Lehman: Plans Can't Bypass the Bankruptcy Code (Even with Consent)

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The Bankruptcy Code has substantive protections that may not be bargained away, and creditor consent cannot cure all defects in a reorganization plan. That is the holding of the United States District Court for the Southern District of New York in a recent decision arising in the *Lehman Brothers* case.[1] The district court decision may have far-reaching implications for the increasingly prevalent bankruptcy practice of elevating consent among debtor's management and select creditors over the commands of the Bankruptcy Code and broader stakeholder interests.

The district court vacated the bankruptcy court's decision allowing the estate to pay creditors' committee members' individual legal fees under the chapter 11 plan. The bankruptcy court had approved the payments as reasonable under 11 U.S.C. § 1129(a)(4) without requiring the creditors to prove a substantial contribution under 11 U.S.C. § 503(b)(3) and without regard to the statutory limitation on paying individual professional fees for committee members under 11 U.S.C. § 503(b)(4). Although it should be no surprise that the district court properly enforced the Code's limits on what creditors' fees and expenses an estate may pay, its ultimate importance likely derives from the broader principles it espouses. Whether denominated a "contractual patch," statutory "work-around" or "backdoor," certain types of "creative" plan provisions undermine the integrity of the Code and thwart the legislative will of Congress. As the district court said, the federal bankruptcy scheme "cannot remain comprehensive if interested parties and bankruptcy courts in each case are free to tweak the law to fit their preferences."[2]

Adelphia, Lehman, and "Consensual" Plan Payments

The plan provision the district court invalidated had its roots in an earlier bankruptcy court decision, *In re Adelphia Communications Corp.*, which permitted the debtors to reimburse the attorney fees of certain key creditors to facilitate plan confirmation.[3] In *Adelphia*, the debtor agreed to pay the legal fees of objecting creditors when those creditors withdrew their plan objections. But those legal fees could not be paid as § 503(b) administrative expenses because the creditors had not demonstrated a substantial contribution to the estate. Nevertheless, the *Adelphia* court concluded that proving substantial contribution was unnecessary: because the

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[1] *Davis v. Elliot Management Corp. (In re Lehman Bros. Holdings, Inc.)*, 508 B.R. 283 (S.D.N.Y. 2014) ("*Lehman II"), vacating In re Lehman Bros. Holdings, Inc.*, 487 B.R. 181 (Bankr. S.D.N.Y. 2013) (*"Lehman I"*), *motion to certify interlocutory appeal under 28 U.S.C. § 1292(b) filed Apr. 25, 2014*.

[2] *Lehman II*, 508 B.R. at 294.

[3] 441 B.R. 6 (Bankr. S.D.N.Y. 2010); *see also* John Sheahan, *You Support My Plan, I'll Pay Your Attorneys: A Troubling Precedent,* XXXI AM. BANKR. INST. J. 24 (May 2012).

fees were part of the plan, they could be approved under § 1123(b)(6), which authorizes plans to include "any other provision not inconsistent" with the Code, as well as § 1129(a)(4), which provides that payments for services or for costs and expenses in connection with the case or with a plan must be "reasonable."[4]

Despite the bankruptcy court's prediction that plans paying creditors' fees outside of § 503(b) would be "rare,"[5] *Adelphia*'s permissive plan payment provision was soon imitated and expanded. For example, in *Lehman*, the plan proponents invoked *Adelphia*, as well as §§ 1123(b)(6) and 1129(a)(4), to pay a $26 million administrative expense for the legal fees incurred by creditors' committee members in their individual capacities. But in 2005, Congress had specifically amended § 503(b)(4) to "exclude professional fee expenses for official committee members."[6] Because the legal fees arose from the creditors' service on the *Lehman* committee and were *not* fees for the committee's retained professionals, the $26 million payment violated § 503(b)(4). Thus, *Lehman I* substantially extended the holding of *Adelphia*, permitting the plan to override the substantial contribution test of § 503(b)(3)—as in *Adelphia*—and to override § 503(b)(4)—which was not at issue in *Adelphia*.

As in *Adelphia*, the U.S. Trustee was the sole objector to the proposed creditor payments in *Lehman*. Though the bankruptcy court candidly observed that the *Lehman* plan provision was designed to "circumvent" the prohibitions of § 503(b), it nevertheless approved the payment.[7] Relying on *Adelphia*, the bankruptcy court concluded that § 503(b) does not apply to "consensual" plan payments, at least where those payments were part of a "spectacularly successful plan process" in which the plan was "accepted in a lopsided affirmative vote by a vast majority of accepting creditors."[8]

On appeal, the district court rejected the bankruptcy court's rationale. The district court correctly observed that the parties had "devised a work-around"[9] of the Code that "smuggled in"[10] these payments through the "backdoor"[11] of a plan. But the district court ruled that "neither the need for flexibility in bankruptcy cases, the consensual nature of [the *Lehman* plan], nor a bankruptcy court's approval of a payment as 'reasonable' can justify a plan payment that is merely a backdoor to administrative expenses that § 503 has clearly excluded."[12] Moreover, the district court vindicated a critical principle underlying the Code: "interested parties and

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[4] *Id.* at 19.
[5] *Id.* at 17.
[6] *Lehman II*, 508 B.R. at 290; *see also* H.R. REP. NO. 109-31, at 142 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 201 ("Expenses for attorneys or accountants incurred by individual members of creditors' . . . committees are not recoverable but expenses incurred for such professional services incurred by such committees themselves would be.").
[7] *Lehman I*, 487 B.R. at 185.
[8] *Id.* at 192.
[9] *Lehman II*, 508 B.R. at 288.
[10] *Id.* at 291.
[11] *Id.* at 293.
[12] *Id*.

bankruptcy courts in each case are [not] free to tweak the law to fit their preferences."[13] The district court also characterized the *Adelphia* decision on which the bankruptcy court relied as "wholly miss[ing] the point" because Congress in the Code had already settled the policy debate about which fees may properly be paid from a bankruptcy estate.[14] As a result, the district court vacated the bankruptcy court's decision and remanded with instructions that the bankruptcy court review the requests for fees under the Code's § 503(b) standards that the *Lehman* plan bypassed.[15]

The Impact of *Lehman II*

Apart from its impact on creditors in the *Lehman* case itself, the decision's implications go far beyond the issue of fees. The Code establishes rules and standards in many areas, such as hiring and paying professionals, awarding bonuses to insiders, and paying claims and expenses in the order of priority. The district court observed that confirming a plan that contravenes the Code can lead to "serious mischief" and gave as an example gift plans, where senior creditors are bypassed and junior creditors are paid in violation of the priority of payment established by Congress.[16] Similarly, the district court was unequivocal that chapter 11 plans may pay only claims and administrative expenses, and allowing so-called "permissive plan payments" not grounded in the Code is unlawful.[17] Notwithstanding the flexibility of chapter 11, parties in bankruptcy courts are not free to "smuggle" through the "backdoor" what cannot permissibly "walk" through the "front."

The district court's analysis is clear and compelling and should have important and positive consequences for the bankruptcy system as a whole. For example, because courts may award only those administrative expenses that Congress has specifically authorized, *Lehman II* should contain the proliferating costs in bankruptcy by ensuring that estates do not bear a creditor's professional expenses unless it has satisfied § 503's stringent substantial contribution requirements. *Lehman II* should also dissuade committee members from demanding payments as a condition for supporting a proposed plan and debtors from offering such payments as incentives for that support. This bolsters confidence in the plan confirmation process by eliminating a serious source of potential conflict for committee members, who owe a fiduciary duty to all the creditors they represent. In that role, committee members "participate in the formulation of a plan" and "advise those represented" by the committee of the "committee's determination as to any plan formulated . . . ."[18] The duty to work with a debtor to write the plan "is so important because the reorganization plan is at the heart of the Chapter 11 process."[19] Thus, an official committee's negotiation and recommendation of a plan must be based solely on

[13] *Id.* at 294.
[14] *Id.*
[15] *Id.* at 296.
[16] *Id.* at 293.
[17] *Id.* at 294.
[18] 11 U.S.C. § 1103(c)(3).
[19] *Lehman II*, 508 B.R. at 287.

the best interests of all its constituents and not tainted by a private inducement offered to committee members alone.[20]

Lehman II also counsels against further efforts to extend *Adelphia* to other sections of the Code.[21] In particular, in *AMR Corp.*, the debtors cited both *Adelphia* and *Lehman I* in support of their request to pay an executive bonus prohibited by § 503(c).[22] The debtors sought to pay the departing CEO $20 million in severance under the plan, after the bankruptcy court had denied the request as impermissible under § 503(c). Although the bankruptcy court in *AMR* struck the CEO's bonus from the plan as a condition of confirmation, the district court's decision in *Lehman II* underscores why the Code's executive compensation restrictions cannot be circumvented in a plan.

Lehman II, Creditor Consent, and the Role of the U.S. Trustee

Perhaps *Lehman II*'s most fundamental lesson is that achieving consensus and compromise, while important, is not the sole objective of the bankruptcy process. In *Lehman I*, the bankruptcy court was presented with a plan that creditors had overwhelmingly ratified and a plan provision that drew no objection by any party other than the U.S. Trustee. To the bankruptcy court, those facts were determinative: to overcome any conflicting provisions of the Code, the parties needed only to draft an appropriate "contractual patch."[23]

But to view a chapter 11 plan in this manner is to misunderstand the very nature of the Code. Although many Code provisions are designed to foster compromise, creditor consent must sometimes yield to other policy objectives. Thus, the Code establishes many rules and standards that are non-negotiable and that must be honored even if the debtor and each of its creditors have agreed to a different result. Among other examples, creditor consent cannot excuse an estate or committee professional from a conflict of interest,[24] nor can creditors agree to pay a professional an unreasonable fee.[25] Likewise, the Code's restrictions on insider bonuses and severance payments are enforceable even if no economic stakeholder objects.[26] And except in very narrowly defined circumstances, a debtor and its creditors are not free to reorder the Code's distribution scheme.[27]

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[20] *See id.* at 294 n.8 ("the risk of such a distortion of the voting process is particularly heightened in cases like this one because the beneficiaries of section 6.7 were the same entities charged with representing creditors in plan negotiations.").
[21] *Id*. at 293 ("The Court is not persuaded by the reasoning of *In re Adelphia* . . .").
[22] *In re AMR Corp.*, 497 B.R. 690 (Bankr. S.D.N.Y. 2013). The AMR court, however, did approve the plan authorizing payment of the individual professional fees of the committee members.
[23] *Lehman I*, 487 B.R. at 185.
[24] 11 U.S.C. §§ 327, 1103(b).
[25] 11 U.S.C. § 330.
[26] 11 U.S.C. § 503(c).
[27] 11 U.S.C. §§ 507, 726(a), 1129(a)(9), 1222(a)(2), and 1322(a)(2).

The district court correctly recognized that the Code's test for the allowance of administrative expenses under § 503(b) is one such non-negotiable provision. Congress did not give parties or courts free rein to award administrative expenses according to their discretion but instead directed that those expenses be paid only according to fixed, objective criteria. To permit a plan of reorganization to circumvent § 503(b) destroys the very framework of that section and in so doing undermines clear Congressional intent.

The bankruptcy court suggested that this result is a "statutory omission" to be overcome with artful language[28] in a plan. But the district court disagreed: "courts cannot challenge the merits of Congress's policy decisions in the Bankruptcy Code." [29] Congress was rightly concerned that members of official committees—who in many cases are large, sophisticated financial institutions—might exploit their positions for personal gain at the expense of other creditors that they represent and to whom they owe a fiduciary duty. Indeed, this very danger appears to have materialized in *Lehman*, where the $26 million fee award subsidized some of the wealthiest and most powerful creditors in the case, at the expense of smaller and perhaps personally unrepresented creditors whose distributions were proportionately reduced.

In any event, as the district court correctly observed, the bankruptcy court's reliance on "creditor consent" (as measured by the number of impaired classes accepting the plan) was not only misplaced, but also overstated.[30] When a debtor joins forces with its most sophisticated creditors at the expense of small creditors, the stakeholders most adversely affected are those who also have the least financial wherewithal to object or to assert their rights in litigation. This is particularly true when the questionable provisions are buried in a plan that creditors must vote to accept or reject as a whole. When faced with such a "take it or leave it" proposition, smaller creditors are likely to "hold their noses" and vote for a plan even if it includes an improper and offensive provision such as the *Lehman* fee payment. But their affirmative vote cannot legitimately be considered "consent" to every jot and tittle in the plan. As the district court in *Lehman II* cogently observed, "[e]ven if a majority of claimants opposed [the fee payments to committee members], the Plan would still have won a majority if claimants were willing to swallow the relatively small price of $26 million spread across all claimants in exchange for moving the process forward."[31] The validity of a plan provision that is otherwise impermissible under the Code should not be determined by the willingness of creditors not on the committee to swallow it.

Lehman therefore stands as an example of the unique role that the U.S. Trustee Program plays in vindicating the Code. Because of our neutral, independent role and our lack of a financial interest, the U.S. Trustees are often the lone parties positioned to advocate on behalf of the interests of small stakeholders, the integrity of the bankruptcy system, the legislative choices made by Congress and the public interest in ensuring compliance with the law.

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[28] *Lehman I,* 487 B.R. at 184.
[29] *Lehman II,* 508 B.R. at 293 (*citing In re DBSD N. Am., Inc.*, 643 F.3d 79, 100 (2[d] Cir. 2011).
[30] *Id.* at 294 n.8 ("Appellees overstate the amount of consent . . .").
[31] *Id*.

We do not exercise this authority lightly. We do not substitute our business judgment for that of the debtors, and we do not discourage parties from entering into appropriate compromises. But any such bargaining must take place within the Code’s boundaries. If those boundaries are violated, to the detriment of other parties and the public, the U.S. Trustees may object even if no economic stakeholder does. For this reason, as in *Lehman*, the USTP will remain vigilant to ensure that the specific commands of Congress are not disregarded in the name of creditor consent.