

CHAPTER 11 - 101 THE NUTS AND BOLTS OF CHAPTER 11 PRACTICE: A PRIMER

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Priorities

Editors' Note: *This is the tenth of 22 installments that are being published here, with permission from the American Bankruptcy Institute. The series, read consecutively, will give the reader a broad overview of the Chapter 11 bankruptcy process. The installments are chapters from a CD-Rom that is available for purchase for \$20 (\$10 to ABI members) through the ABI. For more information, you can call the ABI at (703) 739-0800 or go to www.abiworld.org. The authors welcome your comments and questions as well, and you may feel free to contact them. Jonathan Friedland is a member of the ABI Board of Directors as well as a member of NACM Oregon.*

The priority scheme in bankruptcy dictates the order in which claims are paid. Think of a ladder. The claims standing on the highest rung must be paid in full before any claims on the next rung can be paid anything. The senior class of creditors gets paid in full, then the next class, and so forth, until you come to a class for which assets are insufficient to pay everyone in full.

What happens then? The basic principle is one of *pro rata* distribution among similarly situated creditors. This is supposed to supplant the “race to the courthouse” that would occur if not for automatic stay of bankruptcy. It sounds simple and fair. But—as with many things in bankruptcy—it’s less simple than it initially appears, and whether you think it’s fair probably depends on what rung of the ladder you find yourself standing.

For starters, let’s make sure we understand what we mean when we talk about *pro rata*. It’s pretty straightforward: *pro rata* means that when there are not enough assets to go around, then each creditor gets a share determined by the size of his allowed claim. So if there is enough to pay 20 percent of all claims in a given class, then we pay each creditor in that class 20 percent of his claim.

For example, suppose the Debtor owes \$10 to the Butcher, \$20 to the Baker, and \$30 to the Candlestick Maker—a total of \$60. The Debtor has \$12—just 20 percent of what he owes. Under nonbankruptcy law, assets would go first to the fastest, and others would be left empty-handed. Under the *pro-rata* rule of bankruptcy, since we have assets equal to 20 percent of all claims, we would pay 20 percent of each claim. So, Butcher would get \$2, Baker would get \$4, and Candlestick Maker would get \$6.

Such is the basic bankruptcy rule. But at least four facts

conspire to assure it almost never works out that way.

First and most important, in many cases there are no assets to distribute to creditors. This is particularly true in Chapter 7. One hundred percent of nothing is nothing. Second, the Bankruptcy Code itself mandates a schedule of priority claims. See Bankruptcy Code §§ 507 and 726. We will consider these statutory priorities in more detail below. For now, suppose that Butcher has a priority claim, and that Baker and Candlestick Maker have nonpriority claims (*i.e.*, Butcher is on a higher rung of the ladder). We will pay Butcher \$10. That leaves \$2 for distribution between Baker and Candlestick Maker, *pro rata*. Even where there are assets to distribute, in many cases the priority claims will eat up the assets before we ever get to the residual nonpriority class.

But there is more. The most important “priority” isn’t even on the priority list. That is: a creditor with a valid and perfected security interest in property of the estate will have first dibs on that property. For example, in our case, suppose the asset pool valued at \$12 includes a widget, valued at \$9, in which Butcher has a perfected security interest. Butcher gets the whole \$9 value of the widget. There is still \$3 of value left in the estate, and Butcher still has a \$1 shortfall unpaid on his claim. Butcher (on his \$1 shortfall) shares *pro rata* with Baker and Candlestick Maker on their claims.

The bankruptcy priority schedule is, as we say, explicit in the statute. Oddly enough, neither of the other rules (neither “*pro rata*” nor “secured comes first”) is spelled out in any detail. But there’s no doubt that they are the law. Indeed, that is the point: they are so basic that nobody thought to say so. There are plenty of Code provisions that recognize these basic rules, at least in a backhanded way. If you find the rule spelled out at all, you can suss it out of a series of Supreme Court cases, starting perhaps with *Long v. Bullard*, 117 U.S. 617 (1886) and extending through to *Dewsnup v. Timm*, 502 U.S. 410 (1992).

As if this weren’t enough, there are at least two other principles that complicate the distribution scheme. First, in a Chapter 11 case, the court may confirm a plan of reorganization which (within limits) can vary the off-the-rack rules of distribution. Second, the Bankruptcy Code also provides that the judge may, in an appropriate case, “subordinate” one claim to another. See § 510. Likewise, case law permits the court (under limited circumstances) to

“recharacterize” debt as equity—which of course has an impact on the priority scheme.

The Priority Scheme for Unsecured Creditors

The priorities among unsecured creditors are set forth in § 507. Note the section number: this means that the priority rules are part of Chapter 5, and recall that Chapter 5 applies to all kinds of bankruptcy cases, including liquidating cases under Chapter 7 and reorganization cases under Chapter 11.

Domestic Support Expenses and Trustee Fees

Bankruptcy Code § 507(a)(1) gives first priority to domestic support expenses. Interestingly, the priority for domestic support is likely to be of little value to spouses in the low income Chapter 7 cases, which are usually no asset cases to begin with but where, presumably, the payment of support obligations is most important to the spouse. It may however, afford ex-spouses some relief in Chapter 13 in 11 cases, where higher income debtors are forced to file. This first priority for domestic support obligations is new law as of 2005, enacted as part of BAPCPA. But ignore it: it’s a distraction. For one thing, it doesn’t apply in corporate cases, period (corporations don’t get divorces anyway). In individual cases, there are plenty of domestic obligation claims—but in the vast majority of cases where there are domestic obligations claims, there is no money to pay any claims at all, so the priority still doesn’t amount to anything.

Administrative Expenses

The “real” first priority is the second: § 507(a)(2) gives a second priority to “administrative expenses allowed under § 503(b).” Bankruptcy Code § 503(b)(1)(A) in its turn defines “administrative expenses” as “the actual *necessary* costs and expenses of preserving the estate.” This is, among other things, the place where the lawyers get paid: fees for non-trustee professionals who represent the estate are administrative expenses (But all subject to court control. *See, e.g.*, §§ 327, 330).

And note “*necessary*,” italicized above. This is the stuff that litigation is made of, and some courts have found wiggle room here. The 2005 reform legislation expanded this definition’s nonexclusive list of administrative expenses to include post-petition employee pay, NLRB back-pay rewards, up to two years of rent under a lease that is first assumed then rejected, the costs of closing a health care facility, and the value of 20 days of pre-petition goods delivered to the debtor. *See* § 503(b) This priority also encompasses post-petition taxes incurred by the estate. *See* § 503(b)(7)(B).

Taxes

Aside from administrative expenses, probably the next most important priority is the priority for taxes. *See* § 507(a)(8). There are three quick points about the tax priority that must be made. First, this tax priority stands only eighth on the statutory priority ladder. As a practical matter, however, the tax priority is a lot more important than several of those that precede it. Second, the priority applies only to unsecured tax claims. In plenty of cases, the tax collector will

have statutory tax lien—a kind of secured claim. Working out the relationship between the secured lien claim and the unsecured priority claim is a bankruptcy subspecialty all its own, but the beginning of wisdom is to know that they are different. Third, the priority applies only to tax claims—not to government claims in general. The government’s nontax claims have no special priority under the Code, although what is and is not a tax claim is, again, something that can be fought over.

Employee Priorities

Two Subsections of § 507 address the claims of employees where the debtor is the employer. Subsection 507(a)(4) gives a limited priority for wage claims; Subsection 507(a)(5), for claims under employee benefit plans. These claims are often matters of great urgency to individual employees. Indeed, a practice has developed of paying these priority claims (now up to \$10,000 per employee) soon after the case has been filed. This requires court approval—and there’s nothing in the Bankruptcy Code that specifically authorizes the court to grant such approval—but courts commonly grant the relief anyway.

In an operating Chapter 11, the employee priority claims aren’t likely to be a deal-driver. If there is an employee issue in a complex business Chapter 11 case, it is more likely to involve the issue of employer liability under a government-guaranteed pension plan, the matter of employee rights under a collective bargaining agreement, or proposed retention incentive plans.

Other Priorities—Above and Below the List

Most of the other provisions of Bankruptcy Code § 507 are special-interest rules that have little or nothing to do with the ordinary case. But there are two other kinds of statutory priorities. One is the matter of priorities “above the list”—so-called “superpriorities.” The other is the matter of priorities “below the list”—residual priorities for liquidating cases under § 726.

First, superpriorities. We saw above that the first priority goes to administrative expenses. But not all administrative expenses are created equal. For example, a party who extends post-petition financing to a debtor under § 364 often negotiates for a “superpriority” that trumps other administrative claims. Also, a claim for failure of adequate protection has a super priority. *See* § 507(b). And on occasion you will see a court order that purports to create other “superpriorities” even though not provided for in the Bankruptcy Code. This can happen, for example, with breakup fees payable to outbid prospective purchasers in § 363 sales.

And perhaps the highest priority of all is the priority that trumps the claim of the perfected security interest. Bankruptcy Code § 506(c) permits the trustee to recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim including the payment of all ad valorem property taxes with respect to the property. Only the DIP may assert a

surcharge claim; creditors may not assert it. There are other “priorities” that have the effect of trumping secured claims. One is the “priming lien” for post-petition financing under Bankruptcy Code § 364(d). Another is the “carve-out” often agreed to by secured lenders for the benefit of debtor and committee professionals.

Second, priorities “below the list.” Bankruptcy is about debtors who don’t have enough money to go around. But once in a while, you run into a solvent estate—a case where there is enough to pay all priority and general unsecured claims (maybe market prices shot up after filing). In those cases, you might think the residual would go back to the debtor or its shareholders. In Chapter 11, that is the general rule. But in a Chapter 7 liquidating case, even after all § 507 priorities are paid, money does not go to the debtor until you have paid the separate list of “liquidating priorities” in § 726, including such things as late-filed claims, punitive damages, and post-petition interest.

Priority for Essential Trade Vendors

We have mentioned a few ways that a court order can create a priority that’s not provided for in the Bankruptcy Code. One example worthy of special note is the “essential trade vendor.” Usually these are creditors who have only general unsecured claims, but they jump to the front of the line, getting paid in full even though other claims of a similar rank will probably wait a long time for any payment, and then receive only cents on the dollar. The argument is that these “essential trade vendors” are necessary for the debtor’s survival, and they won’t continue to ship to the debtor unless they are paid in full. Courts often agree with this argument, although it appears that the “essential trade vendor” argument has been somewhat aggressively overused, and that courts are becoming more skeptical. One example of this is the decision of the Seventh Circuit in the Kmart case.

Maybe You Own the Asset?

One way to obtain “priority” over other creditors is to establish that you own the asset in question rather than it being property of the estate, so that other creditors should have no interest in it at all. “Great,” you say, “but how can I manage that?” The answer is, it’s not easy. After all, taking assets out of the estate is inconsistent with the notion of *pro rata* distribution. But there are cases where it can be achieved. And it’s worthwhile to think about this for a few minutes before you assume that you are a creditor who must stand in line with everyone else.

One example is the “constructive trust”—a remedy that may be available to a creditor that was the victim of theft or similar wrongdoing. If you prevail, you may have “your asset” returned to you, rather than divided among creditors.

Another example is the “absolute assignment of rents” that has been recognized by some courts, allowing a mortgage lender “ownership” of the rents rather than a mere security interest.

And a few courts have recognized “equitable liens”—this one won’t give you ownership of the asset, but it may have

the same effect—an unsecured creditor may find itself fully secured.

Some Other Priorities Spread Throughout the Code

There are a few other sections of the Bankruptcy Code that set forth *de facto* priorities. They may not be thought of as priorities, but they have the same effect. For example, § 553 permits a creditor who has a right of setoff to get paid in full (after obtaining stay relief) to the extent of his setoff right, affording priority over other creditors and essentially providing secured creditors status to the set off creditor. And a reclamation creditor may get an administrative claim or a lien that gives it priority over other unsecured creditors, under § 546(c). Then there are more obscure priorities, such as the rights of customers in a brokerage firm’s bankruptcy. Once again, the lesson is to think creatively before you resign yourself to sharing *pro rata*.

Some Notes on Secured Credit

First, the secured creditor has a right to first dibs on his collateral to the extent of his claim. In other words, if she has a claim for \$100 and the collateral is worth \$500, she has first dibs to the tune of \$100, not \$500. Actually, as an oversecured creditor, she will have a right to \$100 plus post-petition interest and maybe her fees and expenses too. *See* § 506(b). Second, she has a right to the value of her claim, not necessarily the right to receive the collateral itself. The debtor may elect to give a secured creditor its collateral, in satisfaction of its claim, but the creditor cannot insist on that treatment. Third, if the security interest is not disposed of in the bankruptcy case, then it “rides through” and remains the creditor’s collateral. So if the secured creditor does not file a proof of claim, and the debtor does not deal with the claim or lien in its plan, the lien will continue in effect (although if we were counsel for the secured lender, we would be loathe to sit back and rely on the ride through).

Watch for next month’s issue—“Obtaining DIP Financing and Using Cash Collateral.”