



## BANKRUPTCY PRACTICE

## Expert Analysis

# Circuit Limits Grounds to Disallow Administrative Expense Claims

In a recent decision by the U.S. Court of Appeals for the Second Circuit in *In re Ames Department Stores Inc.*,<sup>1</sup> the court considered whether a claimant is entitled to payment of an administrative expense claim that it purchased from another creditor before a preference action against the selling creditor was resolved. Relying on the language and statutory context of Bankruptcy Code §502(d) and other relevant statutory provisions, as well as the policy interests embedded in the Bankruptcy Code's claims administration scheme, the court reversed the lower courts and concluded that debtors cannot utilize §502(d) to temporarily disallow an administrative expense claim during the pendency of an avoidance action against the original claimant.

### Statutory Framework

Section 502(d) of the Bankruptcy Code defines the circumstances under which a claim filed in a bankruptcy proceeding may be disallowed. It provides for the disallowance of "any claim" of a party holding property recoverable by the estate pursuant to Bankruptcy Code §§542 or 543 unless the party returns the property at issue or of a "transferee" of an avoidable transfer unless the transferee repays the transfer to the bankruptcy estate.<sup>2</sup> Specifically, "transfers" subject to §502(d) include statutory liens avoidable under §545, preferences avoidable under §547, fraudulent transfers avoidable under §548, and certain postpetition transactions avoidable under §549.

The *Ames* decision devotes considerable attention to the language of §503 of the Bankruptcy Code, which governs the allowance of administrative expenses. As described in greater detail below, §503 "provides that administrative expenses of the type described in section 503(b) are to be allowed by the court after notice and a hearing."<sup>3</sup> Expenses defined as administrative expenses under §503(b)

By  
**John J.  
Rapisardi**



include postpetition wages, the fees and expenses of the debtor's professionals, taxes, and certain expenses incurred by creditors or a custodian. Administrative expenses allowed under §503(b) are accorded priority and must be paid in full under the Bankruptcy Code's distribution scheme.<sup>4</sup>

The lower courts both concluded that §502(d) barred payment on ASM's administrative expense claim until the preference action was resolved and G&A repaid to the debtors the preferential transfer it received.

In August 2001, Ames Department Stores Inc. and its debtor affiliates commenced chapter 11 cases in the U.S. Bankruptcy Court for the Southern District of New York. During the course of the bankruptcy proceeding, ASM Capital, LP, a distressed debt investor, purchased claims from a number of Ames's creditors, which included an administrative expense claim in the amount of approximately \$360,000 held by G&A Sales Inc., a former Ames supplier. In June 2003, after G&A sold its administrative expense claim to ASM, Ames sued G&A to recover allegedly preferential transfers in the amount of approximately \$825,000 (preference action).

While the preference action was pending, Ames elected to begin making interim distributions to administrative expense claimants except those who were either defendants in avoidance actions or acquired their claims from a defendant in a preference action. In April 2005, after the preference

action was pending for nearly two years, ASM filed a motion in the Bankruptcy Court, compelling Ames to pay the administrative claim it acquired from G&A in addition to the administrative expense claims it acquired from other creditors.<sup>5</sup> ASM's motion was denied by the Bankruptcy Court, which denial was affirmed by the U.S. District Court.

### Lower Court Decisions

The Bankruptcy Court and the District Court both concluded that §502(d) barred payment on ASM's administrative expense claim until the preference action was resolved and G&A repaid to the debtors the preferential transfer it received.<sup>6</sup>

The lower courts held that "requests for payment of administrative expenses under section 503" are "claims," as the term is defined in section 101(5) of the Bankruptcy Code.<sup>7</sup> Because §502(d) applies to "any claim" held by an entity from which property is recoverable or that is subject to an avoidable transfer, the Bankruptcy Court and the District Court held that ASM's administrative expenses claim could be temporarily disallowed pursuant to that provision until G&A repaid the amount determined to be a preferential transfer.

However, because G&A itself had commenced a bankruptcy proceeding and transferred all of its assets to a secured creditor, it was highly unlikely Ames would ever collect on any judgment entered against G&A.

As noted by the Second Circuit, the Bankruptcy Court and the District Court "endorsed the reasoning" of the U.S. Bankruptcy Appellate Panel of the Ninth Circuit in *In re MicroAge Inc.*, in which the court held that §502(d) is generally a "valid defense to allowance of administrative claims."<sup>8</sup> In the opinion of the *MicroAge* court, the "sufficiently broad" definition of a "claim" under §101(5), coupled with the explicit exclusion of administrative expense claims in certain other sections of the Bankruptcy Code, suggests that "Congress viewed expenses of administration as merely one type of specialized claim" that should be subject to §502(d).<sup>9</sup>

In overruling the decisions of the lower courts, the Second Circuit first identified distinctions drawn in several Bankruptcy Code sections between "claims" and "requests for payment of administrative expenses."

JOHN J. RAPISARDI is a partner and the co-head of the financial restructuring department of Cadwalader, Wickersham & Taft, and an adjunct professor of law at Pace University School of Law. MICHAEL J. COHEN and JOSEPH V. ZUJKOWSKI, associates of the firm, assisted in the preparation of this article.

For example, the court highlighted the “separate priority” given to claims and administrative expenses under §507(a) and stressed that §101(10) “defines ‘creditor’ in terms that only include holders of prepetition claims and not holders of postpetition claims for administrative expenses under section 503.”<sup>10</sup> The court also noted the exclusion of administrative expenses from §348(d), which treats as prepetition claims all claims filed after the petition date but before a case is converted to a case under another chapter of the Bankruptcy Code.<sup>11</sup>

Quoting a decision from the Bankruptcy Court for the District of Delaware, the court further observed that “the express exclusion of administrative expense claims from section 348(d), and the exclusion of administrative claim holders from the definition of ‘creditor,’ lend support to the view that administrative expense claims are claims that are entitled to distinct treatment separate and apart from pre-petition, or deemed pre-petition, creditor claims.”<sup>12</sup>

The Second Circuit also determined that the “structure and context” of §502(d) suggests that it was not intended by Congress to apply to administrative expense claims. The court observed that §502 governs only the allowance of claims for which proofs of claim are filed under §501. It noted that only creditors can file proofs of claim under §501 and that such proofs of claim may only relate to prepetition claims and certain postpetition claims that are treated as prepetition claims.

Moreover, the court stressed that the procedure for the filing and allowance of requests for payment of administrative expenses, governed by §503 of the Bankruptcy Code, differs in several important respects from §501. As examples, the court highlighted the fact that “any entity” may file an administrative expense request under §503 and that all such requests require notice and a hearing, which is in contrast to claims filed under §501, which requires claims to be filed by “creditors” and provides for notice and a hearing only if a party files an objection.<sup>13</sup>

The Second Circuit dissected the language of §502 to garner support for its position. It noted that the “plain language” of §502(d) provides an exception to the automatic allowance of proofs of claim under §§502(a) and (b) and thus implies that §502(d) is limited to the proof of claim process.

The court also pointed to subsections 502(e) (2), (f), (g), (h) and (i), which explicitly state that certain postpetition claims are subject to §502(d). For example, §502(e) provides that a claim for reimbursement or contribution of a party that is liable with a debtor, which becomes fixed after the commencement of a bankruptcy case, may be disallowed under §502(d) just as if “such claim had become fixed before the date of the filing of the petition.”<sup>14</sup>

Commenting on these provisions, the court observed that “the express invocation of section 502(d) suggests that the section did not already apply to such claims before they were brought within section 502’s reach, and that it does not apply to postpetition claims remaining

outside section 502, such as the requests for administrative expenses addressed by section 503(b).”<sup>15</sup>

Finally, the Second Circuit found that the general “statutory context” of the Bankruptcy Code suggests that §502(d) does not extend to administrative expense claims. The court highlighted the Bankruptcy Code’s “clear division between an entity in its pre- and post-petition states,” noting as an example that requests for payment of administrative expenses generally cannot be set off against prepetition claims.

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The court again stressed the elevated priority given to administrative expenses under §507, which it attributed to a need to encourage parties to continue providing goods and services on credit to a debtor following the filing of a bankruptcy petition. Quoting the District of Delaware bankruptcy court, the circuit concluded by stating that “if trade vendors felt that a preference could be used to prevent the payment of their administrative claims, they would be extremely reluctant to extend post-petition credit to a chapter 11 debtor.”<sup>16</sup>

#### Analysis

The decision of the Second Circuit in *Ames* clearly affords a heightened level of protection to requests for payment of administrative expenses relative to general prepetition claims. As noted above, administrative expenses are already afforded priority treatment under §507 and generally are not subject to setoff under applicable provisions of the Bankruptcy Code. The *Ames* decision, and similar findings in other jurisdictions, eliminates an important statutory basis on which a debtor could unduly delay paying or potentially challenge parties owed administrative expenses.

The decision is also noteworthy because the Bankruptcy Court and the Second Circuit both engaged in a textual analysis of applicable provisions of the Bankruptcy Code and yet reached opposite conclusions.

The Bankruptcy Court relied on the Bankruptcy Code’s broad definition of “claim” and the explicit exclusion of administrative expense claims in several provisions of the Bankruptcy Code as support for the proposition that §502(d)’s silence with respect to such claims means that they are covered by this provision.

However, the Second Circuit relied on specific provisions governing the claims payment process, including the coverage in §502 of certain postpetition claims, as support for interpreting §502(d)’s silence as an indication that §502(d) does not apply to administrative expenses. In this regard, the Second Circuit’s decision is consistent with the maxim of statutory construction that provides that “where there is no clear indication otherwise, a specific statute

will not be controlled or nullified by a general one.”<sup>17</sup>

#### Conclusion

Although the Second Circuit’s decision in *Ames* is highly dependent on the language and statutory context of the Bankruptcy Code sections at issue, bankruptcy practitioners should not overlook its policy implications.

First, §547 of the Bankruptcy Code, which governs preference actions, is concerned with maximizing the size of the debtor’s estate for the benefit of unsecured creditors. However, the priority given to parties that incur administrative expenses under §507 suggests that such parties should be treated differently from general unsecured creditors in order to encourage post-petition dealings with debtors.

Moreover, the debtors in *Ames* allowed the underlying preference action to linger for over two years before ASM petitioned the Bankruptcy Court for relief. The Second Circuit’s decision appropriately will preclude debtors from delaying the prosecution of preference actions as a tactic to delay payment of administrative expenses.

Finally, the *Ames* decision should provide certainty to claims purchasers in a jurisdiction in which bankruptcy claims are actively traded. Under the lower courts’ orders, ASM would not have received payment until G&A repaid preferences that it had no ability to return. However, the Second Circuit’s decision will allow claim purchasers to acquire administrative expense claims without concern that an avoidable transfer was received by the parties from whom such claims are purchased.

1. *In re Ames Department Stores Inc.*, No. 07-1326-bk, 2009 WL 2972510 (2d Cir. Sept. 18, 2009).

2. Section 542 contains the Bankruptcy Code’s general “turnover provisions,” while §543 governs the turnover of property held by a custodian.

3. 4 Collier on Bankruptcy §503.01 (15th ed. rev.).

4. Pursuant to §507 of the Bankruptcy Code, administrative expenses are only junior in priority to domestic support obligations.

5. The claim acquired from G&A represented approximately one-third of the total amount of ASM’s administrative expense claims.

6. *Ames*, 2009 WL 2972510 at \*3.

7. *Id.* at \*4 (noting that §101(5) defines a claim to include any “right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.”)

8. *Id.* (citing *In re MicroAge Inc.*, 291 B.R. 503, 512-13 (B.A.P. 9th Cir. 2002)).

9. *Id.*

10. *Id.* at \*5.

11. *Id.*

12. *Id.* at \*6 (citing *In re CM Holdings Inc.*, 264 B.R. 141, 158 (Bankr. D. Del. 2000)).

13. *Id.*

14. 11 U.S.C. 502(e)(2).

15. *Ames*, 2009 WL 2972510 at \*7.

16. *Id.* (quoting *In re Lids Corp.*, 260 B.R. 680, 683-84 (Bankr. D. Del. 2001)).

17. *Morton v. Mancari*, 417 U.S. 535, 551-52 (1974).