Chapter VI

Credit Bidding's Impact on Professional Fees

A. Should the Amount of the Credit Bid Be Included as Consideration Upon Which a Professional's Fee Is Calculated?

Debtors often retain the services of professionals such as investment bankers to assist with a sale process. Absent clear contractual language, disputes can develop over the amount of compensation these professionals are entitled to, particularly when credit bids are part of an asset purchase and the professional's compensation is calculated based on the sale price for the debtor's assets. A debtor, or even other creditors, will sometimes seek to limit payments owed in a credit bidding scenario compared to a cash sale because the credit bid means less actual cash to the estate.

On the other hand, an investment banker will seek to have its compensation calculation include the amount of the credit bid because the secured creditor is reducing its secured claim by the amount of its bid, the same as if a third party purchased the debtor's assets and turned over the cash to its secured lender. Courts have tended to accept this view, holding that the presence of a credit bid is irrelevant when calculating compensation to a retained third-party professional because a credit bid is the functional equivalent of the secured creditor contributing cash to the estate and the debtor immediately paying said cash back in satisfaction or partial satisfaction of that creditor's secured claim.

For example, in *In re HNRC Dissolution Company f/d/b/a Horizon Natural Resources Company*,[221] investment banker Miller Buckfire sought $9.35 million in fees, plus reimbursement of approximately $173,000 in expenses, pursuant to a contract with the debtors that was approved by order of

221 *In re HNRC Dissolution Company f/d/b/a Horizon Natural Resources Company,* 340 B.R. 818 (E.D. Ky. 2006).

the bankruptcy court. The approved compensation arrangement included (1) a monthly advisory fee of $150,000; (2) a sale transaction fee based on the aggregate consideration paid for the assets, subject to a fee cap of $8 million; and (3) the reimbursement of Miller Buckfire's actual and necessary expenses. The debtor's assets were sold at auction, and the purchase price included as much as $304 million in cash, a credit bid of $482 million and assumed liabilities of $89 million. Miller Buckfire requested a sale transaction fee for the full $8 million based on the purchase price of the debtor's assets.

Various parties objected to Miller Buckfire's request, and the objections were overruled by the bankruptcy court. The court first cited the applicable standard, stating that once a court approves compensation under § 328 of the Bankruptcy Code, it cannot be altered unless the "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."[222]

The bankruptcy court held that the objections, to the extent that they were based on the inclusion of the credit bid in the aggregate consideration upon which the sale transaction fee was based, were not "unanticipated" and thus failed to meet the standard for altering the terms of the retention agreement. In reaching this conclusion, the court noted that modifications were made to the retention agreement at a hearing during which the issue of credit bidding for the assets was negotiated, agreed to by the parties, and factored into the calculation of the purchase price. Moreover, at a pre-auction meeting among the debtors, creditors and Miller Buckfire, the full amount of the purchasers' price was reported, including the amount of the credit bid. Finally, the bankruptcy court reasoned that the credit bid was the same as if the purchasers had paid that amount in cash, and then immediately reclaimed it through distributions on their secured notes.

222 11 U.S.C. § 328 (2014).

Certain creditors appealed the order of the bankruptcy court, arguing that the credit bid should not have been included in the aggregate purchase price for purposes of the sale transaction fee because (1) the credit bid was not contemplated in the retention agreement as the credit bid had no value, (2) it was not anticipated that such a large portion of the sale transaction fee would be based on the credit bid, and (3) Miller Buckfire would earn a "windfall" if the terms of the retention agreement were enforced.

The district court disagreed with the appellants' arguments and affirmed the decision of the bankruptcy court. The district court first found that the credit bid was properly included as aggregate consideration for the assets because it represented an assumption of liabilities and therefore had value. The district court further found that the bankruptcy court properly determined that the credit bid had value, based on (1) § 363(k) of the Bankruptcy Code, which "treats credit bids as a method of payment — the same as if the secured creditor has paid cash and then immediately reclaimed that cash in payment of the secured debt";[223] (2) the fact that the credit bid was consistently treated as the equivalent of cash; (3) the fact that all parties at the auction agreed to the inclusion of the full amount of the credit bid in calculating the purchase price that the purchasers would pay and that all other bidders would have to exceed, and (4) the fact that the bankruptcy court order approving the sale stated that the consideration provided by the purchasers, which included the credit bid and other assumed liabilities, constituted "fair and reasonable" consideration for the assets.

The district court rejected the appellants' arguments that it was not anticipated that such a large portion of the sale transaction fee would be based on the credit bid or that the sale could not have taken place absent unforeseen concessions by the appellants and other parties. The court noted that even when unforeseeable circumstances are present, the bankruptcy

223 *In re HNRC Dissolution Company f/d/b/a Horizon Natural Resources Company,* 340 B.R. at 824-25.

court is not required to modify a professional's approved fee structure.[224] The district court found that the bankruptcy court properly held that "the credit bid's inclusion in the fee calculation was contemplated, discussed in open court, and a motivating factor in the imposition of a cap."[225] Likewise, the district court found "simply untenable" the appellants' argument that absent unforeseen concessions by them and others, the sale would not have occurred.[226] The court indicated that there was no substance behind this argument, and noted that the appellants provided no evidence that Miller Buckfire failed to fulfill any of its obligations under the retention agreement.

The district court also rejected the appellants' argument that Miller Buckfire would receive a windfall if the terms of the retention agreement were enforced. The court found this argument "hyperbolic and unpersuasive," and "not supported by any stretch of the law or facts."[227] The court concluded that the fee structure was an arm's-length transaction approved by the bankruptcy court, and that there is a "need to protect the professional's expectation of compensation and ensure that the most highly qualified professionals remain willing to participate in the bankruptcy process."[228]

Similarly, in *In re Skuna River Lumber LLC*,[229] Equity Partners, Inc. (EPI), an auction services provider, provided services to a debtor pursuant to an agreed-upon and court-approved fee schedule. The fee schedule included a calculation of EPI's fee in the event of a credit bid. The secured creditors who made a successful credit bid objected to the fee to be paid to EPI on the basis that they received no benefit from the auction sale, and thus should not have to pay the commission.

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224 *Id.* at 826.
225 *Id.* at 827.
226 *Id.*
227 *Id.* at 828.
228 *Id.*
229 *In re Skuna River Lumber LLC,* 352 B.R. 788 (Bankr. D. Miss. 2006), *rev'd. in part, Borrego Springs N.A. v. Skuna River Lumber LLC,* 381 B.R. 211 (N.D. Miss. 2008), *rev'd. in part,* 564 F.3d 353 (5th Cir. 2009).

The court rejected the creditors' claim, pointing out that EPI's performance was "exceptional in stimulating interest" in the assets, which would help the lienholders recover on their liens.[230] The court also noted that the objecting creditor "directly involved itself in the bidding process" by withdrawing its motion for relief from stay to allow the sale process to go forward and was equitably estopped from challenging EPI's compenstion.[231] In addition, the court suggested policy reasons for allowing the fee payment because disallowing "compensation to EPI would significantly discourage professionals such as EPI from attempting to assist debtors and trustees."[232]

HNRC Dissolution Company and *Skuna River Lumber LLC* demonstrate that in most cases, courts recognize that a credit bid has inherent value that is tantamount to cash. In addition, courts will generally enforce the terms of a professional's retention agreement, particularly when such agreement was negotiated at arms' length, on notice to the parties in interest, and approved by the bankruptcy court.

B. Calculation of Trustee Fees Under § 326 in Credit Bidding Situations

In chapter 7 and 11 cases where a distribution is available to creditors, the amount of the fees to be paid to the trustee for his or her work in administering the case is generally governed by two provisions of the Bankruptcy Code, §§ 330 and 326. First, § 330(a) provides that, after notice and a hearing, the court "may" award to the trustee — and to any professional — "reasonable compensation for actual, necessary services rendered by the trustee."[233] Section 330(a) contains a list of items to be considered in

230 *Id.* at 794.
231 *Id.* at 795-96.
232 *Id.* at 796.
233 11 U.S.C. § 330(a)(1)(A) (2014).

determining what is reasonable compensation. Second, § 326(a) of the Bankruptcy Code sets forth a mathematical formula for calculating the maximum fee allowable to a trustee and provides that calculations are limited to "monies distributed."[234] This language has raised the issue of whether a credit bid by a secured creditor may constitute "monies distributed" for purposes of this section. While credit bids by secured creditors used to acquire encumbered property of the estate have generally been considered a form of property distribution, courts have generally held that the plain language of the statute prohibits such amounts from being included in the calculation of the fee allowable to a chapter 7 or 11 trustee.

In the most recent case on this issue, the Ninth Circuit Court of Appeals held that a trustee may collect fees only on those transactions for which it pays interested parties in some form of generally accepted medium of exchange.[235] Noting that the condominium buildings that secured a creditor's claim, and that were turned over to the creditor in connection with a credit bid submitted upon a sale of the condominiums in bankruptcy, were about "as far from a medium of exchange" as it was possible to get, the court concluded that the trustee could not include the amount of the credit bid, along with other "moneys disbursed or turned over" in the case, in calculating the commission to which he was entitled.[236]

In rejecting the trustee's request for a higher fee based on the amount of the secured creditor's credit bid, the Ninth Circuit relied on the plain

234 Section 326(a) of the Bankruptcy Code provides:

> (a) In a case under chapter 7 or 11, the court may allow reasonable compensation under section 330 of this title of the trustee for the trustee's services, payable after the trustee renders such services, not to exceed 25 percent on the first $5,000 or less, 10 percent on any amount in excess of $5,000 but not in excess of $50,000, 5 percent on any amount in excess of $50,000 but not in excess of $1,000,000, and reasonable compensation not to exceed 3 percent of such moneys in excess of $1,000,000, upon all moneys disbursed or turned over in the case by the trustee to parties in interest, excluding the debtor, but including holders of secured claims.

11 U.S.C. § 326 (2014).

235 *Hokulani Square Inc. v. UST (In re Hokulani Square Inc.)*, 776 F.3d 1083 (9th Cir. 2015).

236 *Id.* at 1086.

meaning of the word "moneys," as found in § 326(a).[237] A plain-meaning interpretation of the term, as limiting the trustee to earning a fee only on transactions in which he or she paid a creditor in some generally accepted medium of exchange, would not lead to an absurd result, even though, as pointed out by the trustee, this meant that his compensation could vary dramatically based on whether an auction of estate assets was won by a third party paying funds for any assets so acquired or by the creditor whose claim they secured, by means of a credit bid, even though the trustee might have performed the exact same work in getting the assets ready for sale.[238]

The trustee had argued that, under the plain-meaning interpretation of § 326(a), "[w]hen a third party wins an auction, the money collected counts in calculating the trustee's fee, but if a secured creditor tops the third party's bid by a mere dollar, the trustee gets nothing, even though he does the same work and achieves the same result for the estate."[239] However, according to the Ninth Circuit, while "[t]he distinction drawn by section 326(a) may be harsh and misguided, it is not absurd."[240]

Moreover, the court noted that the "absurdity canon isn't a license for us to disregard statutory text where it conflicts with our policy preferences; instead, it is confined to situations 'where it is quite impossible that Congress could have intended the result ... and where the alleged absurdity is so clear as to be obvious to most anyone.'"[241] Regardless of whether the distinctions drawn by § 326(a) were wise or sensible, they were, according to the court, "at least rational," as Congress may have felt that excluding credit bids from the base used to calculate a trustee's commission might encourage trustees to seek out third-party buyers, and thus get better results for the estate.[242] Congress could rationally have decided that this

237 *Id.*
238 *Id.* at 1088.
239 *Id.*
240 *Id.*
241 *Id.*
242 *Id.*

benefit outweighed any of the problems that the trustee found with the court's plain-meaning construction of the statute.[243]

In further support of its holding, the Ninth Circuit noted that it did not want to create a split in the circuits. According to the court, neither the Fifth Circuit Court of Appeals in *In re England* nor the Third Circuit Court of Appeals in *In re Lan Associates XI L.P.* calculated a trustee's fees using a credit bid.

First, in *In re Lan Associates XI L.P.*,[244] the chapter 7 trustee sold the debtor's real property to the debtor's secured lender in consideration for a credit bid, a carve-out to cover administrative expenses, a distribution to the estate estimated by the trustee to be approximately 25 percent, and a waiver of any deficiency claim.[245] After the court approved the sale, the trustee filed an interim fee application that calculated the trustee's commission by including the credit bid and the court-approved application.[246]

The Office of the U.S. Trustee subsequently filed an objection to the trustee's final report, arguing that the amount of the credit bid had been improperly included in the trustee's commission calculation.[247] After a hearing on the final report, the bankruptcy court concluded that because the secured lender had consented to the arrangement and the unsecured creditors received a benefit from the sale, the trustee was entitled to base his commission on the total purchase price of the asset transferred, including the credit bid.[248] Once again, the U.S. Trustee appealed to the district court, which reversed because, under § 326(a) of the Bankruptcy Code, the value of a credit bid does not constitute "'moneys disbursed or

243 *Id.*
244 *Lan Associates XI L.P. v. Cain (In re Lan Associates XI L.P.)*, 192 F.3d 109 (3d Cir. 1999).
245 *Id.* at 112.
246 *Id.*
247 *Id.* at 113.
248 *Id.* at 113-14.

turned over … to a party in interest,' and cannot be used to calculate the maximum allowable amount of trustee compensation."[249]

The trustee subsequently appealed to the Third Circuit Court of Appeals, which noted that, under § 326(a) of the Bankruptcy Code, compensation is awarded "upon all moneys disbursed or turned over in the case by the trustee to parties in interest, excluding the debtor, but including holders of secured claims."[250] Because the court found the term "monies" in § 326(a) to be ambiguous, it undertook a review of the legislative history, which suggested that a commission should not be based on a situation where the trustee either turns over or abandons property to the secured creditor and the secured creditor is permitted to foreclose.[251] Moreover, the court emphasized that although the trustee presumably participated in negotiating the credit bid sale, the trustee did not actually disburse anything to the secured creditor other than the property.[252] The court found that the credit bid sale more closely resembled an abandonment or turnover to the secured creditor than a sale to a third party.[253] As such, the Third Circuit held that Congress did not intend to include credit bids in the trustee's compensation base.[254]

Similarly, in *In re England*, the Fifth Circuit Court of Appeals held that § 326(a) does not allow a trustee to collect on the value of property given to creditors in exchange for a reduction in the amount they are owed.[255] The court reasoned that "[t]he plain language of § 326(a) indicates that

249 *Id.* at 114.
250 *Id.* at 115 (citing 11 U.S.C. § 362(a) (2014)).
251 *Id.* at 116 (citing H.R. Rep. No. 95-595 at 327 (1978)).
252 *Id.* at 117-18.
253 *Id.* at 117.
254 *Id.* at 118. *See also Pink Cadillac Assocs. v. Messer (In re Pink Cadillac Assocs.)*, No. 96CIV 4571 (LLS), 1997 WL 164282, at* 1, 3-4 (S.D.N.Y. Apr. 8, 1997), wherein the District Court for the Southern District of New York reversed the bankruptcy court by concluding that the amount of the credit bid did not constitute "monies disbursed" under § 326(a).
255 *England v. United States Trustee (In re England)*, 153 F.3d 232, 235 (5th Cir. 1998).

the statute caps a trustee's compensation based upon only the moneys disbursed, without any allowance for the property disbursed."[256]

256 *Id.*