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Feature

By Brian M. Resnick, Steven Z. Szanzer and Omer Netzer[1]

A Bird in the Hand Is Worth Two on the Effective Date

Brian M. Resnick
Davis Polk & Wardwell LLP; New York

Steven Z. Szanzer
Davis Polk & Wardwell LLP; New York

Omer Netzer
Davis Polk & Wardwell LLP; New York

Administrative solvency is generally considered a precondition for a bankruptcy court's confirmation of a chapter 11 plan. However, administrative insolvency does not necessarily preclude a confirmable plan. In a growing number of chapter 11 cases, bankruptcy courts have approved chapter 11 plans despite the debtors' inability to pay administrative claims in full on a plan's effective date. By invoking § 1129(a)(9) of the Bankruptcy Code, which allows for plan confirmation when administrative claimants agree to receive "different treatment," bankruptcy courts have approved plans that incorporate a "haircut" for administrative claimants while affording them the opportunity to opt out of such treatment. More recently, bankruptcy courts have even sanctioned discount programs proposed by debtors, notwithstanding the absence of clear administrative insolvency, where such programs grant administrative claimants the right to accept an accelerated payment in exchange for an irrevocable discount to their claim, either as part of the confirmation of a chapter 11 plan or even prior to the filing of a plan.

Administrative Insolvency: Background

In order for a debtor to confirm a chapter 11 plan, the debtor must demonstrate that the plan satisfies the provisions of § 1129. Section 1129(a)(9)(A) requires that "except to the extent that the holder of a particular claim has agreed to a different treatment," a plan must provide for the payment in full in cash of all allowed administrative claims under § 507(a)(2) of the Bankruptcy Code on or before the plan's effective date.

The Code grants such preferred status to administrative claims (which are "actual, necessary costs and expenses of preserving the estate"), pursuant to §§ 503(b)(1)(A) and 507(a)(2) of the Bankruptcy Code, to incentivize trade creditors to continue their business relationships with debtors during bankruptcy proceedings.[2] As a result, trade creditors continue to conduct business in the ordinary course with debtors, thereby affording debtors the opportunity to restructure or reorganize their operations and/or balance sheets under the general assumption that they will be paid in full for the goods and services provided to debtors after the petition date.

However, administrative claims are not considered a "class" for purposes of §§ 1122 and 1123 of the Bankruptcy Code and, as a result, are not entitled to vote to accept or reject a plan. Therefore, the requirement that administrative claims be paid in full in cash as a prerequisite for confirmation of a plan absent the consent of each individual claimant is a meaningful statutory protection that is typically sufficient to induce counterparties to continue to do business with a chapter 11 debtor.

Many recent chapter 11 cases involve debtors that do not emerge from chapter 11 as reorganized entities but rather sell their assets under § 363 of the Bankruptcy Code, and in a growing number of these cases, the debtors' assets available for distribution are or might be insufficient to cover their respective administrative claims in full. In those cases, the debtors may turn to a chapter 7 liquidation or, in the alternative, ask the court to confirm a chapter 11 liquidation plan that would not pay administrative

1 This article represents the views of the authors, and the statements made herein are not those of their firm or its clients. The authors are grateful to **Nate Sokol** for his invaluable comments and suggestions.

2 *See Mass. Div. of Emp't & Training v. Bos. Reg'l Med. Ctr. (In re Bos. Reg'l Med. Ctr.)*, 291 F.3d 111, 124 (1st Cir. 2002) ("The justification for this rule is that the administrative priority is necessary to induce potential contractors to do business with the debtor-in-possession, which in turn is necessary to prevent the business from collapsing entirely with the filing.").

claims in full. How can such a plan be confirmed? The key is § 1129(a)(9), which authorizes a court to confirm a plan if administrative claimants *agree* to receive "different treatment."

Toys "R" Us and *Pier 1*: Opt-Out Mechanisms

Bankruptcy courts have held that a plan providing for less than full payment of administrative claims can still satisfy the requirements of § 1129(a)(9) if such plan contains a provision that allows administrative claimants to opt out of such treatment; the failure of an administrative claimant to exercise its opt-out right would constitute its consent to the "different treatment" under the plan. One prominent example is *Toys "R" Us*,[3] in which the debtors reached a settlement with, among other parties, an *ad hoc* group of administrative claimants on account of their approximately $800 million of administrative claims.

In accordance with the settlement approved by the bankruptcy court,[4] the debtors transmitted forms to all administrative claimants advising them of the settlement terms (*i.e.*, approximately a 22 percent recovery on account of their administrative claims) and offering such claimants the ability to opt out of the settlement treatment. Administrative claimants that did not affirmatively opt out of the settlement were presumed to have accepted the treatment under the settlement. However, the settlement contained a provision that it would be terminated if holders of more than 7.5 percent of the administrative claims affirmatively opted out.

Ultimately, the settlement became effective, and the bankruptcy court approved the debtors' chapter 11 plan,[5] which provided, among other things, less than full payment on account of administrative claims whose holders did not opt out of the settlement, and thus were deemed to have consented to treatment under the settlement, while paying in full on the effective date the administrative claims of those holders that affirmatively opted out of the settlement. Notwithstanding the foregoing settlement, subsequent to plan confirmation the creditor litigation trust commenced a lawsuit against the debtors' former directors and officers and other parties, alleging, among other things, that they misrepresented the debtors' financial condition to encourage vendors to continue supplying the debtors post-petition, thereby resulting in more than $600 million of vendor losses.[6]

Similar to *Toys "R" Us*, the debtors in *Pier 1*[7] were clearly administratively insolvent, and as a result, the debtors were faced with either converting their bankruptcy cases to chapter 7 or offering administrative claimants a "haircut" on account of their claims. Following the *Toys "R" Us* model, the *Pier 1* debtors constructed a settlement for the treatment of all administrative claims under a chapter 11 plan (*i.e.*, administrative claimants were expected to receive cash distributions equal to approximately 10-40 percent of their allowed administrative claims) that allowed holders of administrative claims to opt out of the prescribed settlement program.[8] In fact, the proposed settlement in *Pier 1* represented an even more significant discount to administrative claims than the one approved and accepted in *Toys "R" Us*.

The *Pier 1* debtors explicitly explained in the disclosure statement, which accompanied the proposed plan, that an administrative claimant's failure to opt out of the settlement program would be considered the claimant's agreement to the "different treatment" provided by the settlement. The U.S. Trustee objected to the *Pier 1* plan, arguing that it did not provide for payment in full in cash for all administrative claims and that such claimants should not be deemed to have consented to their treatment under the plan.[9] The debtors, however, argued that § 1129(a)(9) does not require an affirmative agreement to such "different treatment" and that implied consent should suffice.[10] The bankruptcy court approved the plan, overruling the U.S. Trustee's objection, and determined that the mere creation of a viable opportunity to opt out of the settlement treatment under the plan was sufficient agreement to "different treatment" under § 1129(a)(9).[11] While the opt-out mechanic was approved in both *Toys "R" Us* and *Pier 1* by the U.S. Bankruptcy Court for the Eastern District of Virginia, courts in other districts have also approved comparable mechanics.[12]

Sears: Three-Tier Discount Program

Unlike *Toys "R" Us* and *Pier 1*, the debtors in *Sears*[13] were not obviously administratively insolvent. *Sears* represents a new and unusual development: The application of an administrative claims discount program in cases where the debtors were solvent or at least on the cusp of solvency. In *Sears*, the debtors filed a plan that incorporated a three-tier administrative claims consent program based on an agreement reached among the debtors, the official committee of unsecured creditors and an *ad hoc* group of administrative creditors.[14]

Under the *Sears* program, the debtors provided each administrative claimant with an opt-in/opt-out

Brian Resnick is a partner, Steven Szanzer is counsel and Omer Netzer is an associate with Davis Polk & Wardwell LLP in New York. Mr. Resnick is also a past advisory board member for ABI's New York City Bankruptcy Conference.

3 *In re Toys "R" Us Inc.*, Case No. 17-34665 (KLP) (Bankr. E.D. Va.).
4 *Toys "R" Us*, D.I. 4083 (Aug. 8, 2018).
5 *Toys "R" Us*, D.I. 5746 (Nov. 21, 2018).
6 *Toys "R" Us*, Adversary Proceeding No. 20-03038, D.I. 100 (Feb. 22, 2021). The case is currently pending.
7 *In re Pier 1 Imports Inc.*, Case No. 20-30805(KRH) (Bankr. E.D. Va.).
8 *Pier 1*, D.I. 790, p. 15 (June 23, 2020).
9 *Pier 1*, D.I. 890 (July 23, 2020).
10 *Pier 1*, D.I. 941, p. 20-24 (July 28, 2020).
11 *Pier 1*, D.I. 967 (July 30, 2020).
12 *See, e.g., In re Barneys New York Inc.*, Case No. 19-36300 (CGM) (Bankr. S.D.N.Y. Dec. 19, 2019); *In re Specialty Retail Shops Holding Corp.*, Case No. 19-80064 (TLS) (Bankr. D. Neb. June 11, 2019).
13 *In re Sears Holdings Corp.*, Case No. 18-23538 (RDD) (Bankr. S.D.N.Y.).
14 *Sears*, D.I. 5293 (Oct. 1, 2019).

form, and based on each claimant's election (or lack thereof), the debtors determined how such claimant's claim would be classified. The first tier included administrative claims whose holders affirmatively chose to opt into the program and agreed to receive an aggregate cash recovery equal to 75 percent of their allowed administrative claims, and in exchange, they were entitled to receive a *pro rata* share of an expedited initial cash distribution.[15]

The second tier was comprised of administrative claims whose holders neither chose to opt into the program nor affirmatively chose to opt out of it. Those administrative claimants were deemed to agree to receive an aggregate cash recovery equal to 80 percent of their allowed administrative claims.

The third tier consisted of administrative claims whose holders affirmatively opted out of the plan treatment. Such claimants would be paid in full in cash on or before the effective date, but only after administrative claims in the first and second tiers were paid their full cash recovery under the discount program.

The *Sears* debtors emphasized that plan confirmation was not dependent on the discount program, as they expected to be in a position to pay all administrative claims in full regardless of the program, but they noted that the program would allow them to accelerate payments under the plan and provide participants with an opportunity to receive an earlier payout.[16] While the bankruptcy court confirmed the plan containing the discount program, the debtors still have not consummated the plan because the debtors do not yet possess sufficient cash to pay in full on the effective date of the plan all administrative claims whose holders opted out of the program.[17] It appears that the resolution of an adversary proceeding commenced by the restructuring committee against the debtors' controlling shareholder and other parties, in which the committee is seeking more than $2 billion in damages, is one of the factors driving the timing for the conclusion of the *Sears* cases.[18]

Dean Foods: Pre-Plan Consent Program and Post-Effective-Date Distributions

Dean Foods[19] is a case that adds another layer to the developing field of administrative claims consent programs. In this case, the debtors believed that they were on a razor-thin edge of administrative solvency and that a discount program would facilitate two objectives: (1) It would expedite payment of administrative claims to vendors (albeit at a marginal discount) without unfairly and subjectively prioritizing one administrative claimant over another; and (2) it would create value for the debtors' estates to mitigate the potential risks of administrative insolvency. Unlike in *Sears*, however, the discount program was negotiated (between the debtors and the official committee of unsecured creditors) and approved by the bankruptcy court prior to the filing of a chapter 11 plan, and distributions were made on account of participating administrative claims well before the plan was confirmed.

Pursuant to the *Dean Foods* program approved by the bankruptcy court, holders of administrative claims who affirmatively elected to opt in and agree to a 20 percent discount to their allowed administrative claims were paid on an accelerated timeline (unlike in *Sears*, whose program deemed claimants to have accepted the terms of the program unless they expressly opted out).[20] Pursuant to the program, administrative claimants who decided not to opt into the program would receive (subject to plan confirmation, which was ultimately confirmed almost eight months after the court-approved program)[21] payment in full, in cash and in an amount equal to their allowed administrative claim. However, such administrative claimants would not receive any distributions until all opt-in claimants recovered their full payments in accordance with their participation in the program. Moreover, pursuant to the confirmed plan, nonparticipating administrative claimants were deemed to have consented (under § 1129(a)(9)) to post-effective-date distributions on account of their administrative claims unless they timely objected to such treatment, and all rights were preserved respecting the applicability of § 502(d) in connection with the allowance of such claims.

In order to facilitate transparency in the process and assist eligible holders of administrative claims in determining whether to participate in the program, the *Dean Foods* debtors filed notices attaching slides illustrating, among other things, (1) estimated ranges for total sale and asset recoveries, post-petition claims and wind-down costs; and (2) an estimated timeline for the monetization of various assets. In addition, the debtors hosted a virtual conference in which the debtors and their advisors presented the foregoing illustrative slides and responded to questions with respect to their waterfall analysis and the program in general. Finally, in addressing the program's interplay with potential preference claims, the debtors transmitted to each known administrative claimant a notice of the debtors' good-faith estimation of potential preference claims (if any) against such claimant and did not condition payment of "discounted" claims to participating claimants on the resolution of their respective preference claims.

In the end, prior to confirmation of the debtors' plan, more than 800 administrative claimants voluntarily elected to opt into the program. This resulted in the accelerated payment of more than $67 million of administrative claims and saved the debtors' estates approximately $13.5 million in value, thereby increasing broader stakeholder recovery.

Key Takeaways and Possible Future Developments

The current economic downturn and the effects of the COVID-19 crisis are likely to lead to more cases of administratively insolvent debtors that will require the deliberation of options when administering their cases and formulating a confirmable plan. Administrative

15 *Sears*, D.I. 5370, p. 27 (Oct. 15, 2019).
16 *Sears*, D.I. 5296 (Oct. 1, 2019).
17 *Sears*, D.I. 5370 (Oct. 15, 2019).
18 *Sears*, D.I. 5146 (Sept. 13, 2019).
19 *In re Southern Foods Grp. LLC*, Case No. 19-36313 (DRJ) (Bankr. S.D. Tex.) ("*Dean Foods*").
20 *Dean Foods*, D.I. 2724 (July 21, 2020).
21 *Dean Foods*, D.I. 3571 (March 18, 2021).

claim discount programs would generally be beneficial for a debtor's estate when its administrative insolvency is in question, because it would help avoid conversion of its chapter 11 case to a chapter 7 liquidation, which would often leave administrative claimants with even further reduced and delayed recoveries. Indeed, this is the reason why administrative claimants and bankruptcy courts have tended to approve of and participate in such discount programs.

The benefits of these programs are particularly compelling when they allow administrative claimants to choose not to opt in, but rather be paid in full at a later date, even when such programs are approved in advance of filing a chapter 11 plan. However, while discount programs have clear advantages, their potential downsides should be also considered, particularly the effect that they might have on the willingness and negotiation tactics of vendors and suppliers when asked to maintain "customary" or any trade terms, practices and programs during the pendency of chapter 11 cases (regardless of their potential treatment as critical vendors). abi

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