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Court Rules That Professional Fees May Not Be Capped by Standard Carve-Out Provisions

By John C. Tishler and Tyler N. Layne

Secured creditors and debtor-in-possession (DIP) lenders that rely on standard carve-out provisions to limit the impact of bankruptcy professional fees on their collateral would be well-advised to take notice of a U.S. Bankruptcy Court decision from earlier this year. Judge Christopher S. Sontchi of the United States Bankruptcy Court for the District of Delaware (the Court) issued an opinion in *In re Molycorp, Inc.* (Case No. 15-11357) on Jan. 5, 2017 that serves as both a cautionary tale and an instruction manual.

Background

In the case, Molycorp, Inc. and a number of its subsidiaries (collectively, the Debtors) filed for bankruptcy without pre-arranged DIP financing. Approximately one week into the bankruptcy cases, the Debtors filed a motion to approve DIP financing from Oaktree Capital Management, L.P. (Oaktree). The Court approved the DIP financing and the DIP Order contained a commonplace carve-out provision (the Carve-Out) establishing the amount (in this case, $250,000) of the proceeds of the DIP loans, the collateral securing the DIP loans, and the collateral securing Oaktree's prepetition loans (collectively, the Restricted Sources) that could be used to pay the professional fees of the official committee of unsecured creditors (the Committee) in connection with investigating the validity, priority, enforceability, and extent of Oaktree's liens and the Debtors' adequate protection obligations (collectively, the Carve-Out Matters). The DIP Order expressly excluded fees incurred in connection with the prosecution of any challenge related to the Carve-Out Matters from the Carve-Out.

Almost three weeks after the Court entered the DIP Order, it approved the retention of Paul Hastings LLP (Paul Hastings) as counsel to the Committee. About seven months into the bankruptcy cases, the Committee obtained standing to pursue causes of action on behalf of the Debtors' estates against Oaktree and the Debtors' directors and officers. T he Committee commenced an action (the Committee Litigation) against, among other parties, Oaktree. After extensive negotiations, including a mediation between the parties, the Committee and Oaktree entered into a settlement agreement, which was approved by the Court and ultimately led to the consensual confirmation of the Debtors' plan of reorganization (the Plan).

Tyler N. Layne

John C. Tishler

The Objection

After the Plan was confirmed, Paul Hastings filed an interim fee application seeking approval of almost $8,500,000 in fees and reimbursement of over $225,000 in expenses. Oaktree promptly objected to Paul Hastings' fee application, arguing, among other things, that payment of the requested quantum of fees and expenses would contravene the Carve-Out and DIP Order. In particular, Oaktree pointed out that Paul Hastings could not identify any sources from which the requested fees and expenses could be paid other than the Restricted Sources, which represented almost all of the Debtors' sources of cash. Oaktree also argued that Paul Hastings was not entitled to any fees and expenses from the Restricted Sources with respect to

John Tishler is a partner and **Tyler Layne** is an associate in the Finance and Restructuring practice of Waller Lansden Dortch & Davis, LLP. They are based in the firm's Nashville, TN, office. Tishler also served Waller as its chairman from 2008 to 2014. They can be reached at john.tishler@wallerlaw.com and tyler.layne@wallerlaw.com, respectively.

fees and expenses incurred in connection with the prosecution of causes of action against Oaktree, as the DIP Order specifically excluded such fees and expenses from the Carve-Out.

Counsel's Argument

Paul Hastings, on the other hand, argued that the Carve-Out would only become relevant in an administratively insolvent case. Essentially, Paul Hastings argued that the Carve-Out is only relevant as to the priority of the payment of the amount of the Carve-Out ahead of Oaktree. Furthermore, Paul Hastings argued that the confirmed Plan rendered the Carve-Out meaningless because the Debtors were required to pay all allowed administrative expenses of the bankruptcy cases in order to confirm the Plan under Section 1129(a)(9)(A) of Title 11 of the United States Code (the Bankruptcy Code).

The Ruling

The Court sided with Paul Hastings and held that the Carve-Out did not amount to an absolute cap on the amount of fees and expenses that Paul Hastings could recover. In so holding, the Court adopted the argument that the Carve-Out, rather than being a cap, was instead a selective and limited waiver by Oaktree of its priority over administrative expenses in the event the Debtors' estates became insolvent. Of particular relevance to the Court was that: 1) the confirmed Plan contained all creditors holding administrative expense claims would be paid in full in cash, without reference to the Carve-Out or the DIP Order; and 2) that the DIP Order did not contain any reference to a cap on fees and expenses recoverable by the Committee's professionals under Section 1129(a)(9)(A) of the Bankruptcy Code.

Takeaways

The *Molycorp* case is a word of caution to prepetition secured creditors and DIP lenders who believe that standard carve-out provisions, without more, are enough to protect their cash collateral from substantial professional fees of the debtors and committees in cases where there will be a confirmed plan of reorganization. However, the case does offer guidance for secured creditors and DIP lenders seeking more extensive protections of their cash collateral.

Namely, if the intent of a secured creditor or DIP lender is to place a cap on professional fees of the debtor's or committee's professionals, then the applicable cash collateral order, DIP order, or plan of reorganization should explicitly state that: 1) actual payments of fees and expenses to such professionals shall not exceed a certain amount; and 2) such professionals shall not be entitled to an allowed administrative expense claim under Section 1129(a)(9)(A) of the Bankruptcy Code for unpaid fees and expenses in excess of the capped amount. This approach has been approved by the United States Bankruptcy Court for the Southern District of New York (the SDNY Bankruptcy Court) in the context of a DIP order in the *In re Granite Broadcasting Corp.* case.

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Interestingly, the Court in the *Molycorp* case did not specifically embrace the SDNY Bankruptcy Court's approach, stating that it "offers no opinion as to whether it would approve a DIP order containing provisions such as those in the *Granite Broadcasting* order" and that it "does not reach the question whether a per se disallowance of administrative claims provision in a DIP order such as that in the *Granite Broadcasting* order satisfies the consent requirement under section 1129(a)(9) of the Bankruptcy Code."

It is axiomatic that an administrative creditor, such as a professional, may agree to a different treatment of such creditor's claim under Section 1129(a)(9) of the Bankruptcy Code. Thus, it is advisable for a secured creditor or DIP lender to obtain the express consent of all affected professionals to the administrative claim caps contained in a cash collateral order, DIP order, or plan of reorganization, whether that consent is obtained on the record or, ideally, as part of stipulations in connection with entry of such an order or an order confirming a plan of reorganization. This approach would seemingly assuage the concern of the *Molycorp* Court regarding such orders constituting consent of the affected creditor and provide the secured creditor or DIP lender with comfort that its collateral would not be detrimentally affected by the payment of substantial professional fees and expenses in connection with the bankruptcy case.

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