Congress: Resolve Split on Ch. 7 Substantial- Contribution Claims

"W e walk on quicksand when we try to find in the absence of corrective legislation a controlling legal principle."1 Put bluntly by the late U.S. Supreme Court Justice Antonin Scalia, “Rather than rewriting the law under the pretense of interpreting it, the Court should [leave] it to Congress to decide.”2 A recent example of judicial “rewriting [of] the law” arguably occurred when the Sixth Circuit split with its sister circuits3 (and 25 lower courts)4 in In re Connolly by approving payment of a “substantial contribution” administrative expense claim in a chapter 7 case. The Sixth Circuit reached this result “despite the explicitly narrower language in § 503(b)(3)(D)” that only authorizes reimbursement in proceedings under chapters 9 and 11.5

In the February 2016 issue of the ABI Journal, Nathaniel R. Hull (Verrill Dana LLP; Portland, Maine) penned a thought-provoking review of the majority and dissenting opinions in Connolly.6 He persuasively “suggests an additional explanation for why Congress may have intentionally excluded chapter 7 from the ambit of § 503(b)(3)(D).”7 Moving in a different direction and putting aside the issues of statutory interpretation, this article will instead focus on the problem in the Bankruptcy Code brought to light by Connolly and propose a statutory solution. The competing policy considerations are significant: Barring administrative expenses deters creditor participation, whereas allowing such claims encourages creditor involvement but “reduce[s] the funds available for [other] creditors and other claimants.”8 Congress should settle the circuit split and bring into line these conflicting interests by making it clear that creditors might be compensated under § 503(b)(3)(D), after a notice and hearing, for making substantial contributions to the benefit of other creditors in chapter 7 cases.

The Quicksand

Section 503(b)(3)(D) of the Bankruptcy Code “allow[s] administrative expenses [including the] actual, necessary expenses ... incurred by ... a creditor... in making a substantial contribution in case under chapter 9 or 11.”9 In Connolly, a group of creditors successfully removed, replaced and sued the chapter 7 case trustee originally assigned to the case (ultimately reaching a settlement with the ousted trustee). Despite concluding that the creditors’ actions benefited “the bankruptcy estate and the unsecured creditors,” the bankruptcy court (and the district court on appeal) denied their application for an administrative expense claim. The lower courts reasoned that the Code only permits reimbursement for substantial-contribution claims in chapters 9 and 11.10 The Sixth Circuit, in a 2-1 split ruling, reversed on two grounds: (1) the “overriding ... equitable principles” of bankruptcy law require reimbursement under the unique facts of this case,11 and (2) the use of the word “including” in the opening lines of § 503(b) “indicates that Congress did not ... intend to provide an exhaustive list of allowable expenses.”12 The majority held that the examples in the subsections of § 503(b) are not all-inclusive; they merely “provide a contextual framework” for how “creditors ... [can] preserve, or augment the estate” sufficient to warrant awarding a substantial contribution administrative expense claim.13 The subsections of § 503(b), the majority found, “provide guidance”14 from Congress; these are illustrative, not exhaustive.15

The dissent countered that the majority’s reading of § 503(b) is too “sweeping” of a reach.16 Congress “could have explicitly stated that § 503(b) excludes substantial-contribution claims in Chapter 7, [but] it remains just as true that Congress only specified that substantial contribution claims can be considered administrative expenses under Chapters 9

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1 Medofactoring v. McDermott (In re Connolly N. Am. LLC), 802 F.3d 810, 822 (6th Cir. 2015) (quoting Helvering v. Hallock, 309 U.S. 106, 121 (1940)).
3 Compare Connolly, 802 F.3d at 819 (§ 503(b)(3)(D) “does not divert bankruptcy courts of authority to allow reimbursement under § 503(b) of reasonable administrative expenses of creditors whose efforts substantially benefit the bankruptcy estate and its creditors in a Chapter 7 proceeding”), with Lebron v. Mcchem Fin., 27 F.3d 937, 945 (10th Cir. 1994) (§ 503(b)(3)(D) states “not authorize fee awards for expenses incurred after a case is converted from one under chapter 11 to one under chapter 7”).
4 For a list of the bankruptcy and district courts that have either denied recovery for substantial contributions in a chapter 7 case or recognized that § 503(b)(3)(D) is limited to only chapters 9 and 11, see Connolly, 802 F.3d at 822 fn.2 (Malley, J. dissenting).
5 Id. at 820-21.
7 Id. at 36.
8 Connolly, 802 F.3d at 816 (quoting In re Federated Dep’t Stores Inc., 270 F.3d 994, 1000 (8th Cir. 2001)).
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and 11.”17 “[W]hile Congress chose to use ‘including’ in § 503(b), Congress did not use ‘including’ in § 503(b)(3), implying that the list of ‘actual, necessary expenses’ covered by that provision is exclusive.”18 Nonetheless, the majority’s reading of the term “including” carried the day — opening the door for courts to allow claims for expenses not listed in the Bankruptcy Code or contemplated by Congress.

Incentivizing Creditor Participation

“The structure of the Bankruptcy Code reflects a decision by Congress to prefer certain categories of claims over other categories of claims,”19 and the coveted administrative expense claim is the second-highest category of priority.20 This high rank signals a congressional policy decision to promote meaningful creditor participation. “[A]llowing these ‘administrative expenses’ a prior right to payment encourages the necessary parties to undertake the collection and distribution of the assets of the estate so as to be able to generate proceeds to distribute to pre-existing creditors.”21 Since § 503(b)(3)(D) only references chapters 9 and 11, the circuits have, for the most part, limited these administrative expense claims to reorganization cases and not liquidations.22

In contrast, some lower courts (and now the Sixth Circuit) have extended the subsection’s application to chapter 7. For example, one bankruptcy court held that “[t]o not allow ... creditors and their counsel to recover fees and costs incurred and paid with relation to ... investigation of the financial affairs of the debtor and prosecution of action[s] would have a chilling effect upon creditor participation.”23 Another bankruptcy court considered that “the public interest is best served by encouraging [creditors] to alert a Trustee of the existence of assets that will benefit the bankruptcy estate, especially when the record clearly indicates the Trustee has completed his administration and abandoned any further efforts to administer the bankruptcy estate.”24 There is obviously a tension in the Bankruptcy Code that has resulted in a profound conflict over how it is being applied.

The Value of Uniformity

It is well established that courts and Congress “should consider the goals of promoting uniformity in bankruptcy administration [and] fostering the economical use of the debtors’ and creditors’ resources, and expediting the bankruptcy process.”25 In fact, the U.S. Constitution authorizes Congress to make “uniform laws respecting bankruptcy.”26 Unfortunately, as this article has shown, the courts do not uniformly apply § 503(b).

Uniform application of § 503(b) would benefit the bankruptcy system as a whole. Allowing creditors to ask for — and receive — substantial contribution administrative expense claims would reduce the risks that creditors face when chasing assets in chapter 7 cases for the benefit of all creditors. Why would a creditor invest resources in pursuing property of the estate if it knows from the outset that the jurisdiction in which the case is filed will not approve its administrative claim? If instead a creditor knows that it might be compensated for what it recovers for the estate (up to the amount of its allowable administrative claim), the creditor will be more likely to track and collect estate property. By awarding an administrative claim, creditors could reasonably anticipate reimbursement. However, under the current regime of circuit splits and ambiguous Code language, creditors are wise to sit on the sidelines and allow the case trustee to fully fund the administration of the estate. Unless § 503(b)(3)(D) is amended to include chapter 7, the bankruptcy system is failing to fully employ the resources of latent creditors that are justifiably unwilling to help fund liquidation proceedings.

This dilemma is embodied in a ruling by the U.S. Bankruptcy Court for the District of Maryland. There, the late Hon. Paul Mannes found that it was “[u]nquestionable that these creditors made a substantial contribution in this [chapter 7] case. But for their attention and industry, this case would [have] been closed out without any payment whatsoever to any creditor.”27 Yet, unlike the majority in Connolly, Judge Mannes was reluctant to apply the Bankruptcy Code’s elusive “equitable principles.”28 Instead, he recognized that the Code, as written, mandates an unjust result: “The court’s sense of fundamental fairness cries out for [creditor] reimbursement. However, § 503(b)(3)(D) is limited to cases under Chapter 9 or 11 ... and this case never was a case under either chapter.”29

Lower courts that have granted administrative expenses under § 503(b)(3)(D) have taken the Connolly approach to interpreting the term “including.” For example, in the U.S. Bankruptcy Court for the Eastern District of New York, Chief Bankruptcy Judge Melanie L. Cyganowski (ret.) decided that it would consider the creditor’s application for administrative expense status under § 503(b) generally, “rather than [be] limited to the specific category of administrative expense described in § 503(b)(3)(B).”30 Just like the majority in Connolly, Judge Cyganowski found that “[t]he use of the word ‘including’ is significant [and subsection (b)(3)(B) is but one example of administrative expense allowed under 503(b).]”31

17 Id. at 821.
18 Id.
19 4-507 Collier on Bankruptcy ¶ 507.02 (1st 2015).
20 Id. (citing 11 U.S.C. § 507(a)(2) (administrative expense claims are second only to claims for domestic-support obligations)).
21 Id.
22 See, e.g., In re Morad, 328 B.R. 294, 272 (B.A.P. 1st Cir. 2005); In re Bayou Grp. LLC, 431 B.R. 549, 560 (Bankr. S.D.N.Y. 2010); Lebron v. Mechum Fin., 27 F.3d 937 (3d Cir. 1994); In re Consolidated Bancshares Inc., 785 F.2d 1249, 1253 (5th Cir. 1986); In re Jartran Inc., 732 F.2d 584, 586 (7th Cir. 1984); In re Selduna Indt., 220 B.R. 74, 79 (B.A.P. 9th Cir. 1998).
28 Connolly, 802 F.3d at 820.
29 27 Id. at 820.
30 In re Harvey, 2006 Bankr. LEXIS at *5 (emphasis added).
32 Id.

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A Proposed Solution

In light of the “chilling effect[s] upon creditor participation” in the bankruptcy process and the lack of uniformity in applying the Bankruptcy Code, Congress should amend § 503(B)(3)(D) to include chapter 7 cases. This would not yield a windfall for creditors as it is “the rare Chapter 7 creditor ... who [is] forced by circumstances to ‘take[e] action that benefits the [bankruptcy] estate when no other party is willing or able to do so.’” In addition, there are protections in place to avoid creditor abuse. Specifically, creditors are only eligible for reimbursement after notice and hearing. Thus, a creditor has to make its case for reimbursement to the court, other parties-in-interest may object, and then the court may decide whether the claim is warranted. Amending the Code to allow substantial-contribution claims in chapter 7 cases would give courts firm footing on which to evaluate these claims. It would make it clear that the court may — but does not have to — grant such requests. As with any claim, the courts could decide on a case-by-case basis.

The Bankruptcy Code would no longer automatically divest the courts of the authority to do so. If the Code is not amended, then, like walking on quicksand, creditors seeking substantial-contribution claims will remain stuck in the shapeless and diverging interpretations of a puzzling statute.

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32 In re Antar, 122 B.R. at 791.
33 Connolly, 802 F.3d at 818 (citation omitted).