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Limitations on Business Judgment?

The Intersections of §§ 363(b), 365 and 503(b) for Paying Creditors' Professional Fees

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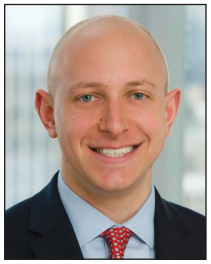

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On Jan. 19, 2021, Hon. **John T. Dorsey** of the U.S. Bankruptcy Court for the District of Delaware in *In re Mallinckrodt plc*[1] approved the debtors' request to reimburse the fees and expenses of parties to a pre-petition restructuring support agreement (RSA), subject to certain modifications. The ruling follows the court's prior decision in the same case denying a similar request for the debtors' failure to demonstrate that the proposed reimbursement would benefit the estate as a whole rather than the creditors individually. The rulings illustrate a potential limitation on a debtor's ability to pay a creditor's fees and expenses under the business-judgment standards under §§ 363 and 365 of the Bankruptcy Code.

Statutory Framework

Section 363(b) authorizes a debtor to "use, sell, or lease, other than in the ordinary course of business, property of the estate" after notice and a hearing.[2] Section 365 authorizes a debtor to assume executory contracts and unexpired leases.[3] Courts generally require that the debtor show that the proposed use of estate property or assumption of an executory contract is a proper exercise of business judgment and is in the best interest of the debtor and its estate.

Section 503(b) of the Bankruptcy Code governs payment of post-petition administrative expenses, which must be paid in full under a chapter 11 plan.[4] Among other things, administrative expenses include the reasonable and necessary costs of the professionals representing the debtor and any official committees appointed by the court that act as fiduciaries for various stakeholders.

Relevant here, § 503(b)(3)(D) provides that a creditor may be reimbursed by the estate for the actual and necessary expenses incurred in "making a substantial contribution" in a chapter 11 case.[5] The Code does not define the phrase "substantial contribution." However, substantial contribution generally requires that "the benefit received by the estate must be more than an incidental one arising from activities the applicant has pursued in protecting his or her own interests."[6] Thus, § 503 "is reserved for those rare and extraordinary circumstances when the creditor's involvement truly enhances the administration of the estate."[7]

Payment of Creditors' Fees and Expenses

Debtors often pay certain fees and expenses that might not otherwise fit within the categories listed in § 503(b). For example, courts have approved the payment of reasonable fees and expenses of proposed bidders for the debtor's assets. Courts have also approved payments of secured creditors' fees and expenses, even where there is no showing that the creditor is oversecured. One question that has arisen, however, is whether a bankruptcy court can authorize a debtor to pay creditors' fees and expenses under § 363(b) as a use of estate funds outside of the ordinary course of business or under an executory contract assumed under § 365 absent a showing that the substantial contribution standard under § 503(b)(3)(D) has been met.

In *In re Lehman Bros. Holdings Inc.*,[8] the U.S. District Court for the Southern District of New York reversed a bankruptcy court order approving a chapter 11 plan's payment of approximately $26 million of fees and expenses incurred by individual members of the official committee of unsecured creditors. In doing so, the district court held that all post-petition administrative-expense claims must fit within one of the enumerated categories in § 503(b) or its "interstices," and that § 503(b)(3)(D) provides the exclusive avenue by which a creditor (or in this case, a committee member) may have its fees and expenses paid by the estate. In *Lehman*'s case, because Congress had amended § 503(b) in 2005 to exclude individual committee members, the district court reasoned that the debtors could not circumvent this provision by creating administrative expense claims under a chapter 11 plan.

In an earlier decision involving § 363(b), the Southern District of New York in *In re Bethlehem*

1 Case No. 20-12522 (JTD).
2 11 U.S.C. § 363(b).
3 11 U.S.C. § 365.
4 11 U.S.C. §§ 503(b)(1)-(9), 507(a) and 1129(a)(9).
5 11 U.S.C. § 503(b)(3)(D). Such expenses must be "reasonable compensation for professional services rendered by an attorney or accountant ... 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." 11 U.S.C. § 503(b)(4).
6 *In re Dana Corp.*, 390 B.R. 100, 108 (Bankr. S.D.N.Y. 2008) (citation omitted).
7 *In re Synergy Pharms. Inc.*, Case No. 18-14010 (JLG), 2020 WL 6537572, at *15 (Bankr. S.D.N.Y. Nov. 5, 2020) (citations omitted).
8 508 B.R. 283 (S.D.N.Y. 2014).

Steel Corp.[9] affirmed a bankruptcy court order authorizing the debtor to reimburse up to $1.4 million of professional fees and expenses incurred by the union representing most of the debtors' approximately 13,200 employees for participating in plan discussions. The district court rejected the U.S. Trustee's argument that the substantial-contribution standard in § 503(b)(3)(D) provides the only basis for a creditor to have its professional fees reimbursed by the debtor. Instead, the court agreed with the debtor that reimbursing the union would incentivize and facilitate meaningful plan negotiations and emphasized the important public policy served by unions.

More recently, the U.S. Bankruptcy Court for the Southern District of New York reconciled these two decisions in *In re Purdue Pharma LP*.[10] In that case, the debtors entered into a reimbursement agreement with an *ad hoc* committee of creditors comprised of certain states and U.S. territories, the Plaintiff's Executive Committee in the national opioid multi-district litigation, and certain other cities and counties that had claims arising from more than 2,600 pre-petition lawsuits regarding the debtors' opioid products. These and other parties had also agreed to the general terms of a non-binding settlement "framework" and term sheet for an eventual restructuring, although the parties did not sign an RSA.

In overruling objections by the official committee of unsecured creditors and the U.S. Trustee, among others, the bankruptcy court followed *Bethlehem Steel* and held that § 363(b) allows for a prospective reimbursement of creditors' fees and expenses where doing so would be in the best interests of the estate and benefit the estate as a whole (rather than the creditor individually). In reaching that conclusion, the bankruptcy court noted the highly unusual circumstances of the case. The members of the *ad hoc* committee were sovereign states and other governmental units that have unique rights under the Bankruptcy Code and pursue public interests different from the general creditor body represented by the official committee of unsecured creditors.[11] In addition, the *ad hoc* committee had already undertaken significant work in negotiating the settlement framework with the debtors, but there were still more negotiations and diligence necessary to achieve a confirmable plan. However, the bankruptcy court required that the order make clear that the *ad hoc* committee's professionals would not be reimbursed for fees and expenses relating to value allocation (an intercreditor issue for which reimbursement would not benefit the estate as a whole, and might favor one group over another) absent a further order of the court.

Enter *Mallinckrodt*.[12] In this case, the debtors entered into a pre-petition RSA with holders of more than 84 percent of the debtors' unsecured notes, 50 attorneys general with respect to claims related to the debtors' opioid medications, and the Plaintiffs' Executive Committee representing more than 1,000 plaintiffs in the national opioid multi-district litigation (collectively, the RSA parties). The RSA included a plan term sheet and incorporated certain settlements regarding the debtors' opioid medications and claims by the Department of Justice. The RSA required the debtors to obtain an order authorizing them to pay the reasonable and documented fees and expenses of the professionals and advisors for the RSA parties (RSA party professionals), and the RSA parties required reimbursement of their costs as a condition to participating in mediation. Certain of these professionals had entered into reimbursement agreements with the debtors.

Rather than seeking to assume the RSA or any of the reimbursement agreements (like in *Purdue*), the debtors first filed a motion to pay the RSA party professionals' fees and expenses pursuant to §§ 105(a) and 363(b). The debtors relied on *Purdue*, arguing that it would be difficult, if not impossible, to negotiate with the myriad plaintiffs holding opioid claims and that the debtors might lose the support of the RSA parties if the motion was denied. The debtors also emphasized the broad support memorialized in the RSA, but noted that such support was only a building block for a chapter 11 plan, which required the debtors to continue negotiating with other parties not yet on board, like their secured lenders, the official committee of unsecured creditors, and the official committee of opioid claimants.

The official committee of unsecured creditors, the official committee of opioid claimants, a group of first-lien lenders and the U.S. Trustee all objected to the motion. These parties primarily argued that the court should review the motion under the substantial-contribution standard in § 503(b)(3)(D) and not the business-judgment standard under § 363(b) as asserted by the debtors. The objectors also challenged the debtors' business judgment in agreeing to pay these fees and expenses because the key parties to any restructuring (such as the senior secured lenders and the official committees) were not parties to the RSA, therefore much more work with critical parties would be needed in order to confirm a plan.

In a Dec. 14, 2020, bench ruling, Judge Dorsey denied the debtors' first motion without prejudice as to the debtors' rights to file a further motion to assume the RSA or the reimbursement agreements. In doing so, the bankruptcy court held that absent an assumption of the RSA or the reimbursement agreements, in circumstances where a debtor is seeking to pay the post-petition fees and expenses of a general unsecured creditor (*i.e.*, the creditor is not making the request), the standard to be applied in approving those payments is the substantial-contribution test in § 503(b)(3)(D) and not the business-judgment test. However, the bankruptcy court clarified that this was not inconsistent with the *Purdue* and *Bethlehem Steel* decisions cited by the debtors, which evaluated whether the proposed reimbursement would benefit the debtors' estates as a whole rather the creditor individually — similar to the substantial-contribution standard that also evaluates whether a creditor's actions benefitted the estate as a whole.

Aside from the legal standard, the bankruptcy court was concerned that various procedural safeguards present in *Purdue* to ensure that parties were not being reimbursed by the estate to promote their own self-interests were not present in *Mallinckrodt*'s case. Specifically, the bankruptcy court noted that reimbursed fees and expenses under § 503(b)

9 Case No. 02 Civ. 2854 (MBM) (S.D.N.Y. July 28, 2003).
10 Case No. 19-23649 (RDD) (Bankr. S.D.N.Y. Nov. 17, 2019).
11 Under the U.S. Trustee's current policy, governmental units may not serve on official committees.
12 *In re Mallinckrodt plc*, Case No. 20-12522 (JTD) (Bankr. D. Del.).

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must (1) be reasonable, and documented and payable under the applicable reimbursement agreement; (2) exclude professionals (including internal counsel) retained or employed by an individual member of the creditor groups; (3) exclude amounts relating to filing objections to other creditors' claims or advancing or prosecuting an RSA party's own claims; (4) exclude payment of fees and expenses related to allocation until there is an order approving the RSA or confirming a plan; (5) require certification that requested fees and expenses do not relate to value allocation; and (6) be subject to the interim compensation order that applied to the estates' professionals (including review by the fee examiner).

Subsequently, on Dec. 30, 2020, the debtors filed a second motion, pursuant to §§ 363 and 365, to assume or enter into new reimbursement agreements with the RSA party professionals, as applicable, as an exercise of their business judgment on the theory that reimbursement of such expenses had already substantially benefitted the estate as a whole and would continue to do so going forward. The proposed order incorporated all of the court's suggestions with one exception: The debtors continued to seek approval to reimburse fees and expenses related to value-allocation disputes. The debtors argued that the resolution of such issues would be a necessary precursor to developing a chapter 11 plan, and that the bankruptcy court in *Purdue* eventually approved such fees and expenses following a successful mediation among the parties.

On Jan. 11-12, 2021, objections to the debtors' second motion were filed by the U.S. Trustee, the first-lien lenders, and plaintiffs in certain non-opioid-related pre-petition lawsuits. The objectors disputed the debtors' characterization of the court's prior ruling, asserting that the court had already determined that the substantial-contribution standard, which cannot be applied to future costs, would apply to the debtors' payment of the RSA party professionals' fees and expenses.

In addition, the objectors raised various technical arguments about the reimbursement agreements not being subject to assumption because there were no material obligations on both sides of the contract — only the condition to reimbursement that the applicable professional submit invoices to the debtors. Aside from whether assumption was appropriate, the first-lien lenders reiterated their position that the debtors had not shown that payment of the RSA party professionals' fees and expenses would benefit the estate as a whole. It is noteworthy that neither of the official committees (each of which had objected to the first motion) objected the second time around, which was apparently due to the debtors' revisions to the proposed order.

After further oral argument, on Jan. 19, 2021, the bankruptcy court approved the debtors' second motion subject to modifications to the proposed order and authorized payment of RSA parties' fees and expenses pursuant to §§ 365(a) and 363(b). The court found that the debtors' revised order satisfied the court's concerns that the parties ensure that reimbursements will only be for work that benefits the estate as a whole. The court reiterated the significant size and complexity of the chapter 11 cases, including that they raised serious public health concerns that touch on nearly every segment of society, and that the parties would be well served by the debtors spending estate funds on reimbursing costs related to negotiations rather than litigation. However, the court required the order to provide that if the mediation fails, the debtors would no longer reimburse any RSA parties' costs absent further order of the court, and if any party had not acted in good faith in the mediation, payment of their fees and expenses would be subject to disgorgement.

Conclusion

The statutory framework analyzed by the bankruptcy court in *Mallinckrodt* will continue to be considered by courts, particularly as debtors explore ways to build consensus and encourage participation in designing and formulating confirmable plans of reorganization supported by their creditors. abi