

Supply Chain Bankruptcy Preference Releases: Good News for the Credit Team, But Watch for the Claim Offset

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Abstract

In managing credit risk with an insolvent customer, the seasoned credit team also appreciates not just the A/R risk, but the preference risk should the customer file bankruptcy, or an out of court liquidation such as an Assignment for Benefit of Creditors. In some settings, suppliers may have larger exposure with preferences than with A/R. The welcome news for suppliers is that a number of large Chapter 11 filings have included supplier preference releases as part of their negotiated exit from Chapter 11. But with a provision in a Chapter 11 that provides for a preference release, suppliers holding priority claims should be mindful that the debtor may take back the supplier chain preference release through a reserved claim objection.

The Bankruptcy Preference

The Bankruptcy Code vests the trustee with far-reaching powers to avoid payments to suppliers within 90 days prior to a bankruptcy filing, and is one of a debtor's most potent weapons to discourage a supplier's collection strategy of racing to the courthouse to seek a judgement against the insolvent customer.

Supply Chain and One-Off Preference Release

Several high-profile companies have exited Chapter 11 with a plan of reorganization that provides for release of preference actions against the supply chain. Recent case examples include Rue 21, Haggens Supermarkets, Gordmans and Central Grocers. These cases highlight the Chapter 11 exit strategy in two settings: (1) a sale of assets, with an asset purchase agreement negotiated between the debtor, the buyer and creditors' committee, that includes a preference release; or (2) an operating plan negotiated by the debtor, secured creditor and creditors' committee that includes in the Disclosure Statement and Plan, a preference release. In both settings, the supplier qualifies for the preference release by offering credit terms for their product or service to the buyer or reorganized debtor upon exit from the Chapter 11.

If the debtor does not propose a supply chain preference release, the supplier may seek to negotiate a preference release only for its own potential liability. The one-off preference release is commonly through a negotiation of supplier trade terms in exchange for early payment of the supplier's 503(b)(9) claim.

With the sale of asset cases, a Trust is created for purpose of retaining the estate's preference actions and sale proceeds. The party responsible for the Trust's assets is often referred to as a plan administrator. The responsibilities of the plan administrator are to maximize the Trust's assets and limit its liabilities. One way to limit liabilities against the Trust is through plan administrator objections to claims submitted by suppliers.

A claim objection can be such things as books and records—the debtor's reconciliation of the supplier's claim does not match, or a late filed claim. Another strategy for the plan administrator to reduce claims is object to a supplier's claim based on the supplier having received a preference. But does such an objection have merit where the Plan provides for a supply chain preference waiver? Is such an objection, selective enforcement of the preference powers as these types of claim offsets are commonly asserted against suppliers, asserting 503(b)(9) claims?

Claim Objection Based on Preference

A plan administrator may object to a supplier's claim, most likely a 503(b)(9) claim, under section 502(d) of the Bankruptcy Code. Section 502(d) provides, in pertinent part, that "the court shall disallow any claim of any entity from which property is recoverable" under the preference statute, unless the preference is repaid.

How might a plan administrator support a section 502(d) claim objection where a debtor under a confirmed Plan releases suppliers from preferences?

For example in *In re Gordmans*, the confirmed Plan (at Article VII, paragraph F) provides:

Any Claims...recoverable under section...547 of the Bankruptcy Code, shall be deemed disallowed pursuant to section 502(d) of the Bankruptcy Code...

However, Article VIII, paragraph C of the Plan provides an unconditional preference release to suppliers from preferences. Thus, the question for a supplier holding a 503(b)(9) claim is whether a plan administrator may disallow the supplier's claim under section 502(d) on the grounds of an alleged preferential payment, even though a preference action cannot be filed as a result of the preference release.

Does the Legal Authority Support the Supplier Dealing with a 502(d) Claim Objection?

In most Chapter 11 cases, suppliers holding non-priority claims generally do not receive a distribution. Rather, only those suppliers holding priority claims, generally 503(b)(9), receive a distribution. Therefore, in most Chapter 11s, the plan administrator's focus with claims' objections, including 502(d) objections, is against priority claimants.

Fortunately, the majority of courts hold that section 502(d) does not apply to 503(b)(9) claims. *In re Lids Corp.*, 260 B.R. 680, 683 (Bankr. D. Del. 2001) (“administrative expense claims are accorded special treatment under the Bankruptcy Code and are not subject to section 502(d)”); *In re Durango Georgia Paper Co.*, 297 B.R. 326, 331 (Bankr. S.D. Ga. 2003) (“Section 502(d) does not apply to administrative expenses that are allowable under § 503”); *In re Plastech Engineered Prod., Inc.*, 394 B.R. 147, 161 (Bankr. E.D. Mich. 2008) (“the allowance of claims under § 502 is entirely separate from the allowance of administrative expenses under § 503”); *In re Ames Dep't Stores, Inc.*, 582 F.3d 422, 427-432 (2d Cir. 2009) (“[w]e hold that section 502(d) does not apply to administrative expenses under section 503(b)”); *In re TI Acquisition, LLC*, 410 B.R. 742, 750-51 (Bankr. N.D. Ga. 2009) (“Section 502(d) does not contain any language or reference which would make it applicable to administrative expenses of any kind”); *In re Momenta, Inc.*, 455 B.R. 353, 364 (Bankr. D.N.H. 2011) (“Because § 502(d) is inapplicable to administrative expense claims, including an expense requested under § 503(b)(9), the claim shall be allowed”); *In re Energy Conversion Devices, Inc.*, 486 B.R. 872, 878 (Bankr. E.D. Mich. 2013) (“The Court is persuaded that the correct reasoning and views are those taken by the Second Circuit in the *Ames Dep't Stores* case, regarding § 503(b) administrative expenses in general, and by the courts in the *Plastech* and *Momenta* cases, regarding § 503(b)(9) administrative expenses in particular”); *In re Quantum Foods, LLC*, 554 B.R. 729, 735 (Bankr. D. Del. 2016) (“Section 502(d), by its terms, does not include administrative expense claims. Conversely, § 503, which addresses administrative expense claims, has no provision similar to 502(d) disallowing administrative claims if the administrative claimant fails to satisfy a preference liability”).

The minority position is that § 502(d) applies to all claims, including administrative expenses. *In re MicroAge, Inc.*, 291 B.R. 503, 508 (B.A.P. 9th Cir. 2002) (“[W]e believe that the better analysis is that § 502(d) may be raised in response to the allowance of an administrative claim”); *In re Circuit City Stores, Inc.*, 426 B.R. 560, 571 (Bankr. E.D. Va. 2010) (“[T]he Court concludes that § 502(d) may be used to temporarily disallow § 503(b)(9) claims”).

Supplier Strategy to Ensure Priority Claim is Free from 502(d) Objection

If the supplier has a provision in a confirmed Plan that provides for a supply chain preference release, the next step is to confirm that a 502(d) claim objection is not preserved by the plan administrator. If so, consider objecting to that provision of the Plan.

If an objection to the Plan is not lodged, the supplier still has an alternative to preserve the priority claim. The court in *In re Energy Conversion* ruled that a provision in a confirmed plan does not override Congressional intent. In *In re Energy Conversion*, the Trustee requested the court delay payment of a supplier's 503(b)(9) administrative expense until after the preference claim against it had been determined. The Court explained that, whatever discretion a court may have to allow a Chapter 11 debtor to defer paying allowed administrative expenses before a plan is confirmed, such discretion no longer exists once a plan has been confirmed; the confirmed plan controls when allowed administrative expenses must be paid.

Supplier Takeaway

As more large Chapter 11 debtors are considering supply chain preference releases, the supplier, especially one holding a 503(b)(9) claim, should be vigilant as to whether the plan administrator seeks to retain 502(d) claim objections. If a supplier preference release is obtained, but 502(d) claim objections are retained, consider objecting to that provision. Otherwise, case authority supports the 502(d) claim objection be overruled.

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