

## Doing Business with a Customer in Bankruptcy in the Time of COVID-19: Administrative Expense Claims—Take Them to the Bank or Throw Them in the Write-Off Bin?

By Michael Myers

It is no secret that business bankruptcies are surging in the wake of the COVID-19 pandemic. In fact, chapter 11 filings increased 26% in the first half of 2020,<sup>1</sup> and some expect the number of cases to increase even more in the coming months.<sup>2</sup> From retailers to airlines to telecommunications companies, few sectors of the economy are immune. As a result, more and more businesses will face the prospect of one or more of their customers filing chapter 11.

When a customer files for bankruptcy there are many issues to consider, which vary depending on the nature of a business's relationship with the bankrupt customer, the "debtor." One consideration common to all businesses, however, is whether the debtor will pay for goods and services while the bankruptcy is pending. The Bankruptcy Code provides that debtors must pay certain obligations—such as nonresidential lease obligations—as they come due. Debtors may pay other creditors in the ordinary course, but they are not specifically required to do so.

What may a business do if a bankrupt customer fails to pay for goods and services provided during the bankruptcy proceeding? One option is to file a request for an administrative expense claim with the bankruptcy court. Courts grant these claims to creditors that provide valuable goods and services to the debtor as an incentive for creditors to continue doing business with the debtor.<sup>3</sup> These administrative claims receive higher priority for payment than general unsecured claims that accrued prior to the bankruptcy, thus providing greater assurance of payment. In order to confirm a chapter 11 plan of reorganization, a debtor must pay all administrative expense claims in full on the effective date of the confirmed plan, unless a creditor agrees to accept a lesser amount.

Holding an administrative expense claim can be a valuable safeguard against the failure of a bankrupt customer to pay for goods and services during its bankruptcy, but there is no assurance the claim will ultimately be paid. For one, it is often uncertain if—and when—a debtor will confirm a plan of reorganization, the trigger that requires

---

<sup>1</sup> *Chapter 11 Business Bankruptcies Rose 26% in First Half of 2020*, Wall Street Journal, <https://www.wsj.com/articles/chapter-11-business-bankruptcies-rose-26-in-first-half-of-2020-11593722250>.

<sup>2</sup> *A Tidal Wave of Bankruptcies is Coming*, The New York Times, <https://www.nytimes.com/2020/06/18/business/corporate-bankruptcy-coronavirus.html>

<sup>3</sup> Despite the Bankruptcy Code requirements to pay certain obligations as they come due, some debtors refuse to do so and the court's remedy is often to grant the creditor an administrative expense claim. Thus, even creditors that would expect to be paid in the ordinary course may nonetheless end up in the same position as creditors which are not required to be paid in the ordinary course.

the debtor to pay administrative expense claims. The debtor may not be able to confirm a plan or, if it does, it could take months or years to do so. In the meantime, a debtor customer may accrue significant liabilities.

This is currently playing out in the bankruptcy of Dean Foods, the largest milk producer in the country, which filed for bankruptcy in the Southern District of Texas in November 2019. In that case, Dean Foods sold substantially all of its assets through a bankruptcy sale process, with the largest portion of those assets sold to Dairy Farmers of America (DFA). Dean Foods ceased paying many of its equipment lessors, vendors, and other creditors around the time it consummated the sales. As a result, many of Dean Foods' creditors filed applications for administrative expense claims for millions of dollars' worth of goods and services, much of which were provided in the months leading up to the sales. As of the writing of this article in July 2020, Dean Foods has not filed a plan of reorganization and it is uncertain whether there will be enough funds to pay all administrative claimants in full upon confirmation of a plan. Instead, the bankruptcy court has authorized an "administrative claims protocol" under which creditors may "opt in" to the protocol and agree to waive at least 20% of their administrative expense claim in exchange for an immediate payment of 30% of the claim.

Even when a debtor does reach the plan confirmation stage, it may attempt to confirm a plan that provides for less than full payment of administrative expense claims. Despite the requirement that administrative claims be paid in full upon confirmation, debtors have been able to side step this requirement in some cases by providing that holders of administrative claims are deemed to consent to less than 100% payment of their administrative expense claims unless they timely file an objection to that treatment. Thus, unwary creditors may find themselves holding administrative expense claims that ultimately receive less than the 100% payment they may have expected.

The bottom line is that businesses must be proactive when their customers file bankruptcy. While administrative expense claims provide an incentive to continue doing business with a customer during its bankruptcy proceedings, they are not a panacea and even have their own pitfalls. Businesses should consider taking the following actions during their customers' bankruptcies:

- Monitor accounts receivable more closely to ensure the customer is not running up a bill that it cannot ultimately pay.
- Assess whether your business has any rights of setoff or reclamation against the customer and, if so, how it can exercise those rights under the contract and the Bankruptcy Code.<sup>4</sup>
- If the relationship is governed by a lease or other contract with ongoing obligations owed on both sides, file a motion to compel the debtor to either assume or reject the contract so that the debtor is forced to either (i)

---

<sup>4</sup> Reclamation rights must be asserted shortly after the commencement of the case so it is imperative to evaluate this option as soon as possible after the bankruptcy filing.

assume the contract and cure all outstanding obligations or (ii) reject the contract to excuse the creditor from providing additional goods and services.

- File a motion for relief from the automatic stay to obtain permission from the bankruptcy court to terminate the relationship.
- Evaluate whether there are any non-debtor obligors, such as a guarantor, from which the business can seek payment outside of the bankruptcy.

Which option to exercise will vary from case-to-case, so it is highly recommended that you speak with an attorney experienced in bankruptcy and restructuring matters who can advise you as to the best possible option based on your particular circumstances. Buchalter is committed to helping our clients assess their rights with respect to COVID-19 and stands ready to assist in navigating these uncharted waters.



### **Michael S. Myers**

Insolvency & Financial Law Group, San Francisco

(415) 227-3530

[mmyers@buchalter.com](mailto:mmyers@buchalter.com)

This communication is not intended to create or constitute, nor does it create or constitute, an attorney-client or any other legal relationship. No statement in this communication constitutes legal advice nor should any communication herein be construed, relied upon, or interpreted as legal advice. This communication is for general information purposes only regarding recent legal developments of interest, and is not a substitute for legal counsel on any subject matter. No reader should act or refrain from acting on the basis of any information included herein without seeking appropriate legal advice on the particular facts and circumstances affecting that reader. For more information, visit [www.buchalter.com](http://www.buchalter.com).