

## The Effect of Conversion on a Post-Petition Lender's Superpriority Claim over a Chapter 7 Trustee's Post-Conversion Administrative Expense Claim

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### Introduction

The Bankruptcy Code provides a priority scheme that dictates the order in which claims are to be paid. Generally, secured claims get paid out first. Secured claims are followed by administrative expense claims, which include expenses incurred for administration of the estate, such as professional fees of the trustee, attorney, or accountant employed by the estate, and certain taxes.<sup>1</sup> These claims are then followed by other priority unsecured claims, and finally general unsecured claims.<sup>2</sup> The amount of the distribution that a creditor will receive in a bankruptcy case depends on numerous factors, including the total number of other creditors in the case, the nature and relative priority of the creditor's claim, and the total value of bankruptcy estate.

Notwithstanding that general priority scheme, the Bankruptcy Code permits a debtor to grant certain creditors a superpriority claim. As a general rule, a superpriority claim will have priority over all other unsecured claims, including administrative expenses, unless there is a carve-out for certain claims. For example, in a chapter 11 case, in certain circumstances, a

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<sup>1</sup> Michael L. Cook & Jason Watson, *Administrative Expense Priority*, BANKR. LITIG. MANUAL §18.05 (2014)

<sup>2</sup> *Id.*

debtor in possession (“DIP”) can grant a lender providing post-petition in financing a superpriority claim under section 364(c) and/or section 507(b), which will have priority over all administrative expense claims.<sup>3</sup>

Converting a case from a chapter 11 to a chapter 7 can give rise to an especially complex issue regarding the relative priority of a superpriority claim granted under section 364(c). Specifically, a court may be required to determine whether a superpriority claim granted in the pre-conversion chapter 11 case retains its relative priority over all other claims, including the administrative expenses claims incurred in the post-conversion chapter 7 case.<sup>4</sup>

Ultimately, the language of the order granting the specific superpriority claim at issue will dictate the relative priorities of the pre- and post-petition claims.<sup>5</sup> This article will examine whether a post-petition lender’s superpriority claim granted under section 364(c)(1) has priority over the administrative expense claims incurred after a bankruptcy case is converted from chapter 11 to chapter 7. Part I will analyze the provisions of the Bankruptcy Code that permit a DIP to grant a post-petition lender a superpriority claim. Part II will analyze the relevant case law and the history of how courts have interpreted the Bankruptcy Code to determine relative priorities of claims in a case that has been converted from chapter 11 to chapter 7. Finally Part III will examine why a DIP lender will likely have superpriority status over the administrative claims when a bankruptcy case is converted from chapter 11 to chapter 7.

## **I. Superpriority and Conversion in the Bankruptcy Code**

The Bankruptcy Code does not define the term “superpriority claim.” Rather, the term is used to describe a claim, which under applicable bankruptcy law and pursuant to court order, is to be paid ahead of some or all of the administrative expenses, and possibly ahead of secured

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<sup>3</sup> 11 U.S.C. §§ 364(c)(1), 503(b) (2012).

<sup>4</sup> See *In re National Litho, LLC*, 2013 WL 23037865, 5 (Bankr. S.D. Fla. 2013)

<sup>5</sup> *Id.*

creditors.<sup>6</sup> A superpriority may be created in two separate ways. The first way a superpriority may be created is under section 507(b) when a secured creditor seeks and is granted adequate protection and that protection subsequently proves to be inadequate.<sup>7</sup> The secured creditor is then entitled to superpriority for the amount of the deficiency.<sup>8</sup>

The second way a superpriority may be created is under section 364(c)(1) and (d). The court may grant a creditor a superpriority claim in order to induce a DIP lender to extend post-petition operating funds to the debtor.<sup>9</sup> Section 364(c)(1) permits a DIP to grant a lender a superpriority claim if the DIP is unable to obtain post-petition credit on an unsecured basis. Specifically, section 364(c)(1) provides, “[i]f the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt with priority over any and all administrative expenses of the kind specified in section 503(b) or 507(b) of this title.”<sup>10</sup> Generally, section 364(c) provides for a superpriority claim that has a priority over all administrative expense claims incurred in the bankruptcy case.<sup>11</sup> However, the superpriority claim granted under section 364(c)(1) is not considered an administrative expense claim under section 503(b).<sup>12</sup>

While the Bankruptcy Code provides a scheme that dictates the relative priority of competing claims, issues arise as the relative priority of certain claims after a case is converted from one chapter to another. For example, the Bankruptcy Code does not provide any guidance as to whether a superpriority claim granted under section 364(c)(1) would also be subordinate to

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<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* (The amount of the deficiency is the amount by which has been damaged by the continuation of the stay or the use of his collateral)

<sup>9</sup> *Id.*

<sup>10</sup> 11 U.S.C. § 364 (c)(1) (2012)

<sup>11</sup> Cook & Watson, *supra* note 1, §18.05.

<sup>12</sup> *Id.*

administrative expense claims incurred of the converted chapter 7 case.<sup>13</sup> Under 726(b), when a chapter 11 case is converted to a case under chapter 7, the chapter 7 expenses of administration take precedence over chapter 11 expenses of administration.<sup>14</sup> Section 726(b) states that a claim allowed under section 503(b) has priority, after a conversion, over a claim allowed under section 503(b), before such conversion and over any expenses of a custodian superseded under section 543.<sup>15</sup> Under section 726(b), an administrative claim for unsecured credit extended under 364(a) or (b) is subordinated to the administrative expenses of the converted chapter 7 case.<sup>16</sup> By allowing the trustee to receive compensation for their services, section 503(b) attempts to ensure that the post conversion bankruptcy process runs smoothly and efficiently.<sup>17</sup>

## **II. Case Law Discussing How Conversion Affects the Relative Priority of Superpriority Claims**

Under 726(b), when a chapter 11 case is converted to a case under chapter 7, the chapter 7 expenses of administration take precedence over chapter 11 expenses of administration.<sup>18</sup> Section 726(b) states that a claim allowed under section 503(b) has priority, after a conversion, over a claim allowed under section 503(b), before such conversion and over any expenses of a custodian superseded under section 543.<sup>19</sup> Under section 726(b), an administrative claim for unsecured credit extended under 364(a) or (b) is subordinated to the administrative expenses of the converted chapter 7 case.<sup>20</sup> By allowing the trustee to receive compensation for their services, section 503(b) attempts to ensure that the post conversion bankruptcy process runs

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<sup>13</sup> *In re Codesco, Inc.*, 18 B.R. 225, 227 (Bankr. S.D.N.Y. 1982)

<sup>14</sup> *Id.* (This has led to the chapter 7 administrative expenses occasionally being referred to as having superpriority status).

<sup>15</sup> 11 U.S.C. § 726(b) (2012)

<sup>16</sup> Cook and Watson, *supra* note 1, §18.05.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* (This has led to the chapter 7 administrative expenses occasionally being referred to as having superpriority status).

<sup>19</sup> 11 U.S.C. § 726(b) (2012)

<sup>20</sup> Cook and Watson, *supra* note 1, §18.05.

smoothly and efficiently.<sup>21</sup> While the Bankruptcy Code provides a scheme that generally dictates the relative priority of competing pre- and post-conversion claims, the Bankruptcy Code does not provide any guidance as to whether a superpriority claim granted under section 364(c)(1) would also be subordinate to administrative expense claims incurred of the converted chapter 7 case.<sup>22</sup> Despite the importance of the relative priority of a conversion has on a post-petition lender's superpriority claim, there has been relatively little case law discussing the issue. Up until a recent decision in *In re National Litho, LLC*, bankruptcy courts have generally held that after a case is converted from chapter 11 to chapter 7, the administrative expenses incurred in the post-conversion chapter 7 case will have priority over the superpriority claims granted to a post-petition lender in the pre-conversion chapter 11 case.<sup>23</sup>

For example, in *In re Sun Runner Marine, Inc.*, the United States Bankruptcy Appellate Panel of the Ninth Circuit held that the administrative expenses of a chapter 7 must have priority over a superpriority claim arising from the failure of adequate protection in a superseded chapter 11 case.<sup>24</sup> The court reasoned that assuring compensation to those liquidating the estate, allows such persons to pursue assets of the estate and increases the overall return to all creditors.<sup>25</sup> The court also opined that the purposes of the Bankruptcy Code were better served by allowing the post-conversion administrative expense claims to have priority over pre-conversion administrative expense claims that were entitled to superpriority based on the failure of adequate protection because this would ensure the efficiency of the present chapter 7 case.<sup>26</sup>

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<sup>21</sup> *Id.*

<sup>22</sup> *In re Codesco, Inc.*, 18 B.R. 225, 227.

<sup>23</sup> *In re Sun Runner Marine, Inc.*, 134 B.R. 4, 7 (B.A.P. 9th Cir. 1991); *In re Summit Ventures, Inc.*, 135 B.R. at 483.

<sup>24</sup> *In re Sun Runner Marine, Inc.*, 134 B.R. at 7.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

Similarly, in *In re Summit Ventures, Inc.*, the court held that subsequent to the conversion of a case from chapter 11 to chapter 7, the administrative expenses incurred in the post-conversion chapter 7 case have priority over the superpriority claims granted to a post-petition lender in the pre-conversion chapter 11 case. There, in the pre-conversion chapter 11 case, the lender was granted superpriority claims and liens under section 364(c) to secure its post-petition loans to the debtor.<sup>27</sup> When the case was converted to chapter 7, the post-petition lender argued that the priority granted to it under section 364(c) was unaffected by section 726(b) but the bankruptcy court disagreed.<sup>28</sup> The court reasoned that the language of section 726(b) affords priority to the chapter 7 administrative expenses over the prior chapter 11 administrative expenses, in order to provide incentive to trustees, professionals and others to act in the present chapter 7 case.<sup>29</sup> The court justified its position by stating that a present need to administer a chapter 7 case is always greater than the past need of the failed chapter 11 case.<sup>30</sup>

Alternatively, the court in *In re Energy Coop., Inc.*, opined that a superpriority obtained pursuant to section 364(c)(1) will prime a superpriority obtained pursuant to a section 507(b).<sup>31</sup> In turn a superpriority obtained pursuant to section 507(b) will prime superseding chapter 7 administrative expenses entitled to priority.<sup>32</sup> The court held that administrative expenses incurred in the superceding chapter 7 case would take priority over the prior chapter 11 case but noted that post-conversion chapter 7 administrative fees only have priority over the prior chapter

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<sup>27</sup> See *In re Summit Ventures, Inc.*, 135 B.R. 478 (Bkrtcy. D. Vt. 1991)

<sup>28</sup> *Id.*

<sup>29</sup> *Id.* at 483

<sup>30</sup> *Id.*

<sup>31</sup> *In re Energy Coop., Inc.* 55 B.R. 957, 969 (Bankr. N.D. Ill. 1985)

<sup>32</sup> *Id.*

11 administrative claims.<sup>33</sup> The court acknowledged that a superpriority granted under 364(c)(1) would have priority over the post-conversion chapter 7 administrative expenses.<sup>34</sup>

Similarly, in *In re National Litho, LLC*, a bankruptcy court held that following the conversion of a bankruptcy case from chapter 11 to chapter 7, a post-petition lender's pre-conversion superpriority claim had priority over any and all post-conversion administrative expenses.<sup>35</sup> In *National Litho*, the debtor initially filed its bankruptcy case under chapter 11 of the Bankruptcy Code. In its motion to approve post-petition financing, the debtor requested the authority to grant the lender a superpriority claim under section 364(c)(1), which would have priority over "any and all administrative expenses."<sup>36</sup> The Court entered an order approving the DIP financing agreement between the lender and the debtor.<sup>37</sup> The order stated, "that the DIP lender has priority over (a) any and all administrative expenses other than those held pursuant to its prepetition or post petition factoring agreement . . . , and (b) the [c]arve [o]ut."<sup>38</sup> The carve-out covered fees for the debtor's chapter 11 professionals and the United States Trustee fees.<sup>39</sup> Two days after the court approved the DIP financing, the court converted the case from chapter 11 to chapter 7.<sup>40</sup> The chapter 7 trustee subsequently objected to the lender's motion to allow its superpriority claim, arguing that because policy objectives underlying section 726(b) outweigh those of section 364(c)(1), and notwithstanding the language of the bankruptcy code, section 726(b) should be read to require that post-conversion chapter 7 administrative expenses must be given priority over pre-conversion superpriority claims.<sup>41</sup>

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<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *In re National Litho, LLC*, 2013 WL 23037865, 5.

<sup>36</sup> *Id.* at 2.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

The court rejected the trustee’s arguments and held that in the absence of language in an applicable order to the contrary, the conversion of bankruptcy case from chapter 11 to chapter 7 does not have an impact on the superpriority of a pre-conversion claim granted under section 364(c)(1).<sup>42</sup> The court found that the phrase “any and all administrative expenses” included any and all of the post-conversion administrative expenses in.<sup>43</sup> Therefore, the court opined that the conversion of the case from chapter 11 to chapter 7 did not impact the priority of a pre-conversion superpriority claim granted under section 364(c)(1).<sup>44</sup> Accordingly, the court held that the DIP lender’s claim had priority over the chapter 7 trustee’s post-conversion administrative expense claim.<sup>45</sup>

### **III. An Analysis of the Effects of Conversion on Superpriority Claims**

Some bankruptcy courts have recognized that maintaining the priority of chapter 7 administrative expenses ensures a complete administration of the chapter 7 estate.<sup>46</sup> These courts have relied on policy concerns in determining that a present need to administer a chapter 7 case is always greater than the past need of the failed chapter 11 case.<sup>47</sup> Between the two competing post-conversion administrative expense claims and the superpriority claim granted under 364(c), policy reasons favor granting the greater priority to the chapter 7 administrative expenses because the prior chapter 11 case is now moot.<sup>48</sup> By affording priority to chapter 7 administrative expenses under section 726(b), trustees and professionals are provided with incentive to act in the superseding chapter 7 case.<sup>49</sup> Requiring that chapter 7 administrative expenses have priority over pre-conversion chapter 11 administrative claims as a matter of policy

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<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> *Id.* at 5.

<sup>45</sup> *Id.*

<sup>46</sup> *In re Sun Runner Marine, Inc.*, 134 B.R. at 7; *In re Summit Ventures, Inc.*, 135 B.R. at 483.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *In re Codesco, Inc.*, 18 B.R. at 227.



ensures that post-conversion bankruptcy process will continue to run efficiently while ensuring that the trustee will receive compensation for the work they have done.<sup>50</sup>

Following *National Litho*, post-petition lenders will likely demand broad priority language so that they can retain priority over any and all administrative expenses if they the case is then converted from chapter 11 to chapter 7.<sup>51</sup> In such a case, the chapter 7 trustees will not be able to obtain a carve-out for his expenses because he will not have been appointed at the time the post-petition financing is approved.<sup>52</sup> Accordingly, the United States Trustee may start demanding that the parties include carve outs for post-conversion chapter 7 administrative expenses going forward in order to ensure that trustees are compensated for their services and not working solely for the benefit of the DIP Lender when a case is converted from chapter 11 to chapter 7. Without such a carve-out, a chapter 7 trustee runs the risk of not having his post-conversion administrative expenses paid if the bankruptcy estate is administratively insolvent.

While some courts have recognized that maintaining the priority of chapter 7 administrative expenses ensures the efficiency of the post-conversion chapter 7 case, they have overlooked the important issue of the extension of financing to a DIP. The bankruptcy court in *National Litho* recognized that allowing section 364(c) claims to maintain priority over post-conversion administrative expense claims encourages creditor financing to chapter 11 debtors.<sup>53</sup> If superpriority claims granted under section 364(c) do not have priority over post-conversion administrative expenses, it might be difficult or impossible for a chapter 11 DIP to obtain unsecured financing.<sup>54</sup>

## Conclusion

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<sup>50</sup> See *In re Summit Ventures, Inc.*, 135 B.R. 478.

<sup>51</sup> See *In re National Litho, LLC*, 2013 WL 2303786.

<sup>52</sup> *Id.*

<sup>53</sup> *Id.* at 2.

<sup>54</sup> *Id.*

When a bankruptcy case is converted from chapter 11 to chapter 7, one issue that arises is whether a post-petition lender's superpriority claim granted under section 364(c)(1) has priority over the chapter 7 trustee's post-conversion administrative expense claim. Some bankruptcy courts have held that after a case is converted from chapter 11 to chapter 7, the administrative expenses incurred in the post-conversion chapter 7 case will have priority over the superpriority claims granted under section 364(c)(1) to a post-petition lender in the pre-conversion chapter 11 case.<sup>55</sup> These courts have recognized that requiring that chapter 7 administrative expenses have priority over pre-conversion chapter 11 administrative claims will ensure that the post-conversion bankruptcy process will run efficiently while also ensuring that the trustee will receive compensation for the work they have done.<sup>56</sup> However, more recently the court in *National Litho*, held that following the conversion of a bankruptcy case from chapter 11 to chapter 7, a post-petition lender's pre-conversion superpriority claim had priority over any and all post-conversion administrative expenses.<sup>57</sup> The court recognized that if section 364(c) claims did not have priority over post-conversion chapter 7 administrative expenses it could make it difficult or impossible for chapter 11 debtors to obtain post-petition financing.<sup>58</sup> Going forward the United States Trustee may start demanding that parties include carve outs for post-conversion chapter 7 administrative expenses going in order to ensure that trustees are compensated for their services and not working solely for the benefit of the DIP lender.

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<sup>55</sup> *In re Sun Runner Marine, Inc.*, 134 B.R. at 7; *In re Summit Ventures, Inc.*, 135 B.R. at 483.

<sup>56</sup> *Id.*

<sup>57</sup> *In re National Litho, LLC*, 2013 WL 23037865, 5.

<sup>58</sup> *Id.*