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Getting Paid and Avoiding Disgorgement

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Getting Paid and Avoiding Disgorgement: Who Pays the Freight in a Section 363 Sale?

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Introduction

It is an unfortunate reality in today's chapter 11 bankruptcy practice that many chapter 11 cases become, at some point, administratively insolvent. Bankruptcy professionals are in the business of solving problems. But what happens when the primary problem that needs to be solved in order for a chapter 11 case to be declared a success becomes: How are the expenses of administering the case going to be paid? In a case where the goal is to sell substantially all of the debtor's assets under section 363 of title 11 of the United States Code (the "Bankruptcy Code"), should bankruptcy court approval of the sale be conditioned on sufficient funds remaining in the estate post-closing to ensure that all administrative expenses receive payment in full? If so, who should be responsible for paying such amounts?

Today's Chapter 11

Chapter 11 practice has changed in recent years. The chapter 11 process that most of us studied in law school, where a company takes advantage of an automatic stay to buy time for it to negotiate with its secured lender and its unsecured creditors and, ultimately, confirm a plan of reorganization under section 1129 of the Bankruptcy Code has, in large part, been supplanted by section 363 sales, which are usually followed by either confirmation of a liquidating plan, conversion to chapter 7 or a structured dismissal. This is particularly true in middle market bankruptcy cases, where the debtor's capital structure often cannot support the expense associated with a protracted chapter 11 reorganization process. While this trend is often criticized,[1] the number of "successful" bankruptcies (including, close to home, General Motors and Chrysler) that have resulted from section 363 sales should not be discounted.[2]

One reason that chapter 11 has changed in this manner is that the lending industry has changed. Today's distressed businesses have substantial access to capital, including asset based financing and mezzanine or second lien financing.[3] Due to the rise of second (or even third) lien debt in particular, companies can often obtain "secured" financing equal to the estimated going concern value of the company itself. Faced with the availability of relatively cheap money and

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[1] Commentators have bemoaned:

> Corporate reorganizations have all but disappeared. Giant corporations make headlines when they file for Chapter 11, but they are no longer using it to rescue a firm from imminent failure. Many use Chapter 11 merely to sell their assets and divide up the proceeds.

See Douglas G. Baird & Robert K. Rasumussen, *The End of Bankruptcy,* 55 Stan. L. Rev. 751, 751 (2002).

> The concept of debtor reorganization and rehabilitation is in peril. The marvel of modern reorganizations of financially distressed businesses that was ignited by the railroad equity receiverships of the nineteenth century and codified by twentieth-century legislation is fading. As the twenty-first century progresses, the use of Chapter 11 of the Bankruptcy Code as a primary reorganization and rehabilitation tool for businesses is under relentless attack—an attack led by those who want to revert back to strict enforcement of contracts and the primacy of creditor rights. Fundamental changes in the economy, accompanied by a shifting and more conservative intellectual approach, are now leading to cries that Chapter 11 is obsolete and irrelevant in a modern economy.

See Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?,* 47 B.C. L. Rev. 129, 129 (2005).

[2] *See* Jared A. Wilkerson, *Defending the Current State of Section 363 Sales*, 86 Am. Bankr. L.J. 591 (2012) (refuting criticism of section 363 sales in chapter 11 and highlighting potential efficiencies of such sales).

[3] One commentator recently stated that junior secured debt issuances "rose from virtually zero in 2000 to a peak of $30 billion in 2007." *See* Athanas, Warren & Khatchatourian, *Bankruptcy Needs to Get Its Priorities Straight: A Proposal for Limiting the Leverage of Unsecured Creditors' Committees When Unsecured Creditors are "Out-Of-The-Money,"* 26 Am. Bankr. Inst. L. Rev. 93, 102-03 (2018).

the understandable resistance by management to commencing a bankruptcy case, distressed businesses typically do not seek relief under chapter 11 until all other avenues have been exhausted. By the time a bankruptcy petition is filed, therefore, all of the debtors' assets are usually encumbered by the liens of one or more lenders. The total amount of the secured loans (likely broken down into at least two tranches of priority) exceeds the enterprise value of the debtor.

Another reason for the shift to section 363 sales is the fact that the bankruptcy reorganization process has become increasingly expensive. Few middle market debtors can afford the expense associated with a traditional chapter 11. This is because bankruptcy introduces costs into a debtor's already stretched budget that do not exist outside of bankruptcy. For example, in addition to paying its own professionals, debtors are responsible for paying various fees to the bankruptcy court and to the Office of the United States Trustee and, more significant yet, the fees and expenses of bankruptcy professionals that are retained by any statutory committees, examiners and trustees.[4]

These costs become administrative expenses under section 503 of the Bankruptcy Code and must generally be paid in full on or before the effective date of any confirmed plan.[5]

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[4] Section 330 of the Bankruptcy Code provides for compensation of all professionals whose retention is approved by the court. Specifically, section 330(a) provides, in relevant part:

> [T]he court may award to a trustee, a consumer privacy ombudsman appointed under section 332, an examiner, an ombudsman appointed under section 333, or a professional person employed under section 327 or 1103
>
> > (A) reasonable compensation for actual, necessary services rendered by the trustee, examiner, ombudsman, professional person, or attorney and by any paraprofessional person employed by any such person; and
> >
> > (B) reimbursement for actual, necessary expenses.

11 U.S.C. § 330(a). A 2007 study of professionals' fees in bankruptcy suggested that "[c]ommittee professionals cost the estate about two-fifths of what the debtor's professionals cost." Jesse Greenspan, *Time Spent In Chapter 11 Doesn't Affect Costs: Study*, Law 360 (Dec. 7, 2007), http://www.law360.com/articles/41896/time-spent-in-chapter-11-doesnt-affect-costs-study.

[5] Section 1129(a)(9)(A) of the Bankruptcy Code provides: "Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that – with respect to a

Amplifying the administrative expense problem in many cases is section 503(b)(9) of the Bankruptcy Code which, generally speaking, grants administrative expense priority for "the value of any goods received by the debtor within 20 days before the date of commencement of a case."[6] This section, which was added to the Bankruptcy Code in 2005, elevates a group of trade creditors, who previously held only unsecured claims, to the same level of priority as estate professionals.

Secured lenders generally prefer section 363 sales over a reorganization because such sales provide a relatively quick and inexpensive mechanism for their collateral to be sold and their claims paid. In furtherance of this goal, sophisticated lenders (sometimes referred to as "creditors-in-possession") have increased their control over the debtor prior to, and after, the petition date. Post-petition, because one or more secured lenders are undersecured (or, to the extent there is an equity cushion, such cushion is rapidly deteriorating), the secured lenders have leverage to insist on strict budgets and default provisions as well as expedited timeframes in cash collateral and post-petition financing orders. As such, most chapter 11 debtors and their professionals have only a short runway to attempt to reorganize. When that runway ends, a section 363 sale process is more often than not the only remaining option for maximizing value and preserving jobs.[7]

But section 363 is just one of many sections of the Bankruptcy Code. It does not contain language similar to section 1129(a)(9)(A) requiring that all administrative expenses of the estate be paid in full. That being the case, when a debtor proposes to sell substantially all of its assets in

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claim of a kind specified in section 507(a)(2) … on the effective date of the plan, the holder of such claim will receive on account of such claim cash equal to the allowed amount of such claim."

[6] 11 U.S.C. § 503(b)(9).

[7] In retail cases, section 363 sales have increasingly turned into sales to liquidators pursuant to so-called agency agreements whereby the liquidators simply conduct going out of business sales at each of the debtors' stores. This is because, in such cases, the liquidation value of the inventory is greater than the going concern value of the debtors.

a section 363 sale, the question of whether such a sale should be approved when all that remains post-closing is an administratively insolvent estate is a difficult one.

A new term of art has arisen in chapter 11 practice: the fulcrum creditor. The fulcrum creditor is the creditor who resides in the debtor's capital structure at the priority level where the firm's enterprise value is exhausted. For the reasons discussed above, fulcrum creditors have, in recent years, moved from being unsecured creditors to junior or mezzanine lenders or the holders of administrative expenses. The fulcrum creditor is the party that stands to benefit the most from the potential upside that a section 363 sale can bring to the table. Secured creditors above the fulcrum creditor in the priority ladder are generally comfortable that they will be paid in full through a liquidation of their collateral. Unsecured creditors below the fulcrum creditor in the priority ladder are often out of the money. Since the fulcrum creditor is the party that benefits the most from the potential upside of a section 363 sale, a compelling argument can be made that it is the party that should be responsible for paying the costs associated with a proposed 363 sale.

Money (That's What I Want)

Faced with limited prospects for a meaningful distribution in most recent cases, creditors' committees and holders of administrative expenses have raised a number of arguments for why a secured creditor (who may or may not be the fulcrum creditor) should be required to pay all or a portion of the administrative expenses including, but not limited to, professional fees for committee counsel and section 503(b)(9) administrative expenses. A few of these arguments are discussed below.

a. Surcharge

"The general bankruptcy rule is that, absent an express agreement to the contrary, the expenses associated with administering a bankruptcy estate are not chargeable to a secured creditor's collateral or claim, but must be borne out of the unencumbered assets of the estate."[8] It has been said that this rule is important because it preserves a secured creditor's collateral value, and thus ensures that secured creditors will receive the benefit of their pre-bankruptcy bargain.[9]

A limited exception to this rule is contained in section 506(c) of the Bankruptcy Code which provides that, "The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim…."[10] Additionally, expenses may be recoverable where the secured creditor expressly or impliedly consents to the incurrence of the expense.[11]

Section 506(c) was enacted as part of the Bankruptcy Reform Act of 1978. The section was a codification of an equitable doctrine in pre-code case law holding that, in limited circumstances, a lienholder could be compelled to contribute to the reasonable and necessary costs of selling the encumbered property.[12] The underlying rationale for the provision, which in essence

[8] 4 COLLIER ON BANKRUPTCY (16th Ed. Rev.), ¶ 506.05, at p. 506-116 (2017); *see also In re Visual Indus., Inc.,* 57 F.3d 321, 324 (3d Cir. 1995) ("post-petition administrative expenses and the general costs of reorganization ordinarily may not be charged to or against secured collateral."); *In re Molycorp, Inc.,* 562 B.R. 67, 75 (Bankr. D. Del. 2017) ("As a general rule, administrative expenses must be satisfied from assets of the estate not subject to liens."); *In re Lunan Family Rests. Ltd. P'ship,* 192 B.R. 173, 178 (Bankr. N.D. Ill. 1996) ("Costs of administering a bankruptcy estate must generally be borne by the estate and its general creditors, and such expenses will not ordinarily be charged against collateral of secured creditors.").

[9] *See e.g., In re Molycorp*, 562 B.R. at 75 ("A secured creditor's interest in its collateral is a substantive property right created by non-bankruptcy law, which may not be substantially impaired when bankruptcy intervenes. A secured creditor should not be deprived of the benefit of its bargain and will be protected in bankruptcy to the extent of the value of its collateral….")

[10] 11 U.S.C. § 506(c).

[11] The most common form of secured creditor consent is a "carve-out", a topic that is separately being addressed by this panel.

[12] *In re Codesco Inc.,* 18 B.R. 225, 230 (Bankr. S.D.N.Y. 1982) (citing *Maxcy v. Walker,* 119 F.2d 535, 536 (5th Cir. 1941) (noting that these costs were "usually to be measured by the actual cost in a state court of foreclosing the lien."')).

circumvents the bankruptcy priority scheme, is that "the general estate and unsecured creditors should not be required to bear the cost of protecting what is not theirs."[13]

Courts generally agree that recovery under section 506(c) is limited to the extent the fees and expenses surcharged: (i) are necessary, (ii) are reasonable, and (iii) confer a direct benefit on the secured creditor rather than the estate, the debtor, or a third party.[14] The benefit requirement is the most important and difficult to prove of the three aforementioned requirements.[15] A secured creditor receives a "benefit" within the meaning of section 506(c) if the relevant expense preserved or increased the value of its collateral. The benefit shown by the moving party cannot be nebulous or even an indirect one but must be a "concrete" and "quantifiable" benefit.[16] Because section 506(c) is an exception to the general rules of distribution in bankruptcy, courts have held that the provision must be strictly construed and given a limited application.[17]

Prior to the United States Supreme Court's decision in *In re Hen House Interstate, Inc.,*[18] there was conflicting authority concerning whether only a bankruptcy trustee could invoke section 506(c) or, alternatively, whether any holder of an administrative expense could do so. In *Hen*

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[13] *Id.*

[14] *See e.g., In re Delta Towers,* 924 F.2d 74, 76 (5th Cir. 1991) (citing *In re Trim-X, Inc.,* 695 F.2d 296, 299 (7th Cir. 1982)); *In re Chicago Lutheran Hosp. Ass'n,* 89 B.R. 719, 727 (Bankr. N.D. Ill. 1988).

[15] *See e.g., In re Daily Medical Equip., Inc.,* 150 B.R. 205, 208 (Bankr. N.D. Ohio 1992).

[16] *See e.g., In re Debbie Reynolds Hotel & Casino, Inc.,* 255 F.3d 1061, 1068 (9th Cir. 2001); *In re Grimland,* 243 F.3d 228, 232 (5th Cir. 2001).

[17] *See e.g., In re D&M Land Co., LLC,* 2010 WL 358525 at *7 (Bankr. E.D.N.C. Jan. 15, 2010) ("The Fourth Circuit has construed § 506(c) narrowly.") (citing *In re K&L Lakeland, Inc.,* 128 F.3d 203, 207 (4th Cir. 1997)); *In re Felt Mfg. Co., Inc.,* 402 B.R. 502, 528 (Bankr. D.N.H. 2009) ("[C]ourts have narrowly construed section 506(c)[.]") (quoting *United Jersey Bank v. Miller (In re C.S. Assoc.),* 29 F.3d 903, 907 (3d Cir. 1994); *In re Parr Meadows Racing Ass'n., Inc.*, 92 B.R. 30, 36 (E.D.N.Y. 1988) ("Courts have narrowly construed § 506(c) to encompass only those expenses specifically incurred for the express purpose of ensuring that the property is preserved and disposed of in a manner that provides the secured creditor with maximum value and apportions those costs to the creditor who will be assuming the asset").

[18] *Hartford Underwriters Ins. Co. v. Union Planters Bank NA (In re Hen House Interstate, Inc.),* 530 U.S. 1 (2000).

House, Hartford Underwriters provided workers' compensation insurance to the debtor (a restaurant and service station operator) during its chapter 11 proceedings. The debtor repeatedly failed to make the monthly payments due under the insurance policy, but Hartford continued to provide the insurance. The debtor's attempt at reorganization was unsuccessful, and the bankruptcy court converted the case to case under chapter 7.

Upon conversion, the debtor owed Hartford more than $50,000 on account of the policy. The chapter 7 estate had no available funds to pay Hartford's administrative claim, so Hartford sought to recover from Union Planters Bank, the debtor's pre- and post-petition secured lender. Hartford filed a motion for allowance of an administrative expense under section 503 and to charge against the bank's collateral under section 506(c). It argued that the insurance it provided the debtor benefited the bank by allowing the debtor to continue to operate its business, and thus preserved the bank's collateral. Hartford also argued that the bank's consent to a post-petition financing order, under which the debtor was authorized to pay the insurance expenses from cash collateral, implied a direct benefit to the bank.

The bankruptcy court ruled in favor of the insurer, allowing it to surcharge the bank's collateral. The district court and the Eighth Circuit affirmed. However, the Eighth Circuit subsequently granted *en banc* review and reversed, concluding that section 506(c) could not be invoked by an administrative claimant.

Justice Scalia, writing for a unanimous Supreme Court, first noted that "administrative expenses … do not have priority over secured claims."[19] However, section 506(c) is "an important exception to the rule that secured claims are superior to administrative claims."[20] Turning to the

[19] *Id.* at 5.

[20] *Id.*

language of section 506(c), the Court decided that the text of the statute was clear: "[T]he trustee is the only party empowered to invoke the provision."[21] "[H]ad Congress intended the provision to be broadly available, it could simply have said so, as it did in describing the parties who could act under other sections of the Code."[22] Notwithstanding various policy concerns raised by Hartford, the court found that the holder of an administrative expense has no right to pursue its administrative expense against the secured lender.[23]

The clear takeaway from the Supreme Court's ruling is that section 506(c) does not provide a remedy for non-trustee/debtor[24] holders of administrative expenses who are seeking to charge a secured lender for the costs associated with a section 363 sale of its collateral. In the absence of a statutory remedy, what arguments can holders of administrative expenses make?

Ensuring Administrative Insolvency is an Implied Requirement of a 363 Sale

Perhaps the best argument for holders of administrative expenses is that a bankruptcy court should not approve a sale process it if will only benefit the secured creditor.[25] This is particularly true where the case is, or will be, administratively insolvent. As noted, all administrative expenses must generally be paid in full in order to confirm a plan under section 1129 of the Bankruptcy Code. If the case is filed to orchestrate a pre-plan section 363 sale, then there must be sufficient

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[21] *Id.* at 6.

[22] *Id.* at 7 (citing 11 U.S.C. 502(a) and 503(b)(4)).

[23] *Id.*

[24] Importantly, the Court stated in a footnote that a debtor in possession, given trustee powers by section 1107, may also bring section 506(c) actions. *Id.* at n. 3.

[25] *But see In re GPA Technical Consultants, Inc.,* 106 B.R. 139, 142 (Bankr. S.D. Ohio 1989), wherein the court determined that it is not *per se* inappropriate for a bankruptcy liquidation to proceed where it will only benefit the secured creditor, stating: "Even if the only reason for the Chapter 11 in the instant case is to maximize the return to the secured creditor … the interests of the secured creditor are legitimate interests to be taken into account…. Pursuant to [the Bankruptcy Code], entities holding secured claims are 'creditors.'"

assets carved out from the sale to pay all costs of administration. If the secured creditors are unwilling to pay the costs associated with the sale, the argument goes, then they should be required to liquidate their collateral in state court (through an article 9 foreclosure and sale) without the benefits of having the process conducted in chapter 11. In other words, if a secured creditor desires to liquidate its collateral through a section 363 sale, paying the freight is the price of admission. A few courts have addressed this argument.

a. *In re Gulf Coast Oil Corp.*

In *In re Gulf Coast Oil Corp.,*[26] an oil and gas exploration company filed a bankruptcy case in the United States Bankruptcy Court for the Southern District of Texas. After six relatively contentious months as a debtor in possession, when it became clear that a reorganization was not possible, the debtors filed a motion to sell substantially all of their assets to the sole secured lender, who held a lien on all assets, through a credit bid. The debtors' financial advisor, who held an administrative expense that would not be paid in full, objected to the sale. The court denied the sale motion, concluding that the debtors had not demonstrated a substantial business reason for conducting a section 363 sale in lieu of a sale pursuant to, and in accordance with the requirements of, a liquidating chapter 11 plan.

The court first noted that sales in bankruptcy can be accomplished under section 363(b) (when a substantial business justification for approving the sale is established) or under section 1123 of the Bankruptcy Code, which provides that a chapter 11 plan may including provisions providing for the sale of estate property. The court noted that "The Bankruptcy Code does not

[26] *In re Gulf Coast Oil Corp.,* 404 B.R. 407 (Bankr. S.D. Tex. 2009).

provide any explicit guidance to determine when § 363(b) is the appropriate procedure and when § 1123 is the appropriate procedure."[27]

The court then engaged in an analysis of the jurisprudence in the Fifth Circuit regarding the approval of section 363 sales.[28] The court also reviewed the analysis set forth in the two primary bankruptcy treatises, COLLIER ON BANKRUPTCY and NORTON BANKRUPTCY LAW & PRACTICE, and in several scholarly articles.[29] After discussing the recent changes in chapter 11 bankruptcy practice, the court acknowledged that there has been "a huge increase in motions to sell substantial parts (or all) of the estate under § 363(b) prior to plan confirmation."[30] The court ultimately concluded, "the bankruptcy court must not authorize a § 363(b) transaction if the transaction would effectively evade the 'carefully crafted scheme' of the chapter 11 plan confirmation process."[31]

Next, the court identified no fewer than 13 factors that a bankruptcy judge must consider in deciding a pre-plan motion to sell substantial assets under section 363(b).[32] Although it applied

[27] *Id.* at 415.

[28] *Id.* at 415-417 (discussing *In re Braniff Airways, Inc.,* 700 F.2d 935 (5th Cir. 1983) (holding that an asset sale which provides for more than a transfer of assets for value effectively "short circuits the requirements of Chapter 11 … by establishing the terms of the plan *sub rosa* ... [and] cannot be authorized under § 363(b)); *Richmond Leasing Co. v. Capital Bank N.A.,* 762 F.2d 1303 (5th Cir. 1985) (stating, in dicta, that "the disposition of a 'crown jewel' asset might, in combination with other factors, severely restrict a future reorganization plan so as to amount to a *sub rosa* plan of reorganization…"); *In re Continental Air Lines, Inc.,* 780 F.2d 1223 (5th Cir. 1986) ("Undertaking reorganization piecemeal pursuant to § 363(b) should not deny creditors the protections they would receive if the proceeds were first raised in the reorganization plan."); *In re Babcock and Wilcox Co.,* 250 F.3d 955 (5th Cir. 2001) ("the provisions of § 363 … do not allow a debtor to gut the bankruptcy estate before reorganization or to change the fundamental nature of the estate's assets in such a way that limits a future reorganization plan.")).

[29] *Id.* at 417-419.

[30] *Id.* at 418-422.

[31] *Id.* at 422.

[32] The 13 factors identified by Judge Steen are as follows:

(i) Is there evidence of a need for speed?
(ii) What is the business justification?

each of these factors to the facts of the case, the court focused heavily on the tenth factor, to wit: Who will benefit from the sale? The court stated:

> If only one party … will benefit from the sale, the movant should be prepared to explain why the sale should take place in a bankruptcy case and why the bankruptcy court should provide the benefits for which Congress imposed substantial requirements. If the sale will not follow the "carefully crafted [Congressional] scheme" by utilizing the "balanced set of tools for both the debtor and the creditor [and] ... multiparty bargaining" then it is hard to justify entitling the few lucky parties to the extraordinary benefits that Congress provided for those who do satisfy the statutory plan confirmation requirements.
>
> [B]ankruptcy is, at its essence, a collective remedy intended to benefit all creditors, not just the secured lender. The § 363(b) movant should be prepared to prove, not just allege, why it is appropriate to provide extraordinary bankruptcy authority and remedies solely for the benefit of a party whose contract under state law does not provide those remedies and benefits. And if the proposed transaction will not even pay all of the expenses of the bankruptcy proceeding, it would be especially difficult to understand why the purchaser should get the benefit of extraordinary bankruptcy powers and remedies for which it did not pay.[33]

Ultimately, the court rejected the sale motion because the debtor had not established a sufficient business justification for approving the section 363(b) sale prior to plan confirmation. The court reasoned that it saw "no authority to provide the benefits of the Congressional scheme … without compliance with Congressional requirements."[34] Notably, the court expressed grave

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(iii) Is the case sufficiently mature to assure due process?
(iv) Is the proposed APA sufficiently straightforward to facilitate competitive bids or is the purchaser the only potential interested party?
(v) Have the assets been aggressively marketed in an active market?
(vi) Are the fiduciaries that control the debtor truly disinterested?
(vii) Does the proposed sale include all of the debtor's assets and does it include the "crown jewel"?
(viii) What extraordinary protections does the purchaser want?
(ix) How burdensome would it be to propose the sale as part of a confirmation of a chapter 11 plan?
(x) Who will benefit from the sale?
(xi) Are special adequate protection measures necessary and possible?
(xii) Is the integrity of the bankruptcy process protected?, and
(xiii) Other factors that apply to the case at hand.

[33] *Id.* at 426-27.

[34] *Id.* at 428.

concern that it could not make the finding required in the plan context by section 1129(a)(9) that all of the administrative expenses will be paid in full.

Subsequently, a handful of courts have adopted the reasoning in *In re Gulf Coast Oil Corp.* when evaluating section 363 sale motions. For example, in *In re Flour City Bagels,* the United States Bankruptcy Court for the Western District of New York relied on *Gulf Coast Oil Corp.* in denying a proposed section 363 sale because, among other reasons, the proposed bid raised "serious concerns that the sale, if approved, would result in [the debtor] being rendered administratively insolvent."[35] In *In re On-Site Sourcing, Inc.,* the United States Bankruptcy Court for the Eastern District of Virginia approved a pre-plan section 363 sale but, in doing so, excised certain sale conditions which would likely result in inadequate funds to pay all administrative expenses in full.[36]

b. *In re Encore Healthcare Associates*

In *In re Encore Healthcare Associates*[37] the debtor, a lessor of real property that housed a nursing facility, filed a bankruptcy case in the United States Bankruptcy Court for the Eastern District of Pennsylvania. The debtor's assets were valued at about $2.5 million. The assets secured a debt to the secured lender, Greenleaf, of approximately $8.4 million. The debtor sought authority to sell the assets for $2.5 million, with the sale proceeds to pay the costs of sale and then all of the remainder to be remitted to the secured creditor in partial satisfaction of its claim.

No parties objected to the proposed sale, but the bankruptcy court *sua sponte* raised its own concerns. The court began its analysis by stating that section 363 does not grant a debtor an

[35] *In re Flour City Bagels, LLC,* 557 B.R. 53, 79-80 (Bankr. W.D.N.Y. 2016).

[36] *In re On-Site Sourcing, Inc.,* 412 B.R. 817, 827-28 (Bankr. E.D. Va. 2009).

[37] *In re Encore Healthcare Assocs.,* 312 B.R. 52 (Bankr. E.D. Pa. 2004).

absolute right to sell its assets. Instead, there must be some business justification other than appeasement of major creditors.[38] Specifically, the court stated, "The debtor applying under § 363(b) must demonstrate that a sale will aid the debtor's reorganization."[39] In the present case, the court noted, there was not going to be a reorganization as the debtor acknowledged that it planned to convert the case to chapter 7 following the sale.

Finding that the bankruptcy sale was effectively a state law foreclosure negotiated pre-petition, the court stated:

> While this Court understands [the purchaser's] interest in acquiring the assets along with a bankruptcy order insulating it from future claims and providing a federal forum to litigate any contract issues, I am hard pressed to see why the bankruptcy court should assume jurisdiction over this sale.[40]

The court also quoted a bankruptcy opinion from the United States Bankruptcy Court for the Northern District of Ohio, *In re Fremont Battery Co.,* stating:

> The proposed sale would not, as a whole benefit the Debtor or creditors. In fact, if allowed, the sale would terminate Debtor's existence. If Debtor's proposed sale were authorized, the likelihood of reorganization would dissipate as there would remain no assets from which a plan could be proposed. Additionally, the proceeds from the proposed sale would, at most, benefit one creditor only. The sale would not create proceeds that would inure to the benefit of the unsecured creditors.[41]

The court acknowledged that pre-plan sales of assets are often an important step in furtherance of a reorganization proceeding. For example, if a sale is proposed at a time when the debtor lacks funds to continue operating, the assets are declining in value and the proceeds "ensure[] the payment of administrative claims," a sale outside a plan may be proper.[42] Here,

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[38] *Id.* at 54-55 (citing and discussing *Committee of Equity Security Holders v. The Lionel Corporation (In re Lionel Corp.),* 722 F.2d 1063 (2d Cir. 1983)).

[39] *Id.* at 55.

[40] *Id.* at 55-56.

[41] *Id.* at 57 (discussing *In re Fremont Battery Co.,* 73 B.R. 277 (Bankr. N.D. Ohio 1987)).

[42] *Id.* (citing *In re Medical Software Solutions,* 386 B.R. 431 (Bankr. D. Utah 2002)) (emphasis added).

however, the sale would generate funds solely for the secured creditor, "which could realize the value of its collateral by foreclosing and selling the assets itself."[43] The proposed sale, the court found: "advances no purpose of a Chapter 11 proceeding," as it would preserve no operating business with continued employment for workers, and the debtor intended to convert the case to chapter 7 shortly after consummation of the sale.[44] Accordingly, the court denied the proposed sale motion.

c. *In re Family Christian, LLC*

Recently, an opinion from the United States Bankruptcy Court for the Western District of Michigan in *In re Family Christian, LLC*[45] has been cited for the proposition that a lender, who stands largely to benefit from a sale of its collateral under section 363, must ensure payment of all administrative expenses. Whether that was in fact the holding of the court (the case had some unique facts, involving a proposed sale to an insider) or, alternatively, just part of the court's rationale is debatable, but it does appear that the specter of administrative insolvency was a concern that weighed heavily on the court when it determined that it could not approve a pre-plan section 363 sale to any of three different potential buyers.

In *Family Christian,* the debtors operated as not-for-profit organizations, selling religious merchandise in more than 250 brick and mortar stores. On the petition date, the debtors' assets were valued at approximately $28 million against secured debt (a portion of which was held by an insider) totaling about $58 million. Administrative expenses totaled approximately $14 million, $5.6 million of which were section 503(b)(9) administrative expenses.

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[43] *Id.*

[44] *Id.* at 57-58.

[45] *In re Family Christian, LLC,* 533 B.R. 600 (Bankr. W.D. Mich. 2015).

Immediately after commencing its chapter 11 case in February 2015, the debtors moved to sell substantially all of their assets to FCS Acquisition, an entity controlled by an insider. After opposition from numerous creditors and other parties in interest, however, the debtors withdrew their initial sale motion. Thereafter, the debtors returned to court with a revised sale process and obtained approval of consensual bidding procedures with no stalking horse bidder.

After an auction that was "nothing short of chaotic,"[46] two status conferences, a request from certain non-insider bidders that the court supervise the auction process, and a second day of bidding, the bidders left standing were: (i) FCS Acquisition, which proposed to buy the debtors' assets for a bid valued at $46.8 million, and (ii) two separate bids from liquidators who proposed to liquidate the debtors' inventory through going out of business sales under so-called "agency agreements." Even though the liquidators' bids were valued at approximately $3 million more than the insider bid, FCS Acquisition was declared the winner by the debtors, purportedly because the liquidators' bids contained various contingencies and did not guarantee a minimum purchase price. Unlike the liquidators' bids, the insider's bid guaranteed that administrative expenses, including professional fees subject to certain caps, would receive payment in full.

After a lengthy contested sale hearing, the bankruptcy court denied the proposed sale to the insider because the debtors had failed to articulate a sound business justification for the sale. The court found that no party in interest had shown any relationship between the proposed sale price and the value of the assets being sold (which, importantly, included insider releases and a waiver of all avoidance actions, which had not been valued). Moreover, the court expressed concerns about the good faith of the insider entity. Finally, although the court did not cite *In re Gulf Coast Oil Corp.,* it stated that it was also concerned that the proposed sale would essentially circumvent

[46] *Id.* at 610.

the requirements inherent in confirming a chapter 11 plan. The court stated, "In these cases, the Acquisition APA contains provisions which are more appropriately included within the plan of liquidation that the Debtors intend to file, especially in light of the insider relationship between the Debtors and Acquisition."[47]

Relevant to the topic of this paper, the court determined that it also could not approve the sale to the liquidators who had been designated as the back-up bidders at the auction. Part of its rationale for rejecting the liquidators' bids was that the liquidators had "failed to provide any firm commitment to this court regarding the payment in full of administrative expenses. The court therefore cannot conclude that the [liquidators' bids were] the highest and best bid."[48]

The court entered an order specifying that if the auction were reopened, any qualifying bid must, among several other requirements, provide for payment of administrative expenses. Alternatively, the court suggested in its opinion that the debtors may consider selling their assets though a plan, which would avoid its concerns that certain elements of their proposed sale were inconsistent with the Bankruptcy Code and improper in the context of a pre-plan section 363 sale. That is exactly what the debtors ended up doing, and the assets were eventually sold as part of a liquidating plan.

Are All Administrative Expenses Created Equal?

The Bankruptcy Code makes no distinction between administrative expenses for post-petition professional fees or operating expenses and pre-petition administrative expenses under section 503(b)(9). None of the opinions discussed above made such a distinction either. Nevertheless, in the context of deciding whether a proposed sale that leaves behind an

[47] *Id.* at 629.

[48] *Id.* at 630-31.

administratively insolvent estate can be approved, there appears to be a split in the case law in Delaware regarding whether administrative expenses under section 503(b)(9) are truly equal to administrative expenses incurred post-petition.

For example, in *In re Townsends, Inc.,*[49] Judge Sontchi initially refused to approve proposed DIP financing and a sale process because the debtors and the secured lender had failed to provide reasonable certainty that administrative expenses would be paid in full through the sales process. The court prohibited the lenders from treating section 503(b)(9) administrative expenses differently from other administrative expenses. Additionally, in *In re NEC Holdings Corp.,*[50] objections to DIP financing and a proposed sale were asserted because no guarantee was provided that section 503(b)(9) administrative expenses would be paid in full. Judge Walsh held that where the secured lender is the primary beneficiary of a sale, it has "to pay the freight, and the freight is not necessarily a tip to the unsecured, but the freight is certainly an administratively solvent estate." After the lender and the creditors' committee subsequently reached an agreement to pay section 503(b)(9) administrative expenses from the sale proceeds, the proposed DIP financing and sale process were approved.

Conversely, in *In re Allen Family Foods, Inc.,*[51] Judge Carey approved a section 363 sale notwithstanding the fact that the pre-petition secured lenders did not assure full payment of section 503(b)(9) administrative expenses. The court distinguished administrative expenses arising under section 503(b)(9) from other administrative expenses because the holders of such claims made no "ongoing contribution to the chapter 11 case." The same conclusion was reached by Judge

[49] *In re Townsends, Inc.,* Case No. 10-14092 (CSS) (Bankr. D. Del. 2010).

[50] *In re NEC Holdings Corp.,* Case No. 10-11890 (PJW) (Bankr. D. Del. 2011).

[51] *In re Allen Family Foods, Inc.,* Case No. 11-11764 (KJC) (Bankr. D. Del. 2011).

Shannon in *In re Real Mex Restaurants Inc.*,[52] who approved a section 363 sale despite the fact that section 503(b)(9) administrative expenses would not be paid in full, noting that "the circumstances for all creditors would be much worse without this sale."

Despite the fact that the Bankruptcy Code makes no distinction between pre-petition and post-petition administrative expenses, the tension reflected in the intra-district split discussed above highlights how difficult this issue is. Understandably, it is hard for bankruptcy courts to reject a sale, on the basis that it does not pay all administrative expenses in full or discriminates amongst different types of administrative expenses, when such a sale may be the best of several less than appealing options.

Conclusion

There is certainly additional precedent in the case law for the concept that secured creditors must fund certain administrative expenses in a case, particularly the fees owed to estate professionals, in order to ensure that the adversarial process contemplated in chapter 11 exists.[53] Nevertheless, despite the frequency with which these issues arise in modern chapter 11 practice, there is surprisingly little case law discussing whether a secured creditor should be required to "pay the freight" when its assets are to be sold in a section 363 sale. This may be because debtors, secured creditors, creditors' committees and other parties holding administrative expenses

[52] *In re Real Mex Restaurants Inc.*, Case No. 11-13122 (BLS) (Bankr. D. Del. 2011).

[53] For example, in *In re Ames Dept. Stores, Inc.,* the United States Bankruptcy Court for the Southern District of New York famously stated as follows in analyzing proposed DIP financing:

> No court of which we are aware has approved financing arrangements with such features. Indeed, it has been the uniform practice in this Court … to insist on a carve out from a super-priority status and post-petition lien in a reasonable amount designed to provide for payment of the fees of debtor's and the committees' counsel and possible trustee's counsel in order to preserve the adversary system. Absent such protection, the collective rights and expectations of all parties-in-interest are sorely prejudiced.

In re Ames Department Stores, 115 B.R. 34 (Bankr. S.D.N.Y. 1990).

generally negotiate a resolution of this issue, given the high stakes that often surround a sale of substantially all of a debtor's assets.

A bankruptcy court cannot force a secured creditor to pay all administrative expenses in full. But it can conclude, as some have, that it should not approve a proposed sale process where a sale will leave behind an administratively insolvent estate. Although section 363 sales may have supplanted confirmation of a plan as the preferred exit strategy for business debtors, it is fair in administratively insolvent cases to expect that the parties benefitting the most from such process ensure that the related, reasonable, costs are paid in full. That is the price of admission for obtaining the benefits that chapter 11 can provide, and is arguably what was contemplated by the drafters of the Bankruptcy Code who could not have anticipated the extent to which section 363 is used today.

At the end of the day, the analysis should focus on who is the fulcrum creditor. That party may or may not be the senior secured creditor. However, it is the fulcrum creditor who needs to decide whether they want the benefits and potential upside that accompanies a section 363 sale process, or not. If the decision is made to proceed under section 363, the burden of "paying the freight" should fall squarely on their shoulders.

Fees-on-Fees: Retention and Payment of Estate Professionals After Baker Botts LLP v. ASARCO, LLC

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Introduction

These materials address the impact of the Supreme Court's decision in *Baker Botts LLP v. ASARCO LLC* ("ASARCO"), 135 S. Ct. 2158 (2015) and examine the cases that have sought to interpret and apply the principles set forth therein under a variety of circumstances. As of the date these materials were prepared, courts are divided on what, precisely, *ASARCO* requires as it relates to the retention and payment of bankruptcy estate professionals.

Baker Botts LLP v. ASARCO LLC

ASARCO, a chapter 11 debtor, had retained professionals, including Baker Botts LLP and Jordan, Hyden, Culbreth & Holzer, P.C. (the "Firms") to represent it in its chapter 11 case. The Firms assisted the debtor in suing its parent company for fraudulent transfer recoveries, which resulted in a judgment worth $7 to $10 billion and a full recovery for general unsecured creditors. After emergence from bankruptcy, the parent corporation regained control of the debtor. The Firms filed final fee applications in the amount of over $120 million. The parent corporation objected, which resulted in a 6 day trial. The bankruptcy court awarded the fees, plus a $4.1 million enhancement for exceptional performance and an additional $5 million for fees and expenses incurred litigating in defense of the fee applications. The parent company appealed to the U.S. District Court for the Southern District of Texas, which affirmed the bankruptcy court, and then to the U.S. Court of Appeals for the Fifth Circuit, which reversed the bankruptcy court.

In an opinion authored by Justice Thomas, the Supreme Court held that 11 U.S.C. § 330(a)(1) does not permit bankruptcy courts to award fees to professionals for defending fee applications.[1] In particular, the Court relied on the "American Rule" that each side must pay its own attorneys' fees, with the exceptions of statutes and contracts which provide otherwise.[2] With the American Rule as a "basic point of reference," the Court held that § 330(a)(1) is not a statute which alters the American Rule because it permits only "reasonable compensation for actual, necessary services rendered" which implies loyal and disinterested service of a client and fees litigation cannot be described as labor performed for or disinterested service to the client.[3]

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[1] *ASARCO*, 135 S. Ct. at 2162-63.
[2] *Id.* at 2164.
[3] *Id.* at 2164.

Open Questions After *ASARCO*

I. **Can parties contract around *ASARCO*? Courts are divided.**

a. **No: *In re Boomerang Tube, Inc.*, 548 B.R. 69 (Bankr. D. Del. 2016)**

i. Holding: Delaware bankruptcy court held that committee counsel could not include a provision in their retention application to protect it from the American Rule through the "contract exception."[4]

ii. Facts: Counsel for the committee attempted to test the "contract exception" to the American Rule, by placing a provision in its retention agreement allowing it to receive defense fees and costs in they successfully defended their fees against a later objection. The U.S. Trustee objected.

iii. Positions of Parties: The U.S. Trustee contended that the provision was precluded by *ASARCO*, that the fee defense provision should not be approved because such fees are outside the scope of employment under § 328, and the provision was unreasonable. The committee attempted to distinguish *ASARCO* by arguing that it sought approval of the fee defense provision under § 328(a), not § 330. The U.S. Trustee countered that although § 328 governs retention, § 330 governs compensation.

iv. Reasoning: The Court addressed the parties' arguments and provided several reasons as to why the committee's counsel could not contract around *ASARCO*.

1. Section 328 allowing court to pre-approve professional's employment "on any reasonable terms and conditions of employment" provided no authority for fee defense provision in counsel's retention agreement because although § 328 is an exception to § 330, it is not a "specific and explicit" statute which authorizes an award of reasonable attorneys' fees or litigation costs to the prevailing party.[5]

2. Parties cannot, by contract, violate another provision of the Bankruptcy Code. While *ASARCO* acknowledged a contractual exception to the American rule, any such exception must be consistent with the Bankruptcy Code.[6]

[4] *Boomerang Tube, Inc.*, 548 B.R. 69 at 74-75.
[5] *Id.* at 72.
[6] *Id.* at 73.

3. While a retention agreement is a contract, it is not a bi-lateral one; it is subject to objection by other parties and ultimately subject to approval and modification by the court.[7]

4. The contract exception could not apply because the proposed "contract" was not between two mutually bound parties; it would be an agreement between the committee and its counsel which bound the estate, a third party, to pay defense costs even if the estate is not the party who objected.[8]

5. Fee defense provisions are not reasonable terms of employment because they do not involve any services for the committee; they are for services performed by counsel for counsel's own interest.[9]

b. **<u>No</u>: *Bletchley Hotel at O'Hare Field LLC v. River Road Hotel Partners, LLC*, 2016 WL 4146480 (N.D. Ill. Aug. 4, 2016)**

i. Financial advisor was retained under an agreement, which contained a success fee for the restructuring. The debtor contested the payment of the success fee and the financial advisor sought reimbursement of its attorneys' fees for defending its success fee. The financial advisor argued that its engagement letter, which allowed reimbursement for its attorneys' fees, overrides the default American Rule. The court rejected that argument because the retention order said that the reimbursement of the expenses shall be subject to further review and approval by the court pursuant to § 330, which does not permit recovery of such fees.[10]

c. **<u>No</u>: *In re Capitol Litho Printing Corporation*, 573 B.R. 771 (Bankr. D. Ariz. 2017)**

i. <u>Holding</u>: Real estate broker could not be awarded attorneys' fees incurred in defending its broker's commission, despite prevailing party attorneys' fees provision in listing agreement.[11]

ii. <u>Facts</u>: Debtors employed a real estate broker to sell certain real estate assets on a fixed commission basis. The broker was required to file an application for expense reimbursement and the court retained the right to adjust the commission. The listing agreement also contained a prevailing party fees provision. After the sale of the property, the debtors objected to

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[7] *Id.* at 74.
[8] *Id.* at 74-75.
[9] *Id.* at 78.

[10] *Bletchley Hotel at O'Hare Field LLC*, 2016 WL 4146480, at * 4.
[11] *In re Capitol Litho Printing Corporation*, 573 B.R. at 776.

the commission and the court overruled the objection. The court permitted the broker to file an application for attorneys' fees and costs incurred in defending the commission.

iii. Reasoning: The court reasoned that the broker could not be awarded its attorneys' fees under § 330 in light of *ASARCO*, and the order approving the broker's retention provided only for commission and expenses allowed under § 330.[12] "To allow professionals to contract around the requirements of sections 327, 328 and 330 in this situation would eviscerate the requirement that professionals be paid for the actual, necessary services they provided and expenses they incurred on behalf of the estate."[13] Additionally, the fees were not actual or necessary to the work for which broker was specifically employed and defense fees did not benefit the estate.[14]

d. **Yes: *In re Hungry Horse, LLC*, 574 B.R. 740 (Bankr. D.N.M. 2017)**

i. Holding: Debtor's counsel could include fees-defense provision in retention under § 328.[15]

ii. Facts: Following withdrawal of chapter 11 debtor's counsel, debtor filed application to employ a law firm as replacement counsel and sought approval of its retention including a "fees-defense" provision. The creditors' committee objected to the proposed rates and the fees-defense provision. Attorney for original debtor's counsel left the firm and joined a new firm. Counsel sought a higher rate than previously approved at his old firm and included a provision in which the debtor agreed to pay all reasonable legal fees incurred in, among other things, dealing with any objections to retention and fee applications. Among other things, the committee objected to the fee-defense provision as contrary to *ASARCO*.

iii. Reasoning: The court did not read *ASARCO* as requiring that a fee defense provision is precluded from being a reasonable term and condition of employment.[16] "Nothing in the Code says that an employment term must benefit the estate to be reasonable."[17] While the debtor does not benefit directly, it benefits indirectly by "obtain[ing] the services of needed, able professionals."[18] In order to be approved, a fee defense provision should: (1) be agreed to by the bankruptcy estate; (2) allow the bankruptcy court

[12] *Id.*, at 776.
[13] *Id.*
[14] *Id.*
[15] *In re Hungry Horse, LLC*, 574 B.R. at 747-48.
[16] *Id.* at 747.
[17] *Id.*
[18] *Id.*

to review and approve the reasonableness of any fee defense fees sought; (3) provide that the estate will also agree to a similar provision for committee counsel; and (4) provide that no fees will be allowed for unsuccessful fee work.[19] Interestingly, the court noted that "[i]n jurisdictions such as New Mexico, which typically have smaller bankruptcy cases with smaller fees, fee defense can be a sizeable percentage of the total fees billed. If estate counsel were forced to successfully defend its fees 'on its own dime,' the net compensation in a bankruptcy case could be substantially reduced."[20]

II. **Scope: What types of fees are/are not prohibited by *ASARCO*?**

a. **U.S. Trustee FAQ[21]**

i. Fees incurred defending fee applications after an objection is filed are objectionable.

ii. Generally, the U.S. Trustee will not object to fees incurred negotiating or explaining a fee application prior to the filing of an objection.

iii. U.S. Trustee will object to engagement letters or retention terms which purport to contract around the American Rule to allow "fees-on-fees." The U.S. Trustee reasons that professionals' employment and compensation arises by statute. Section 330(a) governs awards of compensation and *ASARCO* expressly precludes fees-on-fees. Thus, estate-paid professionals cannot by consent or contract create an exception to what the Bankruptcy Code does not allow.

iv. U.S. Trustee will object to higher rate of compensation based on purported risk of non-payment for future fee litigation.

b. **Pre-petition Receiver's Fees:** *In re 29 Brooklyn Avenue, LLC*, 548 B.R. 642 (Bankr. E.D.N.Y. 2016)

i. Holding: A pre-petition receivers' fees sought under §503(b)(4) are not subject to the American Rule, because §503(b)(4) is "unquestionably" a fee shifting statute that provides for attorney's fees for the "prevailing party."[22]

ii. Facts: Receiver who operated property of the estate for 14 months prior to the filing of the bankruptcy case sought attorneys' fees pursuant to §§

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[19] *Id.*at 748.
[20] *Id.* at 747.
[21] https://www.justice.gov/ust/Prof_Comp/FAQ_Prof_Comp (last accessed on April 19, 2018).
[22] *In re 29 Brooklyn Avenue, LLC*, 548 B.R. at 647-48.

503(b)(3)(E) and 503(b)(4). He first objected to confirmation of the chapter 11 plan because it did not provide for payment of his outstanding expenses or commissions then withdrew his objection after the Debtor agreed to escrow funds sufficient to pay his claim. After the plan was confirmed, the property was sold and the funds were sufficient to pay all administrative expenses and all allowed claims. The receiver's claim consisted of pre-petition paid and unpaid expenses of the property as well as the receiver's commission and legal fees incurred up to that point. The debtor objected to the receiver's claim. After an eight-day trial, the Court allowed the receiver's claim in the amount of $72,223.86. The receiver then filed a motion seeking allowance of his attorneys' fees incurred in the bankruptcy case of roughly five times the amount of the receiver's allowed claim ($355,953.25).

iii. Reasoning: Section 503(b)(3)(4) permits compensation for a custodian's attorney for "reasonable compensation for professional services rendered by an attorney or an accountant of an entity whose expense is allowable under subparagraph . . . (E) . . . ."[23] "Section 503(b)(4) is unquestionably a fee-shifting statute; it provides for the bankruptcy estate to pay 'reasonable compensation for professional services rendered by an attorney . . . of an entity whose expense is allowable under subparagraph . . . (E) . . . ."[24] The Court distinguished *ASARCO* on the grounds that in *ASARCO*, the professional was litigating against its own client versus the case at bar, where the services were rendered to the client and the work was "labor performed for" and "disinterested service" to the receiver.[25] Additionally, § 503(b)(4) governs, not § 330(a).[26] This statute only allows compensation for the attorney of an entity whose expense is allowable, removing the risk that an attorney might receive an award for unsuccessfully defending a fee application.[27] Ultimately the court awarded $234,206.25 in fees and $5,533.30 in expenses.

c. **Fees Supplementing Fee Application**: *In re Stanton*, 559 B.R. 781 (Bankr. M.D. Fla. 2016)

i. Holding: Fees of chapter 7 trustee's counsel incurred supplementing fee application to add additional detail in response to an objection to an interim fee application were compensable by the estate.[28]

[23] *Id.* at 646.
[24] *Id.*
[25] *Id.* at 647.
[26] *Id.*
[27] *Id.*
[28] *In re Stanton*, 559 B.R. at 782.

ii. Facts: Chapter 7 trustee's counsel was retained under § 327 of the Bankruptcy Code to pursue certain fraudulent transfer claims against the debtor's ex-wife. The claims were ultimately settled and the estate recovered approximately $6.5 million from the sale of certain property. The trustee's counsel filed a fee application seeking approximately $750,000 in fees divided into two categories: (1) time spent in the main case, and (2) time spent relating to the fraudulent transfer proceeding. The fee application contained all the information required by the local rules, including name of individuals who performed the work, hourly rate, amount of time spent for each item, and verification of fees and costs as being reasonable. The U.S. Trustee objected on several grounds, all of which related to the level of detail required and which essentially requested that the attorneys provide the level of detail required for a chapter 11 case. In response, the trustee's counsel supplemented his fee application. After further hearing, the court approved the fee application in its entirety. When the trustee's counsel filed a second interim fee application, the U.S. Trustee objected to approximately $27,500 spent supplementing the first fee application, citing *ASARCO*.

iii. Reasoning: Interpreting *ASARCO*, the court determined that the "touchstone" for determining whether fees are recoverable under *ASARCO* is "whether they were incurred in service to the estate."[29] In this case, counsel supplemented the fee application to provide the additional detail complained of by the U.S. Trustee, which the court found "was akin to . . . preparation of an itemized bill as part of his 'services' to the [trustee]."[30] The court also noted that the trustee's counsel was not required to provide that level of detail under the local rules and, though perhaps appropriate given the complexities of the case, the proper way to insist upon that level of detail would have been at the retention stage, not after the fee application was already drafted.[31] Further, the supplement benefitted the administration of the estate, by allowing parties to understand the work performed and, if necessary, dispute the fees.[32]

iv. *See also In re Stanton*, 569 B.R. 840 (Bankr. M.D. Fla. 2017).

d. **Indentured Trustee Fees (Committee Member)**: *In re Nortel Networks*, 2017 WL 932947 (Bankr. D. Del. Mar. 8, 2017)

[29] *Id.* at 785.
[30] *Id.*
[31] *Id.*
[32] *Id.* at 786.

i. Holding: Fee-defense provision in indentured trust agreement came within the contract exception to the American Rule.[33]

ii. Facts: Indentured trustee was a member of the Official Committee of Unsecured Creditors and was represented during the case by three separate law firms relating to its participation on the Committee and a dispute over an allocation of funds raised during the sale of the Debtors' assets. The indenture trustee asserted a claim against the bankruptcy estate, including an $8.1 million claim for attorneys' fees incurred during the case. The indenture trustee also asserted the right to be paid for fees incurred defending the $8.1 million fee request. The indenture, which was a contract between the debtor and the indenture trustee, contained a provision allowing the trustee to be reimbursed for such fees.

iii. Reasoning: The court ruled that the indenture came within the contract exception to the American Rule and the indenture was "clearly outside the circumstances of *ASARCO* and *Boomerang*."[34]

e. **Attorneys' Fees Passed Through As Expense of Another Estate Professional:** In *In re Walker Land & Cattle, LLC,* 535 B.R. 348 (Bankr. D. Idaho 2015), the court refused to award legal fees pursuant to § 330(a)(1) because they were not fees of court-employed professionals, but were fees of attorneys hired by retained professionals.[35] The court approved the debtor's application to employ an auditor and while the application did not indicate the auditor might retain counsel, engagement letter did. The auditor subsequently received a subpoena from a creditor, hired legal counsel to respond to it, and sought reimbursement in a later fee application. The auditor's attorneys' fees and expenses were denied as not necessary to accomplish the task for which the auditor was hired.[36] The language in the engagement letter was not applicable because the order approving employment was limited only to amounts allowed under § 330.[37]

f. **Bad-Faith Litigation**:

i. *Franzin v. Haynes & Boone, LLP (In re Franzin),* 2017 WL 7050632, at *45 (Bankr. N.D. Tex. Dec. 22, 2017) (recognized the existence of bad-faith litigation exception to the American Rule, but found the exception inapplicable on the facts).

ii. *In re River Road Hotel Partners, LLC*, 536 B.R. 228, 243-44 (Bankr. N.D. Ill. 2015) (considered bad-faith exception to the American Rule under

[33] *In re Nortel Networks*, 2017 WL 932947 at *9.
[34] *Id.*
[35] *In re Walker Land & Cattle, LLC,* 535 B.R. at 351-52.
[36] *Id.* at 357.
[37] *Id.*

Court's inherent authority in the context of application for allowance of fees incurred defending a fee application, but found it inappropriate under the facts).

g. **Counsel Defending Itself Against Litigation** *In re Macco Properties Inc.*, 540 B.R. 793 (Bankr. W.D. Okla. 2015)

   i. Holding: Counsel entitled to be paid fees incurred in defending its fee application from "baseless claims of malfeasance" asserted by third parties.[38]

   ii. Facts: Former managers of debtor objected to trustee's counsel's fees, asserting setoff claims and broad objections. The former managers asserted trustee's counsel was not entitled to any compensation.

   iii. Reasoning: "The American Rule precludes fee shifting between these two sets of adversaries, but does not apply to preclude the Estate Professionals from being compensated by the estate for defending themselves from tort claims asserted by [third parties]."[39] "Legal services provided by Counsel to defend Trustee's and MED PLLC's fee applications from objections and setoff claims asserted by [third parties] are clearly services to the 'administrator of the estate.'"[40] The court explained that the professionals were providing services to the estate by defending against claims in order to establish the amount of administrative claims so that the trustee could finalize the administration of the bankruptcy estates.[41]

h. **Chapter 13 Counsel***:* *In re Rose*, 561 B.R. 70 (Bankr. W.D. Mich. 2016). Chapter 13 debtor's counsel filed a second fee application for an interim award of compensation. The Chapter 13 trustee and U.S. Trustee argued that a significant portion of the fees violated *ASARCO* as being in defense of counsel's first fee application. Counsel argued that *ASARCO* did not apply because § 330(a)(4), not (a)(1), applied. The court rejected the distinction, holding that *ASARCO* is broad and extends to § 330(a)(4) as well.[42]

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[38] *In re Macco Properties Inc.*, 540 B.R. at 878-79.
[39] *Id.* at 877.
[40] *Id.* at 878.
[41] *Id.* at 879.
[42] *In re Rose*, 561 B.R. a 75.

2018 Central States Bankruptcy Workshop
Getting Paid and Avoiding Disgorgement: The Basics of Disgorgement

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In bankruptcy proceedings, "counsel is a gambler." *Specker Motor Sales Co. v. Eisen*, 393 F.3d 659, 664 (6th Cir. 2004). In some proceedings, there are sufficient funds for all creditors including counsel to beat the house and turn a profit, while on other occasions, assets are diminished and creditors are unable to recover the value of their investment. Bankruptcy practitioners, however, should be constantly aware of the "ace in the hole" that bankruptcy courts possess: disgorgement. Through disgorgement, courts claw back money that has already been issued and approved to counsel or another administrative creditor. In such cases, once what looked like a sure bet, can quickly turn into a bad beat, leaving counsel with little or nothing to show for the time, effort, and money he or she sunk into representing the debtor.

But as any successful poker player knows, there's a big difference between a "gamble" and a "calculated risk." To move from the former to the latter, players need experience and an understanding of the rules of the game and the probabilities of possible outcomes. Although experience may only be gained over time, these materials offer practitioners a basic understanding of the pitfalls that often lead to disgorgement of fees. These materials are not intended to be a comprehensive analysis of disgorgement law; rather, they are meant to provide practitioners with a foundational understanding of: (1) the statutory authority courts typically cite when disgorging an administrative creditor's fees; (2) a snapshot of recent and seminal cases in which courts ordered disgorgement; and (3) a brief application of the foregoing to the ongoing bankruptcy proceeding for Toys'R'Us, Case No. 17-34665 (E.D. Va.). Armed with this knowledge, counsel can reduce some of the uncertainty associated with bankruptcy proceedings to decide whether to take the calculated risk of representing the debtor.

I. Statutory Authority for Disgorgement

A. Section 327(a)

[T]he 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." (Section 327(a) also applies to a debtor in possession pursuant to Section 1107(a)).

B. Section 328(c)

Except as provided in section 327(c), 327(e), or 1107(b) of this title, the court may deny allowance of compensation for services and reimbursement of expenses of a professional person employed under section 327 or 1103 of this title if, at any time during such professional person's employment under section 327 or 1103 of this title, such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed.

C. Section 329

(a) Any attorney representing a debtor in a case under this title, or in connection with such a case, whether or not such attorney applies for compensation under this title, shall file with the court a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation.

(b) If such compensation exceeds the reasonable value of any such services, the court may cancel any such agreement, or order the return of any such payment, to the extent excessive, to—

(1) the estate, if the property transferred--

(A) would have been property of the estate; or

(B) was to be paid by or on behalf of the debtor under a plan under chapter 11, 12, or 13 of this title; or

(2) the entity that made such payment.

D. Section 330

(a)(1) After notice to the parties in interest and the United States Trustee and a hearing, and subject to sections 326, 328, and 329, the court may award to a trustee, a consumer privacy ombudsman appointed under section 332, an examiner, an ombudsman appointed under section 333, or a professional person employed under section 327 or 1103—

(A) reasonable compensation for actual, necessary services rendered by the trustee, examiner, ombudsman, professional person, or attorney and by any paraprofessional person employed by any such person; and

(B) reimbursement for actual, necessary expenses.

. . . .

(3) 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--

(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.

(4)(A) Except as provided in subparagraph (B), the court shall not allow compensation for—

(i) unnecessary duplication of services; or

(ii) services that were not--

(I) reasonably likely to benefit the debtor's estate; or

(II) necessary to the administration of the case.

. . . .

(5) The court shall reduce the amount of compensation awarded under this section by the amount of any interim compensation awarded under section 331, and, if the amount of such interim compensation exceeds the amount of compensation awarded under this section, may order the return of the excess to the estate.

E. Section 726(b)

(b) Payment on claims of a kind specified in paragraph (1), (2), (3), (4), (5), (6), (7), (8), (9), or (10) of section 507(a) of this title, or in paragraph (2), (3), (4), or (5) of subsection (a) of this section, shall be made pro rata among claims of the kind specified in each such particular paragraph, except that in a case that has been converted to this chapter under section 1112, 1208, or 1307 of this title, a claim allowed under section 503(b) of this title incurred under this chapter after such conversion has priority over a claim allowed under section 503(b) of this title incurred under any other chapter of this title or under this chapter before such conversion and over any expenses of a custodian superseded under section 543 of this title.

F. Section 105(a)

The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, *sua sponte*, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

II. Recent Case Law Examples

While disgorgement may be a "harsh remedy," courts will not hesitate to conclude that the equities of a case demand the outcome. Disgorgement often occurs in one of three situations: (1) a professional fails to satisfy the disclosure requirements of the Bankruptcy Code and Rules, (2) a professional has an interest adverse to the estate or is not disinterested, *see* 11 U.S.C. §§ 327(a), 328(c), or (3) the estate is administratively insolvent after conversion from Chapter 11 to Chapter 7. The following sections provide examples of key and recent cases regarding each of the three common scenarios in which courts order disgorgement.

A. Disgorgement Because of Disclosure Violations

Attorneys that fail to comply with the disclosure requirements contained in Section 327 and Bankruptcy Rule 2014 (focusing on discovery of adverse interests), and Section 329 and Bankruptcy Rule 2019 (addressing disclosure of compensation) are likely to face disgorgement. The disclosure obligations are mandatory and impose a continuing duty to supplement, and "[m]any courts, perhaps the majority, punish defective disclosure by denying all compensation." *In re Grabanski*, 578 B.R. 458, 477 (Bankr. D.N.D. 2017) (quoting *In re Kowalski*, 402 B.R. 843, 848 (Bankr. N.D. Ill. 2009)). Additionally, disgorgement "may be imposed even when the failure to disclose was through inadvertence or negligen[ce], and regardless of whether the estate was actually harmed." *In re Shelnut*, 577 B.R. 605, 610 (S.D. Ga. 2017). The following cases exemplify the risk that attorneys run for failing to disclose pursuant to the Bankruptcy Code and Rules.

***In re Am. Int'l Refinery, Inc.*, 676 F.3d 455 (5th Cir. 2012).**

In this case, the Fifth Circuit upheld a significant disgorgement order. The dispute centered on disclosures made by former debtors' counsel, A&R, regarding its previous interactions with the Chapter 11 debtors and the source of its bankruptcy retainer. Prior to the filing of the petition, A&R had drafted an agreement, whereby one of debtors' largest creditors, GCA, agreed to release a security interest it held in the shares of one of debtors' subsidiaries in exchange for the subsidiary being assigned dividends payable from another of debtors' subsidiaries. The agreement was executed after the filing of the petition and backdated to the date another transaction had occurred. A&R represented neither party to the agreement. A&R did not disclose that it drafted the agreement to the bankruptcy court. A&R later represented one of the debtors in negotiating an agreement with GCA, although the agreement was never fully executed.

A&R also did not disclose the source of its bankruptcy retainer from the debtors. Debtors did not have enough cash to pay the retainer, so, with A&R's knowledge, GCA loaned one of debtors' subsidiaries $200,000 in exchange for a security interest in other property. GCA wired the funds directly to A&R.

A&R was ultimately awarded roughly $778,000 in fees and $63,000 in costs. The liquidating trustee of a trust related to debtors filed an adversary proceeding seeking disgorgement of all fees paid to A&R because A&R was not disinterested and failed to satisfy its disclosure requirements. The bankruptcy court, and later district court, agreed that A&R violated its disclosure duties under Rule 2014(a) and ordered disgorgement of $135,000, or roughly 20% of A&R's fees, and the trustee appealed to the Fifth Circuit.

On appeal, the Fifth Circuit affirmed. The court first acknowledged its discretion to revoke counsels' employment and "deny all compensation to professionals who fail to make adequate disclosure." One key consideration in deciding the appropriate sanction for disclosure violations is whether the failure to disclose was intentional. The court determined that the bankruptcy court's factual finding that A&R unintentionally failed to disclose its prior relationship with debtor and the source of its retainer was not clearly erroneous based on evidence showing that A&R attorneys believed they had made a full disclosure. Thus, the court concluded that the bankruptcy court did not abuse its discretion in ordering disgorgement of only a portion of the fees A&R had received.

***In re Shelnut*, 577 B.R. 605 (S.D. Ga. 2017).**

Shelnut indicates the strict compliance courts expect from debtor's counsel regarding disclosure requirements. Debtor's counsel, MLF, sought fees and expenses of roughly $44,000. In its disclosure regarding compensation pursuant to Section 329(a) and Rule 2016(b), MLF said that within one year prior to the petition being filed, MLF had received $8,283 from the debtor for services rendered or to be rendered to the debtor relating to the bankruptcy. MLF further disclosed that the debtor had paid another $1,717 for the filing fee (a grand total of $10,000). After the petition was filed, MLF received two additional payments worth $6,500. But at no time did MLF amend its disclosures to inform the court that the $6,500 was paid by Four Seasons, a corporation owned by the debtor, not the debtor himself. Four Seasons owed debtor over $4 million and paid debtor's personal expenses; the payments were designated as the debtor's income and as a loan repayment for Four Seasons. The United States Trustee and another party objected to MLF's fee application on the ground that MLF failed to disclose the source of the Four Seasons payment.

The bankruptcy court agreed and ordered the $6,500 payment disgorged from MLF. The court first introduced the requirements of Sections 327 and 329, and Rules 2014 and 2016. The court recognized that Rule 2016(a) "imposes a duty to fully and completely disclose all fee agreements and payments," and that when "a debtor's attorney subsequently receives funds from a non-party, the attorney is required to promptly supplement its disclosure." Failure to do so runs the risk of disgorgement, even if the disclosure was inadvertent.

MLF failed to satisfy the disclosure requirements as to the $6,500 received from Four Seasons, because it never provided the "details" of the transaction. That the money was "actually [d]ebtor's funds because they were loan repayments [did] not alter the fact that MLF failed to disclose the payments were from Four Seasons' account," not the debtor's. The court found, therefore, that disgorgement of the $6,500 payment was appropriate.

Additional Cases

Disgorgement due to disclosure violations is easily avoidable but nonetheless common. Recent cases in which courts ordered disgorgement due to professionals failing to satisfy the disclosure requirements include *In re Grabanski*, 578 B.R. 458 (Bankr. D.N.D. 2017), *In re Hanawahine*, 577 B.R. 573 (Bankr. D. Haw. 2017), *In re Campbell*, 575 B.R. 811 (Bankr. W.D. Mich. 2017), *In re Bennett*, No. 16-74588, 2018 WL 878874 (Bankr. E.D.N.Y. Jan. 30, 2018), and *In re Terrill Manufacturing Co.*, No. 16-60105, 2018 WL 502525 (Bankr. N.D. Tex. Jan. 11, 2018). *Hanawahine* is particularly relevant, in that it clarifies that courts can disgorge compensation beyond that which counsel and other professionals must disclose. 577 B.R. at 578 (stating that although Section 329(a) requires disclosure of all compensation paid within one year of the petition date, "courts have authority to review and disgorge fees paid more than a year prior to filing").

B. Disgorgement Due to the Professional Possessing an Adverse Interest or Lacking Disinterestedness

Attorneys appointed under Section 327(a) may not "hold or represent an interest adverse to the estate" and must be "disinterested." Upon discovery that a professional did not meet these requirements at the time he or she was appointed or fails to do so at any time during the representation, courts may reduce or deny fees pursuant to Section 328(c). Although case law indicates that courts prefer to disgorge fees based on disclosure violations, some cases exist in which disgorgement is ordered due to counsel's failure to comply with Section 327(a). The facts in such cases are often quite egregious, as the following case indicates.

***In re Sundance Self Storage-El Dorado LP*, 482 B.R. 613 (E.D. Cal. 2012).**

Sundance presents a worst-case scenario for an attorney; the court disallowed and disgorged all compensation previously approved to debtor's counsel due to counsel's failure to satisfy the requirements of Section 327(a) and its disclosure duties discussed above. The court first noted that Section 328(c) "operates as a 'penalty' for a professional's failure to avoid a disqualifying conflict of interest" under Section 327(a). And a disqualifying conflict exists regardless of whether there is "proof of actual loss or injury."

The court then provided the key definitions for its ruling. A "disinterested person," as defined in Section 101(14)(A) of the Code is one that "does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders." Said another way, a "disinterested person," can make unbiased decisions without any personal interest in a matter relating to the debtor's estate. An attorney "hold[s] or represent[s] an interest adverse to the estate" when it "serve[s] as an attorney for an entity holding" an adverse interest, that is the possession or assertion of an economic interest that would (1) "tend to lessen the value of the bankruptcy estate," or (2) "create either an actual or potential dispute in which the estate is a rival claimant," or (3) "possession of a predisposition under circumstances that create a bias against the estate."

Applying the foregoing to the facts of the case, the court concluded that counsel's employment for the Chapter 11 debtor-in-possession was "a textbook example of a professional who was actually disqualified from employment at the outset." The court ruled that counsel was not a disinterested person, and that he held and represented interests adverse to the estate, primarily relying on two facts in reaching that conclusion: (1) counsel had represented the debtor in an earlier Chapter 11 case and was still owed $3,000 for his services in that case at the time the instant case began; and (2) counsel simultaneously represented Smith in his personal Chapter 13 case. Smith was the debtor's Manager of Operations and at one point during the proceedings transferred assets of the debtor to another entity unbeknownst to the court and United States Trustee. The court stated that counsel's representation of both Smith and the debtor divided his loyalty between the two clients, and Smith's interests "ran head-on into the fiduciary duty" counsel owed to the debtor. The court also suggested that counsel should have done more to ensure that Smith did not engage in the "chicanery" associated with the transfer or debtor's assets during the proceeding.

Because counsel had utterly failed to satisfy the requirements of Section 327(a), as well as the disclosure requirements discussed above, the court disgorged all fees paid to counsel during his representation of the debtor in the Chapter 11 case.

Additional Cases

As stated, cases in which courts order disgorgement due to a professional's inability to satisfy the prerequisites of Section 327(a) often present egregious facts suggesting overreaching by the attorneys involved. Additional examples of such cases include *In re Sauer*, 222 B.R. 604 (8th Cir. 1998), *In re El San Juan Hotel Corp.*, 239 B.R. 635 (B.A.P. 1st Cir. 1999), *In re C.W. Mining Co.*, 440 B.R. 878 (Bankr. D. Utah 2010), and *In re Keller Financial Services of Florida, Inc.*, 248 B.R. 859 (Bankr. M.D. Fla. 2000). Because of the extreme nature of these cases, courts often order disgorgement of all fees awarded. *See, e.g.*, *In re C.W. Mining Co.*, 440 B.R. at 892.

C. Disgorgement to Comply with the *Pro Rata* Distribution Scheme of Section 726(b) When the Estate is Administratively Insolvent

Even if an attorney acts in good faith and complies with the disclosures and disinterestedness requirements discussed above, disgorgement is still possible under Section 726(b). And unlike the previous two categories of disgorgement cases, case law concerning

Section 726(b) disgorgement is murky, with some courts saying that disgorgement is mandatory, others saying its discretionary, and still others saying it is not allowed at all. The question of whether disgorgement under Section 726(b) is appropriate arises most often when a Chapter 11 bankruptcy is converted to Chapter 7, the estate is administratively insolvent, and the court must decide whether disgorgement of pre-conversion Chapter 11 fees is necessary to comply with the *pro rata* distribution scheme in Section 726(b). The following cases illustrate the dangers that attorneys face in such circumstances.

***Specker Motor Sales Co. v. Eisen*, 393 F.3d 659 (6th Cir. 2004).**

Specker is often acknowledged as the seminal case on this issue, but it has been subject to severe criticism. Specker Motor Sales, Inc. entered Chapter 11 bankruptcy, and the court appointed Donald Bays as Chapter 11 counsel. Soon after, the case was converted to Chapter 7. Bays submitted a final fee application, and the court awarded total fees of $17,343.10, including the $10,000 retainer as interim compensation that he was paid at the outset of the case.

At final liquidation, there were five administrative claims, totaling nearly $205,000, but the estate had only about $11,000. Bay's *pro rata* share was only $973. The bankruptcy court thus ordered Bays to disgorge $9026.59 of his original retainer. Bays challenged the disgorgement, but the bankruptcy court and district court agreed that Section 726(b)'s *pro rata* distribution scheme to administrative claimants mandated disgorgement.

The Sixth Circuit affirmed. Relying on the word "shall" in the statute's text, the appellate court said that Section 726(b) "plainly mandates *pro rata* distribution of assets among creditors in the same statutory class." Bays argued that the retainer had already been paid out of the estate and thus was not subject to disgorgement. The court disagreed, stating that interim compensation—which includes retainers—is an administrative expense, is subject to reexamination and adjustment, and remains property of the estate. Because of the Bankruptcy Code's "central policy" of equality of distribution, Bays could not receive more than his *pro rata* share, even though "[h]e ably provided services." To ensure that all administrative claimants received equal shares, the court affirmed the disgorgement of $9,026.59 from Bays's retainer.

***In re Resource Tech., Corp.*, No. 08 C 4235, 2008 WL 4696073 (N.D. Ill. Oct. 20, 2008).**

In *Resource Tech.*, Ungaretti & Harris, LLP served as the Chapter 11 trustee's counsel for several years until the case was converted to Chapter 7. Ungaretti received payments of approximately $376,000 but claimed that it had not been paid for over $2 million in fees and costs it incurred during the representation. The Chapter 7 trustee moved to disgorge the compensation Ungaretti had been paid, and the bankruptcy court agreed, and Ungaretti appealed to the district court.

The district court affirmed based on two independent reasons: (1) Ungaretti failed to comply with the court's order governing interim professional compensation, and thus the payments were unauthorized transfers, and (2) since the estate was administratively insolvent, disgorgement was necessary to ensure *pro rata* distribution to all administrative claimants pursuant to Section 726(b).

As to Section 726(b), the district court evaluated the three possible approaches taken by other courts: (1) mandatory disgorgement under Section 726(b), (2) discretionary disgorgement under Section 105(a), and (3) no disgorgement because the remedy is not expressly included in Section 726(b). The district court stated that most courts that had considered the issue came down in the middle, finding disgorgement appropriate as a matter of discretion either directly under Section 726(b) or through Section 105(a). The district court ruled that, at a minimum, the bankruptcy court possessed "independent discretion to [order disgorgement] pursuant to its powers under [Section 105] to effectuate the goals" of Section 726(b).

Because the bankruptcy court had not abused its discretion in ordering disgorgement, the district court concluded that it had no reason to determine whether disgorgement was mandatory. The district court stated that Ungaretti had no expectation that the payments received were final, given that Ungaretti should have known that it had failed to comply with Section 331 of the Code and the court's interim compensation order. Ungaretti also should have been aware of the risk of disgorgement based on the recent warnings by other judges in the district. The court also acknowledged that over $80 million in administrative claims remained in the case, and although Ungaretti would receive only a "sliver" of the $2 million that it claimed to be owed, many claimants were in the same position. To ensure that all administrative claimants received a *pro rata* distribution of the available assets, therefore, the court affirmed the disgorgement order.

Additional Cases

As noted, several courts have concluded that the Bankruptcy Code neither mandates nor gives them discretion to order disgorgement under Section 726(b) or under Section 105(a) to effectuate the goals of Section 726(b). Recent reported examples of courts reaching or reaffirming that conclusion include *In re Santa Fe Medical Group, LLC*, 557 B.R. 223 (Bankr. D.N.M. 2016), *In re Home Loan Service Corp.*, 533 B.R. 302 (Bankr. N.D. Cal. 2015), *In re Next Generation Media, Inc.*, 524 B.R. 824 (Bankr. D. Minn. 2015), and *In re Headlee Mgmt. Corp.*, 519 B.R. 452 (Bankr. S.D.N.Y. 2014). For a recent example of a court expressly disagreeing with the foregoing cases, see *In re Nettel Corp.*, No. 00-01771, 2017 WL 5664840 (Bankr. D.D.C. Oct. 2, 2017), in which the court concluded that it had discretion under Section

105(a) to order disgorgement to ensure Section 726(b)'s *pro rata* distribution scheme was followed and expressly rejecting *In re Santa Fe Medical Group*.

III. Practical Application: *Toys'R'Us*

Toy'R'Us, Inc. and several affiliated debtors each filed voluntary Chapter 11 petitions on September 18, 2017, in the United States Bankruptcy Court for the Eastern District of Virginia. The Honorable Keith L. Phillips is presiding over the cases in Case No. 17-34665.

It is impossible from our vantage point to ascertain whether debtors' counsel and professionals have met their disclosure requirements and the mandates for employment pursuant to Section 327(a). At this point, however, there are grumblings that debtors are administratively insolvent. *See, e.g.*, *Crayola LLC's (1) Limited Objection to Debtors' Motion for Entry of an Order . . ., and (2) Joinder in and Adoption of Certain Other Objections Thereto*, Case No. 17-34665, Docket No. 2368, March 23, 2018 ("The undisputed record is that Debtors are very likely administratively insolvent and will remain so for the duration of this process."). If that is true, debtors' counsel and professionals are likely frighteningly aware of the risks they face if the case is converted to Chapter 7. At that point, disgorgement may be a possibility, even if counsel complies fully with the disclosure and disinterestedness requirements of the Code and Bankruptcy Rules.

* * *

Serving as debtor's counsel in a bankruptcy proceeding can be a risky proposition, but it doesn't have to be a gamble. With foresight and an understanding of the Bankruptcy Code and Rules, practitioners can avoid the pitfalls that lead to disgorgement of fees, and the many headaches associated with that outcome.

American Bankruptcy Institute

Central States Bankruptcy Workshop, 2018

GETTING PAID AND AVOIDING DISGORGEMENT

Carve Outs[1]

1. Introduction

Chapter 11 practitioners often speak of a "carve out" in the context of cash collateral, financing, or sale.

> The term "carve out" is one of those uniquely bankruptcy phrases, much like "cram down," that appears nowhere in the bankruptcy statute but connotes definite meaning to parties. It is an agreement by a party secured by all or some of the assets of the estate to allow some portion of its lien proceeds to be paid to others, *i.e.,* to carve out of its lien position.

In re White Glove, Inc., 1998 WL 731611 at *6 (Bankr. E.D. Pa October 14, 1998).

> The carve out is essentially an agreement by the secured creditor to subordinate its liens and claims to certain allowed administrative expenses, permitting such professionals' fees to come first in terms of payment from the estate's assets.

In re Molycorp., Inc., 562 B.R. 67 at 75 (2017)

While the term is frequently used, the specifics and the structure involved can vary greatly. "There is no established form for a carve out agreement, and because *carve out* is not a defined term, it can mean different things to different people." *In re California Webbing Industries, Inc.,* 370 B.R. 480, 483 (Bankr. D. R.I. 2007)(emphasis in the original). Even with an agreement, parties may find that the outcome is less than clear:

> Carve out agreements seldom address the way the carve out should operate when it is most needed, that is, when the debtor's operating cash flow and unencumbered assets are inadequate to pay all administrative expenses. There is little case law to fill in the gaps. So the "definite meaning" that *White Glove* says "carve out" connotes may exist solely in the mind of the beholder.

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[1] These materials are presented by Jeff Hokanson, Ice Miller LLP, Indianapolis, Indiana and Chicago, Illinois, E-mail: jeff.hokanson@icemiller.com, www.icemiller.com, and represent an updated version of the article: Sharing a Piece of the Pie: Carve outs in Chapter 11, presented at the American Bankruptcy Institute's Northeast Bankruptcy Conference 2012, by Janet E. Bostwick, JANET E. BOSTWICK, PC, Boston, MA, E-mail: jeb@bostwicklaw.com, and Roger A. Clement, Jr., VERRILL DANA LLP, Portland, Maine, E-mail: rclement@verrilldana.com, www.verrilldana.com

Richard B. Levin, Almost All You Ever Wanted to Know About Carve Out, 76 Am. Bankr.L.J. 445 (2002)(footnote omitted).

The following materials discuss some issues that arise in connection with carve out agreements in Chapter 11. Attached as Exhibit A are provisions of cash collateral and financing orders dealing with carve out agreements which highlight the different form such agreements can take.

2. The Rationale For A Carve Out

Why would a secured creditor agree to give up a portion of its collateral?

> As a general rule, administrative expense must be satisfied from assets of the estate not subject to liens. A secured creditor's interest in its collateral is a substantive property right created by non-bankruptcy law, which may not be substantially impaired when bankruptcy intervenes (citations omitted). … Therefore, absent equity in the collateral, administrative claimants cannot look to encumbered property to provide a source of payment for their claims.
>
> While professionals' fees allowed under sections 330(a) and 331 enjoy a certain preeminence under the Bankruptcy Code, their payment must be consistent with the Code's overall scheme or priorities. Thus, as a matter of course, "[p]ost-petition attorneys and accountants' fees are administrative expenses and may not be given priority over existing liens and super-priority claims." In other words, where there are insufficient unencumbered assets with which to pay administrative expenses, professionals employed by the debtor or by creditors' committees may not ordinarily look to secured creditors' collateral for payment.
>
> *In re Molycorp*., at 75-76.

Carve outs are usually part of the negotiations with a secured creditor in the context of a financing or a cash collateral order, where the creditor seeks protection for its collateral in a financing or cash collateral, including the grant of postpetition liens, administrative priority, and the waiver of Section 506(c) claims. As part of such negotiations, the debtor and its counsel seek certain protections as well. In addition to the issues raised by the debtor, however, the negotiations often encompass the local practice of the court regarding such issues.

Although not provided for expressly in the Code, carve out agreements are often viewed in relation to Section 506(c). Under Section 506(c) of the Code, the trustee or debtor in possession can seek to surcharge the collateral of a secured creditor for the expenses in connection with maintaining, disposing, protecting or preserving collateral of the secured creditor. 11 U.S.C. §506(c). To recover under Section 506(c), the debtor or trustee must demonstrate that "(1) the expenditure was necessary, (2) the amounts expended were reasonable, and (3) the [secured] creditor benefitted from the expenses." *In re Parque Forestal, Inc.,* 949 F.2d 504, 512 (1st Cir. 1991) (citing *In re P. C., Ltd.,* 929 F.2d 203, 205 (5th Cir. 1991). The benefit must be "concrete" and "quantifiable" *In re Debbie Reynolds Hotel & Casino, Inc),* 255 F.3d 1061, 1067-68 (9th Cir. 2001).

While Section 506(c) offers an avenue for a debtor to recover costs, given the proof required, such a choice is full of uncertainty:

> The post facto attempt by a debtor to recover administrative expenses out of a secured creditor's cash collateral in a chapter 11 case is rare because it is risky. Normative chapter 11 practice dictates a debtor's seeking the secured creditor's consent or a court order for a carve out to cover some or all the debtor's administrative expenses before the expenses are incurred.

In re Strategic Labor, Inc., 467 B.R. 11, 22 (Bankr. D. Mass 2012).

Compounding the risks brought about by insufficient collateral value, proceedings within the case may likewise distress administrative claimants.

> Indeed, “[i]n every case there is the uncertainty that the estate will have sufficient property to pay administrative expenses in full.” Those holding administrative claims may run the risk of non-payment or partial payment whenever there is an adequate protection shortfall under section 507(b), super-priority borrowing under section 364, or conversion of the case and subordination of chapter 11 administrative expenses under section 706(b) of the Bankruptcy Code.

In re Molycorp., at 76.

For the secured creditor, a carve out agreement provides certainty, typically with an agreed upon cap or control of expenses. The lender also avoids the risk and cost of later litigation, where the outcome and amount of expenses charged to its collateral may be unknown.

In addition, carve out agreements also often address the court's expectations. Many courts view carve outs as "necessary in order to preserve the balance of the adversary system in reorganization." *In re Evanston Beauty Supply, Inc.,* 136 B.R. 171,177 (Bankr. N.D. Ill. 1992).

> "Carveouts" are used in order to avoid skewing the necessary balance of debtor and creditor protection needed to foster the reorganization process. Same is designed to accommodate all classes of creditors and equity interests, rather than one especially crafted for the benefit of the pre-petition lender having a perfected lien on all cash collateral, or the principal of the debtor who guaranteed that debtor's debt.

Id.

3. Implied Carve Outs

Can there be an implied consent to payment of professional fees and administrative expenses? If the secured lender has participated in the bankruptcy, and benefitted from the ongoing Chapter 11, will the court imply an agreement to pay such fees?

Consistently, courts have declined to imply consent to payment of expenses in the context of Section 506(c).

> Although a secured creditor may consent to bearing the costs of professional fees incurred by a debtor in possession, "such consent is not to be lightly inferred." *In re S & S Indus., Inc.,* 30 B.R. 395, 398 (Bkrtcy. E.D.Mich. 1983). "It is not to be inferred merely because a secured creditor cooperates with the debtor." *Id.; see Law Research Service, Inc. v. Crook,* 524 F.2d 301, 310 (2d Cir. 1975). . .
>
> Saddling unconsenting secured creditors with professional fees, such as are sought by appellees, would discourage those creditors from supporting debtors' reorganization efforts.

In re Flagstaff Foodservice Corp., 739 F.2d 73, 77 (2nd Cir. 1984).

Similarly, courts have also refused to construe the existence of an implied carve out agreement. "[I]t is essential to note that the carve out is a product of agreement between the secured party and the beneficiary of the carve out. *In re White Glove, Inc.,* 1998 WL 731611 at *6 (Bankr. E.D.Pa October 14, 1998). "A carve out may not exist unless ordered, or approved by the Court with the consent of the affected secured creditor." *In re California Webbing Industries, Inc.,* 370 B.R. at 486.

4. Some Issues For Carve Outs in Cash Collateral and Financing

A. Different Treatment For Different Professionals

In structuring the carve out, can the lender agree to carve out some fees, for example debtor's counsel, but not others, such as the committee's professionals?

Courts have upheld carve out agreements that contain provisions for only debtor's counsel, or set different limits for the professionals for the debtor or trustee and the professionals representing the committee. See *In Re Hotel Syracuse, Inc.,* 275 B.R. 679 (Bankr. N.D.N.Y. 2002); *In Re American Resources Management Corp.,* 51 B.R. 713 (Bankr. D. Utah 1985). Although not unsympathetic to the equitable arguments by counsel who is left out of the provisions, the courts have found no prohibition to such agreement:

> The argument, equitable in nature, has been made that where a secured creditor has liens on substantially all of the debtor's assets and either refuses to permit a carve out altogether or where, as here, singles out one administrative claimant to the exclusion of others, it effectively controls the outcome of a large Chapter 11 case. The argument is also made that by allowing the secured creditor to pick and choose the subjects of its largess, it in effect denies certain constituencies (e.g., the creditors committee) effective legal representation. While this argument is tempting, it is just not supported by the law.

In re Hotel Syracuse, Inc., 275 B.R. at 683. But see *In re Ben Franklin Retail Store Inc.,* 210 B.R. 315 (Bankr. N.D. Ill. 1997)(Court refused to approve agreement between lender and debtor's counsel to pay expenses of debtor's counsel under Section 506(c), on the basis it would result in unequal treatment for administrative creditors.)

While courts have upheld different treatment for different professionals, local practice and rules may affect that issue. Attached as Exhibit B is a collection of local rules addressing the issue of carve outs in the context of cash collateral or financing stipulations. As reflected in Exhibit B, several courts have local rules requiring that a motion to approve a stipulation or financing provide special notice of any proposed disparate treatment among professionals in the carve out provisions or restricting the ability to approve such differences on an interim basis.

B. Limits on the Amount of the Carve Out.

Early last year the "U.S. Bankruptcy Court for the District of Delaware issued an opinion in In re Molycorp Inc. that serves as both a cautionary tale and an instruction manual for secured creditors and debtor-in-possession (DIP lenders seeking to limit the impact of bankruptcy fees on their collateral." ABI Journal (April 2017), *Caveat: Professional Fees Payable from a Lender's Collateral May Not Be Capped by a Carve-Out*, Tyler N. Layne and John C. Tishler.[2]

In Molycorp, the Committee requested allowance and payment of fees and expenses in excess of $8.5 million after first asserting and then settling claims against the DIP lender, which had, as part of the DIP Order, agreed to a carve out of $250,000 from proceeds of the DIP loan and various proceeds of the estate to satisfy claims of the debtor and any statutory committees. A consensual plan was confirmed in the wake of the settlement of the Committee's claims, and Committee counsel filed its fee application.

The DIP lender objected to Committee counsel's application on a variety of basis, including that it violated the carve out provisions in the DIP Order; that the amount of the carve out was, in essence, a cap on the fees that could be allowed in favor of the professionals. In response, Committee counsel argued that the carve out was relevant only in an administratively insolvent case, particularly where, as here, the confirmed plan rendered the carve out meaningless because the debtors were required to pay all allowed administrative expenses as a condition of confirmation under section 1129(a)(9)(A) of the Bankruptcy Code. In revolving this dispute, the Court interpreted the DIP order one might any contractual provision alleged to be ambiguous and determined that:

> The wording of Paragraph 4(b) [of the DIP Order] is not different from a standard carve out provision. It does not connote in any way that the dollar-amount cap would operate as a complete bar against the allowance of administrative claims following plan confirmation. In this respect, the dollar-amount cap was going to come into play if the attempts to confirm a reorganization plan had failed; it was not intended to come into play if a Chapter 11 plan was confirmed.

In re Molycorp, at 79-80.

C. Limits On Use of Carve Out Funds.

Can you restrict what the carve out is used for? In other words, can the lender restrict the use of funds to challenge its lien or assert claims against the lender? As one commentator noted:

[2] Messrs. Layne and Tishler's article is an excellent analysis of the text and teachings of the *Molycorp* decision and interested readers are encouraged to study it in full.

> It is not unusual for a creditor to prohibit the use of cash collateral to fund litigation against the secured creditor. Oftentimes the creditor will insist that its consent to further use of cash collateral will be deemed automatically withdrawn if the debtor objects to the creditor's claim or otherwise instigates litigation with the secured creditor.

5 Norton Bankr. L. & Prac. 3d § 94:14. The Comment to the USBC SDNY Local Rules also provides that a lender can refuse to include in a carve-out the costs of litigation or other assertions of claims against it. Similarly, provisions restricting the use of cash for such litigation are contained in several of the orders attached in Exhibit A.

The issue however is far from clear, and another treatise comments that "prohibitions on use of cash collateral or use of postpetition loan proceeds for investigating claims against the lender are often considered overreaching and disapproved." Dreher and Feeney, Bankruptcy Law Manual § 11:22 (5th ed.)(footnote omitted). For example, in one case, the Court found that the lender's attempts to "close the purse strings to payment of Debtor's counsel for services devoted to any claim or defense" of the lender's claims, created questions of whether the debtor's counsel could be considered "disinterested," given their economic incentive not to investigate. *In re Tenney Village Co., Inc.,* 104 B.R. 562, 568 (Bankr. D.N.H. 1989).

> It is said that a Chapter 11 lender should not be required to finance the prosecution of claims and defenses against it. That is true. If the lender believes that this will occur, it can elect not to make the loan. It cannot expect, however, to change the rules of a Chapter 11 case.

104 B.R. at 569.

In the end, however, carve outs and limitations on professional fees are part of the overall agreement, and counsel for both lenders and debtors must consider the effect of the agreement as a whole. As *Tenney Village* suggests, the cumulative effect of restrictive provisions may lead a court to consider the agreement in its entirety as overreaching. In addition to the written local rules, counsel should also consider the unwritten local practice of a particular court or judge.

D. The Structure of the Carve Out

How the carve out is structured may affect the rights of the parties, in particular, the professionals of the debtor and the committee. Is the carve out evidenced in the form of consent to payment of fees in an approved cash collateral budget? Does the carve out apply to both the lien and to any superpriority administrative expense? Does the provision require separate funding of an escrow account?

A stipulation may provide for fees to be paid as part of the cash collateral budget. Standing alone, such a provision may not offer the professional protection when needed the most — when the case becomes administratively insolvent. In *In re Blackwood Associates,* the Second Circuit held that a provision in a stipulation that a debtor would use cash collateral to pay fees did not give the professional any priority in right to the lender to receive adequate protection payments. *In re Blackwood Associates, L.P.,* 153 F.3d 61, 69 (2nd Cir. 1998). As a result, since there was no express provision granting the fees priority over the lender's payments or lien, the lender was not required to disgorge the adequate protection payments to provide for payment of the fees. *Id.*

In another case, a court concluded that a provision that subordinated the lender's superpriority administrative expense to fees did not also subordinate its lien or right to proceeds to such fees. *In Re Bayer Cadillac,* 164 B.R. 450 (Bankr. E.D N.Y. 1994). In *Bayer,* under the stipulation, the lender was entitled to a superpriority administrative expense if the adequate protection failed, however, such grant was expressly subject to certain professional fees. Debtor's counsel argued that the intent of the stipulation was to provide a carve out for counsel fees and sought payment from the lender from the proceeds of its collateral when the case failed. The court however looked to the language of the stipulation and found that the provision only provided for subordination of the deficiency claim from the estate's assets, and not a carve out from the proceeds received by the lender. 164 B.R. at 453.

E. Are Carve Out Funds Property of the Estate?

What happens after the case fails? Are the carve out funds property of the estate that must be distributed in accordance with the priority scheme in a converted Chapter 7?

Where the carve out for particular professionals has been approved, the courts are reluctant to subsequently change those terms and distribute the funds pro rata.

> The terms of the carve-out were approved by the court and the court is unwilling to alter those terms. It would be unfair to now permit funds that were carved out for professionals to be obtained by other competing cost of administration creditors.

In re Rite Industries, Inc., 2000 WL 33673764 at *4 (Bankr. M.D.N.C. 2000). Another court also found it " unfair to require the court-appointed professionals to lose their entitlement to the carve-out funds after they relied upon a final nonappealable court order." *In re U.S. Flow Corp.,* 332 B.R. 792, 797 (Bankr. W.D.Mich. 2005). The court emphasized that the parties "should have either objected to the order before it was entered, or timely appealed the order after it was entered." 332 B.R. at 798 (footnote omitted). Similarly, where a party had expressly consented to a carve out order, the Court found that he was judicially estopped from subsequently objecting to the carve out terms in connection with allowance of fees. *In re Robotic Vision Systems, Inc.,* 367 B.R. 232 (1st Cir. BAP 2007).

Courts have distinguished the carve out funds from estate property available for payment of all administrative expenses. "The property earmarked and conveyed for the benefit of the court-appointed professionals is specifically reserved solely for the purpose of compensating a category of chapter 11 professionals." *In re U.S. Flow Corp.,* 332 B.R .at 797. Another court rejected the premise that funds carved out from the proceeds of collateral "which would otherwise be payable solely to the secured creditor but for its consent to transfer property to a particular administrative claimant" are required to be paid to the trustee as property of the estate. *In re Nuclear Imaging Systems, Inc.,* 270 B.R. 365, 379 (Bankr. E.D.Pa 2001).

Exhibit A

Samples of Carve Out Provisions in Recent Chapter 11 Cases

In re Claire's Stores, Inc., et al., District of Delaware, Case No.: 18-10584 (MFW), *Interim Order (A) Authorizing Debtors to Obtain Postpetition Financing, etc.* [Docket Entry 130]

7. **Carve-Out**. Each of the DIP Liens, the DIP Superpriority Claims, the Prepetition 1L Liens, the 1L Adequate Protection Liens, the Prepetition 2L Liens, the 2L Adequate Protection Liens, and the 1L Adequate Protection Superpriority Claims shall be subject and subordinate to payment of the Carve-Out.

(a) Carve-Out. "**Carve-Out**" means the sum of (i) all fees required to be paid to the Clerk of the Court and to the Office of the United States Trustee under section 1930(a) of title 28 of the United States Code plus interest at the statutory rate (without regard to the notice set forth in (iii) below); (ii) fees and expenses up to $50,000 incurred by a trustee under section 726(b) of the Bankruptcy Code (without regard to the notice set forth in (iii) below); (iii) to the extent allowed at any time, whether by interim or final compensation order, all unpaid fees and expenses (the "**Professional Fees**") incurred by persons or firms retained by the Loan Parties pursuant to section 327, 328 or 363 of the Bankruptcy Code (collectively, the "**Debtor Professionals**") and any official committee of unsecured creditors (the "**Committee Professionals**" and, together with the Debtor Professionals, the "**Professional Persons**") appointed in the Cases pursuant to section 1103 of the Bankruptcy Code at any time before or on the first business day after delivery by the DIP Agent of a Carve-Out Trigger Notice (as defined below) and all reasonable and documented unpaid out of pocket expenses of the members of any Committee ("**Committee Members**") that are incurred at any time before or on the first business day after delivery by the DIP Agent of a Carve-Out Trigger Notice, whether allowed by the

Court prior to or after delivery of a Carve-Out Trigger Notice and without regard to whether such fees and expenses are provided for in the Approved Budget; provided, however, that this clause (iii) shall exclude any transaction fees or success fees of any Debtor Professionals; and (iv) Professional Fees and expenses of Committee Members incurred after the first business day following delivery by the DIP Agent of the Carve-Out Trigger Notice (including transaction fees or success fees earned or payable to a Professional Person), to the extent allowed at any time, whether by interim order, procedural order or otherwise in an aggregate amount not to exceed \$4,000,000 with respect to Professionals Persons (the amount set forth in this clause (iv) being the "**Post-Carve-Out Trigger Notice Cap**"). For purposes of the foregoing, "**Carve-Out Trigger Notice**" shall mean a written notice delivered by email (or other electronic means) by the DIP Agent to the Loan Parties, their lead restructuring counsel, the United States Trustee, and lead counsel to the Committee (if any), which notice may be delivered following the occurrence and during the continuation of a Termination Event and acceleration of the obligations under the DIP Facilities, stating that the Post-Carve-Out Trigger Notice Cap has been invoked. No amounts set forth at clause (iv) of this subparagraph 7(a) with respect to the Post-Carve-Out Trigger Notice Cap may be modified without the prior written consent of the DIP Agent. On the day on which a Carve-Out Trigger Notice is received by the Loan Parties, the Carve-Out Trigger Notice shall constitute a demand to the Loan Parties to utilize all cash on hand to transfer to the Professional Fees Account cash in an amount equal to all obligations benefitting from the Carve Out as provided herein. Following delivery of a Carve-Out Trigger Notice, the DIP Agent shall deposit into the Professional Fees Account (as defined below) any cash swept or foreclosed upon (including cash received as a result of the sale or other disposition of any assets) until the Professional Fees Account has been fully funded in an amount equal to all obligations benefitting from the Carve-Out. Notwithstanding anything to the contrary in the DIP Documents or this Interim Order, following delivery of a Carve-Out Trigger Notice, the DIP Agent shall not sweep or foreclose on cash (including cash received as a result of the sale or other disposition of any assets) of the Loan Parties until the Professional Fees Account has been fully funded in an amount equal to all obligations benefitting from the Carve-Out. Further, notwithstanding anything to the contrary herein, (i) disbursements by the Loan Parties from the Professional Fees Account shall not constitute DIP Loans, (ii) the failure of the Professional Fees Account to satisfy in full the Professional Fees shall not affect the priority of the Carve-Out and (iii) in no way shall the Carve-Out, Professional Fees Account, or an Approved Budget or any of the foregoing be construed as a cap or limitation on the amount of the Professional Fees due and payable by the Loan Parties or that may be allowed by the Court at any time (whether by interim order, final order, or otherwise). Use of the Carve-Out is subject to the limitations set forth in paragraph 16 of this Interim Order. For the avoidance of doubt, the Carve-Out shall be senior to all liens and claims securing the DIP Facilities, any adequate protection liens, if any, and superpriority claims (whether granted to secure the DIP Facilities or as adequate protection), and any and all DIP Liens.

(b) The Debtors shall (i) contemporaneously with the initial funding of the DIP Loans, transfer cash proceeds from the DIP Facilities in an amount equal to the total budgeted weekly Professional Fees for the first two weekly periods set forth in the Approved Budget, (ii) thereafter on a weekly basis transfer cash proceeds from the DIP Facilities or cash on hand in an amount equal to the total budgeted weekly Professional Fees for the next unfunded week set forth in the Approved Budget, and (iii) on a monthly basis, or otherwise at the request of the DIP Agent, to the extent, based on the invoices or other statements received from the

Debtor Professionals and Committee Professionals, the aggregate amount of their Professional Fees for any cumulative postpetition period exceed the cumulative budgeted amounts for such time period, transfer the aggregate amount of such excess, in each case into a segregated account not subject to the control of the DIP Agent, any DIP Lender, or any Prepetition Non-ABL Secured Party (the "**Professional Fees Account**"). The Debtors shall be authorized to use funds held in the Professional Fees Account to pay Professional Fees and expenses of Committee Members as they become allowed and payable pursuant to the Bankruptcy Code, the Bankruptcy Rules, the Local Rules, and any interim or final orders of the Court; provided that when all allowed Professional Fees have been paid in full (regardless of when such Professional Fees are allowed by the Court), any funds remaining in the Professional Fees Account shall revert to the Debtors for use in a manner not inconsistent with this Interim Order; provided further that the Debtors' obligations to pay allowed Professional Fees shall not be limited or be deemed limited to funds held in the Professional Fees Account. Funds transferred to the Professional Fees Account shall be held in trust for the Professional Persons, including with respect to obligations arising out of the Carve-Out. Funds transferred to the Professional Fees Account shall not be subject to any liens or claims granted to the DIP Secured Parties herein or any liens or claims granted as adequate protection, shall not constitute DIP Collateral, and shall not constitute Cash Collateral; provided that the DIP Collateral shall include the Debtors' reversionary interest in funds held in the Professional Fees Account, if any, after all allowed Professional Fees have been paid in full (regardless of when such Professional Fees are allowed by the Court). The DIP Agent shall be entitled to establish and maintain reserves against borrowing availability under the DIP Facilities on account of the Carve-Out in an amount not to exceed the Post-Carve-Out Trigger Notice Cap. in accordance with the terms of the DIP Credit Agreement.

(c) No Direct Obligation to Pay Professional Fees; No Waiver of Right to Object to Fees. The DIP Secured Parties shall not be responsible for the direct payment or reimbursement of any fees or disbursements of any of the Debtor Professionals, Committee Professionals or Committee Members incurred in connection with the Cases or any Successor Cases under any chapter of the Bankruptcy Code. Nothing in this Interim Order or otherwise shall be construed (i) to obligate any DIP Secured Party in any way to pay compensation to, or to reimburse expenses of, any of the Debtor Professionals, the Committee Professionals or Committee Members, or to guarantee that the Debtors or their estates have sufficient funds to pay such compensation or reimbursement or (ii) to increase the Post-Carve-Out Trigger Notice Cap if actual allowed fees and expenses of any of the Professional Persons and/or Committee Members are higher in fact than the amounts in the Approved Budget or the Post-Carve-Out Trigger Notice Cap. Notwithstanding any provision in this Paragraph 7 to the contrary, no portion of the Carve-Out, any Cash Collateral, any DIP Collateral, any proceeds of the DIP Facilities or any Unencumbered Assets (or the proceeds thereof) that are subject to the DIP Superpriority Claim (including any disbursements set forth in the Approved Budget or obligations benefitting from the Carve-Out) shall be utilized for the payment of professional fees and disbursements to the extent restricted under Paragraph 16 hereof. Nothing herein shall be construed as consent to the allowance of any professional fees or expenses of any of the Debtors, any Committee, any other official or unofficial committee in these Cases or any Successor Cases, or of any other person or entity, or shall affect the right of any DIP Secured Party to object to the allowance and payment of any such fees and expenses.

<u>In re Toys "R" Us, Inc., et al.</u>, Eastern District of Virginia, Case No. 17-34665 (KLP), *Final Order (A) Authorizing the North American Debtors to Obtain Postpetition Financing, etc.* [Docket No. 711]

9. *Carve-Out.*

(a) The "**Carve-Out**" means the sum of:

(i) all fees required to be paid to the Clerk of this Court and to the Office of the United States Trustee (the "**U.S. Trustee**") under section 1930(a) of title 28 of the United States Code plus interest at the statutory rate (without regard to the notice set forth in (iii) below);

(ii) all reasonable fees and expenses up to $150,000 incurred by a trustee under section 726(b) of the Bankruptcy Code (without regard to the notice set forth in (iii) below);

(iii) to the extent allowed at any time, whether by interim order, procedural order, or otherwise, all unpaid fees and expenses (the "**Allowed Professional Fees**") incurred by persons or firms retained by the Debtors pursuant to section 327, 328 or 363 of the Bankruptcy Code (the "**Debtor Professionals**") and the creditors' committee (the "**Creditors' Committee**") pursuant to section 328 or 1103 of the Bankruptcy Code (the "**Committee Professionals**" and, together with the Debtor Professionals, the "**Professional Persons**") (other than any restructuring, sale or other success fee of any investment bankers or financial advisors of the Debtors or any committee) (but excluding fees and expenses of third party professionals employed by Creditors' Committee members) at any time before or on the first business day following delivery by a DIP Agent of a Carve-Out Trigger Notice (as defined below), whether allowed by this Court prior to or after delivery of a Carve-Out Trigger Notice; and

(iv) Allowed Professional Fees of Professional Persons in an aggregate amount not to exceed $20,000,000 incurred after the first business day following delivery by a DIP Agent of the Carve-Out Trigger Notice, to the extent allowed at any time, whether by interim order, procedural order or otherwise (the amounts set forth in this clause (iv) being the "**Post-Carve-Out Trigger Notice Cap**").

(v) For purposes of the foregoing, "**Carve-Out Trigger Notice**" means a written notice delivered by email (or other electronic means) by the ABL/FILO DIP Agent or the Term DIP Agent to the Debtors, their lead restructuring counsel, the U.S. Trustee, and counsel to the Creditors' Committee, which notice may be delivered following the occurrence and during the continuation of an Event of Default (as defined in and under the ABL/FILO DIP Credit Agreement or the Term DIP Credit Agreement) and acceleration of the obligations under the ABL/FILO Revolving DIP Facility or the Term DIP Credit Agreement stating that the Post-Carve-Out Trigger Notice Cap has been invoked.

(b) Carve-Out Reserves. On the day on which a Carve-Out Trigger Notice is given by the ABL/FILO DIP Agent or the Term DIP Agent to the Debtors with a copy to counsel to the creditors' committee (the "**Termination Declaration Date**"), the Carve-Out Trigger Notice shall constitute a demand to the Debtors to utilize all cash on hand as of such date and any available cash thereafter held by any Debtor to fund a reserve in an amount equal to the then unpaid amounts of the Allowed Professional Fees. The Debtors shall deposit and hold such amounts in a segregated account at the ABL/FILO DIP Agent in trust to pay such then unpaid Allowed Professional Fees (the "**Pre-Carve-Out Trigger Notice Reserve**") prior to any and all other claims. On the Termination Declaration Date, the Carve-Out Trigger Notice shall also constitute a demand to the Debtors to utilize all cash on hand as of such date and any available cash thereafter held by any Debtor to fund a reserve in an amount equal to the Post-Carve-Out Trigger Notice Cap. The Debtors shall deposit and hold such amounts in a segregated account at the ABL/FILO DIP Agent in trust to pay such Allowed Professional Fees benefiting from the Post-Carve-Out Trigger Notice Cap (the "**Post-Carve-Out Trigger Notice Reserve**" and, together with the Pre-Carve-Out Trigger Notice Reserve, the "**Carve-Out Reserves**") prior to any and all other claims. All funds in the Pre-Carve-Out Trigger Notice Reserve shall be used first to pay the obligations set forth in clauses (i) through (iii) of the definition of Carve-Out set forth above (the "**Pre-Carve-Out Amounts**"), but not, for the avoidance of doubt, the Post-Carve-Out Trigger Notice Cap, until paid in full, and then, to the extent the Pre-Carve-Out Trigger Notice Reserve has not been reduced to zero, paid to the ABL/FILO DIP Agent for the benefit of the ABL/FILO DIP Lenders until the obligations under the ABL/FILO Revolving DIP Facility (excluding any secured hedge obligations, secured cash management obligations, and contingent obligations) have been indefeasibly paid in full, in cash, and all commitments under the ABL/FILO Revolving DIP Facility have been terminated, in which case any such excess shall be paid to the ABL/FILO Revolving DIP Facility for the benefit of Term DIP Lenders in accordance with their rights and priorities as of the Petition Date. All funds in the Post-Carve-Out Trigger Notice Reserve shall be used first to pay the obligations set forth in clause (iv) of the definition of Carve-Out set forth above (the "**Post-Carve-Out Amounts**"), and then, to the extent the Post-Carve-Out Trigger Notice Reserve has not been reduced to zero, to pay the ABL/FILO DIP Agent for the benefit of the ABL/FILO DIP Lenders until the obligations under the ABL/FILO Revolving DIP Facility (excluding any secured hedge obligations, secured cash management obligations, and contingent obligations) have been indefeasibly paid in full, in cash, and all commitments under the ABL/FILO Revolving DIP Facility have been terminated, and any excess shall be paid to the Term DIP Agent under the Term DIP Facility for the benefit of the Term DIP Lenders in accordance with their rights and priorities pursuant to the DIP Documents, the Interim Order and this Final Order. Notwithstanding anything to the contrary herein, if either of the Carve-Out Reserves is not funded in full in the amounts set forth herein, then any excess funds in one of the Carve-Out Reserves following the payment of the Pre-Carve-Out Amounts and Post-Carve-Out Amounts, respectively, shall be used to fund the other Carve-Out Reserve, up to the applicable amount set forth herein, prior to making any payments to the ABL/FILO DIP Agent, the Term DIP Agent or any prepetition secured creditors, as applicable. Notwithstanding anything to the contrary herein, following delivery of a Carve-Out Trigger Notice, the ABL/FILO DIP Agent, the DIP Term Agent, and any lender under either facility shall not sweep or foreclose on cash (including cash received as a result of the sale or other disposition of any assets) of the Debtors until the Carve-Out Reserves have been fully funded, but shall have a security interest in any residual interest in the Carve-Out Reserves, with any excess paid to the ABL/FILO DIP Agent or the DIP Term Agent, depending on which party then holds the senior-most DIP Lien in such cash, for application in accordance with this Final Order. Further, notwithstanding anything to the contrary in herein, (i) disbursements by the Debtors from the Carve-Out Reserves shall not constitute loans under the Term DIP Facility or increase or reduce the obligations under the Term DIP Facility, (ii) the failure of the Carve-Out Reserves to satisfy in full the Allowed Professional Fees shall not affect the priority of the Carve-Out, and (iii) in no way shall the DIP Budget, Carve-Out, Post-Carve-Out Trigger Notice Cap, Carve-Out Reserves, or any of the foregoing be construed as a cap or limitation on the amount of the Allowed Professional Fees due and payable by the Debtors.

(c) Security and Carve-Out. For the avoidance of doubt and notwithstanding anything to the contrary herein or in the DIP Documents or the Prepetition Secured Debt Documents or in any prepetition secured facilities (including the Prepetition Term Loan Credit Facility and the Prepetition ABL/FILO Credit Facility), the Carve-Out shall be senior to all liens and claims securing the ABL/FILO DIP Facility and the Term DIP Facility, the Canadian Intercompany DIP Facility, the Wayne DIP Facility, Adequate Protection Liens and the 507(b) Claims, and any and all other forms of adequate protection, liens, or claims securing the DIP Obligations, or the obligations secured pursuant to any prepetition secured facilities (including the Prepetition Term Loan Credit Facility and the Prepetition ABL/FILO Credit Facility), and provided further that any residual interest in the Carve-Out shall be subject to the DIP Superpriority Claims and the DIP Liens of the ABL/FILO DIP Lenders set forth above.

(d) Payment of Allowed Professional Fees Prior to the Termination Declaration Date. Any payment or reimbursement made on or prior to the occurrence of the Termination Declaration Date (as defined in the ABL/FILO DIP Credit Agreement) in respect of any Allowed Professional Fees shall not reduce the Post-Carve-Out Trigger Notice Cap.

(e) Payment of Carve-Out On or After the Termination Declaration Date. Any payment or reimbursement made on or after the first business day following occurrence of the Termination Declaration Date in respect of any Allowed Professional Fees shall permanently reduce the Carve-Out on a dollar-for-dollar basis.

(f) Subject only to the express exceptions set forth in paragraph 23 or 24 of this Final Order, the Debtors shall not assert or prosecute, and no portion of the proceeds of the DIP Facilities, the Collateral, including any Cash Collateral or the Carve-Out, and no disbursements set forth in the "**DIP Budget**" (as defined in the ABL/FILO DIP Credit Agreement) may be used for, the payment of professional fees, disbursements, costs, or expenses incurred by any person in connection with (i) incurring indebtedness except to the extent permitted under the DIP Documents; (ii) preventing, hindering, or delaying any of the DIP Agents', the DIP Lenders', the Prepetition ABL/FILO Agent's, the Prepetition Term Loan Agent's, the Prepetition ABL/FILO Lenders' or the Prepetition Term Loan Lenders' (in the case of each of the foregoing, in their respective capacities as such) enforcement or realization upon, or exercise of rights in respect of, any of the Collateral once an Event of Default has occurred and after any Remedies Notice Period (as defined below) other than in connection with an objection filed during a Remedies Notice Period subject to the limitations on such objection set forth in paragraph 13; (iii) objecting, challenging, or contesting in any manner, or raising any defenses to, the validity, extent, amount, perfection, priority, or enforceability of any of the DIP Obligations, the DIP Liens, the Prepetition ABL/FILO Liens, the Prepetition Term Liens or any other rights or interests of any of the DIP Agents, the DIP Lenders, or the Prepetition Secured Parties (in the case of each of the foregoing, in their respective capacities as such); or (iv) asserting, commencing, or prosecuting any claims or causes of action, including, without limitation, any actions under chapter 5 of the Bankruptcy Code and any so-called "lender liability" claims and causes of action, against any of the DIP Agents, the DIP Lenders, or the Prepetition Secured Parties (in the case of each of the foregoing, in their respective capacities as such), or any of their respective agents, attorneys, advisors, professionals, officers, directors, or employees (in the case of each of the foregoing, in their respective capacities as such); (v) asserting, joining, commencing, supporting, investigating, or prosecuting any action for any claim, counterclaim, action, cause of action, proceeding, application, motion, objection, defense, claim, counterclaim, action, cause of action, proceeding, application, motion, objection, defense, or other contested matter seeking any order, judgment, determination, or similar relief against, or adverse to the material interests of the DIP Agents or the DIP Lenders arising out of, in connection with, or relating to the DIP Facility, the DIP Documents or the transactions contemplated hereunder or thereunder, (vi) challenging the Interim Order, this Final Order, the DIP Documents, or any of the transactions contemplated herein or therein, *provided that* nothing herein shall limit the Creditors' Committee's rights to be compensated for any objection to this Final Order, and any allowed fees and expenses of the Committee Professionals with respect thereto may be paid using any of the proceeds of the DIP Facilities, the Collateral, the Prepetition ABL/FILO Credit Facility, the Prepetition Term Loan Credit Facility and the Collateral, including Cash Collateral, or the Carve-Out.

<u>In re hhgregg, Inc., et al.</u>, Southern District of Indiana, Case No.: 17-01302-JJG-11, *Final Order (I) Authorizing Debtors In Possession to Obtain Post-Petition Financing Pursuant to 11 U.S.C. §§ 105, 362, 363, and 364, etc.* [Docket No. 923]

VII. <u>CARVE OUT AND PAYMENT OF PROFESSIONALS.</u>

26. Subject to the terms and conditions contained in this Paragraph 26, the DIP Liens, DIP Superpriority Claim, the Prepetition Liens, the Adequate Protection Liens and the Adequate Protection Superpriority Claims are subordinate to the following (collectively, the "***Carve Out***"):

(a) allowed administrative expenses pursuant to 28 U.S.C. § 1930(a)(6) and 31 U.S.C. § 3717 for fees payable to the Office of the United States Trustee, as determined by agreement of the U.S. Trustee or by final order of this Court and 28 U.S.C. § 156(c) and 31 U.S.C. § 3717 for fees required to be paid to the Clerk of this Court;

(b) all accrued and unpaid fees, disbursements, costs and expenses allowed at any time by this Court (pursuant to a final order that has not been reversed, vacated or stayed) and incurred by professionals retained by the Debtors or the Committee (the "***Case Professionals***"), through and including the date of service by the DIP Agent or FILO Agent of a Carve Out Trigger Notice (as defined below), up to and as limited by the respective Approved Budget amounts for each Case Professional or category of Case Professional through the date of service of said Carve Out Trigger Notice, less the amounts of (i) the Debtors' cash on hand available to pay such fees, disbursements, costs and expenses and (ii) prepetition retainers received by such Case Professionals and not previously applied to such fees, disbursements, costs and expenses; and

(c) all accrued and unpaid fees, disbursements, costs and expenses incurred by the Case Professionals from and after the date of service of a Carve Out Trigger Notice, to the extent allowed at any time, in an aggregate amount not to exceed $1,000,000 (the "***Carve Out Cap***"), less the amounts of (i) the Debtors' cash on hand available to pay such fees, disbursements, costs and expenses, and (ii) prepetition retainers received by such Case Professionals and not applied to the fees, disbursements, costs and expenses set forth in clause (b) above or this clause (c). The Carve Out shall be reduced on a dollar-for-dollar basis by any payments of fees or expenses of the Case Professionals. For purposes of the foregoing, "***Carve Out Trigger Notice***" shall mean a written notice delivered by the DIP Agent to the Debtors and their counsel, the Prepetition Agent, the FILO Agent, the United States Trustee, and lead counsel to the Committee, which notice may be delivered at any time following the occurrence and continuance of any DIP Order Event of Default.

Immediately upon delivery of a Carve Out Trigger Notice, the Debtors shall be required to transfer from their applicable Blocked Account(s) to a segregated account (the "***Carve Out Account***") not subject to the control of the DIP Agent an amount equal to the sum of the Carve Out Cap plus the aggregate amount of unpaid fees, disbursements, costs and expenses described in clause (b) of the definition of "Carve Out". The proceeds on deposit in the Carve Out Account shall be available only to satisfy obligations benefitting from the Carve Out, and (i) the DIP Agent shall not sweep or foreclose on cash of the Debtors necessary to fund the Carve Out Account and (ii) the DIP Liens shall attach to any residual interest in the Carve Out Account available following satisfaction in full of all obligations benefitting from the Carve Out.

27. For the avoidance of doubt, the Carve Out shall be senior to the DIP Liens, the DIP Superpriority Claim, the Adequate Protection Liens, and the Adequate Protection Superpriority Claims. The Carve Out shall exclude and shall not be used to pay any fees and expenses (x) incurred in connection with the assertion or joinder in any Challenge Proceeding or any other claim, counterclaim, action, proceeding, application, motion, objection, defenses or other contested matter, the purpose of which is to seek any order, judgment, determination or similar relief at law, in equity or mixed (A) invalidating, setting aside, avoiding, or subordinating, in whole or in part, (i) the DIP Obligations, (ii) the DIP Agent's Liens on the DIP Collateral, (iii) the Prepetition Secured Debt, (iv) the Prepetition Agent's Liens on the Prepetition Collateral, or (v) the Adequate Protection Liens or claims, or (B) preventing, hindering, or delaying, whether directly or indirectly, the DIP Agent, the other DIP Secured Parties, the Prepetition Agent or the Prepetition Secured Lenders' assertion or enforcement of their Liens and security interests, or their efforts to realize upon any DIP Collateral, Prepetition Collateral, the Adequate Protection Liens, or the Indemnity Account; ***provided, however,*** that such exclusion does not encompass any investigative work conducted by the Case Professionals retained by the Committee, but only up to $25,000 of the Carve Out may be used for such investigative work.

28. Nothing herein, including the inclusion of line items in the Approved Budget for Case Professionals, shall be construed as consent to the allowance of any particular professional fees or expenses of the Debtors, of the Committee, or of any other person or shall affect the right of the DIP Agent, the FILO Agent or the Prepetition Agent to object to the allowance and payment of such fees and expenses. Notwithstanding anything herein to the contrary, from and after the entry of this Final Order, no amount shall be paid to any Case Professional until the principal amount of the DIP Obligations is less than $24,000,000.

Exhibit B

Samples of Carve Out Provisions in Local Bankruptcy Rules

District of Delaware

Rule 4001-2 Cash Collateral and Financing Orders.

(a) Motions. Except as provided herein and elsewhere in these Local Rules, all cash collateral and financing requests under 11 U.S.C. §§ 363 and 364 shall be heard by motion filed under Fed. R. Bankr. P. 2002, 4001 and 9014 ("Financing Motions").

(i) Provisions to be Highlighted. All Financing Motions must (a) recite whether the proposed form of order and/or underlying cash collateral stipulation or loan agreement contains any provision of the type indicated below, (b) identify the location of any such provision in the proposed form of order, cash collateral stipulation and/or loan agreement and (c) justify the inclusion of such provision:

(A) Provisions that grant cross-collateralization protection (other than replacement liens or other adequate protection) to the prepetition secured creditors (i.e., clauses that secure prepetition debt by postpetition assets in which the secured creditor would not otherwise have a security interest by virtue of its prepetition security agreement or applicable law);

(B) Provisions or findings of fact that bind the estate or other parties in interest with respect to the validity, perfection or amount of the secured creditor's prepetition lien or the waiver of claims against the secured creditor without first giving parties in interest at least seventy-five (75) days from the entry of the order and the creditors' committee, if formed, at least sixty (60) days from the date of its formation to investigate such matters;

(C) Provisions that seek to waive, without notice, whatever rights the estate may have under 11 U.S.C. § 506(c);

(D) Provisions that immediately grant to the prepetition secured creditor liens on the debtor's claims and causes of action arising under 11 U.S.C. §§ 544, 545, 547, 548 and 549;

(E) Provisions that deem prepetition secured debt to be postpetition debt or that use postpetition loans from a prepetition secured creditor to pay part or all of that secured creditor's prepetition debt, other than as provided in 11 U.S.C. § 552(b);

(F) Provisions that provide disparate treatment for the professionals retained by a creditors' committee from those professionals retained by the debtor with respect to a professional fee carve-out;

(G) Provisions that prime any secured lien without the consent of that lienor; and

(H) Provisions that seek to affect the Court's power to consider the equities of the case under 11 U.S.C. § 552(b)(1).

(ii) All Financing Motions shall also provide a summary of the essential terms of the proposed use of cash collateral and/or financing (e.g., the maximum borrowing available on a final basis, the interim borrowing limit, borrowing conditions, interest rate, maturity, events of default, use of funds limitations and protections afforded under 11 U.S.C. §§ 363 and 364).

Northern District of Illinois

RULE 4001-2 CASH COLLATERAL AND FINANCING ORDERS

A. Motions

(1) Except as provided in these Rules, all cash collateral and financing requests under §§ 363 and 364 of the Bankruptcy Code must be heard by motion filed pursuant to Fed. R. Bankr. P. 2002, 4001 and 9014 ("Financing Motions").

(2) Provisions to be Highlighted. All Financing Motions must (a) recite whether the proposed form of order or underlying cash collateral stipulation or loan agreement contains any provision of the type indicated below, (b) identify the location of any such provision in the proposed form of order, cash collateral stipulation or loan agreement, and (c) state the justification for the inclusion of such provision:

(a) Provisions that grant cross-collateralization protection (other than replacement liens or other adequate protection) to the pre-petition secured creditors (i.e., clauses that secure pre-petition debt by post-petition assets in which the secured creditor would not otherwise have a security interest by virtue of its pre-petition security agreement or applicable law).

(b) Provisions or findings of fact that bind the estate or all parties in interest with respect to the validity, perfection or amount of the secured creditor's pre-petition lien or debt or the waiver of claims against the secured creditor without first giving parties in interest at least 75 days from the entry of the order and the creditors' committee, if formed, at least 60 days from the date of its formation to investigate such matters.

(c) Provisions that seek to waive any rights the estate may have under § 506(c) of the Bankruptcy Code.

(d) Provisions that immediately grant to the pre-petition secured creditor liens on the debtor's claims and causes of action arising under §§ 544, 545, 547, 548, and 549 of the Bankruptcy Code.

(e) Provisions that deem pre-petition secured debt to be post-petition debt or that use post-petition loans from a pre-petition secured creditor to pay part or all of that secured creditor's pre-petition debt, other than as provided in § 552(b) of the Bankruptcy Code.

(f) Provisions that provide treatment for the professionals retained by a committee appointed by the United States Trustee different from that provided for the professionals retained by the debtor with respect to a professional fee carve-out, and provisions that limit the committee counsel's use of the carve-out.

(g) Provisions that prime any secured lien, without the consent of that lienor.

(h) A declaration that the order does not impose lender liability on any secured creditor.

(i) Provisions that grant the lender expedited relief from the automatic stay in § 362 of the Bankruptcy Code, or relief from the automatic stay without further order of court.

(j) In jointly administered cases, provisions for joint and several liability on loans.

All Financing Motions must also provide a summary of all provisions that must be highlighted under section (A)(2) of this Rule and a summary of the essential terms of the proposed use of cash collateral or financing, including the maximum borrowing available on a final basis, the interim borrowing limit, borrowing conditions, interest rate, maturity, events of default, use of funds limitations, and protections afforded under §§ 363 and 364 of the Bankruptcy Code.

(4) All Financing Motions must also provide a budget covering the time period in which the order will remain in effect. The budget must state in as much detail as is reasonably practical the amount of projected receipts and disbursements during the period covered by the budget.

(5) The court may deem unenforceable any provision not highlighted as required under section (A)(2) of this Rule.

Southern District of Illinois

L.R. 4001-3 – Motions to Use Cash Collateral and to Obtain Credit.

A. **Provisions to be Disclosed.** In addition to the provisions listed in Rules 4001(b)(1)(B) and (c)(1)(B) of the Federal Rules of Bankruptcy Procedure, any motion to use cash collateral or motion to obtain credit (collectively "Financing Motions") must also disclose the following:

1. Cross-Collateralization of Pre-Petition Debt: Provisions that grant cross-collateralization protection (other than replacement liens or other adequate protection) to the pre-petition secured creditor, i.e., clauses that secure pre-petition debt by post-petition assets in which the secured creditor does not assert a valid, perfected security interest by virtue of its pre-petition security agreement or applicable non-bankruptcy law, and provisions that deem pre-petition secured debt to be post-petition debt or that use post-petition loans from a pre-petition secured lender to pay all or part of that lender's pre-petition claim, other than as provided in Section 552(b) of the Bankruptcy Code;

2. Professional Fee Provisions: Provisions that grant a carve-out for professional fees, including the amount of the fee;

3. Priming of Existing Liens: Provisions that prime any secured lien;

4. Loan Documentation Costs: Provisions that call for the payment of fees or costs by the debtor other than reasonable attorney's fees for loan documentation;

5. Plan Restrictions: Provisions that limit, restrict, or otherwise affect the terms of a proposed plan of reorganization; and

6. United States Trustee's Fees: Payment of fees to the United States Trustee.

7. Administrative Claims: Existence of any administrative claim that is sought by the movant.

B. **Summary of Essential Terms.** All Financing Motions must also set forth, unless good cause is shown, the total dollar amount requested, the debtor's proposed budget for the use of the funds, an estimate of the value of the collateral which secures the creditor's asserted interest, the maximum borrowing available on an interim and final basis, the borrowing conditions, interest rate, fees, costs or other expenses to be borne by the debtor, maturity, limitations on the use of the funds, events of default and the protections afforded under Sections 363 and 364 of the Bankruptcy Code.

Southern District of Indiana

B-4001-2. MOTIONS TO USE CASH COLLATERAL AND TO OBTAIN CREDIT

(a) Contents of Motion to Use Cash Collateral

In addition to the requirements of Fed.R.Bankr.P. 4001(b)(1)(B), motions to use cash collateral shall also comply with the requirements of Fed.R.Bankr.P. 4001(c)(1)(B) unless otherwise directed by the Court.

(b) Other Provisions to Be Disclosed
In addition to the provisions listed in Fed.R.Bankr.P. 4001(b)(1)(B) and (c)(1)(B), any motion to use cash collateral or motion to obtain credit (collectively "Financing Motions") must also disclose as a "material provision" any provision of the type indicated below:

(1) Cross-Collateralization of Pre-Petition Debt
Provisions that grant cross-collateralization protection (other than replacement liens or other adequate protection) to the pre-petition secured creditor, i.e., clauses that secure pre-petition debt by post-petition assets in which the secured creditor does not assert a valid, perfected security interest by virtue of its pre-petition security agreement or applicable non-bankruptcy law, and provisions that deem pre-petition secured debt to be post-petition debt or that use post-petition loans from a pre-petition secured lender to pay all or part of that lender's pre-petition claim, other than as provided in 11 U.S.C. §552(b);

(2) *Professional Fee Provisions*
Provisions that provide disparate treatment for the professionals retained by a creditors' committee from that provided for the professionals retained by the Debtor with respect to a professional fee carve-out (payment from a secured creditor's collateral);

(3) Priming of Existing Liens
Provisions that prime any secured lien without the consent of the holder of that lien;

(4) Loan Documentation Costs
Provisions that call for the payment of fees or costs by the Debtor other than reasonable attorney's fees for loan documentation; and

(5) Plan Restrictions
Provisions that limit, restrict, or otherwise affect the terms of a proposed plan of reorganization.

(c) * * *."

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Eastern District of Michigan

Rule 4001-2 Motion for Use of Cash Collateral or to Obtain Financing

(a) Contents of the Motion. In addition to the requirements of F.R.Bankr.P. 4001(b)(1)(B) and F.R.Bankr.P. 4001(c)(1)(B), a motion for use of cash collateral under § 363(c)(2) or to obtain credit under § 364(c) or (d) must explicitly state the moving party's position as to the value of each of the secured interests to be protected. Pertinent appraisals and projections must be summarized in the motion.

(b) Cover Sheet.

(1) The motion must be filed with a completed form "Cover Sheet for Motion to Use Cash Collateral or to Obtain Financing," available on the court's website. When a cover sheet is not filed, the court may enter an order striking or denying the motion without prejudice to the movant's right to re-file the motion in compliance with this rule.

(2) If any proposed order granting interim or final relief would alter any information given in the initial cover sheet, then the movant must file an amended cover sheet concurrently with the submission of the proposed order indicating where appropriate all changes from the original proposed order.

____

Eastern District of Michigan's LR 4001-2(b)(1)

Cover Sheet

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF MICHIGAN
_________ DIVISION

In re:

Case No. ____________

___________________, Chapter 11

Hon. ________________

Debtor.
__________________________________/

COVER SHEET FOR MOTION TO USE CASH COLLATERAL OR TO OBTAIN CREDIT

The debtor has filed a motion to use cash collateral or to obtain postpetition financing, which is attached to this Cover Sheet. In accordance with LBR 4001-2(b) (E.D.M.), the debtor has identified below, by page and paragraph number, the location in the proposed order accompanying the motion of each of the following provisions:

Provision	**Contained in Proposed Order**	**Location in Proposed Order**
(1) Provisions that grant liens on the estate's claims and causes of action arising under Chapter 5 of the Code.	_____ Yes _____ No	Page ____, ¶ ____
(2) Provisions that grant cross-collateralization protection to the prepetition secured creditor (i.e., clauses that secure prepetition debt with categories of collateral that were not covered by the secured party's lien prepetition) other than liens granted solely as adequate protection against diminution in value of a prepetition creditor's collateral.	_____ Yes _____ No	Page ____, ¶ ____

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(3) Provisions that establish a procedure or conditions for relief from the automatic stay.	_____ Yes _____ No	Page ____, ¶ ____
(4) Provisions regarding the validity or perfection of a secured creditor's prepetition liens or that release claims against a secured creditor.	_____ Yes _____ No	Page ____, ¶ ____
(5) Provisions that prime any lien without that lienholder's consent.	_____ Yes _____ No	Page ____, ¶ ____
(6) Provisions that relate to a sale of substantially all of the debtor's assets.	_____ Yes _____ No	Page ____, ¶ ____
(7) Provisions for the payment of professional fees of the debtor or any committees, including any carve-outs for such payments.	_____ Yes _____ No	Page ____, ¶ ____
(8) Provisions for the payment of prepetition debt.	_____ Yes _____ No	Page ____, ¶ ____
(9) Provisions that waive the debtor's exclusive right to file or solicit acceptances of a plan during the time periods specified in 11 U.S.C. § 1121.	_____ Yes _____ No	Page ____, ¶ ____
(10) Provisions that require the debtor's plan to be on terms acceptable to the secured creditor.	_____ Yes _____ No	Page ____, ¶ ____
(11) Provisions that require or prohibit specific terms in the debtor's plan.	_____ Yes _____ No	Page ____, ¶ ____

(12) Provisions establishing that proposing a plan inconsistent with the order constitutes a default.	_____ Yes _____ No	Page ____, ¶ ____
(13) Provisions that waive surcharge under 11 U.S.C. § 506(c).	_____ Yes _____ No	Page ____, ¶ ____
(14) Provisions that address the rights and obligations of guarantors or co-obligors.	_____ Yes _____ No	Page ____, ¶ ____
(15) Provisions that prohibit the debtor from seeking approval to use cash collateral without the secured creditor's consent.	_____ Yes _____ No	Page ____, ¶ ____
(16) Provisions that purport to bind a subsequent trustee.	_____ Yes _____ No	Page ____, ¶ ____
(17) Provisions that obligate the debtor to pay any of a secured creditor's professional fees.	_____ Yes _____ No	Page ____, ¶ ____

Date: ______________ ________________________________

[Debtor's counsel]

Southern District of New York

Rule 4001-2

REQUESTS FOR USE OF CASH COLLATERAL OR TO OBTAIN CREDIT – Amended December 1, 2017

(a) Contents of Motions. The following provisions enumerated below, to the extent applicable, are added to the enumerated lists of material provisions set forth in Bankruptcy Rule 4001(b)(1)(B), (c)(1)(B), and (d)(1)(B). These provisions should be prominently highlighted and easily identified in the motion; failure to do so may result in such provisions being deemed denied by the Court:

(1) the amount of cash collateral the party seeks permission to use or the amount of credit the party seeks to obtain, including any committed amount or the existence of a borrowing base formula and the estimated availability under such formula;

(2) material conditions to closing and borrowing, including budget provisions;

(3) pricing and economic terms, including letter of credit fees, commitment fees, any other fees, and the treatment of costs and expenses of the lender(s), any agent for the lender(s), and their respective professionals;

(4) any effect on existing liens of the granting of collateral or adequate protection provided to the lender(s) and any priority or superpriority provisions;

(5) any carve-outs from liens or superpriority provisions;

(6) any cross-collateralization provision or other provision that elevates prepetition debt to administrative expense (or higher) status or that secures prepetition debt with liens on postpetition assets (which liens the creditor would not otherwise have by virtue of the prepetition security agreement or applicable law);

(7) any rollup provision that applies the proceeds of postpetition financing to pay, in whole or in part, prepetition debt or which otherwise has the effect of converting prepetition debt to postpetition debt;

(8) any provision that would limit the Court's power or discretion in a material way, or would interfere with the exercise of the fiduciary duties, or restrict the rights and powers, of the trustee, debtor in possession, or a committee appointed under sections 1102 or 1114 of the Bankruptcy Code, or any other fiduciary of the estate, in connection with the operation,

financing, use or sale of the business or property of the estate, but excluding any agreement to repay postpetition financing in connection with a plan or to waive any right to incur liens that prime or are pari passu with liens granted under section 364 of the Bankruptcy Code;

(9) any limitation on the lender's obligation to fund certain activities of the trustee, the debtor in possession or a committee appointed under sections 1102 or 1114 of the Bankruptcy Code;

(10) termination or default provisions, including events of default, any effect of termination or default on the automatic stay or the lender’s ability to enforce remedies, any cross-default provision, and any terms that provide that the use of cash collateral or the availability of credit will cease on (i) the filing of a challenge to the lender's prepetition lien or the lender's prepetition claim based on the lender's prepetition conduct; (ii) entry of an order granting relief from the automatic stay other than an order granting relief from the stay with respect to material assets; (iii) the grant of a change of venue with respect to the case or any adversary proceeding; (iv) management changes or the departure, from the debtor, of any identified employees; (v) the expiration of a specified time for filing a plan; or (vi) the making of a motion by a party in interest seeking any relief (as distinct from an order granting such relief);

(11) any change-of-control provisions;

(12) any provision establishing a deadline for, or otherwise requiring, the sale of property of the estate;

(13) any prepayment penalty or other provision that affects the debtor's right or ability to repay the financing in full during the course of the chapter 11 reorganization case;

(14) in jointly administered cases, terms that govern the joint liability of the debtors including any provisions that would govern the nature and/or priority, if any, of any interdebtor claims that would result if a debtor were to repay debt incurred by or for the benefit of another debtor;

(15) any provision for the funding of non-debtor affiliates with cash collateral or proceeds of the loan, as applicable, and the approximate amount of such funding;

(16) any provisions that require the debtor to pay an agent’s or lender’s expenses and attorney’s fees in connection with the proposed financing or use of cash collateral, without any notice or review by the Office of the United States trustee, the committee appointed under section 1102 of the Bankruptcy Code (if formed) or, upon objection by either of the foregoing parties, the Court;

(17) defined terms must either be defined in the motion or the motion shall include a specific reference to where the terms are defined in the applicable loan agreements; and

(18) any provision providing for the reaffirmation of the prepetition loan agreement or the covenants of such agreement.