WHEN BANK-RUPTCY ESTATES RUN DRY

Chapter 11 Debtors' Attempts to Address Administrative Insolvency

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DEBTORS ARE INCREASINGLY FILING CHAPTER 11 CASES WITH SIGNIFICANT SECURED DEBT, LIMITED UNENCUMBERED ASSETS, AND INSUFFICIENT CASH TO FUND THEIR BANKRUPTCY PROCESS AND PAY ALL ADMINISTRATIVE EXPENSE CLAIMS IN FULL. THEY INCLUDE POST-PETITION FEES FOR THE DEBTOR'S AND CREDITORS' COMMITTEE'S LEGAL, FINANCIAL AND OTHER ADVISORS, RENT, WAGES AND—AS IS MOST RELEVANT TO TRADE CREDITORS—THE AMOUNTS OWED FOR GOODS AND SERVICES PROVIDED TO THE DEBTORS ON CREDIT TERMS AFTER THE BANKRUPTCY FILING.

In the bankruptcy claims recovery hierarchy, administrative claims typically rank below secured claims, but are otherwise at the top of the claim's priority ladder (well above general unsecured claims, including claims for goods and services provided to a debtor before the bankruptcy filing). A debtor is administratively insolvent when it lacks sufficient assets to fully pay administrative claims.

The Bankruptcy Code requires full payment of administrative claims under any confirmed Chapter 11 plan. However, it has become increasingly common for Chapter 11 debtors to seek confirmation of plans, despite being administratively insolvent. Relying on the same Bankruptcy Code provision that allows administrative claimants to agree to "different treatment" of their claims, bankruptcy courts have confirmed Chapter 11 plans in cases where the debtors have discount programs and other creative solutions (for lack of a better word) to address administrative expense claims in the face of administrative insolvency. While on the surface these "solutions" may seem like schemes to short-change creditors, the unfortunate reality is that, in many cases, a discounted recovery on an administrative expense claim may be the best-case-outcome given the circumstances of the Chapter 11 case. Vendors deciding whether to extend credit to distressed customers that either are in, or potentially headed toward, Chapter 11 absolutely must consider the risk of potential administrative insolvency and the possible strategies debtors may deploy to address administrative insolvency in Chapter 11.

SOME BACKGROUND ON ADMINISTRATIVE INSOLVENCY: *TOYS R US* AND *SEARS*

Bankruptcy Code § 1129(a)(9)(A) generally mandates that, unless an administrative claimant agrees otherwise, they must receive full cash payment of their allowed administrative claim on the effective date of a Chapter 11 plan. As such, administrative insolvency has historically resulted in the failure of a Chapter 11 case. This is because administratively insolvent debtors had no choice but to convert their cases to Chapter 7 liquidations or dismiss the cases entirely.

Creditors considering whether to extend credit to a debtor after a bankruptcy filing (thus incurring administrative claims) have long relied on the expectation of full payment of their administrative claims, particularly where the debtor obtained debtor-in-possession financing. That is, until the Chapter 11 cases of Toys R Us and its affiliates infamously blew up that expectation. Following a disastrous holiday sales season, administrative claimants ultimately recovered only approximately 22% of their claims, significantly altering creditor perceptions.

Administratively insolvent debtors have since sought to confirm Chapter 11 plans that provided less than full payment of administrative claims, relying on § 1129(a)(9)'s proviso that administrative claimants may agree to accept "different treatment" of their claims. This occurred in the Chapter 11 cases of Sears Holding Corp.

In *Sears*, the debtors proposed a Chapter 11 plan that delayed payment of administrative claims to allow a liquidating trust to pursue estate causes of action to augment the assets available for distribution to creditors. The proposed plan divided administrative claims into three groups based on whether creditors opted into or out of the debtors' proposed mechanism for resolving administrative expense claims:

THESE CASES HIGHLIGHT A GROWING TREND WHERE DEBTORS DEVISE STRATEGIES TO **GAIN CREDITOR CONSENT FOR PARTIAL PAYMENT OF ADMINISTRATIVE CLAIMS, CHALLENGING TRADITIONAL EXPECTATIONS.**

1. Administrative claimants that affirmatively opted into a 25% haircut on their allowed administrative claims, including payment of a *pro-rata* share of an expedited initial cash distribution.
2. Administrative claimants that did not affirmatively opt in or out, were deemed to have agreed to a 20% haircut on their allowed administrative claims.
3. Administrative claimants that affirmatively opted out were entitled to full payment of their administrative claims on or before the effective date of the Chapter 11 plan. However, this group would only receive payment *after* payment was made to administrative claimants in the other two groups.

The debtors' plan was confirmed in October 2019, but did not become effective until October 2022—a three-year gap during which the estate pursued over $2 billion in estate causes of action. Ultimately, the gamble did not pay off for the opt-out group, as the estates ultimately lacked the assets necessary to pay administrative claims in full. Sears' administrative claimants received only approximately 29% of their claims, highlighting the uncertainty associated with relying on litigation recoveries to fill an administrative insolvency hole.

Over the past several months, courts have confirmed Chapter 11 plans in cases like *Steward Health Care System LLC* and *Party City Holdco Inc.*, where administrative claimants agreed (or were deemed to agree) to accept less than full payment of their administrative claims. Similarly, the debtors in the Chapter 11 cases of *New Rite Aid, LLC* have confirmed a plan that offers only a maximum 5% recovery to administrative claimants. These cases highlight a growing trend where debtors devise strategies to gain creditor consent for partial payment of administrative claims, challenging traditional expectations.

STEWARD HEALTH CARE: NAVIGATING AN EXTENSIVE HEALTHCARE BANKRUPTCY

Steward Health Care System LLC and its affiliates (the "Steward Debtors"), a large healthcare provider, initiated Chapter 11 proceedings on May 6, 2024. A *Joint Plan of Liquidation* (the "Steward Plan") was filed on July 11, 2025, and approved by the bankruptcy court on July 25, 2025. This plan involved transferring all of Steward's assets and legal claims against third parties into a litigation trust immediately after confirmation.

The litigation trust is tasked with managing these assets and pursuing various lawsuits against third parties. They include outstanding accounts receivable (approximately $349 million), claims of around $589 million against insurers for alleged bad faith in denying property damage and business interruption coverage, preference claims of about $390 million, substantial damage claims (approximately $1 billion) against a medical insurance company for alleged anti-competitive conduct and a claim to recover approximately $55 million in Medicare funds.

ADMINISTRATIVE CLAIMANTS THAT TIMELY OPTED INTO THE [RITE AID] PROGRAM WOULD BE RELEASED FROM LIABILITY FOR ANY PREFERENCE CLAIMS THE DEBTORS MAY HAVE AGAINST THEM, AND WOULD RECEIVE A MERE 5% RECOVERY ON THE PLAN'S EFFECTIVE DATE IN FULL AND FINAL SATISFACTION OF THEIR ADMINISTRATIVE CLAIMS.

The Steward Debtors openly acknowledged that they lacked sufficient funds to fully pay administrative claims at the time the Steward Plan was approved. To address this, the Steward Plan incorporated two key features designed to reduce the amounts payable to administrative claimants and allow the litigation trust ample time to recover funds necessary to meet the requirements for payment of administrative claims under § 1129(a)(9)(A).

First, the Steward Plan introduced a "Consent Program" to encourage administrative claimants to accept 50% of their allowed administrative claims in full settlement of their claims. Second, the plan's effective date was strategically delayed until June 2027. This delay provides the litigation trust more time to recover sufficient funds to pay 50% of the administrative claims of participating claimants and 100% payment to non-participating claimants as required by § 1129(a)(9)(A). If the trust fails to recover adequate funds, the plan will not become effective, and the case will convert to a Chapter 7 liquidation, resulting in potentially much lower recoveries for all.

The Steward Debtors estimated total administrative claims at approximately $101 million without the Consent Program. The program's success hinged on at least 75% of administrative claims (by amount) agreeing to participate, which would reduce total claims to $58 million. Under the program, administrative claimholders whose claims arose post-Nov. 15, 2024, had to file a Proof of Administrative Claim Form within 20 days of the confirmation order. Crucially, claimants received an opt-out form, which they needed to return by July 2, 2025, if they chose *not* to participate and seek full recovery of their administrative claims, placing the burden on creditors to actively refuse partial settlement of their claims.

Participating administrative claimants were slated to receive their proportional share of an initial $12.5 million fund within 45 days of the confirmation order. Their claims would then be fully satisfied once they received a total of 50% of their allowed administrative claims, including the initial distribution. The remaining cash to reach this 50% recovery would be disbursed on the Steward Plan's effective date.

Significantly, administrative claimants who did not timely opt out of the Consent Program were deemed to have agreed to participate. This meant accepting a 50% payment as full settlement of their administrative claims, thereby satisfying the exception to the full payment rule in § 1129(a)(9)(A). The administrative claimants that timely opted out were entitled to full payment of their administrative claims. Courts, including in *Toys "R" Us* and *Pier 1 Imports Inc.* have upheld this opt-out mechanism as sufficient proof of administrative claimant consent to accepting less than full recovery of their administrative claims.

However, the confirmation of the Steward Plan was appealed by the U.S. Trustee, the Commonwealth of Massachusetts, and creditor TRACO International Group S. De R.L., and these appeals are currently pending, casting some uncertainty on the final outcome.

PARTY CITY: A RETAILER'S STRUGGLE AND CREDITOR COMPROMISES

Party City Holdco Inc. and its subsidiaries (the "Party City Debtors") filed for Chapter 11 on December 21, 2024. They subsequently filed a *Joint Chapter 11 Plan of Liquidation* (the "Party City Plan") on July 11, 2025, which the bankruptcy court confirmed on Aug. 27, 2025.

Throughout its Chapter 11 case, Party City was administratively insolvent, lacking sufficient assets to even fully cover the secured claims of its second lien noteholders. Estimated administrative claims totaled $21 million. Similar to *Steward*, the Party City Plan established a liquidating trust to hold most of the debtors' assets. This trust was tasked with pursuing legal claims against third parties, resolving disputed claims and distributing proceeds to allowed claimholders.

The Party City Plan's viability depended on administrative creditors agreeing to accept an over 67% discount to fully satisfy their claims. Distributions to these administrative claimants were made possible only through a comprehensive global settlement agreement involving the Party City Debtors, second lien noteholders, an *ad hoc* committee of administrative claimants and the unsecured creditors' committee.

Under the settlement, administrative and priority claimants received distributions ranging from 22.8% to 33.2% of their allowed claim amounts. General unsecured creditors recovered 0.1% of their claims, while second lien noteholders recovered between 0.7% and 2.6%. Significantly, if the case had converted to Chapter 7, second lien noteholders would have recovered 1.2% of their claims, but administrative, priority and general unsecured creditors would have received nothing.

Also mirroring the *Steward* case, administrative claimants were deemed to have consented to less than full payment for purposes of § 1129(a)(9)(A), unless they completed and submitted an opt-out form based on court-established procedures. A critical contingency for the Party City Plan's effectiveness was that less than $1 million in administrative and other priority claims opted out of this proposed treatment.

The bankruptcy court confirmed the Party City Plan despite objections from the U.S. Trustee. The U.S. Trustee argued that requiring administrative claimants to proactively opt out of a settlement was an improper way to secure "consent" under § 1129(a)(9)(A), contending that consent must be explicitly provided by each claimant, not merely implied.

Consistent with *its ruling in Steward*, the bankruptcy court held that the opt-out procedures in the Party City Plan were sufficient to demonstrate consent from non-participating claimants, thereby satisfying the § 1129(a)(9)(A) exception for full administrative claim payment. The court noted that actual opt-outs by some administrative claimants supported the finding of implied consent for others.

The *Party City* court also found that plan confirmation was appropriate because administrative and other priority creditors would receive a greater recovery than in a Chapter 7 liquidation (the "best interests" test), and no administrative claimant objected to the global settlement. The U.S. Trustee did not appeal the confirmation order, and the Party City Plan became effective on Sept. 22, 2025, providing a clear path forward for creditors.

NEW RITE AID: ADDRESSING ADMINISTRATIVE CLAIMS IN CHAPTER "22"

New Rite Aid, LLC and its subsidiaries (the "Rite Aid Debtors") filed their Chapter 11 petitions on May 5, 2025, less than a year after Rite Aid had emerged from its previous bankruptcy in late 2024. The Rite Aid Debtors filed a *Joint Chapter 11 Plan of Reorganization* (the "Rite Aid Plan") on Sept. 3, 2025.

The Rite Aid Plan is built upon an agreement among the Rite Aid Debtors, McKesson Corporation (their largest pharmaceutical supplier), the DIP lender and the prepetition secured lender. This agreement allocates up to $5 million of cash collateral (funds secured by the DIP lenders' liens) to address approximately $100 million in administrative claims, indicating a huge shortfall for these creditors.

Similar to *Steward* and *Party City*, the Rite Aid Plan relies on administrative creditors participating in a consent program where they agree to accept less than full payment of their administrative claims. Under this program—which was approved by a bankruptcy court order entered on Aug. 14, 2025—administrative claimants that timely opted into the program would be released from liability for any preference claims the debtors may have against them, and would receive a mere 5% recovery on the plan's effective date (subject to availability from the $5 million pool set aside for satisfying these administrative claims) in full and final satisfaction of their administrative claims. Those who failed to timely complete and return an opt-out form would be deemed to agree to participate, but would not receive a preference waiver and would only receive their *pro-rata* distribution from the remainder of the $5 million fund *after* an initial distribution to claimants who had timely opted into the program. Those who timely completed and returned an opt out form would be entitled to full payment of their administrative claims (but only to the extent the Debtors recover sufficient assets to pay such claims). This tiered approach significantly impacts recoveries and exposes administrative claimants to varying degrees of risk depending on whether they opted in, opted out, or abstained.

Rite Aid's administrative claim procedures created a path toward emergence from Chapter 11. On Nov. 26, 2025, the bankruptcy court entered an order confirming the Debtors' proposed Chapter 11 plan. The confirmation order states that settled administrative claims will be treated in accordance with the previously-approved administrative claims procedures and the plan.

Similar to *Party City*, the Rite Aid Debtors project that administrative claimants would receive no recovery if the case were converted to Chapter 7. The Debtors also argued that plan confirmation is in the best interests of administrative creditors because it offers a recovery, however small, exceeding the recovery in a Chapter 7 liquidation, and that administrative creditors that did not timely opt in or out of the program are deemed to have consented to it pursuant to § 1129(a)(9).

IT IS CRUCIAL FOR CREDITORS TO CAREFULLY EVALUATE THE BENEFITS AND DRAWBACKS OF PARTICIPATING IN ADMINISTRATIVE CLAIMS PROGRAMS.

CONCLUSION

The prevalence of administratively insolvent Chapter 11 cases is unlikely to decrease. As such, debtors will probably continue to propose plans that involve less than full payment for administrative claims. This trend carries significant implications for creditors. Therefore, creditors must be acutely aware of these risks when deciding whether to extend post-petition credit to a Chapter 11 debtor. Furthermore, it is crucial for creditors to carefully evaluate the benefits and drawbacks of participating in administrative claims programs. While accepting a reduced settlement might lead to a significant discount on their claim, a failure to participate could result in no recovery at all. Understanding these dynamics is essential for making informed business decisions in financially distressed situations. BC

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