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Alert

Split Fifth Circuit Affirms Success Fee for Financial Advisers

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A Chapter 11 debtor's financial advisers were entitled to a "Success Fee" based on a percentage of a $50-million "debt-to-equity conversion," held a split U.S. Court of Appeals for the Fifth Circuit on May 4, 2016. *In re Valence Technology, Inc.*, 2016 WL 2587109, *1 (5th Cir. May 4, 2016) (2-1). Key to the opinion was the parties' concession that the "debt-to-equity conversion qualified as a Private Placement under [their] engagement agreements." *Id.*, at n.1. Affirming the lower courts and rejecting the debtor's challenge to the Success Fee, the Fifth Circuit agreed that the parties' "unambiguous" agreements "specifically addressed [the] consideration received from" the debtor's largest secured creditor ("B"). The dissent, however, argued that the "definition of 'Private Placement Value' [in the relevant agreements] expressly excludes the exchange of existing debt for equity that occurred." *Id.*, at *2.

Relevance

Reorganized debtors and other creditors often challenge professional fees at the end of a case, after the professionals have rendered their services. *See, e.g.*, *Baker Botts LLP v. Asarco LLC*, 135 S. Ct. 2158 (2015) (corporate parent of reorganized debtor, the unsuccessful target of litigation brought by debtor's professionals, challenged their fee application; despite lower courts' finding that performance and results achieved by professionals were "rare and exceptional," enabling creditors to be paid in full; professionals still denied fees incurred in defending their fee applications).

Financial advisers, unlike most other professionals, typically seek pre-approval of the terms of their retention under Bankruptcy Code ("Code") §328(a), as they did in *Valence*. When a court pre-approves a professional's retention under §328(a), it may not later change those terms unless it finds that the agreed-upon terms and conditions were "improvident." *See, e.g., In re Smart World Techs, LLC*, 552 F.3d 228, 234 (2d Cir. 2008) (when fee pre-approved under Code §328(a), bankruptcy court erred in reducing fee). Section 328(a) thus insures that a judicially pre-approved retention agreement will not be routinely challenged, although the professional must still show that it earned the fees. *See generally,* R.J. Landry & J.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 (1999).

The dispute in *Valence* turned on the language of the professionals' engagement letter. According to the majority, the "sole issue on appeal is the amount of the ... Success Fee." 2016 WL 2587109, at *1. The dissent insisted, however, that the terms of the parties' engagement letter simply failed to provide for the payment of the Success Fee in a debt-to-equity conversion. *Id.*, at *2.

Facts

The debtor had retained the financial advisers under §328(a) "to arrange for a potential private

placement of [the debtor's] equity." *Id.*, at *1. The relevant engagement agreements provided for the usual engagement fee, retainer fee and an additional Success Fee "in an amount equal to a [fixed percentage] of the Private Placement Value ... ." *Id.*, at *1. The agreements defined "Private Placement Value" to mean "the aggregate amount of cash and the fair market value … of any other consideration received by the Company in any Private Placement, excluding any consideration received by the Company's creditors in satisfaction of claims or debts existing on the date hereof." *Id.* (emphasis added). As for B, the debtor's largest secured creditor, the agreement provided that "[a]ny consideration received" would be subject to a lower Success Fee. *Id.*

For the debt exchange with B, the bankruptcy court awarded the advisers the agreed-upon reduced Success Fee, representing a percentage "of the $50 million debt-to-equity conversion ... ." *Id.* When the debtor appealed, the district court affirmed the fee awards.

Analysis

The Fifth Circuit accepted the bankruptcy court's interpretation of the "unambiguous" engagement letter. First, the engagement letter defines "[p]rivate [p]lacement [v]alue" to include the value of "any other consideration received by [the debtor] in any Private Placement." *Id.*, at *1. A later provision "applies to [B's] exchange of debt for equity because it specifically carves out and addresses any consideration received from [B]." *Id.* "This reading aligns with the engagement agreements' overall purpose for employing [the advisers] to procure equity or equity-linked financing." *Id.*

According to the dissent, the "definition of 'Private Placement Value' expressly excludes the exchange of existing debt for equity that occurred." *Id.*, at *2. In its view, the "Private Placement Value of the transaction with [B] is zero." *Id.*, at *4. As the debtor's largest secured lender, B forgave "the remaining balance of the $50 million of [its] secured debt in exchange for 100% of the new equity in the reorganized company." *Id.*, at *3. Thus, said the dissent, the lower courts erred by allowing the Success Fee when the financial advisers had not "secure[d] an injection of capital outside of restructuring." *Id.*, At *3. "[T]he aggregate amount of consideration received by [the debtor] — the $50 million of debt cancellation — [was] entirely offset by the shares received by [B] as compensation in satisfaction of the forgiven debt. The Private Placement Value of the [transaction] completed with [B] thus was zero." *Id.*, at *4. In short, reasoned the dissent, B did not make an equity investment, but only forgave existing debt in exchange for equity. *Id.*, at *5.

Comment

Valence confirms the need for clarity in a financial adviser's engagement letter. Although four of the five reviewing judges in the case accepted the advisers' interpretation of their engagement letter, the advisers will undoubtedly provide in their future letters that a debt-to-equity conversion is a basis for a success fee.

Authored by Michael L. Cook.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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