

Professional Firm Retention: Determining whether a Professional is a “Professional Person” within Section 327(a) of the Bankruptcy Code

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Introduction

An important issue in chapter 11 cases is whether a “professional person” qualifies as a bankruptcy “professional” within section 327(a) of the Bankruptcy Code. Section 327(a) requires that a trustee or debtor-in-possession must seek court approval for the employment of attorneys, accountants, appraisers, auctioneers, or other “professional persons” assisting the debtor with its bankruptcy case.¹ Further, section 327(a) specifies, among other things, that a trustee or debtor-in-possession may only employ professionals that are “disinterested persons” to assist in the administration of the debtor’s bankruptcy case.² The failure to obtain court approval under section 327(a) “may result in the denial of compensation for services rendered prior to the date court approval is obtained.”³

However, in a chapter 11 case, under section 1108 of the Bankruptcy Code, a debtor-in-possession may employ a professional person in the ordinary course of business, if that person is exclusively assisting the debtor with its non-bankruptcy activities in connection with operating

¹ 11 U.S.C. § 327(a) (2006) (stating “the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons”).

² *Id.* (finding debtor may employ professional persons “that do not hold or represent an interest adverse to the estate, and that are disinterested persons”).

³ Stephen R. Grensky, *The Problem Presented by Professionals who Fail to Obtain Prior Court Approval of their Employment or Nunc Pro Tunc est Bunc*, 62 AM. BANKR. L.J. 185 (1988).

the debtor’s post-petition business, even if that person is not disinterested.⁴ Thus, this issue is significant because it determines whether a professional can be retained in the ordinary course of business, without having to comply with section 327(a).

Courts have continually struggled with how to interpret the term “professional person,” as it is used in section 327(a), because it is not defined by the Bankruptcy Code.⁵ In determining this issue, courts have applied three distinct tests: (1) a qualitative test, (2) a quantitative test, and (3) a six-factor test. These tests focus on different elements of the professional person’s relationship to the debtor and the duties of the professional. This Article will be separated into four parts. Part I will discuss the quantitative test. Part II will discuss the qualitative test. Part III will discuss the six-factor test. Finally, Part IV will conclude by addressing the practical implications of permitting a debtor-in-possession to retain a professional in the ordinary course of business without having to comply with section 327(a).

I. The Quantitative Test

The determination of whether a professional constitutes a “professional person” within section 327(a) was first addressed in *In re Seatrain Lines, Inc.*⁶ There, the court noted that some professionals are “not necessarily professionals whose retention by the estate requires court approval.”⁷ The court found that section 327(a) creates a distinction between those persons who are “merely involved in the mechanics of the debtor’s business” and those persons whose employment “actually affect[s] the administration of the debtor’s reorganization.”⁸ As such, the court held that section 327(a) only applies to professionals who play a “central role” in the

⁴ See *In re Seven Counties Services, Inc.*, 496 B.R. 852, 855 (Bankr. W.D. Ky. July 15, 2013); see also 11 U.S.C. § 1108 (2006) (“Unless the court, on request of a party in interest and after notice and a hearing, orders otherwise, the trustee may operate the debtor’s business.”).

⁵ *In re Semenza*, 121 B.R. 56 (Bankr. D. Mont. 1990).

⁶ 13 B.R. 980 (Bankr. S.D.N.Y. 1981).

⁷ *In re Seatrain Lines, Inc.*, 13 B.R. 980 (Bankr. S.D.N.Y. 1981).

⁸ *Id.* at 981.

administration of the debtor’s reorganization.⁹ Further, the court opined that court approval is required for the retention of attorneys and other professionals who are “intimately involved” in the administration of the debtor’s estate.¹⁰ Applying this quantitative test, the court found that the professionals who were providing services relating to the day-to-day operations of the debtor’s business were not subject to the requirements of section 327(a).¹¹

Although *In re Seatrain Lines, Inc.* provides guidance on the issue of professional employment within section 327(a), many courts have criticized the quantitative analysis by which the court came to its conclusion.¹² Specifically, many courts have found the quantitative test in *In re Seatrain Lines, Inc.* is “difficult to apply and subject to arbitrary and inconsistent results.”¹³ Consequently, courts began relying on a new test—the qualitative test.

II. The Qualitative Test

Under a qualitative test, a court will scrutinize “whether an employee is to be given discretion or autonomy in some part of the administration of the debtor’s estate.”¹⁴ Consequently, a professional performing an “important but nondiscretionary task” does not need to seek court approval under section 327(a). On the other hand, court approval must be sought for the employment of a professional that could exercise a “large measure of discretion.”¹⁵ Applying this qualitative test, courts have held that paralegals and surveyors are not “professional persons,” because these professions perform mechanical, nondiscretionary tasks.¹⁶

⁹ *Id.* at 980.

¹⁰ *Id.*

¹¹ *Id.*

¹² See *In re Fretheim*, 102 B.R. 298, 299 (Bankr. Conn. 1989); see *United States ex rel. Kraft v. Aetna Casualty & Surety Co.*, 43 B.R. 119, 121–22 (Bankr. N.D. Tenn. 1989); see *In re Johns–Manville Corp.*, 60 B.R. 612, 620–21 (Bankr. S.D.N.Y. 1986).

¹³ *In re Fretheim*, 102 B.R. at 299.

¹⁴ *In re Fretheim*, 102 B.R. at 299; see *In re Frederick Petroleum Corp.*, 75 B.R. 774, 780 (Bankr. S.D. Ohio 1987).

¹⁵ *In re Fretheim*, 102 B.R. at 299; see also *In re Semenza*, 121 B.R. 56 (Bankr. D. Mont. 1990).

¹⁶ See *In re Semenza*, 121 B.R. at 56; see also *In re Fretheim*, 102 B.R. at 299.

Proponents of the qualitative test argue that this test is consistent with the primary purpose of section 327(a), which is to “prevent conflicts of interest.”¹⁷ However, despite the creation of a qualitative test, many courts continued to struggle with how to define a “professional person.”¹⁸ As a result, “the disparate treatment” by the courts applying the qualitative test has led to inconsistent judicial holdings and “much confusion” over what constitutes a “professional person” within the meaning ascribed to such term in section 327(a).¹⁹ Therefore, courts have begun to apply a third, six-factor test.

III. The Six-Factor Test

The most recent test for determining the employment of “professional persons” within section 327(a) came with the court’s decision in *In re First Merchants Acceptance Corp.*²⁰ The *Merchants Acceptance* court acknowledged the split between courts following a quantitative approach and those following a qualitative approach.²¹ However, the court noted, “both tests are somewhat vague and difficult to apply” and the tests “need not be mutually exclusive.”²² To provide clarity on this issue, the *Merchants Acceptance* court reviewed several previous court cases that addressed whether an employee was a “professional” within the meaning of section 327(a) and created a six-factor test for future courts to apply.²³ The six factors, which encompass both qualitative and quantitative factors, include:

- (1) Whether the employee controls, manages, administers, invests, purchases or sells assets that are significant to the debtor's reorganization;
- (2) Whether the employee is involved in negotiating the terms of a Plan of Reorganization;

¹⁷ *In re Fretheim*, 102 B.R. at 299.

¹⁸ Karen J. Brothers, *Disagreement among the Districts: Why Section 327(a) of the Bankruptcy Code Needs Help*, 138 U. PA. L. REV. 1733, 1737 (1990).

¹⁹ *Id.*

²⁰ 1997 WL 873551 (Bankr. D. Del. 1997).

²¹ *Id.* at *2.

²² *Id.*

²³ *Id.*

(3) Whether the employment is directly related to the type of work carried out by the debtor or to the routine maintenance of the debtor's business operations;

(4) Whether the employee is given discretion or autonomy to exercise his or her own professional judgment in some part of the administration of the debtor's estate, i.e. the qualitative approach;

(5) The extent of the employee's involvement in the administration of the debtor's estate, i.e. the quantitative approach; and

(6) Whether the employee's services involve some degree of special knowledge or skill, such that the employee can be considered a “professional” within the ordinary meaning of the term.²⁴

The *Merchants Acceptance* court stressed that no one factor was dispositive and that the factors should be weighed against each other and considered *in toto*.²⁵

Many courts have begun using this six-factor test because it is easier to implement than the quantitative and qualitative tests and can be applied more consistently.²⁶

Currently, most courts utilize this six-factor test when determining whether an employee is a “professional” within section 327(a).

For example, recently, in *In re Seven Counties Services, Inc.*, the United States Bankruptcy Court for the Western District of Kentucky applied the six-factor test set forth in *Merchants Acceptance* to determine whether the public relations firm employed by the debtor was a “professional person.”²⁷ The debtor, Seven Counties Services, Inc. (“Seven Counties”), sought to retain Peritus Public Relations, LLC (“Peritus”), a public relations firm, which had been working with Seven Counties prior to its bankruptcy

²⁴ *Id.*

²⁵ *Id.*

²⁶ See *In re American Tissue, Inc.*, 331 B.R. 169, 173 (Bankr. D. Del. 2005); see also *In re Seven Counties Services, Inc.*, 496 B.R. at 855; see also *In re ACandS, Inc.*, 297 B.R. 395, 402 (Bankr. D. Del. 2003).

²⁷ *In re Seven Counties Services, Inc.*, 496 B.R. 852 at 854.

case.²⁸ While employed by Seven Counties, Peritus was engaged in “lobbying, third party advocacy and support of [Seven Counties’] efforts in restructuring its retirement plans and media relations.”²⁹ Seven Counties did not seek to retain Peritus under section 327(a), because Peritus was not a “disinterested person,” as required by the statute, since Seven Counties owed Peritus money for prepetition work.³⁰ Instead, Seven Counties contended that Peritus was not a “professional person” for purposes of section 327(a), despite its “special knowledge and skill.”³¹ Specifically, Peritus was not assisting Seven Counties with “any of its enumerated duties of a debtor-in-possession,” and therefore, Seven Counties asserted that Peritus’s employment was not governed by section 327(a).³²

In analyzing this issue, the *Seven Counties* court acknowledged that other courts have determined whether a professional is a “professional person” within section 327(a) in a “variety of ways, i.e. ‘the qualitative analysis,’ and the ‘quantitative analysis.’”³³ Although other courts previously utilized a strictly qualitative or quantitative analysis, the *Seven Counties* court found that the “better approach” is the test set forth in *Merchants Acceptance*, because the test combines elements of both the qualitative and quantitative approaches.³⁴ Applying the factors listed in *Merchants Acceptance*, the court found that “Peritus [was] not performing any tasks of [Seven Counties] enumerated in [section] 1107, nor [was] it involved in formulating [Seven Counties’] plan of reorganization or the administration of the estate.”³⁵ Moreover, the court found that Peritus's work for Seven Counties would not “involve any part in negotiating the plan, adjusting debtor/creditor relationships, disposing or acquiring assets or performing any duty

²⁸ *Id.* at 853.

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.* at 854.

³² *Id.*

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

required of [Seven Counties] under the Code.”³⁶ After weighing the factors listed in *Merchants Acceptance* against one another, the court held that Peritus did not qualify as a “professional person” for purposes of section 327(a), and Seven Counties could employ Peritus even though the firm was not disinterested.³⁷

IV. Firms That Are Not Disinterested Can Be Retained in the Ordinary Course of Business

The *Seven Counties* holding, in adopting the six-factor test, has important implications for professionals seeking to be retained to provide non-bankruptcy assistance to debtors in chapter 11 cases. As *Seven Counties* illustrates, a “professional” may not always qualify as a bankruptcy “professional person” within the meaning of section 327(a). Consequently, a debtor may be able to retain a professional, even if the professional would ordinarily be disqualified under the disinterested requirement of section 327(a).³⁸

In analyzing the disinterested requirement, courts have held that a “professional person” working with a debtor prior to the debtor’s pre-petition claim is not a disinterested party.³⁹ Generally, courts have also held that a firm that holds a pre-petition claim against the debtor that the firm refuses to waive is not a disinterested party and therefore cannot be retained by the debtor-in-possession.⁴⁰ However, a debtor-in-possession may still retain a professional that is not disinterested, if the professional is only providing non-bankruptcy assistance in the ordinary course of the debtor’s post-petition business.⁴¹ This is significant, because it allows for the employment of professional firms that already have an existing relationship with the debtor.

³⁶ *Id.* at 855.

³⁷ *Id.*

³⁸ *In re Seven Counties Services, Inc.*, 496 B.R. 852 at 853; Richard Lieb, *The Section 327(A) “Disinterestedness” Requirement – Does a Prepetition Claim Disqualify an Attorney for Employment by a Debtor in Possession?*, 5 AM. BANKR. INST. L. REV. 101, 102 (1997).

³⁹ Lieb, *supra note* 38, at 102.

⁴⁰ *In re Talsma*, 436 B.R. 908, 911 (Bankr. N.D. Tex. 2010).

⁴¹ *In re Seven Counties Services, Inc.*, 496 B.R. 852 at 854.

Maintaining existing relationships with professionals is important, because it can save the debtor-in-possession the time and money that would be spent if the debtor had to search for a new firm to employ, especially since that new firm would have to familiarize itself with the debtor's pre-petition business practices.

Conclusion

In a chapter 11 case, determining whether a professional is a “professional person” for purposes of section 327(a) is an important issue for the debtor-in-possession to consider when it decides which professionals to employ. Courts have applied three different tests for determining whether section 327(a) applies to a particular retention application: (1) a quantitative test, (2) a qualitative test, and (3) a six-factor test. Although some courts continue to use solely quantitative and qualitative tests, recently, courts have been applying the six-factor test introduced in *In re First Merchants Acceptance Corp.* For example, the court, in *In re Seven Counties Services, Inc.*, applied this six-factor test in concluding that a debtor-in-possession may employ a professional firm, without having to comply with section 327(a), because the professional firm was assisting the debtor with the normal operation of its day-to-day business. Professionals and debtors-in-possession should be aware of these three tests when determining whether section 327(a) applies to their retention applications.

