UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF GEORGIA
NEWNAN DIVISION

In re	)	**Chapter 11**
	)	
DAN RIVER INC., *et al.*	)	**Case Nos. 04-10990 through 04-10993**
	)	**Jointly Administered**
	)	
Debtors.	)	**Judge Drake**
	)	

DEBTORS' OBJECTION TO APPLICATION PURSUANT TO BANKRUPTCY RULE 2014(a) FOR AN ORDER UNDER SECTIONS 328(a) AND 1103(a) OF THE BANKRUPTCY CODE AUTHORIZING THE EMPLOYMENT AND RETENTION OF HOULIHAN LOKEY HOWARD & ZUKIN CAPITAL AS FINANCIAL ADVISOR FOR THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS NUNC PRO TUNC TO APRIL 19, 2004

Dan River Inc. and its debtor affiliates (the "Debtors") object to the Application Pursuant to Bankruptcy Rule 2014(a) for an Order Under Sections 328(a) and 1103(a) of the Bankruptcy Code Authorizing the Employment and Retention of Houlihan Lokey Howard & Zukin Capital ("Houlihan") as Financial Advisor for the Official Committee of Unsecured Creditors (the "Committee") *Nunc Pro Tunc* to April 19, 2004 (the "Houlihan Application").

SUMMARY OF ARGUMENT

The Houlihan Application contains three fatal flaws. First, it is impossible to tell whether Houlihan's proposed "success fee" is reasonable because the criteria for success and the amount of the fee are left entirely to the discretion of the Committee at some undetermined point in the future. Moreover, the Committee and Houlihan have attempted to insulate their future agreement from judicial review by cloaking it with the strict "improvident" standard of review of

Bankruptcy Code Section 328(a). This effectively displaces the Court as the arbiter of the reasonableness of Houlihan's professional fees.

Second, Houlihan's compensation structure forces the estate *as a whole* to pay for advisors working only for a limited part of the estate. By providing for an ambiguous "success fee" that is to be in an amount to be negotiated only by the Committee and Houlihan and that will be paid "by the Company" rather than out of the unsecured creditors' recoveries, the Committee is in effect giving itself the right to create an administrative expense that will be borne by all creditors but will provide benefit solely to constituents of the Committee. As Houlihan's experience with other bankruptcy courts has shown, such a result is both unfair and impermissible.

Finally, the Houlihan Application requires the Debtors to exculpate and indemnify Houlihan against its own negligence on terms that are impermissible. This broad sweep of indemnification is not warranted because the estate as a whole should not be required to indemnify and forgive the negligence of professionals working only to benefit a limited constituency. Furthermore, simple negligence is not generally absolved in this jurisdiction even by professionals working for the estate as a whole.

FACTS PERTAINING TO THE PROPOSED ENGAGEMENT

1. **Houlihan's Proposed Compensation.** Houlihan's proposed engagement agreement (the "Houlihan Agreement") provides that Houlihan's compensation shall consist of a monthly fee of $100,000 and a "Transaction Fee." The "Transaction Fee" provisions of the Houlihan Agreement state:

> Additionally, the Committee, in its sole discretion, may negotiate a Transaction Fee with Houlihan Lokey on market terms as of April 19, 2004, which Transaction Fee shall not exceed 1.25% of recoveries by unsecured creditors. Any Transaction Fee shall be paid by the Company upon closing or consummation of a Transaction….

See Houlihan Agreement, at 3-4 (attached to the Houlihan Application as Exhibit A).

2. Section 1 of the Houlihan Agreement defines "Transaction" to "include the consummation of any agreement or series of agreements, or transaction or series of transactions," which *may* include (i) a sale or other disposition of the Debtors' assets, (ii) satisfaction of the Debtors' senior bonds, or (iii) "Absent any of the foregoing, an agreement in good faith by the Committee and Houlihan Lokey." *Id.* at 2.

3. **Bankruptcy Court Review of Houlihan's Compensation.** Section 5 of the Houlihan Agreement provides that the Committee shall seek to employ Houlihan "as a professional person pursuant to (and subject to the standard of review of) Section 328(a) of the Bankruptcy Code." *Id.* at 4. The Houlihan Application explains that under the terms of the engagement, "the Court may not subsequently allow Houlihan Lokey's compensation on terms different from the approved Fee Structure unless such compensation 'prove[s] to have been improvident in light of developments not capable of being anticipated at the time' the Fee Structure originally was approved." Houlihan Application, at ¶ 8.

4. **Indemnification of Houlihan by the Debtors but Not the Committee.** Section 12 of the Houlihan Agreement provides:

> the Debtors shall indemnify Houlihan Lokey shall [sic] hold harmless Houlihan Lokey and its affiliates, and their respective past, present and future directors, officer, shareholders, employees, agents and controlling persons … (collectively, the "Indemnified Parties"), to the fullest extent lawful, from and against any and

> all losses, claims, damages or liabilities (or actions in respect thereof), joint or several, arising out of or related to the Agreement, any actions taken or omitted to be taken by an Indemnified Party in connection with Houlihan Lokey's provision of services to the Committee, or any Transaction (as defined herein) or proposed Transaction contemplated thereby. In addition, the Debtors shall reimburse the Indemnified Parties for any legal or other expenses reasonable incurred by them in respect thereof at the time such expenses are incurred; provided, however, there shall be no liability to the Company under the foregoing indemnity and reimbursement agreement for any loss, claim, damage or liability which is finally judicially determined to have resulted primarily from the willful misconduct, gross negligence, bad faith or self-dealing of any Indemnified Party.

Houlihan Agreement, at 5-6.

5. **Exculpation of Houlihan by the Estate and the Committee.** Section 12 of the Houlihan Agreement also provides:

> Neither Houlihan Lokey nor any other Indemnified Party shall have any liability, regardless of the legal theory advanced, to the Committee, the Debtors or any other person or entity (including the Debtors' equity holders and creditors) related to or arising out of Houlihan Lokey's engagement, except for any liability for losses, claims, damages, liabilities or expenses incurred by the Committee and/or the Debtors which are finally judicially determined to have resulted primarily from the willful misconduct, gross negligence, bad faith or self-dealing of any Indemnified Party.

Id. at 6-7.

ARGUMENT

A. The Reasonableness of the Houlihan Agreement's Transaction Fee Provisions Cannot be Evaluated.

The Houlihan Agreement provides that Houlihan's Transaction Fee shall be negotiated "in [the Committee's] sole discretion," on "market terms," and will be earned upon the sale or reorganization of the Debtors, or "an agreement in good faith by the Committee and Houlihan Lokey." The amount of this Transaction Fee can be as high as 1.25 percent of the Debtors' value once secured and priority claims are paid, although the exact percentage is not specified. In other words, the Committee seeks this Court's advance approval of a "Transaction Fee" based on no identifiable criteria and in an amount left to the nearly unfettered discretion of the Committee and Houlihan at some unknown point in the future. Effectively acknowledging the potential for abuse of such loose criteria, the Committee also seeks to insulate the Transaction Fee from scrutiny by this Court and other parties in interest by cloaking its future agreement with Houlihan in the "improvident" standard of Bankruptcy Code Section 328(a).

Bankruptcy Code Section 328(a) expressly requires the Court to find that the Transaction Fee is reasonable. Because the terms of any engagement under Section 328(a) are difficult to rescind, it is especially important that the Court know what it is being asked to approve. *See, e.g., In re C & P Auto Transport, Inc.,* 94 B.R. 682, 685 (Bankr. E.D. Cal. 1988) ("Whenever special terms and conditions are requested [pursuant to Section 328(a)], it is important for the court to focus upon them because, once approved, they are difficult to unravel.").

At this point, however, no one can determine whether the Transaction Fee is reasonable. The Houlihan Agreement (a) provides no limitation on what Houlihan and the Committee may later deem to be a "Transaction" triggering the fee, (b) does not state how recoveries by unsecured creditors are to be calculated or even generally defined, (c) does not state what percentage of the unsecured recoveries will constitute the Transaction Fee, and (d) does not otherwise limit the sole discretion of the Committee to negotiate the Transaction Fee based on undefined market terms. Thus, under the express terms of the Houlihan Agreement, the Committee may agree on some future date to a Transaction Fee that all other parties and the Court would find unreasonable, but that agreement could not be modified unless the Court finds that the egregiousness of the Transaction Fee was not capable of being foreseen at this time.

The Debtors (and, pursuant to Section 328(a), the Court) must have an objective criteria before the reasonableness of the Transaction Fee can be determined. This requirement of objective reasonableness is borne out by the unpublished cases cited by the Committee. In *Kaiser Aluminum*, the bankruptcy court approved the compensation of Lazard Frères & Co. under Section 328(a) because the retention application provided for an objective means of determining when the success fee was earned – the fee was conditioned upon a restructuring approved by the bankruptcy court. *In re Kaiser Aluminum Corp., et al.,* Case No. 02-10429 (Bankr. D. Del. March 19, 2002) (approving engagement letter §§ 1, 2(b)). Moreover, unlike the Houlihan Application, all fees were subject to a reasonableness review by the court upon proper application by Lazard Frères. *Id. at* ¶ 6. Similarly, in *Covad Communications*, the court approved Houlihan's success fee where the fee was based on an objective criteria. There, the fee was a set percentage of the amount of debt restructured or forgiven (nearly identical to that provided for in the Debtor's financial advisor agreement in this case), plus a financing fee based on a set percentage of funds raised. *In re Covad Comm. Group., Inc.,* Case No. 01-10167 (Bankr. D. Del. Nov. 21, 2001) (Houlihan engagement letter, §§ 2(b), 2(c)), *see also In re Casual Male Corp.,* Case No. 01-41404 (Bankr. S.D.N.Y. July 19, 2001) (objective criteria for success fee and review for reasonableness by the U.S. Trustee).[1]

In the case of Houlihan's Transaction Fee, there are no objective criteria; the Transaction Fee is left to the sole discretion of the Committee, limited only by its good faith. The standard of review the Committee proposes renders any fee awarded later by the Committee largely

[1] For the Court's convenience, copies of unpublished opinions cited in this objection are attached as Exhibit "A."

unreviewable. This arrangement cannot pass muster under Bankruptcy Code Section 328(a) because reasonableness is the cornerstone of the Code's criteria for approving the terms of professional retention.[2] *See, e.g., In re iPCS, Inc.,* Case No. 03-62695 (Bankr. N.D. Ga. Jul. 21, 2003) (approving retention of committee financial advisors requested under Section 328(a) but expressly retaining Court authority to review compensation for reasonableness); *C&P Auto Transport*, 94 B.R. at 685-86.

B. The Transaction Fee Should Be Paid from the Unsecured Creditors' Distributions, Not From the Estate as a Whole.

Section 4 of the Houlihan Agreement provides that Houlihan, which works exclusively for the benefit of the unsecured creditors, shall be paid from the estate as a whole. This arrangement forces other classes of creditors, such as junior priority creditors who have no interest in maximizing returns to the unsecured creditors, to bear the administrative expense of Houlihan's Transaction Fee. Moreover, it creates an impediment to confirmation of a plan of reorganization, as it increases the amount of administrative claims that must be paid in full from the Debtors' assets on the plan's effective date. *See* Bankruptcy Code Section 1129(a)(9)(A).

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[2] The Debtors also note that the Houlihan Agreement gives Houlihan exactly what the Committee strenuously argues should not be given to the Debtors' financial advisors, namely, a success fee not reduced by the sum of monthly fees. *Compare* Houlihan Agreement, at 3-4 (no credit for monthly fee payments against the Transaction Fee) *with* Objection of the Official Committee of Unsecured Creditors to Debtors' Motion for Authority to Continue Engagement of Conway, Del Genio, Gries & Co., at 9 ("In the vast majority of other recent textile company chapter 11 cases, the Debtors' financial advisors were required, either immediately or after a limited period of time, to credit 100% of their monthly fees against any possible success fee."). The Debtors believe that the fee structure set forth in their agreement with Conway, Del Genio, Gries & Co. ("CDG"), which credits 50 percent of CDG's post-petition fees against its success fee, is appropriate. Should, however, the Court sustain the Committee's objection to CDG's application in this regard, the Debtors request that this same credit requirement be applied to any "Transaction Fee" awarded to Houlihan.

This illogical arrangement was recently criticized by a bankruptcy court and the Eighth Circuit Bankruptcy Appellate Panel in a case involving both Houlihan and Akin Gump Strauss Hauer & Feld LLP ("Akin Gump"), counsel for the Committee. In *In re Farmland Industries, Inc.*, the creditors' committee, represented by Akin Gump, requested a bankruptcy court determination that a "Transaction Fee" to that committee's financial advisor – Houlihan – be paid from the general assets of the estate. *See In re Farmland Indus., Inc.*, 286 B.R. 895, 897 (Bankr. W.D. Mo. 2002).[3] The bankruptcy court denied the committee's request, articulating four sound reasons. First, it stated,

> the Court views the Transaction Fee that has been negotiated by Houlihan Lokey and the Committee as essentially a contingent fee that will be based upon the amount of any recovery Houlihan Lokey helps obtain for the unsecured creditors. It is customary that parties who contract for the payment – or award, if you will – of a fee based on the success of the representation should pay that "success fee" out of the recoveries made. This is especially true here where the basic fees of Houlihan Lokey are being paid as an administrative expense out of the general fund of the bankruptcy estate. Houlihan Lokey is presently receiving a monthly fee of $150,000.00 that is being paid by the Debtor out of estate funds; thus all creditors are, in effect, bearing that expense…. The Transaction Fee is an additional, contingent fee of 1 percent of the amount distributed to the Committee's constituency, and that additional fee – if one is earned – should rightly be paid by the creditors who directly benefit from the recoveries made.

Id. at 898-99. Second, the court noted that the "Transaction Fee should be paid out of the distributions made to the general unsecured creditors because Houlihan Lokey is working specifically for the benefit of those creditors, and not for the benefit of all creditors or the overall benefit of the bankruptcy estate." *Id.* at 899. Third, the court observed, "Houlihan Lokey's

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[3] Notably, Houlihan's "Transaction Fee" in the *Farmland Industries* case was a set amount – one percent of the amount distributed to the unsecured creditors – and thus did not suffer from the infirmities discussed in section A of this objection.

Transaction Fee was bargained for by the Committee, acting on behalf of the general unsecured creditors. It was not bargained for by the Debtor, the bondholders, or any other creditor group. The Committee should not be permitted to impose on all creditors payment of the success fee that the Committee has bargained for on behalf of its own constituency. If it receives the benefit of that bargain, it should pay for that benefit." *Id.* Finally, the Court observed that other creditors (in that case, the bondholders, who were separately represented) would have to bear more than their fair share of the Transaction Fee if the fee were a general administrative expense paid from the estate's general funds. *Id.*

The bankruptcy court's decision was appealed by the committee's counsel. The Bankruptcy Appellate Panel for the Eighth Circuit affirmed the bankruptcy court's decision. *Official Committee of Unsecured Creditors v. Farmland Indus., Ind. (In re Farmland Indus., Inc.)*, 296 B.R. 188, 193 (8^{th} Cir. BAP 2003). The appellate panel concluded, "The transaction fee is an additional, contingent fee of one percent of the amount distributed to the Creditors' Committee's constituency and should be paid by the creditors who directly benefit from the recoveries made." *Id.*

This case is identical to that confronted by the two *Farmland Industries* courts – even down to the same financial advisor and committee counsel – and the same result governs. Junior priority creditors in this case, like the bondholders in *Farmland Industries,* should not be "primed" by an administrative claim created solely to benefit the unsecured creditors. To quote the *Farmland Industries* court, "That is simply not fair." 286 B.R. at 899.

Finally, to the extent the Committee wants to pay a Transaction Fee to its financial advisors, that fee must be paid from the unsecured creditors' recovery. At this point, the Debtors do not know whether the unsecured distributions will consist of cash, stock in the reorganized company, or some other recovery. Because the Transaction Fee is required to be paid from whatever the unsecured creditors recover, if unsecured creditors receive stock on account of their claims, the Transaction Fee should be paid in stock as well. The Transaction Fee should not impose a cash burden on the estate if cash is not distributed to the unsecured creditors.

C. The Houlihan Agreement Includes Impermissible Indemnity and Exculpation Provisions.

Another flaw in the Houlihan Agreement is its sweeping indemnity and exculpation provisions that require the Debtors' estates to indemnify Houlihan against the consequences of its own negligence. Section 12 of the Houlihan Agreement requires the Debtors to indemnify Houlihan against any claims other than those primarily based upon "willful misconduct, gross negligence, bad faith or self-dealing." The same provision requires the Debtors and the Committee to forgive any similar wrongful conduct. Thus, the Houlihan Agreement insulates Houlihan from the consequences of its own ordinary negligence.

The scope of these indemnification and exculpation provisions is impermissibly broad for two reasons. First, in this district and elsewhere, financial advisors for creditors' committees in large chapter 11 cases are not generally indemnified by the debtor's estate because the estate has no control over the Committee's professionals. As the Eighth Circuit Bankruptcy Appellate Panel observed in *Unsecured Creditors Comm. v. Pelofsky (In re Thermadyne Holdings Corp.),* 283 B.R. 749, 758-759 (8th Cir. BAP 2002), "In situations where the debtor is the client indemnifying the professional it hires, the debtor has a certain amount of control over the acts of the firm and can minimize the risk of negligent acts. In contrast, when the debtor is not the client yet is still responsible for indemnification of its opponent, there is virtually no control over the acts of the firm, and consequently there is no control over potential negligent acts the firm may commit." *See also In re Metricom, Inc*., 275 B.R. 364, 373 (Bankr. N.D. Cal. 2002) ("Houlihan points out that the terms of the Application were negotiated at arm's length between Houlihan and the Bondholders' Committee, but Houlihan does not claim to have negotiated with the estate, which is the entity that would bear the burden of the provisions for indemnity/contribution and exculpation.").

While not expressly so holding, the limitation on a debtors' duty to indemnify a committee's professionals is consistent with orders in this District that have not granted this sort of indemnification; in most cases, committee professionals have been reluctant even to ask for this indemnification. *See, e.g., In re The New Power Co.,* Case No. 02-10835 (Bankr. N.D. Ga. Aug. 8, 2002) (Drake, J.) (indemnification of committee's professionals neither asked for nor granted); *In re Centennial HealthCare Corp.*, Case No. 02-74974 (Bankr. N.D. Ga. Jan. 18, 2003) (Massey, J.) (same); *In re Wolf Camera, Inc.,* Case No. 01-83470 (Bankr. N.D. Ga. Sept. 10, 2001) (Mullins, J.) (same).

Second, even the Debtors' own financial advisors are not insulated from the consequences of their own negligence. The Debtors' retention agreement with Conway, Del Genio, Gries & Co. ("CDG") provides that CDG is not entitled to indemnification for simple negligence. This is because it is unreasonable for a financial advisor to expect protection from the consequences of its own negligence. *See, e.g., In re Centennial HealthCare Corporation*, Case No. 02-74974 (Bankr. N.D. Ga. Dec. 23, 2002) (Massey, J.) (approving CDG retention on terms that did not permit indemnification of CDG against its own ordinary negligence). For these reasons, Houlihan's indemnification provisions are inappropriate.

CONCLUSION

For the foregoing reasons, the Debtors ask that the Court deny the Houlihan Application.

This 26th day of May, 2004.

Respectfully submitted,

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