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The *Farmland Industries* Decisions: Impact on the Retention and Payment of Investment Bankers in Chapter 11 Cases

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<u>Introduction</u>

Investment bankers and other financial advisors are retained and employed by chapter 11 debtors and statutorily appointed committees to assist in the maximization of the value of the estates' assets by providing financial advisory services, marketing and sale efforts and debt and equity financing initiatives. Investment bankers, as professionals, must be retained pursuant to applicable provisions of the Bankruptcy Code and all terms of the proposed retention are subject to court approval. Court approval of fees and expenses is also required. Typically, fees and expenses for professionals retained by the trustee, the debtor or a committee are afforded administrative expense status and are paid from general estate funds.

Recently, however, the bankruptcy court presiding over the *Farmlands Industries, Inc. et al* cases held that certain fees of professionals were payable out of a specific creditor constituency's recovery and not out of general estate funds. *In re Farmland Industries, Inc.,* 286 B.R. 895 (Bankr. W.D. Mo. 2002; hereinafter the "*Farmland Opinion*"). The bankruptcy court was affirmed on appeal by the Bankruptcy Appellate Panel for the Eighth Circuit. *In re Farmland Industries, Inc.*, 296 B.R. 188 (8th Cir. BAP 2003; hereinafter, the "*BAP Opinion*"). This paper will briefly address the background, circumstances and ramifications of the *Farmland* decisions.

In the *Farmland* cases, there were two competing creditor constituencies — general unsecured creditors ("GUCs") and bondholders. It is unclear from the opinions

the precise allocation of debt as between the GUCs and the bondholders.[1] As will be illustrated below, the outcome turned on the existence of competing creditor constituencies.

<u>Background: Statutory Bases for the Retention and Payment of Investment Bankers/Financial Advisors</u>

Bankruptcy Code Section 1103 authorizes a committee appointed pursuant to Section 1102 to select and employ "one or more attorneys, accountants, or other agents, to represent or perform services for such committee." 11 U.S.C § 1103(a). Section 1103(a) requires court approval of the retention and the terms of such retention of professionals, including investment bankers and financial advisors. Once retention of the investment banker is approved by the court, other Bankruptcy Code provisions govern the compensation of such professionals. Professionals retained by committees must be familiar with, and understand the nuances of, Bankruptcy Code Sections 328 and 330, which govern compensation procedures and standards.

Section 328(a) provides, in relevant part, that professional persons employed by a trustee or committee be retained "on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, or on a contingent fee basis." 11 U.S.C. § 328(a). This mandate is straight-forward enough. The catch, however, appears in the next sentence of the Code section. "Notwithstanding such terms and conditions, the court may allow compensation different from the compensation provided under such terms and

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1. The *Farmland Opinion* refers to GUC debt in the approximate amount of $200 Million and bondholder debt of approximately $580 Million. *Farmland Opinion* at 899. The *BAP Opinion* refers to the Creditors' Committee's brief in which the amount of GUC debt is alleged to be approximately $567.7 Million, net of rejection damage claims. *BAP Opinion* at 193. Both the *Farmland* Opinion and the *BAP Opinion* state that the respective courts' ruling did not turn on the allocation of debt.

conditions after the conclusion of such employment, if such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions." *Id.*

While Section 328(a) mandates, and courts interpreting the statutory language of Section 328(a) agree, that the determination of what constitutes reasonable terms and conditions of employment must be addressed at the time the court considers the retention application, the statute allows a court to change terms of employment retroactively under certain, unlikely circumstances. Under Section 328(a), courts must approve or deny the employment application of a professional at the time it is presented to the court. The court must then determine if employment on the proposed terms is in the best interests of the estate. If the court deems that the terms and conditions are not in the best interests of the estate, then it must deny the application — a court simply cannot — or at least should not rewrite the terms of a proposed professional retention. *See, e.g., In re Thermadyne Holdings Corp.*, 283 B.R. 749, 754 n.6 (8th Cir. BAP 2002); *In re Farmland Industries, Inc.*, 286 B.R. 895 (Bankr. W.D. Mo. 2002). Likewise, if approved by the court, the only way for a court to allow compensation different from the approved terms at the conclusion of employment is upon a showing of changed conditions that could not have been anticipated at the time of retention — a tough threshold to meet. This concept is known as the "sanctity of contract" and provides professionals with the security of knowing that they were approved on the terms bargained for and that deviations from their expected compensation arrangements should occur only in the unlikely event that there existed "developments [in the case] not capable of being anticipated at the time of the fixing of such terms and conditions." 11 U.S.C. § 328(a).

If retention is denied by the court, the professional and the party seeking to retain the professional have two alternatives. Upon disapproval of a retention the professional can elect to turn down the employment. The second option, of course, is to renegotiate with the trustee, debtor or committee to craft a deal that satisfies the parties and resolves whatever concern the court had that resulted in denial of the retention. If the precise terms of the retention are not specified in the professional's engagement letter and if the retention is not sought pursuant to Section 328 (a) of the Code and approved by the court at the time of the engagement, the standards for determining the professional's compensation will be addressed by Section 330.

Section 330 of the Bankruptcy Code allows for the "reasonable compensation for actual, necessary services rendered by the trustee, examiner, professional person, or attorney and by any paraprofessionals employed by such person," and "reimbursement for actual, necessary expenses." 11 U.S.C. § 330(a)(1)(A), (B). Retention and subsequent compensation under Section 330 gives the Court wide latitude and discretion in the allowance of fees paid to professionals. The practical effect is that the relative certainty provided by retention under Section 328 (the sanctity of contract) is not present when the reasonableness of a professional's compensation is not fixed at the commencement of the engagement, but is determined, per Section 330, at the time of payment.

The Bankruptcy Court decision in *Farmland*

On June 18, 2002, the Official Committee of Unsecured Creditors (the "Committee") for the chapter 11 bankruptcy estates of Farmland Industries, Inc. and its affiliates (the "Debtors") filed an application for approval of the employment of Houlihan

Lokey Howard & Zukin Financial Advisors, Inc. ("Houlihan Lokey") as financial advisors for the Committee pursuant to Bankruptcy Code Sections 1103(a) and 328(a). The Committee sought to compensate Houlihan Lokey as follows: (1) a monthly fee of $150,000 to be paid by the Debtors from general estate funds; and (2) a transaction fee of 1% of the amount distributed to GUCs (i.e., the Committee's constituency). As defined in the Houlihan Lokey retention application, the transaction fee payable to Houlihan Lokey would be a minimum of $1,000,000, with a cap of $3,000,000, with half of Houlihan Lokey's monthly fees for six months (totaling $450,000) to be credited against the transaction fee.

In *Farmland,* there was also an official statutory committee for bondholders (the "Bondholders' Committee"). At the time the Committee filed its application to retain Houlihan Lokey, the Bondholders' Committee had already obtained court approval to retain Ernst & Young as its financial advisors. The Ernst & Young retention provided for a monthly advisory fee to be paid out of general estate assets, just like the proposed Houlihan Lokey retention, and for a "completion fee." However, the terms of the Ernst & Young retention expressly provided that the completion fee payable to Ernst & Young would be payable exclusively out of the distribution due to bondholders, not from general estate funds. *Farmland Opinion* at 899.

At the hearing on the Houlihan Lokey retention, the Debtors and the Bondholders' Committee argued that the Houlihan Lokey transaction fee should be paid out of the recoveries from unsecured creditors and not out of general estate funds. The Committee, in an effort to move forward with the retention of Houlihan Lokey, proposed that the bankruptcy court approve the retention application on an interim basis, but

reserve on its determination of the treatment and source of payment of Houlihan Lokey's transaction fee until a later hearing. The Debtors and the Bondholders' Committee did not object to the entry of an interim order approving Houlihan Lokey's retention on those terms. The court specifically reserved for a later hearing the issue of whether the transaction fee, if awarded, would be paid out of general estate funds. At the subsequent hearing, the Debtors and the Bondholders' Committee renewed their arguments that the transaction fee should be paid out of the recovery to GUCs and not out of general estate funds. In opposing the payment to Houlihan Lokey out of general estate funds, the Debtors highlighted the fact that the Bondholders' Committee had hired its own financial advisors on terms that provided that any completion fee (analogous to the transaction fee payable to Houlihan Lokey) earned would be paid out of the distributions made to the bondholders and not out of general estate funds. The Debtors argued that fairness and equity should dictate that each of the GUCs' and bondholders' constituencies should bear the costs of the deals that they bargained for with their respective professionals. Otherwise, the Debtors argued, the bondholders would "disproportionately bear the cost of the Houlihan Lokey's transaction fee" as the bondholders would be paying both their professionals (from its distribution) and for Houlihan Lokey through the reduction of estate funds resulting from the payment of Houlihan Lokey's transaction fee. *Farmland Opinion* at 899.

The bankruptcy court held that the transaction fee would be afforded administrative expense priority pursuant to Section 503 of the Bankruptcy Code. The bankruptcy court then held that "the fair and equitable thing is for any Transaction Fee earned by Houlihan Lokey to be paid out of any distribution that shall be made to the

unsecured creditors." *Farmland Opinion* at 898. The Court's rationale rested on four grounds. First, the court stated that the Committee was acting solely on behalf of its own constituency, the general unsecured creditors, when it bargained for Houlihan Lokey's services. Second, the underlying employment tasks that would bring about the payment of the transaction fee would benefit only GUCs. Third, Houlihan Lokey's transaction fee was negotiated and bargained for by the Committee for the benefit of general unsecured creditors, and thus should not be imposed upon the Debtors or the bondholders. Fourth, the bondholders had retained their own financial advisors and were paying for any completion fee out of their own recovery and therefore, the bondholders would be paying a disproportionate share of professional fees. Therefore, the court concluded, only the GUCs should pay for such services. *Id.* at 899.

In the *Farmland Opinion,* the court does not cite to a single case as authority for its ruling. But, the *Farmland* court uses the words "fair" or "fairness" five times. The court's reliance on its sense of fundamental fairness was cogently stated: "[t]he Court's decision turns, very simply, on what is most fair to all creditors." *Farmland Opinion* at 899.

Not surprisingly, the Committee disagreed with the bankruptcy court's order. The Committee sought reconsideration of the retention order entered by the bankruptcy court, and that relief was denied. Thereafter, the Committee appealed to the Bankruptcy Appellate Panel of the Eighth Circuit (the "BAP").

The Committee's Appeal to the Bankruptcy Appellate Panel

In its appeal to the BAP, the Committee argued that the bankruptcy court (1) changed the terms of Houlihan Lokey's retention agreement by ordering payment to be made solely from the GUCs' recovery, contrary to concepts generally accepted in the interpretation and application of Sections 503 and 328(a); (2) violated the priority scheme contained in Section 507 by providing that an allowed administrative expense under Section 503 was payable from a source other than general estate funds; and (3) based its decision on clearly erroneous findings of fact. *See BAP Opinion.*

The BAP held that the bankruptcy court did not abuse its discretion in holding that the transaction fee be paid only from distributions made to the GUCs and, thus, affirmed.

Referring to its decision in *Thermodyne,* the BAP acknowledged that a bankruptcy court may approve or disapprove of a retention but it cannot change the bargained-for terms of the parties. However, and significantly, the BAP noted that at the first hearing on Houlihan Lokey's application the Committee specifically requested that the bankruptcy court approve of Houlihan Lokey's retention, while reserving on the issue of the source of the payment of the Houlihan Lokey transaction fee. The BAP stated that the Committee "should have insisted that the bankruptcy court either approve the employment pursuant to those terms or disapprove." *BAP Opinion* at 194.

Furthermore, the BAP agreed with the bankruptcy court that the benefit of Houlihan Lokey's retention would inure only to the benefit of the GUCs represented by the Committee and not to the estate generally. The BAP also recognized that the

Bondholders' Committee retained its owned financial advisors whose completion fee was payable at its own expense and that, as a result, the bondholders would be unfairly forced to contribute to the payment of the transaction fee for the GUCs' advisors if the transaction fee were to come out of general estate funds. In a relatively short decision, the BAP consistently and repeatedly relied upon the fact Houlihan Lokey had duties that flowed exclusively to the Committee, and that the retention of Houlihan Lokey would benefit only GUCs and would not, and could not, provide any benefit whatsoever to the estate.

Also of particular importance to the BAP was the fact that Houlihan Lokey, under terms of the approved retention agreement, was receiving its monthly fee of $150,000, paid by the Debtors from general estate funds. *Id.* The BAP noted that the transaction fee was an additional and contingent fee, based solely on the recoveries of those creditors who directly benefited from the recoveries made, and, implicitly, from the direct efforts of Houlihan Lokey on behalf of its constituency. The BAP found that these factors, as relied upon by the bankruptcy court, were not clearly erroneous and justified the bankruptcy court's decision.[2] On the ultimate issue of determining the "pot of money" out of which the Houlihan Lokey transaction fee should be paid, the *BAP Opinion* cites no cases in support of its decision.

2 The Committee has now filed an appeal with the Eighth Circuit Court of Appeals, which is still pending at the time of preparation of this paper.

Conclusion:
Effect of the *Farmland* decisions on Future Retentions of Investment Bankers and Financial Advisors

In a certain sense, in the short term Houlihan Lokey was not adversely affected by the *Farmland* decisions. Both courts agreed that the transaction fee was an allowed administrative expense and was payable to Houlihan Lokey under applicable statutory standards. Thus, in the strictest of senses, Houlihan Lokey is entitled to its money. The effect of the *Farmland* decisions, if ultimately affirmed by the Eighth Circuit Court of Appeals, however, has interesting implications on future retentions of investment bankers and financial advisors in cases in which there are competing creditor constituencies, and inter-committee litigation and strategy. In those cases, committees may be less willing to retain investment bankers in the first place because the cost may come directly out of their own pockets. Also, in cases with competing creditor constituencies, committees may seek to jointly engage investment bankers so as to limit costs to each in retaining necessary advisory services. Investment bankers ought to think about how best they can accommodate the unusual demands of such an engagement.

Secondary Source Materials Addressing the *Farmland* Issue

Bankruptcy Service Lawyers Edition s 58:359, s 58:359. Employment of professionals; fee and/or expense awards (2004).

Federal Procedure, Lawyers Edition s 9:106, *Court Always Open* (2002).

Compensation of Investment Bankers in Bankruptcy Proceedings: Just or Unjust Enrichment?, 23 Ann. Rev. Banking & Fin. L. 485, 531 (2004).

2004 Bankruptcy Service Current Awareness Alert 8, a Chapter 11 case, Bankruptcy Court can impose a cap on fees on a professional's retention and can require one committee's professional to rely on information gathered by another (2004).

2003 Bankruptcy Service Current Awareness Alert 10, Circuit BAP affirms Bankruptcy Court's decision requiring success fee for financial advisor to unsecured creditors' committee to be taken out of recovery by unsecured creditors (2003).

041504 American Bankruptcy Institute 939, Ethics/Mass Torts/Professional Compensation Committees Part I & II (2004).

020504 American Bankruptcy Institute 503, *Fair Pay for Honest Work: Bankruptcy Compensation and Ethics* (2004).

Powers and Duties of Creditors' Committees: Recent Developments, 862 PLI/Comm 579, 585 (2004).