Section 503(b) Not Exclusive Authority for Payment of Creditor Fees and Expenses in Chapter 11

May/June 2011

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Section 503(b) of the Bankruptcy Code delineates categories of claims that are entitled to elevated priority as "administrative expenses." Under section 503(b)(3)(D), administrative expenses include "actual, necessary expenses" incurred by a creditor, indenture trustee, equity holder, or unofficial committee "in making a substantial contribution" in a chapter 11 case. In addition, section 503(b)(4) provides that administrative priority can be conferred by the court upon claims for "reasonable compensation for professional services rendered by an attorney or an accountant of an entity whose expense is allowable" under section 503(b)(3).

These provisions codify long-standing practice and reflect the recognition that a creditor which incurs costs in acting for the benefit of the entire bankruptcy estate rather than its own parochial interests should be compensated by the estate for its trouble. However, because the estate (and thus effectively other creditors) are footing the bill, the standard applied in determining whether a creditor's expense qualifies is a rigorous one. Courts narrowly construe what constitutes a "substantial contribution" to a chapter 11 case, what kinds of qualifying creditor expenses are "necessary," and what qualifies as "reasonable" professional compensation.

Speculation has occasionally arisen concerning whether a creditor's reimbursement of such expenses from estate assets is authorized elsewhere in the Bankruptcy Code. One focus of inquiry is section 363(b) of the Bankruptcy Code. Under section 363(b), a debtor in possession may use, sell, or lease property of the estate outside the ordinary course of business upon a court

finding that the requested use, sale, or lease of estate property represents an exercise of sound business judgment. Another is the court's general equitable powers in section 105(a). Section 105(a) authorizes the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code.

Certain other potential sources of authority for creditor expense reimbursement from estate assets—sections 1129(a)(4), 1123(b)(3), and 1123(b)(6)—were examined by the bankruptcy court overseeing the chapter 11 cases of Adelphia Communications Corp. and its affiliates. In *In re Adelphia Commc'ns Corp.*, the court ruled that professional fees and expenses incurred by a creditor may be paid by the estate if such costs are reasonable and expressly made payable as part of a chapter 11 plan, even if incurred solely to increase the creditor's personal recovery without benefit to the estate. The court also held, however, that that payment of fees is inappropriate where such fees were incurred to advance interests unrelated to claim recovery or for activities that were destructive to the estate.

Adelphia

Adelphia Communications Corp. ("Adelphia") was the fifth-largest operator of cable television systems in the U.S. prior to its chapter 11 filing in 2002 in New York. In 2005, Adelphia entered into an agreement to sell substantially all of its assets to Time Warner New York Cable LLC and Comcast Corporation for $12.5 billion in cash and certain other consideration. The agreement required that the sale be implemented through a chapter 11 plan by a specified date. Intercreditor disputes, however, stalled the plan-confirmation process and jeopardized the consummation of the sale. Consequently, Adelphia proposed to restructure the sale under section 363 and filed a "motion in aid of confirmation" to establish a framework to resolve intercreditor disputes.

After lengthy negotiations, creditors entered into a settlement agreement (the "Global Settlement Agreement") that was incorporated into a chapter 11 plan later confirmed by the bankruptcy court. Among other things, the Global Settlement Agreement provided that the estate would bear all reasonable fees and expenses incurred in connection with Adelphia's chapter 11 case (the "Fee Provision"), including fees incurred by the settling parties in connection with intercreditor litigation. Fourteen ad hoc committees and individual creditors sought reimbursement of their legal fees and professional expenses under the Fee Provision. The Office of the U.S. Trustee objected.

The Bankruptcy Court's Ruling

The court began with a textual analysis of whether the Bankruptcy Code permits enforcement of the Fee Provision. The court explained that, while sections 503(b)(3)(D) and 503(b)(4) expressly authorize reimbursement of nonfiduciary creditor or equity security holders' fees if certain requirements are met, the provisions do not explicitly provide that they are the exclusive means by which fees of this character may be reimbursed by a debtor's estate. The court found telling that the list of administrative expenses that may be paid under section 503(b) is preceded by the word "including," which the Bankruptcy Code defines as "not limiting" under section 102(3). As such, the court reasoned that it was free to examine whether other provisions of the Bankruptcy Code might authorize the Fee Provision.

The official creditors' committee argued that section 1129(a)(4) provides the necessary authorization. Section 1129(a)(4) provides that:

> Any 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.

The court agreed to a point, finding that section 1129(a)(4) "contemplates" that there may be other payments reimbursable by the estate for "something," but that the " 'something' might or might not be for individual creditors' legal fees. . . . [a]nd if they were, they might or might not be for fees that would be capable of being requested, without any debtor assent, under section 503(b)." Otherwise, the court reasoned, there would be no need to state the "reasonableness" standard in both provisions. However, the court determined that section 1129(a)(4) "suggests, though it does not compel the conclusion, that there might be other payments by the debtor, 'for costs and expenses in or in connection with the case,' beyond those expressly permitted by section 503(b)."

Having determined that an award of fees and expenses in Adelphia's chapter 11 case might be appropriate, the court turned to sections 1123(b)(3) and 1123(b)(6) of the Bankruptcy Code. These sections provide, respectively, that a chapter 11 plan may provide for "the settlement or adjustment of any claim or interest belonging to the debtor or to the estate" and "include any other appropriate provision not inconsistent with the applicable provisions of" the Bankruptcy Code. In previously approving the Global Settlement Agreement (of which payment of the fees was an element) under Federal Rule of Bankruptcy Procedure 9019, the court expressly found that the settlement was one of those matters for which "a plan may . . . provide," under section 1123(b)(3). However, the court noted, it "did not then decide whether the payment of the Fees, since it was part of the settlement in the Plan, was likewise authorized under the settlement

authority granted by section 1123(b)(3).” Acknowledging that “textual analysis would tend to suggest the possibility that it could be so authorized, under Code language that is fairly broad in that respect,” the court concluded that it need not decide whether such payments could be authorized under section 1123(b)(3) (or Rule 9019) alone, “[i]n light of the remainder of its analysis.”

The court then examined section 1123(b)(6), the “most potentially relevant provision of all.” In this analysis, the court explained, it had to determine: (i) whether the Fee Provision was inconsistent with any applicable provisions of the Bankruptcy Code; and (ii) whether the provision was “appropriate.” Having already concluded that section 503(b) is not the exclusive Bankruptcy Code provision for estate reimbursement of creditor fees, the court determined that the Fee Provision was inconsistent with neither section 503(b) nor any other provision of the Bankruptcy Code.

As to whether the Fee Provision was appropriate, the court noted that the word “appropriate” is ambiguous, not being defined in the Bankruptcy Code. Canvassing case law addressing permissible chapter 11 plan provisions in this context, the court observed that those decisions suggest that courts have rarely found plan provisions to be inappropriate within the meaning of section 1123(b)(6), except where the provision was inconsistent with the Bankruptcy Code, nonbankruptcy federal statutory law, or existing case law.

As a matter of public policy, the court noted that the wisdom of permitting reimbursement of nonfiduciary creditor fees under the circumstances is debatable. On the one hand, an estate’s

reimbursement of legal fees for intercreditor disputes might materially increase the cost of chapter 11 cases. This is particularly troubling, the court explained, in disputes involving distressed-debt investors that voluntarily participate in the chapter 11 process for profit. On the other hand, the ability to allocate value among creditors increases the ability of fiduciaries to settle controversies. Mindful of these opposing policy arguments, the court concluded that the Fee Provision was *not inappropriate* as a matter of public policy under section 1123(b)(6).

Finally, turning to whether the fees requested satisfied the reasonableness standard under section 1123(b)(6), the court held that fees incurred by a creditor solely to increase its recovery, in the absence of more, is not a sufficient basis for deeming a creditor's fees unreasonable. However, the court disallowed fees incurred by certain creditors whose behavior it deemed to be "outrageous" and beyond the bounds of ordinary negotiation and advocacy. As examples of "outrageous" conduct, the court cited moving to appoint a chapter 11 trustee, which would have effectively caused a default under Adelphia's debtor-in-possession financing facility and prevented consummation of the sale transaction; shorting certain bonds to cause a delay in the case; making inappropriate threats to Adelphia's board; and leaking information to the media to advance a bargaining position.

Outlook

Under the court's holding in *Adelphia,* creditor fees and expenses may be paid by the estate outside the confines of section 503(b) if the fee provision is an element of a confirmed chapter 11 plan, provided that such fees are reasonable, such that they relate to activities undertaken to maximize recovery on claims, rather than conduct that exceeds the bounds of normal negotiation and advocacy, or for activities that are abusive, irresponsible, or destructive to the estate.

Fees and expenses incurred in connection with intercreditor disputes are often substantial in complex chapter 11 cases. As a consequence, plan provisions relating to the payment of such fees and expenses often are heavily negotiated by the creditor groups involved. *Adelphia* provides authority for the position that creditor groups can contract pursuant to a settlement or a chapter 11 plan for payment of such fees and expenses out of the debtor's estate without satisfying the "substantial contribution" requirement under section 503(b).

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

U.S. v. Energy Resources Co., 495 U.S. 545 (1990).

In re Mercado, 124 B.R. 799 (Bankr. C.D. Cal. 1991).

In re Trans World Airlines, Inc., 185 B.R. 302, 313 (Bankr. E.D. Mo. 1995).