ABI/TMA Panel: Lawyers and FA's — All for One and One for All

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Retention of Financial Advisors

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Hiring Financial Advisors

- Disinterestedness
  - 11 USC §327 provides "the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee…"

Hiring Financial Advisors

- Disinterestedness (cont.)
  - 11 USC §101(14) provides "disinterested person" means a person that:
    - Is not a creditor, an equity security holder or an insider;
    - Is not and was not, within 2 years before the date of filing of the petition, a director, officer, or employee of the debtor; and
    - Does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or for any other reason.
  - To request approval of employment, the professional must submit to the court an employment application as well as a professional affidavit.

Hiring Financial Advisors

- Disinterestedness (cont.)
  - Actual or Potential Conflicts:
    - Some courts provide that a professional may be disqualified only if there is an actual conflict of interest.
    - Other courts provide that even the appearance of impropriety should result in disqualification.
    - Professionals should rely upon counsel to determine what standard is applicable and whether their facts and circumstances present risks.
  - Pre-Petition Representation of the Debtor
    - A professional employed by the debtor pre-petition may still be retained, but only if they meet disinterestedness standards.
    - The professional must not have a claim for unpaid fees.
    - The professional must not have a potential claim that would result from an avoidance action.

Hiring Financial Advisors

- Disinterestedness (cont.)
  - Representation of Adverse Interests
    - Lack of disinterestedness by one member of a firm may result in the entire firm being determined to be not disinterested.
    - Firms must be careful to create ethical walls to allow retention even if one or more members of the firm would be held to be not disinterested.
    - Disclosure of potential conflicts is essential to be able to be able to effectively create ethical walls.

Hiring Financial Advisors

- Getting Retained
  - Doing your retention papers correctly
    - Historically employment applications have been prepared by the estate's or committee's counsel.
    - Professionals should be aware that estate or committee counsel represent the estate or committee, not the professional.
    - In large or complex cases, professionals should consider retaining their own counsel.
  - Know your client
    - Employment applications must be filed by the party, the trustee, committee or debtor-in-possession, employing the professional.

Hiring Financial Advisors

- Disclosure of conflicts
  - Rule 2014(a) requires that the professional seeking to be retained disclose, after appropriate inquiry, all connections with the debtor, creditors, any party in interest, the court where the bankruptcy is pending, and all employees of the US Trustee's office.
  - Failure to disclose potential conflicts may involve significant sanctions by the court.
  - Disclosure is an ongoing responsibility.

Hiring Financial Advisors

- Retention
  - 328 versus 327
    - 11 USC §327(a) provides that "the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title."
    - 11 USC §328(a) provides that "the trustee, or a committee appointed under section 1102 of this title, with the court's approval, may employ or authorize the employment of a professional person under section 327 or 1103 of this title, as the case may be, on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, on a fixed or percentage fee basis, or on a contingent fee basis."

Getting Hired

- Retention (cont.)
  - 328 versus 327 (cont.)
    - The importance of 328 retention comes in cases where billing is done on a basis other than hourly billings, investment bankers for example, to prevent fees negotiated at the beginning of the case from being questioned under Lodestar at the end of the case.

Hiring Financial Advisors

- Retention (cont.)
  - 363 "Protocol"
    - The hiring of a turnaround professional as an officer of a company pre-petition may present a problem under the disinterestedness standard of 11 USC §§101(14) and 327 when the turnaround professional then seeks to be hired post-petition.
    - Court approval of the retention of a turnaround professional as an officer is generally sought under 11USC §363(b) as a use of property of the estate outside of the ordinary course of business.

Hiring Financial Advisors

- Carve outs and retainers
  - Carve outs are agreements with secured lenders to "carve out" a portion of the collateral to be available to pay professional fees.
  - Carve outs provide protection if the debtor becomes administratively insolvent by elevating the professional fees (subject to the cap) to secured claims.
  - Some courts may exempt payments received through a carve out from disgorgement.

Hiring Financial Advisors

- Carve outs and retainers (cont.)
  - "Evergreen" retainers held after the filing are not allowed in all jurisdictions.
  - The existence of the evergreen retainer and the professional's intention to maintain during the case should be clearly disclosed in retention documents.
  - Retainers probably don't afford any protection from court ordered disgorgement of fees.

Managing Risk as Financial Advisor

- D&O Insurance
  - If you take management and officer roles you need to be covered by the client's D&O insurance.
  - Client should name specific individuals in D&O policy when possible (usually need to first be nominated an officer or director).
  - Scrutinize policies carefully, especially for clauses that permit rescission, termination or non-renewal. Look into what conditions would invalidate coverage. For example, many times a CRO is called in when there may be fraud or misrepresentation by management.

Managing Risk as Financial Advisor

- D&O Insurance (cont.)
  - Some D&O policies allow the insurer to cancel coverage where there was misrepresentation (i.e., fraud) in obtaining the policy.
    - "Full Severability" clauses prevent an insurer form imputing the misrepresentations of one insured to any other insured.
    - "Limited Severability" clauses typically provide that no knowledge or information possessed by any individual insured will be imputed to any other individual except for material facts or information known to the persons who signed the application.
  - If the company's D&O policy is in jeopardy consider obtaining separate coverage.

Managing Risk as Financial Advisor

- Indemnity
  - Generally will not provide protection for:
    - Gross Negligence
    - Willful Misconduct
    - Bad Faith or Misdealing
    - Fraud
    - Breach of Fiduciary Duty
    - Willful or Reckless Misconduct
    - Breach of Trust
  - May Be Allowed If:
    - Acted in Good Faith
    - Reasonable Belief that Conduct was in Best Interests of Company
    - No Reasonable Cause to Believe Conduct was Unlawful

Managing Risk as Financial Advisor

- Indemnity (cont.)
  - Duty of Care
    - Good Faith
      - Act Honestly
      - No Action, or Cause the Company to Act, in an Unlawful Way
      - Relying on Information Known to be Untrue is not Good Faith
    - Care
      - Pay Attention and Act Diligently and Reasonably
    - Ordinary Prudent Person
      - Common Sense, Practical Wisdom, Informed Judgment
    - In a Like Position
      - Held to a Standard Based on Background and Qualification of Advisor
    - Under Similar Circumstances
      - Depends on the Factual Situation
    - Reasonably Believes
      - Conduct is Objective not Subjective
    - Best Interests of the Corporation
      - Primary Allegiance to the Corporation

Managing Risk as Financial Advisor

- Indemnity (cont.)
  - Business Judgment Rule
    - Act in Good Faith
    - Reasonably Informed
    - Rationally Believe Actions in Best Interest of Corporation
  - Duty of Loyalty
    - No Conflicts of Interest
    - No Personal Gain
    - Cannot Usurp Corporate Opportunity

Financial Advisor Compensation

- Liquidity
  - Payment, as with any client, is dependent on the client having the liquidity to make the payment.
  - If the debtor cannot pay its administrative expenses it is considered "administratively insolvent."
  - Chapter 7 trustees may seek to recover fees already paid to professionals by administratively insolvent debtors to provide for equitable distribution to all administrative creditors.

Financial Advisor Compensation

- 11 USC §330(3) provides "In determining the amount of reasonable compensation to be awarded to an examiner, trustee under chapter 11, or professional person, the court shall consider the nature, the extent, and the value of such services, taking into account all relevant factors, including:
  - The time spent on such services;
  - The rates charged for such services;
  - Whether the services were necessary to the administration of, or beneficial at the time at which the service was rendered toward the completion of, a case under this title;
  - Whether the services were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed; and
  - Whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.

Financial Advisor Compensation

- 11 USC §330(4) provides "the court shall not allow compensation for:
  - Unnecessary duplication of services; or
  - Services that were not –
    - (I) reasonably likely to benefit the debtor's estate; or
    - (II) necessary to the administration of the case.

Financial Advisor Compensation

- Fee Auditors
  - Larger cases may authorize the use of a fee auditor to review fee applications.
  - Typically fee auditors are verifying that the requirements of 11 USC §330 have been met.
  - Approval by a fee auditor does not provide any safe harbor form other parties in interest who may object to fees.

Financial Advisor Compensation

- US Trustee
  - The responsibilities of the US Trustee include that, whenever they deem appropriate, US Trustee will review applications for compensation and reimbursement of the expenses under §330 of the Bankruptcy code in accordance with procedural guidelines adopted by the Executive office for the United States Trustees.
  - Under these guidelines compensation for hourly billing must be prepared: 1) in tenths of an hour; 2)with each individual task listed separately; and 3) by discrete project billing code.

Financial Advisor Compensation

- US Trustee (cont.)
  - Generally, applications for compensation should include:
    - Detailed information about the application and the professionals, including resumes of the key individuals working on the engagement.
    - General information concerning the status of the case, based on the professional's knowledge concerning the status of the bankruptcy case, based on his or her duties to the estate or committee.
    - A summary sheet that contains a summary of the fees and expenses requested by the professional in its formal application.
    - Detailed billing of professional fees and reimbursable expenses, with fees broken out pursuant to the project billing format set forth in the US Trustee guidelines.
    - A presentation demonstrating why the work done by the professionals and the expenses incurred constitute actual and necessary expenses of the estate.

Financial Advisor Compensation

- Administrative Insolvency
  - Debtors are required to pay costs of administering the estate as they become due. This includes paying for goods and services according to trade terms agreed to by suppliers. It also applies to professional fees incurred and payable under court order.
  - If a debtor cannot pay its administrative expenses it is "administratively insolvent" and must cease to incur additional indebtedness.

Financial Advisor Compensation

- Disgorgement
  - Professionals that are determined to have failed to properly disclose conflicts or to otherwise not be disinterested may be ordered to disgorge compensation previously awarded and paid.
  - Professionals that have received court awarded compensation from a debtor that becomes administratively insolvent may be required to disgorge fees received that were previously approved and awarded by the court order so that the administrative claims can receive equal treatment.

Financial Advisor Compensation

- Fee Applications (how to)
  - Professionals employed under §327 must apply for an order approving interim fees and expenses under the provisions of §331. Interim applications may not be made more frequently than every 120 days.
  - Interim awards are subject to review and modification at any time prior to the court's final award of fees under §330.
  - Billing done on an hourly basis must be done in tenths of an hour; and, must be individually separated out into separate tasks and may not be lumped together in a single billing entry.

Financial Advisor Compensation

- Fee Applications, how to (cont.)
  - Even if the professional has been fully compensated through interim applications, a final fee application must be filed. The court overseeing the bankruptcy has the duty to fully review all fee applications on its own. Final fee applications can only be approved after notice to all parties in interest and a hearing has been held.

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Financial Advisor Fee Arrangements

1) Financial advisors for a Debtor or the Creditors' Committee can be retained under either Section 328(a) or Section 330 of the Bankruptcy Code.
    a. A wide array of compensation structures are allowed by Section 328(a):
        i. **Section 328(a)** --- Limitations on Compensation of Professionals
        The trustee……., with the court's approval, may employ or authorize the employment of a professional person……. on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, on a fixed or percentage fee basis, or on a contingent fee basis.
        ii. Once the terms and conditions of employment are approved by the court, the fee structure negotiated between the parties is generally respected and not subject to a "reasonableness" standard upon filing of applications for payment.
        iii. However, with the benefit of such certainty also come limitations if the duties or time commitment differs from what the parties initially expected. For **Section 328(a) continues**: Notwithstanding such [retention] terms and conditions, the court may allow compensation different from the compensation provided under such terms and conditions after the conclusion of such employment, if such terms and conditions prove to have been improvident **in light of developments not capable of being anticipated** at the time of the fixing of such terms and conditions.
            a. *In re Asarco LLC* (5th circuit court of appeals; 12/2012) recently considered the issue of what is "not capable of being anticipated". The court took a very expansive view of what, in retrospect, could have been anticipated. It found that a four year dysfunctional bankruptcy of a private company (and thus, more limited information) was not wholly unforeseeable and therefore it denied additional compensation for what was clearly work beyond that originally contemplated by the parties. The bottom line was that the parties chose the certainty of

328(a) and the court was going to make them live with this in both good and bad times.

b. The Court denied a $975,000 fee enhancement for doing "extraordinary" tasks---but remanded for the lower court to consider whether a $2M fee enhancement for a great outcome was warranted in view of the reversal of the $975k---but said the lower court does not have to apply the looser Section 330 standards.

c. For car buffs, Asarco is also notable for the large number of references to a Corvette analogy.

2. A somewhat different aspect of Asarco, but also very important for professional fee considerations, it should be observed that Barclay's (Lehman) also lost its right to $6M "auction fee" because the engagement letter entitling it to such fee was never approved by the court. [Note: A different Asarco professional fee dispute, this one involving its law firm, Baker Botts, is presently before the US Supreme Court which must determine whether a professional firm is entitled to be paid for its time spent successfully defending its fee application against objections by its client.]

b. In contrast, retention under Section 330 is subject to substantially greater subsequent judicial review.

i. **Section 330 (a)**---

(a) (1) …subject to sections 326, 328, and 329, the court may award to a … professional person employed under section 327 or 1103—

(A) **reasonable compensation** for actual, necessary services rendered by the … professional person… and by any paraprofessional person employed by any such person; and

(B) reimbursement for actual, necessary expenses.

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

(A) the time spent on such services;

(B) the rates charged for such services;

(C) whether the services were necessary to the administration of, or beneficial at the time at which the service was rendered toward the completion of, a case under this title;

(D) whether the services were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed;

(E) with respect to a professional person, whether the person is board certified or otherwise has demonstrated skill and experience in the bankruptcy field; and

(F) whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.

2) Potential Compensation Structures
    a. Hourly (time & material)
        i. "Standard rates"
            1. Typically the hourly rate varies based on experience and seniority of the professional rendering the service
            2. Aligns the rate with the expertise and skill of professionals who actually render services
            3. Advantageous when tasks, and hence necessary personnel and skill sets, are unknown
            4. Can create conflict between client and professional firm over "who" works on each task---is the professional lowest level (and hence least expensive), adequately experienced person?
        ii. Blended rate
            1. A uniform hourly rate for all professionals
            2. Perceived as transferring responsibility to efficiently staff engagement to the professional services firm, which theoretically can best manage that role
            3. Works best when likely tasks (staffing needs) are known in advance since expected average bill rate will differ significantly depending upon necessary sophistication/experience to perform tasks
        iii. Who can charge
            1. Irrespective of the hourly rate, local rules usually prohibit clerical personnel from charging for their time, but allow

paraprofessionals to charge (from Greek meaning “alongside”, “irregular”)

b. Monthly fixed fee, often with some form of “bonus” fee
    i. These arrangement take a myriad of forms, but in all cases the following issues must be negotiated:
        1. Is the monthly fee the same for the entirety of the matter or will it step down after the initial, usually more intense months have passed?
        2. What will be the basis of the “bonus fee”
            a. Earned upon performing a specified act, such as selling an asset or negotiating a particular debt restructuring (a “success fee”), or
            b. Earned upon a particular status occurring, such as confirmation of any plan of reorganization or disposition of substantially all of the Debtor’s assets (a “completion fee”)
        3. Will some or all of the monthly fee be credited to the bonus fee (if earned)?
    ii. In the event of a bonus/contingent fee, does it affect the testimony/independence of the financial advisor---can the advisor competently testify about asset valuations, feasibility of a plan of reorganization or solvency if its own compensation is dependent upon the judicial determination of the issue about which he/she testifies?
    iii. Definition of “scope of services” is a key issue---what is included and what is out of scope for the monthly fixed fee?
        1. Issue has additional complexity when both a fixed fee and an hourly financial advisor is engaged by the same party---it then matters which advisor performs each service
    iv. Recent case, River Run litigated whether a “success fee” is due to Debtor’s financial advisor when creditor’s plan confirmed. The Court allowed payment in that case based on specific facts, but raised numerous planning issues:
        1. Be careful what you call the bonus fee---“success” sets a high hurdle in the often compromise-prone bankruptcy environment and invites a challenge that the outcome was other than a “success” for the retaining party. A “completion” or similar status adjective is broader.

2. Be careful of using inconsistent language in the multiple places retention is described----engagement letter, application to employ, supporting declaration, court orders. Court found ambiguity between engagement letter and retention order.

c. Fee for project—ex. Valuation or fairness opinion
    i. Does its structure make it a "disabling" contingent fee? See TOUSA decision.
    ii. Fixed or a percentage of transaction or asset value?
    iii. Be sure the specific task is identified and approved by a specific court order. The issue determined by the Asarco court is hotly debated, but much bigger issue in that matter than the $2M fee on review is the $6M auction fee claim that the financial advisor abandoned because the engagement letter providing for this activity and fee was never approved by a court order during 4 year case.