

Second Circuit: 502(d) Does Not Apply to Administrative Claims

By Marion M. Quirk

In *ASM Capital, LP v. Ames Department Stores, Inc.* (*Ames Department Stores, Inc.*), 582 F.3d 422 (2nd Cir. 2009), the Second Circuit Court of Appeals (the “Second Circuit”) held that § 502(d) of the Bankruptcy Code, which disallows claims until the claimant has returned all voidable preferential payments and other voidable transfers from the debtor’s estate, does not apply to disallow administrative claims under 503(b). As the first circuit court to consider the issue, the Second Circuit agreed with the majority of lower courts that had addressed the issue. The practical result is that a claimant who has a general administrative claim under 503(b) will not have this claim disallowed or reduced on the basis that the claimant must first return voidable preferential payments or other voidable transfers from the debtor’s estate under 502(d).

The ruling provides a significant benefit to creditors because payment of their 503(b) administrative claims will not be delayed pending determination of a preference or other voidable transfer. In contrast, the ruling eliminates the debtor’s ability to reduce 503(b) administrative claims by asserting 502(d) defensively or affirmatively through the pursuit of a judgment recovering preferential or other transfers. Finally, it is important that the Second Circuit specifically noted that it was not addressing the interaction between § 503(b)

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(9) and § 502(d) since neither party to the appeal suggested that 503(b) (9) applied.

THE AMES CASE

Ames Department Stores, Inc. (“Ames” or the “Debtor”) filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code on Aug. 20, 2001. A year later, Ames obtained approval from the bankruptcy court to close its business and sell its assets. At that same time, Ames suspended payment on its administrative expense claims and commenced adversary proceedings by filing complaints against former suppliers and other creditors to recover alleged preferential transfers, including against G&A Sales, Inc. (“G&A”). The appellant, ASM Capital, LP (“ASM”), acquired, among others, an administrative claim against Ames’ bankruptcy estate from G&A. ASM moved to compel payment of its administrative claim. The Debtor objected under § 502(d), arguing that payment should be barred pending the return of preferential transfers allegedly made to ASM’s predecessor, G&A. The bankruptcy court ultimately found that ASM’s administrative claim was temporarily disallowed under § 502(d) until the preference action against G&A was resolved and G&A paid the amount (or turned over any property) judicially determined to be payable to Ames’ estate. The bankruptcy court noted that while Ames had obtained a default judgment against G&A for a voidable preference, the repayment requirement remained unsatisfied. Due to the fact that G&A filed for bankruptcy and suspended its business operations, the bankruptcy court determined that the disallowance of the administrative claim “will likely be permanent.” 582 F.3d at 425-26. ASM appealed the bankruptcy court’s order to the district court. In turn, the district court concluded that based upon the bankruptcy court’s findings, “while the disallowance of ASM’s claim under § 502(d) of the code nominally is temporary, in practical effect it is final” and the district court affirmed the bankruptcy court’s decision. *Id.* at 426. The Second Circuit mentioned that Ames indicated that it still intends to collect the judgment against G&A, but did not identify any

assets available for such recovery. In addition, the Second Circuit pointed out Ames’ lackadaisical efforts in pursuing the preference action against G&A as evidenced by the fact that the action sat for three years without entry of an appearance by G&A before Ames moved for entry of a default judgment. The Second Circuit determined that these facts weighed against deferring consideration of the appeal and the court decided that the bankruptcy court’s order was a final order for purposes of the appeal before the court.

THE COURT’S ANALYSIS

The Second Circuit’s analysis first involved the statutory interpretation of § 502(d) and then the court examined §§ 502(d) and 503(b) both in their specific context and in the Bankruptcy Code as a whole.

Statutory Analysis

The Second Circuit started by examining the plain language of § 502(d). The court noted that the bankruptcy court and district court determined that requests for payment under § 503(b) are “claims” under section 101(5) of the Bankruptcy Code and that because § 502(d) encompasses “any claim” it applies to administrative claims. Both the bankruptcy court and the district court adopted the reasoning of the United States Bankruptcy Appellate Panel of the Ninth Circuit in *MicroAge, Inc. v. Viewsonic Corp.* (*In re MicroAge, Inc.*), 291 B.R. 503 (9th Cir. BAP 2002). The bankruptcy appellate panel noted that the language of other provisions of the Bankruptcy Code (namely, 346(e) and 365(n)(1)(B)(i)) suggest that “‘Congress viewed expenses of administration as merely one specialized type of claim,’ and that Congress intended such expenses to be subject to section 502(d).” *Id.* at 428. In addition, the explicit exclusion of administrative claims from some sections (*i.e.*, 348(d), 752(a), 1123(a)(1) and 1326(b)(1)) but not from § 502(d) supported the bankruptcy appellate panel’s view that administrative claims are intended to be subject to § 502(d). The Second Circuit pointed out that several other courts have noted that other sections of the Bankruptcy Code

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distinguish between “claims” and requests for administrative expenses under § 503(b). See, e.g., *In Plastech Engineered Products, Inc.*, 394 B.R. 147 (Bankr. E.D. Mich. 2008); *Beasley Forest Products, Inc. v. Durango Ga. Paper Co. (In re Durango Ga. Paper Co.)*, 297 B.R. 326 (Bankr. S.D. Ga. 2003); *In re Lids Corp.*, 260 B.R. 680 (Bankr. D. Del. 2001); *Camelot Music, Inc. v. MHW Adver. & Public Relations, Inc. (In re CM Holdings, Inc.)*, 264 B.R. 141 (Bankr. D. Del. 2000). For example, “section 507(a) refers to ‘expenses and claims,’ and establishes a separate priority for ‘administrative expenses’ than for ‘claims’ Section 101(10) defines ‘creditor’ in terms that include only holders of prepetition claims (and certain postpetition claims deemed to be prepetition claims) and not holders of postpetition claims for administrative expenses section 503 And section 348(d) similarly applies to any postpetition claim ‘other than a claim specified in section 503(b).’” *Id.* at 429. The Second Circuit concluded that “the general definition of ‘claim’ in section 101(5) does not by itself resolve the scope of section 502(d).” *Id.*

The Second Circuit next looked at the structure and context of § 502(d) as compared with § 503(b). First, the process for the allowance and objection to claims versus administrative expenses is different. Section 502 along with § 501 sets forth a separate procedure for the allowance of claims from the procedure for the allowance of administrative expenses under § 503. As provided under § 502(a), a claim is deemed allowed when filed unless a party in interest objects and, when an objection is filed, § 502(b) requires the court to determine the allowable amount of the claim after notice and a hearing. The Second Circuit pointed out that “[b]ecause claims for administrative expenses may not be filed under section 501, they are not subject to sections 502(a) and (b).” *Id.* The filing of requests for administrative expenses and the allowance of those claims is governed by § 503. The procedure set forth in § 503 “is indepen-

dent from the procedure for filing and allowance of prepetition claims under sections 501 and 502, and differs in significant respects.” *Id.* First, § 503(a) provides that any “entity” can file a request for payment of an administrative expense in contrast to § 501 that only allows “creditors” to file proofs of claims. In addition, the Second Circuit stated that “while section 502 requires notice and a hearing for a prepetition claim only if there is an objection to the claim, section 503(b) requires notice and a hearing on all requests for administrative expenses, regardless of whether any objection has been made.” *Id.* at 430. Second, the express language of § 502(d) suggests that it does not cover claims addressed by § 503 but, instead, only applies in the context of § 502. Specifically, the plain language of § 502(d) “introduces section 502(d) as an exception to the automatic allowance of proofs of claim under sections 502(a) and (b), and suggests that the subsection’s scope is limited to that process and does not extend to claims allowable under section 503.” *Id.* at 430. The Second Circuit commented that this “suggestion is reinforced by the absence from section 502(d) of any reference to section 503.” Third, the express mention of 502(d) in sections 502(e)(2), (f), (g), (h) and (i) “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).” *Id.* Fourth, § 503(b) uses mandatory terms that require courts to allow requests for administrative expenses and that conflicts with § 502(d)’s mandatory disallowance of claims. “Section 502(d) avoids a similar conflict with sections 502(a) and (b) by expressly providing that it applies ‘[n]otwithstanding subsections (a) and (b) of this section.’” *Id.* The Second Circuit concluded that the structure and context of § 502(d) “suggests that Congress intended to differentiate between claims and administrative expenses.” *Id.* at 429.

Statutory Context

The Second Circuit next analyzed § 502(d) and 503(b) in the context

of the Bankruptcy Code as a whole. “[T]he Bankruptcy Code establishes a clear division between an entity in its pre- and post-petition states.” *Id.* For example, administrative claims are postpetition claims that generally cannot be set off against prepetition claims. In addition, administrative expenses have a higher priority than prepetition claims “in order to encourage third parties to supply goods and services on credit to the estate, to the benefit of all the estate’s creditors.” *Id.* at 431. The Second Circuit commented that this “intent would be frustrated by allowing a debtor automatically to forestall or avoid payment of administrative expenses by alleging that the vendor had been the recipient of a preferential transfer.” *Id.* Looking at the legislative history to § 502(d), the Second Circuit determined that neither of the Congressional reports even discusses whether § 502(d) was meant to apply to administrative expenses under § 503 and, as a result, the legislative history is inconclusive on the issue. The Second Circuit concluded that the important policy of encouraging third parties to do business with the debtor postpetition confirms the court’s conclusion that “Congress did not intend section 502(d) to apply to administrative expenses under section 503(b).” *Id.*

CONCLUSION

In *Ames*, the Second Circuit found that § 502(d) does not apply to administrative expenses under § 503(b). This conclusion was based upon statutory interpretation of § 502(d) and an analysis of the structure and context of §§ 502(d) and 503(b) in the Bankruptcy Code as a whole. While the Second Circuit explicitly left open the issue of whether its conclusion applied equally to § 503(b)(9) claims, the court’s analysis suggests that it would. However, until the Second Circuit specifically decides whether § 502(d) applies to 503(b)(9) claims, debtors will continue to use § 502(d) as a means to reduce or eliminate § 503(b)(9) claims since these claims often create significant hurdles to confirmation of a Chapter 11 plan.

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