Published on *The National Law Review* https://natlawreview.com

Stormy Seas for Indenture Trustees and Bondholders Settling Claims in Bankruptcy

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Recently, in ***Caesars Entertainment Operating Co. ("Caesars")***, U.S. *Bankruptcy* Judge A. Benjamin Goldgar denied payment of indenture trustee Wilmington Trust's attorneys' fees and costs in connection with the Debtors' motion to approve a settlement. The U.S. Trustee objected to payment arguing that the Debtor could not rely on 11 U.S.C. § 363 (seeking settlement approval) as authority to pay Wilmington Trust's fees and costs. Sustaining the U.S. Trustee's objection, the Court found that as a matter of statutory interpretation, indenture trustee legal fees for unsecured notes could not be paid under section 363 of the Bankruptcy Code. Judge Goldgar made it clear that while payment under section 363 was not available, his ruling did not address whether the indenture trustee fees could be paid under section 503(b) of the Bankruptcy Code or under a plan of reorganization.[1]

While the Bankruptcy Code is clear on when and how an unsecured creditor can be paid legal fees and costs, as a practical matter, the strict interpretation of the Code will hamper the timing and implementation of settlements with bondholders in large complex cases such as Caesars. The result is that the parties will be forced to embed the settlements in a plan of reorganization or the indenture trustee must seek reimbursement under section 503(b). Judge Goldgar's ruling is also a harbinger of the objections that will no doubt arise when indenture trustees seek payment of fees and costs under section 503(b) as the standard is elusive at best. Lastly, unlike many other creditors seeking payment of professional fees and costs from the estate, indenture trustees have the benefit of an express contractual priority of payment for the trustee's fees and costs over payment to their bondholders and a charging lien on recoveries to the extent that the fees and costs are not otherwise paid.

Bondholders Beware – A Showing of Substantial Contribution is a Question of Fact

 Under the Bankruptcy Code, indenture trustees must seek fees and costs as part of the plan process or file a motion seeking reimbursement under section 503(b)(3)(D) and (b)(4), both of which require the indenture trustee to establish that the actual fees and costs, including attorneys' fees, were incurred "in making a substantial contribution" to the case. In either case, the fees must be reasonable.

The present statutory provisions governing substantial contribution claims reflect an accommodation between encouraging creditor participation and keeping fees and costs at a minimum so as to preserve the bankruptcy estate. Congress did not define "substantial contribution" which leaves the determination to a court's consideration on a case-by-case basis. As a general rule, courts require a creditor to establish facts that show the services delivered fostered and enhanced the bankruptcy process, rather than impeding it. "Substantial contribution" is a question of fact that requires an applicant under section 503(b) to show an actual and demonstrable benefit to the bankruptcy estate. The benefit must be more than incidental to the activities pursued in protecting the creditor's own interest. Lastly, the services cannot be a duplication of services rendered by attorneys for a committee or the debtor. Some courts also examine the creditor's motivation and assume that a creditor is acting in its own interest and not for the benefit of the estate.

Negotiating Settlements That Bring Clarity and Predictability for Bondholders and Indenture Trustees

Bondholders want clarity in connection with negotiated plan settlements that the indenture trustee's fees and costs will be paid by the bankruptcy estate. If such an agreement is not reached, or cannot be implemented, then the bondholders' recovery can be reduced by the indenture trustee's right to priority of payment and charging lien. Settlement negotiation, if done pursuant to a restructuring and support agreement, needs to focus on when and how indenture trustees may be paid under the plan or section 503(b). Either way, there is a delay in the determination of whether the fees and costs can be paid by the estate, thereby leaving the bondholders and indenture trustee without clarity regarding payment of fees and costs. This process also leaves much uncertainty as to when and what return will be distributed to bondholders in connection with any negotiated settlement. This uncertainty likely will force indenture trustees to exercise charging liens sooner rather than later for unpaid fees and costs.

Committee Membership and Risk of Payment

Indenture trustees who become members of the official creditors' committee are at risk when it comes to payment of fees and costs because committee members are not entitled to have their

individual professional fees and costs paid. In the Caesars bankruptcy case, Wilmington Trust was a member of the official committee. This provided the U.S. Trustee with a second basis for objecting to the payment of Wilmington Trust's fees and costs, namely that the there was no record that Wilmington Trust did anything other than perform its statutory duties as a member of the official committee. The risk when a trustee sits on a creditors committee lies in establishing what fees and costs were incurred in connection with committee work and what fees and costs were incurred in connection with the trustee's role as an independent creditor. These roles frequently overlap making it difficult if not impossible to differentiate roles and meet an evidentiary showing the fees and costs resulted in a "substantial contribution." Counsel for indenture trustees should consider maintaining separate time records for work done in connection with the creditors' committee and work done in connection with discharging the trustee's duties under the indenture and for the benefit of the bondholders as independent creditors.

Indenture Trustee Fees under Attack

Indenture trustee fees have been under attack in a number of recent bankruptcy cases where debt is being converted to equity, as is becoming common in oil and gas cases. These attacks range from fee caps imposed in the restructuring and support agreements and plans of reorganization to threatened objections from debtors, new equity and unsecured creditors' committees. Behind the objections lies the overarching challenge in a debt to equity case—the lack of liquidity on exit.

Often challenges to payment of trustee fees and costs ignore the indenture trustee's duties and obligations under the indenture and the benefits to the estate of the trustee's administration. Majority bondholders often fail to account for the fact that the unrepresented nonparticipating bondholders are still looking to the indenture trustee to discharge its duties under the indenture. This means, if the majority holders do not provide the trustee with a direction letter, the trustee is obligated to actively follow the case on behalf of the unrepresented nonparticipating bondholders. If the parties want to reduce indenture trustee fees and costs, a direction letter addressing the plan support agreement or the pre-negotiated plan acceptable to the indenture trustee can help achieve that goal.

In response to increasing objections to payment of fees and costs, indenture trustees have been forced to take pre-emptive and protective steps to protect their charging lien. These steps include seeking specific language in both the restructuring and support agreements and bankruptcy plans that: (1) precludes any distribution to the bondholders until the trustee's fees and costs have been paid in full; (2) implements the charging lien in the amount of the outstanding fees and costs; (3) provides that the charging lien is not discharged, by the plan or otherwise, until the trustee's fees and costs are paid in full; and (4) identifies the process and timing for objecting to and resolving the trustee's fees and costs. Lastly, indenture trustees must take steps to ensure that the plan does not terminate their ability to appear in bankruptcy court in connection with post-confirmation matters, including resolution of fees and costs.

Takeaways For Smoother Sailing

Indenture trustees seeking to navigate stormy seas should: (1) carefully review restructuring and support agreements and pre-negotiated plans to ensure that their charging lien is intact even if the agreement or plan provides for payment of fees and costs; (2) request direction letters from majority bondholders at the early stages of the restructuring process to avoid the need to incur legal fees and costs at a level that would otherwise be required absent a direction letter; and (3) when serving on the creditors' committee, take care to separate fees and costs incurred in connection with committee work from those fees and costs incurred in discharging legal and fiduciary duties under the governing

indenture. No matter how the fee resolution process is viewed, it has become something that requires the early attention of both trustees and bondholders.

[1] As a result of this ruling, Caesars has withdrawn its motion requesting payment of the fees and expenses of the indenture trustees for the second lien notes.

National Law Review, Volume VI, Number 326