

# Beware the Administratively Insolvent Debtor: Cautionary Tales for Extending Credit During Bankruptcy

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On paper, the Bankruptcy Code assures trade vendors extending credit to a Chapter 11 debtor that their postpetition claims will be paid in full. In practice, that is not always the case. This article discusses the concept of administrative solvency (and its supervillain counterpart, administrative insolvency) through the lens of two cases—one from 2018 and one the present day: *Toys 'R' Us* and *Big Lots*, respectively. As these cases made clear, the Bankruptcy Code's promise that administrative expense claims must be paid in full in a Chapter 11 case can—and, in difficult cases, sometimes does—ring hollow.

Administrative solvency refers to the ability of a Chapter 11 debtor to pay obligations arising after the filing of its bankruptcy petition in full. By extension, administrative insolvency is the *inability* of a debtor to do so.

To balance the inherent risk in extending credit to an insolvent entity with the importance to a debtor in maintaining business operations and successfully emerging from bankruptcy, the Bankruptcy Code and bankruptcy courts give priority treatment to postpetition "administrative expense" claims. To confirm a Chapter 11 bankruptcy plan, the debtor must be able to demonstrate that it can pay all administrative claims in full unless the holders of such claims agree otherwise—in other words, that the debtor is administratively solvent.

Bankruptcy courts typically look for assurances of administrative solvency throughout the case. At the outset of a Chapter 11 case, the court will first assess administrative solvency in connection with the debtor's proposed debtor-in-possession (DIP) financing, which will include a budget setting forth its projected ability to pay, among other things, administrative expense claims. As the case proceeds, the court will likely again address administrative solvency concerns if faced with a proposed plan of reorganization or the increasingly common motion to sell substantially all of the debtor's assets.

Historically, bankruptcy courts have held that secured lenders cannot benefit from (including retaining all the proceeds of) a sale of substantially all of the debtor's assets unless the debtor's estate is administratively solvent following the sale. This concept, commonly referred to as "paying the freight" of the Chapter 11 case, was intended to reassure vendors—who are providing the very goods and services that permit the debtor to maintain operations that make a sale possible in the first place—that they will receive payment in full if they continue to do business with the debtor while it is in bankruptcy. That doctrine has been gradually eroded over time, making the administrative expense claim less of a magic talisman than it once was.

In the current distressed debt environment, the COVID-era liquidity actions by the Federal Reserve that enabled overleveraged, troubled companies to refinance debt at record-low interest rates, extend maturities, and take on even more debt have led to current-day Chapter 11 debtors entering bankruptcy with eye-watering levels of debt that frequently cannot be restructured. Asset sales under Section 363 of the Bankruptcy Code have become the typical strategy in such cases, and frequently leave secured lenders with nine-figure deficiency claims. Against that backdrop, debtors in difficult cases frequently face strong pressure to craft lean administrative expense budgets that leave little room for error and stringent default remedies in the event of an unforeseen revenue shortfall or other misstep.

Despite the protections granted to postpetition vendors under the Bankruptcy Code and case law, businesses should proceed with caution when deciding whether, and under what terms, to provide goods or services on credit to a Chapter 11 debtor. For example, where the debtor's intention is not to have a plan

confirmed but rather intends to use the bankruptcy process to sell all its assets and then either dismiss the case or convert it to a Chapter 7 proceeding, there is not an explicit requirement that administrative creditors are paid. The *Toys 'R' Us* and *Big Lots* cases are cautionary tales where administrative creditors were left holding the bag. Creditors should increasingly be on high alert if this trend continues, which appears likely.

In 2018, *Toys 'R' Us* filed for Chapter 11 bankruptcy after years of financial decline. At the start of the case, the debtors obtained \$3.1 billion of DIP financing and encouraged vendors to continue shipping goods to the debtor on credit by assuring them their claims would be paid, at least in part, from the proceeds of their DIP financing. Unbeknownst to trade creditors who continued to supply goods to the debtors (including many with promises of payment of their prepetition claims as an inducement to extend postpetition credit pursuant to "critical vendor" agreements), *Toys 'R' Us* defaulted on financial covenants contained in the DIP financing agreement while stockpiling inventory that, vendors would soon learn, would be used to conduct a going out of business sale and pay the DIP lenders. Ultimately, secured lenders were paid through the company's full-chain going out of business (GOB) sale, but administrative claimants—with claims totaling over \$800 million, largely for the very merchandise that facilitated the GOB sale—were paid just twenty-two cents on the dollar pursuant to a "settlement" proposed by the debtors in the wake of their meltdown.

The *Big Lots* Chapter 11 bankruptcy case is a more recent poignant example of the risk vendors face in extending postpetition trade credit.

After filing for bankruptcy, *Big Lots* continued operating stores and placing orders with vendors, incurring upwards of \$250 million of postpetition trade liabilities. At the outset of the case, *Big Lots* sought authority to commence GOB sales at over 800 store locations, cautioning that without approval of the sale, the debtors would have to liquidate their assets. With liquidation being the only alternative, the bankruptcy court ultimately approved the sale. Trade creditors ultimately faced steep losses, and the sale process has been criticized as being unfairly tilted in favor of the secured lenders.

Like *Toys 'R' Us*, *Big Lots* touted a commitment to preserve business operations through a critical vendor program potentially allowing for the payment of trade vendors' claims of up to \$60 million in the aggregate. The critical vendor program enabled *Big Lots* to continuously order goods from vendors post-bankruptcy to keep stores stocked with inventory, preserve operations, and try to attract a buyer. *Big Lots* ultimately purchased vast amounts of inventory while it was clear that vendors and other administrative claimants could not be paid in full. As the sale process unfolded, *Big Lots* ran GOB sales to dispose of inventory and generate cash for the estate and secured lenders but has since foreshadowed that administrative expense claims likely will not be paid in full.

Although the customary wisdom that administrative expense claims must be paid in full in a Chapter 11 bankruptcy case has been eroded in recent years, trade vendors nevertheless can take steps to protect themselves while still (cautiously) providing postpetition credit to a Chapter 11 debtor:

1. Become a Critical Vendor: Where possible, negotiate with the debtor to obtain critical vendor status. Among other things, seek payment in full (or as close as possible to payment in full) of your prepetition claim, a waiver of preference claims, and appropriate events of default to enable your business to cease extending credit should the debtor fail to uphold its end of the bargain or become administratively insolvent.
2. Monitor Administrative Solvency: Vendors should closely monitor the debtor's liquidity and keep an eye out for (i) changes in payment from the debtor and (ii) motions for payment of administrative claims filed by other creditors. In *Toys 'R' Us*, the debtors' delayed filing of their mandatory monthly operating reports was a meaningful red flag before the DIP financing default became public knowledge. If it appears the debtor is teetering on the edge of administrative insolvency, the ven-

dor should consider ceasing to continue extending credit or narrowly restricting terms, if able to do so. The vendor should also prepare and file a motion for payment of any unpaid administrative expense claims to seek immediate allowance, if not payment, of outstanding amounts.

3. Participate in a Committee: Participating in an official committee of unsecured creditors gives creditors a powerful, collective voice in the bankruptcy process. Creditors' committees have increased access to continuously updated financial information from the debtor, can oppose unreasonable DIP financing and sale processes, advocate for fair treatment of trade creditors, and negotiate with the debtor and secured lenders.
4. Sale Process Protections: Vendors with meaningful administrative expense claims should insist that a sale of all or substantially all of the debtor's assets must leave the debtor with sufficient funds to pay *all* administrative claims.
5. Negotiate for Better Terms: Cash on delivery or cash in advance terms for postpetition goods and services provide the strongest possible protection (short of declining to sell) for vendors selling to a Chapter 11 debtor when administrative solvency is in question.
6. Enhanced Disclosure: Vendors with significant leverage can and should request that a Chapter 11 debtor provide periodic disclosures of liquidity and compliance with DIP financing covenants. Transparency can allow vendors to make more informed decisions about whether to continue extending credit to the debtor.

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