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Can Selfish Be Substantial?

Motivation in Substantial Contribution Claim Standards

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In the August 2012 decision in the *Tropicana* case, the U.S. Court of Appeals for the Third Circuit upheld the U.S. Bankruptcy Court for the District of Delaware's denial of a creditor group's $2.3 million "substantial contribution" claim for expenses incurred while attempting to impose governance changes after alleged mismanagement led to the company's bankruptcy. The decision is nonprecedential, but in upholding a bankruptcy court ruling based largely on the motives underlying the creditor actions at issue, it nonetheless offers a further gloss on the demanding standard applied to substantial contribution claims in the Third Circuit and underscores why a creditor's selfish motives are almost always fatal to its substantial contribution claim under that standard.

Competing Standards

Claims for expenses of creditors and other stakeholders incurred in making a "substantial contribution" to the estate are included in § 503(b) of the Bankruptcy Code's list of administrative expenses that are given priority claim status.[2] The Code does not define "substantial contribution," so two competing interpretations have developed.

The majority view, followed in the Second and Third Circuits, among others, is that to be "substantial," the contribution must go beyond what the applicant would have done in pursuit of its own self-interest, absent any expectation of reimbursement. Under this reading, Congress's authorization of the payment of fees of creditors by the estate is tempered by the long-standing general principles that administrative costs should be minimized to conserve estate resources, similarly situated creditors should be treated similarly, and that, as a default, creditors are expected to bear their own legal costs. These considerations yield a balancing of the objective of fostering meaningful creditor participation against the hazards of mushrooming administrative costs and unequal treatment of creditors when considering substantial contribution claims.

The competing minority view, followed in the Fifth and Eleventh Circuits, is based more on a plain reading of the statute and requires only that the contribution be "substantial" in the ordinary, everyday sense of that word. These courts take the view that what matters is the significance of the contribution, which is not diminished by the creditor's underlying motives.

The Leading Cases

Development of the Majority View

In *Lebron*, the leading Third Circuit case setting forth the majority view, a former director of the debtor sought reimbursement of approximately $60,000 in expenses incurred in exposing and attempting to stop the debtor's fraudulent business practices.[3] The Third Circuit did not question the bankruptcy court's finding that the director's actions had benefitted the estate, but held that conveying a significant benefit was not enough, standing alone, to warrant reimbursement. The court focused instead on the question of whether (or to what extent) the former director's actions had been undertaken in pursuit of the director's own interests instead of those of the larger estate and its creditors, ultimately remanding the case for further consideration of the director's motivations.

In discussing the applicable standard, the *Lebron* court framed the statute in its legislative and statutory context,[4] casting substantial contribution awards for creditors as exceedingly rare. The court discussed the roots of § 503(b)(3) and (4) in the predecessors of the current Bankruptcy Code, noting that all predecessor provisions were motivated by "an accommodation between the twin objectives of encouraging meaningful creditor participation in the reorganization process and keeping fees and administrative expenses at a minimum so as to preserve as much of the estate as possible for the creditors."[5] In particular, the *Lebron* court noted that prior to the Bankruptcy Reform Act of 1978, a creditor seeking a substantial contribution claim was required to show that its efforts transcended self-protection[6] and that the Bankruptcy Reform Act of 1978 was intended to effect only a minor modification of this standard.[7]

With that background in mind, other courts in the majority line of cases have consistently held that exten-

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2 11 U.S.C. § 503(b)(3)(D) (2006). *See also* 11 U.S.C. § 503(B)(4) (2006) (allowing reasonable compensation for professional services by an attorney or accountant in connection with, *inter alia*, § 503(b)(3)(D) claims).

3 *Lebron v. Mechem Financial Inc.*, 27 F.3d 937, 940-41 (3d Cir. 1994).

4 *Lebron*, 27 F.3d 937, 943-44 (tracing predecessor provisions of 11 U.S.C. § 503(b)(3)(D), discussing legislative history and collecting cases, including *In re Solar Mfg. Corp.*, 206 F.2d 780, 781 (3d Cir. 1953) ("[A creditor's attorney's] work must be at the expense of their clients unless it is in some manner beneficial to the estate.")).

5 *Id.* at 944 (internal citations omitted) (citing, *inter alia*, *Otte v. U.S.*, 419 U.S. 43, 53 (1974)).

6 *Id.* (citing *In re Solar Mfg. Corp.*, 206 F.2d 780 (3d Cir. 1953) (applying former Bankruptcy Act, which was repealed in 1978)).

7 The minor modification referred to was a clarification in the Bankruptcy Act of 1978 that a substantial contribution need not lead to confirmation of a plan and could in fact be the defeat of an inappropriate plan if that defeat were beneficial to the estate. S. Rep. No. 95-989, at 66-67, *reprinted in* 1978 U.S.C.C.A.N. 5787, 585253 (1978).

sive participation in a case alone is insufficient to merit reimbursement of a creditor's expenses under § 503(b), even if that participation is ultimately beneficial to the estate.[8] Creditors in particular, of the different stakeholders cited in § 503(b)(3)(d), face a difficult burden under the majority rule since they are presumed to be acting primarily in their own interests,[9] and "efforts undertaken by creditors solely to further their own self-interest are not compensable under section 503(b)."[10]

The extraordinary actions looked on most favorably by courts following the majority rule are those where a creditor takes a leadership role in the reorganization, going beyond what would typically be expected of a creditor protecting its own interests.[11] Unsurprisingly, courts are also more inclined to grant reimbursement where there is general consensus among the parties in interest that the applicant rendered a substantial benefit in the case,[12] and where the applicant has made some effort to limit its reimbursement request by screening out activities undertaken solely in service of its own self-interest.[13]

The Minority View

The leading Fifth Circuit case setting forth the minority view, *In re DP Partners*,[14] concerned a substantial contribution claim filed by Hall Financial Group (HFG), a professional investor that purchased claims following the debtor's filing of its first plan because it believed that the proposed plan undervalued the debtor's property holdings.[15] Among other things, HFG identified potential fraudulent-conveyance litigation and sparked a bidding war for the debtor, resulting in an increase in distributions to creditors of at least $3 million.[16]

HFG clearly acted in pursuit of its self-interest; however, it was also not disputed that HFG's actions enhanced the reorganization by adding value to the estate. In awarding HFG its fees, the court relied heavily on the principle that the plain statutory language is the best guide to Congress's intent, beginning with the observation that Congress chose to frame § 503 as a mandatory, rather than discretionary, award of fees.[17] The *DP Partners* court took the view that this mandatory language militates against a reading that would yield extensive judicial discretion, cutting against inquiries into a creditor's motives.

Turning to the phrase "substantial contribution" itself, the court noted the majority view but declined to adopt any distinction between self-protective acts and those that go beyond the pursuit of self interest, instead reiterating the importance of giving the words of a statute their ordinary meaning. On this basis, the court held that any contribution to the estate that is "considerable in amount, value or worth"[18] should satisfy the statutory requirement, and the significance of a contribution is "not diminished by selfish or shrewd motivations."[19] The only gloss offered by the *DP Partners* court regarding what makes a contribution "substantial" is that any such actions should "foster and enhance, rather than retard or interrupt, the progress of reorganization."[20] As the court acknowledged, this standard provides little concrete guidance, but it clearly furthers an open-handed policy.

In *Celotex*, the Eleventh Circuit adopted the *DP Partners* standard without substantial variation.[21] Adding to the Fifth Circuit's reasoning, however, the Eleventh Circuit commented that an "altruism requirement" essentially reads creditor substantial contribution claims out of the Code since "it is difficult to imagine a circumstance in which a creditor will not be motivated by self-interest in a bankruptcy proceeding"[22] and because such a requirement would "render [§ 503(b)(3)-(4)] meaningless as to creditors."[23]

Policy Arguments

The competing views of the relevance of creditor motivations reflect two different ways of thinking about substantial-contribution claims. Courts that follow *DP Partners* and *Celotex*, ignoring creditor motivations, do not treat substantial-contribution claims as a means of bringing about a desired result. In *DP Partners*, for example, there is little doubt that HFG would have done what it did even fully expecting to bear its own costs. Because those actions ultimately benefited the estate, however, HFG received reimbursement as a kind of reward for a job well done, even if its motivation was limited to self-protection. The notion of fostering creditor participation in the bankruptcy process is of secondary importance in this reading.[24] If, after all, activities would have been undertaken absent the expectation of reimbursement, the purpose of that reimbursement cannot be to encourage creditors to undertake those activities.

The majority view, on the other hand, treats substantial contribution claims as a means by which the estate obtains services that it "wants" but that, importantly, would not be provided absent at least the possibility of reimbursement. There was little dispute that the claimant's actions in the *Lebron* case were beneficial, but there was similarly little dispute that they likely would have been done regardless of who was expected to pay the bill. This second inquiry, the "but-for" test, is the most demanding aspect of the Third Circuit's standard. In this view, even assuming that these activities are beneficial to the estate, if those activities can be expected to be paid for by self-interested creditors, why should the estate expend its limited resources to pay for them?

The split between the *Lebron* and *DP Partners* standards is frequently seen as a disagreement regarding the relevance of "selfish" motivations on the part of the creditor-applicant. The secondary inquiry of *Lebron* and its progeny, regarding whether the prospect of reimbursement

8 *In re McLean Indus. Inc.*, 88 B.R. 36, 38 (Bankr. S.D.N.Y. 1988).
9 *In re Best Products Co. Inc.*, 173 B.R. 862, 866 (Bankr. S.D.N.Y. 1994) (citing *In re U.S. Lines Inc.*, 103 B.R. 427, 430 (Bankr. S.D.N.Y. 1989)).
10 *Id.*
11 *See, e.g., In re Best*, 173 B.R. at 866.
12 *See, e.g., In re Richton Int'l Corp.*, 15 B.R. 854, 855 (Bankr. S.D.N.Y. 1981).
13 *Id.* at 856.
14 *Hall Financial Group Inc. v. DP Partners Ltd. Partnership (In the Matter of DP Partners Ltd. Partnership)*, 106 F.3d 667 (5th Cir. 1997).
15 *Id.* at 670.
16 *Id.* (court noted that by some measures that increase could be as high as $12.5 million).
17 11 U.S.C. § 503(b) ("After notice and a hearing, there *shall* be allowed administrative expenses.") (emphasis added); *see also In re DP Partners*, 106 F.3d at 670-1 ("[T]he word 'shall' connotes a mandatory intent.").
18 *In re DP Partners*, 106 F.3d at at 673 (quoting *Webster's Third New International Dictionary* 2280 (4th Ed. 1976)).

19 *Id.*
20 *Id.* at 672 (quoting *In re Consolidated Bancshares Inc.*, 785 F.2d 1249 (5th Cir. 1986)).
21 *Speights & Runyan v. Celotex Corp.*, 227 F.3d 1336 (11th Cir. 2000).
22 *Id.* at 1339.
23 *Id.*
24 *In re DP Partners*, 106 F.3d at 672 (quoting *In re Consolidated Bancshares Inc.*, 785 F.2d 1249 (5th Cir. 1986)).

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was necessary to induce the creditor to undertake the beneficial actions at issue, however, ultimately better captures the nature of the disagreement.

The *Tropicana* Decision

The claimant in *Tropicana* was a group of noteholders formed prior to the company's bankruptcy. Similar to the fact pattern in *Lebron*, the noteholder group was active in the period leading up to *Tropicana*'s bankruptcy, pushing for governance changes in the wake of the revocation of the company's New Jersey gaming license and a cascade of other negative regulatory actions. After the bankruptcy, the noteholder group moved for the appointment of a chapter 11 trustee, ultimately reaching a settlement under which the company's chairman, CEO and owner agreed to step down from his management position.

Although their activities of course went beyond the prosecution of that particular motion, the noteholders limited their substantial contribution claim to those expenses incurred in seeking the appointment of a trustee. The company supported the application (as it had agreed to do in connection with the settlement), but on the objection of certain other creditors and certain of the debtors not bound by the settlement, the bankruptcy court denied the application. Key to the bankruptcy court's analysis was its finding that although the noteholder group's efforts were beneficial to the estates, they were undertaken "largely in the self-interest of the movants here *and would have been taken whether there would have been estate reimbursement or not*."[25]

On appeal, the noteholders argued that the bankruptcy court had erred by focusing entirely on the question of whether the trustee motion would have been prosecuted without an expectation of reimbursement. The Third Circuit rejected this argument, reaffirming the principle that self-interested creditor activities that "would have been undertaken absent an expectation of reimbursement from the estate" do not warrant reimbursement.[26] Addressing the specific factual record, the court found that the bankruptcy court properly considered the noteholder group's failure to present evidence indicating that an expectation of reimbursement was important to its decision to take an active role in the case in concluding that the noteholders had failed to overcome the presumption that they acted solely in their own self-interest.

Takeaways from *Tropicana*

The Third Circuit's decision in *Tropicana* is not surprising: That court has been clear since the *Lebron* decision that it rarely views substantial contribution claims for creditors as appropriate. As noted, courts favoring the minority rule have argued that the Third Circuit standard is impossible, as no creditor will ever be able to show that it did not act out of self-interest. With the but-for test given primary importance, however, as it is in *Tropicana*, the standard is strict but not impossible, and its parameters are well defined.

Creditors need not be "altruistic" in some perfect sense in order to satisfy this standard; they can be eligible for reimbursement if and to the extent that their actions went beyond what they would have done absent the prospect of reimbursement. While creditors are generally presumed to act in their self-interest, this standard acknowledges that there are instances in which creditors take a more significant role and in which the estate properly should pay for them to do so. In light of the *Tropicana* decision, however, it is clear that the Third Circuit believes that those instances are rare and that creditors face a heavy burden in persuading courts in the Third Circuit that estate resources should be used to pay their expenses. abi

25 Emphasis added.

26 *In re Tropicana Entertainment LLC*, No. 10-3970, 2012 WL 3776531, at *2 (3d Cir. 2012).