



What is a "Carve-Out," and How Does it Impact Creditors?

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Our clients are sometimes creditors of companies that file for protection under Chapter 11 of the Bankruptcy Code. In some cases, they may be unsecured trade creditors with no collateral as to which they may assert their claim. In other cases, particularly regarding Banks, they may have a superior right to get paid because they have a perfected lien on certain property.

Secured Creditors holding an enforceable lien may share a portion of their collateral, or its proceeds when liquidated, with others. That sharing is called a Carve-Out.

Carve-Outs are usually, but not always, used to ensure the payment of professional fees of the Debtor's and the Unsecured Creditors' Committee's (Committee) legal counsel and financial advisors. This is particularly important in cases where the ability of the Debtor to pay professional fees from collateral not secured already, is limited. If the Debtor's operations are funded through its use of the secured party's collateral, the Bank should approve its use for that purpose in an agreement called a cash collateral order.

Thus, Carve-Outs are important to unsecured creditors who benefit from the advice of counsel which is paid for out of the secured assets. On occasion, the secured party may agree to a Carve-Out to fund payments to unsecured creditors.

But why do secured parties agree to share their collateral? There are several possibilities, including the benefit to all creditors if the case is handled orderly and professionally. In some cases, the Bank may negotiate a consent to the validity and priority of its lien in exchange for such sharing.

Several recent cases highlight the complexity of Carve-Out arrangements. Contested issues include what happens if a case is converted to liquidation under Chapter 7 and the necessity of approval of professional fees.

Secured, or not, it is in the best interest of creditors to consult counsel regarding the impact of proposed Carve-Outs in a case where one finds the customer has entered the Chapter 11 process.

Please note that this is a general overview of developments in the law and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and recipient. If you have questions regarding these provisions, or any other aspect of employment law, please contact Michael Traison at 312.860.4230

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