Bankruptcy Brief

by Justin Alberto

The Bankruptcy Court Gave and the District Court Hath Taken Away: A Commentary on the Southern District of New York's Lehman Bros. Decision

The U.S. District Court for the Southern District of New York, in an opinion written by Judge Richard J. Sullivan, recently held that a plan of reorganization that provides for the payment of professional fees of the individual members of an official committee violates § 503(b) of the Bankruptcy Code.[1] The decision, in an appeal from the Lehman Brothers bankruptcy, reversed a 2013 ruling by Judge James M. Peck of the Southern District of New York Bankruptcy Court that the plan payment provision was permissible under § 1123(b)(6)'s catchall provision, as not inconsistent with § 503(b).[2] The bankruptcy court's opinion provided added support to a growing trend of cases that followed a similar 2010 decision from the SDNY Bankruptcy Court in *Adelphia*,[3] which seemed to bless the use of plan provisions to pay a creditor's professional fees solely on the basis of that creditor's committee membership and without demonstrating that the creditor's actions constituted a substantial contribution to the case. The district court's recent decision seems to discredit this practice, but all may not be lost for creditors seeking payment of their professional fees from the bankruptcy estate.

The Interplay of §§ 503(b)(3) and 503(b)(4)

A brief review of the statutory predicates is helpful in understanding the impact of the district court's decision. The opening clause of § 503(b)(3) indicates that certain favored post-petition expenses will be afforded administrative priority status and be paid in full from the debtor's estate.[4] Achieving administrative expense status is critical for creditors because unsecured claims commonly receive less than 100 percent recovery in Chapter 11 plans. Section 503(b)(3) lists the types of allowable administrative expenses in subsections A through F. For instance, § 503(b)(3)(D) allows a creditor or indenture trustee to recoup its actual and necessary expenses upon a showing that it made a substantial contribution to the case.[5] Similarly, § 503(b)(3)(F) allows reimbursement of expenses incurred by the members of an official committee as a result of those entities' participation on the committee.[6]

The opening sentence of § 503(b)(3), however, expressly excludes professional services from the administrative claims otherwise allowable under subsections A through F. Thus a creditor seeking reimbursement of legal fees incurred in the bankruptcy case must look to another section of the code. For its part, § 503(b)(4) accords administrative priority status to professional fees where the entity requesting the reimbursement holds an expense otherwise available for administrative expense status under subsections A through E of § 503(b)(3) and establishes a reasonableness standard for the court to employ in reviewing the requested fees. Notably, the category of expenses allowed by subsection 503(b)(3)(F)—committee member expenses—had been among those listed in § 503(b)(4) but was removed from the code as part of the 2005 Bankruptcy Abuse and Consumer Protection Act (BAPCPA) amendments. In other words, while a creditor that demonstrates a substantial contribution to the case under § 503(b)(3)(D) can recoup its reasonable legal fees under § 503(b)(4), a creditor may not recoup legal fees incurred solely by virtue of its membership on a committee even though its nonprofessional, out-of-pocket expenses are otherwise allowable as administrative expenses under subsection 503(b)(3)(F).

The Bankruptcy Court's Decision

The Lehman Brother's bankruptcy cases were the largest in history and among, if not the, most complex cases ever filed. The varying positions and holdings of the parties, coupled with complex issues that stretched across legal and political landscapes, underscored the unprecedented nature of the proceedings. Achieving a consensual Chapter 11 plan—a primary goal of every Chapter 11 case—was an unimaginable feat at the time the cases commenced. After three years of negotiations, however, the parties, including the Official Committee of Unsecured Creditors, resolved their disputes and developed Lehman's Third Amended Plan. Lehman's creditors overwhelmingly approved the plan and allowed the parties to avoid what would have been, as Judge Peck put it, an impossible confirmation battle.

The parties' success in formulating a consensual plan came at

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a high price, with professional fees totaling almost $2 billion. The debtors, presumably in recognition of the committee's plan-related efforts, agreed to pay the professional fees incurred by the committee's individual members. Section 6.7 of the plan memorialized the parties' agreement in that respect and provided for payment from the estates of all reasonable professional fees subject only to the bankruptcy court's entry of the confirmation order. Relying on § 6.7 of the plan, various applicants sought payment of $26.3 million collectively from the estates.

The Office of the U.S. Trustee opposed the request and argued that the payments are not permitted under § 503(b)(3), which it alleged is the exclusive pathway for a member of an official committee to receive compensation for legal fees. The plan, according to the U.S. Trustee, circumvented the standards and restrictions of § 503(b) by allowing reimbursement of professional fees on the basis of committee membership alone. Stated differently, the U.S. Trustee maintained that the omission of § 503(b)(3)(F) from § 503(b)(4) completely eliminates, under any circumstance, the possibility of recovery on account of professional fees incurred by individual members of a committee.

Judge Peck found the U.S. Trustee's reasoning to be too restrictive, as bankruptcy plans are living, breathing documents that must be flexible to adapt to the particular concerns of a case. According to Judge Peck, § 1123(b)(6) of the Bankruptcy Code serves as Congress' "invitation to the creativity of those who are engaged in drafting plan language" by allowing a plan to include any "appropriate provision not inconsistent with the applicable provisions of [the Bankruptcy Code.]"[7] He therefore analyzed the plan's treatment of committee members' professional fees not under § 503(b), but under § 1123(b)(6)'s general endorsement of plan provisions that are not inconsistent with other applicable provisions of the Bankruptcy Code.

Applying this approach, the court found that § 6.7 of the plan was not inconsistent with § 503(b) because it provided for a consensual payment of professional fees, not for the payment of administrative priority expenses. According to Judge Peck, requests for administrative expenses under § 503(b) and the right to payments made consensually under a plan are distinct events, however subtly.[8] "The fact that administrative claim status may not be allowed [under § 503(b)(3)] does not mean that an agreed payment under a fully consensual plan should not be permitted [under § 1123(b)(6)]."[9] This decision meant that, in appropriate cases, § 503(b) would not be the only avenue for individual creditors' professional fees to be paid from a debtor's estate and also strengthened the marketplace's reliance on the *Adelphia* decision that had approved similar plan-based payments for professional fees incurred by members of an *ad hoc* committee.

The District Court Reverses

On appeal by the U.S. Trustee, the Southern District of New York reversed the Bankruptcy Court's decision. It found that while individual members of an official committee oftentimes hire their own professionals in complex cases, § 1123(b)(6) is not a tool to circumvent the prohibition against treating those fees as administrative expenses. According to the district court, the exclusive source of administrative expenses is § 503(b), which on its face does not permit the payment of professional fees to a creditor solely on the basis of committee membership, and that § 1126(b)(6) was not designed

to allow parties to undermine that express statutory prohibition. The court therefore invalidated plan § 6.7 because it provided for the payment of expenses that §§ 503(b)(3) and 503(b)(4) forbid.

The district court found unpersuasive the committee's argument that the plan did not create a new category of administrative expenses, but embodied a consensual agreement overwhelmingly approved by Lehman's constituents to pay professional fees.[10] Relying on the *Adelphia* decision, the appellees had argued that § 6.7 of the plan called only for permissive payments authorized by § 1123(b)(6)'s catchall language.[11] The district court, however, disagreed. According to the district court, two types of creditors are paid under plans in a bankruptcy case—those that hold claims and those that are entitled to post-petition administrative expenses.[12] Because professional fees incurred post-petition by a creditor can never fall into the category of a claim, they must fit the definition of an administrative expense under § 503(b) to receive a distribution pursuant to a Chapter 11 plan. Here, the court decided that § 503(b)'s facial omission of committee member professional fees was dispositive. Finally, the district court expressed concerns about allowing payment of anything other than claims or administrative

expenses under a plan—whether pursuant to § 1123 or otherwise—because it "could lead to serious mischief" and potential infringement on the absolute priority rule.[13] In that regard, the district court held that the need for flexibility in drafting plans does not outweigh established bankruptcy and distribution policies and rules.

Lessons Learned

The reversal of the bankruptcy court's decision would seem to close the door, at least in the Southern District, on the ability of parties to incorporate into a plan payment of professionals serving committee members.[14] But has the prospect of plan-based estate reimbursement of professional fees incurred by committee members been completely eviscerated? Although Judge Peck's decision was reversed, the district court dismissed the U.S. Trustee's contention that § 503(b)(3) wholly prohibits reimbursement of committee members' professional fee expenses.[15] Thus, if a member satisfies another subsection of 503(b)(3), such as substantial contribution to the case under § 503(b)(3)(D), its professionals fees would be reimbursable from the estate pursuant to § 503(b)(4) and the district court's decision. The substantial contribution standard, while obviously a tougher litigation burden to prove than mere committee membership, provides an alternative avenue for the Lehman committee members to recoup some, if not all, of their professional fees from the estates.

Significantly, the district court's decision does not address whether litigation is actually required to obtain a substantial contribution ruling. Creditors looking to streamline the process without filing an application could potentially use the plan confirmation process to obtain such a ruling. Plans and confirmation orders routinely include various and far-reaching findings and conclusions with respect to litigable issues such as notice, releases, settlements, and substantive consolidation. Strictly speaking, § 503(b) requires only "notice and hearing" before a court can make a substantial contribution finding. According to the rules of construction in § 102(a), the phrase "after notice and hearing" means only such notice and opportunity for a hearing that "*is appropriate in the particular circumstances*."[16] Proposed plans and their corresponding disclosure statements are among the most detailed and widely noticed documents filed in a Chapter 11 case. Indeed, disclosure statements and plans are considered on no less than 28 days notice to all parties in interest, including the debtor's creditors and equity security holders.[17] This is seven days more than the notice required when a substantial contribution request is presented by motion and would include a larger universe of notice parties, such as the debtor's equity security holders.[18] There is clearly an argument that a proposed substantial contribution finding noticed as part of a plan and disclosure statement would satisfy the notice and hearing requirements of § 503(b) and allow professionals to avoid a separate application process.[19] It remains to be seen, however, whether this approach will be utilized and, if so, approved as a means to have committee member professionals paid in connection with a plan. ⊙

Endnotes

[1] *Davis v. Elliot Mgmt. Corp. (In re Lehman Bros. Holdings Inc.)*, No. 13 Civ. 2211, 2014 WL 1327980 (S.D.N.Y. March 31, 2014).

[2] *In re Lehman Bros. Holdings Inc.*, 487 B.R. 181 (Bankr. S.D.N.Y. 2013).

[3] *In re Adelphia Commc'ns Corp.*, 441 B.R. 6 (Bankr. S.D.N.Y. 2010).

[4] 11 U.S.C. § 503(b)(3).

[5] 11 U.S.C. § 503(b)(3)(D).

[6] 11 U.S.C. § 503(b)(3)(F).

[7] *In re Lehman Bros. Holdings Inc.*, 487 B.R. at 190 (quoting 11 U.S.C. § 1123(b)(6)).

[8] *In re Lehman Bros. Holdings Inc.*, 487 B.R. at 191.

[9] *Id.*

[10] *Davis v. Elliot Mgmt. Corp. (In re Lehman Bros. Holdings Inc.)*, No. 13 Civ. 2211, 2014 WL 1327980, at *5-7 (S.D.N.Y. March 31, 2014).

[11] *Id.*

[12] *Id.* at 6.

[13] *Id.*

[14] At the time this article was written, the district court's decision had not been appealed to the Second Circuit.

[15] *Elliot Mgmt. Corp.*, 2014 WL 1327980, at *7-8.

[16] 11 U.S.C. § 102(a) (emphasis added).

[17] *See* Fed. R. Bankr. P. 2002 and 3017.

[18] *See* Fed. R. Bankr. P. 2002.

[19] Of course, if any objection is filed, counsel must be prepared to carry its burden at the confirmation hearing.

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[3] *Titlow v. Burt*, 680 F.3d 577, 582 (Mich. 2012).

[4] *Id.* at 583.

[5] *Burt v. Titlow*, 134 S.Ct. at 13.

[6] *Id.* at 14.

[7] *Id.*; *quoting Titlow v. Burt*, 680 F.3d 577, 589 (Mich. 2012).

[8] 28 U.S.C. § 2254(d)(2).

[9] § 2254 (e)(1). *Burt v. Titlow*, 134 S.Ct. at 15.

[10] *Wood v. Allen,* 558 U.S. 290, 301, 130 S.Ct. 841, 175 L.Ed.2d 738 (2010).

[11] § 2254(d)(1). *Burt v. Titlow*, 134 S.Ct. at 15.

[12] *Id.*

[13] *Id.* at 13; *citing Cullen v. Pinholster,* 563 U.S. ——, ——, 131 S.Ct. 1388, 1403, 179 L.Ed.2d 557 (2011).

[14] *Id.* at 15-16; *quoting Harrington v. Richter,* 562 U.S. ——, ——, 131 S.Ct. 770, 786–787, 178 L.Ed.2d 624 (2011).

[15] *Id.* at 16; *quoting Harrington v. Richter,* 131 S.Ct. at 786.

[16] *Id.*; *quoting Harrington v. Richter,* 131 S.Ct. at 786 (internal quotation marks omitted).

[17] *Id.* at 18.

[18] *Strickland v. Washington,* 466 U.S. 668, 690, 104 S.Ct. 2052, 80 L.Ed.2d 674 (1984).

[19] *Id.* at 687.

[20] *Id.* at 689.

[21] *Burt v. Titlow*, 134 S.Ct. at 17; *quoting Rice v. Collins,* 546 U.S. 333, 335, 126 S.Ct. 969, 163 L.Ed.2d 824 (2006).

[22] 110 Stat. 1214.

[23] *Strickland v. Washington,* 104 S. Ct. 2052.

[24] *Id.* at 13.