Ethics Panel: Current Issues in the Retention and Compensation of Bankruptcy Professionals

Michael P. Richman, Moderator
Hunton & Williams LLP

Kathryn A. Coleman
Hughes Hubbard & Reed LLP

Jonathan L. Flaxer
Golenbock Eiseman Assor Bell & Peskoe LLP

Daniel A. Lowenthal
Patterson Belknap Webb & Tyler LLP

Alec P. Ostrow
Becker, Glynn, Muffly, Chasin & Hosinski LLP

William P. Weintraub
Goodwin Procter LLP

Hon. Louis A. Scarcella
U.S. Bankruptcy Court (E.D.N.Y.)

Hon. Elizabeth S. Stong
U.S. Bankruptcy Court (E.D.N.Y.)

ASARCO And Its Aftermath

Materials for the
American Bankruptcy Institute
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Jonathan L. Flaxer
Golenbock Eiseman Assor Bell & Peskoe LLP
New York, New York

ASARCO

- In *Baker Botts L.L.P. v. ASARCO LLC*, 135 S.Ct. 2158 (2015), the Supreme Court ruled that debtors' counsel could not be awarded fees for defending its fee application from objection.
  - Facts:
    - ASARCO was a mining company that filed for chapter 11 bankruptcy.
    - The most significant issue in the case was a litigation brought by the debtor against its parent, in which a multi-billion dollar judgment was entered in favor of the debtor.
    - Eventually, the debtors' business and assets were sold to an affiliate of its parent after an extensive, competitive bidding process. All creditors were paid in full.
    - The reorganized debtor objected to the debtors' counsel's fee application.

ASARCO

- Issue:
  - Whether the time spent by debtor's counsel defending itself from the reorganized debtor's objections to its fees is compensable under section 330(a)(1)(A) of the Bankruptcy Code.
- Holding:
  - The language of § 330(a) – allowing "reasonable compensation for actual, necessary services" rendered by the professional – does not justify departure from the "American Rule" that ordinarily, in the absence of an agreement to the contrary, each side pays its own fees.
  - The Court held that defending one's own fee application from objection by the estate is not "actual, necessary services" rendered to the estate.
  - Responding to an argument of the Government, the Court held that fees incurred in preparing a fee application is compensable.

The Contract Argument

- As *ASARCO* held, the "American Rule" specifies that each side pays its own fees, "unless a statute or contract provides otherwise." *ASARCO*, 135 S.Ct. at 2164.
- Several law firms have attempted to add "contract" provisions providing for the payment of defense fees to get around the *ASARCO* precedent.
- So far, courts have rejected this approach.

The Contract Argument

- *In re Boomerang Tube, LLC,* Case No. 15-11247, 2016 WL 385933 (Bankr. D. Del. Jan. 29, 2016):
  - Committee counsel requested approval of retention that included payment of fees for defending fee application. The US Trustee objected.
  - Held:
    - Section 328 retention, like section 330(a)(1)(A), does not provide an exception to the "American Rule."
    - The retention agreement is a contract between a law firm and the committee that would obligate a third party (the estate), who is not a party to the contract, to pay the fees for defending a fee application. This type of contract cannot serve as an exception to the "American Rule."
    - A provision for the payment of fee application defense fees is not a reasonable term for the employment of Committee counsel.
    - Whether such provisions are market standard outside of bankruptcy is irrelevant.

The Contract Argument

- *In re Samson Resources Corp.*, Case No. 15-11934 (Bankr. D. Del.)
  - Debtors' counsel sought approval of a provision in retention that provided for reimbursement of fees in defense of objections by third parties.
  - Judge Sontchi followed Judge Walrath's decision in *Boomerang Tube* and would not approve the provision.
- *In re New Gulf Resources, LLC*, Case No. 15-12566 (Bankr. D. Del.)
  - Debtors' counsel's retention included a fee premium of 10%, which would be waived in the event it did not incur "material fees and expenses defending against any objection with respect to an interim or final fee application."
  - Chief Judge Shannon followed Judge Walrath's decision *in Boomerang Tube* and would not approve the provision.

The Contract Argument

- *In re River Road Hotel Partners, LLC*, 536 B.R. 228 (Bankr. N.D. Ill. 2015).
  - Facts
    - Financial Advisor's engagement letter included provision providing for "reasonable fees and expenses of legal counsel."
    - Financial Advisor's application for restructuring fee was unsuccessfully objected to.
    - Financial Advisor sought payment of its counsel's fees in representing it on the objection.
  - Holding
    - Language was insufficient to overcome American Rule, as it did not include "prevailing party" language
    - Defending ones fees is litigating against the estate, rather than providing services to the estate.

Exceptions to ASARCO

- *In re Macco Props., Inc.*, 540 B.R. 793 (Bankr. W.D. Okl. 2015)
  - Facts
    - Chapter 11 Trustee's counsel sought fees for responding to fee objections by equity owners.
    - Throughout case, equity owners were highly litigious, "blatant[ly] attempt[ed] to mislead the Court," and generally advanced multiple vexatious litigations throughout the case.
    - The fee application was supported by all other parties in the case.
  - Holding:
    - Distinguished *ASARCO* on the grounds that the objection came from third party, not the estate.

Exceptions to ASARCO

- *In re Schwartz-Tallard*, 803 F.3d 1095 (9th Cir. en banc 2015)
  - 11 U.S.C. § 362(k) – "[A]n individual injured by any willful violation of [the automatic] stay . . . shall recover actual damages, including costs and attorneys' fees . . . ."
  - Notwithstanding ASARCO, pursuant to section 362(k), Debtor was entitled to award of attorneys' fees for (i) prosecuting action for damages for violation of automatic stay and (ii) successfully defending judgment on appeal.

Exceptions to ASARCO

- *In re Lehr Construction Corp.*, Case No. 11-10723 (Bankr. S.D.N.Y.)
  - Facts
    - Lehr filed for chapter 11 due to a fraudulent overbilling scheme by some insiders.
    - A chapter 11 trustee was appointed.
    - A critical issue was the extent to which estate funds were traceable to a particular project, rendering them subject to a statutory trust, or whether they were property of the estate.
    - Subcontractor objected to the payment of all of the trustee's professional fees, arguing that all funds constituted a statutory trust and thus were not available to pay fees.
  - Result
    - The Court overruled the objection and subsequently awarded the professional fee applications, including fees incurred in defending the subcontractor's objection to the fee application.

In re Connolly North America, LLC
802 F.3d 810 (6th Cir. 2015)

Substantial Contribution in a Chapter 7 Case: A New Way of Looking at Administrative Fees

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Materials Prepared for the
American Bankruptcy Institute
2016 New York City Conference

By

Alec P. Ostrow
Becker, Glynn, Muffly, Chassin & Hosinski LLP
New York, New York

I. The Case

A. The Issue

Can there be an award of attorneys' fees to creditors who make a substantial contribution in a chapter 7 case?

B. The Holding – Yes.

C. Background

In a chapter 7 case, three creditors successfully obtained the removal of a chapter 7 trustee for misfeasance in prosecuting a lawsuit. (The trustee's discovery abuses had caused the court to dismiss the estate's claims with prejudice.) The successor trustee then sued his predecessor and the predecessor's lawyers, and obtained a settlement that enabled a substantially increased distribution to creditors.

The creditors then sought attorneys' fees for making a substantial contribution in a chapter 7 case. The bankruptcy court acknowledged the contribution, but held that there was no entitlement to such a fee award in chapter 7. The district court affirmed. The Sixth Circuit reversed in a split decision.

D. The Statute – 11 U.S.C. § 503(b) [emphasis added]

(b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, **including** –

* * * * * * * * * *

(3) the actual, necessary expenses, other than compensation and reimbursement specified in paragraph (4) of this subsection, incurred by –

* * * * * * * * * *

(D) a creditor, an indenture trustee, an equity security holder, or a committee representing creditors or equity security holders other than a committee appointed under section 1102 of this title, in making a substantial contribution in a case under **chapter 9 or 11** of this title;

* * * * * * * * * *

(4) reasonable compensation for professional services rendered by an attorney or an accountant of an entity whose expense is allowable under subparagraph . . . (D) . . . of paragraph (3) of this subsection, based on the time, the nature, the extent, and the value of such services, and the cost of comparable services other than in a case under this title, and reimbursement for actual, necessary expenses incurred by such attorney or accountant.

E. The Majority's Approach – Authored by Circuit Judge Bernice Bouie Donald (a former bankruptcy judge)

Equitable principles govern bankruptcy cases and jurisdiction. [Citing pre-Code Supreme Court cases *Bank of Marin v. England*, 385 U.S. 99 (1966) and *Curtis v. Loether*, 415 U.S. 189 (1974).]

The plain meaning approach governs statutory construction. [Citing Supreme Court Code cases *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235 (1989) and *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1 (2000).]

In general, Section 503(b) would allow these creditors' substantial contribution claim, but for the argument that in subsection (3)(D), Congress limited such claims to chapter 9 and 11 cases.

The statute contains no such limitation.

On the one hand, administrative expenses should be strictly construed, because they "reduce the funds available for creditors and other claimants." [Quoting *City of White Plains v. A&S Galleria Real Estate, Inc. (In re Federated Dep't Stores, Inc.)*, 270 F.3d 994 (6th Cir. 2001).]

On the other hand, the "Code itself encourages an expansive reading of § 503(b)," because the "statute explains in § 102(3) that the terms 'includes' and 'including' are not limiting." This permits allowance of administrative expenses in circumstances that were not anticipated.

The examples in § 503(b) are administrative expenses that should be allowed, but they are not the only administrative expenses that may be allowed.

The exclusion of chapter 7 from § 503(b)(3)(D) reflects a sense that "in all but the most atypical chapter 7 case," the U.S. Trustee performs the monitoring function of assuring proper estate administration. But, the U.S. Trustee "is not a fail-proof safeguard," as the facts in the present case demonstrate.

The canon of statutory construction *expression unius est exclusio alterius*, as relied on by the Supreme Court in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012), is inapplicable, because *RadLAX* construed § 1129(b)(2)(A), which does not contain the term "includes" or "including." Congress could have put an express limitation prohibiting chapter 7 substantial contribution claims, but did not do so.

Finally, as a matter of policy, denying substantial contribution claims in appropriate chapter 7 cases disincentivizes creditor participation and goes against the notion of equitable principles governing bankruptcy cases.

F. The Dissent's Approach – Authored by Circuit Judge Kathleen M. O'Malley (of the Federal Circuit, sitting by designation)

Equitable principles in bankruptcy "can only be exercised within the confines of the Bankruptcy Code." [Quoting Supreme Court cases *Law v. Siegel*, 134 S. Ct. 1188 (2014) and *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988).]

Claims for administrative expenses must be strictly construed. [Also quoting *Federated Dep't Stores.*]

Although Congress used "including" in the introductory part of § 503(b), it did not use "including" in the § 503(b)(3), making the enumeration within that subsection exclusive.

Allowing substantial contribution claims in chapter 7 cases would render § 503(b)(3)(D) superfluous.

Legislative history supports the limitation of substantial contribution claims to chapter 9 and 11 cases.

Prior Sixth Circuit authority construing § 503(b)(3)(B), which grants and administrative expense claim to a "creditor that recovers, after the court's approval, for the benefit of the estate property transferred or concealed by the debtor," held such provision applied in both chapter 7 and chapter 11 cases, distinguishing such provision from § 503(b)(3)(D), which expressly applies only in chapter 9 and 11 cases. [Citing *Hyundai Translead, Inc. v. Jackson Truck & Trailer Repair, Inc. (In re Trailer Source, Inc.)*, 555 F.3d 231 (6th Cir. 2009).]

Other provisions of § 503(b)(3) apply in all chapters, which strongly suggests that Congress intentionally excluded chapter 7 cases from substantial contribution claims in § 503(b)(3)(D).

No other circuit court decisions, even those that recognize that the § 503(b) categories are not exhaustive, has permitted a substantial contribution claim in a chapter 7 case in light of the language of § 503(b)(3)(D) specifying chapters 9 and 11.

No pre-Code precedent exists for allowing substantial contribution claims in chapter 7 cases.

No other provision of § 503(b)(3) authorizes administrative expenses similar to substantial contribution claims in chapter 7 cases.

Equitable and policy considerations cut both ways. One of the creditors seeking a substantial contribution claim holds 50% of the debt, so would receive 50% of the benefit from the increased funds. It did not require a substantial contribution claim to encourage its participation. Other non-major creditors would see their recoveries diminish if this creditor also receives a substantial contribution claim.

The Supreme Court has cautioned against courts, as opposed to Congress, providing incentives with respect to the operation of the Bankruptcy Code. [Citing *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992).]

II. Direct Application of *Connolly* Result

In re Ideal Mortgage Bankers, Ltd., 539 B.R. 409 (Bankr. E.D.N.Y. 2015) – citing *Connolly*, assumed substantial contribution claims permitted in chapter 7, but ruled against claimant on the merits for failing to demonstrate a substantial contribution.

III. Indirect Application – Other Worthy Claimants

A. Debtor's Counsel

Lamie v. U.S. Trustee, 540 U.S. 526 (2004) – the Court construed the 1994 amendment to 11 U.S.C. § 330, which deleted the authorization to award fees to the debtor's attorney, and rejected the contention that such deletion was a scrivener's error.

In re Ames Dep't Stores, Inc., 76 F.3d 66 (2d Cir. 1996) – the Second Circuit observed in dicta that the omission of the authorization to award fees to the debtor's counsel in the 1994 amendments to § 330 was inadvertent.

Can the *Connolly* result be used to award fees to debtor's counsel in chapter 7 cases, or in chapter 11 cases in which a trustee is serving, when debtor's counsel performs necessary services or confers a benefit?

Note that debtor's counsel is such instances is not a professional retained by the trustee under § 327, so there would not be a direct conflict with § 330. This distinguishes *Baker Botts L.L.P. v. ASARCO LLC*, 135 S. Ct. 2158 (2015).

B. Creditors' Counsel – Plan Provisions

Can the *Connolly* result be used to authorize payment of attorneys' fees for major chapter 11 participants pursuant to a confirmed plan without demonstrating a substantial contribution?

If so, it would reverse the result in *Davis v. Elliot Mgmt. Corp. (In re Lehman Bros. Holdings Inc.)*, 508 B.R. 283 (S.D.N.Y. 2014), *rev'g In re Lehman Bros. Holdings, Inc.*, 487 B.R. 181 (Bankr. S.D.N.Y. 2013).

C. Other Unenumerated Administrative Expenses

Does the *Connolly* result supply a rationale for treating certain pre-petition claims as administrative expenses?

Critical vendors

Foreign creditors

Employees above the statutory priority

Note that since BAPCPA took effect in 2005:

Pre-petition claims can be administrative - § 503(b)(9).

There is an express prohibition against certain administrative expenses – § 503(c). Other potential administrative expenses are not expressly prohibited.