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Southern District of Texas Bankruptcy Court Rules That Indenture Trustees Must Provide a Substantial Contribution in Exchange for Payment of Fees by Estate

On May 3, 2021, Judge Marvin Isgur of the United States Bankruptcy Court for the Southern District of Texas held that indenture trustees must satisfy the “substantial contribution” standard to obtain administrative expense status for their fees and expenses incurred in a chapter 11 case.¹ In his ruling, Judge Isgur expressly rejected the indenture trustee’s argument that it could obtain administrative expense status upon a showing that its fees and expenses were an actual, necessary cost of preserving the debtor’s estate. Allowed administrative expense claims are typically paid in full, in cash, by a reorganizing debtor’s estate.

Background and Standards

Section 507(a) of the Bankruptcy Code provides that administrative expenses are given priority over all other unsecured claims, and section 503(b) delineates claims entitled to administrative expense status. For example, section 503(b)(1)(A) provides that administrative expenses include “the actual, necessary costs of preserving the [debtor’s] estate.” Courts have interpreted this standard to generally require that the expense must benefit the estate and its creditors.² In addition, sections 503(b)(3)(D) and 503(b)(4) create administrative expense eligibility for the “actual, necessary expenses,” including the reasonable professional fees of creditors, indenture trustees and certain other third-parties incurred in making a “substantial contribution” to a debtor’s chapter 11 case. Section 503(b)(5) also creates administrative expense eligibility for “reasonable compensation for services rendered by an indenture trustee in making a substantial contribution” to the case.

Given the priority afforded administrative expenses under the Bankruptcy Code, and that a chapter 11 debtor is generally required to pay administrative expenses in full on the effective date of its chapter 11 plan,³ indenture trustees and other creditors often seek to ensure their postpetition fees and expenses receive administrative expense status. In many scenarios (*e.g.*, DIP or cash collateral orders, plan confirmation orders, 363 sale orders and backstop rights offering orders), creditors obtain the debtor’s consent to administrative expense status and the debtor seeks court authority to pay these fees and expenses as administrative expenses. Where the debtor’s consent cannot be obtained, it is up to the claimant to seek administrative expense status for its fees and expenses on a contested basis.

This latter type of dispute recently arose in the chapter 11 cases of Sanchez Energy Corporation (“Sanchez”). Before filing for bankruptcy in August 2019, Sanchez had issued two series of senior notes for which Delaware Trust Company (“Delaware Trust”) acted as the successor Indenture Trustee. Sanchez confirmed its chapter 11 plan in April 2020. As required by the Bankruptcy Code, the plan provided that allowed administrative expense claims would be paid in full in cash. The plan also provided for the rejection of the indentures.

¹ *In re Sanchez Energy Corp. et al.*, No. 19-34508 (Bankr. S.D. Tex. May 3, 2021).

² *In re H.L.S. Energy Co., Inc.*, 151 F.3d 434, 437 (5th Cir. 1998).

³ *See* 11 U.S.C. § 1129(a)(9)(A).

Delaware Trust filed a proof of claim asserting a claim of \$928,345 for its direct costs and professional fees incurred during Sanchez’s chapter 11 cases prior to the rejection of the indentures. Delaware Trust then filed a motion seeking to allow its claim as an administrative expense pursuant to section 503(b)(1)(A). In its motion, Delaware Trust argued that Sanchez “knowingly and voluntarily” accepted services from Delaware Trust during its chapter 11 cases that benefitted Sanchez’s estate.

Mesquite Energy, Inc. (“Mesquite”), the renamed reorganized debtor, objected to Delaware Trust’s motion. Mesquite argued that (a) as an indenture trustee, Delaware Trust applied the wrong standard and could only obtain administrative expense status for its claim if it satisfied the substantial contribution standard and (b) Delaware Trust’s services failed to meet that standard.

The Bankruptcy Court’s Decision

The court began its analysis with the threshold issue of the appropriate standard to apply to Delaware Trust’s claim under section 503(b): the actual, necessary cost of preserving Sanchez’s estate or whether Delaware Trust made some substantial contribution to the case.

Starting from the principle of statutory construction that specific provisions govern more general provisions, the court reasoned that the substantial contribution standard applied to Delaware Trust’s claim because section 503(b)(5) of the Bankruptcy Code specifically addresses reasonable compensation of indenture trustees, and sections 503(b)(3)(D) and 503(b)(4) specifically address their actual, necessary expenses. The court also characterized the substantial contributions standard as a higher, more stringent standard than the “benefit to the estate” standard under section 503(b)(1). Instead of a mere “benefit to the estate,” the court stated that a contribution is substantial only if it is “considerable in amount, value or worth,” and the applicant must show a specific causal relationship between the services provided and the alleged substantial contribution. The court reasoned that if indenture trustees and other creditors could seek administrative expense status under the more permissive standard of section 503(b)(1), it would render sections 503(b)(3) – (5) “entirely superfluous.”

Applying the substantial contribution standard to Delaware Trust’s claim, the court held that most of the claim failed to satisfy the requirements of sections 503(b)(3) – (5). Although the court acknowledged the important role indenture trustees play in chapter 11 cases, the court concluded that the majority of Delaware Trust’s services—providing general case updates to noteholders, filing proofs of claim on the noteholders’ behalf, engaging in plan negotiations, etc.—were done primarily for the noteholders’ benefit. Ultimately, the court concluded that the only portion of Delaware Trust’s services that provided a substantial contribution were the services Delaware Trust performed as a noticing agent for the noteholders with respect to the notices Sanchez was required to provide under the Bankruptcy Code (which only amounted to approximately \$6,000 of Delaware Trust’s total claim). These services provided a substantial contribution, according to the court, by reducing the burden and costs on Sanchez’s estate if Sanchez was otherwise required to notice the noteholders directly.

Conclusion

Although Judge Isgur’s ruling is not binding precedent in the Fifth Circuit, indenture trustees and creditors should expect US Trustees, debtors, and other objecting parties to cite this decision in situations where they oppose indenture trustees and other creditors’ requests for administrative expense status or expense reimbursement provisions in chapter plans and other in-court transaction documents.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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