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Court's Sensible Analysis Saves Banker Fees In Bankruptcy

By **Michael Cook, Schulte Roth & Zabel LLP**

Law360, New York (January 4, 2017, 11:22 AM EST) -- "Transaction fees are part of the standard, negotiated base compensation for the investment banker," held the U.S. Bankruptcy Court for the Southern District of New York on Dec. 16, 2016. In re Relativity Fashion LLC, 2016 Bankr. LEXIS 4339, *10 (Bankr. S.D.N.Y. Dec. 16, 2016) (Wiles, B.J.). The court denied objections to the transaction fees sought by two investment bankers, P and H, ruling that the objecting parties (a fee examiner, the debtor and a secured lender) had no right under Bankruptcy Code § 328(a) to challenge the transaction fees. Id. at *25. Moreover, said the court, it "had no power to give anyone else [other than the U.S. trustee in this case] the right to assert objections based on ["reasonableness"] standards." Id. The sensible, sweeping opinion in Relativity Fashion is essential reading not only for investment bankers and their counsel, but also for lawyers and other business bankruptcy professionals.

Relevance

Bankruptcy Code § 327(a) provides that a bankruptcy trustee or a Chapter 11 debtor in possession, "with the court's approval, may employ one or more accountants, appraisers, auctioneers, or other professional persons ... to represent or assist the trustee in carrying out the trustee's [or debtor in possession's] duties" in the case. Bankruptcy Code § 328(a) further provides that a trustee or Chapter 11 debtor in possession, "with the court's approval, may employ or authorize the employment of a professional person under section 327 ... on any reasonable terms and conditions of employment." In other words, under § 328(a), a trustee may hire a professional on either a fixed-fee or contingency-fee basis.

Trustees and Chapter 11 debtors often retain investment bankers on terms that are quite different from the hourly rate method used by accountants and attorneys. In a "structure that is common to most investment banker retentions, both within and outside bankruptcy," reasoned the court in Relativity Fashion, investment bankers usually receive "monthly fees plus a transaction fee." Id. at *2. Although the monthly fees are typically "paid on an ongoing basis," as was the case here, the "transaction fee was to be paid if and when a transaction was consummated, so long as any other conditions in the agreement were met." Id.

Bankruptcy courts have at times in the past been hostile to the retention of investment bankers, particularly when they sought to be retained on a fixed-fee basis. See, e.g., In re Wang Laboratories Inc., 143 B.R. 794, 795 (Bankr. D. Mass. 1992) ("Even if debtor could gain some potential benefit from the proposed services of [the investment banker] that are not redundant to the services of the other employed professionals, that benefit would be severely offset by the tremendous expense to the estate

of hiring [the investment banker]."); In re Drexel Burnham Lambert Group Inc., 133 B.R. 13, 25, 26, 27 (Bankr. S.D.N.Y. 1991) (" ... investment bankers want to be paid like residential real estate brokers but with none of the accountability required under the Code"; "whenever we have dealt with investment bankers ..., we have been left with the strong impression that for them the debtor is the cash cow to be milked, Chapter 11 the milking parlor, and the Judge the milking stool"; applications to retain investment bankers must describe selection process; "indemnification agreements are inappropriate," explaining that they are inconsistent with professionalism and reflect an attempt to impose banker's overhead expenses on debtor's estate); In re Mortgage & Realty Trust, 123 B.R. 626, 630-31 (Bankr. C.D. Cal. 1991) (same). In an auspicious ruling, however, the Third Circuit signaled a change in how courts should be reviewing the retention of financial advisers and investment bankers. United Artists Theater Co. v. Walton, 315 F.3d. 217, 230, 234 (3d Cir. 2003) (Chapter 11 debtor's retention of financial adviser under agreement with indemnification clause "reasonable and ... permissible;" "market-driven" approach; indemnification "common in the marketplace;" "financial advisors are an essential part of reorganizations.").

When the court "preapproves" the terms of a professional's retention under Bankruptcy Code § 328(a), it may not later change those terms unless it finds that the agreed-upon terms and conditions were "improvident." In re National Gypsum Co., 123 F.3d 861, 862, (5th Cir. 1997) (bankruptcy court could only change terms and conditions of employment if they proved "to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions.") (quoting Bankruptcy Code § 328(a)); In re Smart World Technologies LLC, 552 F.3d 228, 234 (2d Cir. 2008) (when fee had been preapproved under § 328(a), bankruptcy court erred in reducing fee because of developments that were unforeseen, because correct standard is "not capable of being anticipated"); In re Northwestern Corp., 332 B.R. 534, 537 (D. Del. 2005) (reversing bankruptcy court, fee arrangement held not "improvident" when potential duplication of services between two investment banks was "not unforeseeable" because services to be performed were clearly set forth in banks' engagement agreements).

Facts

Both P and H were to be paid monthly fees on an ongoing basis. They also would receive a transaction fee "if and when a transaction was consummated, so long as any other conditions in the agreement were met." 2016 Bankr. LEXIS 4339, at *2. The fee examiner and a secured lender challenged P's application, while the fee examiner, the secured lender and the debtor challenged H's transaction fee.

The objectors essentially argued that: (a) P had not satisfied "the contractual conditions to the payment of the transaction fee"; (b) the court should review the P and H applications "for reasonableness using the standards set forth in" Bankruptcy Code § 330, not the standard under Bankruptcy Code § 328(a); (c) the fee applications did not satisfy the criteria of § 330 "with respect to the proposed transaction fees"; and that (d) the court should deny the transaction fees "in their entirety." Id. at *3-*4. Neither the U.S. trustee nor the creditors committee objected to the fee requests.

Analysis

Significance of Bankruptcy Code § 328(a)

The court stressed the different standards of judicial review for professional fee applications under §§ 328(a) and 330. "… Section 330 calls for a review of reasonableness that, to some extent, is made after the fact, although the case law makes clear that the judgment is not supposed to be done completely

with 20/20 hindsight." Id. at *6. § 328(a), in contrast, allows the court to judge "reasonableness ... in advance, and the issue is not revisited except in the very narrow circumstances permitted by the statute." Id. Regardless of whether §§ 328(a) or 330 applies, however, "a professional does not earn compensation if the terms and conditions of the retention agreement do not call for it." Id. at *5.

Finally, explained the court, § 328(a) "reflects the view that professionals are entitled to know what they are likely to be paid for their work …. [T]here should be some comfort that the compensation will be paid and that a court will not simply impose a new and different deal after all the work has been done." Id. at *7.

Investment Banker Compensation

Investment bankers typically receive monthly fees, but their "main compensation is through transaction fees … contingent on the consummation of a transaction …." Id. at *8. The transaction fees "merely require that the transaction occur with no other conditions whatsoever [and are usually] independent of the amount of time it takes to complete the transaction, the involvement of other people, etc." Id. at *8.

Investment bankers also typically charge for their services "in this exact same way outside of bankruptcy," and New York courts have regularly "upheld and enforced this transaction fee structure." Id. at *9. More significant, the judicial rulings outside of bankruptcy have "rejected claims … that a banker had not played a pivotal role in a transaction, or had not identified the party with whom the final transaction actually was completed …." Id. Despite confusion in some bankruptcy cases when objecting parties have referred to, or sought to characterize, transaction fees as "bonuses" or "success fees," "[t]ransaction fees are part of the standard, negotiated, base compensation for the investment banker …." Id. at *10.

The court quickly rejected cases relied upon by the objectors in Relativity Fashion for the proposition that transaction fees are success fees or bonuses. See, e.g., In re Northwest Airlines Corp. 400 B.R. 393 (Bnkr. S.D.N.Y. 2009) (court denied request for extra compensation when retention agreement and order did not provide for payment of any such fee, but merely provided for monthly fees). In sum, reasoned the court, "[t]here is a big difference between a discretionary bonus and a percentage-based or flat fee that is the base compensation for the professional's work." Id. at *13.

The court also rejected any attempt "to calculate an investment banker's compensation based on inferred hourly rates." Id. at *13. Not only is this "a false understanding of what the [investment banker] fees represent," but such a "calculation would always show that the monthly fees have already covered the reasonable hourly rates" — a "false assumption that the monthly fees represent the full expected compensation for all of the work that was done." Id. at *13-14.

The Blackstone Protocol

The court expressed strong skepticism about the validity of the so-called "Blackstone Protocol," "an arrangement that started in the Southern District of New York …. It says, in effect, that parties are bound by the Section 328(a) standards, except for the United States Trustee, which has the right to object on Section 330 grounds [i.e., reasonableness]." Id. at *15. Delaware courts later accepted this practice, after a period of "heated negotiations between the United States Trustee and the bankers" because, as in New York, "some bankers did not want to fight over it, and it was hard for bankers to ask for limitations on the United States Trustee's objection rights if other bankers in similar positions did not think those limits were needed." Id.These provisions, now common in many jurisdictions, "typically bar[

] parties other than the U.S. Trustee from" objecting to an investment banker's fee application under § 328(a). In the words of the court, the practice "creates a hybrid situation in which the court must apply or may apply the Section 330 standards to an objection made by the U.S. Trustee, but otherwise must apply Section 328(a)." Id. at *17.

The court doubted whether "Congress contemplated this kind of hybrid approach when it enacted Section 328(a)." Id., citing In re Smart World Technologies LLC, 552 F.3d 228 (2d Cir. 2009). As the Second Circuit noted, "Section 328 and 330 [are] 'mutually exclusive,' and … a court may not conduct a Section 330 inquiry if there has been a Section 328(a) approval." Id. at *17, citing Smart World, 552 F.3d at 233.

Moreover, once a court has approved a banker's retention under § 328(a), it may not "appoint a new party with standing to object and give that new party the right to make objections on grounds other than Section 328(a)." Id. at *18-*19. In the court's view, the Second Circuit prohibited a court "from doing that" in Smart World. Id. at *19. "Once the arrangement is approved and becomes part of the approved terms of employment, it is locked in." Id.

Finally, the court expressed strong skepticism as to whether the so-called Blackstone Protocol "makes sense. Why should the United States Trustee retain a right to object after the fact on points that could have been raised and resolved at the outset? Fairness to all parties … means that issues that can be raised at the time of retention should be raised then, so the terms are resolved as far in advance as possible before the work is done." Id. at *20.

Disposition of P and H Applications

No party objected to H's application on the agreed premise that "the Section 328(a) standard applies." Id. at *2. But the fee examiner and the secured lender argued that P "did not provide material support or services after the restructuring," as required under P's retention agreement, claiming that it "worked only on the sale of" particular assets of the debtor. Id. at *29. The court readily dismissed the objection, stressing that the sale "was an integral part" of the restructuring and admittedly "part of a single package with the rest of the restructuring," confirmed by undisputed witness testimony, by filed papers, and by the parties' representations. Id. at *29-*30. Not only was P's work part of the entire reorganization "package," but it also "provided material support and services in producing that package," leading "directly to the confirmed [reorganization] plan," Id. at *31. Merely because "other people played a part" in the plan negotiations "hardly means that [P] did not provide material support and services." Id. at *32.

Comment

Relativity Fashion sheds welcome light on investment bankers' fees in business reorganization cases. Because of its thoughtful, thorough analysis — one based on fairness — other bankruptcy courts should follow it.

The ability of U.S. trustees to challenge investment bankers' fees in § 328(a) retentions should be eliminated for the reasons cited by the court. The issue was not directly before the court in Relativity Fashion, but investment bankers now have powerful ammunition to resist a U.S. trustee's attempt to second-guess a fixed-fee or contingent-fee retention under Bankruptcy Code § 328(a). Most significant, fairness, not political expediency, should govern the professional compensation process.

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