# Benchnotes

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## "Blackstone Protocol," Transaction Fees and Materiality Explained

In a recent opinion from *In re Relativity Fashion LLC*,[1] Hon. **Michael E. Wiles** addressed concerns over investment bankers' fees and the so-called "Blackstone protocol." In this case, the debtors hired two investment banker firms (Houlihan Lokey Capital Inc. and PJT Partners LP, formerly known as Blackstone Advisory Partners LP) to help locate buyers or new capital investors. As is typical for such retentions, both PJT and Houlihan sought approval under § 328(a) of the Bankruptcy Code for their retention agreements, which offered services in exchange for monthly flat fees and expense reimbursements, with a transaction fee to be paid upon consummation of a transaction. The two agreements also provided that the transaction fee would be payable if the professional provided "material" support toward the consummation of a transaction.

The court approved both applications under § 328(a) early in the case, but pursuant to the so-called Blackstone protocol. Under that protocol, which has become common in New York and other jurisdictions, the U.S. Trustee agreed not to challenge the § 328(a) approval, provided that the U.S. Trustee (and no other party) would be allowed to object to reasonableness under § 330(a) at the end of the engagement — as if the court's approval under § 328(a) did not preclude the U.S. Trustee. The court noted that while this practice has become commonplace, it is based on somewhat complicated logic.

Before turning to the merits of the objection, the court pointed out the distinctions between the standards of §§ 328 and 330 of the Bankruptcy Code. Quoting *In re National Gypsum Co.*,[2] the court explained that § 328(a) "reflects the view that professionals are entitled to know what they are likely to be paid for their work." Similarly, the court explained the distinctions between a typical investment banker's "transactional fee" and what other professionals sometimes refer to as a "success fee" or bonus. The court made it clear that the transaction fees requested by Houlihan and PJT in this case were not bonuses or contingencies. Thus, the court declined to apply the standards generally applicable to "success fees" paid to chief restructuring officers and other professionals.[3]

Next, the court discussed the Blackstone protocol as applied to the facts of this case. Here, the U.S. Trustee did not object to the final fee applications; a fee examiner and some other parties filed objections. While the fee examiner was appointed at the U.S. Trustee's request, the court made clear that the examiner served in his own capacity, not as an extension of the U.S. Trustee. For this reason, the court concluded that the fee examiner (and the other objecting parties in this case) lacked standing under the protocol to raise after-the-fact objections to the "reasonableness" of the bankers' fees.

Finally, the court rejected the notion that the investment bankers failed to provide "material" support in order to earn their transaction fees. Under the objecting parties' definition of "material," the investment bankers would have had to be the primary — if not sole — contact for every aspect of every deal point in the negotiations. However, reading the dictionary definition of the word and applying common sense, the court found that the word "did not require that PJT's services infuse every corner of the deal, or that PJT be the sole or even primary driving force in achieving what happened, or even that PJT's work be the most important factor in what happened. It merely required that PJT's services be important." Finding that PJT's work served as the foundation for all subsequent negotiations, the court concluded that PJT's services were material within the meaning of the word, as used in PJT's retention agreement.

## Court Rejects Critical-Vendor Payments, Citing *Jevic* Decision

In *In re Pioneer Health Services*,[4] the debtor asked the court to treat two of its physician employees as "critical vendors" and authorize payment of their pre-petition claims in full. Hon. Neil P. Olack noted that a small part of the claims would be entitled to priority under § 507(a)(4), and that the unpaid amounts could arguably be paid as cures upon the assumption of the employment agreements under § 365(b). Nevertheless, because the debtors chose to treat these employees as critical vendors, the court considered the request under the standards typically applied to critical-vendor payments.[5]

In analyzing the request, the court began by citing the U.S. Supreme Court's recent decision in *Jevic* for the proposition that "*CoServ*'s and *Kmart*'s restrictive view of critical-vendor payments is the

1 2016 Bankr. LEXIS 4339, 2016 WL 8607005 (Bankr. S.D.N.Y. Dec. 16, 2016).
2 123 F.3d 861, 862 (5th Cir. 1997).
3 *See, e.g., In re Residential Capital LLC*, 504 B.R. 358 (Bankr. S.D.N.Y. 2014).
4 2017 Bankr. LEXIS 939 (Bankr. S.D. Miss. April 4, 2017)
5 *See, e.g., In re CoServ LLC*, 273 B.R. 487 (Bankr. N.D. Tex. 2002); *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004); *but see In re Mirant Corp.*, 296 B.R. 427, 429 (Bankr. N.D. Tex. 2003) (concluding that debtors demonstrated grounds to authorize critical-vendor payments under *CoServ* standard previously espoused).

correct approach." However, while few courts applying the *CoServ* and *Mirant* critical-vendor standards in recent years have found the burdens to be insurmountable, the court in this case held that the debtors failed to carry their burden.

First, the debtors failed to present any testimony about the employees' education, skills, training or licensing to support the debtors' argument that the employees were "irreplaceable." Second, the court found no evidence that the employees really would leave if they were not paid, rejecting the debtors' preference to "avoid risk" that the employees might actually quit if not paid. Third, the court noted that the employees might actually be violating the automatic stay by demanding payment on their pre-petition claims, and explained that the debtors' willingness to yield to the employees' demands was not an exercise of sound business judgment. Finally, the court expressed concerns that approval of payment to these two employees — 10 months into the bankruptcy case — would "open a floodgate" of additional demands from the debtors' other 240 employees. For all of these reasons, the court denied the motion to pay the employees' pre-petition salaries as critical-vendor payments.

## Miscellaneous

• *WD Equipment LLC v. Cowen (In re Cowen)*, 849 F.3d 943 (10th Cir. 2017) (defendant's passive refusal to return debtor's trucks that had been repossessed pre-petition was not an affirmative "act" that violated the automatic stay under § 362(a)(3) because the passive retention of the debtor's property, without more, was not an "act" to obtain possession or exercise control over the debtor's property; defendant was not absolved of liability because the court of appeals remanded to district court to determine whether post-petition falsification of title documents and potential perjury warranted sanctions under § 105(a));

• *Lunsford v. Techs. Servs. LLC (In re Lunsford)*, 848 F.3d 963 (11th Cir. 2017) (court of appeals affirmed judgment of nondischargeability against the debtor under § 523(a)(19), concluding that (1) state court's judgment clearly supported finding that debtor's judgment debt was incurred based on state securities violations; and (2) debt could be nondischargeable even without specific finding that debtor committed the securities violation; use of "debt for" language in § 523(a)(19) demonstrated congressional intent not to limit nondischargeability actions to debtor's violations, but to third-parties' securities violations as well); and

• *Wiggains v. Reed (In re Wiggains)*, 848 F.3d 655 (5th Cir. 2017) (chapter 7 trustee sold debtor's homestead for $3.4 million, resulting in $550,000 in net proceeds; after paying debtor's capped exemption under § 522(p), nonfiling spouse sought remaining proceeds as her separate property based on pre-petition partition agreement with debtor, which had been recorded one hour before bankruptcy filing; court of appeals (1) affirmed avoidance of partition agreement as fraudulent transfer, (2) held that nonfiling spouse had no economic interest in homestead and (3) agreed that spouse failed to carry her burden under § 363(j) to obtain compensation from homestead sale proceeds). abi

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