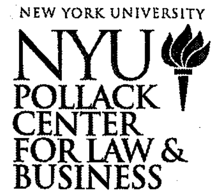

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REIMBURSEMENT OF PROFESSIONAL FEES FOR CREDITORS IN CHAPTER 11 CASES

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I. Introduction

A. Seeking Payment of Creditor Expenses. In maximizing their recoveries from a bankruptcy case, creditors may attempt to have their expenses for professional fees connected to the case reimbursed as an administrative expense of the case. This is made possible by Bankruptcy Code sections 503(b)(3) and (4),[1] which list certain categories of administrative expenses related to a debtor's case that may be paid from the debtor's estate, and section 507, which grants administrative expenses priority in the distribution of assets, thereby increasing the likelihood of recovery.

B. Organization of Outline. As the Court of Appeals for the Second Circuit noted in ASM Capital, LP v. Ames Dep't Stores, Inc. (In re Ames Dep't Stores, Inc.), 582 F.3d 422, 431 (2009), "the Bankruptcy Code gives a higher priority to requests for administrative expenses than to prepetition claims." The court in In re Am. Preferred Prescription, 194 B.R. 721, 726 (Bankr. E.D.N.Y. 1996) explained that the purpose of Section 503 of the Code is to "promote meaningful creditor participation in the reorganization case," but "it is well settled that [Section 503] should be narrowly construed." Part II of this outline discusses in more depth the narrow construction courts use. Part III of this outline explores an additional avenue of professional fee reimbursement under Chapter 11 of the Code, outside the realm of statutorily-based administrative expenses.

II. General Reimbursement Scheme for Creditor Expenses

A. Allowed Secured Claim under Section 506(b). To the extent that the value of a secured creditor's interest in collateral exceeds the amount of its prepetition claim (often referred to as being "oversecured"), Bankruptcy Code section 506(b) affords the secured creditor an allowed secured claim for the reasonable fees or costs provided for under the relevant security agreement or statute. Such recovery is not an administrative expense, but is an extension of the creditor's secured claim and is entitled to be treated similarly to the rest of the secured claim.

B. Administrative Expense Treatment under Section 503. Creditors and certain other parties may seek to recover professional fees as an allowed administrative expense pursuant to section 503(b). Section 503(b)(3) lists six categories of allowable administrative expenses for the "actual, necessary expenses, other than compensation and reimbursement specified in paragraph (4) of [Section 503(b)] incurred by – (A) a creditor filing a petition under Section 303 of this title; (B) a creditor that recovers, after the court's approval, for the benefit of the estate any property transferred or concealed by the debtor; (C) a creditor in connection with the prosecution of a criminal offense relating to the case or to the business or property of the debtor; (D) a creditor, an indenture trustee, an equity security holder, or a committee representing creditors or equity security holders other than a committee appointed

1 Unless otherwise specified, all references to the "Code" refer to the Bankruptcy Code and all section references are to sections of the Code.

under section 1102 of this title, in making a substantial contribution in a case under chapter 9 or 11 of this title; (E) a custodian superseded under section 543 of this title, and compensation for the services of such custodian; or (F) a member of a committee appointed under section 1102 of this title, if such expenses are incurred in the performance of the duties of such committee." (emphasis supplied). The fees of professionals in the service of the various parties mentioned in section 503(b)(3) are expressly permitted as allowable with regard to subparagraphs (A) through (E), but notably *not* (F), by section 503(b)(4).

C. Section 503(b)(3) and "Substantial Contribution"

1. Pursuant to section 503(b)(F), members of an official committee are entitled to reimbursement of their expenses incurred in connection with the performance of the duties of the committee without any showing of "substantial contribution" or other benefit. However, 503(b)(F) is limited to members of official committees, so creditors are not generally entitled to administrative expense treatment for their postpetition expenses for matters such as recovering on their individual claims or service on unofficial committees.

2. But section 503(b) provides an exception to the general rule that creditors are not entitled to administrative expense treatment for expenses outside the official committee context. As noted above in Part II.B. above, sections 503(b)(3)(D) and (4) permit creditors, among others, to seek reimbursement for actual and necessary expenses, plus reasonable compensation for professional fees, where the creditor has made a "substantial contribution" to a Chapter 11 case. The Code does not define "substantial contribution" nor does it stipulate criteria a court are to use in making a determination whether a substantial contribution has been made. Thus, the issue is a question of fact and the applicant bears the burden of proof by a preponderance of the evidence. In re Bayou Grp., LLC, 431 B.R. 549, 560 (Bankr. S.D.N.Y. 2010).

3. Not surprisingly, courts tend to interpret "substantial contribution" narrowly so that Chapter 11 estates do not get overly burdened with paying the postpetition expenses of much of the non-official participants in their Chapter 11 cases. In Cellular 101, Inc. v. Channel Commc'ns, Inc. (In re Cellular 101, Inc.), 377 F.3d 1092, 1096 (9th Cir. 2004), the Court of Appeals for the Ninth Circuit stated that the principal test for substantial contribution is "the extent of the benefit to the estate." To maintain the integrity of section 503(b), courts strictly limit reimbursement to "extraordinary creditor actions which lead directly to tangible benefits to the creditors, debtors, or estate." In re Bayou Grp., LLC, 431 B.R. at 560 (quoting In re Best Prods. Co., 173 B.R. 862, 866 (Bankr. S.D.N.Y. 1994)). The Bayou court went on to say that the benefit must be a substantial net benefit to qualify and cannot be solely established by extensive participation in the case or based on services duplicative of other professionals already

compensated by the estate. Id. at 561. "The majority of cases allowing creditors' substantial contribution claims under sections 503(b)(3)(D) and (b)(4) have, therefore, found that the creditor played a leadership role that normally would be expected of an estate-compensated professional but was not so performed . . . [and] involved a creditor who actively facilitated the negotiation and successful confirmation of the Chapter 11 plan or, in opposing a plan, brought about the confirmation of a more favorable plan." Id. at 562 (referencing In re Granite Partners, 213 B.R. 440, 446-47 (Bankr. S.D.N.Y. 1997)).

4. Courts have considered several factors in determining whether a party's participation constitutes substantial contribution, including whether the services were undertaken for the benefit of all parties in the case or only the party itself (see e.g., Haskins v. United States (In re Lister), 846 F.2d 55 (10th Cir. 1988)(finding creditor did not make substantial contribution because creditor undertook attachment proceedings for its own benefit) and whether the actions duplicated the efforts of the debtor, a trustee or an official committee (see e.g., In re Bayou Grp., LLC, 431 B.R. at 561; In re Mirant Corp., 354 B.R. 113 (Bankr. W.D. Tex. 2006)(declining to award fees to an ad hoc committee for work which was duplicative of the official committee's work). *Collier on Bankruptcy* lists other factors courts have considered, such as whether the creditor would have taken the action on its own behalf without the expectation of reimbursement and whether the benefit conferred exceeds the costs in obtaining the benefit. *Collier on Bankruptcy* ¶ 503.10.

5. There is a split among the Circuits as to the relevance of a creditor's motivation in pursuing the action that underlies a substantial contribution claim. The Courts of Appeals for both the Third and Tenth Circuits deny payment of professional fees under section 503(b)(3)(D) if the creditor's action were motivated by self-interest and with no expectation of reimbursement (see e.g., Lebron v. Mechem Financial, Inc., 27 F.3d 937, 944 (3d Cir. 1994); In re Lister, 846 F.2d at 57). The Courts of Appeals for the Fifth and Eleventh Circuits do not consider a creditor's motivation to be relevant if the creditor's actions provided the estate with a demonstrable benefit (see e.g., In re DP Partners, Ltd., 106 F.3d 667, 673 (5th Cir. 1997); In re Celotex Corp., 227 F.3d 1336, 1338 (11th Cir. 2000)). The Court of Appeals for the Ninth Circuit has "declined to choose between the two competing approaches." In re Cellular 101, Inc., 377 F.3d 1092, 1097 (9th Cir. 2004).

6. Other examples of creditor action found to constitute a "substantial contribution" include successfully seeking the appointment of a chapter 11 trustee, negotiated transactions resulting in reduced fees charged by counsel for the debtor and increased funds available to the estate, creditor assistance that was instrumental to the plan process, drafting efforts with respect to the Chapter 11 plan of reorganization that reduced the fees the debtor or estate would have otherwise had to pay to its advisors. *Collier on Bankruptcy*

¶ 503.10.

III. Alternatives to Section 503(b) for Reimbursement of Creditor Expenses in Chapter 11 Cases

A. Arguable Gaps in Current Statute. In a Chapter 11 case involving a capital structures dominated by undersecured debt, multiple debtors with separate capital structures and/or other complexities beyond general unsecured claims, the constituencies with the most major economic stakes in the case may not be represented by (or even eligible to be represented by) an official committee. Arguably, the approach taken in the Code with respect to creditors' committees, including the allowance of expenses, might have been different had secured debt been as prevalent in capital structures in 1978 as it is today.

B. Chapter 11 Plan Provisions. Plan negotiations among the major constituencies may include an entitlement to recover their postpetition expenses without having to demonstrate an entitlement to administrative expense treatment under the fairly narrow "substantial contribution" strictures of section 503(b)(3)(D). In two large and contentious chapter 11 cases discussed below, Bankruptcy Judges in the Southern District of New York have in one case allowed the payment of professional fees of *ad hoc* committees, and in the other professional fees of the members of the official committee, in each case pursuant to provisions of confirmed chapter 11 plans notwithstanding the lack of authority under section 503. The following chapter 11 provisions figured prominently in those cases:

1. Section 1123(b):

'(b) Subject to subsection (s) of this section, a plan may –

...

(3) provide for –

(A) the settlement or adjustment of any claim or interest belonging to the debtor or to the estate; or

... and

(6) include any other appropriate provision not inconsistent with the applicable provisions of this title."

2. Section 1129(a)(4), which requires that:

"[a]ny payment made or to be made by the proponent, by the debtor, or by a person issuing securities or acquiring property under the plan, for services or for costs and expenses in or in connection with the case, or in connection with the plan and incident to the case, has been approved by, or is subject to

the approval of, the court as reasonable."

C. *Adelphia* – Professional Fees of *Ad Hoc* Committees

1. In re Adelphia Commc'ns Corp., 441 B.R. 6, 10 (Bankr. S.D.N.Y 2010), Bankruptcy Judge Gerber described the *Adelphia* chapter 11 case "as among the most contentious in bankruptcy history" (citation to prior decision by Judge Gerber omitted). The case was noteworthy (some would say notorious) for the large number of separately represented creditor constituencies in its multiple debtor structure, it's extremely aggressive intercreditor battles, and for the fact that creditor fighting posed a serious threat to the debtors' ability to take advantage of a $19.1 billion offer to purchase the debtors' business. After substantial delays, litigation and hard-fought negotiations, the business was sold under section 363 and a largely consensual Chapter 11 plan was confirmed and became effective.

2. As a negotiated part of the settlement that resulted in the Chapter 11 plan, the debtors and creditors agreed that the estate would bear the professional fees of the principal creditor constituencies and, in connection therewith, Section 6.2(d) of the Chapter 11 plan provided that the creditors would be reimbursed for reasonable fees. Id. at 11. The plan imposed a reasonableness standard but did *not* require a "substantial contribution" showing so as to fit within section 503(b)(b)(D). Indeed, the parties clearly intended that compensation would be paid for fees expended in advocating intercreditor positions that, while increasing the recovery of the relevant constituency at the expense of other constituencies, might not have enhanced the overall estate. In his decision confirming the Chapter 11 plan, Judge Gerber expressed some skepticism about the permissibility of Section 6.2(d) of the plan:

   "there is no basis in the Bankruptcy Code of which I'm now aware that authorizes fees of this character to be paid to creditors or their professionals without satisfying the requirements of the Code for fee awards – which include application to the Court and at least seemingly satisfying the requirements of section 503(b), and particularly sections 503(b)(3) and 4." In re Adelphia Commc'ns Corp., 368 B.R. 140, 270 (Bankr. S.D.N.Y 2007).

   Nonetheless, Judge Gerber said he would "keep an open mind" an invited the relevant constituencies to submit applications for the requested fees. Id. at 270-71.

3. Fourteen *ad hoc* committees and individual creditors (all but one of which was or represented unsecured creditors) sought the payment of professional fees under the plan provision. The U.S. Trustee's office objected to the payment of the fees as unauthorized absent a showing of "substantial contribution." Id. at 8.

4. Notwithstanding his prior skepticism, Judge Gerber was apparently moved

by the briefs submitted by those advocating in favor of allowing the requested fees. He observed that, "[i]mportantly, section 503(b) does not provide, in words or substance, that it is the *only* way by which fees of this character may be absorbed by an estate." Id. at 6. After analyzing Section 503(b) of the Code, Judge Gerber determined that he was "free to look to other provisions of the Code that might also authorize a payment." Id. at 13. He distinguished between section 503(b)'s unique authorization for non-consensual allowance of such an administrative expense and the possibility that provisions of chapter 11 might permit allowance on a consensual basis. Id. at 12-13.

5. Judge Gerber noted that section 1129(a)(4) "expressly *contemplates* that payments may be made in connection with a reorganization plan – presumably, consensually – by a debtor, plan proponent, issuer of securities, or acquiror of property" and "any such payments must be approved by the court as reasonable, or that they be subject to such a review." Id. As the court interpreted the Code, the existence and substance of section 1129(a)(4) permits the possibility that section 503(b) is not the exclusive source of authority to pay professional fees under a plan and "suggests, though . . . does not compel the conclusion, that there might be other payments by the debtor . . . beyond those expressly permitted by section 503(b)." Id. at 14. Because section 1129(a)(4) states requirements for plan confirmation rather than providing authorization for payments, he stated that authorization for the payments must be found elsewhere.

6. He then went on to analyze section 1123(b) and specifically noted that section 1123(b)(6) was particularly relevant. Id. (Judge Gerber noted that section 1123(b)(3)(A) might serve to authorize the payments as part of a settlement, but did not discuss that concept at length and focused far more heavily on section 1123(b)(6)). Because neither section 503(b) nor any other provision in the Code expressly prohibits the payment of professional fees as part of a confirmed plan (thereby rendering the payment of fees inconsistent with a provision of the Code), the court reasoned that the final analysis turned on whether the payments were "appropriate." Id. After reviewing the scant caselaw discussing appropriateness under section 1123(b)(6), he noted that "if there is a common thread in the cases, it is that the courts have historically not found a plan provision to be impermissible because it is not 'appropriate' except where the plan provision, while not inconsistent with the provisions of [the Code], is violative of a statutory provision found *elsewhere* in the U.S.C. (*i.e.*, is violative of nonbankruptcy federal statutory law), or is violative of existing caselaw." Id. at 17. Public policy concerns also did not compel a finding that payment of professional fees under Section 1123(b)(6) is inappropriate. Id. at 19. Thus, the court ruled that "to the extent the requested fees are reasonable, and the requirements of section 1129(a)(4) likewise are complied with," Section 6.2(d) of the plan was permissible and the Code permitted recovery of professional fees under that provision without having to demonstrate substantial contribution under sec-

tion 503(b)(3). Id. The court also concluded that "'reasonableness' in the context of fees so awarded permits payment for fees (otherwise reasonable) that have been incurred solely to increase the applicant's personal recovery on a long position in claims against the estate (even without benefit to the estate), but does not permit payment for fees to advance interests unrelated to recovering on claims (such as short positions or competitive advantage), or for activities that go beyond normal advocacy or negotiation, that represent scorched earth tactics, or that are abusive, irresponsible, or destructive to the estate." Id. at 9-10.

D. *Lehman* – Professional Fees of Official Committee Members

1. Section 503(b)(2) provides for the allowance as administrative expenses of the fees of professionals serving an official committee, and section 503(b)(3)(F) provides for the allowance as administrative expenses of the expenses of individual members of an official committee incurred in connection with the performance of their duties as members of the committee. But nothing in section 503 expressly provides for the nonconsensual allowance of the professional fees of such individual members. Moreover, section 503(b)(4), which authorizes the payment of the fees of professionals retained by the creditors and other parties identified in sections 503(b)(3)(A) through (E), does not include 503(b)(3)(F)(referring to committee members).

2. Bankruptcy Judge Peck's description of the *Lehman* case in In re Lehman Bros. Holdings, Inc. 487 B.R. 181 (2013) sharply contrasts with Judge Gerber's description of the *Adelphia* case. Judge Peck's decision starts as follows:

   "These historic bankruptcy cases have been characterized by professional excellence and creative problem solving leading to negotiation, cooperation and the ultimate compromise of conflicting positions." Id. at 182.

   Other aspects of the cases are similar. As part of the settlement that resolved competing plans and resulted in a largely consensual Chapter 11 plan, the parties agreed that the professional fees of the individual members of the official creditors committee would be paid, and this agreement was embodied in Section 6.7 of the Chapter 11 plan that was confirmed and became effective. Applications were filed for payment of the professional fees. Once again the U.S. Trustee objected, this time on the basis that section 503(b) is the only avenue for payment of fees as administrative expenses and section 503(b) does not authorize the payment of the professional fees of individual committee members. Id. at 188.

3. Judge Peck disagreed with the U.S. Trustee's reading of section 503(b), finding that "[s]ection 503(b) is not a straitjacket" and does not control the provisions of Chapter 11 governing the plan process. Id. at 186. Like

Judge Gerber, Judge Peck interpreted sections 1123(b)(6) and 1129(a)(4) as a basis for authorizing allowance of administrative expenses in the context of a consensual Chapter 11 plan:

> "Moreover, the objection of the UST discounts both the enormous leeway granted to the architects of plans under Section 1123(b)(6) of the Bankruptcy Code (providing that a plan may include any other appropriate provision not inconsistent with the applicable provisions of this title) and the authority and discretion of the bankruptcy court to approve payments in connection with a plan as being reasonable under Section 1129(a)(4)." Id.

E. What's Next? One can expect (1) creditors to continue to negotiate for the allowance of their fees as administrative expenses under Chapter 11 plans, (2) the U.S. Trustee's office to continue to advocate the position that section 503(b) is the sole source of authority for the allowance of administrative expenses, and (3) many Bankruptcy Judges to interpret sections 1123(b)(6) and 1129(a)(4) as authorizing allowance of administrative expenses in chapter 11 plans (at least consensual ones) that would not be allowed under a strict reading of section 503. Absent a legislative fix to the issue, or clear statements from the Courts of Appeals, the tension will continue. An appeal of the *Lehman* case is pending.