

# Protecting creditors' administrative claims in Chapter 11 bankruptcy cases

By Schuyler G. Carroll, Esq., Bethany D. Simmons, Esq., and Noah Weingarten, Esq., Loeb & Loeb LLP

DECEMBER 6, 2021

Most vendors that trade with debtors know that administrative expense claims are required to be paid in full. In recent large Chapter 11 cases, however, debtors have leveraged the risk of administrative insolvency to escape their obligation to pay trade and ordinary-course administrative claim holders in full as required under sections 503(b), 507(a)(2), and 1129(a)(9) of the Bankruptcy Code. Some debtors have continued paying certain administrative claim holders (typically, professionals) in full, while trade and ordinary-course administrative claimants receive only a small percentage.

## Illustrations of debtors becoming administratively insolvent

In many recent Chapter 11 cases, debtors were able to avoid paying administrative claimants in full.

**Verity — Administrative claims reduced after plan reserve underestimated the amount of the claims.** Recently, in the *Verity Health System of California, Inc.* bankruptcy in the Central District of California, the debtors secured post-plan confirmation approval from Judge Ernest Robles to pay certain administrative claimants between 15% and 23%. Professionals and administrative claim holders that had already been paid were not subject to this reduction.

The plan established a \$52,749,000 reserve to satisfy non-professional administrative claims that were allowed and unpaid as of the plan's effective date. The reserve amount was based on the debtors' projections of administrative claims that were to be filed. In support of plan confirmation, the debtors submitted a declaration from their financial advisor attesting to the sufficiency of the administrative claim reserve.

The plan was confirmed before the bar date for administrative claims, however, and the debtors greatly underestimated the amount of administrative claims — by a factor of eight. In fact, according to the debtors, at one point, they had a mere \$5.3 million to satisfy over \$25 million in administrative claims. This shortfall led to the liquidating trustee seeking and obtaining court approval — over vehement creditor objection — to pay administrative claimants between 15% and 23%.

**Southern Foods — Administrative claim reduced by protocol enabling the accelerated payment of reduced claims.** In the *Southern Foods* bankruptcy before Judge David Jones in the Southern District of Texas, the debtors, seeking to avoid administrative insolvency, obtained approval of administrative claim "protocols" that would enable them to reduce the amount of administrative claims.

Under the protocols, administrative claimants that affirmatively opted in received an "accelerated" cash distribution in exchange for reducing their claim to 80% of the "reconciled" claim amount. These administrative claimants received an initial cash distribution equal to 30% of the reduced administrative claim within 10 business days after opting in, with the remaining amount to be paid at some future date to be determined by the debtors with the consent of the official committee of unsecured creditors. Conversely, claimants that declined to reduce their administrative claim were subordinated to the administrative claimants that opted in.

In this case, the debtors successfully leveraged the risk of administrative insolvency to reduce the amount of administrative claims.

**Pier 1 — Administrative claims put in peril after court orders delay in payment until plan effective date.** Finally, in the *Pier 1* bankruptcy in the Eastern District Court of Virginia, Judge Kevin Huennekens approved the debtors' motion to delay payment of all but certain "critical expenses" included on an interim budget.

Numerous landlords, among other creditors, objected to the motion because the rent due under their respective leases would be deferred. As an alternative, the landlords requested the immediate payment of rent. The court granted the landlords an administrative expense claim for the deferred rent but denied their request for immediate payment.

After the debtors remained in possession of their leased premises and delayed paying rent for two months, the debtors became administratively insolvent, resulting in the landlords' administrative claims becoming virtually worthless.

The debtors subsequently filed a plan that called for administrative claimants to receive reduced payment. In order to obtain creditor body approval, the plan provided a release from Chapter 5 causes

of action for administrative claim holders that voted in favor of the plan. (Chapter 5 of the bankruptcy code contains the debtor's avoidance powers, including preferences and fraudulent transfers under 11 U.S.C. §§ 547 and 548.) The creditor body voted in favor of the plan, and administrative claimants were paid far less than 100-cent dollars.

### Proactive steps to protect administrative claims

While creditors are required to continue providing services to debtors post-petition and the Bankruptcy Code requires administrative claims to be paid in full, *Verity*, *Southern Foods*, *Pier 1* and other cases, such as *Sears* (Bankr. S.D.N.Y. 2018) and *Toys "R" Us* (Bankr. E.D. Va. 2017), show that holders of administrative claims must be vigilant in protecting their claims; otherwise, they may be left with drastically reduced claims.

Below are several tips that can assist creditors in collecting 100% of their administrative claims. Of course, whether these will work depends on the circumstances of the case and the creditor's leverage:

- Be proactive. Do not assume that administrative claims will be paid in full. Monitor the debtors' operations and ensure, to the extent possible, that the debtors make payment in advance or on delivery.
- Participate on the creditors committee. Committee members will receive timely periodic reporting on cash flows (and administrative solvency).
- Attempt to work with the debtors to obtain immediate payment on an informal basis, rather than seeking court intervention. As *Pier 1* demonstrates, seeking court intervention may backfire badly for administrative claimants. As in *Pier 1*, the court may allow debtors to defer the payment of the administrative claim until a plan effective date, creating the risk that the debtors could become administratively insolvent in the interim.
- If the administrative claim is based on an executory contract, move to compel the assumption or rejection of the executory contract. The assumption of the executory contract will ensure that post-petition cure amounts are paid. The rejection would cap the amount of the administrative claim that would potentially be at risk.
- If the plan calls for administrative claims to be satisfied from a reserve, make sure that the administrative bar claim date occurs before plan confirmation, in order to ensure the sufficiency of the administrative claim reserve. Additionally, seek discovery from the debtors to confirm the sufficiency of the plan's reserves.
- Ensure that the plan provides identical treatment for all administrative claims and does not permit certain claims (i.e., professional fees) to be paid ahead of others.
- Negotiate a plan provision providing for (i) cash distributions to comply with the absolute priority rule to avoid any distribution to any lower priority creditor prior to the satisfaction of all administrative claims; (ii) any excess amount set aside for professionals to be paid to administrative claimants that remain unpaid; and (iii) the clawback of previously paid administrative claims in the event of a shortfall in the distribution to administrative claimants.
- Negotiate release and exculpation provisions to become effective only upon the actual payment in full for administrative claims.
- Negotiate for the capping of professional fees that may otherwise deplete the debtors' estates.
- Negotiate to trade a reduction in the administrative claim in exchange for a release of Chapter 5 claims.

### About the authors



**Schuyler G. Carroll** (L) is a partner in **Loeb & Loeb's** Restructuring and Bankruptcy practice. His practice focuses primarily on Chapter 11, 15 and 7 bankruptcy proceedings; distressed acquisitions; creditors' rights enforcement; and litigation and advisory work. He can be reached at [scarroll@loeb.com](mailto:scarroll@loeb.com). **Bethany D. Simmons** (C), a partner with the firm's Restructuring and Bankruptcy practice, focuses her practice on bankruptcy reorganization and commercial litigation, and has experience guiding debtors in health care and oil and gas

industries through the stages of Chapter 11. She can be reached at [bsimmons@loeb.com](mailto:bsimmons@loeb.com). **Noah Weingarten** (R), an associate in the firm's Restructuring and Bankruptcy practice, provides advice on complex bankruptcy and restructuring matters. He maintains a commercial and bankruptcy litigation practice with an emphasis on bankruptcy avoidance litigation and media and entertainment disputes. He can be reached at [nweingarten@loeb.com](mailto:nweingarten@loeb.com). The authors are based in New York.

This article was first published on Reuters Legal News and Westlaw Today on December 6, 2021.

© 2021 Thomson Reuters. This publication was created to provide you with accurate and authoritative information concerning the subject matter covered, however it may not necessarily have been prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional. For subscription information, please visit [legalsolutions.thomsonreuters.com](https://legalsolutions.thomsonreuters.com).