

**PROFESSIONAL COMPENSATION IN BANKRUPTCY:
USING CONTRACT LAW PRINCIPLES TO INTERPRET
AMBIGUOUS RETENTION ORDERS**

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“[T]here are two tragedies in life. One is to lose your heart’s desire. The other is to gain it.”¹

I. INTRODUCTION

In 1978, Congress’ heart desired higher professional fees for services rendered in bankruptcy.² Low and often arbitrary compensation was causing specialists to leave bankruptcy for more lucrative fields, thereby hurting debtors and creditors in the process.³ As a result, Congress reformed the Bankruptcy Code and enacted 11 U.S.C. § 328⁴ and 11 U.S.C. § 330.⁵

Sections 328 and 330 each created a different approach to professional fees. The first approach allows a professional, hired by the trustee or a committee, to request an employment retention order under § 328(a) that fixes the terms and conditions of compensation.⁶ The bankruptcy court has the sole discretion to

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¹ BERNARD SHAW, *MAN AND SUPERMAN* act 4, 208 (Penguin Books 2004) (1903).

² See Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 1978 U.S.C.C.A.N. (92 Stat. 2549) 5787, 6286.

³ *Id.*

⁴ 11 U.S.C. § 328 (2007).

⁵ 11 U.S.C. § 330(a) (2007).

⁶ 11 U.S.C. § 328(a); Robert J. Landry, III & James R. Higdon, *A Primer on 11 U.S.C. 328(A) and Its Use in Alternative Billing Methods in Bankruptcy*, 50 MERCER L. REV. 537, 541 (1999). However, the judge may award compensation different from the fixed terms and conditions “if such terms and conditions prove to be 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. § 328(a).

approve a retention order and a fee arrangement under § 328.⁷ The second approach permits a professional to request a retention order and reserve compensation issues until the end of employment.⁸ At that time, the court awards “reasonable compensation” under § 330(a).⁹

Each approach to professional fees provides distinct advantages. Section 328 rewards entrepreneurship, compensates for the professional’s opportunity costs, allows the professional to manage risk, and reduces transaction costs. In contrast, § 330 reduces the bankruptcy court’s information costs, reduces collusion among the trustee and the professional, and prevents strategic withholding by creditors. Bankruptcy courts attempt to gain the advantages of both approaches by writing ambiguous retention orders. These orders purport to approve the professional’s compensation under § 328 but reserve the court’s ability to make a § 330 reasonableness evaluation if the compensation appears excessive.¹⁰ However, ambiguous retention orders blend the two approaches and strip § 328 of the certainty it is meant to guarantee for professionals.¹¹ As a result, professional fee awards are once again mired in arbitrariness. Reviewing courts add to the uncertainty by interpreting ambiguous retention orders with conflicting default rules.¹²

Academic scholarship on professional fees in bankruptcy extends from arguments that high compensation signals the need for a “serious reform” of the

⁷ Compare 11 U.S.C. § 328(a) (requiring court approval of a retention order and fee arrangement and giving the court the ability to later adjust the amount of compensation for improvident circumstances) with 11 U.S.C. § 330(a) (allowing the court to award “reasonable compensation” for actual services rendered).

⁸ 11 U.S.C. § 330(a); Landry & Higdon, *supra* note 6, at 541.

⁹ 11 U.S.C. § 330(a); Landry & Higdon, *supra* note 6, at 541.

¹⁰ See, e.g., *In re Vern D. Blanchard*, No. 96-12037-H7 1, 10-11 (Bankr. S.D. Cal. Dec. 19, 2005), www.casb.uscourts.gov/pdf/96_12037m.pdf.

¹¹ See *id.* (stating that ambiguous retention orders are subject to review under § 330).

¹² Compare *Circle K Corp. v. Houlihan, Lokey, Howard & Zukin, Inc.* (*In re Circle K Corp.*), 279 F.3d 669, 672, 674 (9th Cir. 2001) (amended Jan. 30, 2002) (holding that review under § 330 was appropriate when the retention order did not mention § 328 and included language stating that the retainer agreement was subject to review by the court) with *Peele v. Cunningham* (*In re Tex. Sec., Inc.*), 218 F.3d 443, 445 (5th Cir. 2000) (holding that review under § 330 is not appropriate when a court has approved the terms of an employment agreement).

entire Code¹³ to an exposition on the intricacies of § 328.¹⁴ Furthermore, at least one article highlights the negative effects of some bankruptcy courts' continued insistence on awarding below market compensation and suggests this to be a violation of due process.¹⁵ However, no scholarship has addressed the problem that reviewing courts face in interpreting ambiguous retention orders.

To this effect, I propose a solution which draws upon the interpretation principles and default rules of contract law. Reviewing courts should first apply the maxim *contra proferentem*—ambiguity will be read against the drafter—to read ambiguous orders in favor of § 328. If, however, the specific terms or rate of compensation remain uncertain after this maxim is applied, then reviewing courts should fill the gap with § 330. This proposal creates an incentive for less ambiguous retention orders and enhances overall efficiency.

Only bankruptcy professionals consider personal compensation the goal of bankruptcy.¹⁶ However, compensation is what makes bankruptcy work.¹⁷ An increase in the uncertainty regarding professional fees is a signal that Congress' desires are sinking and both creditors and debtors will be left struggling in the water. Therefore, this problem invites further examination.

The body of this Article proceeds in four main sections. Part II reviews the Congressional history of the 1978 bankruptcy reform and the mechanisms of the current §§ 328 and 330. Part III examines the conflicting precedents of the Ninth and Fifth Circuits and briefly points out the problems associated with the rules adopted in each circuit. Part IV compares the advantages of § 328 with the advantages of § 330 and examines why bankruptcy courts draft ambiguous retention orders. Furthermore, Part IV provides an example from a recent case and explains why ambiguous retention orders are eroding Congress' goal of attracting qualified professionals to the bankruptcy arena. Part V summarizes contract law principles for

¹³ Cynthia A. Baker, *Other People's Money: The Problem of Professional Fees in Bankruptcy*, 38 ARIZ. L. REV. 35, 36-37 (1996).

¹⁴ See Landry & Higdon, *supra* note 6.

¹⁵ Ralph C. McCullough, II, *Attorneys' Fees in Bankruptcy: Toward Further Reform*, 95 COM. L. J. 133, 162-68 (1990).

¹⁶ Baker, *supra* note 13, at 38.

¹⁷ *Id.*

interpreting ambiguous contracts and applies these principles to propose a mechanism to aid reviewing courts in interpreting ambiguous retention orders.

II. CONGRESSIONAL HISTORY

In 1978, Congress enacted a bankruptcy reform act to modernize the Bankruptcy Code.¹⁸ The guiding principle of compensation under the old bankruptcy rules was “economy,”¹⁹ which placed “conservatism of the estate and return to creditors” above all other factors.²⁰ Under the old rules, professionals were compensated “on a quantum meruit basis.”²¹ In enacting the reform, Congress reasoned that qualified specialists who could earn higher fees in other fields would leave the bankruptcy arena if the limits on professionals’ compensation remained unchanged.²² Furthermore, the benefit of quality representation and efficient management to both the debtor and creditor far exceeded the savings of arbitrary fee

¹⁸ Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 1978 U.S.C.C.A.N. (92 Stat. 2549) 5787, 5965.

¹⁹ This principle is commonly referred to as “conservation of the estate and economy of administration.” *Seiler v. First Nat’l Bank of Babbitt (In re Benassi)*, 72 B.R. 44, 47 (D. Minn. 1987) (citing *In re Penn-Dixie Indus.*, 18 B.R. 834, 838 (S.D.N.Y. 1982)); Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 1978 U.S.C.C.A.N. (92 Stat. 2549) 5787, 6286. Numerous other names exist for this principle. See, e.g., GEORGE M. TREISTER ET AL., FUNDAMENTALS OF BANKRUPTCY LAW 105 (American Law Institute 1996) (referring to the “economy principle”); Leif M. Clark, *Paying the Piper: Rethinking Professional Compensation in Bankruptcy*, 1 AM. BANKR. INST. L. REV. 231, 231-32 (1993) (referring to the “economy standard”); McCullough, *supra* note 15, at 134 (referring to the “spirit of economy”).

²⁰ McCullough, *supra* note 15, at 134. McCullough cites to *Mass. Mutual Life Ins. Co. v. Brock*, as an illustration of this principle. *Id.* at 134 n.3 (citing *Mass. Mut. Life Ins. Co. v. Brock*, 405 F.2d 429, 432-33 (5th Cir. 1968)). In *Brock*, the court remanded fee awards in which the lower court had considered the time involved, the complexity of the case, and the results obtained, but abused its discretion by failing to consider “the public interest which is inherent in bankruptcy matters” *Id.* (citing *Mass. Mutual Life Ins.*, 405 F.2d at 432-33).

²¹ *In re Benassi*, 72 B.R. at 47; 2 COLLIER ON BANKRUPTCY § 328.02, at 328-4 (Lawrence P. King et al. eds., 15th ed., 1996); see also *Moshein v. Beverly Crest Convalescent Hosp., Inc. (In re Beverly Crest Convalescent Hosp., Inc.)*, 548 F.2d 817, 821 (9th Cir. 1976) (amended Mar. 2, 1977), *superseded by statute*, 11 U.S.C. § 330 (1978) (reducing fee award to the hourly rate of a district judge).

²² *In re Benassi*, 72 B.R. at 47; Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 1978 U.S.C.C.A.N. (92 Stat. 2549) 5787, 6286; Clark, *supra* note 19, at 232 (“[B]ankruptcy professionals were expected to be paid less for their services than they would receive in other kinds of work. As a result, many able professionals simply avoided bankruptcy work altogether . . .”).

cuts.²³ Thus, Congress explicitly abandoned the principle of economy and allowed professionals to be compensated as in any other field.²⁴

Four provisions of the reformed Code deal with the employment and compensation of professionals.²⁵ First, § 327 authorizes the trustee, subject to the court's approval, to employ professionals to represent or assist the trustee in performing services for the estate.²⁶ These professionals include, but are not limited to, attorneys, accountants, appraisers, and auctioneers.²⁷ Second, § 328 authorizes the trustee or an appointed committee, with the court's approval, to employ a

²³ *In re Benassi*, 72 B.R. at 47; McCullough, *supra* note 15, at 138.

²⁴ Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 1978 U.S.C.C.A.N. (92 Stat. 2549) 5787, 6286 (“The effect . . . is to overrule . . . cases that require fees to be determined based on notions of conservation of the estate and economy of administration.”). Furthermore, the House bill was passed over the Senate’s version of the bill. McCullough, *supra* note 15, at 137. The Senate Report stated, “[t]he compensation is to be reasonable, for economy in administration is the basic objective.” Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 1978 U.S.C.C.A.N. (92 Stat. 2549) 5787, 5826. The Senate reasoned that “persons of merit and quality have not eschewed public service in bankruptcy cases merely because bankruptcy courts, in the interest of economy in administration, have not allowed them compensation that may be earned in the private economy of business or the professions.” *Id.* However, as mentioned, the House bill that was passed explicitly repudiated both of these ideas. *Id.* at 6286; BANKRUPTCY CODE, RULES & OFFICIAL FORMS 115 (Thomson West 2007) (“[T]he policy of this section is to compensate attorneys and other professionals . . . at the same rate as the attorney or other professional would be compensated Contrary language in the Senate report . . . is rejected”). *But cf.* McCullough, *supra* note 15, at 152 (“Cuts of this kind, made without consideration of reasonable necessity, suggest that courts maintain a lingering adherence to the economy principle of the Act.”).

²⁵ These provisions, §§ 327, 328, 330, and 331, were enacted as part of the 1978 Bankruptcy Reform Act. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 1978 U.S.C.C.A.N. (92 Stat. 2549) 5787, 6284-87. While all but § 331 have since been amended, none of the amendments substantively changed the statutes for the purpose of this Article. Compare 11 U.S.C. § 330(a) (1978) (the initial provisions enacted) with 11 U.S.C. § 330(a) (2006) (incorporating amendments from 1984, 1986, 1994, and 2005). See generally Cynthia A. Baker, *Fixing What's Broken: A Proposal for Reform of the Compensation System in Bankruptcy*, 5 J. BANKR. L. & PRAC. 435, 435-36 (1996) (suggesting that the Bankruptcy Reform Act of 1994 “tightened the standards” of professional compensation in bankruptcy but did not resolve its inherent problems).

²⁶ 11 U.S.C. § 327(a) (2007); see also William H. Gindin, *Professionals in Bankruptcy Proceedings: Appointment, Right to Compensation and Conflicts of Interest*, 21 SETON HALL L. REV. 895 (1991) (discussing appointment of professionals under § 327).

²⁷ 11 U.S.C. § 327(a).

professional on any reasonable terms and conditions.²⁸ These terms and conditions include performing work “on a retainer, on an hourly basis, on a fixed or percentage fee basis, or on a contingent fee basis.”²⁹ If approved, the terms of employment can only be altered if they “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.”³⁰ This provision altered settled practices. Under the previous rules, compensation was subject to the uncertainty of what a court would decide the work was worth after it was completed.³¹ Furthermore, contingency fee contracts were often invalidated.³² Thus, § 328 provides professionals a means for predictability in their compensation.³³

Third, § 330, subject to § 328, allows a court to award “reasonable compensation” to a professional.³⁴ Section 330(a)(3) provides six factors that a court may use to determine a reasonable compensation.³⁵ Congress further emphasized its intent to abandon the “economy principle” by making comparable compensation in cases other than bankruptcy one of the six factors.³⁶ Lastly, § 331 allows a professional to be paid on an interim basis.³⁷

²⁸ 11 U.S.C. § 328(a) (2007); *see also* Landry & Higdon, *supra* note 6, at 538-39 (discussing use of § 328(a)).

²⁹ 11 U.S.C. § 328(a).

³⁰ *Id.*

³¹ *Donaldson Lufkin & Jenrette Sec. Corp. v. Nat'l Gypsum Co. (In re Nat'l Gypsum Co.)*, 123 F.3d 861, 862 (5th Cir. 1997).

³² *Seiler v. First Nat'l Bank of Babbitt (In re Benassi)*, 72 B.R. 44, 46-47 (D. Minn. 1987) (citing *Watkins v. Sedberry*, 261 U.S. 571, 575 (1923)).

³³ *In re Nat'l Gypsum Co.*, 123 F.3d at 862; Landry & Higdon, *supra* note 6, at 539.

³⁴ 11 U.S.C. § 330(a)(1) (2007).

³⁵ 11 U.S.C. § 330(a)(3). These factors are: (1) “the time spent on such services;” (2) “the rates charged for such services;” (3) whether the services were necessary or beneficial; (4) whether the services were performed in a timely manner; (5) the qualifications and experience of the professional; and (6) the rates charged by “comparably skilled practitioners” in non-bankruptcy fields. *Id.*

³⁶ 11 U.S.C. § 330(a)(3)(F); Landry & Higdon, *supra* note 6, 543-44.

³⁷ 11 U.S.C. § 331 (2007). Without the ability for interim compensation, professionals were often forced to wait—sometimes for years—before receiving compensation. McCullough, *supra* note 15, at 144. “This policy impaired efficient administration of the bankruptcy estate by forcing attorneys to

In summary, Congress created two approaches for professionals to establish a fee arrangement.³⁸ The first approach “is to request a retention order under [§] 328 that fixes the terms and conditions of the employment.”³⁹ Approval occurs before any services have been rendered.⁴⁰ Once granted, the terms and conditions set forth in the court order govern compensation unless the bankruptcy court makes a finding of “improvidence” under § 328.⁴¹ The second approach “is to request approval to be employed” but reserve compensation issues until the filing of the fee application.⁴² Once the fee application is filed, the court awards reasonable compensation according to § 330.⁴³ In adopting these two approaches, Congress sought to increase compensation to market levels for the express purpose of “attracting highly qualified professionals to the bankruptcy arena.”⁴⁴

III. DIVERGENCE AMONG THE CIRCUITS

In most bankruptcy cases a flat fee is charged.⁴⁵ As a result, problems regarding compensation typically only arise in the more complex Chapter 11 cases⁴⁶

‘lend’ their services to the estate: unlike other attorneys, although they received no compensation while they worked on a case, they were of course still required to pay salaries and office overhead.” *Id.*

³⁸ See also Landry & Higdon, *supra* note 6, at 541. Compare 11 U.S.C. § 328(a) (2007) (fixing the terms of employment in advance) with 11 U.S.C. § 330(a) (allowing a court to award reasonable compensation after services are completed).

³⁹ Landry & Higdon, *supra* note 6, at 541.

⁴⁰ Seiler v. First Nat’l Bank of Babbitt (*In re Benassi*), 72 B.R. 44, 47 (D. Minn. 1987).

⁴¹ *Id.*

⁴² Landry & Higdon, *supra* note 6, at 541.

⁴³ *Id.*

⁴⁴ *In re Benassi*, 72 B.R. at 49.

⁴⁵ Landry & Higdon, *supra* note 6, at 537.

⁴⁶ *Id.* at 538. Chapter 11 cases generally deal with debtor rehabilitation or reorganization. DAVID G. EPSTEIN, BANKRUPTCY AND RELATED LAW IN A NUTSHELL 125 (West 7th ed. 2005). In a Chapter 11 case, the debtor retains possession of its assets and makes payments to creditors according to a court approved plan. *Id.* at 126.

or when a professional is hired for a special purpose.⁴⁷ However, even in those cases, a bankruptcy court generally reviews a professional's fee application under § 330 after services have been provided.⁴⁸ Thus, application of § 328 causes most of the problems. As stated above, § 328 permits a professional to seek court approval of specific terms and conditions of compensation at the time of application for employment.⁴⁹ Approval is discretionary.⁵⁰ However, if granted, the retention order should state that employment is granted under § 328 and set forth the express terms and conditions that apply.⁵¹ While this is a routine matter in some districts, it is not a universal practice.⁵² Thus, an order granting employment can be ambiguous as to whether it is approving both the professional's employment and compensation, or simply the professional's employment.⁵³ Appellate courts have fashioned default rules to deal with such ambiguity.⁵⁴ These default rules can be understood by looking at the precedents of two circuits: the Ninth Circuit and the Fifth Circuit.⁵⁵

A. Ninth Circuit

In *In re B.U.M. International, Inc.*, the debtor filed an application to employ a financial consultant who would receive a combination of both a monthly and a contingency fee.⁵⁶ The bankruptcy court initially approved the application.⁵⁷

⁴⁷ Landry & Higdon, *supra* note 6, at 538.

⁴⁸ *F.V. Steel & Wire Co. v. Houlihan Lokey Howard & Zukin Capital L.P.*, 350 B.R. 835, 838-39 (E.D. Wis. 2006).

⁴⁹ 11 U.S.C. § 328(a).

⁵⁰ Landry & Higdon, *supra* note 6, at 544.

⁵¹ *Id.* at 546-47.

⁵² *Id.*

⁵³ *Id.* at 547.

⁵⁴ *Id.*

⁵⁵ The Sixth Circuit has approached this differently. See *Nischwitz v. Miskovic (In re Airspect Air, Inc.)*, 385 F.3d 915, 922 (6th Cir. 2004) ("We hold that whether a court 'pre-approves' a fee arrangement under § 328 should be judged by the totality of the circumstances, looking at both the application and the bankruptcy court's order.").

⁵⁶ *Friedman Enters., Inc. v. B.U.M. Int'l, Inc. (In re B.U.M. Int'l, Inc.)*, 229 F.3d 824, 825 (9th Cir. 2000). The agreement called for \$7,500 per month, plus expenses, and contingency fees based on the

However, after objections were filed, the court conducted a hearing and determined that each professional employed under § 327 may have his fees reviewed for reasonableness once all services were rendered.⁵⁸ One month later, the court entered an order approving the employment with “an additional proviso that ‘all fees and costs of [the consultant] are subject to Court approval.’”⁵⁹ When the consultant finished rendering services, he submitted a fee application.⁶⁰ Although the monthly fees were approved, the court conducted a § 330 reasonableness evaluation and denied the contingency fee in its entirety.⁶¹ The district court affirmed.⁶²

On review, the court of appeals first stated that “[t]here is no question that a bankruptcy court may not conduct a § 330 inquiry into the reasonableness of the fees and their benefit to the estate if the court already has approved the professional’s employment under 11 U.S.C. § 328.”⁶³ Second, the court noted that neither the application for employment nor the court’s order referred to either § 328 or § 330.⁶⁴ Third, the court acknowledged the order’s “proviso” making fees and costs subject to court approval.⁶⁵ Finally, the court held that “while the bankruptcy court may have *conditionally* approved [the professional’s] employment, it did not convey its complete approval under § 328.”⁶⁶ Because the court “specifically reserved the right

value of the secured debt, unsecured debt, unsecured trade debt, consideration received by the company, and capital. *Id.* at 825-26.

⁵⁷ *Id.* at 826.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.* at 827.

⁶¹ *Id.* Through this evaluation, the court concluded “that [the professional’s services] had not benefited the estate.” *Id.*

⁶² *Id.*

⁶³ *Id.* at 829 (citing *Pitrat v. Reimers (In re Reimers)*, 972 F.2d 1127, 1128 (9th Cir. 1992)).

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

to review the fees,” a § 330 review was proper.⁶⁷ The court distinguished the circumstances of *In re B.U.M. International, Inc.* from an earlier decision, *In re Reimers*.⁶⁸ Unlike *In re Reimers*, the court reasoned that the bankruptcy court’s language put the professional on notice that the court had only conditionally approved the fee structure.⁶⁹ However, the court commented that, in the future, the bankruptcy court should either accept or reject the fee agreement and not make acceptance conditional, as this would allow professionals to “know exactly where they stood before undertaking the engagement.”⁷⁰

Similarly, in *In re Circle K*, a creditor’s committee sought to employ a financial advising company.⁷¹ The retainer agreement specified that the company would be paid \$100,000 per month.⁷² Although the agreement acknowledged that any compensation remained subject to a final fee application, it did not refer to § 328.⁷³ The bankruptcy court approved the employment in a retention order that mentioned neither § 328 nor § 330.⁷⁴ On submission of the company’s fee application, the court

⁶⁷ *Id.* at 829, 831.

⁶⁸ *Id.* at 829. In *Reimers*, the trustee requested the bankruptcy court’s permission to employ an attorney. *In re Reimers*, 972 F.2d at 1127. The fee agreement between the parties provided that the attorney would be paid forty percent of the amount he recovered in litigating a claim for the debtor estate. *Id.* at 1127-28. The court approved both the employment and the fee arrangement in the same order. *Id.* at 1128. The professional successfully recovered \$37,871.30, but when he applied for his fee, the court estimated an hourly rate and awarded him only \$6,000. *Id.* Both the trustee and the professional filed a motion for reconsideration which was denied. *Id.* The district court affirmed. *Id.* On further appeal, the court stated that once a bankruptcy court approves a fee arrangement under § 328, it cannot alter that arrangement without first finding “unanticipated developments” that render the original terms improvident. *Id.* Thus, the court held that the award was improper. *Id.* at 1128, 1129.

⁶⁹ *In re B.U.M. Int’l, Inc.*, 229 F.3d at 829.

⁷⁰ *Id.* This is somewhat contradictory because the court previously stated that the conditional language in the order gave the professional notice that it was not approved under § 328.

⁷¹ *Circle K Corp. v. Houlihan, Lokey, Howard & Zukin, Inc. (In re Circle K Corp.)*, 279 F.3d 669, 672 (9th Cir. 2001) (amended Jan. 30, 2002).

⁷² *Id.*

⁷³ *Id.* The exact language is: “[a]ll fees so paid remain subject to subsequent Bankruptcy Court approval in a final fee application to be submitted to the Court.” *Id.*

⁷⁴ *Id.*

conducted a reasonableness review and awarded half of the requested fees.⁷⁵ However, on appeal, the district court reversed.⁷⁶ The court held that the company had been approved under § 328, and, without a finding of “improvidence,” must be awarded its requested fees.⁷⁷

The court of appeals disagreed.⁷⁸ First, the court stated that the facts of the case before it were similar to *In re B.U.M. International, Inc.*⁷⁹ Second, the court noted the lack of reference to § 328 in the application and the “subject to” language in both the application and the order.⁸⁰ The court held that “the bankruptcy court had only conditionally approved the employment agreement and that § 330 review was therefore appropriate.”⁸¹ Further, the court cited the treatment of another professional in the same proceeding⁸² as well as the bankruptcy court’s belief that it had only conditionally approved the company’s fee agreement in support of its conclusion.⁸³ The court explicitly disagreed with the Fifth Circuit’s holding in *In re National Gypsum Co.*, discussed below.⁸⁴

⁷⁵ *Id.* The professional “submitted its first Final Fee Application ‘pursuant to Sections 327 and 330,’” rather than pursuant to § 328. *Id.* at 672 n.3. However, an amended fee application stated that § 328 was the appropriate standard. *Id.* The debtor contended that because the professional first cited § 330, “it should be judicially estopped from now arguing that § 328 applies.” *Id.* The court refused to resolve this issue in light of its other holdings. *Id.*

⁷⁶ *Id.* at 672.

⁷⁷ *Id.*

⁷⁸ *Id.* at 673.

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.* That professional explicitly cited § 328 in his application and the court’s order stated that payments “shall be subject to the right of the Bankruptcy Court under 11 U.S.C. § 328(a) to review such payments.” *Id.*

⁸³ *Id.*

⁸⁴ *Id.* at 673-74.

B. Fifth Circuit

In *In re National Gypsum Co.*, the debtor applied⁸⁵ to employ a professional at a rate of \$125,000 per month.⁸⁶ The bankruptcy court issued an order approving both the employment and terms of payment but stated that it “retain[ed] the right to consider and approve the reasonableness and amount of [the professional’s] fees on both an interim and final basis.”⁸⁷ After the professional submitted a fee application, the court reduced the amount requested by \$400,000.⁸⁸ The court believed the lower figure represented “reasonable compensation in the light of hourly compensation that had been allowed in similar bankruptcy cases in the same district.”⁸⁹ The district court affirmed, holding that review was appropriate because the bankruptcy court had only conditionally approved the fee agreement.⁹⁰

On further review, the court of appeals reiterated Congress’ impetus in enacting § 328: “Prior to 1978[,] the most able professionals were often unwilling to work for bankruptcy estates where their compensation would be subject to the uncertainties of what a judge thought the work was worth after it had been done.”⁹¹ The court stated that the same uncertainty remained under § 330 but could be avoided by obtaining the court’s approval under § 328.⁹² Thus, “[i]f the most competent professionals are to be available . . . they must know what they will

⁸⁵ If a trustee is not appointed in a Chapter 11 case, the debtor is a debtor-in-possession. EPSTEIN, *supra* note 46, at 131. In this position, the debtor stands in as the trustee and can employ a professional under § 327. COLLIER ON BANKRUPTCY, *supra* note 21, at § 327.01, at 327-4 n-1 to 327-5.

⁸⁶ *Donaldson Lufkin & Jenrette Sec. Corp. v. Nat’l Gypsum Co. (In re Nat’l Gypsum Co.)*, 123 F.3d 861, 862 (5th Cir. 1997).

⁸⁷ *Id.*

⁸⁸ *Id.* The professional claimed it was owed \$2,825,000 by virtue of the agreed monthly compensation. *Id.* However, the debtor objected to this amount and the parties agreed to reduce the compensation to \$2,400,000. *Id.* The bankruptcy court further reduced this figure by \$400,000 to \$2,000,000. *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *Id.* The court recognized that § 328 approval could still be reviewed under the “improvident” standard of § 328. *Id.*

receive Courts must protect those agreements and expectations, once found to be acceptable.”⁹³

Turning to the case before it, the court noted that the bankruptcy court could have approved the professional’s retention and left compensation to be determined under § 330.⁹⁴ Instead, the court expressly approved the compensation agreement.⁹⁵ The court held that the bankruptcy court granted § 328 approval and that the order’s contingency language only “recited [the bankruptcy court’s] control of compensation in the event of subsequent and unanticipated circumstances”⁹⁶ The court remanded for an award in accordance with § 328.⁹⁷

Similarly, in *In re Texas Securities, Inc.*, the trustee employed a law firm as special litigation counsel.⁹⁸ The employment order provided that compensation would be forty percent of all assets recovered but did not specify whether § 328 or § 330 governed.⁹⁹ Slightly more than a year later, the bankruptcy court modified the order.¹⁰⁰ The new order established a combination of contingent fee and hourly fee compensation but did not set a specific rate of payment.¹⁰¹ In the modifying order, the court specified that “it ‘[did] not modify, in any respect, [the court’s] authority to review this and all employment orders in accordance with *Section 328 of the Bankruptcy*

⁹³ *Id.* at 862-63.

⁹⁴ *Id.* at 863.

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ *Peele v. Cunningham (In re Tex. Sec., Inc.)*, 218 F.3d 443, 444 (5th Cir. 2000). Later, a single attorney replaced the firm. *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.* The initial order, dated April 6, 1994, was modified on October 20, 1995. *Id.*

¹⁰¹ *See id.* at 444-45.

Code.”¹⁰² After the final fee application was submitted, the court conducted a § 330 evaluation and reduced the award.¹⁰³ The district court affirmed.¹⁰⁴

The court of appeals, citing *In re National Gypsum Co.*, stated that “[i]f prior approval is given to a certain compensation, § 328 controls”¹⁰⁵ The court reiterated this holding stating “[s]ection 328 applies when the bankruptcy court approves a particular rate or means of payment, and § 330 applies when the court does not do so.”¹⁰⁶ The court then reasoned that because both orders approved compensation structures governed by § 328, a reasonableness review was improper.¹⁰⁷ Thus, the court reversed, instructing the bankruptcy court to recalculate the professional’s fees in accordance with § 328 and to set the hourly rate at the rate the law firm charged on the date the modifying order went into effect.¹⁰⁸

C. Summary

In cases where it is ambiguous as to whether § 328 or § 330 governs a professional’s compensation, the Ninth Circuit and the Fifth Circuit are in conflict.¹⁰⁹ In the Ninth Circuit, if a bankruptcy court includes conditional language in the retention order, then § 330 governs a professional’s fees, regardless of whether the

¹⁰² *Id.* at 445.

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* (citing *Donaldson Lufkin & Jenrette Sec. Corp. v. Nat’l Gypsum Co. (In re Nat’l Gypsum Co.)*, 123 F.3d 861, 862-63 (5th Cir. 1997)).

¹⁰⁶ *Id.* The court also stated that “[o]nce the bankruptcy court has approved a rate or means of payment, such as a contingent fee, the court cannot on the submission of the final fee application instead approve a ‘reasonable’ fee under § 330(a), unless the bankruptcy court finds that the original arrangement was improvident due to unanticipated circumstances as required by § 328(a).” *Id.* at 445-46.

¹⁰⁷ *Id.* at 446.

¹⁰⁸ *See id.* at 444-46. One judge dissented and argued that because the modifying order did not set a rate of compensation, the bankruptcy court should be allowed to set a reasonable rate, under § 330, for the post-modifying order compensation. *See id.* at 446, 448.

¹⁰⁹ *See supra* Part II.A-B.

court pre-approves a fee arrangement.¹¹⁰ In contrast, in the Fifth Circuit, § 328 governs a professional's fees if a court pre-approves a fee arrangement, regardless of whether it includes conditional language or only states a means of payment.¹¹¹ However, conditional language is not the only source of ambiguity. Determining whether a court has pre-approved a fee arrangement or added conditional language to the order may also result in ambiguity. Thus, neither the Ninth Circuit nor the Fifth Circuit provide bankruptcy courts or professionals a clear indication of when § 328 will govern an ambiguous retention order.

IV. THE CAUSE OF AMBIGUOUS RETENTION ORDERS

The problem of deciding between ex ante and ex post compensation is a familiar one in service occupations. Each fee structure has its unique advantages. For example, in the construction industry, the two common forms of contracts are the lump-sum contract and the cost-plus contract.¹¹² In a lump-sum contract, the parties negotiate a fixed price before the project begins.¹¹³ As long as the contract is for a standard project, the lump-sum contract promotes efficiency.¹¹⁴ In contrast, a cost-plus contract compensates the contractor for actual costs and a percentage of the total cost of the project upon completion.¹¹⁵ The main advantage of a cost-plus contract is the ability to begin construction with incomplete design information.¹¹⁶ Thus, "[t]he type of fee structure employed depends on the type of project, the goals of the parties, and the willingness of certain parties to accept the risk of either

¹¹⁰ *Circle K Corp. v. Houlihan, Lokey, Howard & Zukin, Inc. (In re Circle K Corp.)*, 279 F.3d 669, 673 (9th Cir. 2001) (amended Jan. 30, 2002); *Friedman Enters., Inc. v. B.U.M. Int'l, Inc. (In re B.U.M. Int'l, Inc.)*, 229 F.3d 824, 825 (9th Cir. 2000).

¹¹¹ *In re Tex. Sec., Inc.*, 218 F.3d at 444; *In re Nat'l Gypsum Co.*, 123 F.3d at 863 (5th Cir. 1997).

¹¹² THE CONSTRUCTION CONTRACTS BOOK: HOW TO FIND COMMON GROUND IN NEGOTIATING DESIGN AND CONSTRUCTION CONTRACT CLAUSES 122 (Daniel S. Brennan et al. eds., 2004) (hereinafter "THE CONSTRUCTION CONTRACT BOOK"); see also JAMES ACRET, ATTORNEY'S GUIDE TO CALIFORNIA CONSTRUCTION CONTRACTS AND DISPUTES § 2.4 (2d ed. 1990) (identifying lump-sum contracts, cost-plus contracts, and cost-plus with a guaranteed maximum as the main types of construction contracts when classified according to method of pricing).

¹¹³ FUNDAMENTALS OF CONSTRUCTION LAW 20 (Carina Y. Enhada et al. eds., 2001).

¹¹⁴ KEITH COLLIER, CONSTRUCTION CONTRACTS 71-72 (3d ed. 2001).

¹¹⁵ FUNDAMENTALS OF CONSTRUCTION LAW, *supra* note 113, at 21.

¹¹⁶ COLLIER, *supra* note 114, at 86.

overpayment . . . or underpayment . . . for the . . . services provided.”¹¹⁷ Similarly, §§ 328 and 330 each provide a distinct set of advantages for both professionals and bankruptcy courts.

A. Advantages of § 328 Ex Ante Compensation

Section 328 provides a mechanism for bankruptcy courts to approve the terms and conditions of a professional’s compensation before any services have been rendered.¹¹⁸ Advantages of this ex ante form of compensation include rewarding entrepreneurship, compensating the professional for opportunity costs, allowing the professional to manage risk, and reducing transaction costs.

1. Entrepreneurship

Ex ante compensation provides a reward for entrepreneurship. Section 328 allows the professional to receive approval of specific terms and conditions of employment.¹¹⁹ This creates an incentive for qualified professionals to locate the opportunities within the bankruptcy system where they can provide the most value. For example, if a professional works for a contingency fee based on the amount of assets drawn into the bankrupt estate, the professional will seek out the estate in which the greatest potential for assets exists. Both the professional and the bankruptcy system benefit as particular problems are matched with particular skill sets.

2. Opportunity Costs

For professionals, the ex ante fee structure also compensates for opportunity costs associated with business that cannot be completed because of the bankruptcy employment. By seeking a retention order from a bankruptcy court, the professional

¹¹⁷ THE CONSTRUCTION CONTRACTS BOOK, *supra* note 112, at 201; *see also* JAMES ACRET, CALIFORNIA CONSTRUCTION CONTRACTS AND DISPUTES §§ 2.12-2.13 (3d ed. 2006) (comparing briefly the advantages of the cost-plus arrangement to the advantages of the lump-sum form of payment); COLLIER, *supra* note 114, at 70-72, 86-87 (explaining the advantages and disadvantages of lump-sum and cost-plus contracts); Steven N.S. Cheung, *Transaction Costs, Risk Aversion, and the Choice of Contractual Arrangements*, 12 J.L. & ECON. 23 (1969) (discussing the choice between types of contracts in agriculture).

¹¹⁸ Landry & Higdon, *supra* note 6, at 538-39.

¹¹⁹ 11 U.S.C. § 328(a) (2007).

foregoes potential future business for the time period spent on that particular case.¹²⁰ Section 328 allows a professional to evaluate whether the terms and conditions of a particular employment are worth the lost opportunities.

3. Risk

Ex ante compensation allows professionals to manage risk. Professionals can ask for increased fees or more certain compensation schemes¹²¹ if they anticipate an employment to be a particularly risky venture. This allows professionals to balance increased risk against increased or more certain reward.

4. Transaction Costs

An additional benefit of ex ante compensation is a reduction in transaction costs.¹²² Professionals in bankruptcy are required to maintain and submit to the court detailed time records of all services rendered as part of their ex post fee applications.¹²³ The resources of the court are unduly drained in reviewing these records, especially in large cases,¹²⁴ and an expert is often needed to comply with § 330's review process.¹²⁵ Furthermore, attorneys are compensated for the time spent preparing and defending fee applications.¹²⁶ As with all professional fees, this

¹²⁰ See *In re Merry-Go-Round Enters., Inc.*, 244 B.R. 327, 331 (Bankr. D. Md. 2000) (noting that the professional agreed that the representation of the estate would be given priority).

¹²¹ See 11 U.S.C. § 328(a) (allowing any reasonable terms and conditions).

¹²² But see generally David M. Driesen & Shubha Ghosh, *The Functions of Transaction Costs: Rethinking Transaction Cost Minimization in a World of Friction*, 47 ARIZ. L. REV. 61, 64 (2005) (stating that “[r]educing transactions costs carries risks of reducing the benefits that these costs purchase.”).

¹²³ McCullough, *supra* note 15, 145-46 (requiring a detailed fee application and stating that “[a]t the very least, every fee application must contain a specific analysis of each task performed”). See generally *Pitrat v. Reimers (In re Reimers)*, 972 F.2d 1127, 1128 (9th Cir. 1992) (requiring submission of additional documentation when requested by the court); *In re Motor Freight Express*, 80 B.R. 44, 46 (Bankr. E.D. Pa. 1987) (“In the case of photocopying, counsel should inform the Court of the number of copies, the cost of each copy, and provide, if possible a breakdown of the reasons why photocopying of certain documents was necessary.”).

¹²⁴ Landry & Higdon, *supra* note 6, at 567.

¹²⁵ 11 U.S.C. § 330(a)(3) (2007) (outlining the factors used to award reasonable compensation); 11 U.S.C. § 330(a)(4)(A)(i) (prohibiting compensation for duplicative services); 11 U.S.C. § 330(a)(4)(A)(ii) (outlawing fees for services that were unnecessary or unlikely to benefit the estate).

¹²⁶ *In re Nucorp Energy, Inc.*, 764 F.2d 655, 662 (9th Cir. 1985); McCullough, *supra* note 15, 149.

additional compensation is paid out of the bankrupt estate.¹²⁷ While ex ante approval does require hearings to set the fee arrangement, such hearings are less time consuming than the review of “voluminous fee applications” associated with ex post review.¹²⁸

B. Advantages of § 330 Ex Post Compensation

Section 330 provides a mechanism by which bankruptcy courts can approve a professional’s employment but reserve compensation issues until after the services have been rendered.¹²⁹ Advantages of this ex post form of compensation include reducing the bankruptcy court’s information costs, reducing collusion among trustees and professionals, and preventing strategic withholding by creditors.

1. Information Costs

Ex post compensation reduces the court’s information costs. It is impossible for courts to know the complete nature of the professional’s employment before the services have been rendered.¹³⁰ Because courts have limited information when attempting to predict the value of future services, they are more efficient at awarding reasonable compensation ex post rather than ex ante. While courts may not know the exact nature of the services after they are completed, ex post compensation reduces much of the information costs associated with valuation.

2. Collusion

Ex post compensation prevents collusion between trustees and professionals. The bankruptcy system provides little incentive for a trustee to limit a professional’s fee award. First, if both the trustee and the professional are repeat players in the bankruptcy arena, the trustee is unlikely to “bargain down” the professional’s

¹²⁷ *In re Nucorp Energy, Inc.*, 764 F.2d at 662.

¹²⁸ Landry & Higdon, *supra* note 6, at 567. Furthermore, bankruptcy courts are likely to become more efficient in § 328 hearings as a precedent of allowing and disallowing various compensation schemes under § 328 develops.

¹²⁹ *Id.* at 541; *see* 11 U.S.C. 328(a) (2006).

¹³⁰ *See* 11 U.S.C. 328(a) (allowing for modification of pre-approved terms and conditions if they “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*”) (emphasis added).

requested compensation. Second, in Chapter 7 and Chapter 11 cases,¹³¹ the court awards the trustee compensation according to § 326:¹³²

The court may allow reasonable compensation . . . after the trustee renders such services, not to exceed 25 percent on the first \$5,000 or less, 10 percent on any amount in excess of \$5,000 but not in excess of \$50,000, 5 percent on any amount in excess of \$50,000 but not in excess of \$1,000,000, and reasonable compensation not to exceed 3 percent of such moneys in excess of \$1,000,000, upon all moneys disbursed or turned over in the case by the trustee to parties in interest, excluding the debtor, but including holders of secured claims.¹³³

“Although these percentages were intended as limits on reasonable compensation, in practice they sometimes work like commissions”¹³⁴ Thus, the trustee has a monetary stake in the amount brought into the estate, possibly aligning the trustee’s interests with the professional rather than the bankruptcy court. By allowing courts to evaluate the services after they are performed, and not as they are described by the trustee and the professional, ex post compensation mitigates the potential negative effects of collusion.

3. Strategic Withholding

Ex post compensation also prevents strategic withholding by creditors. Especially in Chapter 11 cases, creditors do not have an incentive to object to a professional’s compensation even if the professional’s services are unlikely to provide value.¹³⁵ “In bankruptcy, the absolute priority rule combined with an

¹³¹ Chapter 7 and Chapter 11 are the most common forms of large bankruptcies. EPSTEIN, *supra* note 46, at 124-26. The other three forms, Chapters 9, 12, and 13, deal, respectively, with government entities as debtors, family farmer bankruptcies, and individuals with “regular income,” unsecured debt of less than \$307,675, and secured debt of less than \$922,975. *Id.* at 124, 126.

¹³² 11 U.S.C. § 326(a) (2007). Compensation of officers is awarded under § 330 which incorporates § 326. 11 U.S.C. § 330(a)(1) (2007).

¹³³ 11 U.S.C. § 326 (2007).

¹³⁴ TREISTER ET AL., *supra* note 19, at 107.

¹³⁵ I am perhaps understating the problem. Bankruptcy Judge Harold Lavien asks:

[W]ho is there to help the court make these [fee] evaluations? Counsel may have fought bitterly during the case, but now each is self-interested in not rocking the

administrative expense priority for all professional costs requires the ‘last class in the money’ to pay all [professional] fees incurred in the case’¹³⁶ The “last class in the money” refers to the creditor who is last in line to receive payment and would receive payment but for the professional fees.¹³⁷ Which creditor is the “last class in the money” remains uncertain as long as doubt remains regarding the debtor’s value.¹³⁸ In terms of a bankruptcy professional, as long as that professional’s services will bring some benefit to the estate, the debtor’s value will remain uncertain. Thus, with ex ante compensation, creditors withhold information they have regarding the professional’s services on the assumption that they will enjoy any benefit the services provide without incurring any of the cost.¹³⁹ Ex post compensation prevents this effect. Since an ex post award occurs after the services have been performed, a creditor will know if it is the “last class in the money.” Thus, at least this creditor will have an incentive to object to an excessive fee.

boat. As a matter of fact, an argument might be made that counsel for the debtor, and certainly for the creditor’s committee is, at the time of the fee hearing, in a conflict of interest position between his self-interest in his fee and his responsibility to his client. The courts, until the 1978 Code at least, could fall back on the economic spirit of bankruptcy, but even that has been stripped away by Congress.

Harold Lavien, *Fees as Seen from the Bankruptcy Bench*, 89 COM. L. J. 136, 136 (1984).

Furthermore, Judge Lavien states that fee hearings in bankruptcy are not adversary proceedings.

[S]eldom is there more than a cursory objection submitted to the court in any fee hearing. After all, it is the nebulous estate’s money, and tomorrow’s counsel for the creditors’ committee may be in the position of debtor’s counsel. Therefore, fee hearings become a mutual admiration society which may be explained as human nature

Id. at 137-38; see also Peter Lattman & Henny Sender, *Bankruptcy Fees Face Legal Test In Collins & Aikman Billing Case*, WALL ST. J., Dec. 14, 2006, at A15 (stating that creditor challenges to professional fees are rare).

¹³⁶ Baker, *supra* note 25, at 437.

¹³⁷ *Id.* at 442-43.

¹³⁸ *Id.* at 448.

¹³⁹ *Id.* Baker suggests that lower priority classes either do not know they are the “last class in the money” because of doubts regarding the debtor’s value or if they do know, believe that the professional’s employment is their only road to recovery. *Id.* Furthermore, the transaction costs associated with objecting to the professional’s fees make an objection less likely to occur even if the creditor is not hindered by the other obstacles. *Id.*

C. Seeking the Advantages of Both Ex Ante and Ex Post Compensation

By attempting to combine the advantages of both §§ 328 and 330, bankruptcy courts are writing ambiguous retention orders. Bankruptcy courts likely prefer to approve a professional's employment under § 330 because of the advantages outlined above. However, bankruptcy courts also recognize that if they are accurate in their ex ante evaluations, § 328 reduces transaction costs and appeases those professionals applying for pre-approval. As a result, many bankruptcy courts are strategically drafting ambiguous retention orders in an attempt to procure the advantages of both approaches. These orders purport to approve the professional's compensation under § 328 but reserve the court's ability to make an ex post reasonableness evaluation if the compensation looks excessive.

In re Vern D. Blanchard provides a recent example.¹⁴⁰ In that case, the trustee filed an application to employ an attorney to litigate various claims for the estate.¹⁴¹ The bankruptcy court approved employment and a fifty percent contingency fee¹⁴² in an order stating that "compensation was 'subject to further court approval after due notice and hearing, and subject to the provisions of Bankruptcy Code sections 328 and 330'"¹⁴³ The professional obtained a default judgment for \$14,631,640 and successfully recovered assets in excess of the total claims against the debtor.¹⁴⁴ The debtor was the only party to object to the fee application.¹⁴⁵

In reviewing the professional's fee application, the bankruptcy court noted that the retention application did not cite § 328.¹⁴⁶ The court further explained that "the order[,] while purporting to base the fees on section 328, also provided the

¹⁴⁰ *In re Vern D. Blanchard*, No. 96-12037-H7 1 (Bankr. S.D. Cal. Dec. 19, 2005), www.casb.uscourts.gov/pdf/96_12037m.pdf.

¹⁴¹ *Id.* at 2.

¹⁴² *Id.* at 103. There was disagreement as to whether the contingency fee applied to all assets recovered or only those necessary to pay the creditors. *Id.* at 3. In either case, it appears that the fifty percent number was not in dispute. *Id.*

¹⁴³ *Id.* at 2 (citing Order ¶ 3).

¹⁴⁴ *Id.* at 2, 3.

¹⁴⁵ *See id.* at 3.

¹⁴⁶ *Id.* at 10.

court discretion to review the reasonableness of the fees pursuant to section 330.”¹⁴⁷ Therefore, the bankruptcy court reasoned that because its own order had cited both §§ 328 and 330, the order was ambiguous as to which section applied to the fee application.¹⁴⁸ Thus, the court conducted a § 330 reasonableness review.¹⁴⁹

D. Consequences of Ambiguity

In attempting to gain the advantages of both §§ 328 and 330, bankruptcy courts are creating a precedent of arbitrary enforcement that is likely to eliminate the advantages that Congress intended to create by enacting § 328. Ambiguity can have value.¹⁵⁰ Ambiguous retention orders offer bankruptcy courts the advantages of both §§ 328 and 330 by providing them a means for correcting inaccurate ex ante approvals. However, this system only works if bankruptcy courts have a reputation for fair enforcement. While bankruptcy courts have used ambiguous retention orders to decrease excessive fees, they have not used the same mechanism to increase meager fees.¹⁵¹ Thus, bankruptcy courts have only enforced the system in a way that lowers professionals’ pre-approved compensation.

¹⁴⁷ *Id.* at 10-11.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.* at 11 (citing *Circle K Corp. v. Houlihan, Lokey, Howard & Zuken, Inc. (In re Circle K Corp.)*, 279 F.3d 669 (9th Cir. 2001) (amended Jan. 30, 2002)). After a reasonableness review, the court concluded that the attorney was entitled to fifty percent “of the proceeds necessary to pay creditor claims plus interest and administrative expenses.” *Id.* at 13. However, the court left the calculation of the “exact dollar amount” to the trustee. *Id.* at 12.

¹⁵⁰ Gillian K. Hadfield, *Weighing the Value of Vagueness: An Economic Perspective on Precision in the Law*, 82 CAL. L. REV. 541, 545 (1994) (recognizing the benefits of vagueness and stating that “vagueness, by improving the ability of limitedly competent courts to control behavior optimally, may be institutionally advantageous.”).

¹⁵¹ See *Smith v. Lounsbury (In re Amberjack Interests, Inc.)*, 326 B.R. 379 (Bankr. S.D. Tex. 2005). In *Amberjack Interests*, the court stated that even if it were to conduct a § 330 review, the result would not be a higher fee award. *Id.* at 387. However, *Amberjack Interests* appears to be the only published opinion in which a bankruptcy court has even considered whether to increase compensation potentially governed by § 328. In contrast, numerous courts have decreased what they hold to be an excessive § 328 fee. E.g., *In re Susan L. Gilbertson*, 340 B.R. 618, 623 (Bankr. E.D. Wis. 2006) (holding that the early and easy resolution of the case made the pre-approved contingency fee improvident). While it is possible that collusion between the trustee and the professional is so extensive that professionals never underestimate the amount of work a particular employment will entail, it is more likely that this situation is the result of bankruptcy courts surreptitiously enforcing the “economy” principle. See generally *McCullough*, *supra* note 15 at 133, 138 (discussing the purported abandonment of the old “spirit of economy” and finding that the “the legacy of the old approach

Congress enacted § 328 to provide professionals with a means for predictability.¹⁵² Ambiguous retention orders eliminate this predictability by blending §§ 328 and 330 together. While the Fifth Circuit is more favorable to professionals seeking § 328 approval than the Ninth Circuit, neither circuit's approach provides professionals with a clear rule for when § 328 will govern. Thus, there is an increased likelihood that highly qualified professionals who desire the advantages § 328 provides will once again leave the bankruptcy arena for more lucrative fields.

V. INTERPRETING AMBIGUOUS RETENTION ORDERS

The uncertainty created by ambiguous retention orders and the harm they cause can be eliminated at the appellate level. To terminate this uncertainty, retention orders should be viewed as contracts between bankruptcy courts and professionals. In addition, reviewing courts should use contract law principles to interpret ambiguous retention orders.

A. An Overview of Contract Law Principles

A contract is ambiguous on its face when it either has conflicting terms or does not contain a provision covering the dispute that has arisen.¹⁵³ In the first instance, courts apply interpretive rules to determine what the contract says.¹⁵⁴ In the second, courts apply default rules to fill any gap.¹⁵⁵ Arguably, no analytical distinction exists between the two types of rules, and both can be classified as default rules.¹⁵⁶

persists as seen in the courts arbitrary reduction in attorneys' fees."'). In either case, only bankruptcy courts are gaining an advantage from ambiguous retention orders which will affect professionals' behavior in deciding whether to accept a particular employment within the bankruptcy arena.

¹⁵² See *supra* notes 31-33 and accompanying text.

¹⁵³ Eric A. Posner, *The Parol Evidence Rule, the Plain Meaning Rule, and the Principles of Contractual Interpretation*, 146 U. PA. L. REV. 533, 535 (1998).

¹⁵⁴ Eric A. Posner, *There Are No Penalty Default Rules in Contract Law*, 33 FLA. ST. U. L. REV. 563, 565-66 (2006).

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* at 566.

There are two types of default rules: majoritarian and penalty.¹⁵⁷ Majoritarian default rules are further divided into two additional categories: tailored and untailored.¹⁵⁸ Tailored rules interpret ambiguous terms in a contract to mean what is most efficient for the particular contract—they are individualized.¹⁵⁹ In contrast, untailored default rules interpret ambiguous terms in a contract to mean what most parties would want in the contract—they are one-size-fits-all.¹⁶⁰ Both rules reduce the consequences of high transaction costs by allowing parties to enter into incomplete contracts with the knowledge that courts will interpret the contract in a manner that promotes efficiency.¹⁶¹

In contrast, penalty default rules interpret ambiguous terms in a contract to mean what one party, or both, would not have wanted.¹⁶² Penalty default rules promote complete contracts by discouraging the strategic withholding of information among parties.¹⁶³ In addition, the rules minimize the incentive for “externalizing the cost of interpreting the contract on the courts.”¹⁶⁴

Ian Ayres and Robert Gertner suggest that the choice of rule should be governed by the reason for incompleteness.¹⁶⁵ They identify two broad reasons for

¹⁵⁷ See generally Ian Ayres, *Default Rules for Incomplete Contracts*, in 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, 586-87 (Peter Newman ed., 1998) (discussing the choice between majoritarian and penalty default rules); Ian Ayres & Robert Gertner, *Filling in Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91 (1989) (discussing penalty default rules); Eric A. Posner, *Economic Analysis of Contract Law After Three Decades: Success or Failure?*, 112 YALE L.J. 829 (2003) (describing the effect of choosing either majoritarian or penalty default rules).

¹⁵⁸ Ayres, *supra* note 157, at 586 (refers to untailored rules as “one-size-fits-all”).

¹⁵⁹ *Id.* at 586; Posner, *supra* note 153, at 547.

¹⁶⁰ Ayres, *supra* note 157, at 586; Posner, *supra* note 153, at 547.

¹⁶¹ See Ayres & Gertner, *supra* note 157, at 92-93; Posner, *supra* note 157, at 839.

¹⁶² Ayres & Gertner, *supra* note 157, at 91, 97; Posner, *supra* note 157, at 839. But see Posner, *supra* note 154, 563 (arguing that penalty default rules do not exist).

¹⁶³ Ayres & Gertner, *supra* note 157, at 91, 97; Posner, *supra* note 157, at 839.

¹⁶⁴ Posner, *supra* note 157, at 839.

¹⁶⁵ Ayres & Gertner, *supra* note 157, at 127 (“The first step . . . should be to ask ‘why does the gap exist?’”).

incompleteness: strategic incompleteness and transaction costs.¹⁶⁶ Strategic incompleteness is the withholding of information essential to form a complete contract.¹⁶⁷ Parties may strategically withhold information to gain a bargaining advantage.¹⁶⁸ To borrow Ayres and Gertner's metaphor, a party might withhold information that would increase the overall size of the pie, in an effort to increase its share of the pie.¹⁶⁹ Transaction costs are the costs associated with both negotiating and enforcing a contract.¹⁷⁰ If the costs of contracting for a certain provision exceed that provision's benefit, rational parties would leave the contract incomplete.¹⁷¹

According to Ayres and Gertner, when a gap exists because of strategic incompleteness, a penalty default is appropriate.¹⁷² When a gap exists because of transaction costs, a majoritarian default rule is appropriate.¹⁷³ However, a penalty default rule is "appropriate when it is cheaper for the parties to negotiate a term *ex ante* than for courts to estimate *ex post* what the parties would have wanted."¹⁷⁴ Additionally, courts should be sensitive to the effects created by penalty defaults,¹⁷⁵

¹⁶⁶ *Id.* at 92-94. *But cf.* Hadfield, *supra* note 150, at 547-48, 550 (identifying four reasons for incompleteness in contracts: transaction costs, strategic deferral, strategic withholdings, and uncertainty of the law).

¹⁶⁷ Ayres & Gertner, *supra* note 157, at 94.

¹⁶⁸ *Id.* at 99-100.

¹⁶⁹ *Id.* at 94, 99.

¹⁷⁰ *Id.* at 92-93; Driesen & Ghosh, *supra* note 122, at 62, 84.

¹⁷¹ Ayres & Gertner, *supra* note 157, at 92, 93.

¹⁷² *Id.* at 94.

¹⁷³ *Id.* at 93.

¹⁷⁴ *Id.* at 127-28; *see also* Duncan v. Theratx, Inc., 775 A.2d 1019, 1021 n.4 (Del. 2001) ("Because majoritarian rules reduce transactions costs, they are preferred-unless there is a reason to select a 'penalty default' rule that forces parties with superior information to disclose some of that information . . .").

¹⁷⁵ Ayres & Gertner, *supra* note 157, at 128. Ayres and Gertner warn that if the information being withheld is private and "acquired with economic resources, the value of information revelation must also be weighed against the private incentives to acquire it." *Id.*

as well as the possibility that some market correctives may produce inefficiencies in other markets.¹⁷⁶

B. Interpreting Ambiguity and Gaps

As discussed in Part IV, bankruptcy courts are acting strategically by drafting ambiguous retention orders. A penalty default creates an incentive for bankruptcy courts to draft more complete orders. Thus, ambiguity should be interpreted in favor of § 328. However, if ambiguity remains in the fee structure, § 330 should govern the professional's compensation.

1. Contra Proferentem

Ambiguous retention orders should be interpreted against bankruptcy courts. In both contract disputes and pseudo-contract disputes,¹⁷⁷ courts have long used the interpretive maxim *contra proferentem*: ambiguities in written contracts will be construed against the drafter.¹⁷⁸ The rule places “the risk of ambiguity, lack of clarity, and absence of proper warning on the drafting party which could have forestalled the controversy.”¹⁷⁹ It also creates an incentive for contract drafters to use clear language and saves non-drafting parties from “hidden traps not of their own making.”¹⁸⁰ However, the maxim is only applied when the contract's ambiguity is latent—non-obvious—in character. If the ambiguity is patent—obvious—then the non-drafter has a duty to seek clarification from the drafting party.¹⁸¹

¹⁷⁶ Thomas S. Ulen, *Courts, Legislatures, and the General Theory of Second Best in Law and Economics*, 73 CHI-KENT L. REV. 189, 216 (1998). However, the authors point out that it is the legislature, and not the courts, that should deal with these concerns because courts “competency is limited by the arguments of the parties before them in light of legal precedent and social custom.” *Id.* at 217, 218. Furthermore, courts would be overstepping their function if they considered such far removed effects. *Id.* at 217.

¹⁷⁷ *United States v. Transfiguracion*, 442 F.3d 1222, 1228 (9th Cir. 2006) (using *contra proferentem* to interpret a criminal plea agreement against the government).

¹⁷⁸ See e.g., *Ins. Co. v. Boon*, 95 U.S. 117, 128 (1877); JEFFREY FERRIELL & MICHAEL NAVIN, UNDERSTANDING CONTRACTS 266 (LEXIS 2004).

¹⁷⁹ *Sturm v. United States*, 421 F.2d 723, 727 (Ct. Cl. 1970).

¹⁸⁰ *Id.*

¹⁸¹ *H & M Moving, Inc. v. United States*, 499 F.2d 660, 671 (Ct. Cl. 1974). Compare *Id.* (construing ambiguous language that is latent in character in a contract for moving services against the

Contra proferentem is a penalty default rule that induces the drafting party to relate information to the other parties to the contract.¹⁸² In the professional fees context, *contra proferentem* would initially interpret ambiguous retention orders in favor of § 328.¹⁸³ Thus, it would eliminate the incentive for bankruptcy courts to draft incomplete orders when they wish to approve a professional's employment under § 330.¹⁸⁴

For example, in *In re Vern D. Blanchard*, the retention order stated that "compensation was 'subject to further court approval after due notice and hearing, and subject to the provisions of Bankruptcy Code sections 328 and 330'"¹⁸⁵ First, a reviewing court would have to decide whether the order is ambiguous.¹⁸⁶ Second, if the court considers the order to be ambiguous, the court would need to determine whether the ambiguity was patent or latent. This order, if found to be

government) *with* Chris Berg, Inc. v. United States, 455 F.2d 1037, 1044-45 (Ct. Cl. 1972) (finding that the ambiguity was "patent and glaring," and thus, the plaintiff had a duty to seek clarification).

¹⁸² Ayres, *supra* note 157, at 587. *But see* Posner, *supra* note 153, at 578-80 (arguing that the *contra proferentem* rule, if classified as a default rule, is majoritarian).

¹⁸³ This assumes that the professional is arguing that he was employed under § 328. This is a safe assumption. A professional would not argue that he was employed under § 330 when the bankruptcy court contends it employed him or her under § 328 because a § 330 reasonableness evaluation could never guarantee higher compensation than a fee structure approved under § 328.

¹⁸⁴ It would do this by directly affecting the sources of judicial utility: reputation and popularity amongst other judges and members of the legal profession; prestige; and avoiding reversal. *See* Richard A. Posner, *What Do Judges and Justices Maximize? (The Same Thing Everybody Else Does)*, 3 SUP. CT. ECON. REV. 1, 13-15, 31 (1993). Furthermore, bankruptcy judges are not Article III judges; thus, the "carrot" of possible promotion would have higher utility to bankruptcy judges than the federal appellate judges focused on by Judge Posner. *See id.* at 4-7. Moreover, promotion is likely influenced by the aforementioned sources of utility. Therefore, the sources may have an even higher value for bankruptcy judges.

¹⁸⁵ *In re Vern D. Blanchard*, No. 96-12037-H7 1, 2 (Bankr. S.D. Cal. Dec. 19, 2005), www.casb.uscourts.gov/pdf/96_12037m.pdf (citing Order ¶ 3).

¹⁸⁶ There is a strong argument that the order unambiguously approves the professional under § 328. Section 330 is made explicitly "subject to" § 328. 11 U.S.C. § 330(a)(1) (2007). Furthermore, § 328 only covers fees, not expenses. Landry & Higdon, *supra* note 6, at 555. Reimbursement of expenses is governed by § 330(a)(1)(b), which provides for "reimbursement for actual, necessary expenses." 11 U.S.C. § 330(a)(1)(b). Thus, a reasonable interpretation of the order is that § 328 governed the compensation for services rendered and other compensation, such as the reimbursements of expenses, was governed by § 330.

ambiguous, would be latent because §§ 328 and 330 are not mutually exclusive.¹⁸⁷ Third, the court would interpret the order such that § 328 governed the professional's compensation as long as the order specified a specific rate and means of payment.

2. Filling Gaps

A gap exists when the fee structure is ambiguous after the order is interpreted against the bankruptcy court. In such a case, § 330 should govern the professional's compensation. In contract disputes, a contract that does not state a price is, by default, either interpreted to incorporate a reasonable price¹⁸⁸ or is not enforced due to lack of completeness.¹⁸⁹ However, in the professional fees context, neither of these solutions is satisfactory. First, a rule that incorporates a reasonable price into the order is unhelpful. Both §§ 328 and 330 are designed to award reasonable compensation.¹⁹⁰ Thus, to say that a court should imply a reasonable fee is tautological. Second, refusing to enforce the retention order eliminates approval of the professional's employment. Such a rule creates the possibility that professionals either would not be compensated for services already performed or would be penalized for contesting an ambiguous retention order. Either result would be unjust.

An incomplete fee structure is more likely the result of transaction costs than strategic incompleteness. Section 328 is explicitly limited to situations where particular compensation "terms and conditions" have been pre-approved by the bankruptcy court.¹⁹¹ Professionals could not reasonably expect § 328 to govern compensation if a specific rate and means of payment were not approved in the retention order. Moreover, if either of these were ambiguous, professionals would be on notice to seek clarification. Therefore, an incomplete fee structure is indicative of the courts and professionals' inability to agree on a fee arrangement because of

¹⁸⁷ See *supra* note 186 and accompanying text.

¹⁸⁸ E.g. U.C.C. § 2-305(1)(3) (2007).

¹⁸⁹ U.C.C. § 2-305(3)-(4) (2007). But see *Echols v. Pelullo*, 377 F.3d 272 (3d Cir. 2004) (refusing to invalidate a boxing contract that failed to specify the price of each fight because the contract established the relationship between the parties and price was not a material and essential term).

¹⁹⁰ See *Landry & Higdon*, *supra* note 6, at 567 ("To obtain the benefit of section 328 . . . requires prior approval of the fee contract, which in turn usually requires some type of reasonableness test.").

¹⁹¹ See 11 U.S.C. § 328(a) (2007).

the transaction costs associated with pre-approval. Furthermore, Congress intended § 330 to govern professionals' fees unless there was prior agreement to a fee arrangement, prescribing § 330 as the untailored majoritarian default rule. Thus, because an ambiguous fee arrangement is likely the result of transaction costs, Congress' majoritarian default rule, § 330, should be used to fill the gap.

For example, in *In re Texas Securities, Inc.*, the bankruptcy court's modifying order established a combination of contingent fee and hourly fee compensation but did not set a specific rate of payment.¹⁹² Furthermore, the modifying order stated that "it '[did] not modify, in any respect, [the court's] authority to review this and all employment orders in accordance with Section 328 of the Bankruptcy Code.'"¹⁹³ A reviewing court might find the later language ambiguous and use *contra proferentem* to make an initial finding that § 328 governs the professional's compensation. However, because the order only states the means of determining payment and not the rate, § 330 would ultimately govern the order.

C. Summary

Reviewing courts should use contract law principles to interpret ambiguous retention orders. Courts should apply *contra proferentem* to read ambiguous orders in favor of § 328. However, if a gap remains, § 330 should be the default rule. This proposal will increase clarity in professional compensation through more complete retention orders. Although bankruptcy courts considering a professional's retention application will have to decide between the advantages of § 328 and the advantages of § 330, statutory reform is the proper solution to any problems associated with this decision. Hopefully, the proposed interpretive strategy will highlight these problems for Congress by restoring the distinction between §§ 328 and 330 that Congress desired when it reformed the Bankruptcy Code.

VI. CONCLUSION

Numerous critics have decried the "staggering" height of professional fees in bankruptcy proceedings.¹⁹⁴ "For better or worse, professional compensation is the 'lightening rod' of the bankruptcy system, attracting adverse publicity for a system that already suffers from misunderstanding at the hands of the public and the

¹⁹² *Peele v. Cunningham (In re Tex. Sec., Inc.)*, 218 F.3d 443, 444-45 (5th Cir. 2000).

¹⁹³ *Id.* at 445.

¹⁹⁴ *E.g.*, Baker, *supra* note 13, at 35.

press.”¹⁹⁵ However, the solution is statutory reform, not ambiguous retention orders and conflicting interpretative standards.

While Congress’ desire for a competitive compensation scheme will attract qualified professionals to the bankruptcy arena, the courts’ arbitrary and uncertain interpretation will deeply undermine this effect. Professionals need to feel secure in the status of their compensation, even if this security is only the knowledge that their fee is subject to a “reasonableness” review. Ambiguous retention orders are, at best, disconcerting, and at worst, dishonest. Furthermore, they only soften the problems associated with choosing between *ex ante* and *ex post* compensation while producing additional and more costly effects. Reviewing courts must create an incentive for clarity. Using contract law principles to interpret ambiguous retention orders will achieve this result. Otherwise, qualified professionals will once again start an exodus toward more lucrative fields. This would be a tragedy not only for Congress but also for debtors and creditors—the very parties the bankruptcy system is meant to assist.

¹⁹⁵ Clark, *supra* note 19, at 235.