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Losing Bidder Has Standing to Seek Reimbursement of Fees and Expenses

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A New York bankruptcy court recently held that a losing acquiror in a competing Chapter 11 plan fight had "standing" to seek reimbursement of its legal fees and expenses as a "substantial contribution" to the reorganization case. In re S & Y Enterprises, LLC, et al., 2012 Bankr. LEXIS 4622, at *4-5 (Bankr. E.D.N.Y., Sept. 28, 2012). Nevertheless, the losing acquiror failed to recover because, in the court's view, it failed to satisfy the statutory requirements for reimbursement with the requisite "preponderance of the evidence." Id. According to the court, Bankruptcy Code (Code) § 503(b)(3)(D) permits an entity in a reorganization case "to seek … to recover its 'actual, necessary expenses' in making a substantial contribution" only if it proves that its "contributions are of such consequence to the bankruptcy process and the parties as a whole that the debtor's estate, rather than the entity should bear the reasonable cause of those contributions . …" Id. at *2. The losing acquiror failed this test, reasoned the court, in a close call, at best.

Relevance

S&Y deals with an asset acquiror who had no contractual expense reimbursement rights. On the facts stated by the court, the acquiror never asked for such a provision when making its offer to the debtors. More significant, however, was the court's granting the acquiror standing to seek reimbursement while imposing, at the same time, a virtually impossible obstacle to recovery.

Facts

Each of the two debtors in S&Y was a single asset real estate entity with properties in New York City. They had initially agreed to sell their properties to acquiror A for $20 million plus a 25% interest in the acquiring entity. A intended to develop the properties into "an upscale retail property." Id. at *6. Because of "increased construction costs and zoning issues," A later reduced the purchase the price "from $20 million to $16.5 million." Id. at *6. When a lender and another entity objected to the debtors' proposed reorganization plan based on the proposed asset sale to A, a new potential acquiror, B, offered to buy the property for $21 million, plus a 35% equity interest. After further litigation, A increased its offer to $21.9 million with a waiver of its claims based on the debtors' rejection of the original sale agreement. Despite B's objection, the court eventually confirmed a new reorganization plan based on A's higher bid.

B later applied to the court, seeking "allowance of an administrative expense for making a substantial contribution in" the two debtor cases. According to B's papers, it "contributed to the success of the … reorganization by causing [A], the successful purchaser, to increase its offer for the Debtors' properties, by drafting and defending the

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Debtors' … plans and disclosure statements, which were ultimately not confirmed, by participating in motion practice and negotiations, and by paying the counsel fees and expenses of the Debtors' principals … ." Id. at *3.

Applicable Standards for a Substantial Contribution Award

Bankuptcy Code § 503(b)(3)(D) enables recovery of the "actual, necessary expenses" incurred by "a creditor, an indenture trustee, an equity security holder, or a committee representing creditors or equity security holders … in making a substantial contribution in a case" under Chapter 11 (emphasis added). These expenses may include "reasonable compensation for professional services rendered by an attorney of … an entity whose expense is allowable" under § 503(b)(3)(D). Code § 503(b)(4).

The substantial contribution provision "is intended to promote meaningful … participation in the reorganization process, but not to encourage mushrooming administrative expenses." In re Alert Holdings Inc., 157 B.R. 753, 757 (Bankr. S.D.N.Y. 1993). According to the court in S&Y, "[p]ayment from the debtor's estate of a creditor's or other entity's counsel fees and expenses based on a substantial contribution … should be the exception, not the rule, because any allowed administrative expense diminishes the assets … available for the debtor's plan of reorganization." Id. at *12. A court should thus "strictly limit … compensation to extraordinary creditor actions which lead directly to tangible benefits to the creditors, debtor or estate." Id., quoting In re Best Prods. Co., 173 B.R. 862, 866 (Bankr. S.D.N.Y. 1994).

Standing to Seek Substantial Contribution Award

Bankruptcy Code § 503(b)(3)(D) enables certain prospective applicants, "including … a creditor, an indenture trustee, an equity security holder, or a committee representing creditors or equity security holders" to seek a substantial contribution award. Because this list is nonexclusive, lower courts are split as to whether standing is limited to creditors. See, e.g., In re Bethlehem Steel Corp., 2003 WL 21738964, at *8 (S.D.N.Y. July 28, 2003) (third-party plan funder "was not a creditor, and thus could not have applied for reimbursement"); In re Innkeepers USA Trust, Case No. 10-13800, Transcr. 71-72 (Bankr. S.D.N.Y. Aug. 2, 2011) (although bidder "was an active and positive participant in the debtor's auction and plan process," it was not a creditor and thus "not a party eligible to submit a substantial contribution claim. … "). Other courts, however, do not require creditor status in this context. In re Frog and Peach Ltd., 38 B.R. 307, 310 (Bankr. N.D. Ga. 1984) (no "outright bar against an administrative claim by a meritorious, non-creditor claimant which has directly conferred a benefit upon the debtor and whose claim is outside the literal categories defined by … § 503(b)."); In re Amfesco Industries, Inc., 1988 WL 141524, *4 (E.D.N.Y. Dec. 21, 1988) (acquiring investor had standing to seek substantial contribution award despite its not being "a 'creditor' in the traditional sense"), citing Frog and Peach, 38 B.R. at 309-10).

The S&Y court found the list of prospective applicants in Code § 503(b) to be "illustrative, not exclusive." 2012 Bankr. LEXIS 4622, at *17-18. According to the court, "a substantial contribution in a Chapter 11 case may come from many quarters, and that sometimes, an applicant's efforts in advancing a debtor's reorganization are of such a nature and extent that the reasonable costs of those efforts should be shifted from the applicant to the estate. … But § 503 does not open that door too wide, and the inquiry in each situation should be case-specific and fact-intensive." Id. at *18.

Losing Acquiror Has Standing

The Debtor and A argued that "an unsuccessful bidder for estate assets [who] is not a creditor lacks standing" to seek a substantial contribution award. Id. at *19. Moreover, they argued that B "could have sought a break-up fee expense reimbursement or other bid protection terms at the outset of its involvement

… ," but did not do so. Id. Rejecting these arguments as to B's lack of standing, the court held that B had standing to apply for a "substantial contribution" award "to recover the counsel fees and expenses that it paid on behalf of itself and [the debtors' principals]," reasoning that the Code's list

of "prospective applicants" is "illustrative, not an exclusive, list." Id. at *20. Moreover, Congress could not draft "a comprehensive list" of eligible applicants because of "the wide range of entities and enterprises that may merit" a substantial contribution award. Id.

Standard for Substantial Contribution Award

The applicant for a substantial contribution award has the burden of proving by "a preponderance of the evidence" that it is entitled to extraordinary relief. In re Drexel Burnham Lambert Grp. Inc., 134 B.R. 482, 489 (Bankr. S.D.N.Y. 1991). Moreover, the burden "is exceedingly difficult since the general presumption is that the [applicant] is acting in its own interest." In re Villa Luisa, 354 B.R. 345, 348 (Bankr. S.D.N.Y. 2006). Thus, one court held, in the context of a bankruptcy auction that a substantial contribution award to an unsuccessful bidder was not warranted:

[W]hen a creditor is pursuing its own economic self-interest, as by definition it does as a bidder at a bankruptcy auction, then that creditor cannot establish the requisite 'direct benefit' which the case law requires in order to grant a creditor a [substantial contribution] award.

In re Pub. Serv. Co. of N.H., 160 B.R. 404, 452 (Bankr. D.N.H. 1993).

Courts have focused on "process as much as on contribution, on the movant's substantial contribution in the case — that is, the entire Chapter 11 case." In re Bayou Grp., LLC, 431 B.R. 549, 561 (Bankr. S.D.N.Y. 2010):

The majority of cases allowing creditors' substantial contribution claims under sections 503(b)(3)(D) and (b)(4) have … found that the creditor played a leadership role that normally would be expected of an estate-compensated professional but not so performed; most have, … involved a creditor who actively facilitated the negotiation and successful confirmation of the Chapter 11 plan or, in a opposing a plan, brought about the confirmation of a more favorable plan.

Bayou, 431 B.R. at 562. Relying on these few precedents, the S&Y court applied them narrowly to B's claim.

B's Arguments

B argued that its efforts resulted in a $4.5 million higher bid from A; "provided a greater ownership interest in" the reorganized entity for the debtor's principals; enhanced the debtors' "negotiating leverage" with A; formulated and defended a new reorganization plan on the debtors' behalf; participated in "extensive discovery" to show that it "was a 'real' bidder and that the second amended plans were viable"; and participated in motion practice and discovery. 2012 Bankr. LEXIS 4622, at *28. Arguing that "it effectively acted as co-counsel to the Debtors," that its services were "essential" and that "self-interest [did] not preclude" an award, B sought "counsel fees and expenses" of "more than $1 million." Id. at *28-*29.

Court's Reasoning: Indirect Benefit Not a Substantial Contribution

Despite acknowledging B's standing to seek reimbursement, the court denied its application. First, B's activities were "principally in furtherance of its efforts to acquire the Debtors' properties … and to advance [its] own interests, not the interests of the bankruptcy estate or the parties as a whole." Id. at *32. Second, despite causing A to increase its purchase price, the court found this activity led to "an indirect benefit," which was "not enough." Id. at *32-*33. Finally, although the reorganization was successful in the sale of the debtors' properties, B's "efforts were directed toward its own objectives, not the entire bankruptcy process." Id. at 33.

Nor could B be compensated for its legal fees incurred on behalf of the debtors' principals. First, there was no evidence that the principals "played a role in the bankruptcy process that yielded a direct and significant benefit to the bankruptcy estate or the parties as a whole." Id. at *38. Nor did B show that the principals "would have been unable to retain counsel or participate in these … cases if it had not paid these sums." Id.

Comments

1. The S&Y court summarily dismissed the tangible benefit conferred by B on the debtors' estate and all creditors: causing A to increase "its offer for the … properties by $4.5 million … ." Id. at *28. According to the court, "the primary objective of [B's] activities was to advance [its own] interest,

not the interest of the bankruptcy estate or the parties as a whole." Id. at *32. As shown below, however, the court's analysis is unfairly narrow in view of applicable case law.

2. B was no mere bidder at an auction. When A, the only apparent buyer, unilaterally reduced its original bid, B stepped up with a $4.5 million higher bid, causing A to top B's offer by another $900,000. B also did the work to amend the debtors' original reorganization plan and disclosure statement, effectively inducing A to return with an even higher offer for the debtors' assets. In the end, it was only because of B's effort that creditors realized $21.9 million rather than the reduced $16.5 million offer from A.

3. Significantly missing from the S&Y court's decision was any mention of important appellate decisions authorizing "substantial contribution" awards on similar or even less favorable facts. See, e.g., In re DP Partners Ltd. Partnership, 106 F.3d 667, 673 (5th Cir. 1997) ("Thus, the phrase 'substantial contribution … means a contribution that is 'considerable in amount, value or worth.' The benefits, if any, conferred upon an estate are not diminished by selfish or shrewd motivations. We therefore hold that a creditor's motive in taking actions that benefit the estate has little relevance in the determination whether the creditor has incurred actual and necessary expenses in making a substantial contribution to a case … . At a minimum, the court should weigh the cost of the claimed fees and expenses against the benefits conferred upon the estate which flow directly from those actions"; party discovered fraudulent transfers, and caused amendment of reorganization plan; " … participation in the confirmation fight resulted in a least a $3,000,000 benefit to all creditors of the estate."); In re Celotex, 227 F.3d 1336, 1339 (11th Cir. 2000) (adopting the Fifth Circuit's holding in DP Partners that motive "has little relevance" in determining whether a party made substantial contribution; " … it is difficult to imagine a circumstance in which a creditor will not be motivated by self-interest in a bankruptcy [case]. To impose an altruism requirement on the ability to obtain" an award "would effectively render the section meaningless … ."; applicant "played a significant role in the successful negotiation of a consensual plan …"; "a large portion of credit for achievement of the plan was attributable to [him] because of his credibility and the experience … that he brought to the process"; without his "efforts a reorganization plan may not have been achieved"; " … a substantial contribution has been demonstrated."); In re Cellular 101, Inc., 377 F.3d 1092, 1097 (9th Cir. 2004) (creditors "substantially contributed to the reorganization. [They] formulated and presented the only reorganization plan that … resulted in the payment to creditors of 100% of the creditors' allowed claims with funds remaining for the equity security holders. … [A] creditor need not provide the funds used in the reorganization in order to 'substantially contribute' to the plan."); In re Roberts, 93 B.R. 442, 445 (D. So. Cir. 1988) (affirmed bankruptcy court's "substantial contribution" award to unsecured creditor whose "efforts to secure interest payments for all unsecured creditors was continuous throughout the pendency of" case; creditor "was protecting the interests of all unsecured creditors rather than just its own interests"; its "efforts may have resulted in as much as an additional … $75,000 … in interest payments to the unsecured creditors."). See also In re 9085 E. Mineral Office Bldg., Ltd., 119 B.R. 246, 249-50 (Bankr. D. Colo. 1990) (held, substantial contribution when, due to applicant's efforts, all creditors received superior payout to that proposed by debtor).

4. An appellate court in S&Y could easily reach a different result from the one reached by the bankruptcy court. The Second Circuit has yet to weigh in on Code § 503(b)(3)(D), but if $3 million is enough for the Fifth Circuit in DP Partners, supra, $4.5 million should be "substantial," even in New York. If that is not a "substantial contribution" in a relatively small real estate case, nothing will ever be.

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