AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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Trustee Talk

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Carve-Outs: The Unexpected Costs of Turning Nothing into Something

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An asset that is fully encumbered by secured interests will have no value to the estate if liquidated, as all proceeds would be paid to the secured creditors with interests in the asset in the order of their priority.[1] Thus, when presented with a fully encumbered asset, a trustee typically has little recourse but to abandon the asset pursuant to § 554(a) of the Bankruptcy Code.[2] Upon abandonment, the secured creditors will be free to pursue their rights with respect to the asset, and the estate will not realize any recovery from the asset.

For the Secured Creditor: A Viable Alternative Route to Recovery?

At first blush, a bankruptcy filing might seem like a disruption or inconvenience for a secured creditor seeking to foreclose its collateral, as the creditor will have to overcome the automatic stay and potentially wait out the trustee's investigation of the asset's value before resuming its enforcement and recovery efforts. Nonetheless, for a number of reasons, a secured creditor might see a debtor's bankruptcy filing as an occasion for a more expeditious recovery. For example, with real property, bankruptcy could present an opportunity for a lienholder to circumvent the often long and tedious foreclosure process, thereby reducing future tax liabilities, maintenance costs and legal fees, as well as minimizing the risk that the property's value could diminish over time. In addition, the unique aspects of a bankruptcy sale, including the potential for property to be sold free and clear of any interests pursuant to § 363(f), can provide buyers with increased security in taking title compared to a foreclosure sale, thus enhancing the marketability and value of the property.

Recovering or liquidating collateral might also require litigation, such as suing for outstanding receivables or for turnover, and a secured creditor might see some benefit from the trustee assuming the costs and risks of such efforts. Of further possible appeal to the creditor, the chore of dealing with a recalcitrant debtor that might attempt to obstruct the process, and add time and expense to the creditor, can be reallocated to the trustee and his/her professionals who will undertake the necessary "dirty work" to liquidate or recover the asset. Finally, a trustee, through his/her broad investigative powers (including under Bankruptcy Rule 2004), might be in a better position than the creditor to uncover concealed assets subject to the creditor's lien.

With the foregoing benefits in mind, a secured creditor could approach a trustee to facilitate a sale or pursue recovery of the creditor's fully encumbered collateral through the bankruptcy as an alternative to the creditor enforcing its interest through normal channels. In order to provide recovery to the estate and to incentivize the trustee to assume the costs of administering the asset, the secured creditor will need to provide the estate with a carve-out from the creditor's interest in the recovery from the asset. If agreed, a carve-out could greatly hasten the creditor's recovery while effectively providing the estate with something from nothing.[3]

For the Trustees: Too Good to Be True?

Carve-outs are enticing to a trustee because they essentially create an opportunity to pro-

1 Chapter 7 trustees are instructed that "when the property is fully encumbered and of nominal value to the estate, the trustee must immediately abandon the asset." *Handbook for Chapter 7 Trustees* (2012) at pp. 4-7, *available at* justice.gov/ust/file/handbook_for_chapter_7_trustees.pdf/download (last visited on Sept. 17, 2018).

2 11 U.S.C. § 554(a) provides, "After notice and a hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate." *See also In re Feinstein Family P'ship*, 247 B.R. 502, 507 (Bankr. M.D. Fla. 2000) ("It is now almost universally recognized that where the estate has no equity in a property, abandonment is virtually always appropriate because no unsecured creditor could benefit from the administration.").

3 For a good summary of the potential mutual benefits of a carve-out arrangement, *see In re Feinstein Family P'ship*, 247 B.R. at 507.

vide the estate with something from nothing, not to mention a chance to generate a commission under § 326(a).[4] However, in agreeing to liquidate property through a bankruptcy in exchange for a carve-out, a trustee could end up assuming a costlier endeavor than what was originally anticipated, with the carve-out ultimately proving to be insufficient to cover the expenses incurred by the trustee and his/her professionals.

While a sale of an asset might seem relatively straightforward at first, effectuating the sale might necessitate unforeseen litigation, for example. A title report might uncover interests in the asset that were not previously disclosed or known to the secured creditor or trustee, and the trustee could wind up mired in litigation to address title issues or lien-validity or priority issues. There might be additional costs in the trustee having to secure the property, which can grow if disposing of the asset takes longer than expected. The trustee might also have to address unexpected opposition, or perhaps deal with a buyer that develops cold feet. The secured creditor might also add unpredicted costs if it seeks to micromanage the situation.

The greatest unforeseen expenses that a trustee could encounter can result from efforts to overcome an obstreperous debtor or third parties bent on impeding the trustee's administration of the asset. The amount of work that a trustee and his/her professionals could face in such a situation could increase dramatically from what could have been initially anticipated. If the trustee is not careful to procure a carve-out that will likely sufficiently cover both anticipated and a certain amount of unanticipated professional costs, the trustee's efforts to administer the asset could quickly become an administrative quagmire in which professionals could end up expending more in fees and costs than they will earn. In addition, if administrative fees are inordinately high compared to the ultimate value that the estate will receive from a carve-out agreement, professionals may have their fees scaled back or denied altogether.[5]

Legality of Carve-Outs

Notwithstanding the surcharge provision of § 506(c),[6] the Bankruptcy Code "establishes that a secured creditor's collateral may only be diminished to the extent that the secured creditor waives its right to the protections afforded by the Code, or to the extent that the expense priority directly confers a benefit on the secured creditor."[7] In effect, "a secured creditor may consent to permit its collateral to be surcharged and paid to an administrative claimant."[8] Secured creditors can also limit carve-outs to specific administrative claims, such as professional's fees.[9]

While carve-out agreements are legally permissible, the *U.S. Trustee Handbook* requires that carve-outs "result in a meaningful distribution to unsecured creditors."[10] Most notably, the Ninth Circuit Bankruptcy Appellate Panel has inferred a "rebuttable presumption of impropriety" that a trustee must overcome when entering into carve-out agreements, and focused the inquiry on whether "the trustee fulfilled his or her basic duties? Is there a benefit to the estate (*i.e.*, prospects for a meaningful distribution to unsecured creditors)? Have the terms of the carve-out agreement been fully disclosed to the bankruptcy court?"[11] A court might deem a carve-out agreement to be presumptively improper if it would merely benefit administrative professionals and would not produce some benefit to unsecured creditors.[12]

> **[I]n taking a page from *In re Jevic*, courts have held that a carve-out agreement cannot alter the priorities of distribution or prejudice junior lienholders.**

An application for professional fees related to work on liquidating an asset subject to a carve-out agreement might be denied if the fees are exorbitant and the ultimate benefit to unsecured creditors is minimal.[13] Thus, in order to demonstrate that a carve-out agreement will produce a meaningful distribution to the estate, it will need to produce sufficient proceeds to first compensate the trustee's commissions and administrative expenses.[14] In addition, in taking a page from *In re Jevic*, courts have held that a carve-out agreement cannot alter the priorities of distribution or prejudice junior lienholders.[15]

Tips

In negotiating a carve-out agreement, a trustee should be mindful of the known and unknown risks that he/she could face in administering an asset, and aim to ensure that there will be a "meaningful recovery" for unsecured creditors. The

4 Pursuant to 11 U.S.C. § 506(c), "The trustee may recover from property securing an allowed secured claim, the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim." A trustee could attempt to sell a fully encumbered asset and seek to surcharge the secured creditor. A secured creditor with a fully secured or undersecured lien that is intent on pursuing its rights in the collateral outside of the bankruptcy will likely object to any effort by the trustee to liquidate the asset, thereby undercutting any possibility that the trustee could one day recover under § 506(c).

5 *In re Blackwood Assocs. LP*, 153 F.3d 61, 68 (2d Cir. 1998).

6 *In re Nuclear Imaging Sys.*, 270 B.R. 365, 371 (Bankr. E.D. Pa. Dec. 31, 2001). *See also In re Robotic Vision Sys.*, 367 B.R. 232, 237 at fn.23 (1st Cir. 2007) ("[A] 'carve-out agreement' is generally understood to be an 'agreement by a party secured by all or some of the assets of the estate to allow some portion of its lien proceeds to be paid to others, *i.e.*, to carve-out its lien position.' ... 'The carve-out is intended to guarantee that a lien or super-priority will not reach certain funds, usually up to a maximum dollar amount, in order that professional fees can be paid ... justification for the carve-out has rested upon a general appeal to the needs of the bankruptcy system, not upon the Bankruptcy Code.'" (internal citations omitted)).

7 *See, e.g., id.* at 372-73 ("[I]f the holder of a secured claim expressly consents to the payment of a specific administrative claim from its collateral, then the secured creditor's consent [might] be enforceable to ensure payment of the claim of the administrative claimant from the collateral."); *In re Rite Indus.*, 2000 Bankr. Lexis 2116 (Bankr. M.D.N.C. Aug. 16, 2000) (carve-out limited to professional fees was negotiated, bargained for and approved in final order entered after hearing); *In re Blackwood Assocs. LP*, 153 F.3d at 67 ("We first note that it is undisputed that so-called 'counsel fee carve-outs' are a normal and enforceable provision in cash-collateral orders."); *In re IBI Sec. Serv.*, 133 F.3d 205, 208 at fn.4 (2d Cir. 1997) ("A 'carve-out' is an agreement by a creditor holding a secured or super-priority claim to earmark funds for the payment of estate professionals whose claims would ordinarily be of a lower priority."); *In re US Flow Corp.*, 332 B.R. 792, 794 (Bankr. W.D. Mich. 2005) (quoting Craig B. Cooper, "The Priority of Post-Petition Retainers, Carve-Outs, and Interim Compensation Under the Bankruptcy Code," 15 *Cardozo L. Rev.* 2337 2346 (1994) ("A carve-out is 'an agreed-upon term in a cash-collateral stipulation where a specific amount of the cash collateral, either in existence or to be generated, is earmarked for the payment of counsel fees and disbursements....'")).

8 *Handbook for Chapter 7 Trustees* at pp. 4-14.

9 *In re KVN Corp. Inc.*, 514 B.R. 1, 7-8 (B.A.P. 9th Cir. 2014).

10 *In re All Island Truck Leasing Corp.*, 546 B.R. 522, 533 (Bankr. E.D.N.Y. 2016); *see also In re Scoggins*, 517 B.R. 206, 222 (Bankr. E.D. Cal. 2014) (noting that *U.S. Trustee Handbook* states that "trustee shall not administer ... an estate or an asset in an estate where the proceeds of liquidation will primarily benefit the trustee or the professionals").

11 *See In re Bird*, 577 B.R. 365 (B.A.P. 10th Cir. 2017) (finding that nearly $120,000 in administrative fees related to administering asset under carve-out agreement for $10,000 were not "reasonably likely to benefit the estate" such as to be compensable).

12 *See In re Jones*, 548 B.R. 658, 661 (Bankr. W.D.N.Y. 2016).

13 *See In re Christensen*, 561 B.R. 195, 210 and 214 (Bankr. D. Utah 2016).

14 A secured creditor could require a cap on the trustee's commissions, payable either through the carve-out or from the gross proceeds of a sale, as part of the carve-out agreement.

15 *See In re Bird*, 577 B.R. 365.

following points are some items for a trustee to keep in mind when considering a carve-out arrangement:

- *From experience, a trustee likely has a decent to good idea of how much work will be required to administer an asset under the circumstances of the case.* A trustee should draw upon past experience when negotiating a carve-out agreement, and seek to provide an economic cushion for the unknown difficulties that may arise.
- *With the preceding point in mind, a trustee should also consider the likely return for the asset in question.* If it is believed that the asset is likely to yield a significant recovery, having the carve-out be a percentage of the recovery that is sufficient to cover the anticipated costs and then some, while also providing a meaningful return for unsecured creditors, might be wise. However, if the asset's value or the costs of administering the asset are uncertain, it might be more prudent for the carve-out to provide a guaranteed minimum amount of recovery for the estate, including specifically for professional fees. Further kicker provisions, such as for percentages above the minimum, depending on the amount of recovery, may also be negotiated.
- *Ideally, the trustee should request that his/her commission under § 326(a) be paid not from the carve-out, but from the gross proceeds of the sale.* While the secured creditor might be hesitant to concede such a cost, it should be viewed as incentivizing the trustee to seek out the best deal for the asset, since doing so will be to the trustee's benefit while potentially increasing the recovery for the secured creditor. If a trustee's commission is limited by a carve-out, then a trustee might be more interested in getting the quickest result rather than the best. Similarly, any commissions earned by a broker or auctioneer should ideally be paid from the gross proceeds rather than the carve-out.
- *A trustee should get a clear understanding from the secured creditor at the outset with respect to its expectations for recovery, as well as for how involved it wants to be in the process.* A secured creditor's active participation can often be helpful for the trustee and can reduce costs,[16] but it can also be an impediment and raise costs if too many demands or restrictions are placed on the trustee. In addition, a trustee will not want to proceed with a sale that would not be palatable to the secured creditor.
- *Before entering into the carve-out agreement, the trustee should do as much due diligence as possible with respect to the asset.* It is advisable to obtain title reports so that the trustee is aware of any issues or parties that might have to be addressed, and the potential attendant costs. While title reports can be costly, the gained knowledge can inform the carve-out negotiation or save eventual costs by either planning for or avoiding surprises. Obtaining a valuation for the property is also advisable, as doing so can also help direct the carve-out negotiations.
- *The trustee should have a plan for how to deal with the asset and an idea of how long it could take to execute the plan, including any time-related costs that might be needed in order to preserve the asset, such as rent or insurance.*
- *Professionals should be apprised and accepting of the inherent murkiness of the situation at the outset, and the prospects that they might have to scale back their fees if they are inordinate with the recovery in order to ensure a meaningful recovery to unsecured creditors.*
- *Lastly, in order to best survive judicial scrutiny, the carve-out should provide a guaranteed amount of recovery for unsecured creditors.* abi

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16 For example, a creditor might already have buyers or mechanisms lined up for sale, but needs the trustee to steward the sale through § 363. The creditor could also have a strong familiarity with the asset, the debtor or the relevant industry, and can advise on how best to proceed.