

# CLIENT ALERT

## BANKRUPTCY



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## Delaware Bankruptcy Court: Debtors Can Offset Administrative Claims Before General Unsecured Claims

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While section 503(b)(9) claims deserve priority payment over general unsecured claims, they do not provide a basis for stripping a debtor's defenses in determining the allowed amount of a section 503(b)(9) claim.

*Note: Pepper Hamilton LLP serves as co-counsel to the Official Committee of Unsecured Creditors (the Committee) in the ADI case. The views expressed herein are solely those of the authors and not of the Committee.*

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In *In re ADI Liquidation, Inc.*, Judge Carey of the U.S. Bankruptcy Court for the District of Delaware found that the debtors were free to apply their setoff rights *first* to the administrative (including section 503(b)(9) administrative claims) or the secured portion of a claimant's claim *before* applying setoff rights to the claimant's general unsecured claims. This is an important decision for debtors who are faced with large section 503(b)(9) claims and the obstacles such claims present in trying to confirm a plan. Additionally, *AWI* is important for creditors who hold both section 503(b)(9) claims and unsecured claims against a debtor regarding the effect of the debtor's setoff rights on their claims.

In *ADI*, the debtors and the Committee filed a joint motion seeking authority for the debtors to offset certain prepetition amounts owing to the debtors as credits or refunds (collectively, the Credits) first against the administrative or secured portion of creditors' claims. The debtors asserted that they, in their discretion, should be able to decide how to apply the Credits to offset various claims, including section 503(b)(9) claims, against the bankruptcy estate. Numerous objections were filed to the joint motion, disputing the debtors' freedom to set off or recoup the Credits against section 503(b)(9) claims before setting off against general unsecured claims.

The court agreed with the debtors and the Committee that applicable case law, the Bankruptcy Code, and equitable considerations support the position that the debtors may apply their setoff or recoupment rights at their discretion, against secured claims, administrative claims (including section 503(b)(9) claims), or general unsecured claims. The court reasoned that a debtor's right to effectuate setoffs, as it exists under state law, is one of the personal defenses preserved under section 558 of the Bankruptcy Code. Looking to the court's prior decisional law, Judge Carey noted the distinction between prepetition and post-petition debts is not relevant under section 558, distinguishing it from section 553's preservation of a creditor's setoff rights so long as both the creditor's and the debtor's debts and obligations arose pre-petition. As such, the Bankruptcy Code does not treat a debtor's and a creditor's right to setoff equally, and allowing the debtors to offset post-petition claims, while restricting a creditor's setoff rights, is consistent with the plain language of the Bankruptcy Code and furthers the goals and objectives of the Code.

The court rejected the objectors' argument that allowing setoff of their section 503(b)(9) claims violates section 1129(a)(9)(A) of the Code, which requires full payment of allowed administrative expense claims on a plan's effective date, unless the claimant agrees to different treatment. The court held that, while section 503(b)(9) claims deserve priority payment over general unsecured claims, they do not provide a basis for stripping a debtor's defenses in determining the allowed amount of a section 503(b)(9) claim. The

court also rejected the objectors' argument that because section 506 of the Bankruptcy Code characterizes setoff as a secured claim, the debtors needed to provide adequate protection to the extent the debtors' setoff rights reduce the creditor's setoff rights. The court, relying on *In re Circuit City Stores, Inc.*, 2009 WL 4755253 (Bankr. E.D. Va. Dec. 3, 2009), found that permitting the debtors to offset prepetition Credits against administrative claims did not erode the value of the claims because the creditors get the benefit of the extinguishment of the debt owed to the debtors, dollar for dollar. Finally, the court also rejected the objectors' argument that the debtors' setoff rights are limited by contract provisions or prior course of dealings between the parties. The court stated that there is a presumption that the claimants' prior course of dealing, industry standards and contract do not operate as a waiver of the debtors' equitable remedies, but each claimant had the right to rebut the presumption at a hearing on the merits of their claim.

The court also denied the request by some section 503(b)(9) claimants for interest on their unpaid claims. The court reasoned that the Bankruptcy Code contains no provision for the pre-confirmation recovery of interest on section 503(b)(9) claims in a Chapter 11 case, and the claimants provided no basis for the allowance of post-petition interest pursuant to section 506(b) or otherwise under the circumstances of the case.

The *AWI* decision is an important affirmation of debtors' offset rights under section 558 of the Bankruptcy Code. In finding that debtors may offset first against section 503(b)(9) claims before general unsecured claims, the court interpreted a debtor's rights under section 558 to be flexible in administration, thereby affording debtors a tool with which to potentially reduce the amount of administrative claims against the estate.