of the transaction. See, e.g., *Lewis v. S.L. & E., Inc.*, 629 F.2d 764, 769 (2d Cir. 1980).

expand to include a duty to creditors (in addition to shareholders).¹⁵ A fundamental question is raised by these additional fiduciary obligations: when a debtor-in-possession retains a lawyer, who is the client of the lawyer? Some courts have stated that management and its counsel owe fiduciary duties to an estate in bankruptcy. In *In re Blue Top Family Restaurant, Inc.*,¹⁶ Judge Bentz of the Bankruptcy Court for the Western District of Pennsylvania found that the actual client of an attorney hired by the debtor-in-possession is the estate with its creditors.¹⁷ However, some courts have held that because of the conflicting interests that an estate is created to serve, it is impossible for debtor's counsel to attempt to serve the estate, and it is the debtor itself that counsel must serve. In *Jones & Leta P.C. v. Segal*,¹⁸ Judge Brett of the United States District Court in Utah agreed with this view. Judge Brett found that the estate of a Chapter 11 debtor is merely a collection of proprietary interests that is not in itself a legal entity and therefore cannot exist as a client.¹⁹ Judge Brett also argued that safeguards exist that require counsel to help the debtor carry out its responsibility to act in the best interest of the estate.²⁰ These safeguards are of statutory origin: a disinterestedness requirement,²¹ a disclosure requirement,²² and a reasonableness of compensation requirement.²³

Chapter 11 is a rehabilitative process to reorganize an insolvent individual or corporation and put the party on a path to financial viability.²⁴ Either a voluntary petition by the debtor or an involuntary petition initiates the Chapter 11 process.²⁵ In Chapter 11, a debtor is normally allowed to remain in possession of its assets and to continue to operate the business, with oversight from the bankruptcy court and a committee of creditors.²⁶ The goal of the Chapter 11 debtor is to formulate a plan of reorganization, accepted by a majority of creditors and confirmed by the court, that binds all parties to the reorganization.²⁷

15. *Geyer v. Ingersoll Publ'n Co.*, 621 A.2d 784, 786 (Del. Ch. 1992). Marcia Goldstein and John Rapisardi have conducted a thorough analysis of the fiduciary duties an attorney owes to an insolvent corporation. See Marcia Goldstein and John Rapisardi, *Fiduciary Duties for Distressed Companies Murky*, N.Y. L.J., Sept. 14, 1998, at 11.

16. 110 B.R. 777 (Bankr. W.D. Pa. 1990).

17. *Id.* at 777.

18. 220 B.R. 434 (D. Utah 1998).

19. See *id.* at 450-51.

20. See *id.* at 465.

21. See FED. R. BANKR. P. 2014.

22. See FED. R. BANKR. P. 2016.

23. See 11 U.S.C.A. § 330 (2005).

24. WILLIAM WARREN & DANIEL BRUSSELL, *BANKRUPTCY* 585 (6th ed. 2002).

25. *Id.* at 22-23.

26. *Id.* at 594.

27. *Id.* at 760.

At the outset of the bankruptcy process, a bankruptcy “estate” is created out of all legal and equitable interests that the debtor possesses, subject to certain exemptions as provided by state or federal law.²⁸ Two fundamental issues are involved in Chapter 11 proceedings: 1) the size of the estate (and how to maximize it); and 2) the division of the estate.²⁹ Professional services are designed to help maximize the estate.³⁰ Because the debtor is insolvent, its creditors have an interest in minimizing the costs of these services, as excessive expenditures on attorneys translate into a smaller estate.

Several statutory sections of the Bankruptcy Code address retention of an attorney; the sections share a commonality in that they all require that the attorney’s compensation be reasonable.³¹ Reasonableness is a classic amorphous standard that is preclusive of bright-line rules. By its

28. *Id.* at 28.

29. Cynthia A. Baker, *Other People’s Money: The Problem of Professional Fees in Bankruptcy*, 38 ARIZ. L. REV. 35, 42 (1996).

30. Attorneys for debtor corporations can help maximize the estate through several devices. For instance, the Bankruptcy Code permits a debtor-in-possession to recover from creditors payments made shortly before the bankruptcy filing where the payment gave the creditor more than other similarly situated creditors would obtain through the bankruptcy process (subject to several possible defenses). See 11 U.S.C. § 547 (2000).

31. The relevant sections of the Bankruptcy Code are listed below in pertinent part:

- a) The trustee, or a committee appointed under section 1102 of this title, with the court’s approval, may employ or authorize the employment of a professional person under section 327 or 1103 of this title, as the case may be, on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, or on a contingent fee basis. Notwithstanding such terms and conditions, the court may allow compensation different from the compensation provided under such terms and conditions after the conclusion of such employment, 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.

11 U.S.C.A. § 328 (2005).

(a) Any attorney representing a debtor in a case under this title, or in connection with such a case, whether or not such attorney applies for compensation under this title, shall file with the court a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered . . .

(b) If such compensation exceeds the reasonable value of any such services, the court may cancel any such agreement, or order the return of any such payment, to the extent excessive, to—

- (1) the estate, if the property transferred—
 (A) would have been property of the estate; or
 (B) was to be paid by or on behalf of the debtor under a plan under chapter 11, 12, or 13 of this title; or
 (2) the entity that made such payment.

Id. § 329 (2005).

(a) (1) . . . the court may award to a trustee, a consumer privacy ombudsman appointed under section 332, an examiner, an ombudsman appointed under section 333, or a professional person employed under section 327 or 1103—

- (A) reasonable compensation for actual, necessary services rendered by

very nature the standard invites resolution on a case-by-case basis.³²

The courts, in their limited appraisals of the validity of an evergreen retainer, use two different approaches when evaluating their reasonableness. One approach is premised on the belief that these retainers are reasonable only in very limited circumstances. Provided these circumstances exist, the fee is justified by public policy that necessitates risk-minimization to avoid injuring the debtor's ability to secure high-quality representation.

The second approach is a "market-driven" analysis of reasonableness. Because evergreen retainers are acceptable tools outside of the

the trustee, examiner, ombudsman, professional person, or attorney and by any paraprofessional person employed by any such person; and
(B) reimbursement for actual, necessary expenses.

....
(3) In determining the amount of reasonable compensation to be awarded . . . the court shall consider the nature, the extent, and the value of such services, taking into account all relevant factors, including—

- (A)** the time spent on such services;
- (B)** the rates charged for such services;
- (C)** whether the services were necessary to the administration of, or beneficial at the time at which the service was rendered toward the completion of, a case under this title;
- (D)** whether the services were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed;
- (E)** with respect to a professional person, whether the person is board certified or otherwise has demonstrated skill and experience in the bankruptcy field; and
- (F)** whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.

(4) **(A)** Except as provided in subparagraph **(B)**, the court shall not allow compensation for—

- (i)** unnecessary duplication of services; or
- (ii)** services that were not—
 - (I)** reasonably likely to benefit the debtor's estate; or
 - (II)** necessary to the administration of the case.

....
(5) The court shall reduce the amount of compensation awarded under this section by the amount of any interim compensation awarded under section 331, and, if the amount of such interim compensation exceeds the amount of compensation awarded under this section, may order the return of the excess to the estate.

(6) Any compensation awarded for the preparation of a fee application shall be based on the level and skill reasonably required to prepare the application.

(7) In determining the amount of reasonable compensation to be awarded to a trustee, the court shall treat such compensation as a commission, based on section 326.

Id. § 330 (2005).

32. *Black's Law Dictionary* defines "reasonable" as "fair, proper, or, moderate under the circumstances." BLACK'S LAW DICTIONARY 1293 (8th ed. 2004).

bankruptcy world, they are presumptively reasonable. The inquiry then moves on to particular terms that may require alteration to better conform to the court's vision of what the case requires and how to best balance the needs of all the players in the Chapter 11 reorganization.

The seminal case on risk-minimization is *U.S. Trustee v. Knudsen Corp. (In re Knudsen)*,³³ a decision rendered by the Bankruptcy Appellate Panel for the Ninth Circuit Court of Appeals. Knudsen, a dairy corporation, sought approval for a fee payment and application procedure that would permit periodic post-petition payments to their lawyers without prior court approval of the payments.³⁴ The structure of the fee itself was quite similar to the evolved evergreen retainer that courts are now grappling with.³⁵ The monthly fee application operated in similar fashion to an evergreen retainer in that it permitted periodic replenishment of the attorney's retainer.³⁶ The *Knudsen* court recognized the problem implicit in absolutely rejecting these risk-minimizing steps: "[W]hen counsel must wait an extended period for payment, counsel is essentially compelled to finance the reorganization. This result is improper and may discourage qualified practitioners from participating in bankruptcy cases; a result that is clearly contrary to Congressional intent."³⁷ *Knudsen*, however, must be read in a restrictive light, because it requires four findings to authorize this type of retainer:

- 1) [t]he case is an unusually large one in which an exceptionally large amount of fees accrue each month;
- 2) [t]he court is convinced that waiting an extended period for payment would place an undue hardship on counsel;
- 3) [t]he court is satisfied that counsel can respond to any reassessment; and
- 4) [t]he fee retainer procedure is, itself, the subject of a noticed hearing prior to any payment thereunder.³⁸

In *Knudsen*, the court was likely also influenced by the fact that the reorganization was a controlled liquidation for the principal secured creditor, who approved the procedure and was advancing the fees.³⁹ Indeed, an important factor that runs throughout cases considering the validity of evergreen retainers is whether the creditors have approved the procedure.⁴⁰ No objection is favorable to the validity of the evergreen fee: the "no harm, no foul" maxim.

Recent developments in how "reasonableness" is defined, coupled

33. 84 B.R. 668 (9th Cir. B.A.P. 1988).

34. *See id.* at 669-70.

35. *See In re Pan Am. Hosp. Corp.*, 312 B.R. 706, 711 (Bankr. S.D. Fla. 2004).

36. *See Knudsen*, 84 B.R. at 669-70.

37. *Id.* at 672 (footnote omitted).

38. *Id.* at 672-73.

39. *See id.* at 673.

40. *See In re Benjamin's-Arnolds, Inc.*, 123 B.R. 839, 841 (Bankr. D. Minn. 1990); *In re Insilco Techs., Inc.*, 291 B.R. 628, 635 (Bankr. D. Del. 2003).

with a persistent concern for ensuring high-quality representation, have sparked a retreat from the restrictive analysis set forth in *Knudsen*. *In re Insilco Technologies, Inc.*,⁴¹ a decision by the United States Bankruptcy Court in Delaware, is representative of this retreat. Insilco Technologies entered into bankruptcy after a significant and continuous downturn in the telecommunications industry.⁴² *Insilco* was a very large bankruptcy case, with assets of over \$345 million and liabilities in excess of \$4 billion.⁴³ The size of the bankruptcy compelled Insilco to seek retention of several large law firms to assist in the bankruptcy proceedings.⁴⁴ As part of the terms of the proposed retention, the law firms sought evergreen retainers.⁴⁵

Judge Carey upheld the use of evergreen retainers in Insilco's Chapter 11 proceedings. Judge Carey noted that the framework under the Bankruptcy Code first requires determining what is reasonable.⁴⁶ While evergreen fees are not valid simply because of their use in the marketplace, Judge Carey observed, the prevalence of evergreen retainers in practice is noteworthy.⁴⁷ Judge Carey rejected a bright-line approach to evergreen retainers, noting that they must be tailored to the particular circumstances of the case.⁴⁸ Five factors to be considered include:

- 1) whether the terms of an engagement agreement reflect normal business terms in the marketplace; 2) the relationship between the Debtor and the professionals, i.e., whether the parties involved are sophisticated business entities with equal bargaining power who engaged in an arms-length negotiation; 3) whether the retention, as proposed, is

41. 291 B.R. 628.

42. *Id.* at 631.

43. *Id.* at 631 n.5.

44. *Id.* at 631.

45. *Id.* at 632.

46. *Id.* at 633.

47. *Id.* at 634. Judge Carey relied on *United Artists Theatre Co. v. Walton*, 315 F.3d 217 (3d Cir. 2003), for this proposition. *Id.* *Walton* involved a retention agreement made between bankrupt United Artists and financial advisors Houlihan Lokey that exempted Houlihan Lokey from their own negligence. 315 F.3d at 223. To examine whether this provision was reasonable, Judge Ambro placed the fee under the sophisticated (yet deferential) glare of a corporate law framework. *Id.* at 229-33. This approach created three opinions, despite the fact that the three-judge panel came to the same conclusion. Judge Ambro's opinion is sharply refuted by Judge Rendell. *Id.* at 235 (Rendell, J., concurring). Judge Alito's middle ground appears to present the case in a light most agreeable to this panel. Judge Alito reads the majority opinion as stating that while such indemnification agreements entered into by bankrupt companies are not interpreted in accordance with corporate law, corporate law provides a sophisticated framework for evaluating circumstances in which indemnification agreements are not categorically unreasonable under the Bankruptcy Code. *Id.* at 235 (Alito, J., concurring). Thus, corporate law principles are useful in shedding light upon market circumstances and understanding particularized conduct by parties, but should not determine reasonableness in and of itself.

48. *In re Insilco*, 291 B.R. at 634.

in the best interests of the estate; 4) whether there is creditor opposition to the retention and retainer provisions; and 5) whether, given the size, circumstances and posture of the case, the amount of the retainer is itself reasonable, including whether the retainer provides the appropriate level of “risk minimization” especially in light of the existence of any other “risk-minimizing” devices, such as an administrative order and/or a carve-out.⁴⁹

Under this approach to evergreen retainers, Judge Carey found that each prong of the enunciated test was met.⁵⁰ However, the court called for any application of employment to highlight the evergreen retainer provision and attach an exhibit that makes clear the intent to hold an evergreen retainer.⁵¹

III. *IN RE PAN AMERICAN HOSPITAL*

A. *The Factual and Procedural Background of In re Pan American Hospital*

Pan American Hospital’s tale is a unique one. The non-profit hospital was founded in western Miami-Dade County by Cuban exiles in 1963, in response to the influx of Cuban immigrants in the wake of the turbulent social and political events in Cuba.⁵² Pan American was initially a modest hospital with approximately 75 beds; by 1997 the hospital had grown to 146 beds.⁵³

Notably, throughout its history Pan American maintained a significant and close connection to the Cuban community. For example, the hospital served patients black beans and rice (traditional Cuban cuisine).⁵⁴ This cultural focus in turn inspired loyalty from the Cuban population—even as the company filed for bankruptcy, its occupancy rates hovered near 90 percent, far exceeding that of many area hospitals.⁵⁵ This historically strong foundation, along with its unique benefits to the principally Cuban clientele, helped the hospital maintain financial

49. *Id.*

50. *Id.* at 634-35.

51. *Id.* at 636.

52. Pan American Hospital, <http://www.pahnet.org/history.html> (last visited Sept. 18, 2005).

53. *Id.*

54. John Dorschner, *West Dade Hospital Files for Bankruptcy Protection*, MIAMI HERALD, Mar. 12, 2004, at 1C.

55. This fact is particularly relevant in understanding why *Pan American Hospital* is a corporate reorganization (Chapter 11) as opposed to liquidation (Chapter 7). Bankruptcy proceedings normally impose adverse effects on the reputation of a business—a taint that further burdens a company in the midst of bankruptcy. High occupancy rates during bankruptcy are encouraging signs of the viability of Pan American Hospital and its potential to successfully complete the reorganization process (known in bankruptcy parlance as the “confirmation plan”).

viability.⁵⁶

Like many corporations, Pan American's fall was brought about by a mixture of bad luck and bad business decisions. The hospital's problems can be attributed primarily to two sources: labor unrest and onerous debt from the purchase of several clinics.⁵⁷ The former problem arose after Pan American hired a new Chief Executive Officer who subsequently reduced employee benefits, including vacation time for first-year nurses and the available number of sick days.⁵⁸ In response to these actions, the unhappy employees of Pan American voted to unionize.⁵⁹

The more significant impetus to bankruptcy, however, was a 1999 purchase of 17 clinics from United Healthcare for \$65 million and a percentage of proceeds to the health insurer.⁶⁰ While the purchase was initially a move to expand the hospital's services (and likely to capitalize on the Cuban-oriented service the hospital was renowned for), it quickly revealed itself to be a disastrous transaction for Pan American Hospital.⁶¹ United Healthcare took the patients of the clinics with them and the clinics hemorrhaged money.⁶² Pan American Hospital sought to negotiate with United Healthcare, but these efforts proved fruitless and the hospital closed the clinics and fired the employees.⁶³ United Healthcare then exercised a contractual provision providing for binding arbitration.⁶⁴ The arbitrator rejected most of the hospital's defenses, creating a claim by United Healthcare for \$60 to \$70 million.⁶⁵

Additionally, the hospital fired the executive who made the deal, who in turn sued Pan American Hospital, claiming that the firing was in retaliation for her discovery of financial irregularities.⁶⁶ These labor and contractual burdens were also accompanied by rising malpractice insurance costs, and ever-present costs associated with accepting underinsured and uninsured patients for emergency medical treatment.⁶⁷

On March 5, 2004, Pan American Hospital filed a voluntary peti-

56. Soma Biswas, *Pan American Hospital Goes Under*, DAILY DEAL, Mar. 15, 2004, available at 2004 WLNR 17772013. Prior to an acquisition of the clinics, the hospital had \$30 million dollars in cash. *Id.*

57. Dorschner, *supra* note 54.

58. *Id.*

59. *Id.*

60. *See id.*

61. *See id.*

62. *Id.*

63. *Id.*

64. *See id.*

65. *See id.*

66. *Id.*

67. *Id.*

tion for relief under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Southern District of Florida.⁶⁸ Three days later, the hospital made its first-day motions; among these was an application for the employment of Kluger, Peretz, Kaplan & Berlin (“Kluger Peretz”), pursuant to 11 U.S.C. § 327.⁶⁹ As part of the employment agreement, the hospital requested authority to give Kluger Peretz a general retainer with compensation fixed by the court.⁷⁰ The hospital also requested a risk-minimization device for Kluger Peretz, known as a “shortened fee application,” that would allow them to be compensated and reimbursed for expenses every sixty days.⁷¹ The court approved both the employment application and the shortened fee application.⁷²

Two months later, Kluger Peretz filed its first interim fee application, which divulged its intention to hold a pre-petition retainer of \$79,557.00.⁷³ This retainer, Kluger Peretz explained, would be treated as an evergreen retainer.⁷⁴ The U.S. Trustee objected to the evergreen retainer, and argument was heard before Judge A. Jay Cristol on June 1, 2004.⁷⁵

B. *The Court's Opinion in In re Pan American Hospital*

The court's opinion started by noting that there are two types of retainers: classic retainers (a payment to a lawyer made irrespective of any service, merely to secure the lawyer's availability for a given period of time), and special retainers, which take one of three different forms: (a) a security retainer, which the attorney periodically deducts from for actual services rendered; (b) an advance fee retainer, by which the debtor pays in advance for the services expected to be performed on behalf of the debtor, or; (c) an evergreen retainer, in which the retainer remains intact and the interim compensation is paid from the debtor's operating capital, while the professionals holding the retainer “do not look to this sum until such time as a final fee application is presented and approved by the court.”⁷⁶

The court noted the relevant statutory provisions regarding professional retention and compensation, excerpting 11 U.S.C. § 328 and 11

68. *In re Pan Am. Hosp. Corp.*, 312 B.R. 706, 708 (Bankr. S.D. Fla. 2004).

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.* at 709.

U.S.C. § 329.⁷⁷ These provisions, the court found, compel the bankruptcy court to scrutinize the terms of a debtor's professional engagement by the aforementioned reasonableness standard, with discretion given to the court to determine which services and charges are reasonable.⁷⁸

Judge Cristol incorporated the "market-driven" approach of *Insilco* while addressing the issue of reasonableness.⁷⁹ However, the Delaware analysis was not accepted as wholly dispositive.⁸⁰ In addition to reviewing the evergreen retainer under the permissive *Insilco* analysis, the court subjected the retainer to the *Knudsen* test.⁸¹

There are two possible explanations for this bifurcated analysis. First, because a risk-minimization device already existed, perhaps the court worried that additional protection would be unreasonable and superfluous for Kluger Peretz, and potentially hazardous to other players in the Chapter 11 process. This naturally invites the question of whether the existence of multiple risk-minimization devices trigger a *Knudsen* analysis. However, the bifurcated analysis is better clarified by an alternative explanation: perhaps *Pan American Hospital* stands for the proposition that evergreen retainers should be filtered through both forms of analysis, thus producing a more comprehensive assessment of the costs and benefits of permitting the retainer.

Yet the court in *Pan American Hospital* watered down the *Knudsen* analysis. *Knudsen* envisioned the application of these risk-minimization devices in rare cases that satisfy four conditions: a) an unusually large case featuring exceptional amounts of monthly fee accrual; b) in which waiting an extended period of time for payment would place an undue hardship on counsel; c) where the professional is capable of disgorging fees if necessary; and d) where the fee retainer procedure itself is subject to prior notice and hearing.⁸²

First, the court dismissed the U.S. Trustee's objection that while *Pan American Hospital* may be an important case to local citizens, it is not "unusually large" under *Knudsen*, as *Knudsen*'s fees dwarfed those of *Pan American Hospital* (from the court's figures, *Knudsen* cost around \$3,000,000 per year, while *Pan American Hospital* cost around \$878,000 per year).⁸³ *Pan American Hospital* thus offers an alternative

77. *Id.* at 710.

78. *Id.*

79. *See id.* at 710-11.

80. *Id.* at 711.

81. *Id.*

82. U.S. Trustee v. Knudsen Corp. (*In re Knudsen*), 84 B.R. 668, 672-73 (9th Cir. B.A.P. 1988).

83. *In re Pan Am. Hosp.*, 312 B.R. at 711.

to the stringent limitations imposed by *Knudsen*: as long as the fees incurred meet a substantiality requirement—thereby justifying the need for risk-minimization—the “unusually large” prong of the *Knudsen* test is satisfied.⁸⁴

The second prong of *Knudsen* received similar scrutiny from the court. At the outset, the court noted that it originally approved the shortened fee application process to prevent any undue hardship to Kluger Peretz.⁸⁵ The court reasoned that, by requesting greater protection, Kluger Peretz implicitly alleged that a shortened fee application was insufficient to hedge the risks involved in the case.⁸⁶ Thus, the court held that Kluger Peretz failed to meet their burden regarding the necessity of implementing multiple risk-minimization devices.⁸⁷ This represents *Pan American Hospital's* second lesson: to obtain the benefit of multiple risk-hedging devices, lawyers must demonstrate that multiple devices are necessary to prevent undue hardship. This requirement diverges from *Insilco*. *Insilco* asked whether, at the beginning of the case, plan confirmation was a probable outcome.⁸⁸ If it is uncertain whether the case will reach the plan stage of the reorganization, the existence of other risk-minimizing devices should not preclude an otherwise appropriate evergreen retainer.⁸⁹ *Pan American Hospital*, on the other hand, placed the burden of persuasion regarding the necessity of multiple risk-minimization devices on the party seeking to obtain the evergreen retainer.⁹⁰ That party must prove that the needs of the case justify placing additional constraints on the debtor's capital.⁹¹ While the uncertainty of success remains a factor under *Pan American Hospital*, it is less determinative than in *Insilco*.⁹²

Finally, the court in *Pan American Hospital* did not address the disgorgement prong of the *Knudsen* test, and only mentioned the notice requirement in a footnote, in determining the reasonableness of the evergreen retainer.⁹³

84. See *id.* at 711-12.

85. *Id.* at 712.

86. *Id.*

87. *Id.* (“By requesting an additional risk-minimizing device, KPKB is essentially asserting the 60-day period for interim fee applications is not sufficient to protect against the risk of non-payment. The Court disagrees; the shortening of time for the filing of fee applications is sufficient to adequately minimize KPKB's risk of non-payment in this case. The Court is not persuaded that KPKB has proven it is necessary to implement multiple procedures to protect it from the risk of non-payment of its fees.”)

88. *In re Insilco Techs., Inc.*, 291 B.R. 628, 635 (Bankr. D. Del. 2003).

89. See *id.*

90. See *In re Pan Am. Hosp.*, 312 B.R. at 712.

91. *Id.*

92. *Id.*

93. See *id.* at 712-13, 713 n.1.

Ultimately, *Pan American Hospital* represented a judicial attempt to allocate risks through a pragmatic, fact-intensive balancing of each party's interests, with a view toward the consequences imposed by an evergreen retainer. The court sought a middle ground between two undesirable outcomes. On the one hand, making counsel's risk-minimization efforts presumptively unreasonable dissuades top lawyers from taking Chapter 11 cases, where risk of nonpayment is possible.⁹⁴ On the other hand, providing lawyers too much protection gives credence to the public perception that Chapter 11 is merely a "cash cow" for lawyers.⁹⁵ Hence, the *Pan American Hospital* court offered the debtor the ability to attract the best counsel, provided the individual terms would not render the retainer improvident. The court also intimated that in extraordinary cases, lawyers may utilize multiple risk minimization devices.⁹⁶

C. What *In re Pan American Hospital* Means

In re Pan American Hospital is a curious addition to the current evergreen retainer doctrine. The court appears to have avoided both the market-driven approach of *Insilco*, and the heavily-regimented approach of *Knudsen* and its progeny. Alternatively, the court adopted reasoning from both lines of cases, while offering its own unique protection for creditors—evergreen retainers will frequently exclude other risk-minimization devices.⁹⁷

The emerging middle ground, however, yields numerous uncertainties. Satisfaction of the market-driven reasonableness test espoused by *Insilco* appears to be insufficient under a *Pan American Hospital* analysis. Arguably, *Pan American Hospital* employed the *Knudsen* test in lieu of the fifth *Insilco* element.⁹⁸ Under this approach, the retainer terms have to meet some level of fee substantiality, which leads the court to believe there are appropriate conditions for risk-minimization.⁹⁹ But, *Pan American Hospital* significantly derogates from *Knudsen*.

One uncertainty under the *Pan American Hospital* approach is whether the length of time of reorganization is a critical factor. For instance, in *In re Benjamin's-Arnolds, Inc.*,¹⁰⁰ an important factor

94. See *id.* at 711.

95. See *In re ACT Mfg., Inc.*, 281 B.R. 468, 473 n.2 (Bankr. D. Mass. 2002); see generally SOL STEIN, A FEAST FOR LAWYERS (1989).

96. *In re Pan Am. Hosp.*, 312 B.R. at 712.

97. See *id.*

98. *In re Insilco Techs., Inc.*, 291 B.R. 628, 634 (Bankr. D. Del. 2003) (stating the fifth element as "whether, given the size, circumstances and posture of the case, the amount of the retainer is itself reasonable, including whether the retainer provides the appropriate level of 'risk minimization,' . . .").

99. *In re Pan Am. Hosp.*, 312 B.R. at 711-12.

100. 123 B.R. 839 (Bankr. D. Minn. 1990).

announced by the bankruptcy judge was that the reorganization was to be a swift one.¹⁰¹ An evergreen retainer is designed to help secure a lawyer from risk of nonpayment. The policy goal ultimately to be achieved is to ensure that qualified lawyers will take on Chapter 11 cases that could be filled with uncertainty and risk. Yet swift reorganizations are often the antithesis of uncertainty and risk. Many swift reorganizations are in fact “pre-negotiated bankruptcies” or “prepackaged bankruptcies.”¹⁰² A lawyer that involves himself in this kind of bankruptcy knows the risks going into the case and much of the necessary planning is completed either before or shortly after the case begins. Essentially, the structure of the case already acts to minimize risk, and it should be questioned whether an additional risk-minimization device is necessary. It is also contrary to *Knudsen*, in that in a swift reorganization no real undue hardship would exist, because there is no extensive wait.¹⁰³ There may be a wait, to be sure, but in a swift reorganization that connotes a high degree of organization and planning, negotiation itself should provide an adequate means of risk-minimization for lawyers.

However, targeting the protection of risk-minimization devices toward a more typical Chapter 11 case, where a plan and disclosure statement is filed many months (and sometimes years) after the case is filed, is also problematic. If a case is drawn out with a small chance of success, serious inquiry must be made as to whether an evergreen retainer is a provident restriction of operating expenses. When framed in terms of the best interest of the estate, evergreen retainers become questionable because they impose doubly on the debtor’s operating capital (through both the retainer and the drain on operating capital).

Some legal commentators suggest that *Pan American Hospital* requires one risk-minimization device only.¹⁰⁴ Nonetheless, it is clear that evergreen retainers are valid in Chapter 11 bankruptcy reorganizations in Florida in at least some cases. The more difficult step is to parse how such a retainer is analyzed. *Pan American Hospital* runs evergreen retainers through both a market-driven test to establish reasonableness under the Code, and a watered down *Knudsen* analysis that seeks to

101. *Id.* at 841.

102. *United Artists Theatre Co. v. Walton*, 315 F.3d 217, 224 n.5 (3d Cir. 2003) (“‘Pre-negotiated’ bankruptcies have plans of reorganization and disclosure statements filed shortly after the cases themselves file, usually before the committee of unsecured creditors is formed . . . [whereas in a prepackaged bankruptcy,] the plan and disclosure statement are filed, and sufficient favorable votes on the plan are solicited and obtained, before the Chapter 11 case begins, leading to a prompt plan confirmation.”).

103. *See In re Knudsen*, 84 B.R. 668, 672-73 (9th Cir. B.A.P. 1988).

104. *Only 1 Risk-Minimizing Device Per Customer*, 43 No. 10 Bankr. Ct. Dec. (LRP) 1, Aug. 24, 2004.

establish a substantiality of need.¹⁰⁵ *Pan American Hospital* places a high evidentiary burden on lawyers seeking multiple risk-minimizing devices to establish the existence of an undue hardship.¹⁰⁶ Continued reasonableness was also important to the court, and it was explicitly noted that at the time a hearing is held on a law firm's fee application for interim compensation, any party in interest can object that the terms have become unreasonable over time.¹⁰⁷

D. *Aftermath*

The restructuring of Pan American Hospital has not gone smoothly. Notably, the court appointed an examiner to act as an independent investigator into the corporation's problems.¹⁰⁸ The examiner's report was highly critical of the hospital's management, accounting practices, and purchasing habits.¹⁰⁹ In the wake of this report, the court replaced the board of directors with a new slate approved by the company's creditors.¹¹⁰ The bankruptcy currently stands at a fork in the road. While there is some optimism that the hospital can eventually become profitable again, it is becoming increasingly more likely that the hospital will be purchased by another hospital group.¹¹¹

Nor has the restructuring gone smoothly for Kluger Peretz, the counsel for Pan American Hospital. In addition to the problems that *Pan American Hospital* has presented, the firm's evergreen retainer has backfired. After approval of the evergreen retainer, the court eventually approved a shortened fee application for everyone *except* Kluger Peretz, because Kluger Peretz already had the protection of its evergreen retainer.¹¹² While every other party in the litigation was paid every 60 days, Kluger Peretz was paid every 120 days.¹¹³ Kluger Peretz then drew down on the evergreen retainer, per the debtors' instructions.¹¹⁴ In an order denying Kluger Peretz's shortened fee application, the court

105. See *In re Pan Am. Hosp. Corp.*, 312 B.R. 706, 710-12 (Bankr. S.D. Fla. 2004).

106. See *id.* at 711.

107. See *id.* at 713.

108. The appointment of an examiner is an alternative to the appointment of a Chapter 11 trustee. See DAVID G. EPSTEIN, ET AL., *BANKRUPTCY* § 10-10 (1992). The Code sets out the scope of an examiner's role and the method by which they are appointed. See 11 U.S.C.A. § 1104(b) (2005).

109. See Brian Bandell, *Pan American Hospital Criticized*, S. FLA. BUS. J., Apr. 18, 2005, available at http://www.bizjournals.com/industries/economic_view_bankruptcies/2005/04/18/southflorida_story1.html.

110. See Brian Bandell, *Judge Installs New Board at Pan American*, S. FLA. BUS. J., May 2, 2005, available at <http://www.bizjournals.com/southflorida/stories/2005/05/02/story2.html>.

111. See Bandell, *supra* note 109.

112. *In re Pan Am. Hosp., Inc.*, No. 04-11819-BKC-AJC (Bankr. S.D. Fla. Apr. 6, 2005).

113. *Id.* at 2-3.

114. *Id.* at 4.

stated the “the Evergreen Order was not permissive . . . [by acting] without court authority in using, or directing the use of the retainer, [Kluger Peretz is] thereby acting at [its] own peril.”¹¹⁵ Kluger Peretz now has neither the security of a shortened fee application schedule, nor the benefits of the evergreen retainer they obtained at the beginning of the proceeding.

IV. COMMENTARY

A. *Lawyers*

Implicit in the *Pan American Hospital* court’s opinion is a recognition that a pool of highly skilled bankruptcy lawyers willing to represent debtors is necessary to give businesses a real shot at reorganizing.¹¹⁶ Preserving this pool is a consistent concern to the bankruptcy bar because the success rate of Chapter 11 is already low, and diminishing the number of debtors’ counselors would merely exacerbate the problem of reorganizations converting into liquidations.¹¹⁷

The general presumptive validity of evergreen retainers is important to bankruptcy practitioners. It stands to reason that most lawyers will want a substantial retainer before becoming counsel for a Chapter 11 debtor. Evergreen retainers provide superior security to traditional or security retainers in lengthy cases. For example, unexpected eventualities that may wreck the reorganization will at least be tempered by the presence of the evergreen retainer. A more traditional retainer, or a security retainer, will have already been exhausted by that point. Provided that a lawyer can prove that the fees are “substantial” and that they comply with a market-driven conception of reasonableness, bankruptcy practitioners should employ the use of evergreen retainers in large Chapter 11 cases.

However, in very large Chapter 11 cases, the evergreen retainer will provide only minimal security for the law firm. A million-dollar evergreen retainer is not significant if the client is Enron, because monthly fees will dwarf the retainer. In these situations, if multiple risk-minimization devices are not an available option, it would be wiser for the firm to rely on interim fee applications. However, in smaller cases

115. *Id.* at 11.

116. *Cf.* Jay Westbrook, *Fees and Inherent Conflicts of Interest*, 1 AM. BANKR. INST. L. REV. 287, 288 (1993). Professor Westbrook notes that the ability to obtain top counsel for a debtor has become increasingly difficult. One reason is that many bankruptcy firms have been subsumed by large firm practices that are inherently more subject to conflicts of interest in conducting debtor work. *Id.* Professor Westbrook also praises debtors’ lawyers as the “better half” of the bankruptcy bar, in part because they must “orchestrate the overall case using high-level legal, personal, and administrative skills. . . . [D]ebtor’s counsel often needs multiple expertise.” *Id.*

117. *See* WARREN & BRUSSEL, *supra* note 24, at 593.

the evergreen retainer could cover several months of fees, providing significant security, even if other devices are precluded.

B. *Businesses*

Businesses are placed in a difficult position by *Pan American Hospital*. Evergreen retainers are more burdensome on the estate than most retainers, because of the additional constraint upon operating capital. Not only is the evergreen retainer itself held outstanding until the final fee application, the interim payments must come from the operating capital of the debtor. Part of the problem is that courts have not viewed evergreen retainers as more invidious than a traditional retainer or a shortened fee application. Courts' ability to modify the terms of employment upon motion by a creditor or the U.S. Trustee pursuant to 11 U.S.C. § 328 provides a great deal of comfort to the courts; if the terms ever become unreasonable, the court can step in at the behest of creditors.¹¹⁸ The use of § 328(a) as a panacea for evergreen retainers that become unwieldy, however, is jurisprudentially questionable. In construing § 328(a), some courts have found that a bankruptcy court is not free to modify a pre-approved agreement under § 328(a) absent circumstances incapable of being anticipated at the time of approval.¹¹⁹ In the case of *Committee of Equity Security Holders of Federal-Mogul, Inc. v. Official Committee of Unsecured Creditors (In re Federal Mogul-Global, Inc.)*,¹²⁰ Judge Alito of the Third Circuit wrote that "[t]he second sentence of 11 U.S.C. § 328(a) thus forecloses the argument that a Bankruptcy Court, if presented with an application containing an unreasonable term or condition, may approve the application but correct the unreasonable term when compensation is later sought."¹²¹ This places a significant limitation on the ability of creditors to use § 328(a) as a check against improvident evergreen retainers.

Accepting the procedural benefit that § 328(a) may offer in this circumstance, a core issue still remains: granted that evergreen retainers are, in some cases, permissible under the Bankruptcy Code, what circumstances make it financially provident for an insolvent firm to entice attorneys with an evergreen retainer?

Insilco includes "the best interests of the estate" as a factor in assessing the reasonableness of an evergreen retainer, but provides little guidance for what constitutes the estate's "best interests."¹²² Maintain-

118. See *In re Pan Am. Hosp. Corp.*, 312 B.R. 706, 713 (Bankr. S.D. Fla. 2004).

119. E.g., *In re High Voltage Eng'g Corp.*, 311 B.R. 320, 331 (Bankr. D. Mass. 2004); *In re Merry-Go-Round Enters., Inc.*, 244 B.R. 327, 336-37 (Bankr. D. Md. 2000).

120. 348 F.3d 390 (3d Cir. 2003).

121. *Id.* at 397.

122. See *In re Insilco Techs., Inc.*, 291 B.R. 628, 634 (Bankr. D. Del. 2003).

ing good relations with pre-petition counsel, for instance, is in “the best interests of the estate” under *Insilco*.¹²³ It is easy to see that “the best interests of the estate” can be broad and permissive, and indeed, the cases addressing this issue concur. In *Nostas Associates v. Costich (In re Klein Sleep Products, Inc.)*,¹²⁴ Judge Calabresi of the Second Circuit addressed the concept of “benefit to the estate” in a lease assumption, dismissing the bankruptcy court’s “unduly narrow view of the benefit conferred on an estate when a trustee assumes an unexpired lease.”¹²⁵ Notably, Judge Calabresi refused to require a “net benefit,” because it would mean that any post-bankruptcy contract entered into for the benefit of a debtor’s estate would lose priority “the moment the deal turned sour.”¹²⁶ By analogy, “benefit to the estate” in the case of evergreen retainers would need to be similarly interpreted. Because the quality of the attorney is directly related to the chances of success in a Chapter 11 case, almost any concession made by the business to an attorney, provided the terms themselves are reasonable in the court’s opinion, could be seen as in “the best interest of the estate.” After all, the alternative is that the corporation is left with inferior representation that is more likely to result in a failed plan, which is most certainly not in the estate’s best interest. Therein lies the quandary faced by a debtor: law firms are permitted to request from their clients a retainer that may impede ultimate success in achieving the plan. In the alternative, firms with less leverage with regard to bankruptcy prominence may provide more rational benefit-to-cost ratio, but the increased risk of not achieving confirmation of the plan is preclusive of this option for a distressed, risk-averse corporation.

For businesses, the likely solution is contractual. To ensure that they can free up at least part of an evergreen retainer in case of a catastrophic event that significantly constrains the cash flow on hand, a company should negotiate with a prospective law firm for a clause that would release a percentage of funds upon a certain trigger. For example, if Law Firms A, B, and C each possess evergreen retainers for \$700,000, a company could draft a contractual term that would automatically release a small percentage of those funds when liquid assets possessed by the company hit a designated floor. Such a clause would serve the necessary function of sustaining a company if the problem is a relatively minor one, while simultaneously providing security to the law firm if the

123. *Id.* at 635.

124. 78 F.3d 18 (2d Cir. 1996).

125. *Id.* at 24.

126. *Id.* at 26.

problem is or becomes significant enough to derail the reorganization process.

Another way for a business to manage the risk of evergreen fees is to file a prepackaged or pre-negotiated Chapter 11 bankruptcy. This option is less likely to be practicable in large, complex bankruptcy matters.¹²⁷ But for those companies that can take advantage of this legal mechanism, the costs are on average one-third to one-fourth less than a conventional case, last one-third of the time, and the companies emerge with lower debt ratios.¹²⁸ However, a prepackaged or pre-negotiated bankruptcy is not a fool-proof way to manage the risks and costs of a Chapter 11 case, as the plan confirmation must still comport with applicable non-bankruptcy law dealing with the adequacy of disclosure.¹²⁹

C. Critiques

Because courts encourage debtors to engage high-quality lawyers to guide the reorganization, and because *Pan American Hospital* requires only a showing of “substantial” fees to warrant the application of an evergreen retainer, attorneys concerned with recouping fees for their work have an avenue for minimizing risk. However, such burdens on operating capital create a risk of failing to achieve the ultimate goal of Chapter 11: confirmation of a reorganization plan. Chapter 11 is already a selfish process—management is seeking a plan that will preserve their livelihood. More significantly, the bankruptcy process strips rationality from the cost-benefit approach that normally guides retention of lawyers. A market-driven approach to reasonableness, therefore, is at odds with a system that some commentators criticize as eschewing the rationality that is inherent in the marketplace.

Cynthia Baker, a former professor of law at Emory University, criticizes the Chapter 11 process as one that ignores professional costs and creates a “basic economic infirmity” in the current system.¹³⁰ Professor Baker notes that this results because the priority rules of bankruptcy place the cost of bankruptcy upon the lower (or “junior”) classes.¹³¹ The debtor itself and the senior stakeholders in the Chapter 11 process have no incentive to act rationally in hiring professionals, because costs incurred that exceed benefits are not borne by those parties, but by jun-

127. See Fernando Diz & Martin J. Whitman, *The Professional Costs of Chapter 11: A Different View*, 14 J. BANKR. L. & PRAC. 2 Art. 1 (2005) (demonstrating that “[f]irms involved in conventional Chapter 11 cases are on average three times larger than those filing as prepackaged or prenegotiated cases”).

128. *Id.* at 4.

129. See *In re Southland Corp.*, 124 B.R. 211, 223 (Bankr. N.D. Tex. 1991).

130. See Baker, *supra* note 29, at 42.

131. *Id.* at 46.

ior stakeholders.¹³²

Similarly, Professor Baker is highly critical of court review of attorney's fees.¹³³ "In large cases, reviewing fees and poring over hundreds of pages in time records, consumes significant amounts of scarce judicial resources . . . [as well as] creates potential due process problems"¹³⁴ Indeed, in her view, "[t]he current system's reliance on court review is a relic from the past, and should be discarded."¹³⁵ Professor Baker proposes three modifications to correct the "perverse economic incentives to overspend."¹³⁶ Her proposal includes eliminating court review except where a party in interest objects, charging fees and expenses by an official committee against distribution to the class that the committee represents, and allocating fees incurred by the debtor-in-possession's professionals "among all classes of unsecured claims and equity interests [in the estate] in proportion to the value of property distributed to each class under the plan of reorganization."¹³⁷

D. *Lamie*

Finally, a recent decision by the United States Supreme Court may lead to the increased usage of evergreen fee agreements. In *Lamie v. U.S. Trustee*,¹³⁸ the Court denied compensation in a Chapter-11-turned-Chapter-7 bankruptcy proceeding because "§ 330(a)(1) does not authorize payment of attorney's fees unless the attorney has been appointed under § 327 of the [Bankruptcy] Code."¹³⁹ Section 327(a) allows for the appointed trustee to employ one or more attorneys to represent or assist the trustee in carrying out the trustee's duties, or under § 327(e) to employ for special purposes an attorney that has represented the debtor.¹⁴⁰

Post-*Lamie*, attorneys who provide services to a debtor post-conversion have a right to be skittish, unless they are qualified under § 327. Practicing attorneys, in response to *Lamie*, have devoted time to hedging the significant risk that conversion presents if compensation cannot be rendered under § 327(a). One solution for this problem is for a debtor's attorney to request an evergreen retainer, and for whatever services rendered after the conversion date to be covered by a retainer fee. The

132. *See id.* at 42, 46.

133. *See id.* at 59-67.

134. *Id.* at 67.

135. *Id.*

136. *Id.* at 38.

137. *Id.*

138. 540 U.S. 526 (2004).

139. *Id.* at 529.

140. *See id.* at 531.

Supreme Court did not address the issue of whether post-conversion legal fees could be paid out of a pre-petition retainer, and this seems to be precisely an instance where a law firm would want an evergreen retainer.

V. CONCLUSION

Pan American Hospital is a decision that can be difficult to parse. The court was between a rock and a hard place. On the one hand, they had a law firm that sought a method of compensation that inflicted constraints upon the operating capital of the debtor and was possibly hazardous to borderline Chapter 11 bankruptcies. This necessarily creates a need for some scrutiny. But too much scrutiny, such as per se invalidity, would cause the best bankruptcy attorneys to shy away from Chapter 11 work; without these top attorneys operating on behalf of debtors, very few Chapter 11 restructurings would reach completion. Given these two unacceptable results, the court reached out for a middle ground: provided that the debtor can show some substantiality in fees (and an undue hardship if the professionals seeking compensation involve more than one risk-minimizing device) and compliance with factors enunciated in *Insilco*, evergreen retainers are valid.¹⁴¹ To hedge against the possibility of such a retainer unconscionably constraining the debtor's operating capital, the court allowed for a continuing reassessment of the reasonableness of the size and terms of the retainer, provided the U.S. Trustee and vigilant creditors object.¹⁴²

Rather than discarding *Insilco*, *Pan American Hospital* attempts to mend its flaws by filtering the terms of the retainer through a watered-down *Knudsen*. Evergreen retainers, as they exist today, require substantial fees and allow for many grounds for objection by creditors or the U.S. Trustee. While this compromise between the restrictive *Knudsen* and market-driven *Insilco* is appropriate in terms of enticing premier bankruptcy attorneys to take on Chapter 11 cases, it still fails to acknowledge the possible irrationality that may occur when a debtor hires an attorney.¹⁴³ To fully extinguish the risks of irrationality that would taint the Chapter 11 process, courts should also establish procedures to ensure that the evergreen retainer is narrowly tailored to achieve the least risk-minimization necessary to entice counsel, while simultaneously providing the most liquidity possible to the reorganizing debtor. While *Pan American Hospital* does this implicitly, such a requirement

141. See *In re Pan Am. Hosp. Corp.*, 312 B.R. 706, 710-12 (Bankr. S.D. Fla. 2004).

142. See *id.* at 713.

143. See *supra* note 129, and accompanying text.

must be set out explicitly to provide a defined equilibrium to the players in the game of Chapter 11.

STEVEN E. SEWARD*

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