

# Super Priority or Administrative Claims-Which Get Paid First?

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Although often counterintuitive to many potential debtors, survival during Chapter 11 requires access to a sufficient level of cash to operate the business. Thus, one cannot be completely “broke” and hope to avoid liquidation. As a result, DIP financing is often sought either from the pre-petition lender or a new source. Such lenders typically obtain a long list of protections through a financing order which helps ensure the recovery of the principal, interest and fees related to the loan. One of the key protections is a super-priority claim granted under Section 364 of the Bankruptcy Code.

Not surprisingly, the Bankruptcy Code’s priority scheme guides the order in which claims are paid. Under Section 507, for example, secured claims (paid from the underlying collateral securing the debt) are satisfied before those expenses which were incurred during the administration of the bankruptcy estate (known as “administrative expense claims” by virtue of Section 503(b)). Furthermore, secured claims and administrative expense claims are paid ahead of unsecured claims.

To make matters a bit more confusing, Section 364(c)(1) provides that certain super-priority claims are to be paid even before administrative expense claims. Section 364(c)(1) provides, in pertinent part, that “if the trustee is unable to obtain unsecured credit allowable under Section 503(b)(1) of this title as an administrative expense, the court ... may authorize the obtaining of credit or the incurring of debt with priority over any or all administrative expenses of the kind specified in Section 503(b) or 507(b) of this title.” Thus, Sections 364(c)(1) and 364(d) incentivize post-petition lending. Finally, complicating all of the foregoing is Section 726(b), which provides that upon conversion, chapter 7 administrative expenses receive priority over all chapter 11 administrative expenses.

Neither Section 726(b), nor any other Bankruptcy Code section for that matter, however, specifically addresses the treatment of a Chapter 11 super-priority section 364(c)(1) claim in a converted Chapter 7 case, which is precisely the issue addressed in a recently decided New Jersey bankruptcy court decision in *In re Packaging Systems*, 2016 Bankr. LEXIS 3597 (Bankr. D.N.J. Sept. 30, 2016). Packaging Systems sold packaging and distribution services to food, pharmaceutical and household product manufacturers. In December 2010, the company entered into a factoring and security agreement with Harborcove Financial for the purchase of its accounts receivable and Harborcove’s issuance of credit in return. As part of the transaction, Harborcove was granted a perfected first priority security interest in and lien upon all of the borrower’s assets.

In April 2012, Packaging Systems filed its Chapter 11 bankruptcy petition. A month later, the court authorized it to assume the Harborcove factoring agreement as its post-petition financing facility, granted Harborcove a super-priority 364(c)(1) claim (subject to carve-outs for the U.S. trustee's fees and debtor's counsel's capped fees and expenses) and granted Harborcove a first priority lien on debtor's estate except for Chapter 5 avoidance action proceeds. The order was silent as to what would happen to Harborcove's super-priority claim in the event the case went to Chapter 7.

A year later, the court, in fact, converted the case to Chapter 7 on the U.S. Trustee's motion. Harborcove filed a proof of claim for approximately \$182,000 and asserted that its claim was secured against the debtor's assets and perfected by a UCC financing statement and its claim was entitled to immediate payment as a priority administrative expense claim under Section 507. Harborcove did not otherwise file a formal request for payment during the pendency of the Chapter 7 case, nor was any other action taken in connection with such request. This is notwithstanding the fact that it was improper for Harborcove to claim priority under Section 507 by simply filing a proof of claim (as is noted directly on the proof of claim form).

During the administration of the Chapter 7, the trustee entered into a consent order vacating the automatic stay, thus allowing Harborcove to liquidate its machinery and equipment collateral. In May of 2016, the Trustee's final report revealed that over \$92,000 from Chapter 5 actions was recovered, which would be used to pay Chapter 7 administrative expenses on a pro rata basis of approximately 50.6 percent (the Chapter 7 administrative expenses exceeded the estate's funds). The trustee's final report excluded Harborcove's secured claim from the proposed distribution plan. Not unexpectedly, Harborcove objected to the final report arguing that its pre-conversion Section 364(c)(1) super-priority claim should take priority over Chapter 7 administrative expenses.

In a letter decision, Judge Christine M. Gravelle noted that the case law is split on the issue of whether Section 726(b) should be interpreted to prioritize post-conversion administrative expenses over Section 364(c)(1) claims. Certain courts have found that section 364(c)(1), which gives priority to such claims over all administrative expense claims provided in Sections 503(b) and 507(b), must apply to post-conversion administrative expenses as well. Courts have also determined that section 364(c)(1) claims should be accorded priority over post-conversion obligations because a section 364(c)(1) claim is not an administrative expense at all; the section's language gives a Section 364(c)(1) claim priority over "any or all administrative expenses" (rather than priority over "other" administrative expenses).

On the other hand, some courts have reasoned that policy concerns may dictate a different result: Chapter 7 administrative claims should take precedence over Section 364(c)(1) claims to ensure that the post-conversion bankruptcy process is administered efficiently and that the trustee receives compensation for such work. Nevertheless, despite these "persuasive" policy concerns, the *Packaging Systems* court ruled that a "post-conversion Chapter 7 trustee must take into account the existence of a pre-conversion super-priority claimant." In this case, the debtor's only assets were the potential Chapter 5 claim proceeds and it was the trustee's job to determine whether prosecuting such actions was worthwhile given Harborcove's super-priority claim. Of course, if the trustee did not pursue the Chapter 5 claims, the estate would not have had funds sufficient to pay Harborcove's claim. Ironically and unfortunately for the trustee, because Harborcove's lien on the estate's assets excluded Chapter 5 recoveries, the trustee was also prevented from asserting a Section 506(c) carve-out for the reasonable and necessary costs and expenses incurred in preserving estate property for Harborcove's benefit.

But, all was not lost for the trustee, as the court also found Harborcove at fault. Gravelle noted that Harborcove failed to properly assert its claim for payment of its administrative expense and apparently failed to communicate with the trustee regarding its claim or the prosecution of the chapter 5 causes of action. Moreover, finding that Harborcove could not have enjoyed any recovery but for the trustee's efforts, the court invoked its equitable powers to allow the trustee to be reimbursed for the costs and expenses necessary to collect the Chapter 5 recoveries.

The *Packaging Systems* decision is an important lesson for post-petition lenders. First, the decision highlights the risks inherent in obtaining a Section 364(c)(1) super-priority claim given the ever-present risk that the case is later converted to a Chapter 7. While the New Jersey bankruptcy court upheld the super-priority status of Harborcove's 364(c)(1) claim (subject to reimbursement of the trustee's costs for recovering the chapter 5 claims), other courts have taken the opposite approach on policy grounds. Those which decline to prioritize 364(c)(1) claims in a Chapter 7 may be setting a difficult precedent and may unwittingly handicap vulnerable chapter 11 debtors in desperate need of post-petition financing.

Arguably, the issue before the *Packaging Systems* court could have been avoided if, at the time that the court granted Harborcove its super-priority claim, the parties had addressed the potential issue of Chapter 7 administrative expense priority. In the future, U.S. trustees may insist on carve-outs for post-conversion administrative expense claims to ensure that Chapter 7 trustees are compensated for their services. Whether the interplay between sections 364(c) and 726(b) will be a recurring issue in bankruptcy courts remains to be seen.

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