AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
The Essential Resource for Today's Busy Insolvency Professional

Problems in the Code

By Daniel A. Lowenthal and Dennis J. Shaffer

The "Substantial Contribution" Test for Indenture Trustees

Is It an Unfair Requirement?

Daniel A. Lowenthal
Patterson Belknap Webb & Tyler LLP
New York

Dennis J. Shaffer
Whiteford Taylor Preston LLP; Baltimore

Daniel Lowenthal is a partner with Patterson Belknap Webb & Tyler LLP in New York and chair of its Business Reorganization and Creditors' Rights Practice. Dennis Shaffer is a partner with Whiteford Taylor Preston LLP in Baltimore.

Indentures often provide that an indenture trustee's expenses incurred after an event of default constitute administration expenses under applicable bankruptcy law. However, § 503(b)(5) requires indenture trustees to show that they have made a "substantial contribution" in a case in order to receive their fees and costs. This means that a trustee is held to a higher standard than the "actual, necessary" standard that other administrative expense claimants must satisfy pursuant to § 503(b)(1)(A). Even so, some courts permit trustees to be paid from estate funds under the terms of a chapter 11 plan without satisfying the substantial-contribution standard, although the case law is not uniform.

For example, the U.S. Bankruptcy Court for the District of Delaware recently allowed payment of an indenture trustee's professional fees under a plan provision without satisfying the substantial-contribution test.[1] In contrast, the U.S. District Court for the Southern District of New York reversed the bankruptcy court's decision to allow a trustee's individual professional fee under § 1129(a)(4) of the Bankruptcy Code,[2] holding that § 503(b) and its substantial-contribution test is the sole source of recovery for an indenture trustee to receive administrative expense payments for work on a creditors' committee.

This inconsistency can — and should — be resolved by an amendment to the Code. The fix is simple: Congress should delete the substantial-contribution requirement in § 503(b) for indenture trustees. This would enable trustees to receive fees and expenses incurred as an administrative expense claim if, like other similarly situated creditors, they satisfy the "actual, necessary" test.

The Indenture Trustee's Role in a Bankruptcy Case

Like other administrative creditors, a trustee often plays a significant role in a bankruptcy case. However, unlike some other creditors who may not expend resources to actively participate in a case, an indenture trustee is *required* under its indenture to actively participate in a case for its noteholders and, as a member of the creditors' committee, on behalf of all creditors.

Both federal law and the language included in most indentures mandate this active role. Section 315(c) of the Trust Indenture Act of 1939 (TIA) imposes "prudent man" duties upon indenture trustees:

> The indenture trustee shall exercise in case of default (as such term is defined in such indenture) such of the rights and powers vested in it by such indenture, and to use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.[3]

Congress has established the public policy goals underpinning the TIA:

> [T]he national public interest and the interest of investors in notes, bonds, debentures, evidences of indebtedness, and certificates

1 *See In the Matter of Se. Grocers LLC*, No. 18-10700 (MFW), (Bankr. D. Del. 2018) (rejecting challenge to indenture trustee's professional fees). *See also* Ben Feder, "Delaware Judge Rejects Challenge to Payment of Fees for Indenture Trustee in Southeastern Grocers Chapter 11 Case," *Bankruptcy Law Insights* (June 12, 2018), *available at* bankruptcylawinsights.com/2018/06/delaware-judge-rejects-challenge-to-payment-of-fees-for-indenture-trustee-in-southeastern-grocers-chapter-11-case (last visited on Jan. 3, 2019).

2 *See Davis v. Elliott Mgmt. Corp. (In re Lehman Bros. Holdings Inc.)*, 508 B.R. 283, 290 (S.D.N.Y. 2014).

3 15 U.S.C. § 77ooo.

> of interest or participation therein, which are offered to the public, are adversely affected ... when the trustee does not have adequate rights and powers, or adequate duties and responsibilities, in connection with matters relating to the protection and enforcement of the rights of such investors; ... [and] when the trustee does not have resources commensurate with its responsibilities.[4]

Most indentures require the indenture trustee to act as a "prudent person" when an issuer defaults. The following language is standard in indentures: "The Trustee shall exercise such rights and powers vested in it by this Indenture, and use the same degree of care and skill in its exercise, as a prudent person would exercise or under the circumstances in the conduct of such person's own affairs." Moreover, indentures are often governed by New York law, which requires indenture trustees to act prudently after an event of default.[5]

The Bankruptcy Code and its legislative history contemplate an active role for indenture trustees in bankruptcy cases. The Code includes many references to indenture trustees: § 101(29) (defining "indenture trustee"); § 303(b)(1) (an indenture trustee might be a petitioning creditor in an involuntary case); § 343 (an indenture trustee might examine the debtor at a § 341 meeting); § 501(a) (an indenture trustee might file a proof of claim); § 1106(a)(4) (an indenture trustee must receive any statement of investigation conducted by a chapter 11 trustee or examiner); § 1109(b) (an indenture trustee might appear and be heard in a case under title 11); and § 1121(c) (an indenture trustee could file a plan). Moreover, the legislative statements contained within the revision notes to chapter 11 make clear Congress's recognition that, "[g]iven the high standard of care to which indenture trustees are bound, [indenture trustees] are invariably active and sophisticated participants in efforts to rehabilitate corporate debtors in distress."[6]

Most indentures require issuers to compensate the indenture trustee for its fees and expenses, as well as those of its agents and counsel. Indentures often state that when a trustee incurs expenses or renders services after an event of default, such expenses "are intended to constitute expenses of administration under any Bankruptcy Law," thus elevating a trustee's claim to be on par with other administrative creditors. Indentures also grant a "charging lien" to trustees to secure repayment of fees and expenses, ensuring that trustees are paid from distributions to noteholders.[7]

These provisions are important in the protections that they are intended to provide to an indenture trustee in fulfilling its statutory and contractual duties to act prudently for noteholders in bankruptcy cases, which often requires significant additional services. These services include acting as a liaison with the debtor, providing administrative services to noteholders by streamlining the claims and balloting processes, and service on a creditors' committee.

In addition, debtors' estates directly benefit from the work of indenture trustees. Debtors need not communicate directly with all noteholders, but only with the indenture trustee, who will communicate with its noteholders about case developments and deadlines. Indenture trustees will also file a single proof of claim for all noteholders, relieving the estate from handling the administration of scores of separate claims on behalf of possibly thousands of individual noteholders.

The Problem Facing Indenture Trustees When Performing Duties

There is an issue that often arises when indenture trustees play an active role and incur significant fees and expenses: Should a trustee's fees and expenses be paid by the estate under a chapter 11 plan, under the charging lien included in the indenture or as an administrative expense claim as provided for in the indenture? The different forms of reimbursement can impact noteholder recovery. Application of the charging lien forces noteholders to directly bear the expenses of the indenture trustee, while having such expenses paid directly from the bankruptcy estate as an administrative expense or under a plan fulfills the contractual requirement under the indenture while placing the burden of these expenses on the debtor's estate, consistent with the intent of the indenture.

It is not disputed that an indenture trustee's expenses can be paid out of the debtor's bankruptcy estate. Section 503(b)(3)(D) and (b)(4) permit payment of an indenture trustee's fees as an administrative expense of the estate, while § 503(b)(5) provides for the payment of compensation for indenture trustees as an administrative expense. However, both the reimbursement of fees and expenses and payment under § 503(b) require a substantial contribution by the indenture trustee. Thus, even if a consensual plan permits payment as an administrative expense,[8] an indenture trustee could be required to satisfy the substantial-contribution test.

The Offices of the U.S. Trustee in New York and Delaware have taken this view and have objected to plans that permit indenture trustees to be paid fees and expenses under a plan pursuant to §§ 1123(b)(6) and 1129(a)(4). However, this places a greater burden on the trustee than a typical administrative expense claimant, which must show only that its claim relates to the "actual, necessary costs and expenses of preserving the estate" under § 503(b)(1).

Can Fees and Expenses Be Allowed Without Showing Substantial Contribution?

Some courts have allowed trustees to be paid their fees and expenses under § 1123(b)(6), which provides that "a plan may ... include any other appropriate provision not

4 15 U.S.C. § 77bbb(a) and (a)(2).

5 *See, e.g., Beck v. Mfrs. Hanover Trust Co.*, 218 A.D.2d 1, 13 (N.Y. App. Div. 1995) ("The trustee must in the post-default context act prudently, but only in the exercise of those rights and powers granted in the indenture"; despite this, "[t]he trustee is not required to act beyond his contractually conferred rights and powers, but must, as prudence dictates, exercise those singularly conferred prerogatives in order to secure the basic purpose of any trust indenture, the repayment of the underlying obligation.").

6 11 U.S.C. § 1101.

7 Typically, indentures governed by New York law include such language as, "To secure the payment obligations of the issuer and the guarantors, the trustee shall have a lien prior to the notes on all money or property held or collected by the trustee. Such lien shall survive the satisfaction and discharge of this Indenture."

8 *See, e.g.*, Order Confirming Fourth Amended Plan of Reorganization, *In re Exide Techs.*, No. 1311482 (KJC) (Bankr. D. Del. March 27, 2015), ECF No. 3423; Fourth Amended Plan of Reorganization § 2.5, ECF No. 3243-2 (providing, in reorganization plan, for debtor to pay fees and expenses incurred by subordinated notes trustee); *see also* Order Confirming Seventh Amended Joint Plan of Affiliated Debtors Pursuant to Chapter 11, *In re Washington Mut. Inc.*, No. 08-12229 (MFW) (Bankr. D. Del. Feb. 24, 2012), ECF No. 9759.

inconsistent with applicable provisions of this title," and § 1129(a)(4), which provides for the payment of costs and expenses in a case, or in connection with a plan and incident to a case, that has been approved or is subject to court approval as reasonable. In *In re Southeastern Grocers LLC*, the U.S. Trustee objected to a plan provision that permitted payment of an indenture trustee's professional fees without requiring the showing of a substantial contribution under § 503(b). The bankruptcy court overruled the objection, stating that payment under the plan was appropriate and that it was unnecessary to review the expenses or interfere with that agreement.[9]

This ruling follows the decision in *Energy Future Holdings Corp.*, where indenture trustees (and others) sought fees under a plan provision under §§ 1129(a)(4) and 1123(b)(6)[10] while arguing that they had made a substantial contribution and would be entitled to payment under § 503(b).[11] The U.S. Trustee argued that trustees should receive payment only from either the exercise of the charging lien or upon satisfaction of the substantial contribution test in § 503(b)(3)(D) and (b)(4).[12]

The court approved the payments, stating that the parties provided a substantial contribution,[13] further stating that it could authorize the indenture trustees' fees outside of § 503 and without court review as to reasonableness, citing *In re Adelphia Communications Corp*.[14] While the court said it did not reject the reasoning of *Adelphia*, it concluded that § 503 was satisfied.[15]

This ruling followed *Lehman I*,[16] where the plan provided for the payment of indenture trustees' professional fees under § 1129(a)(4) for their service on the official creditors' committee.[17] The U.S. Trustee objected to payment under § 1129(a)(4), arguing that the trustees had to satisfy § 503(b)(3)(D) and (b)(4).[18] However, the court disagreed with the U.S. Trustee and allowed payment under the plan, following the decisions in the *Adelphia* and *AMR* cases that allowed payments under §§ 1104(a)(4) and 1123(b)(6).[19]

In reversing on appeal, the district court held that § 503(b) is the "sole source of administrative expenses," requiring indenture trustees (and others) that seek administrative expense payments for work on a creditors' committee to satisfy the substantial-contribution standard.[20] However, this decision is inconsistent with the aforementioned decision in *Southeastern Grocers*.

A Legislative Solution: Remove the "Substantial Contribution" Requirement

To avoid inconsistent approaches, § 503(b)(4) and (b)(5) should be amended to delete the requirement that indenture trustees must make a substantial contribution in order to be reimbursed directly from the debtor's bankruptcy estate. This would not only resolve the inconsistent standards placed on indenture trustees in having fees and expenses approved, it would provide fair treatment to indenture trustees *vis-à-vis* other administrative creditors. Indenture trustees should only be required to satisfy the same standard for administrative expense claims as other administrative creditors. abi

Reprinted with permission from the ABI Journal, Vol. XXXVIII, No. 2, February 2019.

9 *See* Transcript of Hearing Held May 14, 2018; pp. 37-38, *In re Se. Grocers LLC*, Case No. 18-10700 (MFW) (Bankr. D. Del. 2018).

10 *See, e.g.*, Sixth Amended Joint Plan of Reorganization of Energy Future Holdings Corp., *et al.*, Pursuant to Chapter 11 of the Bankruptcy Code, *In re Energy Future Holdings Corp.*, Case No. 14-10979 (Bankr. D. Del. 2014), ECF No. 7188.

11 *See* Transcript of Hearing Held Dec. 3, 2015; pp. 34-35, *In re Energy Future Holding Corp., et al.*, Case No. 14-10979 (Bankr. D. Del. 2014).

12 *See id.* at 34-35, 80-81 (court discussing U.S. Trustee's argument regarding payment via charging lien or via showing of "substantial contribution").

13 *See id.* at 36-37.

14 441 B.R. 6 (Bankr. S.D.N.Y. 2010).

15 *Id.*

16 *In re Lehman Brothers Holdings Inc.*, 487 B.R. 181 (Bankr. S.D.N.Y. 2013), *rev'd*, 508 B.R. 283 (S.D.N.Y. 2014).

17 *Id.*

18 *Id. See* U.S. Trustee's Objection to the Fifth Amended Joint Plan of Reorganization of Energy Future Holdings Corp., *et al.*, Pursuant to Chapter 11 of the Bankruptcy Code and the Motion of Energy Future Holdings Corp., *et al.*, to Approve a Settlement of Litigation Claims and Authorize the Debtors to Enter into and Perform Under the Settlement Agreement, *In re Energy Future Holding Corp., et al.*, Case No. 14-10979 (Bankr. D. Del. 2014) ECF No. 6705.

19 *Id.* at 190-93. *See Adelphia*, 441 B.R. at 22-23; *In re AMR Corp.*, 497 B.R. 690 (S.D.N.Y. 2013).

20 *Davis v. Elliott Mgmt. Corp. (In re Lehman Bros. Holdings Inc.)*, 508 B.R. 283, 290 (S.D.N.Y. 2014). *Davis* could be narrowly viewed in that it did not address whether indenture trustees could be paid for their work in a case unrelated to service on the creditors' committee.