Bankruptcy During the COVID-19 Pandemic: An Argument for Uniformity with Respect to the Reimbursement of Professional Fees and Expenses

It is now widely known that the novel coronavirus (COVID-19) pandemic changed society for a variety of industries, whom either have deteriorated significantly or now cease to exist. At the core of the pandemic's repercussions are mortgage lenders and other related companies — arguably suffering some of the most significant harm among affected industries during an unprecedented period in global history. One such company is Stearns Holdings, LLC, which, along with six debtor affiliates (the debtors), filed for chapter 11 protection on July 9, 2019, in the U.S. Bankruptcy Court for the Southern District of New York.[i]

Although many factors come into play when filing bankruptcy, it is undisputed that COVID-19 adds an extra burden for most, if not all, mortgage companies seeking to restructure under the Bankruptcy Code.[ii] Quickly changing times require even quicker adaptation. Such adaptation will provide the common or not-so-common mortgage lenders with a smooth path to recovery and the next version of normal.

Debtors today routinely utilize § 105 of the Bankruptcy Code in requesting authority to pay a creditor's professional fees and expenses. This now-common use, though, has not always worked to a debtor's benefit; some courts remain reluctant to grant relief pursuant to § 105 despite the existence of COVID-19. Other courts, however, have shown an increased willingness to rely upon § 105's broad equitable powers when considering the challenges many debtors face that are inevitably birthed by the pandemic unto the mortgage industry and various related industries.

Section 105 of the Bankruptcy Code

Section 105 of the Bankruptcy Code empowers a bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code. Notwithstanding this broad language, the Supreme Court and other lower courts have held that § 105(a) is limited in scope and does not "create substantive rights that would otherwise be unavailable under the Bankruptcy Code."[iii] In other words, any request for relief made solely pursuant to § 105 is inadequate, as this provision is not an independent source of jurisdiction or substantive rights and may only be enforced when used in conjunction with other Bankruptcy Code provisions. However, § 105 does not preclude a bankruptcy court from *sua sponte* taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

The *Stearns Holdings* Bankruptcy and Relevant Case Law and Statutory Authority

Concurrently with the filing of their chapter 11 cases, the debtors filed a plan and disclosure statement pursuant to which Blackstone Capital Partners VI NQ/NF L.P. and Blackstone Family Investment Partnership VI-NQ-ESC L.P. (collectively, Blackstone), a 70% equity holder, agreed to serve as plan sponsor and to inject $60 million of cash into the debtors. Thereafter, for cautionary purposes, the debtors continued to actively pursue other alternatives, including the negotiation of a consensual restructuring with certain noteholders memorialized in a restructuring support agreement (the RSA) that the debtors properly executed on Sept. 5, 2019. The debtors sought authority to enter into the RSA, which the court approved on Sept. 26, 2019, pursuant to §§ 105 and 363[iv].

The chapter 11 plan contemplated by the RSA provided that on the effective date, the debtors would pay or reimburse the reasonable and documented fees and expenses incurred by Pacific Investment Management Company LLC (PIMCO) (the investment manager and adviser to the majority holders of senior secured notes issued by the debtors), Blackstone and certain other creditor professionals in connection with the debtors' restructuring efforts. In response to this requested relief, the U.S. Trustee objected by asserting, in part, that such professionals must first seek retention under § 327 and subsequently move for reimbursement pursuant to § 503(b) of the Bankruptcy Code, which provides that any reimbursements must be limited to work done that advances the interests of the estates as a whole, rather than a specific individual or group of creditors — or as courts and the Bankruptcy Code put it, making a "substantial contribution."[v] The debtors and PIMCO disagreed by asserting that (1) the debtors' business decision to pay such fees had already been approved by the court's orders approving the debtors' entry into the RSA, and (2) payment of such fees is appropriate under § 363(b) of the Code, which provides that a debtor-inpossession may use, sell or lease property of the estate outside the ordinary course of business upon a court finding that the requested use, sale or lease of estate property represents an exercise of sound business judgment. The court ultimately approved the payment of the above-noted creditor professionals via confirmation of the debtors' plan and pursuant to § 363(b) and Bankruptcy Rule 9019.[vi]

The debtors' failure to reimburse the fees and expenses of various creditor constituencies potentially had the effect (by failing to satisfy the terms of a global settlement a/k/a the RSA) of eliminating the inherent risk of further contentious and costly litigation, as well as jeopardizing the debtors' ability to consummate a plan of reorganization and destroying the value of their businesses. Thus, the *Stearns Holdings* ruling reaffirms a tension concerning when courts should choose to apply certain standards rather than others in a request to reimburse a creditor's professional fees. During the COVID-19 era, § 503(b) is arguably the more appropriate provision.

Although some courts have authorized payment of professional fees and expenses pursuant to §§ 105 and 363(b) in connection with a court's approval of a debtor's assumption of or entry into a restructuring support agreement or a fee letter,[vii] other courts believe that § 503(b) is the proper avenue for awarding payment of fees in a large, complex chapter 11 case.[viii] Compensation under § 503 is typically reserved for those rare and extraordinary circumstances when the creditor's involvement truly enhances the administration of the estate.[ix] Thus, what justification exists to warrant the payment of a creditor's professional fees if those very fees were incurred whether or not the creditor substantially contributed to a debtor's case?

This was the focus in the *In re Bethlehem Steel Corp.*[x] decision. That court was faced with a request to pay certain professional fees to be incurred by the United Steelworkers of America in connection with due diligence and financial analysis, as well as negotiations regarding a possible plan of reorganization. In granting Bethlehem's request to pay United Steelworkers of America's fees pursuant to §§ 363 and 105, the court noted that (1) the circumstances under which reliance upon §§ 363(b) and 105 is warranted are very limited (i.e. satisfying the business judgment standard), and (2) § 503(b)(3) is not rendered meaningless simply because in certain unique circumstances a bankruptcy court approves a debtor's motion to enter into an agreement to reimburse a creditor for professional fees.

With a split among courts on this issue, it can be unclear where § 105 serves its purpose and when debtors should utilize it in requesting relief. Should courts perhaps consider a uniform approach in evaluating payment of fees and expenses? While it is no less immoral for a creditor to advance its own interests in any common case — especially in a time where the financial market continues to struggle due to an unpredictable pandemic — parties should be required to "substantially contribute" in advancing the interests of the bankruptcy estate prior to being paid by that very same estate.

If *Stearns Holdings* instead sought relief under an alternative Bankruptcy Code provision, could the court nonetheless sua sponte grant relief pursuant to § 105 despite the failure to assert the applicable underlying standard? Should Congress seek to temporarily amend § 105 of the Code for purposes of specificity for the duration of the pandemic? The answers remain to be seen.

Takeaway

Issues regarding the payment of professional fees and expenses in a bankruptcy case during the coronavirus pandemic should be evaluated with especially careful scrutiny. With extra hurdles inevitably arising due to the pandemic, the risk of failure associated with a debtor's case increases exponentially. Although payment of significant fees and expenses arguably

depletes estate assets, professionals are nonetheless disincentivized to continue work if they will not be paid.

Should professionals choose to discontinue work, what ramifications might this have on the bankruptcy process? Public policy favors the constitutional right to a fresh start in bankruptcy, but also the ability to allocate value among professionals who serve as creditors. Allocating value pursuant to a chapter 11 plan and in bankruptcy generally are known to increase the ability of such professionals to settle controversies. Without proper adjustment and adaptation by the courts and Congress, mortgage lenders considering bankruptcy could turn to alternative options, further diminishing any potential to successfully continue operations and imposing long-term negative effects for society in the foreseeable future.

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[i] These bankruptcy cases are jointly administered under case number 19-12226 (SCC) and entitled *Stearns Holdings, LLC, et al*. The docket is publicly accessible at https://cases primeclerk com/stearns/Home-DocketInfo

[ii] All references to the Bankruptcy Code mean 11 U.S.C. § 101 *et seq.*

[iii] See, e.g., *Law v. Siegel,* 571 U.S. 415, 417 (2014) ("It is hornbook law that section 105(a) 'does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code.'") (citing 2 *Collier on Bankruptcy* ¶ 105.01 [2], p. 105-06 (16th ed. 2013)); *In re Women First Healthcare Inc.*, 332 B.R. 115, 120 (Bankr. D. Del. 2005) (quoting *United States v. Pepperman*, 976 F.2d 123, 131 (3d Cir. 1992)).

[iv] *In re Stearns Holdings LLC*, et al., Case No. 19-12226 (SCC), Dkt. Nos. 317 and 350.

[v] *In re Stearns Holdings LLC*, et al., 607 B.R. 781, 792 (Bankr. S.D.N.Y. 2019) (emphasis added).

[vi] *See id.* ("Even assuming, *arguendo*, that this Court had not previously authorized the Debtors' entry into the RSA (and, accordingly, payment of the professional fees) in accordance with section 363(b)(1) of the Code, the Court finds that payment of such fees is also appropriate under Bankruptcy Rule 9019.").

[vii] *In re Hercules Offshore Inc*., Case No. 15-11685 (KJC) (Bankr. D. Del. 2015) (approving payment of professional fees for unsecured creditors as part of assumption of restructuring support agreement); *In re Dendreon Corporation*, Case No. 14- 12515 (PJW) (Bankr. D. Del. 2014) (same); *In re ASARCO L.L.C.*,

650 F.3d 593 (5th Cir. 2011) (affirming the ruling of the district court and bankruptcy court to approve payment of bidders' due diligence and work fees requested pursuant to § 363); *U.S. Trustee v. Bethlehem Steel Corp*., 2003 WL 21738964, at *10 (S.D.N.Y. July 28, 2003) (affirming bankruptcy court's approval of reimbursement of creditors' counsel's costs and expenses pursuant to §§ 363(b) and 105(a)); *In re Adelphi Commc'ns Corp*. 441 B.R. 6 (Bankr. S.D.N.Y. 2010) (finding that while § 503(b)(3)(D) expressly authorizes reimbursement of fees if certain requirements are met, it does not explicitly provide that it is the exclusive means by which fees of a certain character may be reimbursed by a debtor's estate).

[viii] *See In re Bayou Grp. LLC*, 431 B.R. 549, 560 (Bankr. S.D.N.Y. 2010); *see also In re Sedona Institute*, 220 B.R. 74, 79 (B.A.P. 9th Cir. 1998) (describing substantial contribution provisions as "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 creditors.'") (quoting *Lebron v. Mechem Fin. Inc*., 27 F.3d 937, 944 (3d Cir. 1994)).

[ix] *In re Am. Preferred Prescription Inc*., 194 B.R. 721, 727 (Bankr. E.D.N.Y. 1996) (citing *In re Best Products Co. Inc*., 173 B.R. 862, 865 (Bankr. S.D.N.Y. 1994)).

[x] 2003 WL 21738964 (S.D.N.Y. July 28, 2003).