Addressing Section 503(b)(9) Claims Issues at the Outset

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It is a common fact pattern among cases filed in the U.S. Bankruptcy Court for the District of Delaware over the past decade: an over-leveraged debtor is in default under its prepetition credit facility, and the prepetition secured lender is looking to liquidate its collateral and get out as quickly and inexpensively as possible. It is this fact pattern, along with an increased awareness of the costs and uncertainty associated with "free fall" Chapter 11 bankruptcies, that has helped maintain the popularity of sale cases under Section 363 of the Bankruptcy Code. Assuming an appropriate marketing process has been conducted, Section 363 generally enables a debtor to complete a sale of substantially all of its assets within 60 to 90 days of the petition date. There are, however, still significant costs involved in funding a sale process of this length, including, among other things, funding the post-petition costs and expenses of operating the business through the sale process. More likely than not, these costs will need to be funded by the prepetition secured lender in the form of a DIP (debtor-in-possession) credit facility or through the consensual use of the prepetition lender's cash collateral. This article discusses the impact that Section 503(b)(9) of the Bankruptcy Code may have on the funding needs of a case and explores the manner in which the Delaware bankruptcy court has addressed the issue.

In seeking bankruptcy court approval of DIP financing or the consensual use of cash collateral, the general requirement is that the debtor be able to demonstrate that the case will be "administratively solvent" through the conclusion of the sale process. Generally speaking, this requires a showing from the debtor that the DIP financing and/or use of cash collateral will provide for the payment of all post-petition administrative claims incurred by the debtor in operating its business through the sale process. These expenses include, among other things, post-petition amounts owed to trade vendors, employees, utility providers and certain professionals incurred in the ordinary course of operating the debtor's business. Section 503(b)(9) of the Bankruptcy Code, however, complicates a debtor's ability to demonstrate administrative solvency early in a Chapter 11 case. Section 503(b)(9) essentially elevates prepetition claims for "goods received by the debtor within 20 days before the" petition date to administrative claims against the debtor's estate. While this has an obvious effect on how such claims will be treated under any Chapter 11 plan, it also presents a potential financing issue early on in a Section 363 sale case. Specifically, the issue is whether a debtor can demonstrate administrative solvency where the proposed financing budget does not provide assurance of payment for all Section 503(b)(9) claims. This issue typically arises as a dispute between the proposed DIP lender, who wants to limit the funding necessary to get through the sale process, and an objecting creditors' committee or individual claimant.

The Delaware bankruptcy court has addressed this issue in a number of different sale cases, with varying results. In *In re Townsends*, No. 10-14092 (CSS) (Bankr. D. Del.), Tr. of Jan. 21, 2011 Hr'g at 23-25, U.S. Bankruptcy Judge Christopher S. Sontchi initially refused to approve the debtors' post-petition financing package where the prospects for payment of Section 503(b)(9) claims were slim. Indeed, it was only after the DIP lender and creditors' committee reached an agreement on the payment of Section 503(b)(9) claims from the sale proceeds that the court ultimately approved the financing. By contrast, in *In re Allen Family Foods*, No. 11-11764 (KJC) (Bankr. D. Del.), Tr. of July 27, 2011 Hr'g at 44-45, U.S. Bankruptcy Judge Kevin J. Carey approved a sale of the debtors' assets over objection despite there being no assurance that allowed Section 503(b)(9) claims would be paid in full.

More recently, this issue was addressed by the court in *In re NE Opco*, No. 13-11483 (CSS). In *NE Opco*, the debtors had limited funds in their DIP financing budget and a short timeframe within which to obtain a purchaser of their assets. Complicating the situation were the competing interests of the debtors' lender, the creditors' committee, the debtors' nondebtor parent and the debtors' largest secured creditor. Without a prospective purchaser in place, the debtors negotiated a deal with the other parties that provided for, inter alia, the funding of a segregated escrow account for payment of allowed Section 503(b)(9) claims. At the hearing to approve the proposed settlement, several Section 503(b)(9) claimants objected, arguing that the proposed settlement provided no assurance that such claims would be paid in full and, in fact, the financial constraints of the case made it speculative as to whether Section 503(b)(9) claims would be paid at all. After careful consideration, the bankruptcy court ultimately approved the proposed settlement, noting that the settlement was the most likely path to facilitate a sale that would maximize value for the debtors' estate and constituents. The court rejected the notion that there needed to be a guarantee of payment for Section 503(b)(9) claims. Instead, the court looked to whether there was a "reasonable likelihood, or more likelihood than not, that Section 503(b)(9) claims will be paid in full." After having considered the testimony and evidence that was presented at the hearing (including testimony regarding potential recoveries and offsets relating to Chapter 5 causes of action), the bankruptcy court was able to make this finding. Significantly, the court acknowledged a concern that some administrative claimants may be paid more than others, but indicated that this was sometimes a business reality and that the mere possibility of this result did not warrant rejection of the proposed settlement.

While *NE Opco* provides some helpful guidance in addressing Section 503(b)(9) issues at the outset of a Section 363 sale case, it is only a transcript ruling and the law on this issue remains far from settled. Thus, in cases where Section 503(b)(9) claim exposure is significant, debtors, secured lenders and prospective buyers must be cognizant of the issue and aware that it could potentially add an additional layer of expense to getting through a sale process under Section 363 of the Bankruptcy Code.

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