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Editorial Office
230 Park Ave., 7th Floor, New York, NY 10169 (800) 543-6862
www.lexisnexis.com

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U.S. Bankruptcy Fee Flip: Legal Expenses for Unsecured Creditors; Considerations for Lenders and Administrative Agents

By David A. K. Linley, Joaquin M. C de Baca, and Youmi Kim*

Lenders and agents should be aware of the restrictions on the direct payment of legal fees following the commencement of a bankruptcy proceeding. For unsecured creditors, there is the further risk that post-petition legal fees might not be allowed as an unsecured claim against the estate, even if there is a valid and enforceable pre-petition indemnification in the credit facility. In this article, the authors explore the issue and advise lenders and agents to evaluate new and ongoing loan files with fee restrictions in mind.

Pacific Gas and Electric Company's Chapter 11 filing earlier this year has highlighted an issue that is well settled but sometimes overlooked: Unsecured creditors generally have no right to receive immediate payment of their legal fees from a bankrupt borrower, regardless of any contractual rights they might otherwise have absent the bankruptcy. Further complicating this issue, courts are divided as to whether legal fees incurred post-petition are eligible to be allowed as valid unsecured claims (and therefore eligible to share in any estate property that will be available to satisfy unsecured claims).

Administrative agents should keep these issues in mind in respect of distressed unsecured facilities, including considering how and when to protect and enforce their indemnification rights.

CREDITORS' RIGHTS TO PAYMENT OF LEGAL EXPENSES

Under most standard credit agreements,[1] borrowers are required to pay the legal expenses of the lenders. The model credit agreement published by the

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* David A. K. Linley is counsel in the Banking & Finance practice at Mayer Brown, concentrating his practice in finance transactions, including ABL and leveraged finance, securitization and structured finance, and specialty capital markets transactions. Joaquin M. C de Baca is a Restructuring, Bankruptcy & Insolvency partner at the firm handling transactional and litigation work in the context of in-court and out-of-court workout and reorganization proceedings. Youmi Kim is an associate at the firm and a member of the Restructuring, Bankruptcy & Insolvency practice. The authors may be reached at dlinley@mayerbrown.com, jcdebaca@mayerbrown.com, and ykim@mayerbrown.com, respectively.

[1] Some structured credits, repurchase agreements and other forms of borrowing may not have such a requirement.

Loan Sales and Trading Association ("LSTA") contains a typical formulation:

> The Borrower shall pay (i) all reasonable out-of-pocket expenses incurred by the Administrative Agent and its Affiliates (including the reasonable fees, charges and disbursements of counsel for the Administrative Agent) . . . in connection with the syndication of the Facilities, the preparation, negotiation, execution, delivery and administration of this Agreement and the other Loan Documents, or any amendments, modifications or waivers of the provisions hereof or thereof (whether or not the transactions contemplated hereby or thereby shall be consummated), (ii) all reasonable out-of-pocket expenses incurred by any Issuing Bank in connection with the issuance, amendment, extension, reinstatement or renewal of any Letter of Credit or any demand for payment thereunder, and (iii) all out-of-pocket expenses incurred by the Administrative Agent, any Lender or any Issuing Bank (including the fees, charges and disbursements of any counsel for the Administrative Agent, any Lender or any Issuing Bank) . . . in connection with the enforcement or protection of its rights (A) in connection with this Agreement and the other Loan Documents, including its rights under this Section, or (B) in connection with the Loans made or Letters of Credit issued hereunder, *including all such out-of-pocket expenses incurred during any workout, restructuring or negotiations in respect of such Loans or Letters of Credit* [emphasis added].[2]

Particular language will vary across credit agreements, and in syndicated facilities legal fees are typically payable if incurred by the agent on behalf of the lenders, rather than the borrower paying the legal expenses of each separate lender. Lenders may of course retain their own counsel in relation to a syndicated facility, and might wish to do so if they require additional advice, if they are otherwise entitled to be reimbursed by the borrower, or if they believe that their interests might not align with those of the others in the lender group.

However, lenders will commonly forgo retaining separate counsel and instead rely on the agent and the agent's counsel to advance the interests of the lender group. If legal expenses are incurred by the agent in connection with the administration of the facility, lenders would generally expect the borrower to pay directly such expenses. This expectation is important to bear in mind, because most credit agreements also contain a *pari passu* indemnification of agent expenses by the lenders. Again, a typical formulation can be found in the

[2] *See* www.lsta.org.

model credit agreement published by the LSTA as follows:

> To the extent that the Borrower for any reason fails to indefeasibly pay any [amounts, including legal expenses, as required by the credit agreement], each Lender severally agrees to pay to the Administrative Agent . . . such Lender's pro rata share (determined as of the time that the applicable unreimbursed expense or indemnity payment is sought based on each Lender's Applicable Percentage at such time) of such unpaid amount (including any such unpaid amount in respect of a claim asserted by such Lender) . . .

In practice, this indemnification is seldom called upon because borrowers pay the agent's counsel's fees and expenses directly. Upon the filing of a bankruptcy petition, however, this process becomes prohibited.

SECURED CREDITORS' RIGHTS

Upon a filing of a bankruptcy petition,[3] a wide variety of actions and claims are automatically stayed,[4] and the debtor is generally barred from making post-petition payments on non-essential obligations such as lender fees and expenses.

However, if secured lenders are over-secured, then such lenders may be able to receive direct periodic payment of post-petition legal fees as "adequate protection" for the debtor's use of lender collateral[5] or as part of the lender's secured claim.[6]

Most commonly, debtors will request access to cash collateral in order to facilitate operations and/or effectuate their restructuring goals in exchange for a package of protections against the diminution in value of such collateral, and secured creditors will require the periodic payment of legal expenses.[7] If approved by the court, the net effect to secured lenders is that the debtor remains obligated, post-petition, to pay the lenders' legal expenses, subject to the terms of the original contractual arrangement between the lenders and the debtor and the Bankruptcy Code's requirements as to the reasonableness of allowed expenses.

Additionally, outside of the adequate protection regime, it is also possible to

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[3] 11 U.S.C. § 101 *et seq.*

[4] 11 U.S.C. § 362(a).

[5] 11 U.S.C. § 361.

[6] 11 U.S.C. § 506(b).

[7] 11 U.S.C. § 361(1).

have certain attorneys' fees paid by the debtor if such fees can be justified as qualified administrative expenses.[8] These administrative expenses would be paid under the plan of reorganization on a preferential basis over general unsecured claims.[9]

UNSECURED CREDITORS' (LACK OF) RIGHTS

Lenders will commonly adopt the payment and indemnification rights described above, regardless of whether the relevant facility is secured or unsecured. Unsecured lenders are therefore accustomed to legal expenses being paid directly by the borrower.

However, when a borrower files a bankruptcy petition, the resulting automatic stay prevents both the payment of lender legal fees and all related payment demands, to the extent such demands do not conform with the bankruptcy claims submission/resolution and plan of reorganization process.[10] As such, even if the borrower were willing to pay the legal expenses of its unsecured lenders, it could not do so (and legal expenses paid pre-petition can, in certain circumstances, even be clawed back).[11]

Unsecured post-petition claims for legal expenses also typically will not qualify to be allowed as administrative expense claims against the debtor, unless lenders can somehow show that the underlying expenses relate to services which provided a "substantial contribution" to the bankruptcy estate.[12]

Notably, courts are currently divided as to whether unsecured claims for post-petition attorneys' fees arising from an otherwise enforceable pre-petition contract can form the basis for an allowable unsecured claim (to be paid pro rata at the same rate as all other similar unsecured claims). Specifically, certain federal courts of appeals, including courts in the Second, Fourth, and Ninth Circuits,[13] have held that such claims are allowable, while certain bankruptcy and district courts in other circuits, including the First, Fifth, Tenth, and

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[8] 11 U.S.C § 503(b). Note that under § 361(3), compensation allowable under § 503(b)(1) is not permitted as a form of "other relief" granted as adequate protection.

[9] 11 U.S.C. § 507(a).

[10] 11 U.S.C. §§ 362, 541.

[11] 11 U.S.C. §§ 547(b), 548(a).

[12] 11 U.S.C. § 503(b)(3)(D).

[13] *See, e.g.*, *Summitbridge Nat'l Invs. III, LLC v. Faison*, 915 F.3d 288 (4th Cir. 2019); *Ogle v. Fid. & Deposit Co. of Maryland*, 586 F.3d 143 (2d Cir. 2009); *SNTL Corp. v. Centre Ins. Co. (In re SNTL Corp.)*, 571 F.3d 826 (9th Cir. 2009).

Eleventh Circuits, have challenged or denied such claims.[14]

CONSIDERATIONS FOR ADMINISTRATIVE AGENTS

Entitlement to payment of expenses can be an important factor in a lender's strategy for dealing with exposure to a distressed debtor. Unsecured lenders, knowing that they cannot collect post-petition interest, might wish to avoid incurring similarly unrecoverable legal expenses and elect instead to sell their debt. Indeed, there is an active market for sub-par purchases of debt, where the discount reflects the investor's estimation of the likely recovery and the time that might be needed to get there.

In a syndicated facility, such a sale generally would take effect as an assignment and the credit agreement will set out the documentation and consents needed for such an assignment.

Even if borrower consent is not generally required post-petition, consent from the administrative agent generally is required. Before rubber-stamping such an assignment, agents should consider the question of legal expenses.

As noted above, the credit agreement usually would have an indemnification of the agent by the lenders, covering the legal expenses of the agent in its capacity as such. However, legal fees can accrue rapidly in complex cases and are often billed in arrears. At any point in the month, an agent's counsel may have thousands of dollars of unbilled legal fees that are payable by its client, i.e., the agent, and one or more invoices still being processed. The agent, in turn, is protected by the above-described indemnity from the lenders. If all of the lenders are regulated banks, such an indemnity should not be a source of concern for the agent.

However, if a lender makes an assignment, the agent might wish to pause and reevaluate, among other things, the levels of unbilled or unpaid legal expenses that are payable by the assignor lender and whether that lender should be required to make payment on such expense before its assignment is approved. The agent might also want to consider whether the assignee is a credit-worthy entity for ongoing fee indemnity purposes, including careful examination of special purpose entities which might not have assets available for fee reimbursements and/or offshore entities where suits for recovery would be burdensome and expensive.

Of course, if an agent perceives it has a risk of bearing legal expenses without

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[14] *See, e.g.*, *In re Augé,* 559 B.R. 223 (Bankr. D.N.M. 2016); *In re Old Colony, LLC*, 476 B.R. 1 (D. Mass. 2012); *In re Seda France, Inc.*, 2011 Bankr. LEXIS 2874 (Bankr. W.D. Tex. July 22, 2011); *In re Elec. Mach. Enters., Inc.*, 371 B.R. 549 (Bankr. M.D. Fl. 2007).

reimbursement from lenders, that agent could seek to decline to act or to resign. Both avenues may cause problems. Declining to act inevitably raises the risk of liability claims. And, even if the agent has solid defenses based on exculpatory language in the credit agreement and counterclaims for lenders' non-payment of legal expenses, the agent would incur further legal expenses and would consume management time in defending and seeking dismissal of such claims. Resigning presumes that a successor can be found, which is by no means certain, especially if the outgoing agent is resigning because of unpaid (or uncertain) indemnification. To address this concern, some credit agreements, including the model published by the LSTA, contain provisions that allow the administrative agent to effectively resign, even if no successor is yet appointed.

However, such a provision is protective of the agent and does not solve the dysfunction that would arise if no lender or other qualified entity were willing to step forward as agent. Inevitably, one or more lenders might have to accept the agent role if only to maintain the prospect of a recovery and related bankruptcy distributions.

Lenders wishing to avoid these types of entanglements might be more highly incented to assign their debt, with the consequences noted above.

CONCLUSION

Lenders and agents should be aware of the restrictions on the direct payment of legal fees following the commencement of a bankruptcy proceeding. For unsecured creditors, there is the further risk that post-petition legal fees might not be allowed as an unsecured claim against the estate, even if there is a valid and enforceable pre-petition indemnification in the credit facility.

The differing treatment by courts in different circuits has the potential to affect lender and agent strategies, and the interests of agents and lenders might not align in all circumstances.

In all cases, lenders and agents should evaluate new and ongoing loan files with these fee restrictions in mind.