Business Bankruptcy

Business Bankruptcy

Elizabeth Warren
William A. Schnader Professor of Commercial Law
University of Pennsylvania Law School

Federal Judicial Center
1993

Contents

1 Policy Rationales in Bankruptcy Law

A fundamental shift is occurring in American commercial life. Bankruptcy, once a distant and unlikely prospect for any but the most marginal of businesses, has become an almost commonplace event. Few businesspeople today have not had some dealings with a bankrupt business, as long-established enterprises crowd the bankruptcy courtrooms alongside their upstart cousins. The difficulties now being resolved in the bankruptcy courts go well beyond ordinary tales of business failure to encompass complex social and economic problems—environmental disasters, mass torts, underfunded retirement plans, labor unrest, disintegrating international trade arrangements. The broad scope and critical importance of the problems being handled through the bankruptcy process have meant a greatly expanded role for the bankruptcy system in American commercial life.

The rise in bankruptcy filings has been well documented in the popular press. Total bankruptcy filings were nearly three times greater in 1992 than they were when the new Bankruptcy Code took effect in 1979.[1] But the impact on the federal appellate courts has not been so widely publicized. The number of bankruptcy cases heard in the courts of appeals rose nearly 300% during the same time period, having grown at more than twice the rate of growth of all other appellate hearings combined. In the district courts as well, bankruptcy cases have taken up an ever larger portion of the caseload: Some 10% of the appellate cases heard in 1979 came up

1. These comparisons are based on calculations from data published annually by the Administrative Office of the U.S. Courts.

from the bankruptcy courts, whereas nearly 25% of the cases heard in 1991 originated there.[2] Bankruptcy is increasingly becoming the business of the federal court system.

This book is intended to provide federal district and appellate judges with a general overview of the policies and practices of the business bankruptcy system. The book covers the basic structure of a Chapter 7 liquidation and of a Chapter 11 reorganization, both in a business context. Some degree of detail is necessarily sacrificed in order to focus attention on the overall design of the bankruptcy system and the relationships among its parts. Each section of the book discusses the issues at stake and the policy rationales behind a different set of Bankruptcy Code provisions.

The subject matter of this book is deliberately limited to business bankruptcies. The doctrinal overlap between consumer or personal bankruptcy and business bankruptcy is considerable. Individual debtors and business debtors use the same bankruptcy courts and invoke some of the same bankruptcy provisions during the course of their cases. Nonetheless, the systems are both theoretically and practically distinct. The social policy concerns that drive the consumer system differ sharply from those that predominate in the business context. Moreover, the realities of practice that give life to the bare statutory outlines are very different in consumer and commercial settings. A single, small book to deal with both systems would most likely contain little more than sterile doctrinal analysis and trivial generality. The consumer bankruptcy system, and its integration into the larger consumer credit system, deserves full treatment on its own. Here, the business bankruptcy system receives full attention.

The Early Years

The drafters of the Constitution made little provision for the ordering of commercial life. Only in this century has Congress, armed with an expansive interpretation of its powers under the commerce clause, become an active participant in business affairs; originally,

---

2. Of all the categories tracked by the Administrative Office of the U.S. Courts, only cases related to banks and banking showed a greater percentage increase in the number of appellate cases during the 1980s.

authority over the enforcement of contracts and the regulation of property was left almost exclusively to the states. Indeed, apart from the power to coin money, the Constitution gave Congress a significant role in domestic commercial matters only through its power to establish "uniform Laws on the subject of Bankruptcies throughout the United States."[3]

This provision attracted little contemporary comment, and the uses to which it has been put have evolved considerably over time. During the first hundred years of the new republic, Congress invoked its bankruptcy powers only infrequently. Bankruptcy laws were short-lived affairs, passed to provide quick relief in an economic downturn and repealed when times got better. It was not until the end of the 19th century that Congress enacted bankruptcy legislation with some staying power. The Bankruptcy Act of 1898 outlined the first modern bankruptcy law, providing for both creditor collection rights and debtor relief in liquidation. The Act was significantly amended during the 1930s to add reorganization alternatives for both businesses and individuals. That law remained intact until the 1978 Bankruptcy Code (the Code) took effect in 1979.

Theoretical Underpinnings—A Specialized Collection System

The current Bankruptcy Code, adopted in 1978 and implemented for cases filed after October 1, 1979, provided the outline of a system for coping with business failure. But it is left to the courts to work out the details that bring the system to life, both in the articulation of principles of decision and in the application of rules to particular cases. It is useful to begin the discussion of the business bankruptcy system with an outline of the normative principles evident in the structure and implementation of the Code. These principles collectively reflect the fundamental policies that reverberate throughout the bankruptcy system and that provide the touchstone for any discussion of the operation of that system.

One of the principal functions of bankruptcy is to provide a systematic method for dealing with economic failure. Inherent in a capitalist system is the risk taking essential to produce new product lines, create innovative services, develop lower-cost production

---

3. U.S. Const. art. I, § 8.

methods, and start new businesses. While this risk taking results in some spectacular successes, it also produces the failures implied by the term *risk,* for which a legal system to define the rights of all the parties is essential.

Without bankruptcy laws, there would still be business failures. State collection laws would then undoubtedly be pressed into service for the purpose of resolving disputes between debtors and creditors. Those laws, however, are not primarily designed to deal with business failure. The principal objective of state collection law is to provide a creditor with a way to collect on unpaid obligations.[4] Some collection suits are brought because the debtor denies liability on a debt. Others are brought because the debtor is slow to pay, irrationally stubborn, or just plain vindictive. State collection law offers a means to resolve a single debtor–creditor dispute with only a limited inquiry into the overall debtor–creditor relationship. It permits most collection suits to proceed with minimal complexity, delay, and expense, which is appropriate for the kinds of issues most frequently involved.

When a debtor faces business failure, the possibility of default on a number of outstanding obligations or of complete cessation of business activities changes collection issues in important ways. Any single collection decision necessarily affects both the legal rights and the practical positions of numerous creditors. For example, if one unsecured creditor is able to collect a large judgment in full, the debtor may have too few assets remaining to pay what it owes other unsecured creditors. Moreover, if the debtor can cease doing business altogether, larger social and economic issues are implicated when the collection rights of a particular creditor are enforced. Workers may lose jobs, taxing authorities may lose ratables, trade creditors may lose customers, and so on. The interaction of competing interests is nearly always complex, and balancing the relative

4. General collection law is an amalgam of statutory law and common law. A number of seemingly unrelated statutes, of both local and federal origin, bear on collection rights. Those rights are then interpreted and modified by various common-law principles. Most of these legislative enactments and judge-made precedents emanate from the state level, and for convenience are referred to collectively in this book as "state collection laws," notwithstanding the recognition that the term subsumes some significant federal collection law as well.

rights of a multitude of parties is inevitably difficult. The statutory framework created in federal bankruptcy law to resolve the many issues implicated by the threat of business failure is necessarily more deliberate and intricate than the ad hoc state collection system, and the factual inquiry conducted to resolve the disputes that arise unavoidably reaches much further.

State collection law and federal bankruptcy law together create a specialized collection system. State collection law provides a circumscribed set of procedures for balancing the interests of a nonpaying debtor with those of a collecting creditor, creating a system that accommodates only limited factual inquiry but is readily accessible for resolving routine disputes. Federal bankruptcy law creates a multifaceted, integrated system for coping with the competing concerns of a wider range of interested parties in more complicated relationships and more distressed circumstances. The federal system thus addresses a number of normative concerns that arise in connection with the potential demise of an ongoing business but are typically not implicated by state-law collection actions. Having developed two different collection systems, American law offers a measure of flexibility to provide fora that are reasonably calculated to resolve the key issues in dispute in different kinds of cases.

A System to Reduce Strategic Behavior

Strategic, and often wasteful, action is a persistent problem in collection systems. Under any system, both debtors and creditors can be counted on to press whatever advantages they have. Exploitation of superior information or greater bargaining power, for example, is an expected—and, according to most commentators, beneficial—aspect of the contract bargaining process. But some advantages arise because of differences between legal systems, or because ineffectual laws permit parties to avoid enforcement of rights they long ago bargained away. Such advantages create a different kind of exploitation. Attempts to take advantage of opportunities inadvertently created by the collection system dissipate both debtors' and creditors' resources while producing little identifiable benefit.

Multiple collection systems, such as those in the fifty states, often provide fertile ground for unproductive strategic behavior. The debtor faced with coercive state collection actions can sometimes avoid them by moving property to another location. Simply by driving its tractor across the state line, a debtor can force its creditor to begin the collection process and win in a different state's forum—assuming, of course, that the creditor is able to locate the tractor in its new home. If the debtor is sophisticated, the opportunity to play this game, both before and after judgments are rendered and collection efforts have begun, is almost limitless.

State law does allow creditors to make certain countermoves—for example, by sequestering property before judgment—but such moves are expensive. Moreover, because they trigger constitutional concerns about deprivation of property without due process, creditors' remedies are hemmed in by a number of procedural and substantive safeguards. When applied against a wily debtor, these remedies are of doubtful value. The debtor may be forced to plan its moves a bit more in advance, but the safeguards against creditor overreaching make it virtually impossible for a creditor to trap property without tipping off the debtor and opening up the possibility of strategic behavior. The debtor's strategic moves and its creditor's countermoves waste resources, but such behavior is often cost-effective for debtors and creditors facing a fifty-state collection scheme.

The debtor most likely to engage in wasteful strategic behavior is the debtor facing business failure. This debtor has the least to lose and the most to gain from such strategies. By providing a uniform bankruptcy law that stretches across the nation (and even has some international reach), the Code ensures that the circumstances most fraught with the potential for waste are better controlled. A single bankruptcy filing creates an estate that nets all the debtor's property, wherever located, and covers all the debtor's economic relationships, in whatever stage of performance or breach. The sweep of bankruptcy law is the same regardless of where the filing is made and which bankruptcy court issues the orders. This reach and uniformity of bankruptcy law sharply reduces the opportunities for strategic behavior.

The Code also helps to curtail strategic behavior by increasing collective monitoring of the debtor. The details of the Code are discussed in the following chapters, but a few examples make the point clear: Following a bankruptcy filing, the debtor has affirmative obligations to reveal information about the operation of the business, making it easier for the creditor to scrutinize the disposition of the debtor's assets. The debtor is prohibited from engaging in any transactions other than those undertaken in the ordinary course of its business, and is therefore prevented from concealing or moving assets so as to make collection difficult. If the debtor wants to engage in out-of-the-ordinary transactions, it must notify its creditors and seek court approval. Debtors who violate such rules may find themselves replaced by a trustee who reports directly to the court and the creditors. Furthermore, the creditors have the right to monitor the debtor's activities, and the U.S. trustee, an officer of the Department of Justice, assumes some direct monitoring functions as well. In short, the Code is replete with provisions to enhance control over the post-filing debtor and to frustrate any attempts by the debtor to conceal property from its creditors.

There is no doubt that bankruptcy itself allows debtors to devise strategies for delay. Opportunities for strategic delay are in some instances the result of poorly considered Code provisions, and in others, the unavoidable consequence of a careful balance of debtor and creditor power. But those opportunities can be minimized in the unified federal system in ways that could never be accomplished in the state system.

Increasing Value and Reducing Loss

The bankruptcy system is intended to deal with the economic losses that result from business failure. The focus is on creditors as a group, rather than on any one creditor, and sometimes one creditor will be forced to endure somewhat greater losses to enhance the return to all the creditors. The system is designed from top to bottom both to enhance the overall value of the failing business and to reduce the losses that creditors collectively must suffer—to implement what could be called the principle of collective benefit.

The idea of collective benefit is ubiquitous in the Code, equally crucial to understanding its individual provisions and understanding their interrelation. Indeed, this idea underlies the Code's central distinction: the distinction between liquidation and reorganization. The Code's drafters began with two empirically based economic assumptions: orderly liquidation is likely to produce more value (and prevent more loss) than piecemeal liquidation, and going-concern value is likely to be higher than liquidation value. Chapter 7 implements the first premise—that an organized liquidation monitored by all the creditors and supervised by the bankruptcy court is likely to produce greater value than a chaotic mix of self-help repossession and judicial execution. The Chapter 11 reorganization alternative implements the second premise, explicitly attempting to capture the going-concern value of a business that would likely be lost in liquidation and to pass that benefit on to those who would be injured by a business collapse. Thus, the twin goals of enhancing overall value and reducing collection loss dominate the structure of the bankruptcy system.

The same principle of collective benefit explains the Code's fundamental approach to debtor–creditor relations. Bankruptcy law does not focus on a single complaining creditor, as does state law; it protects creditors collectively. If the overall value of the debtor's business can be enhanced by deviating from the priorities established by state law, the Code does not hesitate to do so. For example, a creditor with a state-law right to repossess collateral may be forced to relinquish that right in bankruptcy if the debtor business is thereby made more valuable. The individual creditor loses something by forgoing immediate liquidation and waiting for continuing payments, but the business—and all those that rely on it—may well gain by the Code's making it possible either to sell the business as a going concern or to reorganize it into a viable enterprise.

Similarly, insofar as overall losses can be avoided by abandoning the state-law collection scheme, that scheme has been wholly supplanted in bankruptcy. For example, in state law, secured creditors are given access to cheaper methods of seizing assets, and they gain from quick moves to repossess debtor assets before the property value declines or the debtor has a chance to dispose of them. Among unsecured claimants, the quickest creditors may suffer no losses, while those farther back in line bear the entire burden of the debtor's failure. Both secured and unsecured creditors are rewarded for racing for assets, thereby dismantling debtors in distress and precipitating business failures that might have been averted. In effect, the state system distributes benefits to aggressive creditors rather than cooperative ones, thus raising business failure rates generally. By putting a premium on piecemeal liquidation, the state system does nothing to enhance the value available to all creditors if the debtor is in serious trouble and ignores the fact that losses may be inequitably apportioned among creditors. Bankruptcy simply denies creditors access to more aggressive collection methods and ends the race to dismantle the debtor. This may increase the losses some individual creditors will suffer, but if all goes well it will decrease the total number of business failures and secure for the creditors collectively a greater overall return.

The Code does not require complete collectivization of benefit. It permits the survival of a number of priorities granted outside the bankruptcy system, even though those priorities sometimes diminish the estate. In some cases, for example, the secured creditor may repossess property even if doing so will doom the business's reorganization effort. The other creditors' individual rights are restricted, but not extinguished. The Code seeks only to balance the interests of an individual creditor demanding its out-of-bankruptcy collection rights with the collective interest to be served by curtailing those rights.

In some respects, the Code works directly to reduce costs for both debtors and creditors and thereby to reduce the losses suffered in a business failure. A number of its provisions are designed to increase collection efficiency: Quick decisions, abbreviated trials, estimated claims, collective creditor actions, elimination of duplicative efforts, minimal paperwork, automatic stays from collection, and stipulated valuations are all methods designed to capture value for the estate under the adverse conditions presented by multiparty litigation involving a failing business. There is perhaps no legal system more cognizant of the transaction costs of collection and dispute resolution than the bankruptcy system, and there is surely no system so conspicuously directed toward cost reduction.

The bankruptcy courts are also directly involved in efforts to enhance the value of the bankruptcy estate. Such involvement follows from the enormous discretionary power the courts enjoy in bankruptcy cases. Judges are called upon to make countless decisions—for example, whether to permit the assumption of an executory contract, whether to approve the appointment of an examiner—based on their assessment of what will yield greater returns for the estate. In addition, a number of statutory provisions specifically require the exercise of judicial discretion, such as those that require the court to choose between competing valuations in deciding whether a debtor can offer substitution of collateral, or to assess varying projections of business prospects in determining whether a reorganization plan is reasonably calculated to support its proposed payouts. These fact-specific inquiries demand careful business decisions, as well as legal decisions, from the judges, giving them a substantial say in what the bankrupt business will eventually be worth.

The devices for achieving collective benefit vary, but the bankruptcy system's devotion to the principle is consistent and unmistakable. From the most basic structural features to the smallest technical details, the Code is replete with provisions designed to balance the interests of the individual creditors against the collective interests represented by the estate, and to enhance the value available for distribution while minimizing the losses to be spread among the parties.

The Distributive Norms

Any collection system necessarily has distributional implications. Imbedded in state collection law, for example, is a straightforward scheme of distribution: Secured creditors get cash or take their collateral; the first-judgment creditor collects in full from what remains; the next-judgment creditor takes in full from what still remains; and so on, until all the assets are gone. This payment scheme is sometimes augmented by statutory lien and trust fund laws that give certain creditors automatic priority. In any event, so long as the debtor pays the rest of its obligations as they mature, seizure of property by one creditor creates no inequality among creditors—the others can still expect to be paid in full. When there are insufficient assets to satisfy all claims against the debtor, however, the state collection scheme means that some creditors will receive payment in full while other creditors will bear all the costs of the debtor's failure. Clearly, the state-law system has a powerful distributional impact when the debtor fails.

The bankruptcy system reflects deliberate decisions to pursue different distributional objectives from those embodied in the de facto scheme of general collection law. Rejecting the race to the courthouse that characterizes state law, the watchword of bankruptcy is "equity is equality." The fundamental premise with which the Code begins is that all similarly situated creditors ought to be treated alike. This premise finds its most direct expression in the fact that the general creditors—the last residual class of creditors, for whom much of the bankruptcy operation is run—share assets on a pro rata basis.

Not surprisingly, implementing such a simple approach in a thoroughgoing fashion is neither economically nor politically feasible. The bankruptcy system lays down an equality principle as its baseline, but it builds in numerous exceptions. The Code promotes some creditors ahead of others, providing enhanced collection rights for taxing authorities, lessees of residential leases, and the employees of a failing business, among others. This does not mean that the Code's commitment to equality is half-hearted. It is more accurate—and perhaps more telling—to note that when bankruptcy law deviates from a strict equality principle, it does so for self-consciously redistributive ends. Every distribution that benefits a particular creditor at the expense of the collective estate represents a considered judgment to depart from the norm in a particular instance. Equality—and deviations from equality—stand at the center of bankruptcy policy.

The very nature of the bankruptcy system indicates the importance of equality: Within a single bankruptcy case, consequences of debtor default can be determined for a large number of diverse parties, far more than could be heard in any state collection suit. Secured creditors and unsecured creditors, creditors with present claims and creditors with contingent claims, creditors with liquidated claims and creditors with unliquidated claims—all face very different collection options outside bankruptcy. Tort victims, for example, may face years of discovery and long waits for state court trials before they have noncontingent, liquidated claims against their debtors, while lenders enforcing negotiable notes have noncontingent, liquidated claims as soon as a debtor misses a scheduled payment. If the debtor's business survives and the debtor can pay everyone, those differences are of little consequence. But if failure of the debtor's business is imminent, all those creditors want a share of the business's assets. Because they recognize that what they cannot get now they will most likely never get, they exercise whatever collection rights they have as quickly as possible. The differences in the rights possessed by the various creditors, however, are quite significant. Allowing these rights to battle for supremacy at state law will result in a distribution of assets heavily skewed in favor of secured, present, and liquidated claims. Bankruptcy law avoids this result by bringing the competing creditors into a single forum where their rights can be adjusted in a single proceeding—distributing assets and losses among them all without undue regard for their respective state-law collection rights.

The distributional effects that receive consideration in bankruptcy extend even to the impact of a debtor's failure on those who are not creditors and who have no collection rights at state law. Employees who will lose jobs, taxing authorities that will lose ratable property, suppliers that will lose customers, nearby property owners who will lose a beneficial neighbor, and current customers who will be forced to go elsewhere are among those affected by an economic collapse. The opportunity to sell a business intact as a going concern in Chapter 7 or to reorganize that business in Chapter 11 has distributional implications for all these parties, despite their lack of specific collection rights. Their interests still receive indirect protection in the bankruptcy process, largely through the Code provisions that forestall liquidation to permit the current business to remain afloat. Notwithstanding the derivative nature and limited extent of this protection, Congress made it clear that these parties were among the intended beneficiaries of a successful reorganization procedure and that the Code was written in part to safeguard their interests. To the extent that assets are reallocated from a particular party to the group as a whole and the reorganization effort is enhanced thereby, the Code carries out a deliberate distributional policy in favor of all those who would have been hurt by a business failure.

On what basis does bankruptcy law allocate value among affected parties? The following are some of the considerations that are important in ordering distributional priorities. In addition to the principle of equal treatment, these considerations reflect a number of other values with which the bankruptcy system is concerned, particularly those associated with preserving the estate and minimizing the effects of default. The list is only partial, but it identifies many of the key factors.

- *Relative ability to bear the costs of default.* Some creditors are unlikely to have anticipated the risk that a business will cease to function, while others may face especially acute difficulties in absorbing the costs of a debtor's default. A debtor's employees, for example, may be particularly ill-suited to the task of assessing and spreading risk so as to shield themselves from the effects of their employer's misfortunes. Priority of repayment for past due wages gives employees preferential treatment, reducing their costs when a business fails. (section 507(a)(3))

- *Encouraging debtor risk-taking.* If debtors perceive that whenever a business is in some financial trouble it faces immediate liquidation, they will most likely have two responses: not start businesses in the first place, or direct the extant business toward more risk-averse enterprises. To the extent that reorganization alternatives give companies that pursue these risky alternatives the ability to survive some short-term dislocations, they encourage those companies to engage in some risk-taking behavior.
- *Incentive effects on pre-bankruptcy transactions.* To encourage creditors to work with a failing debtor and to avoid the state-law "asset grab" that pushes many debtors into bankruptcy, Code provisions are designed with a view toward their ex ante incentive effects. For example, the Code neutralizes pre-bankruptcy collection actions that diminish the estate and hasten its demise, while it sanctions other creditor activities that tend to benefit the estate. Thus, the collection on an undersecured debt shortly before bankruptcy may be undone and the creditor who collected ahead of all its cohorts will have to repay its gain to the general pool, while a purchase money security interest given to secure a new extension of credit still will be enforced after the bankruptcy filing. (section 547(b), (c))
- *Similarity over time.* The bankruptcy system equalizes the treatment of creditors when timing differences give them very different formal rights. For example, those who have been injured by a debtor's product, such as workers who have been exposed to asbestos, can bring their state-law actions only after their injuries are manifest. Under bankruptcy law, however, both present and future claims may be resolved at once, and the court may approve a plan to pay victims over time using similar procedures and providing similar payouts re-

gardless of when their injuries became evident. (sections 101(5), 502) The Code generally minimizes the consequences of timing differences, as it reorders rights based on an underlying similarity of rights.

- *Owners bear the primary costs of business failure.* Residual owners of the business have the least protected status in bankruptcy. This mirrors the principle outside bankruptcy that those who take the largest gains if the business succeeds also assume the risk of loss if the business fails. Accordingly, the Code permits the owner to retain ownership of the post-bankruptcy business only if the creditors collectively consent to it or the business is able to pay all the creditors in full. (section 1129(b)(2)(B)(ii))
- *Minimizing disruption of established economic patterns.* While bankruptcy necessarily reorders the rights of all parties with claims against the estate, the Code gives powerful residual protection for the most established forms of transactions, thereby reducing the impact of a bankruptcy filing on ordinary commercial expectations. Secured creditors provide a case in point. The Code might have provided that they receive nothing more in bankruptcy than unsecured creditors do, thereby giving greater force to other normative principles identified here. Instead, they are the most overtly protected parties in the bankruptcy process. While the decision to extend such protection to secured creditors might be justified by presumptions about ex ante incentives, it also seems that Congress feared that equalization of creditor status in bankruptcy would wreak too great a disruption on commercial expectations.

This list is not exhaustive. A number of elements in the distributional scheme, such as the special rights enjoyed by shopping centers or repayment priorities for fishermen, are hard to explain by any principled analysis. (sections 365(b)(3)(D), 507(a)(4)) The list, however, provides a sense of the key normative objectives, and it illustrates the ways in which distributional norms are important in delineating the rights of each party in bankruptcy.

The distributional decisions in bankruptcy may appear in many guises: in the exceptions to a voidable preference rule, in the limitations on contract assumption by a bankrupt debtor, and in the power to "cram down" a dissenting creditor. Each has powerful distributional consequences, as it determines the extent to which an individual creditor must yield to the collective interest and how much that creditor may demand on account of its pre-bankruptcy collection rights. The Code establishes a rough allocation of power among all the parties affected by the outcome of a bankruptcy case, an allocation that is subject to refinement by the courts through their interpretation of the statutory provisions.

Internalizing Costs to Parties Dealing with the Debtor

The bankruptcy system is also designed to constrain the externalization of losses to public resources when a business fails. Once again, this principle is followed in general direction only, and some counter-examples are clear in the Code. Nonetheless, the bankruptcy laws are organized to minimize the loss to the general public when a business fails and to force the parties dealing with the failing debtor to bear the burden of the failure.

The benefits of such a policy are obvious. To the extent that creditors can externalize losses, their incentives to make carefully considered lending decisions or to monitor the debtor to assure repayment are significantly blunted. But if a lender knows it must bear the bulk of the losses, the lender is more likely to develop appropriate levels of investigation and monitoring ex ante. With greater certainty of risk-bearing and a reduced load on the public fisc, the incentives are higher to accomplish appropriate diligence and caution in debtor–creditor relations.

Bankruptcy policy minimizes losses to the public fisc in a most obvious way: it requires payment first and in full to government taxing authorities. This requirement is implemented in a number of different provisions governing the repayment of tax debt. Outside bankruptcy, the government has fairly strong collection powers that are exercised primarily through the power to enforce liens against property. In bankruptcy, a taxing authority has the same power to collect, for example, by enforcing tax liens. In addition, if the debtor's property is insufficient to satisfy the lien, the tax debt cannot be extinguished through discharge, unlike other secured or unsecured debts. (section 1129(a)(9)(B))

Many of the costs of operating the bankruptcy system are also borne directly by the parties rather than passed on to the taxpayers generally. For example, the costs of case supervision are paid from the debtor's filing fees, a portion of which goes directly to the U.S. trustee program and a portion of which goes to the private trustee who administers the case.

The bankruptcy system also forces greater internalization of costs by providing a mechanism for dealing with failing companies and the enormous claims against those companies in a manner that discourages the parties from demanding a public bailout. Bankruptcy provides companies with the opportunity to reorganize, and with the opportunity comes the hope that creditors will eventually be repaid, tort victims will be compensated, and employees will be able to keep their jobs—all without subsidization from the taxpayer. Even if the reorganization effort fails, liquidation in bankruptcy involves some delay, which may give those who depend on the failing business an opportunity for final collection and some cushion for the losses they will face. By cushioning the impact of economic failure, the bankruptcy system gives Congress somewhat greater leeway to withstand the pleading of all those who will be injured by the failure of the business, which, in turn, tends to block the development of an ever-growing number of specialized government programs that externalize the costs of a business failure.

A Voluntary System

As a mechanism to deal with failing businesses, the bankruptcy system offers a number of potential benefits. The system may foster substantial enhancement of the value of the bankruptcy estate, so that parties receive more than they would under alternative collection systems. It may also distribute that value in a superior manner, offering protection to a number of deserving parties that might otherwise receive none. The system constrains the impulse of parties to externalize their losses to others, but it can have no practical effect on commercial life unless it is used. A crucial feature of the bankruptcy system—and one that is essential to implementation of the other normative goals of the system—is that an effective means exists to bring the system into play at the appropriate time.

Both involuntary and voluntary systems for dealing with failing businesses are in use throughout the world. In some Asian and

European countries, government or regulatory intervention is the standard means for coping with insolvent corporations. The American bankruptcy system relies on a different mechanism: Recourse to the bankruptcy courts is voluntary, available only at the initiation of the parties most directly affected by its operation. No public resources are allocated to monitoring a debtor's financial condition or to bringing a debtor in danger of collapse under bankruptcy court supervision. There are no "debt police" to scrutinize the likelihood that a debtor will not pay, nor are there state-authorized trustees to impose bankruptcy protection on those at risk. Debt-collection and asset-distribution costs are left to the private parties that stand to lose or gain as the debtor suffers or prospers. The state merely provides procedures for facilitating and regulating the parties' efforts—which presumably reduce costs borne by taxpayers at large.

The normative preference for private initiation over public initiation has a number of justifications. A private decision to use the bankruptcy process is likely to be a better decision than is a public decision. Private initiation leaves the parties with the best information to determine whether to use bankruptcy. The parties can assess the degree of risk involved in a transaction and the level of debt enforcement they need. If they perceive little risk of loss, if the losses are sufficiently small, or if there is little hope for greater payment in bankruptcy, the parties can simply decide not to invoke the system. Thus not only are the costs of the system allocated to those most affected by its use, but no bankruptcy cost is imposed on the parties when there is no benefit in its use.

A voluntary system also avoids the difficulties that arise when an official determination that a party is bankrupt sets the machinery in motion. Mistakes by regulators can force a complex bankruptcy scheme upon a debtor that could have resolved its problems more simply outside bankruptcy. They can also cause a struggling business that otherwise might have succeeded over time to fail at once. Reliance on regulators invites both overly aggressive and insufficiently vigorous enforcement, imposing error costs on the parties in either situation.

A properly constructed bankruptcy system thus places the bankruptcy decision in the hands of the parties that have superior information about the finances and the likely future of the debtor's business. More often than not, the party that best fits the description of well-informed decision maker is the debtor itself. The debtor is typically the only party with access to full information about its outstanding obligations, future business plans, and income projections. And although no one is a perfect decision maker, usually the debtor is best able to assess how successful the business is likely to be in meeting its continuing obligations and to determine whether bankruptcy provides an opportunity to enhance the value of the business.

A difficult decision faces any debtor considering a bankruptcy filing. Not all the normative premises of bankruptcy favor the interests of the debtor. The Code puts an end to much of the strategic maneuvering that state law would permit: Specialized bankruptcy laws give the court and the creditors much greater say in the operation of the debtor's business than they would have in a state forum. The value enhancement required by the Code might mean selling off the business, a move that could leave current management without jobs while freezing out old equity holders altogether. Even if this does not occur, the distributive norms of the Code are nearly always contrary to the interest of the business owners, who are placed at the end of the distributional line that forms outside the debtor's door in bankruptcy. Moreover, at every turn the Code makes it clear that the debtor has far greater disclosure obligations and is subject to much more extensive court supervision than would exist outside bankruptcy. Ultimately, the management and owners of a business must face the fact that in filing for bankruptcy they run a substantial risk that they will lose control of their business entirely.

So why do debtors choose to file voluntarily? Typically, they choose bankruptcy because it gives them a real chance to salvage a failing business. Bankruptcy halts, at least temporarily, the debtor's downward slide, providing a breathing space within which to try to turn things around. If the debtor wants to try to save its business, bankruptcy, with all its attendant restrictions and constraints, often offers the only practical opportunity to do so. Of course, if the owner of the business prefers to loot it and run, or sees no hope of recovery, or is intent on turning it over to a particular creditor, the business will not file for bankruptcy voluntarily. In an overwhelming proportion of bankruptcy cases, however, the owner or manager wants to stay on and turn the failing business around.

The system could, of course, have been structured so that bankruptcy would typically be initiated by the creditor rather than by the debtor. But such an approach presents a number of problems. Creditors are not as likely as debtors are to have immediate access to the information necessary to make the filing decision, and creditor-initiated petitions would most likely trigger disputes over the appropriateness of the filing, which would consume assets and cause delay. Moreover, the creditors with the best information are likely to be sufficiently sophisticated and alert to have protected themselves thoroughly at state law; thus, the creditors best able to act are the ones least likely to want to move toward the collective process of bankruptcy. The law is structured to minimize creditor-initiated petitions, and, in fact, creditors initiate only a tiny proportion of bankruptcy filings. The bankruptcy system is de facto a voluntary, debtor-initiated system.

The premise of the voluntary system is that the debtor will file for bankruptcy in appropriate cases. Because many of the normative goals of bankruptcy favor parties other than the debtor, a difficult tension is built into the system: The debtor may well know when to file, but if the bankruptcy system serves only the interests of non-debtor parties, the debtor may well not *want* to file. The Code's solution is to give the debtor enough incentives to file for bankruptcy so that troubled businesses will be managed within the system, thereby benefiting both debtor and non-debtor parties.

One of the key reasons for the adoption of the 1978 Code was the widespread perception that the old Code was unworkable. Debtors perceived that they could not use bankruptcy to save a business in trouble, and their creditors largely viewed the system as one that dissipated assets and delayed payouts unnecessarily. The new Code—and Chapter 11 in particular—was designed with an avowed intention of making bankruptcy more attractive to troubled businesses.

Here, as in many other instances under the Code, bankruptcy policies overlap. Value-enhancement norms coincide with voluntary filing norms, so that many of the features of the Code that give debtors the opportunity to reorganize also preserve going-concern value and give debtors a reason to file. Similarly, the distributional scheme of bankruptcy replaces the state-law collection scheme, while the externalization of costs to the public fisc is constrained. At the same time, values may conflict. To the extent that management is bribed to bring a failing business into bankruptcy, some cost is presumably transferred, directly or indirectly, from the creditors to the managers. It is a legitimate subject of inquiry to explore whether the appropriate incentives have been implemented to encourage optimal use of the system at the lowest cost. Once again, identification of the normative principle does not conclude the policy inquiry. This discussion, however, suggests that the benefits and burdens of bankruptcy combine to create a system that parties will perceive as a workable means to deal with the debts of a failing company. By giving businesses an opportunity to survive an immediate financial crisis, the system serves a number of normative goals, including the goal of encouraging voluntary filing.

An Alternative Approach—The Law and Economics Model

In contrast to the multifaceted and sometimes contradictory policy underpinnings of bankruptcy presented in this book, there is a different theoretical approach that offers a much more unified theory of bankruptcy law. That position, ably led by Professor Douglas Baird and Provost Thomas Jackson, posits that bankruptcy law exists to serve a single function: to solve the "common pool" problem that occurs when a debtor's assets are insufficient to satisfy the collective demands of its creditors. These scholars see business failure as creating conditions under which the self-interested impulses of individual creditors, if left uncontrolled, would place these creditors in costly competition with one another for limited resources. They see bankruptcy as a device for channeling these creditors by force into a coordinated and orderly liquidation of the debtor's assets. They view such a value-enhancing liquidation as the defensible goal of bankruptcy, with the corollary that they see little excuse for a bankruptcy system to reorganize debtors to avoid such a sale. For these scholars, the business of bankruptcy is limited to efficient debt collection, not to the rehabilitation of the business debtor or to control over the distribution of the debtor's assets.

There is some overlap between the Law and Economics approach and the more eclectic approach explored in this book. Obviously, the effort to maximize the value of the debtor's assets is common to both approaches. Moreover, some of the principles of efficiency, transactions costs, and so on, employed in this book borrow heavily from the discipline of economics. In some cases, the difference between the two theoretical approaches is one of emphasis; in other cases (such as the rationale for a reorganization statute) the views simply conflict. In the bibliography that follows the text, a number of works that explore the Law and Economics approach are cited.

Conclusion

As this discussion illustrates, the bankruptcy system attempts to reconcile the tensions between numerous competing interests and policy considerations. For example, whether employees should have better collection rights than tort claimants involves both value-enhancement and distributional questions, but it also implicates political, economic, and social questions that Congress must decide when it determines the payment priority for each claimant. Bankruptcy is far more than mere debt collection; it provides the framework for implementing fundamental decisions about how to manage the social and economic consequences of business failure.

Bankruptcy law, like general collection law, shapes and restricts other substantive legal rights and remedies. A creditor may have an ironclad contract, but if its debtor has declared bankruptcy, the rights the creditor can enforce may be vanishingly slim. Bankruptcy policy is constantly in conflict with the full enforcement of valid substantive rights against the debtor. Bankruptcy law also conflicts with general collection law, providing a different set of curbs and restrictions on the enforcement of legal rights. Because of the conflicts that a bankruptcy system necessarily engenders, it is unsurprising that bankruptcy law has had a stormy history and continues to provoke passion among the coolest bankers, the steadiest businesspeople, and the calmest commentators. Bankruptcy is about changing obligations, about balancing interests differently, and about dealing with loss. Ultimately, bankruptcy is about reordering the legal effects of a promise.

The operation of the bankruptcy system may differ from its basic structure. Code provisions may represent sensible balances among competing interests, or they may result in waste or giveaways. Court interpretations may veer in directions that upset balances and redistribute value. While the implementation of the system may suffer from any number of defects, the normative principles of bankruptcy are nonetheless designed to deal systematically with the circumstances of economic failure and to reduce injury to all those affected by that failure.

2 An Overview of Business Bankruptcy

This book is itself an overview of the business bankruptcy system. Nonetheless, the bankruptcy system is sufficiently complex and rich in detail that it is easy to lose an overall sense of how it works. By describing how the bigger pieces fit together, this chapter should make the policy discussions and operational details in the following chapters more meaningful.

This chapter also gives some idea of the tools in the toolbox—what kinds of bankruptcy alternatives are available and who may use them. In turn, this discussion sets the stage for an understanding of the strategic use of bankruptcy by both debtors and creditors.

The Structure of the Code

The Bankruptcy Code is a relatively short compilation of statutory provisions that alter the collection rights of the creditors of those entities brought under its jurisdiction when a bankruptcy petition is filed. The petition can be filed by the debtor or, in a tiny percentage of the cases, by its creditors. Without a bankruptcy petition, there is no bankruptcy case.

The Code is organized into three odd-numbered chapters that apply generally to all cases (Chapters 1, 3, and 5), followed by five chapters that outline different kinds of bankruptcy relief (Chapters 7, 9, 11, 12, and 13). Chapter 1 deals with general provisions of the Code—definitions, rules of construction, applicability of chapters, and powers of the court. Both administrative matters, such as public access to bankruptcy papers, and basic substantive matters, such as who may be a debtor, are covered there. Chapter 3 of the Code deals with case administration—how a case begins, the identity and responsibility of officers of the bankruptcy estate, and the administration of the estate. Chapter 5 deals with the obligations and rights of creditors, the duties and benefits of debtors, and the rights of the newly created bankruptcy estate. A bankruptcy case proceeds under one of the chapters that follow—Chapter 7, Chapter 9, Chapter 11, Chapter 12, or Chapter 13—adding the provisions of the particular chapter to the general provisions of Chapters 1, 3, and 5.

Chapter 7 governs the liquidation of an enterprise and covers nearly all types of entities—individuals, partnerships, and corporations. Its coverage is not universal, however: Railroads and governmental entities have their own special Bankruptcy Code provisions, and are therefore denied access to Chapter 7. Banks and insurance companies use liquidation proceedings provided elsewhere in law and are similarly barred from Chapter 7. (section 109(b)) Nonbusiness trusts are denied access to bankruptcy altogether. (sections 109(a), 101(35)) Even so, Chapter 7 sets forth the basic procedure for winding up the financial affairs of and settling the outstanding obligations of debtors of almost every stripe.

The remaining chapters—Chapter 9, Chapter 11, Chapter 12, and Chapter 13—are all reorganization chapters. They represent alternatives to liquidation, providing mechanisms for payments to creditors over time and, frequently, eventual discharge of some outstanding debt. These four chapters are tailored to meet the needs of very different kinds of debtors. Chapter 9 is reserved for municipalities. (section 109(c)(1)) Chapter 12 is for family farmers trying to reorganize their farming operations. (section 109(f)) Chapter 13 is for individuals with regular income who owe less than $100,000 in unsecured debt and less than $350,000 in secured debt. (section 109(e)) Chapter 11 is the primary reorganization chapter for businesses,[5] and it is the focus of the business bankruptcy system.

Chapter 7

A typical Chapter 7 filing is voluntary; the debtor itself chooses to file for bankruptcy. The filing includes a one-page petition, with

---

5. Individuals may use Chapter 11, but Chapter 13 is more attractive for most individuals if their debts are low enough to permit them to qualify. Creditors in Chapter 13 proceedings have fewer rights to object to reorganization plans and to disrupt debtors' management of their own cases.

basic information about the debtor (name, employer identification number, principal place of business) and a statement that the debtor is eligible to file for bankruptcy relief. (Official Form No. 1) The debtor pays a filing fee; there is no *in forma pauperis* recognized in the bankruptcy system. The debtor asks the court to permit it to pay the fee in up to four installments spread over no more than 180 days, but such a delay in fee payments will be conditioned on the representation of debtor's counsel that neither counsel nor any bankruptcy trustee will receive any compensation in connection with the bankruptcy until after the fees are paid in full. (Bankruptcy Rule 1006)

Eligibility requirements for Chapter 7 are minimal. With the exceptions noted earlier for railroads, governmental units, insurance companies, nonbusiness trusts, and banks, any legal entity may file for Chapter 7. (sections 109(b), 101(35)) Although the debtor need not demonstrate anything about its financial condition or its prospects for repayment, it must attach schedules to the petition to provide basic information about its assets and liabilities and the operation of its business. The debtor must also give access to its financial statements, income statements, and books and records. The bankruptcy petition also contains a filing matrix listing the names and addresses of the creditors so that the court can send notices, including a notice of the initial filing, to all interested parties. (Bankruptcy Rule 1007) Changes in filing requirements are underway with the adoption of the BANCAP system to computerize the bankruptcy court system and to make record keeping and notification more efficient.

When the debtor files for bankruptcy, a bankruptcy estate is created. (section 541(a)) The estate succeeds to all legal and equitable interests of the pre-bankruptcy debtor. (section 541(a)(1)) Prebankruptcy claims against the debtor become claims against the estate. (section 502) An automatic stay is imposed to stop all individual collection actions against the estate and to protect the property of the estate. (section 362) In effect, a Chapter 7 liquidation involves two distinct entities: the pre-bankruptcy debtor and the postfiling bankruptcy estate.

After the filing, the U.S. trustee appoints an interim trustee to administer the bankruptcy estate. (section 701(a)(1)) All Chapter 7 estates are administered by an outside trustee. The creditors may later elect a trustee of their own choosing, but they are rarely interested enough to do so in practice. (section 702(b)) In most cases they simply ratify the U.S. trustee's choice.

The trustee administers the bankruptcy estate, primarily for the purposes of liquidating its assets and distributing the proceeds to the creditors. The primary obligation of the trustee is to collect the property of the estate and sell it for distribution to the creditors. (section 704(1)) But during the course of that process, the trustee may perform a number of other services. In general, the trustee acts on behalf of the creditors collectively, furnishing all creditors with information about the administration of the bankruptcy estate. The trustee may pursue certain actions to enhance the value of the estate, or the trustee may make available to the creditors information which will permit them to act.

Among the trustee's enumerated duties is the requirement to account for all the property in the estate. (section 704(2)) Often a business is still operational at the time of the bankruptcy filing, so the trustee is obligated to monitor the debtor's business activities. The trustee also makes certain that the debtor provides required information about the operation of the business. When it seems appropriate, the trustee investigates the financial affairs of the debtor. (section 704(4)) The trustee has the obligation to try to uncover any dealings in which the debtor's management or others may have dissipated assets of the debtor—assets that the trustee may now be able to recover for the estate.

The trustee also takes over a number of business operations. The trustee supervises the business and may sell the assets individually or as part of a sale of the going-concern business, depending on an assessment of what will yield greater value to the estate. The court may permit the trustee to operate the business for a limited period, if doing so will benefit the estate. (section 721) It is the trustee's obligation to file business reports and tax returns on behalf of the estate.

When the estate is wound up and the trustee has liquidated all the property and distributed the assets, he or she will make a final report and a final accounting of the administration of the estate with the court and with the U.S. trustee. (section 704(9))

In addition to monitoring the activities of the debtor, the trustee examines the claims for payments submitted by the creditors. By doing this, the trustee makes certain that the estate pays to each creditor only its entitled share of the estate's assets. This obligation often will include examination of the amount a creditor claims, challenge to the creditor's secured status or priority repayment claim, and examination of whether payments were made to the creditor immediately before the bankruptcy filing that can now be set aside. (section 704(5))

Creditors are required to file proofs of their claims by a date specified by the court, usually ninety days after the initial meeting of creditors. (section 341, Rule 3002) If the amount of a claim is disputed by the trustee, the court will determine its value. (sections 501(a), 502(a), (b)) The creditors may act collectively through an elected creditors' committee to make recommendations to the trustee and to question the administration of the estate, although, again, most Chapter 7 cases proceed without sufficient creditor interest to induce formation of such a committee. (sections 702(a), 704(a), 705(b))

Once the trustee has gathered and liquidated the assets and established the validity of the claims against the estate, the trustee distributes those assets to the creditors. The order of distribution is set out in the Bankruptcy Code as follows: (1) creditors with valid security interests receive either the proceeds from the sale of their collateral or the collateral itself if the trustee has abandoned it; (2) creditors with priority claims are paid according to a priority list set forth in the Code; and (3) the remainder of the estate is divided pro rata among all the creditors with claims still unpaid. (sections 726, 506, 507) If the trustee has sold the business as a going concern, the intact business is transferred to the new buyer with the security interests in place against collateral, and the proceeds from the sale are distributed to the creditors with priority claims and those with general unsecured claims according to Steps 2 and 3 above. (sections 725, 726)

When the distribution is complete, individual debtors are discharged from their responsibility for remaining debt. (section 727(a)) Corporate debtors and partnerships are denied discharge, however, so that "liquidation" for a business in Chapter 7 is more than metaphorical. (section 727(a)(1)) The affairs of the corporation or partnership are wound up. If the assets have been sold or abandoned, the business ceases to exist; if the business has been sold as a going concern, it survives under new ownership and control.

This final point—that businesses die in Chapter 7—is worthy of special note. It is the reason for its unpopularity among business debtors. In effect, a business Chapter 7 is a winding up of the company or a sale of the company as a going concern to new owners. For management unwilling to walk away from a failed enterprise and owners unwilling to abandon their investment, it means that Chapter 11 is the only hope.

All reorganization efforts, for both consumers and businesses, proceed in the shadow of the Chapter 7 alternative. Few businesses voluntarily choose liquidation,[6] but Chapter 7 is nonetheless critical to the bankruptcy system. Reorganizations are designed and evaluated by comparison with the outcomes available under Chapter 7. For example, preference recovery and plan confirmation in Chapter 11 depend on calculations of the treatment creditors would have received under Chapter 7. (sections 1129(a)(7)(A), 547(b)) Moreover, the conceptual elements of the Chapter 11 system were developed by varying and modifying principles established in the liquidation context, so that the outlines of Chapter 7 are embedded in the framework of reorganization under Chapter 11.

Chapter 11

The ways in which Chapter 11 differs from Chapter 7 become evident at the instant of filing. Instead of requiring appointment of a trustee to liquidate and distribute the assets of the estate, Chapter 11 leaves the debtor in control of the assets. The ultimate goal is not the orderly winding up of the debtor's affairs, but the reorganization of its business. In effect, there are three successive entities in a successful Chapter 11 proceeding: the pre-bankruptcy debtor, the post-filing estate, and the post-bankruptcy business that emerges from the reorganization process.

---

6. According to the Administrative Office of the U.S. Courts, business filings are roughly divided between Chapter 7 and the reorganization chapters—Chapters 11, 12, and 13. These filings include a large number of individual cases, however, and are not limited to incorporated businesses, for which most experts believe the proportion of Chapter 11 filings is much higher.

A voluntary Chapter 11 filing begins with a petition like the one that initiates a Chapter 7 filing. After the filing, however, the management of the debtor's business retains control of the new Chapter 11 entity. A trustee is appointed only if the court finds cause, such as fraud, dishonesty, incompetence, or gross mismanagement by the debtor. (section 1104) Management continues to function, now in the guise of Debtor in Possession (DIP)—in possession, that is, of the bankruptcy estate. The DIP enjoys all the rights of and must perform all the duties of a court-appointed trustee. (section 1107(a)) Management's obligations under Chapter 11 are similar to those of the Chapter 7 trustee: to be accountable for all property received, to examine the creditors' claims, to furnish information about the estate to the creditors, to file business reports and tax returns, and to make a final report and accounting of the estate. (section 1106(a)(1)) The DIP also investigates the financial condition of the debtor, its assets and liabilities, its past conduct, and its business prospects. (section 1106(a)(3)) However, the Chapter 11 DIP is fundamentally unlike the Chapter 7 trustee in that it is not required to gather and liquidate the assets. Instead, the DIP is authorized to operate the business if it is in the interests of the estate to do so.

The DIP can take advantage of a number of Code provisions to reshape the business. The estate may assume some outstanding contracts and reject others, recover preferential payments from some creditors, avoid certain liens against the estate, recover fraudulent conveyances, and equitably subordinate some debts. (sections 365, 544, 547, 548) Labor contracts may be abrogated. (sections 1113, 1114) The DIP may arrange for new financing for business operations. (section 364(a), (b))

The creditors may meet and act collectively, as they can during a Chapter 7 proceeding. (section 1102(a)(1)) The court may order the appointment of additional committees of creditors or of equity holders if they are necessary to ensure adequate representation of different interests. (section 1102(a)(2)) Creditors may file proofs of their individual claims, although they need not do so if the listing in the debtor's schedules is accurate. (section 1111(a))

The DIP, or in some cases the creditors, may propose a plan of reorganization. (section 1121(b)) The proposed plan will be circulated to the creditors, who will vote on whether to approve it. The plan might call for the restructuring of certain obligations, the partial repayment of others, and the discharge of some debt. (sections 1123, 1126) It will generally classify creditors according to the kinds of claims they hold (i.e., secured, priority unsecured, or general unsecured); creditors' treatment under a plan may thus be greatly affected by how their claims are classified. (section 1122) Similarly, creditors' voting rights with respect to a plan's confirmation will turn on classification. A plan may be confirmed consensually only if, within each creditor class, the holders of a majority of the number of claims and representing more than two-thirds of the amount of the debt vote in its favor. (section 1126) If some classes vote against a plan, it may nonetheless be confirmed in certain circumstances in a proceeding known as a "cram down." (section 1129) In any event, no plan may be confirmed if it does not meet a number of basic legal requirements, most notably, each dissenting creditor must be paid the present value of what it would have received in a Chapter 7 liquidation and the court must find that the plan is feasible. (section 1129(a)(7), (11))

Plan-confirmation hearings set the parameters of the terms for converting or selling the Chapter 11 estate to the post-reorganization business. At plan confirmation, ownership of the post-reorganization business is determined. The plan may call for a distribution of stock in the new business to pre-bankruptcy creditors that are not otherwise paid off under the plan. Or, new buyers may purchase the business. Or, with the consent of the creditors, old equity holders may stay on in the reorganized business. Some plans combine elements of all three approaches.

If a plan cannot be confirmed, the case is either converted to a Chapter 7 proceeding for liquidation and distribution of assets, or it is dismissed from the bankruptcy process altogether and the business is dismantled under the general state-law collection system. If a plan is confirmed and implemented, the Chapter 11 estate ceases to exist. The post-reorganization business operates like any other, with neither the protections nor the burdens of the operating procedures imposed in bankruptcy. The business is obligated to fulfill its promises under the confirmed plan, and it can be sued if it does not.

Chapter 7–Chapter 11 Interplay

Current estimates suggest that more than 80% of Chapter 11 cases fail before confirmation.[7] Very large business bankruptcies fare considerably better than this—more than 90% reach confirmation[8]—but they make up only a tiny portion of the total business filings. Because of the uncertainty of making it through to a successful plan, Chapter 7 lurks in the background throughout the course of every Chapter 11 reorganization effort. Whenever it appears that the debtor will not be able to confirm a plan of reorganization, the creditors threaten the debtor with liquidation. At the same time, recognizing that most creditors will be paid more in a successful Chapter 11 cases than they will receive in a Chapter 7 case, debtors trying to negotiate with their creditors in the course of a Chapter 11 case will often threaten to liquidate the business themselves. In effect, the debtor is much like a person standing in the window of a tall building and threatening to jump while the creditors are threatening to push him.

Chapter 7 and Chapter 11 together frame the bankruptcy alternatives for business debtors. While Chapter 7 is rarely the first choice, it is nonetheless conceptually integrated into the Chapter 11 reorganization scheme. It is also where the bodies of the failed Chapter 11 cases are sent.

Policy Considerations

One of the goals of bankruptcy is to enhance the value of the estate. In its broadest outlines, Chapter 7 can be seen as effectuating that goal. It creates an orderly process for the collection and sale of the assets of the estate, so that much of the chaos—and the concomitantly depressed prices—of a piecemeal liquidation can be avoided.

---

7. Administrative Office of the U.S. Courts, Bankruptcy Statistical Information (April 1990) (estimating that 17% of Chapter 11 cases filed prior to 1987 would be confirmed).

8. Lynn LoPucki & William Whitford, *Venue Choice*, 1991 Wis. L. Rev. 11, 41 n.105; Lynn LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code*, 57 Am. Bankr. L.J. 99, 109 (1983) (reporting on an empirical study that showed a positive correlation between size and likelihood of confirmation).

Sheriff's sales, conducted at the behest of a creditor seeking only a large enough return to satisfy the debts it is owed, are avoided. Moreover, the Chapter 7 trustee has the power to enhance the value of the estate by investigating the affairs of the pre-bankruptcy debtor, looking for undiscovered assets, and exploring whether the estate may have certain rights against other parties. The trustee can also reduce total collection costs. By acting on behalf of all the creditors and sharing the expenses of discovery and management, the trustee ensures that the costs of pursuing assets in a liquidation are diminished and that creditors with relatively small stakes can benefit from collection efforts that might have been too expensive to pursue individually. Chapter 7 liquidation is designed to generate greater value on behalf of the creditors collectively than the creditors would have received in the individualistic race of general collection law.

The distributional objectives of Chapter 7 are fairly explicit. Certain creditors are given special treatment, and secured creditors and creditors with priority claims come out ahead of the pool of unsecured creditors. For creditors within the same legal classification—the general, unsecured creditors—pro rata distribution replaces the general-collection-law race that permits aggressive creditors to get paid in full while cooperative creditors get nothing. The bankruptcy system substitutes a distributional scheme clearly at odds with the state collection system.

Chapter 11 implements the same fundamental bankruptcy policies as Chapter 7, while attempting to improve on the value-enhancing functions of Chapter 7. Chapter 11 provides for the same orderly collection of assets. But by permitting operations to continue through the reorganization process, Chapter 11 attempts to get as much as possible out of the troubled business. Going-concern value is protected and sometimes even enhanced. By curtailing the collection rights of individual creditors, Chapter 11 increases the overall value of the estate. Financial obligations that drain the business can be modified and, if necessary, discharged.

The value-enhancing objective of Chapter 11 is explicit. For example, a reorganization plan must pay at least the present value of a Chapter 7 liquidation. If it does not, any objecting creditor can derail the plan. If the plan does not generate a greater return than liquidation does, it is not to be confirmed. Similarly, creditors are given the opportunity to vote their economic interests. When they disagree, confirmation depends on whether there is sufficient evidence that overall reorganization will put the creditors in a better position than liquidation would. The details of this process are discussed in later chapters of this book, but the thrust—if not always the effect—of bankruptcy law is to bring greater value to the creditors of a failing estate and to distribute that value according to an established scheme.

Creditors' Right to File Bankruptcy

Although it is the debtor in financial trouble that usually invokes the benefits of the Code, those benefits are available to creditors as well. (section 303) Creditors rarely file involuntary petitions against their debtors, but their ability to do so is an important part of the bankruptcy scheme.

Filing Requirements

Creditors may file an involuntary petition under either Chapter 7 or Chapter 11. (section 303(a)) Reorganization under one of the other chapters—Chapter 9, Chapter 12, or Chapter 13—can be initiated only voluntarily by the debtor. Creditors may file against anyone who is eligible for a Chapter 7 or Chapter 11 proceeding, except farmers and not-for-profit corporations. The latter may not be the subject of involuntary filings even though they may file in either chapter voluntarily. (section 303(a))

Three or more creditors must join in an involuntary petition, and their claims must aggregate at least $5,000 of unsecured debt. (section 303(b)(1)) To count toward the debt limit, the claims must not be contingent or the subject of a bona fide dispute. (section 303(b)(1)) If a debtor has fewer than twelve creditors, one or more creditors with total unsecured claims of at least $5,000 may file. (section 303(b)(2)) After an involuntary filing, other creditors may intervene. Because these creditors have added themselves to the petition, their claims will count toward the filing requirements. (section 303(c)) Partnerships face the difficult possibility that one or more partners—but not all—may want to file for bankruptcy for the partnership. A filing of fewer than all the partners is treated as involuntary and must meet the Code restrictions on involuntary petitions. (section 303(b)(3))

The debtor may contest the involuntary petition. (section 303(d)) If that occurs, the bankruptcy court may decide the case by summary judgment or it may conduct a trial. The court may order relief against the debtor on two grounds only: if the debtor is generally not paying its debts as they come due, or if a general custodian has been appointed to deal with the debtor's property within 120 days before the petition was filed. (section 303(h))

The first permissible ground for an involuntary petition—generally not paying—is notable because it does not rely on any of the traditional badges of insolvency or on balance-sheet tests of insolvency. It does not ask whether the debtor *could* pay, but rather whether the debtor *is* generally paying debts that are not subject to bona fide dispute. It is a shorter, more direct inquiry that avoids the complications, uncertainties, and expenses of searching out financial records which the creditors have little pre-petition access to and which may be in disarray once they are found. The test focuses on the question of most immediate interest to the creditors: Is the debtor generally paying its debts? The ultimate decision is very fact-specific, and courts concentrate on a number of factors, including the proportion of debts not being paid, the importance of those debts, and the extent to which the debtor may be paying its debts late but eventually pays them.

The second permissible ground for declaring the debtor bankrupt involves even less inquiry, but it is rarely used because it is based on state collection proceedings that are rarely invoked. If the debtor has suffered the appointment of a custodian, such as a state-law assignment for the benefit of creditors (typically called an ABC), the creditors have 120 days to move the case to a bankruptcy court. (section 303(h)) The Code shows a definite preference for federal bankruptcy relief, granting the debtor virtually unfettered rights to file in bankruptcy and giving the creditors the option to pursue their claims in bankruptcy court rather than state court if it appears that the debtor's failure is imminent.

The debtor may decide not to resist an involuntary filing. If it does not resist, the court will order relief under the petition. (section 303(h)) The debtor may also accept the filing and convert the case for proceedings under another chapter for which it is eligible. (sections 706, 1112, 1208, 1306) Creditors who might like to resist the filing, such as those who were faring well in the state-law proceedings, have no standing to contest it. (section 303(d))

Dismissals

Even if grounds for an involuntary bankruptcy exist, the court has broad power to dismiss a petition if it finds that the interests of all the creditors and the debtor would be better served by dismissal. (section 305(a)(1)) This provision has rarely been invoked—for example, where the debtor has worked out a state-law composition with its creditors and, at the last minute, one creditor decides it would prefer to see the case resolved in bankruptcy. Nonetheless, such a broad grant of power, coupled with little direction other than to do what works best, illustrates a philosophical approach that is repeated in other Code sections. The Code generally articulates the procedures and the grounds on which the courts should act, but it is shot through with unguided—and unconstrained—grants of power to the bankruptcy courts to do whatever seems reasonable under the circumstances.

If the debtor resists the involuntary petition and the court determines that the necessary grounds are not present, the court will dismiss the petition. (section 303(h)) The court may then charge the filing parties with the fees and costs incurred by the debtor in resisting the petition. (section 303(i)(1)) To discourage strategic creditor filings for purposes other than collection, the court is given broad discretion, on determining that a filing was made in bad faith, to assess costs to cover other damages imposed on the debtor or to award punitive damages. (section 303(i)(2))

Policy Considerations

Not every bankruptcy filing is wealth enhancing. Some filings reduce rather than enhance the value of the estate—particularly if the debtor's business was not failing. A bankruptcy filing can injure a debtor's business and make business operations difficult. The fact of filing can drive away customers, scare off employees, and dry up credit. Permitting the creditor to threaten to put the debtor in bankruptcy may help the creditor collect for itself outside bankruptcy—but at the expense of the other creditors and the survival of a business.

Still, the primary benefits of the bankruptcy filing ultimately flow to the creditors, so it is unsurprising that the Code permits creditors to have recourse to the system themselves. Creditors can, for example, use bankruptcy to enhance the value of the estate, demanding a going-concern sale rather than a piecemeal liquidation. They can use bankruptcy to select the distributional scheme they find most beneficial. Unsecured creditors who have been slow to dismantle the debtor at state law can use bankruptcy to equalize their rights with those creditors who moved earlier in the process. Although the creditor has considerably less information on which to base such a decision, and the risk that a filing will injure the business is substantial, the provisions on involuntary bankruptcy filings reflect a careful balance of creditors' interests in using bankruptcy when the debtor collapses and the debtor's interest in maintaining a viable business free from damage by the creditor.

In fact, creditors make infrequent use of the bankruptcy system. Less than 1% of all bankruptcy filings are initiated by the creditors.[9] In addition to the informational problems that a creditor faces and the Code penalties for a wrong guess, one reason for creditors' infrequent use of bankruptcy is that the creditors most likely to overcome the information barriers are often the same ones that would lose rights rather than gain them in bankruptcy. Often, the creditor most likely to monitor the debtor and to act if the debtor has difficulty paying is the same creditor that protected itself at state law either by securing the debt or by moving early to collect on an unsecured debt. Such a creditor often profits more from piecemeal liquidation in the state system than it would from the collective action of bankruptcy.

Notwithstanding their reluctance to file an involuntary petition in bankruptcy, creditors often participate indirectly in the filing decision. When creditors prefer that a debtor deal with its problems in

9. In the fiscal year ending 1988, for example, of the 594,567 total bankruptcy filings, only 1,409 were involuntary petitions. Moreover, the proportion of petitions that have been initiated by the creditors has declined throughout the 1980s. Administrative Office of the U.S. Courts, Annual Tables. LoPucki and Whitford noted, however, that involuntary bankruptcies are much more frequent in large cases. Their study revealed that 14% (6 of 43 cases) were initiated by involuntary filings. LoPucki & Whitford, *supra* note 8, at 26 n.54.

bankruptcy—as they sometimes do—they have alternative methods for accomplishing that end. Secured creditors may repossess key collateral under state law, thus forcing the debtor to file for bankruptcy protection in order to retain the property and forestall immediate closure of the business. Unsecured creditors may also pursue critical property—through state collection, judicial liens, and sheriff sales—with the intent of forcing a bankruptcy filing. Some lenders may require a bankruptcy filing as part of the price of refinancing a troubled debtor, since loans made post-petition enjoy greater protection. Trade creditors, owed outstanding obligations, may refuse to ship, precipitating a crisis for a business. They may couple their refusal with an offer to resume shipments as soon as the debtor files for bankruptcy, making their new debts an administrative expense of the business and more likely to be repaid in full. As these scenarios illustrate, that a petition is deemed "voluntary" if the debtor initiated the paperwork and "involuntary" if the creditors did so may fail to reflect the true mental states or motivations of the parties.

Although involuntary petitions are rarely filed, their presence in the Code scheme provides a background for pre-bankruptcy discussions and workouts of troubled loans. They are sometimes used to great effect by creditors seeking to invoke the distributional scheme of bankruptcy, and they serve as some moderating influence on the debtor's operation of its business when it is in financial difficulty.

Businesses That Use Bankruptcy

While this book offers an overview of the bankruptcy system, with an emphasis on rules and doctrines, policies and strategies, it would be incomplete if it pretended that all debtors and creditors used the system alike. In fact, how debtors and their creditors use the bankruptcy system differs dramatically from setting to setting. And it requires some sense of that setting for the rules and policies to become meaningful.

The key differences in the use of the bankruptcy system occur when the system is invoked by big businesses or by small businesses. A large company filing for Chapter 11 may have a team of lawyers, accountants, investment bankers, and public relations specialists who number well into the hundreds. The filing may draw national attention, and some disputes may be played out in the popular press. Creditors are likely to be active, typically monitoring the debtor's activities closely. At the same time, the business dealings of the debtor may be so complex that only a chosen few people may fully understand the operation, so that the possibility for continuing to operate the business without the complete understanding of either the court or the creditors is high. Both debtors and creditors usually have ample resources to fight their battles. Creditors may be very sophisticated, making a complicated resolution of the cases not uncommon. Success rates in very large cases tend to be high and payouts are substantial.

In small cases a Chapter 11 proceeding can look very different. Debtor management may not seek legal help until some legal action has been instituted that will have the effect of shutting down the business, and the decision to file may be made under acute time pressure with little opportunity to explore all the ramifications of a filing—or the possibility of an out-of-bankruptcy workout. Creditors may not take much interest in the bankruptcy proceedings, either because the costs of such participation will most likely exceed their recovery or because they have too little information to understand what they could accomplish in a bankruptcy case. Cash-flow problems plague the small business, and many attorneys are never paid their fees in full for representing a small business in trouble. Failure rates in small business cases are high, often exceeding 90%.

The rules applicable in bankruptcy proceedings do not differ from small to large cases, but the impact of the rules can differ sharply in these different settings. When it seems most appropriate, this book distinguishes between how a rule or a policy may work in small bankruptcies and in large bankruptcies.

What is a large case and what is a small case? There is no clear demarcation. Cases of publicly traded companies are usually large bankruptcies when they are filed, but there are large bankruptcies among privately held companies as well. Different dollar figures could be used to define "mega-cases" or other large cases, but such technical definitions are unnecessarily complex for the purposes of this discussion. Here the term "small business bankruptcy" is used to refer to the filings of privately held businesses with limited assets and debt and usually only one or two lines of operation—the cases that constitute the overwhelming bulk of the business bankruptcy docket. The term "large business bankruptcy" is used for the much less frequent case that involves assets and debts running into the tens of millions and beyond and that triggers the kind of active representation of both debtors and creditors that tends to characterize any dispute where a great deal of money is at stake.

There is only one official business bankruptcy system, but it sometimes takes on the characteristics of two different systems. This discussion tries to account for the reality that confronts the rules and policies of the legal system.

Conclusion

Both debtors and creditors may invoke the protections of the bankruptcy system, although in practice debtors seek the help of the bankruptcy system far more often than their creditors do. Chapter 7 is a liquidation alternative that aims toward a quick sale of the business assets, whereas Chapter 11 works toward the confirmation of a reorganization plan that transfers the surviving business to those contributing to the plan. Any management that can convince itself that there is value to be preserved in continuing the business, and any owner that hopes to participate in the surviving business, will prefer a Chapter 11 reorganization to a liquidation either under Chapter 7 or at state law. But, as the data suggest, the restrictions of Chapter 11 prove difficult for many troubled businesses, and the overwhelming majority of businesses fail to make it to plan confirmation.

The remainder of this book focuses on the Chapter 11 alternative—the requirements imposed by the Code, how those requirements express various policy objectives of the bankruptcy system, and how various parties use those requirements as they work through a Chapter 11 reorganization.

3 The New Entity: The Bankruptcy Estate

When a bankruptcy petition is filed, a new entity is created—the bankruptcy estate. Metaphorically, bankruptcy is much like death: One entity ceases to function, and an estate succeeds to the obligations and property of the deceased. Much like the law of decedents' estates, the law of bankruptcy governs the operation of the post-filing business and the disposition of property of the pre-bankruptcy debtor. In effect, the old, pre-bankruptcy debtor has no more property, no more contractual rights, and no more power to pay bills or to incur new obligations. At filing, the new bankruptcy estate succeeds to all the rights—and receives some new ones of its own.

When the Bankruptcy Code creates a new entity, it provides protection for that entity as well. An order for relief is entered, as a matter of law, at the instant the debtor files its petition, well before a judge hears the case or a creditor receives notice.[10] (sections 301, 303(h)) The effects of this order for relief are far-reaching and affect everyone who dealt with the old debtor or who deals with the new estate.

---

10. In an involuntary bankruptcy, the date of the order for relief is the date the involuntary petition is granted by the court. Because the debtor may successfully resist the involuntary filing, however, the entry of the order in an involuntary bankruptcy is not automatic. It will not occur until the court so orders, either because the debtor has failed to controvert the filing in a timely manner or because the creditor has successfully demonstrated that grounds for an involuntary petition exist. The date of the initial filing—as opposed to the order for relief—is important for a number of other purposes, such as determining when the preference period begins to run. For a fuller discussion of involuntary bankruptcies, see Chapter 2 *supra*.

The cleavage between the old debtor and the post-filing estate occasioned by the act of filing a bankruptcy petition is critical to the bankruptcy system. The conceptual separation between the old debtor and the new estate helps to explain both the new powers enjoyed by the post-filing estate and the new limitations imposed on the estate's operation. The bankruptcy court exercises supervision over the estate that no court would ordinarily exercise over a nonbankrupt business. At the same time, the creditors' rights are sharply curtailed, in that collection against the estate is modified and channeled through the bankruptcy court.

The focus of this chapter is the initial shift in the rights of the parties at the commencement of a bankruptcy proceeding: the automatic stay to stop collection, the transfer of property of the debtor to the bankruptcy estate, and the conversion of creditors' claims against the old debtor into claims against the new bankruptcy estate.

The Automatic Stay

The linchpin of the bankruptcy system is its imposition of an automatic stay against all attempts to collect from the debtor. In effect, at the filing of the bankruptcy petition, the new estate comes under the full protection of federal bankruptcy law. From that moment on, no one can commence or continue any act to collect any obligation owed by the pre-bankruptcy debtor. (section 362(a)) All claims against the pre-bankruptcy debtor become claims against the bankruptcy estate for resolution in the bankruptcy process.

Scope of the Stay

The provisions of the automatic stay are drafted in the broadest terms possible. The Code has seven different ways of saying that all collection efforts shall cease at the time of the bankruptcy filing. The stay operates against any attempt to begin or to continue any legal proceedings against the debtor. (section 362(a)(1)) It operates against the enforcement of any judgment already obtained. (section 362(a)(2)) It operates against any attempt to obtain possession or control of property of the estate. (section 362(a)(3)) It operates against any attempt to create, perfect, or enforce a pre-petition lien. (section 362(a)(4),(5)) It operates against any setoff of a pre-petition debt. (section 362(a)(7) It stops any proceedings before the U.S. Tax

Court. (section 362(a)(8)) Perhaps the clearest statement of the overall intent of the automatic stay is that filing a bankruptcy petition shall operate as a stay against "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title." (section 362(a)(6))

In order to make the protection of the automatic stay as complete as possible, the Code states that the automatic stay operates as a prohibition against "all entities"—including the sheriff, the marshal, and the collection agency. Moreover, the automatic stay applies to actions against the debtor (section 362(a)(1), (2), (6), (7), (8)), property of the estate (section 362(a)(2), (3), (4)), and property of the debtor (section 362(a)(5)).

Not every entity owed an obligation by a bankrupt debtor will think of itself as a creditor. Indeed, for many parties there may be a dispute over whether a debt is owed at all. Nonetheless, the automatic stay applies to all claims against the estate, including claims that are disputed, claims that are contingent, and claims that are unliquidated. (section 101(4)) Thus, the attempt to establish in court that a debt is due, as one step in the process of collection, is halted. Even creditors asking for equitable remedies rather than money payments must cease their efforts; both requests for remedies and requests for payments are collection attempts under the Code, and both are halted. (section 101(4))

Creditors that violate the stay are subject to sanctions, including fines and civil imprisonment until they comply with the court's order.[11] Moreover, collection actions in violation of the automatic stay are generally treated as having no effect. The Code requires creditor compliance even if the creditor has not received a formal notice of the filing. (section 362) A violation is a violation; knowledge of the filing is relevant only to the question of willfulness and the scope of an appropriate remedy. Debtors injured by a violation of the automatic stay may collect costs and attorneys' fees and, in cases involving willful violations, punitive damages. (section 362(h))

In real terms, once a petition is filed, creditors may not continue to ask for payment of pre-petition obligations. They cannot make

11. What sanctions may be imposed by the bankruptcy court directly and what sanctions must issue only from the district court are discussed in Chapter 7 *infra*.

dunning phone calls or send bills. They cannot sell the debtor's property at a private sale or permit the sheriff to sell the property at a judicial sale. They cannot repossess property, and they cannot retain property they repossessed earlier. They cannot take a security interest, perfect a lien,[12] or set off a debt. They cannot initiate a lawsuit against the debtor or continue a lawsuit in progress. Any post-filing enforcement of any obligations against the debtor must be channeled through the bankruptcy court.

The business may continue to operate, to use collateral, to spend money, and so on, subject to the restrictions discussed in the next chapter. It may even continue its own lawsuits against others. But actions against the business cease, creating a markedly different operating environment for the post-filing business.

Who Benefits from the Stay

Collection actions are not always confined to a single party. Sometimes creditors proceed against a number of related entities, such as a tortfeasor and its insurer, an obligor and its guarantor, a corporation and its directors, or a partnership and its individual partners. It is not uncommon for one party to file for bankruptcy while the other party subject to collection attempts does not. In such instances, the nonbankrupt party may ask for a stay of collection activities against it while the bankruptcy proceeds and the bankrupt debtor makes efforts to pay some portion of the joint obligation.

Nothing in section 362 extends the stay beyond the named debtor, property of the debtor, and property of the estate. Nonetheless, the Code gives the bankruptcy court a general equitable power to effectuate its decisions. "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." (section 105(a)) To have a meaningful automatic stay against the debtor, courts have sometimes invoked this provision to extend the stay to include other parties. Typically, they have done so when collection efforts against a nonfiling party would injure the estate. Such injury might occur in

---

12. There is a narrow exception to the general rule that a creditor cannot take any steps to perfect a lien post-filing. That exception is discussed *infra*.

any number of ways. For example, a debtor might be called on to defend a suit against related parties, thus drawing its time and attention away from its reorganization efforts; in such situations, some courts have stayed actions against officers of the debtor corporation.[13] Or the result of a suit against a related party might necessarily be to increase liability against the estate; in these cases, some courts have stayed actions against insurers or co-makers with rights of indemnification.[14] Finally, successful collection against a party might deplete assets that the debtor could otherwise draw upon; faced with this possibility, some courts have stayed actions against the individual partners of a debtor partnership when they have promised to help fund the partnership's repayment plan.[15]

The broad equitable power granted in section 105 reappears from time to time in the analysis of various Code provisions. The jurisprudential approach it demands is characteristic of the design of the Code: Specific rules governing collection rights following a bankruptcy filing are coupled with a nonspecific grant of whatever power is necessary to effectuate the Code's provisions. The specific rules are in place to provide certainty, to encourage parties to plan their affairs in advance, and to reduce litigation and enhance settlement. The rules strike an explicit balance between the rights of the estate and the rights of individual creditors. But the Code also acknowledges that the rules will not cover all the circumstances of every failure. The residual grant of power is broad so that the court can provide protection in unanticipated circumstances to assist in the resuscitation of a failing business. Courts are reluctant to use such unrestricted grants of power to rewrite bankruptcy obligations, however, and the statutory injunction that the court should use its power "to carry out the provisions of this title" creates difficult jurisprudential problems. The provision gives the bankruptcy courts the opportunity to make case-by-case decisions to

---

13. *See, e.g.*, United States v. Seitles, 106 B.R. 36 (Bankr. S.D.N.Y. 1989) (extending stay to president as sole executive officer of debtor corporation so that president could concentrate his efforts on rehabilitation).

14. *See, e.g.*, A. H. Robbins, 880 F.2d 769 (4th Cir. 1989).

15. *See, e.g.*, *In re* Myerson & Kuhn, 121 B.R. 145 (Bankr. S.D.N.Y. 1990) (extending stay, through a temporary restraining order, to partners who promised to contribute money to help pay partnership's debts).

effectuate the larger principles of the Code. At the same time it forces the courts to confront the question of when the opportunity becomes an obligation, and how far afield they should range in finding protection for bankrupt debtors.

Exceptions to the Stay

Not surprisingly for a provision so broadly written, there are also statutorily provided exceptions to the automatic stay. But the exceptions are drafted narrowly to permit only limited activities against the estate.

The specific exceptions meet a number of different, but fairly obvious, objectives. Criminal proceedings against the debtor may continue. (section 362(b)(1)) The reason for this exception is not surprising. The Code is designed to apportion losses among creditors, not to provide a refuge from the enforcement of criminal laws. The government has an interest in enforcing criminal laws, which the drafters of the Code decided would take precedence over bankruptcy's automatic stay. At the margins where enforcement of criminal sanctions involves the payment of money, as in restitution payments for criminal activity or the prosecution of bad-check charges, the courts have struggled to separate debt collection attempts that should be stayed by a bankruptcy petition from those that should go forward under the criminal-action exception. In general, the distinction the courts have settled on looks to whether the state is attempting to collect a pre-petition debt (in violation of the bankruptcy system's principles of distribution) or whether it is trying to enforce the social interests articulated in a criminal prohibition (to which the bankruptcy system explicitly defers).

A second exception permits a governmental unit to commence or continue an action to enforce its "police or regulatory power" without violating the automatic stay. (section 362(b)(4)) In part, this provision supplements the power granted to the state in subsection (b)(1), discussed earlier. But it also extends that power by allowing the state to pursue a wide range of regulatory objectives that do not involve criminal sanctions. Here is the authority for a governmental unit to continue enforcement of toxic-dumping prohibitions, safety regulations, and licensing requirements even against the new bankruptcy estate. Again, however, collection functions and regulatory functions sometimes overlap—the government might, for example, seek both payment under a cleanup order for past dumping and a prohibition against future dumping. The regulatory exception is somewhat more narrowly drawn than the criminal-action exception is, providing relief from the prohibition of section 362(a)(1) on efforts to commence or continue proceedings, but not from the other provisions of the automatic stay, which prohibit efforts to collect. Once again, the court must untangle which actions are encompassed by the stay and which are not. And again, the guiding principle is whether the state is attempting to collect a pre-bankruptcy obligation from the estate, in which case it will have to process that claim through the bankruptcy court, or is exercising police or regulatory powers, in which case the Code defers.

A few other actions involving governmental regulatory functions are also permitted. Setoffs against commodity and security contracts in margin accounts and setoffs by repo participants have some limited protection. (section 362(b)(7), (8)) The Secretary of Housing and Urban Development may foreclose a mortgage insured by the National Housing Act for multiple-unit housing. (section 362(b)(8)) Taxing authorities may issue tax delinquency notices. (section 362(b)(9)) And special provisions exist for actions brought by the Secretary of Transportation under the Ship Mortgage Act. (section 362(b)(12), (13))

Private creditors have only a tiny window through which they may continue some actions post-bankruptcy. Creditors with unperfected interests have a limited opportunity to perfect them. (section 362(b)(3)) In practice, this exception usually means that a lender with a purchase money security interest obtained within ten days before the bankruptcy filing can still record the security interest during the period remaining on its ten-day window after the filing. (section 547(e)(2)(A)) A creditor with a statutory lien that requires subsequent actions to perfect may complete its perfection post-petition by giving notice to the debtor. (sections 362(b)(3), 546(b)) A lessor may remove a debtor whose nonresidential lease terminated prior to the filing, in effect making it clear that such eviction is not an action to collect. (section 362(b)(10)) A holder of a negotiable instrument may present the instrument for notice and protesting dishonor, largely to preserve its rights under U.C.C. Articles 3 and 4. (section 362(b)(11))

A party that can claim its activities are protected by an exception to the stay may continue the activities without court approval. Such a party acts at its own peril, however: If it is mistaken in believing that an exception applies to its activities, it has violated the stay and is subject to sanctions.

Lifting the Stay

The bankruptcy court may terminate or modify the automatic stay and permit specified creditor activity to go forward. There are two circumstances in which the court must lift the stay: (1) for cause, including lack of adequate protection of a creditor's interest in property; and (2) if the debtor does not have equity in property subject to a security interest and the property is not necessary to an effective reorganization.

The exceptions to the automatic stay center around permission for a secured creditor to repossess the collateral that is the subject of its security interest notwithstanding the stay imposed in bankruptcy. Thus, another distributional policy of the Code emerges: Creditors with perfected security interests receive better treatment than creditors without such interests. Secured creditors are given a limited right to repossess their collateral, liquidate it, and receive payment, whereas unsecured creditors have no corresponding right.

When the court permits or denies the secured creditor the right to repossess collateral that has become property of the estate, it balances the interests of an individual creditor against the collective interests of those who are helped by survival of the estate. The balance involves both value-enhancing and distributional aspects. Often, the estate will be more valuable if the property is left in place, but the secured creditor will run additional risks of nonpayment. The Code settles on a compromise: Secured creditors have somewhat protected status. The key distributional decision is obvious—on the one hand, secured creditors are not forced to give up all their possessory and collection rights and to participate pro rata with the unsecured creditors. On the other hand, their repossession rights are restricted so that the estate can benefit from the use of the collateral.

The details of the balance show the extent to which the bankruptcy system will deviate from a principle of equality of distribution in order to protect the preferred position of some creditors. The Code instructs the court to lift the stay, permitting repossession and liquidation of a piece of the estate, if the creditor is not given "adequate protection" of its interest in the property. (section 362(d)(1))

If the collateral is stable in value and unlikely to suffer either market decline or casualty loss, a court may determine that the creditor is adequately protected and the property will then be left in the estate. If, for example, the collateral is a valuable piece of machinery, fully insured and unlikely to decline in value as the estate uses it, a court will be unlikely to grant a creditor's motion to lift the stay. The court will most likely conclude that the creditor's interest is adequately protected simply by leaving the property in place.

For collateral that might decline in value, the Code provides that the estate may satisfy the adequate-protection requirement in a number of different ways and thereby retain the property. The estate may make cash payments to offset the decline in value, or it may provide additional or replacement liens on other property of the estate to offset the declines. (sections 361(1), (2)) Alternatively, the court may fashion any other relief that will give the secured party the "indubitable equivalent" of its interest in the collateral. (section 361(3)) If the collateral is a production machine, for example, the court may require the debtor to make payments equal to its depreciation and insurance costs.

When the court permits the estate to retain possession of collateral during the bankruptcy proceeding, it determines that the creditor's interest represented by the property is unlikely to diminish. Of course, for anyone familiar with the concept of time value of money, it is clear that the secured creditor suffers from such delay. Repossessing and liquidating the collateral immediately is obviously worth more than repossessing and liquidating months or even years hence in the course of the Chapter 11 proceeding, even if precisely the same sale price is achieved at either date. The appropriate balance was disputed in the courts of appeals in the 1980s, but the Supreme Court resolved the issue in *In re Timbers of Inwood Forest*

Association,[16] holding that "adequate protection" requires protection of the value of the collateral but does not require compensation for what the debtor lost because of the time value of money as a result of its inability to repossess. Thus a creditor could successfully lift the stay if it is owed $50,000 secured by collateral worth $40,000 if the collateral is declining in value by $1,000 each month and the debtor is making no payments to offset the loss. But if the value of the collateral is steady and the creditor's only loss is the interest it could make if it could foreclose the property and invest the cash elsewhere, the creditor is simply stuck during the bankruptcy process. The balance is clear: The secured party loses some rights (the right of immediate repossession and concomitant cash-out) to enhance the value of the estate, but it retains some rights (e.g., the right to repossess if the debtor cannot assure adequate protection) that put it ahead of the general creditors participating pro rata in the estate.

A somewhat different balance is reflected in the second provision under which the creditor may repossess collateral. If the debtor has no equity in the property and the property is not necessary to an effective reorganization, the stay will be lifted and the secured creditor may repossess, liquidate immediately, and reinvest its cash. The debtor cannot resist by showing that it can safeguard the creditor's position with adequate protection payments. Instead, if the creditor can show that the property does not enhance the value of the estate ("is not necessary to an effective reorganization") and the estate has not succeeded to partial ownership of the property ("debtor does not have an equity in such property"), the secured creditor prevails. This provision illustrates another aspect of the balance between the individual secured creditor and the collective interests of the estate: Secured creditors' possessory rights will be impaired only if the estate has some equitable claim to the property and it profits the estate to retain possession of the property.

Implications of Stay Litigation

Stay litigation often begins within days of the bankruptcy filing and quickly accelerates into a life-or-death struggle for the estate. The

---

16. 484 U.S. 365 (1988).

secured creditor, fearful of holding an interest in declining collateral that it cannot sell, wants to repossess. The estate recognizes that without the collateral the business will collapse. Stay litigation, with its heavy dependence on current and future valuation, is intensely fact-specific. Moreover, the courts are called upon to make judgments about the future valuations of both the property and the business, often being forced to decide early in the case whether the business has any hope of enhancing its value if it remains under the protection of the bankruptcy court.

If the stay is lifted too easily, the estate has no opportunity to enhance the value of the property to be distributed. Distribution to the creditors is closer to general collection law—the secured creditor takes the critical property and the other creditors line up for what little is left. If the stay is not lifted when it is appropriate, however, the value of the estate can be dissipated generally as the business struggles on in a hopeless quest. Moreover, if the value of the property declines below the amount owed to the secured creditor, the injury is imposed on that creditor directly and not shared among the creditors generally, which effectively imposes a different distributional scheme from the one articulated in the Code.

Experts estimate that about 60% of all bankruptcy litigation concerns lifting the stay. The consequences of this litigation are critical, and a delay in lifting the stay can cost the secured creditor dearly. In recognition of these factors, the Code provides for accelerated treatment of stay litigation. A stay is terminated 30 days after a creditor moves for relief, unless a court has ruled that the stay shall remain in effect. (section 362(e)) Empirical evidence suggests, however, that stay litigation often takes much longer.[17] The very factors that make it important to have an immediate answer also make it difficult for the court to rule on such an abbreviated schedule. Usually the parties are engaged in a monumental struggle over whether the business will continue operations. Other pressing matters, including emergency orders permitting businesses to stay in operation, are known to crowd out immediate resolution of stay

17. *See* American Bankruptcy Institute, Perception and Reality: American Bankruptcy Institute Survey on Selected Provisions of the 1984 Amendments to the Bankruptcy Code 45–46 (1987).

litigation. Although the bankruptcy courts tend to be quite sensitive to the consequences of delaying decisions that affect the survival of the business and tend to give stay litigation a high priority, continuances are typical when relief from the stay is sought.

Policy Objectives

The automatic stay serves, metaphorically, to lock all the doors and windows of the newly created bankruptcy estate until the assets can be accounted for and rational decisions about their distribution can be made. Because old management of the business is typically left in place,[18] especially during the period immediately following the bankruptcy filing, this period is often referred to as a "breathing space" for management to hold off collection attempts and to prevent the estate from being dismantled while it plans a strategy to improve the value of the business.

At the instant of filing, the relationship between the old debtor and its creditors is transformed. Until the filing, the relationship is governed by a general collection system of "each creditor for itself," and the debtor is able to resist some creditors, pay others, and manage its assets as it sees fit. At filing, creditors' actions move from individualistic to collective. Creditors' rights in bankruptcy are determined by legal classification. If a creditor tries to take more than its determined share, both the debtor and other creditors have the power to resist. The automatic stay is critical to the Code's collective proceeding, permitting only limited exceptions for individual creditor action.

These consequences are consistent with the overall policy goals of the bankruptcy system to enhance the value of the bankruptcy estate and to require a new allocation of the losses of economic failure. By holding off individual debt collection, the manager of the estate can make a more considered disposition of the assets. And, as the assets are collected and maximized, the de facto distributional scheme of state law yields to the distributional scheme imposed by the bankruptcy system.

---

18. The interim management of the bankruptcy estate is discussed in Chapter 4 *infra*.

Property of the Estate

The bankruptcy filing creates an estate. (section 541(a)) At the instant of filing, all the debtor's legal and equitable interests in property are transferred to the estate. This transfer is automatic and unconditional. With a few exceptions discussed *infra,* restrictions on transfer that would be enforceable against the pre-petition debtor are vitiated by the Bankruptcy Code.

What Is Property of the Estate?

Property of the estate encompasses the widest possible sweep of property from the old, pre-bankruptcy debtor. "All legal or equitable interests of the debtor" as of the commencement of the case are conveyed to the estate. (section 541(a)(1)) The debtor's interest may be full ownership, or it may be something less, such as the possessory interest of a lessee. Whatever the scope of the debtor's interests, the estate succeeds to them. Similarly, it does not matter where the property is held; property of the debtor that is in the custody of others is automatically transferred to the estate, and custodians of such property are required to turn it over to the bankruptcy estate as soon as they learn of the bankruptcy. (sections 541(a)(3), 543(a))

Claims of a debtor against others are another form of property of the estate. Warranty claims benefiting the debtor, lawsuits the debtor might pursue against others, insurance proceeds covering the debtor's losses, claims of a bankrupt debtor partnership against its general partners, and claims of a corporate debtor against its officers and directors—all become claims that belong to the bankruptcy estate. (section 541(a)(1))

The estate also becomes the owner of the books and records of the pre-bankruptcy debtor's financial affairs. (section 542(e)) Attorneys, accountants, and others with information about the debtor's financial circumstances may be required, subject to any applicable privilege, to disclose such information. (section 542(e))

The estate is not fixed at the filing of the bankruptcy petition. It can conduct business after filing, generating new property that will become property of the estate. (sections 1108, 541(a)(7)) Property in the estate may produce more property, such as rents and proceeds, and that property, too, will come into the estate. (section 541(a)(6)) Life insurance benefits paid to the debtor as beneficiary within 180 days of the filing of the bankruptcy petition also accrue to the estate. (section 541(a)(5)(C))

In addition to everything the pre-bankruptcy debtor owned, the estate enjoys rights to property unavailable to the debtor outside bankruptcy. For example, the estate may recover payments made to creditors during the last ninety days before filing, even though the debtor itself had no right to demand back money it had paid on lawful debts. (sections 541(a)(3), 547(b)) Similarly, property may be brought into the estate through equitable subordination, setting aside fraudulent conveyances, avoiding liens, voiding preferential payments, and reversing unapproved post-petition transfers. (section 541(a)(3), (4))

One of the most difficult questions for courts to decide has been whether some bundle of rights needed to operate the business, often a license issued to the debtor by the government or a private agency, is property to which the bankruptcy estate succeeds. Taxicab medallions, commercial airline landing slots, liquor licenses, and seats on the stock exchange are assets of this kind. It is easy to appreciate the sorts of conflicts they create. On the one hand, the bankruptcy estate wants to lay claim to the rights, either because it plans to use them in a reorganization effort or because they have significant economic value that the estate hopes to realize by transferring them to someone else. On the other hand, the licensor, anxious to retain control within its regulatory sphere, insists that the rights must either remain with the pre-bankruptcy debtor or dissolve on transfer to a third party.

Although there is no clear dividing line, the courts generally follow a principle that, if the license could not be assigned outside bankruptcy for reasons other than a contractual no-assignment clause, the license is not assignable.[19] This distinction would encompass the personal-services contracts that cannot be assigned under common law as well as any other contracts in which a change in the identity of the performing party upsets the reasonable expectations of the contracting parties. These distinctions are discussed in greater detail in the section on executory contracts in Chapter 5, *infra.*

---

19. *See, e.g., In re* Braniff Airways, Inc., 700 F.2d 935 (5th Cir. 1983).

Property Excluded from the Estate

The exclusions of property from the estate of the debtor are even more narrowly drawn than are the exceptions to the automatic stay. The powers a debtor exercises solely for the benefit of others, for example, as trustee for a trust, do not come into the estate. (section 541(b)(1)) Also, the Code makes explicit that any interest of a lessee debtor under a nonresidential lease that has terminated before the bankruptcy filing is not property of the estate—the counterpart to the exception to the automatic stay for a lessor who wants to remove a debtor whose lease terminated prior to filing. (sections 541(b)(2), 362(b)(10)) If the debtor is an individual, individual income earned after the filing will not be property of the estate, although earnings from any property of the estate will be. (section 541(a)(6)) Otherwise, if the debtor has an interest pre-bankruptcy, that interest belongs to the estate once the bankruptcy petition is filed.

Turnover of Property of the Estate

The Code provides that anyone holding property of the estate shall deliver to the trustee either the property or the value of that property. (section 542(a)) This may give the estate a possessory interest even in property in which the debtor had no such interest. So, for example, property held by virtue of a lawful pre-bankruptcy repossession can nonetheless be recovered from the creditor on the issuance of a turnover order.[20] (section 542(a))

Policy Considerations

Like the provisions creating the automatic stay, the provisions determining what property shall constitute "property of the estate" are written broadly. The policy considerations are similar. The Code, by giving the broadest possible definition to "property of the estate," enables the estate to retain property that may be used to

---

20. This point was clarified in United States v. Whiting Pools, Inc., 462 U.S. 198 (1983). The IRS had seized the debtor's assets pre-petition. The debtor had no right to recover them without paying the taxes due. The estate, however, had a possessory interest under section 542(a). This, said the Supreme Court, required the return of the collateral to the estate, with appropriate provision made for affording the IRS adequate protection.

enhance the value of the estate in a subsequent sale or reorganization. Moreover, a broad sweep brings all the property into the estate for distribution according to bankruptcy priorities.

The collective nature of a bankruptcy proceeding is also reflected in the broad definition of property of the estate. The estate is constructed for the benefit of the creditors as a group. Having been granted interests in property superior to those the pre-bankruptcy debtor could enforce, the estate is better able to safeguard the collective rights of the creditors by denying any single creditor a disproportionate share of the available resources. The estate is thus composed of all the legal and economic interests of the debtor and the collective economic and legal interests of the creditors as well.

The interplay between substantive rights granted elsewhere in law and collection rights redefined in bankruptcy permeates the concept of property of the estate. Generally, the substantive rights of the debtor under a lease, a contract, a tort action, a warranty, and so on, are preserved intact for the estate—bankruptcy neither enlarges nor narrows those rights. But because the bankruptcy estate can resist some collection efforts that would have been effective against the debtor and can exercise some rights to capture assets that the debtor would not have enjoyed, the Code effectively narrows the rights of other parties while it enlarges those of the estate.

Creditors' Claims Against the Estate

Just as property of the debtor becomes property of the estate at filing, claims against the debtor become claims against the bankruptcy estate. The transfer of obligations from the debtor to the estate works in tandem with the establishment of property of the estate and the imposition of an automatic stay to protect the estate, completing the separation between the pre-bankruptcy debtor and the post-filing entity.

Pre-bankruptcy Claims

The separation of the old debtor from the new bankruptcy estate is evident in the claims process. Claims are divided in the first instance into pre-bankruptcy claims against the estate inherited from the debtor and post-filing claims, which are obligations of the estate itself. The implications of this distinction become clearer when one considers the management of the case and the distributions made pursuant to a plan of reorganization. For now, it is sufficient to note that post-filing claims are priority claims against the estate, to be paid in full before the estate may make any distributions to pre-bankruptcy unsecured creditors. (section 507(a)(1)) The estate pays its own bills first and only then distributes the remainder to the pre-petition creditors.

A key function of the bankruptcy estate is dealing with the pre-filing claims. Once again, the Code is written in expansive language: A "claim" encompasses both rights to payment and rights to an equitable remedy that gives rise to a right to payment. (section 101(4)(A), (B)) A right to specific performance, for example, is a claim, since money damages might be awarded as an alternative remedy. The status of the obligation owed by the debtor at the time of filing is irrelevant. A debtor need not be in default on a claim for the claim to be dealt with in bankruptcy. A claim may be reduced to judgment or not, liquidated or unliquidated, fixed or contingent, legal or equitable, secured or unsecured. (section 101(4)(A)) So that all claims can be dealt with in the course of the bankruptcy, claims are accelerated and estimated if they are not yet fixed. (section 502(b)(1), (c)) Claims estimation can be a fairly straightforward proposition in the instance of a sum certain borrowed and not repaid, but it can be a far more difficult proposition when a claim is contingent or unliquidated.

The breadth of the concept of a claim against the estate is illustrated by a 1985 decision by the Supreme Court in *Ohio v. Kovacs*.[21] The state had obtained a mandatory injunction under its environmental protection laws requiring the debtor to clean up certain pollution for which he was responsible. When the debtor filed for bankruptcy, the state argued that the obligation under the environmental laws was not a "claim" for bankruptcy purposes. The Supreme Court disagreed, with the result that the claim was to be processed—and presumably discharged—in bankruptcy. All obligations owed by the pre-bankruptcy debtor become claims against the bankruptcy estate.

Generally, the substantive claims of a creditor are neither enlarged nor narrowed by the bankruptcy filing. A claim that is not

---

21. 469 U.S. 274 (1985).

enforceable against the debtor under applicable non-bankruptcy law is not enforceable against the estate in bankruptcy. (section 502(b)(1)) In the parlance of the bankruptcy courts, such a claim is not "allowed." (section 502(a)) To the extent that a debtor could interpose certain defenses against paying a pre-bankruptcy obligation, the estate succeeds to those defenses and the claim is thereby diminished. (section 502(b)(1)) Thus, the estate's obligation to pay a seller for goods purchased by the debtor is reduced by any unsatisfied warranty claims the debtor may have had against the seller.

Although a claim against the estate is generally allowed in an amount equal to whatever the creditor could have commanded outside bankruptcy, some distributional aspects appear at the claim-valuation stage as well. Some claims are limited in bankruptcy even though they might have been fully collectible otherwise. Claims for the services of an insider or an attorney of the debtor may not exceed "the reasonable value of such services." (section 502(b)(4)) Claims for breach of a lease, for compensation for breach of employment contracts, and for reductions in applicable credits for employment taxes are restricted. (section 502(b)(6), (7), (8)) The court monitors the extent of certain obligations incurred by the pre-bankruptcy debtor and reduces some of those obligations in the bankruptcy context.

The cleavage that occurs at the filing of bankruptcy is illustrated by yet another aspect of the claims-valuation process. Because claims are valued as of the time of filing, interest provided for by contract but not yet earned will be excluded from a general creditor's allowed claim, whereas interest earned before the filing will be part of that claim. (section 502(b)(2)) This provision has a distributional impact as well. By mandating that the unsecured creditors experience the consequences of any delay in the bankruptcy proceedings similarly, the Code places all of them—tort creditors and contract creditors, creditors with favorable interest terms and creditors with no interest terms—in equivalent circumstances, although they would not all have fared alike outside bankruptcy. For the unsecured creditors, no interest is collected after filing, regardless of what their contracts provide or what their legal entitlements otherwise would be.

Secured and Unsecured Claims

Notwithstanding the maxim "equity is equality," bankruptcy law permits a huge difference in treatment between two basic classes of creditors: those with properly perfected security interests and those without them. At state law, secured creditors have greatly enhanced collection rights. There has been some dispute over the rationale for security: Some commentators argue that it promotes more efficient lending markets; others argue that the low costs of secured lending are offset by the concomitantly higher costs of unsecured lending. Nonetheless, security interests enjoy historical protection, and business practices have embedded such devices in standard commercial transactions. Bankruptcy law extends their protection, so that creditors with security interests generally enjoy better protection in bankruptcy than those without them.

As a bankruptcy case proceeds, the Code distinguishes sharply between secured creditors and unsecured creditors. Unsecured creditors are left with the claims already described—general claims against the estate for the amount outstanding plus interest accrued at the time of filing. (section 502) Secured creditors, by contrast, receive an "allowed secured claim," which permits them to claim more than a pro rata distribution. An allowed secured claim is calculated according to the value of the collateral that is covered by the lien or the amount that is subject to a setoff. (section 506(a)) For the creditor whose claim is less than the value of the collateral, the claim is fully secured. For the creditor whose claim is greater than the value of the collateral, the claim is bifurcated into a secured portion (equal to the value of the collateral) and an unsecured portion (the remaining debt). (section 506(a))

Although the allowed claim of an unsecured creditor is fixed at the bankruptcy filing, the secured creditor's claim may continue to grow. Interest that accrues during the pending bankruptcy will be added to the secured creditor's claim—as will the fees, costs, and charges of collection provided for in the pre-bankruptcy contract—up to the point at which the collateral value is exhausted. (section 506(b)) In terms of distribution, just as secured creditors do better than unsecured creditors, oversecured creditors do better than undersecured creditors.

Estimation of secured claims is necessarily more complex than estimation of unsecured claims. With secured claims, the court must determine not only the amount owed to the creditor but also the value of the collateral. The Code directs that collateral is to be valued "in light of the purpose of the valuation and of the proposed disposition," suggesting that a liquidation valuation would be appropriate in a foreclosure proceeding and that a going-concern valuation would be appropriate in the reorganization context. (section 506(a)) Collateral valuation, of course, determines whether a claim is fully secured or is bifurcated into secured claims and unsecured claims. A creditor with a claim of $100,000 secured by property valued at $120,000 has a fully secured claim and the opportunity to accrue up to $20,000 of post-petition interest; if the same property were valued at $60,000, the same creditor would have an allowed secured claim of only $60,000, an unsecured claim of $40,000, and no entitlement to interest. (sections 506(a), 502(a))

The court must also decide whether the creditor's claim of security is valid. A detailed discussion of the debtor's abilities to attack outstanding security interests is provided in Chapter 5 *infra*; however, it is important to note here that these abilities are not insubstantial. They are, for that matter, quite potent: When the debtor is able to avoid a security interest in bankruptcy, the underlying claim against the estate is demoted to unsecured status.

Once all the unsecured claims have been identified, they are further divided into priority unsecured claims and general unsecured claims. The differences between claims are particularly relevant at the time of liquidation or plan confirmation, when priority unsecured claims will receive favorable treatment. For purposes of understanding the rights of the parties at the inception of the bankruptcy, however, the key distinction is the larger one between secured creditors and unsecured creditors.

Policy Considerations

The transformation of claims against a debtor into claims against an estate protects the collective nature of the bankruptcy proceeding. By converting creditors' claims against the pre-bankruptcy debtor to claims against a bankruptcy estate, the Code gives the estate manager a position to account for, to monitor, and to value each charge against the estate's assets. The claims process works in tandem with the automatic stay to encourage a somewhat more carefully planned administration of the interim bankruptcy estate, presumably enhancing its value thereby.

The transformation of claims also breaks any legal or equitable ties creditors may have had to various pieces of the debtor's property. In this sense, the claims process works together with the concept of property of the estate to move property out of the reach of creditors. Thus, a creditor with bare legal title under a conditional sale before bankruptcy has only a claim against the estate after the filing.

The claims process is critical to the distributional objectives of the Code. As claims are estimated, valued, and assigned certain priority rights, the distributional scheme of the bankruptcy system comes to life. Whether an obligation owed by a debtor becomes a claim—and can thus be discharged—raises a critical distributional question among competing creditors. Similarly, the discharge of claims or the rewriting or payment obligations over time necessarily distributes the assets of the estate among competing parties.

Conclusion

A profound shift in the relationship between debtors and creditors occurs at the filing of a bankruptcy petition. A new estate is created, comprising both the legal and economic interests of the old debtor and the collective economic and legal interests of the creditors. Creditors lose their individual collection rights against the debtor, and they are forced to deal with an estate operating on behalf of all the creditors. A powerful automatic order staying actions against the estate goes into place to protect the new estate.

The bankruptcy system offers an opportunity to enhance value by creating and protecting the new estate. At the same time, the distributional objectives of the Code begin to surface, which reduce collection rights for all parties, but provide comparatively better rights for the secured creditors.

4 Operating the Business in Chapter 11

During the period after the bankruptcy petition is filed and before a plan can be confirmed, the business in Chapter 11 continues to operate. The automatic stay is in place to protect the estate against creditor collection actions, but the business must still pay the expenses of daily operation and generally prove its value if it is to have a successful reorganization. This chapter offers a brief look at how the business functions in Chapter 11.

Who Runs the Show?

There are two likely candidates to run the post-filing Chapter 11 business: the management of the old, pre-filing debtor and an appointed trustee. The creditors could seek this role for themselves, but they have conflicting interests, as well as businesses of their own to run, so they typically either leave things in the hands of current management or ask for a trustee to protect their collective interests.

The American bankruptcy system has reflected different approaches to the question of who should be left in control of the bankrupt business. Under the 1898 Act, as amended in 1938, a trustee was appointed in large businesses' reorganizations (the old Chapter X), whereas old management remained in control only in small businesses' reorganizations (the old Chapter XI). Dissatisfaction with this scheme was widespread. It spurred the development of a complex jurisprudence to classify "large" and "small" businesses, as firms labored mightily to avoid Chapter X and to fit within Chapter XI (and thereby retain current management). In addition, many argued that the cumbersome Chapter X process of appointing a receiver and changing the management of a business just as it underwent financial upheaval was wasteful and contributed to the downfall of faltering businesses. These concerns prompted one of the key changes implemented in the 1978 Code.

Replacing the DIP

Under the Code, the management of the old debtor retains control during the bankruptcy case—as the so-called Debtor in Possession (DIP). For a trustee to be appointed in a Chapter 11 case, a party in interest must move for such an appointment; the court must then find either that cause exists to replace management or that such an appointment would best serve the creditors, stockholders, and other interests of the estate. (section 1104(a)) Typically, a court will consider such an appointment only at the insistence of a group of creditors or the U.S. trustee.

The reasons justifying removal of a DIP "for cause" are explicitly defined within the Code to include "fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case." (section 1104(a)(1)) Thus, the court can replace a bad manager who cannot run the business so as to earn the profits that might otherwise be produced, and it can replace a dishonest manager who may be diverting assets of the business. The Code makes it clear, however, that business failure alone is not a sufficient cause to replace current management. (section 1104(a)(1)) Greater mismanagement must be shown.

The second major ground for removing a DIP is set forth in far less detail than the first. If the bankruptcy court finds for any reason that the appointment of a trustee would be in the interests of the creditors or the equity holders, or would serve the other interests of the estate, it has virtually unconstrained power to remove the DIP and appoint a trustee. (section 1104(a)(2)) If, for example, workers were so furious with a management team that personal differences made a successful reorganization unlikely, a judge might consider removal of a DIP without any showing of mismanagement. Here again, the Code displays the characteristic pattern of providing fairly specific guidance to the court while empowering it to act in any way necessary to accomplish the goals of the reorganization.

A court that is reluctant to appoint a trustee may nonetheless order more careful oversight of the DIP through the appointment of an examiner. (section 1104(b)) An examiner can investigate the debtor and the conduct of the debtor's business affairs. (section 1104(b)) In large business reorganizations—those involving unsecured debts greater than $5 million—the Code provides for appointment of an examiner whenever a creditor requests one. (section 1104(b)(2)) In the reorganizations of smaller businesses, an examiner is appointed only when it is in the interests of the creditors, equity holders, or other interests of the estate. (section 1104(b)(1)) The big cases, once automatically slated for a trustee, can now be investigated by an examiner whenever a creditor wants one, and the small cases can be investigated when the court finds reason to do so.

Managing As a DIP

The DIP serves as the trustee in a Chapter 11 case. (section 1101(1)) With only a few exceptions, the DIP has all the rights of a trustee, but it also has all the burdens. (section 1107(a)) Among the trustee's—and hence, the DIP's—duties are the following. The DIP is accountable for all the estate's property. (sections 1106(a)(1), 704(2)) It examines the claims submitted by creditors and opposes those that are improper. (sections 1106(a)(1), 704(5)) It furnishes information to all parties in interest about the operation of the estate. (sections 1106(a)(1), 704(7)) It files tax reports, and it makes a final accounting of the estate. (sections 1106(a)(1), 704(8), (9)) The DIP is excused only from the trustee's obligation to investigate the actions of the debtor—a function that can be performed by an examiner, if one is needed. (sections 1107(a), 1106(a)(3))

The most important power given to the DIP is the authorization to continue the business. The DIP need not ask the court's permission. (section 1108) Instead, after filing, the business can continue to operate as usual. This permits the debtor to maintain operations so that the business need not be shut down at filing—an action that would result in losing revenue and potentially damaging the business's prospects even further.

Policy Considerations

Disputes among the parties over the interim operation of the Chapter 11 business can run the gamut, from disagreements over minor aspects of daily operations to allegations of dishonesty and unfair dealing. Often a dispute over who runs the business is a dispute over the central question of whether the business should be run at all—or instead be liquidated. At other times, disputes over interim operations are distributional disputes in which the central—but often unspoken—issue is whether the business is being run in a way that may profit some creditors at the expense of others.

To leave the old management in control as DIP is to run a number of risks. Old management, after all, often comprises the same folks who brought the business to the brink of collapse, and this may not be a strong endorsement for their management skills and business acumen.[22] More important, old management may have incentives that are at odds with those articulated in the bankruptcy system—incentives that may undermine the rationale for providing the company with bankruptcy protection.

There are any number of ways in which the efforts of old management to retain its jobs and its perquisites of office can create costs that are ultimately borne by creditors, shareholders, or both. For example, old management will usually want to participate in

22. Recent studies show that the CEO of a large business who presides over its demise will often be replaced either just before filing or shortly thereafter. LoPucki and Whitford studied the largest Chapter 11 cases in the 1980s and found a turnover rate of 91% for top management during the eighteen months before a bankruptcy filing and the six months following a filing. Lynn LoPucki & William Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Traded Companies,* 141 U. Pa. L. Rev. 669, 726 (1993). Betker reported that only 9% of the top managers in 202 publicly traded companies still had their jobs two years after the bankruptcy filing. Brian Betker, *Management Changes, Equity's Bargaining Power and Deviations from Absolute Priority in Chapter 11 Bankruptcies,* at 11 (unpublished manuscript, October 1991 draft). Gilson examined 409 publicly traded companies from 1979 through 1984 and reported that 71% of managers lost their jobs within two years following a bankruptcy filing. Stuart C. Gilson, *Management Turnover and Financial Distress,* 25 J. Fin. Econ. 241 (1989). Other studies show management turnover rates of about 3% to 5% (excluding retirements). In small Chapter 11 bankruptcies, however, which constitute the bulk of filings, old management tends to remain entrenched throughout the bankruptcy proceedings. Lynn LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code?,* 57 Am. Bankr. L.J. 247, 266–69 (1983). For a discussion of the implications of high management turnover rates and the effect on the decision to file bankruptcy, see Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11,* 102 Yale L.J. 437 (1993).

the reorganized business. Angling to be installed as the new management of the surviving entity, old management has an incentive to continue business operations past the point at which the value of the estate begins to dissipate; liquidating the company might permit a greater payment to the creditors but offers nothing to the departing managers. Moreover, old management's primary loyalty may be to the new investors who fund the reorganization—a loyalty that may not be conducive to increasing the value of the estate for distribution to the old creditors. In the reorganizations of large businesses, old management may contemplate a management buyout or a stock compensation plan, pitting it directly against the old equity holders and possibly the creditors as well. In smaller businesses, where the old equity holder and the manager are often the same person, the entire thrust of the reorganization may be to find a way for the old equity holder to emerge as the owner of the reorganized business regardless of the effect on creditors (or, for that matter, regardless of the effect on the business itself). In a number of cases, involving both large and small businesses, old management has fought single-mindedly to resist any plan that would involve its replacement by a new management team. These conflicts of interest may be kept in the background and settlements may be reached amicably, or they may become hotly disputed and provoke bitter fights.

The DIP also faces the difficulty that different classes of creditors have adverse interests. The fully secured creditor, for example, may stand to recover completely in an immediate liquidation, whereas under a reorganization, it risks a decline in the value of the collateral. The fully secured creditor often has much to lose and little to gain by supporting the efforts to reorganize. By contrast, the unsecured creditor who will be paid nothing on liquidation has a keen interest in seeing the business continue. The unsecured creditor may have nothing to lose and will therefore benefit if the reorganization is even modestly successful. Other parties—those who buy and sell to the Chapter 11 business, or who are employed by it, or who collect taxes from it—may also want to see the business continue. Seeing few pitfalls and plenty of benefits for themselves, they may support efforts to, in effect, gamble for recovery with the property of the estate. Lacking a single "creditor position" to guide it, the

DIP is placed in the position of trying to satisfy a number of conflicting interests that often may be impossible to reconcile.

Standing alone, these factors would support replacing old management in virtually every case; however, such a move carries costs of its own. To bring in a trustee at the moment of the bankruptcy filing would be to switch management precisely when the business is at its most precarious point. Confusion over the effects of the filing is at its peak, new payment arrangements with suppliers and employees often need to be negotiated, and quick decisions that are often crucial to the business's survival are required about which business lines to continue and which to abandon. To make these decisions and to implement them swiftly require intimate familiarity with all the operations of the business. It can be extraordinarily difficult to find a trustee familiar with the details of a particular business in a short time. In fact, management desertions in Chapter 11 tend to hamper reorganization efforts, not help them. Ousting a management group that is willing to stay on may sometimes involve throwing out whatever value the going-concern business might have.

Retention of current management serves other Code goals as well. Managers are typically those who direct the business into bankruptcy. If managers know it is virtually certain that they will be replaced in Chapter 11 even if they are doing a good job in trying to turn around a troubled business, they will hardly be inclined to file even if it would be the wisest course for the business. As a result, fewer companies will choose bankruptcy, and more companies will delay filing until the business no longer has any reasonable prospect for reorganization. With fewer and later filings, whatever wealth-enhancing effects the reorganization of troubled businesses in Chapter 11 might produce will be lost. Moreover, the distributional objectives of the bankruptcy system will be met less often, as distribution of the assets of failing corporations is accomplished more often through general collection law. Permitting those who make the bankruptcy filing decision to remain in control after filing ensures that bankruptcy will be a viable alternative for businesses in trouble.

Finally, it is worth noting that replacing old management will not solve some of the most fundamental conflicts. The basic conflicts between creditors—conflicts between those that are better served by immediate liquidation and those that are better served by reorganization—arise whether a trustee or old management runs the business.

The Code's drafters were convinced that the system would operate better if current management were left in place. Legislative history shows that the drafters believed such a policy would generally enhance the value of the estate as well as encourage more troubled businesses to file for Chapter 11. But they also recognized that the consequences of leaving management in control could be value-reducing and that mechanisms were needed to control and, if necessary, to replace management in such cases. Moreover, they recognized that unintended distributional effects might follow from permitting old management to run the post-filing business. Thus, while the Code leaves old management in control as a general rule, it hems in its operation of the business and provides for oversight by the court and the creditors.

Management is permitted to direct the business operations, but it does so with explicit instructions to assume the role of "debtor in possession," acting on behalf of all interested parties, not simply old management or the old equity holders it once represented. The DIP, for example, can only operate the business in the ordinary course without court approval and must negotiate either a consensual plan or a plan that pays all creditors in full before old equity holders retain any ownership. The DIP is in control of the day-to-day operations, but the Code is replete with specific checks to ensure that creditor interests are appropriately protected.

Role of the Creditors

Although old management remains in control and the business continues to operate, post-filing operations take place in a milieu very different from that which obtained before the debtor filed for bankruptcy. On the one hand, the creditors are prevented from continuing their collection activities. On the other hand, they are given much greater leeway to examine the business and, in proper circumstances, to demand its outright liquidation.

Functioning Through a Committee

The U.S. trustee convenes a meeting of creditors in every Chapter 11 case. (section 341(a)) The trustee may also call a meeting of equity holders, but it rarely does so. (section 341(b)) The initial creditors' meeting is of little practical significance: Creditors generally conduct their important business with the debtor either individually or through a creditors' committee appointed under the Code. (sections 1102, 1103) The single most important committee is the creditors' committee, which is composed of creditors that hold unsecured claims. Other committees may be formed, composed of secured creditors, equity holders, or even some subset of unsecured creditors (such as tort claimants or pension fund beneficiaries). (section 1102(a)(2)) The creditors' committee, along with any other committees formed, is intended to play a key role in the Chapter 11 process. (section 1102(a)(1),(b))

The creditors' committee is given the opportunity to monitor the activities of the DIP. To assist it in that role, the committee may seek court approval for the selection of lawyers, accountants, and other professionals to represent its interests. (section 1103(a), (b)) The expenses of the professionals are reviewed by the court and paid out of the estate as an administrative priority expense. (sections 503(b)(1)(a), 1103(a)) Thus, creditors are encouraged to act collectively to reduce expenses and to balance the power put into the hands of the DIP.

The creditors' committee is a "party in interest" with the right to be heard on any issue, to request the appointment of a trustee or examiner, and to move to convert the Chapter 11 proceeding to a Chapter 7 liquidation. (sections 1109(b), 1103(c)(4), 1104(a), 1112(b)) It can consult with the DIP concerning administration of the case—and the DIP, for its part, is required to meet with the committee. (section 1103(c)(1), (d)) Furthermore, the committee is specifically authorized to inquire into the acts, conduct, assets, liabilities, and financial condition of the debtor, and to investigate the operation of the debtor's business. (section 1103(c)(2)) It is also charged with the responsibility of examining the desirability of continuing the business and any other matter relevant to the formulation of the reorganization plan. (section 1103(c)(2)) Moreover, the committee is permitted to participate in negotiating the plan and to recommend whether the plan should be accepted or rejected by those it represents. (section 1103(c)(3)) Finally, to make certain it can operate effectively to balance the powers of the DIP, the committee is given the power to "perform such other services as are in the interest of those represented." (section 1103(c)(5))

Despite the strong role carved out for the creditors' committee, creditors need not operate within this structure to exercise some power over the functioning of the estate. Any creditor is a "party in interest" in Chapter 11 and as such may seek the appointment of a trustee or examiner, move to liquidate the estate in Chapter 7, or object to the plan. (sections 1109(b), 1104, 1112, 1128) Special provision is made for participation by the Securities and Exchange Commission, which can appear and be heard on any issue in Chapter 11 but cannot appeal from the bankruptcy court's judgments. (section 1109(a)) Such participation has declined in recent years, although there has been some recent discussion of the SEC's taking a more active role, particularly in cases involving brokerage houses.

The Code is clearly set up to strengthen the creditors' role through a creditors' committee and thereby to balance the power given to the debtor. In reality, only the largest cases tend to have active creditors' committees. In such cases, the committee can be tremendously influential. For example, in very large Chapter 11 cases, a creditors' committee wields such power that a debtor rarely proposes a plan for confirmation without having first obtained the committee's endorsement. The situation in small Chapter 11 cases is very different. Most U.S. trustees report that in typical cases no creditor is willing to serve on a committee because the amounts at stake and the assets likely to come from the reorganization are too small to justify the amount of time the creditor would have to spend. Often, the DIP is able to manage the business with little interference from the unsecured creditors.

Structurally, the Code balances the disparate interests in a Chapter 11 reorganization effort by creating a dynamic tension. The DIP has the power to run the business, but the creditors can investigate how the business is run, move to replace the DIP, recommend liquidation, and participate in the plan process. In practice, large cases differ from small cases, and the potency of the threat of creditor intervention varies dramatically in the two contexts.

Policy Considerations

The balance of power in the Code depends in critical part on the interest and involvement of the creditors. This is reasonable, in theory. After all, it is the creditors that stand to lose the most if the DIP mismanages the business, and it is the creditors that stand to profit if the estate is well managed. In fact, however, many Chapter 11 cases proceed with little creditor interest. The Code does not assume, however, that in such circumstances the creditors' rights will simply be lost. Instead, it provides some minimal procedures to protect even inattentive creditors. These features show up in the Code as restrictions on the power of the DIP to run the business and to impose a plan on the creditors. Thus, the creditors can choose to be active, monitoring the debtor closely, perhaps in this way best protecting the value to be distributed in the estate. But even if they choose not to engage in regular monitoring, the Code invites their involvement at key points in the process. Moreover, it imposes at least some constraints on the DIP's powers during the bankruptcy.

The opposing interests of the unsecured creditors and the secured creditors are also accommodated by this structure. The standard creditors' committee represents the collective interests of the unsecured creditors. The need for collective action here is particularly acute, since the distributional policies of the Code require that a benefit gained by one will be shared by all. Secured creditors, by contrast, are given certain rights they can exercise individually. Secured creditors may act in ways that will profit all creditors, for example, by moving to replace an incompetent manager, but they may also want to exercise rights that are at odds with those of the general creditors, for example, by repossessing a piece of collateral that is essential to the operation of the business.

The Code draws the line between the collective interests of all creditors and the individual interests of the secured creditors, as it defines the scope of rights that an individual secured creditor can assert. Both limitations on and recognition of secured creditors' rights reflect critical distributional decisions embedded in the Code: Secured creditors get some special relief, but not as much as they would at state law. In contrast, creditors collectively make some inroads on the rights of individual creditors, but cannot intrude upon all those rights. A proper balance is difficult to achieve, both theoretically and practically, and is one of the central preoccupations of the Code.

How the Business Operates

For nearly all businesses in Chapter 11, the most pressing need is for operating capital. To keep the business going until long-range plans for enhanced profitability can be developed, the debtor must somehow manage to pay its employees, buy supplies, meet its utility bills, and so on. The need for cash after filing a Chapter 11 petition is often greater than it was beforehand, as uneasy suppliers that once extended credit now demand cash, and lines of credit and other financing arrangements that may have been in place are frozen. At the same time that the business has an acute need for cash, there is undeniably some risk in giving the debtor control over an asset that can so quickly disappear.

Thus, while the DIP may be in control of the business, it is not given the free rein to operate in Chapter 11 that it would have had outside bankruptcy. There are two important restrictions placed on the DIP operating in Chapter 11. In general, the DIP is permitted to use cash generated by the business and to use, sell, or lease any property of the estate—so long as the DIP acts "in the ordinary course" of the business's operations. (section 363(c)) This means, in effect, that the DIP has authority only to continue the ordinary operations of the old debtor. If it wants to sell off some equipment, cease production of a particular product, take up a new line of business, settle a pending dispute, or engage in any other "out of the ordinary" activities, creditors must be notified and given an opportunity to object, and court approval must be obtained. (section 363(b))

The first restriction is aimed generally at preventing the DIP from squandering the estate's assets. The second is focused more narrowly on the use the DIP makes of cash. Again, the issue of access to cash is often a life-or-death question for the struggling Chapter 11 business. On the one hand, if the business cannot use its cash even in the ordinary course of its operations, the estate will soon be starved for operating capital and operations will cease. On the other hand, cash, in comparison with other types of assets, is so valuable and so difficult to trace that special measures are necessary to protect the creditors that have bargained for an interest in cash generated by the estate. The Code draws the line by granting the DIP immediate access to cash on which there is no recognized legal encumbrance while imposing formidable restrictions on the debtor's use of "cash collateral." (section 363(c)(2))

Cash collateral consists of the cash and cash equivalents in which a creditor has a recognized security interest. (section 363(a)) When a secured creditor holds a valid security interest in accounts receivable, for example, all cash that is generated as those receivables are paid off becomes cash collateral. Indeed, any time property of the estate that is the subject of a security interest is liquidated, the resulting proceeds are cash collateral—so long as the original lien continues against them. The Code holds that a DIP cannot use cash collateral, even in the ordinary course of its business, unless the court authorizes such use. Authorization may be granted only if the creditor remains adequately protected, a concept developed in the context of the automatic stay and discussed in Chapter 3 *supra*. (sections 363(d), 362(d))

To avoid leaving a business completely without cash immediately after filing, a court can hold a preliminary hearing to authorize the use of cash collateral, pending a final hearing with the creditors present. The balance sought to be maintained is clear: The estate, run for the creditors collectively, operates in the ordinary course, and the secured creditor, with an interest in particular property of the estate, can monitor more closely how that property is used, thereby ensuring that its particular interests are protected.

Even with access to the cash generated by the business, the debtor may well need more money to operate during the reorganization effort. The DIP has a fair amount of discretion to arrange for interim financing for the business, since unsecured debt may be incurred as part of the ordinary course of operations of the business. (section 364(a)) This provision is typically used only for trade credit, often the only unsecured credit available to a DIP. If it is unable to get adequate unsecured financing, the DIP can attempt to arrange for secured financing. The DIP can negotiate for credit by offering security interests in unencumbered property of the estate, liens on encumbered property equal to those of current secured creditors, and priority repayment as an administrative expense to be taken out of the general assets of the estate before payment of the unsecured creditors. (section 364(c)) Secured financing can only be arranged with the approval of the bankruptcy court, however, for obvious reasons. As such debts begin to reshape the business, they affect both the assets the estate will have left to distribute and how the estate will distribute those assets. The DIP cannot take a step so important in the operation of the estate without giving creditors an opportunity to examine and object to the proposed financing. Even if the creditors do not act, the DIP will have to provide them with notice and ask for a hearing for the court to approve its plans.

Conclusion

The amount paid to the creditors in Chapter 11 depends in large part on the success of the business's operations, or, in the alternative, on its expeditious liquidation. The mechanism the Code relies on to ensure that the best course is followed is, in a sense, enlightened self-interest. The Code purposefully creates a tension by putting power in the hands of both the DIP and all the creditors. It provides rules to control and direct this tension in an attempt to prevent abuse or unfair advantage while it permits the managed resolution of conflict in ways that will be of general benefit to the estate.

The issues that emerge in the context of running the business echo throughout the Code, particularly when the rights of individual secured creditors are pitted against the collective interests of the unsecured creditors and the interests of the employees, trade suppliers, customers, and taxing authorities that hope for the successful reorganization of the business. These issues reappear with particular intensity at the plan-confirmation stage, when final agreements among the parties are hammered out.

5 Shaping the Chapter 11 Estate

The automatic stay protects the bankrupt debtor and provides time to develop a plan of reorganization. To create a business that can survive and prosper, however, the DIP typically needs to alter business operations. The Bankruptcy Code gives the DIP broad powers to redesign the Chapter 11 estate. These provisions permit the DIP to assume, to assign, and to reject executory contracts; to set aside unrecorded security interests; to recover certain preferential payments and fraudulent conveyances; and to subordinate the debts of certain creditors. These powers reconfigure the relationship between the new bankruptcy estate and those who did business with the debtor before bankruptcy.

The extent to which any particular DIP will use the provisions discussed in this chapter depends critically on both the debtor's current obligations and the shape the DIP hopes the new business will take. For some businesses, the principal difficulty is in the enterprise's financial structure: The debtor cannot meet loan payments as they come due, and debt restructuring is the thrust of the reorganization. In such cases, the debtor may plan to continue business operations just as they were before the bankruptcy filing. The outstanding contracts may be amicably assumed by the new estate, and the crucial negotiations will be with key lenders over the long-term financial structure. For other businesses, the reverse is true: The debtor needs to reshape its business operations, with financing only a secondary concern. Here, the focus of the reorganization will be on dealing with the debtor's various contractual obligations, so that the entire business operation is recast by the selective rejection and acceptance of its outstanding agreements. Moreover, a number of the debtor's continuing, post-filing relationships, for example, with trade creditors or long-term financers, may be powerfully affected by how the DIP uses—or threatens to use—the powers granted to reshape the business and reorder its commercial ties.

Executory Contracts

The instant of filing for bankruptcy is a critical moment, as the pre-bankruptcy debtor loses all its property and the bankruptcy estate comes into existence to assume control of that property. But for virtually every business filing in Chapter 11, that moment will not coincide neatly with the completion of all outstanding contractual obligations. For most businesses, at any given time a number of contractual obligations are outstanding, often in varying stages of performance or breach. With the legal termination of the old debtor, the question of how to deal with outstanding contracts arises. Should the new estate be saddled with them, forced to perform at any cost? Or may it escape all obligation, shrugging off the mistakes of the old debtor?

Basic Structure

In order that all pre-filing claims against the estate can be dealt with at once, the bankruptcy filing accelerates all the debtor's outstanding obligations, making them ripe for resolution in the bankruptcy case. "Claim" is broadly defined to include every sort of obligation, liquidated and unliquidated, contingent and noncontingent, matured and unmatured, disputed and undisputed, secured and unsecured, legal and equitable. (section 101(4)) This broad definition of course encompasses every executory contract to which the debtor is a party. Thus, the contractual obligations of the debtor are reduced to claims against the estate.

The DIP is authorized to assume, assign, or reject the old debtor's contracts as the interests of the estate may require, although court approval is necessary to ratify the DIP's decisions. (sections 365(a), 541(c)) Such decisions reshape the estate and are not in the ordinary course of the debtor's business; the Code thus requires that the court retain some supervisory authority over the DIP. The creditors, meanwhile, receive notice and an opportunity to be heard if they object to the direction in which the DIP proposes to move the business. Typically, however, the only complainant is the nondebtor party to the contract who would prefer some other treatment than that chosen for it by the DIP. If the technical requirements (detailed *infra*) are met, the courts use a business-judgment test for determining whether the DIP may assume, assign, or reject a contract. Not surprisingly, that test tends to ratify the decisions of the DIP.

For the DIP to assume, assign, or reject a contract, the contract must be "executory." (section 365) There is no statutory definition of "executory," but the courts generally use a definition advanced nearly thirty years ago by Professor Vern Countryman: An executory contract is one in which obligations of the debtor and the nondebtor party are both so far unperformed that the failure of either to perform would constitute a material breach excusing performance of the nondebtor party.[23] Once one party has completed performance, there remains only a claim by the nondebtor party; since the contract is no longer executory, the Code provisions concerning assumption, assignment, and rejection are no longer applicable.

Rejection

If the DIP rejects a contract, the estate becomes liable for the damages resulting from its breach. This breach is treated as if it had occurred before the filing of the petition, in order to equalize the treatment of claims for the breach of the debtor's pre-petition contracts. (section 502(g)) Regardless of whether they arose before or after the bankruptcy was filed, all claims become claims against the estate.

In general collection law, a number of different contract remedies may be available, depending on the circumstances. Money damages are typical, but in some cases the parties are entitled to equitable remedies, such as specific performance or injunctive relief. Bankruptcy law reduces all contract claims to claims for money damages. (sections 365(g), 502(g)) Even equitable remedies must be translated into some monetary equivalent, and the bankruptcy court estimates the size of the claim to be allowed against the estate. (section 502(c)(2)) The loss of equitable remedies hits some parties particularly hard, such as the party buying a unique good or hoping to enforce a covenant not to compete. But the Code policy is unmis-

23. *See, e.g., In re* Select-A-Seat Corp., 625 F.2d 290, 292 (9th Cir. 1980).

takable. If parties otherwise entitled to equitable remedies could enforce those remedies while those entitled to money damages were restricted to pro rata distribution, there would be no equality of treatment among essentially similar claimants. To ensure that the losses of bankruptcy are distributed on a pro rata basis, the Code explicitly takes away equitable remedies and reduces all claims to money damages. Apart from this, contract damages are calculated as they would be outside bankruptcy.

Assumption

If the DIP assumes a contract, the estate becomes obligated to perform according to the contract's terms. A subsequent failure to perform during the bankruptcy case is a breach by the estate. (section 365(g)) Repayment is an administrative expense, and damages are payable in full. (section 365(g)(2)) This gives the nondebtor party to a contract the strongest assurance the estate can offer that either the contract will be performed or the party will collect full compensation for the breach.

The nondebtor party is also protected from the consequences of past breach: For the DIP to assume a contract, all defaults must be cured. (section 365(b)(1)(A)) If the nondebtor party has been injured by an earlier default, the estate must either pay the damages or ensure prompt compensation. (section 365(b)(1)(B)) Finally, the DIP must provide adequate assurance of future performance, much like the requirement under the Uniform Commercial Code. (section 365(b)(1)(C); U.C.C. § 2-609(1))

The estate's assurances are not, of course, perfect guaranties of its performance, and other parties may well be reluctant to go forward with their performance under their contracts with the debtor. Nonetheless, they may have no choice in the matter. Once the DIP has properly assumed a contract, another party's failure to perform will constitute a breach, entitling the estate to collect full contract damages as property of the estate. (section 541(a)(7))

The Code bolsters the DIP's assumption powers by denying effect to certain contractual provisions that purport to restrict those powers. Financial-condition clauses—those that provide that the contract is terminated when a bankruptcy case commences, when the debtor becomes insolvent or financially distressed, or when a trustee or receiver is appointed—are nullified in bankruptcy. (sections

363(l), 365(e), (f), 541(c)) To recognize such contractually defined events of "default" would be to run counter to most fundamental policies of the Code. The Code prohibits parties from opting out of the bankruptcy system by private agreement.

Assignment

Once the estate has assumed a contract, it may assign it to a third party, usually in return for money from the assignee. (section 365(a)) Such assignment protects the estate's ability to realize the full economic value of a contract.

The DIP must meet the requirements for assumption before it may assign the contract, and it must also provide the nondebtor party with adequate assurance of future performance by the assignee, whether or not there has been a breach. (section 365(f)(2)(B)) After an assignment, the estate is not liable for new defaults, even if it would have remained liable in nonbankruptcy law. (section 365(k))

The DIP enjoys greater rights than the pre-petition debtor to assign a contract and thereby realize its economic value. The DIP can assume and assign a contract even if the debtor expressly consented to a prohibition on assignment in the contract. (section 365(f)(1), (3)) By its terms, the Code prohibits the same with respect to applicable nonbankruptcy law: Nonbankruptcy prohibitions on assignment in law are also ineffective against the DIP. (section 365(f)(3)) The courts, however, have generally declined to enforce these provisions as written. Thus, certain well-established common-law prohibitions on assignment, such as the restrictions on assignment of personal-services contracts, and some important general statutory prohibitions, such as the federal restrictions on assignment of defense contracts, are given effect in bankruptcy notwithstanding the seemingly absolute language of section 365(f).

Expanding the availability of assignment powers maximizes the value of the estate. Such value obviously may come at the cost of changing the promises outlined in the negotiated contract, but the injury to the nondebtor party is lessened by the retention of the common-law assignment rules. In effect, when common law treats assignment as frustrating the reasonable expectations of the parties, assignments are prohibited; when common law treats the contractual obligations as more nearly fungible, assignment is permitted.

Similarly, the statutory restrictions on assignment are honored when they seem to be designed to protect legitimate interests of contracting parties.

Interim Treatment of Executory Contracts

The DIP is not required to appear before the court immediately after filing to reveal which contracts it proposes to assume, which to assign, and which to reject. To impose such a requirement would impinge on the breathing space provided by the automatic stay and deprive the DIP of the opportunity to make decisions that maximize the value of the estate. Sometimes, however, parties that have dealings pending with the debtor can be injured during this interim period if they cannot determine the status of their contracts.

The Code expressly limits the time the DIP has to make a decision about a contract in a Chapter 11 proceeding in only one instance: With respect to all nonresidential leases, the DIP must assume the contract within sixty days of filing or the contract will be deemed rejected. (section 365(d)(1), (4)) The court may extend that time for cause, but the deadline at least provides some guidance for the parties. This restriction mirrors the sixty-day decision time given the trustee in all Chapter 7 cases, which allows the nonbankrupt parties to learn quickly what is happening to their contracts as the case moves toward liquidation.

For all other contracts, the time limits in Chapter 11 are more fluid. The DIP is required only to assume or reject all executory contracts before confirmation of the plan. (section 365(d)(2)) This maximizes the DIP's flexibility, but in some Chapter 11 cases, it may mean that the parties are left in limbo for years. The nondebtor party to the contract may ask the court to set a time for acceptance or rejection of the contract, but the Code articulates no grounds on which the court should grant or deny such a motion. Generally, the court will give the DIP a reasonable time to decide, taking into consideration the cost imposed on the nondebtor party by delay. The amount of time that is "reasonable" varies greatly from case to case.

The Code is silent about the rights and obligations of the parties to an executory contract during the interim period before acceptance or rejection. Until a contract has been rejected, most courts take the position that the nondebtor party must continue to perform, although there is no direct statutory authority for this position. If the nondebtor party fails to perform, it may be liable for damages incurred even before the debtor accepted the contract. Moreover, the court may order performance under its general equitable powers. (section 105(a)) Even if the debtor has defaulted, the nondebtor party cannot take it for granted that the contract has been rejected. On the one hand, the DIP has the power to reject a contract only with court approval. (section 365(a)) On the other hand, the Code permits the DIP to cure even post-petition defaults in order to assume contracts. The nondebtor party thus faces powerful incentives to continue its performance under the contract while it awaits definitive action from the DIP and the bankruptcy court, even though the contract may ultimately be rejected. One source of solace for such a party is that the estate will be liable for any benefits conferred on it after the filing as a priority administrative expense—payable in full, not as a pro rata distribution on a general, unsecured claim. (section 503(b))

Special Contracts

A number of parties have argued that although the rules of assumption, assignment, and rejection generally work, some contractual relationships deserve special treatment. Congress has agreed with some groups, creating exceptions to the general rules for committed lenders, labor unions, retirees, real estate and time-share lessors, shopping center lessees, licensees of intellectual properties, and buyers of real estate.

Perhaps the best protection is reserved for the most vulnerable parties—those parties that have outstanding obligations to lend money to the bankrupt debtor. The Code declares that these contracts for "financial accommodations" cannot be assumed by the DIP. (section 365(c)(2)) Bankruptcy terminates such obligations, whether or not the contract creating them so provides. The debtor fortunate enough to have a commitment for future financing must give it up when it files for bankruptcy.

The economic policy at work here is hazy at best. A seller of goods is required to deliver on credit when the debtor assumes a contract, even at the risk of losing the value of those goods if the debtor ultimately proves unable to repay. If a lender were forced to lend cash according to its earlier promise, it would run a similar risk. But the Code provisions sharply distinguish between the two, holding the seller to the contract if the debtor assumes it and excusing the lender from any future contract performance. The consequences of this distinction are becoming more conspicuous as debtors come forward with prepackaged bankruptcy plans under which lenders commit to financing in contemplation of a bankruptcy filing—only to have the Code grant them a right to back out after the debtor files.

It may be that the drafters of the Code were convinced that financial-accommodations contracts should be called off so that the debtor's post-petition financing arrangements could be scrutinized as a whole. Or it may be that the distinction reflects the idea, pervasive both in commercial law generally and in the Code, that money is sufficiently volatile and difficult to trace that it should receive special treatment. Or it may reflect the influence of banks and other commercial lenders on congressional legislation. In any case, the provision deserves reexamination.

Labor union contracts also receive special treatment. Under the 1984 amendments to the Code, the DIP has post-filing obligations to negotiate with the union and to reveal important information about the business. (section 1113(b)) Moreover, the DIP cannot reject a collective bargaining agreement on the simple business-judgment test employed generally in the assumption, assignment, and rejection of executory contracts. (section 1113) To give extra protection to unionized workers, the Code provides that the DIP may reject a collective bargaining agreement only if "the balance of the equities clearly favors rejection of such agreement." (section 1113(c)) The distributional intent of this provision is obvious: If possible, unionized employees should suffer less from the debtor's failure than other creditors should, but they should bear their share of the losses if it is necessary for a reorganization.

A similar attempt to offer some protection to a specific group of creditors is evident in 1988 amendments to the Code that place restrictions on the rejection of agreements covering retired employees' health and pension benefits. The Code now provides for representation of retirees and for negotiation with the DIP regarding the appropriate level of benefits. (section 1114(b), (c), (d), (f)) The estate is obligated to continue such benefits during the negotiation period, unless the court orders otherwise. (section 1114(e)) Modification of retiree benefits shall be authorized only if the court finds that the proposal is fair and equitable to all the affected parties, is necessary for an effective reorganization, and is "clearly favored by the balance of the equities." (section 1114(g)) Once again, the distributional intent is clear, this time favoring retired employees who have intact health and pension benefit plans at the time the business files for bankruptcy.

When the debtor is a lessee, the Code is more explicit about the limitations on the scope of the DIP's authority under the executory contract provisions. If a nonresidential lease has terminated pre-petition, a debtor–lessee may not cure and assume the contract. (section 365(c)(1)(B)(3)) Moreover, the DIP may not require the landlord to furnish services under an unexpired lease without prepaying for the services. (section 365(b)(4)) Nonetheless, long-term leases lose more value than other claims in bankruptcy. If the tenant files for bankruptcy and rejects its lease, the landlord may file a claim against the estate limited to one year's rent or 15% of the remaining lease term, plus any past due rent. (section 502(b)(6)) The Code also restricts the ability of the landlord to insist on a larger deposit based solely on the DIP's assumption and assignment of the contract. (section 365(l)) The landlord is stuck with whatever would be the ordinary deposit for a similar tenant. This provision prevents the landlord from indirectly avoiding the impact of the assumption and assignment powers given the DIP.

The Code offers general protection for debtor–lessees, but it imposes specific restrictions on debtors who lease shopping center space. For shopping center leases, adequate assurance of future performance includes consideration of percentage rents, tenant mix, location relative to other businesses, and exclusivity provisions. (section 365(b)(3)) This gives the landlord greater discretion in refusing a DIP's proposed assumption and assignment of a shopping center lease.

Debtor–landlords also face some restrictions. The debtor that is a landlord or lessor in a time-share agreement may reject unfavorable leases, but the impact of rejection is somewhat limited. The lessee may accept the rejection, leave the property, and submit a claim for damages against the estate for breach of the lease, as can any nondebtor party to a contract that has been rejected in bankruptcy. (section 365(h)(1)) Or, the lessee may stay and offset the damages it has incurred against the rental obligation it owes to the debtor. (section 365(h)(2)) In the latter situation, the lessee will waive any other claim against the estate. (section 365(h)(2)) This additional protection—permitting lessees to finish out their lease terms—gives them some leverage against debtors that might use bankruptcy as a means of clearing a building quickly.

Similarly, if a seller of real property declares bankruptcy, the buyer who is in possession of the property has greater protection than do most parties to an executory contract. If the seller rejects the contract, the buyer may either accept the rejection and file a claim, or remain in possession and offset its damages against the payment obligations as they come due. (section 365(j)) If the buyer pays for the property in full, it is entitled to a clear title, in effect nullifying the rejection. (section 365(j)) Once a buyer is in possession of property under a purchase agreement, bankruptcy is not an effective means to recover the property for the estate.

When the debtor is a licensor of intellectual property, the licensee has rights on rejection of the license similar to those of a buyer of real property or a lessee of property or a time-share interest if the debtor rejects the real estate contract or lease. In such a case, the licensee may accept the rejection and file a claim, or it may retain a right to exclusive use of the license, waiving any additional rights to claim or offset damages against the estate and effectively nullifying the debtor's rejection. (section 365(n))

These provisions on shopping centers, time-shares, real property, and intellectual property were added to the Code in response to industry complaints about bankruptcy "abuses." The characterization of the abuses vary from constituency to constituency, as do the policy rationales for better protection of select groups doing business with parties that declare bankruptcy. All the provisions have clear distributive consequences, favoring one class of creditors over other classes. Some of the provisions may have been adopted in response to egregious cases that were not properly decided under the general provisions of executory contract law, whereas others may have been adopted to provide greater assurance to some constituencies and to avert concerns about how courts might deal with these pending cases.

Policy Issues

Any business can breach its contracts. As Justice Oliver Wendell Holmes pointed out, a contract is only an agreement in the alternative: Do the thing promised or pay the damages.[24] If a business not in bankruptcy breaches its contract and the nondebtor party pursues its rights, the breaching party will pay a legally imposed remedy. The same is true in bankruptcy. The DIP can perform or breach the pre-bankruptcy debtor's contractual obligations. If it breaches them, the nondebtor party will have a claim against the estate for the contract remedy. The claim will be an ordinary unsecured claim, unless the parties had made arrangements to secure performance with a right to offset or a security interest. The rub, of course, is that outside bankruptcy, the breaching party pays the damages in full, whereas in bankruptcy the debtor is most likely paying all its creditors only pro rata distributions of what is owed. The DIP pays for its breach, but it pays in tiny little bankruptcy dollars.

The Code makes it clear that the DIP has the same option to breach the debtor's outstanding obligations that any nonbankrupt party would have. A consequence is to reduce those contractual obligations to their bare essentials: unsecured claims against an insolvent estate. That is, of course, all they were before filing. To burden the estate with paying all obligations not in breach at the time of filing would promote those claims to priority repayment status, to be paid ahead of other unsecured claims. The Code avoids inequality of distribution among creditors by permitting the estate to abrogate obligations after filing just as the debtor could abrogate them before filing, so that all unsecured claimants brandishing broken contracts are treated the same by the estate regardless of when the breaches occur.

A second consequence of permitting post-petition breaches of pre-petition obligations is that the DIP can make rational business decisions about which opportunities to pursue after filing. The DIP has the opportunity to breach contracts that are no longer useful to the estate, permitting a reorganization along new business lines that

24. Oliver Wendell Holmes, The Common Law 236 (Mark DeWolfe Howe ed., 1967).

implement new management decisions. The executory contract provisions are designed to give the DIP the ability to redesign the faltering business.

The DIP can also assume outstanding contracts. Not everyone who has signed a contract with the now-bankrupt debtor will be delighted by such an assumption. Sometimes the nondebtor party worries about the financial stability of the post-filing debtor. At other times the nondebtor party would like to use the fact of bankruptcy as an excuse to escape from a contract that is profitable to the estate but has become burdensome to the nondebtor party. The nondebtor party may have agreed to sell to the debtor at a price that now appears too low or to buy at a price that now seems too high, and escape from such a contract is usually high on its agenda.

To permit the debtor to assume a contract profitable to the estate harks back to the concepts that govern the formation of the estate and the determination of what property goes into it. At filing, all legal and equitable interests of the pre-petition debtor become property of the estate. Because the estate is permitted to assume the outstanding executory contracts, it captures the economic value of the contracts for the benefit of all the creditors—rather than the one creditor who happens to be a party to the contract.

If the estate assumes a contract, whatever value it has is accompanied by the burdens of performance. Once the DIP assumes the contract, the estate must abide by the old debtor's contractual agreements, including payment in full of any monetary obligations. To enforce the written contract is to capture value already exchanged in the contract; to demand the benefits without assuming the burdens would be to insist on a new agreement that the parties had not negotiated. In part, this represents an application of the standard contract-law doctrine that contracts are not severable unless the parties specifically so agree. To enforce an agreement, the enforcer must meet its own obligations.

The circumstances of bankruptcy raise an interesting distinction between contracts that have reciprocal obligations due and contracts in which one party has performed and now awaits performance by the other. The distinction goes to the heart of the debtor–creditor relationship: If the nondebtor party has already extended value (e.g., shipped the goods or lent the money) and awaits only payment from the debtor, then the nondebtor party is simply a creditor with a claim. But if the nondebtor party has agreed to extend value only after performance from the debtor, the reciprocal nature of the obligations changes the relationship. Both parties are now creditors and both are debtors with respect to the underlying obligations. In bankruptcy, the estate that wants to capture the value of the nondebtor party's promises needs to meet its own obligations to the nondebtor as well.

The requirement that the estate assume the obligations of any contract it wants to enforce underscores the fact that the estate is a separate entity, able to incur debts and obligated to pay them in its own name. The estate, like any other actor in the business world, makes contracts—or assumes the contracts of its predecessor—in full. And it pays for those obligations in full as administrative-expense priority claims.

The complaint is sometimes heard that the bankruptcy scheme permits the DIP to come out ahead no matter what: Contracts profitable to the estate are assumed while contracts injurious to the estate are breached—a sort of "heads-I-win, tails-you-lose" situation that is unfair to the nondebtor. The difficulty with this analysis is that it misses a central point of all contract law. Any party at any time may elect to perform its profitable contracts and breach its unprofitable ones, so long as it is willing to face the risk that the contract damages it will have to pay will wipe out the gains it realizes by its breach. In bankruptcy the same option is presented. The difference, of course, is that a damage action against a bankrupt estate is not worth as much as a damage action against a solvent estate. This, however, is a problem facing every claimant against a bankrupt estate: A breach of contract claim is simply not worth as much when the breaching party cannot pay. It is economic reality, not bankruptcy policy, that causes the loss to fall on the nondebtor party to a contract with an insolvent debtor.

A second cause for grumbling is the DIP's ability to assume the agreements of the old debtor while escaping enforcement of some of the duly negotiated terms of those agreements. There is, of course, no justification for forcing the nondebtor party to perform a contract on terms substantially different from those it had bargained for. But the terms of any individual bargain may affect collection priorities in ways that violate bankruptcy norms. For example, the parties might have agreed to a contract under which the debtor is to buy oranges at $1 per bushel, with a provision that calls off the deal if either party files for bankruptcy. If the market price of oranges had risen to $1.25 by the time of bankruptcy, the DIP would want to assume the contract. But if the termination clause were enforceable, the nondebtor party to the contract would be enabled to escape the consequences of its bad bargain by the fortuity of a bankruptcy filing. The estate would be diminished by losing the valuable contract that would have been enforceable outside bankruptcy, all because it had fallen on hard times in its other affairs—not because of any substantive breach of the oranges contract.

Allowing the nondebtor to escape such a contract clearly violates the value-enhancing norms of bankruptcy. Moreover, if one creditor caught in mid-performance can escape bankruptcy treatment because it had the leverage to insist on a contract provision while no other creditors can opt out of the bankruptcy system, the goal of equality of treatment is also upset. Once again, bankruptcy protects the interests of the creditors collectively by limiting the effect of advantages that happen to be enjoyed by the individual creditor. Not surprisingly, "ipso facto" clauses and other similar provisions that have the effect of permitting one party to opt out of the bankruptcy system when a debtor files are not enforceable under the Code. (section 365(e)(1))

In some cases, the estate is not able to perform on a valuable contract. In those cases, the only way for the troubled business to realize the full value of the contract is to assign it to another company that can perform, often for a payment to the estate. Contract assignment raises the same questions as contract assumption, especially the question whether the debtor that assigns its rights is forcing the nondebtor party to perform on a contract that is substantially different from the contract to which it agreed, or whether the nondebtor party who resists assignment is merely an opportunist seeking to avoid the collective action of bankruptcy.

Summary

The DIP, with court consent, has broad powers to assume, assign, or reject contractual obligations outstanding at the time of the bankruptcy filing. Rejection reduces the obligations to claims for money damages against the estate, just as if the contracts had been breached just before the filing. Assumption permits the DIP to retain valuable contracts for the estate. The DIP has wide latitude to assume these contracts, including a right to cure any outstanding breach. Moreover, the parties cannot opt out of the bankruptcy system with clauses that terminate contracts upon the filing of bankruptcy.

While the executory contract provisions generally equalize matters as between debtor and creditor, and among creditors, they also enforce distributional objectives that diverge from the principle of equality. Lenders, labor unions, retirees, landlords, tenants, land buyers, and intellectual-property licensees receive specialized treatment, thereby diminishing the assets available to the general creditors.

The Strong-Arm Clause

In the period just before it files for bankruptcy, a business may enter into a number of agreements that promise certain collection rights to its creditors—such as granting a Uniform Commercial Code Article 9 security interest or a real estate mortgage. At state law, those agreements are good against the debtor as negotiated, but they are generally not effective against competing creditors unless additional steps are taken, such as properly perfecting the security interest or recording the real estate mortgage. Once the business files for bankruptcy, the creditors want these negotiated agreements enforced to give them better collection rights against the DIP. The Code provisions that permit the DIP to resist these agreements are collectively known as "the strong-arm clause."

Operation of the Strong-Arm Clause

When the estate is formed, the DIP has the right to represent the interests of the creditors collectively. By statute, the DIP is a hypothetical judgment lien creditor, a hypothetical execution creditor, and a hypothetical bona fide purchaser of real property, able to set aside any transfer of property that these creditors or purchasers could set aside. (section 544(a)) The sweep of these provisions is broad, so that the DIP may avoid any transfer of property of the debtor or any obligation incurred by the debtor if one of the imputed creditors could have avoided it. (section 544(a))

The status of the hypothetical judgment lien creditor permits the DIP to exercise the rights of the judgment lien creditor at state law at the instant of the bankruptcy filing. An unrecorded security interest, for example, is effective against the debtor but ineffective against a judgment lien creditor under state U.C.C. law. (U.C.C. § 9-301(1)(b)) In such a case, the DIP preserves the superior interest of the hypothetical judgment lien creditor for the benefit of the estate and the creditors collectively. (section 550(a)) If state law gives the execution creditor rights superior to those of other creditors, those rights are preserved for the benefit of the estate as well. (section 544(a)(2)) This means, for example, that if a secured creditor had an interest in a piece of machinery, but the interest was unrecorded and therefore vulnerable to attack by a judgment lien creditor under U.C.C. § 9-301(1)(b), the DIP could take the interest of the hypothetical judgment lien creditor in the property and preserve that interest for the estate. In effect, the estate would take the value from the equipment, rather than permitting that value to go to the creditor who held an unrecorded security interest.

Land transactions can also be set aside if they would yield either to a judgment lien creditor or to a bona fide purchaser for value. (section 544(a)(1), (3)) The extension of the DIP's status to that of a bona fide purchaser extends protection for the bankruptcy estate even in states that do not give judgment lien creditors priority over unrecorded real estate interests. As a practical matter, creditors claiming interests that are good against the debtor but are ineffective against other creditors because of defects in perfection will lose those interests. Such creditors then join the ranks of the unsecured creditors.

The strong-arm clause permits the DIP to work within the state-law system to create and preserve rights for the estate. Because the state-law system is used to develop these rights, the variations in the system that permit unrecorded or late-recorded interests to prevail are controlling in bankruptcy as well. This means, for example, that a buyer in possession of real estate who has no recorded interest but whose open and notorious possession would permit it to prevail over a bona fide purchaser of the real estate at state law would obtain the same result in bankruptcy. While the strong-arm clause gives the DIP the powers certain creditors would have enjoyed at state law, it does not contract or expand them.

Policy Issues

The provisions of the strong-arm clause are neither extensive nor conceptually difficult. Nonetheless, they express a central concept of bankruptcy law: The estate succeeds to the rights of both the debtor and collecting creditors. If the estate succeeded only to the rights of the pre-petition debtor, whatever agreements the debtor had negotiated would most likely be honored in bankruptcy. But because bankruptcy is a collective action, taken on behalf of all the creditors, the DIP gets powers greater than those of the debtor.

The strong-arm clause also demonstrates a collection feature of the bankruptcy system. A bankruptcy petition, even a petition voluntarily filed by the debtor, is a supercollection petition. It is as if the creditors had simultaneously filed collection actions against the debtor and had taken all steps necessary to perfect their interests in the state-law scheme. The creditors have the rights that general creditors would have had in state law—including the right to ignore deals negotiated between the debtor and an individual creditor if those deals are not properly perfected.

The distributional aspects of the strong-arm provisions are obvious. The collective rights of the creditors are preserved in bankruptcy, whereas the individual rights of particular creditors against that collective interest are more sharply curtailed. Equality of distribution once again dominates the bankruptcy system.

The strong-arm provisions also strengthen the value-enhancing elements of bankruptcy policy. By making such collection rights automatic and available to all creditors, the provisions ensure that the expense of the one-at-a-time approach of state collection can be avoided. And the possibility of bringing value back into the estate is an incentive to the businesses not to wait too long to file for bankruptcy, thereby encouraging voluntary, timely bankruptcy filings when a business is in trouble.

Summary

The DIP has the power to enforce the rights of judgment lien creditors, execution creditors, and bona fide purchasers of real estate. Those powers permit the DIP to set aside collection rights that are good against the debtor and to exercise its powers for the collective benefit of the creditors.

Voidable Preferences

During the period immediately preceding the bankruptcy filing, creditors often intensify their collection efforts. When they learn that the debtor is in financial trouble, they may exercise both their extralegal leverage and their formal collection rights to extract payment from the failing company. They do so, in part, in recognition that there is unlikely to be enough money to go around and that they need to beat other creditors who may be closing in. Some creditor collection actions that occurred before filing are honored, while others are set aside. The Code provisions on voidable preferences delineate which actions remain effective and which do not.

Basic Structure

The DIP can set aside a transfer that occurred before bankruptcy if it is a voidable preference. The qualifications of a voidable preference are set by statute. They are detailed and specific. A voidable preference is:

transfer

of the debtor's property

on an antecedent debt

made within ninety days before the filing

while the debtor was insolvent

to or for the benefit of a creditor

that permits the creditor to recover more than it would have recovered in liquidation if the transfer had not been made. (section 547(b))

If any of the elements are absent, the transaction is not a voidable preference. The Code provides for specific exceptions, so that some voidable preferences cannot be set aside. (section 547(c))

1. *The avoided transaction must be a transfer.* (section 547(b)) The Code defines *transfer* broadly. (section 101(50)) Transfers may be voluntary or involuntary, so that making payments and taking judicial liens are both transfers. Receiving any interest in property qualifies as a transfer, which means that taking a security interest or recording that interest to perfect it against other creditors qualifies as a transfer. The transfer provision is broad enough to encompass

not only making payments to creditors and perfecting security interests, but also other activities, such as the debtor's acquisition of property that becomes subject to a creditor's after-acquired property clause. A transfer may occur, for example, when the debtor hires workers to assemble bicycle parts that are subject to a security interest or when the debtor buys fertilizer and water to grow crops subject to a security interest. Whenever the debtor or creditor engages in some transaction that enhances value for a particular creditor, a transfer has taken place. The only creditor to enjoy some increase in value without a transfer is the creditor who has a security interest in property that simply appreciates by the good fortune of market forces.

2. *The transfer must be a transfer of an interest in property of the debtor.* (section 547(b)) When the debtor pays money, clearly it transfers an interest in its property. But just as surely, if the creditor records a security interest, the creditor perfects an interest in the property that had belonged to the debtor. If, however, a third party paid the debtor's obligations, the creditor who was paid off may have done better than the other creditors, but did not profit from an interest of the debtor. By contrast, if the third party paid off an unsecured debt and received a security interest for its payment, the transfer involved an interest of the debtor. Similarly, if the third party simply made a loan to the debtor and the debtor used the funds to pay one creditor rather than another, it is clear that the estate was enhanced (when it received the money) and diminished (when the money went to one creditor rather than another). Although the debtor's balance sheet may have remained the same, the money lent to the debtor became the debtor's property, available for distribution to all the creditors. If the debtor used that money to pay one creditor, even if that was its announced plan, a transfer of the debtor's property occurred. Whether the funds from the third party were sufficiently "earmarked" by the parties so that the transaction did not involve a transfer to the estate and a resulting voidable preference has been the subject of hot factual dispute in a number of cases.

3. *The transfer must be on account of an antecedent debt.* (section 547(2)) A purely cash transaction does not qualify as a transfer. This provision permits the failing business to continue to operate at least on a cash basis. It limits the sweep of voidable pref-

erence law to minimize the disruption of commercial life that would be involved in setting aside cash deals. Moreover, the provision permits other simultaneous exchanges, such as granting and recording a security interest in return for new credit. The focus on antecedent debt also emphasizes that these provisions are designed to equalize the treatment of creditors. Other provisions restrict other kinds of transactions, such as executory contracts and fraudulent conveyances, which do not involve antecedent debt. By focusing on transfers on account of preexisting debt, this provision deals with equalizing the treatment of pre-petition creditors.

4. *The "reach-back" period to avoid transfers is limited.* (section 547(b)(4)) For most creditors, that period is ninety days—an arbitrary date for fixing which creditors must be treated equally. (section 547(b)(4)(A)) For one class of creditors, however, there is a longer reach-back. Transfers to insiders can be set aside for one year. (section 547(b)(4)(B)) Once again, the Code uses a broad definition to maximize the sweep of the provision. An insider includes (but is not limited to) a director, officer, person in control, general partner, or a relative of any of these. (sections 101(30), 102(3)) The longer reach-back for insiders reflects the longer period that insiders can divert assets to themselves without attracting notice from their creditors. The provision also reflects the concern that insiders, with better financial information, may have moved earlier to profit themselves at the expense of the business. The provision also reasserts the importance of the Code's distributional objectives by opening to scrutiny the transactions of insiders and the debtor business for a full year before the filing, making them vulnerable to a pro rata distribution.

5. *The transfer must be made while the debtor is insolvent.* (section 547(b)(3)) This requirement highlights the pre-bankruptcy monitoring aspect of the voidable preference provisions. Payments made while the debtor is solvent are all right, even if they permit some creditors to do better, whereas payments made when the debtor is insolvent subject those recipients to "give-backs" in bankruptcy. Transactions with faltering debtors, not debtors that are financially solvent, are scrutinized. A debtor is insolvent if its debts exceed its assets, with assets valued at "fair valuation." (section 101(31)) The Code presumes that the debtor was insolvent during the last ninety days before filing, but the presumption can be

rebutted. (section 547(f)) For the one-year reach-back against insiders, the presumption of insolvency only runs for the ninety days immediately preceding filing; thereafter, the DIP will be required to prove insolvency.

6. *The transfer must be to or for the benefit of a creditor.* (section 547(b)(1)) A *creditor* is broadly defined as anyone holding a pre-petition claim against the debtor. (section 101(9)) The creditor need not receive the transfer directly. If the transfer benefited the creditor, the statutory requirement has been met. As the earlier examples show, the debtor may acquire property that is subject to the creditor's security interest or spend money to enhance collateral in which the creditor has an interest. Both will be transfers for the benefit of a creditor.

The "for the benefit" provision has raised particular difficulties with co-obligors. In a very interesting—and somewhat controversial—decision, the Seventh Circuit held that when a loan was paid off, both the lender and the guarantor on the note benefited—the former from the payment directly and the latter by a reduction in its contingent liability.[25] Since the guarantor had a contingent claim against the debtor if it defaulted on the loan, the guarantor was also a creditor. (section 101(9)) The payment met all the qualifications of a voidable preference to the lender, except that it was outside the ninety-day preference period. But, said the court, the preference period for this transaction is one year because the guarantor who also benefited from this transaction was an insider. The payment was set aside as a voidable preference.

The broad language of "to or for the benefit" of a creditor is clearly designed to extend the sweep of voidable preference law to pick up any transaction that benefits a creditor—whether the transfer was made directly to the creditor or not. It embodies an economic—rather than a formalistic—approach.

7. *The transfer must enable the creditor to receive more than it would have received in a liquidation if the transfer had not taken place.* (section 547(b)(5)) This restriction is frequently referred to as requiring that the transfer have a preferential effect. If the creditor would have received the same payment in a Chapter 7 proceeding

25. *See* Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186 (7th Cir. 1989).

without the transfer, the distributional objectives of the Code are not violated by permitting the creditor to keep the transfer. The circumstances under which a transfer permits a creditor to receive more than it would in liquidation are fairly simple: If a liquidation would yield anything less than payment in full of all claims, the transfer to an unsecured creditor always permits that creditor to receive more than it would have received in liquidation. The unsecured creditor reduces its claim dollar for dollar with the payment it receives. But the claim was only worth some pro rata distribution in liquidation. Similarly, a payment to a partially secured creditor reduces the unsecured portion of the claim first, since the security interest remains in effect to cover the remainder of the debt. By definition, the undersecured creditor who receives a payment is also receiving more than it would have received in liquidation. The only creditor who does not receive more from a pre-petition payment is the creditor who would have been paid in full in liquidation—the fully secured creditor. Payments to a creditor with a valid security interest in collateral that meets or exceeds the creditor's claim does not receive a preference when it is paid shortly before bankruptcy. Such a creditor receives payment in full with or without the disputed payment. This is true, of course, only for oversecured creditors. The undersecured creditor who reduces its level of undersecurity with pre-petition payments has received a voidable preference. The Code follows a strictly construed set of rules to determine voidable preferences, even as it ignores the time value of money. The fact that payment earlier is better than payment later does not make the transfer a voidable preference.

Finally, it is worth noting what is *not* an element of a voidable preference. The Code contains no intent or state-of-mind provision. Transactions are set aside because of their effects, regardless of whether either the debtor or the creditor intended to participate in a preferential transfer. Moreover, the Code does not require that the transfer diminish the estate—although the concept seems to be related to the provision that the transfer be of "an interest of the debtor." Some creditors raise equitable arguments, trying to preserve certain transactions that they entered into in good faith or that they believe did not diminish the estate. The Code provisions make these arguments irrelevant.

Because the definition of *voidable preferences* turns on such highly technical provisions, the Code provides additional details to clarify when some transfers take place. Generally, transfers of security interests and mortgages take place when they are good against other creditors under applicable nonbankruptcy law. (section 547(e)(1)) A transfer of real property takes place when it is so perfected that a bona fide purchaser could not defeat the transferee's interest. (section 547(e)(1)(A)) Similarly, a transfer of an interest in personalty takes place when it is perfected. (section 547(e)(1)(B)) This means, in effect, that the filing to perfect these interests is itself a transfer.

Some leeway is inserted into the Code, however, to reflect the fact that a creditor may take a security interest and file it a few days later. The Code deems such a transfer to occur at the time it takes place between the debtor and the transferee, if the perfection step is taken within ten days. (section 547(e)(2)) This gives creditors ten days to file their interests and still have their perfection declared contemporaneous with the rest of the transaction between the debtor and creditor. Thus, the creditor who lends money in return for a security interest, which it perfects within ten days, has not filed on account of an antecedent debt and hence is not subject to having the filing set aside. In the judgment of the Code drafters, these delays conform with standard business practices, and the bankruptcy system protects them.

Sometimes the facts are reversed, so that the filing precedes the debtor's acquisition of property. This often occurs when the creditor has an after-acquired property clause, sweeping subsequent property into the creditor's net, or when the creditor has a floating lien, covering such property as inventory and accounts receivable where the identity of the particular pieces of collateral tend to change over time. In these situations, the Code deems the transfer to take place when the debtor acquires rights in the collateral. (section 547(e)(3)) This means that if the debtor acquires any property within the preference period before filing and the property is covered by any creditor's security interest, the transfer occurs when the debtor acquires rights in the property and the transaction is subject to voidable preference attack.

Exceptions to the Voidable Preference Rules

Some transactions are protected even though they may be preferential transfers. The exceptions are as specific as the rule creating preferences, however, and transactions that do not quite fit the exceptions can still be set aside.

The almost-contemporaneous exchange is protected. (section 547(c)(1)) A truly contemporaneous exchange, such as the transfer of goods for cash or the transfer of a loan for security interest, is not a voidable preference because there is no antecedent debt. (section 547(b)(2)) But a transaction may be intended by the parties to be a contemporaneous exchange for new value and be only substantially contemporaneous. If one examines a transaction closely, it might be that the seller gave the debtor goods just minutes before the debtor paid the creditor—technically making the payment on account of an antecedent debt. The Code drafters wanted to avoid such hypertechnicality, so they added an exception to make it clear that substantially contemporaneous exchanges could be saved as well. The exception reinforces the policy decisions evident in the antecedent debt provision of the Code.

When the provision was adopted, a number of people thought it would apply to payment by check. If the debtor paid for goods with a check and the creditor cashed it in the ordinary course, the parties may well have intended this to be a contemporaneous exchange, although there was a brief extension of credit. The Code would protect such a transaction as substantially contemporaneous. But if the debtor post-dated the check, the parties would have intended a credit relationship, and the transaction would not qualify under the subsection (c)(1) exception, no matter how brief the period of credit extension. If the check were dishonored and paid only after re-presentment or other collection efforts, the transaction would no longer be substantially contemporaneous and would lose its qualification for the exception as well. This interpretation has become somewhat controversial, however, and not all court decisions are consistent on the point.

Ordinary-course payments are also protected from set aside as voidable preferences. (section 547(c)(2)) If a debt is incurred in the debtor's ordinary course of business and it is repaid in the ordinary course of business according to ordinary business terms, the transaction will be protected. (section 547(c)(2)) This exception insulates payments that do not result from the creditor's stepped-up collection efforts, thereby preserving ordinary commercial routines. Thus, only extraordinary activities of the pre-petition debtor and its creditors are monitored under the Code scheme. The exception permits the debtor to prefer some creditors "in the ordinary course," however, and its application may be broader than its policy justification. Like the provisions exempting cash transactions, this provision permits the debtor to remain in business even while it is in financial difficulty. Its creditors can continue ordinary operations and not be concerned that they will have to disgorge their payments if the debtor files for bankruptcy.

Purchase money security interests (PMSIs) are given special protection. (section 547(c)(3)) A PMSI loan that is perfected within ten days of the time the debtor receives possession of the collateral will be insulated from voidable preference attack. (section 547(c)(3)) The rationale mirrors the PMSI exception in Article 9 of the Uniform Commercial Code, following the theory that such lending should be encouraged and that the estate is not diminished by such a transaction.

Creditors who extend subsequent unsecured credit after they have received a voidable preference can offset their later extensions against repaying the preferences. (section 547(c)(5)) The "net result" test was an exception developed under the old Act, which involved adding up all the credit extensions from the creditor and all the payments from the debtor, regardless of when each was made. Only the final balance, if it favored the creditor, was a preference. The current Code exception gives more limited protection to creditors. The Code protects only subsequent extensions of credit. An extension of credit that precedes the voidable preference saves nothing, whereas an extension of credit that follows the preference will offset the preference. There is an equitable notion here: Creditors that have aided the estate after their preferences should get credit for their subsequent aid, but those who aided the debtor and then received transfers from the debtor should get no help.

Inventory and accounts receivable financing are given special protection. (section 547(c)(5)) The turnover of the items in inventory and receivables makes security interests on such items vulnerable to set aside as voidable preferences. In a grocery store, for example, the canned goods for sale on June 1 are not likely to be exactly the same as the canned goods for sale on September 1, even if there are an equal number of cans of fruits and vegetables on both dates. Similarly, the accounts outstanding for a department store on June 1 are not likely to be exactly the same accounts with the same amounts owed. The Code protects security interests in such collateral subject to a test: The difference between the value of the collateral and the outstanding loan is determined for the date ninety days before the bankruptcy filing and again on bankruptcy filing day. If the loan was oversecured ninety days before filing, the security interest at filing is fully protected. If the loan was undersecured ninety days earlier, the portion of the security interest that reduces the undersecurity by bankruptcy day will be avoided. (section 547(c)(5)) This means, for example, that if the lender's inventory loan was undersecured by $50,000 on the ninetieth day before bankruptcy, but it was undersecured by only $20,000 on bankruptcy day, the interest would be avoided on $30,000 of the collateral. The actual numbers of both the loan and the collateral value are immaterial, except to calculate the undersecurity. Only changes in undersecurity are relevant.

In effect, the Code exception does not protect the undersecured inventory or receivables financer that improves its position within the ninety days preceding bankruptcy.[26] The Code does, however, ignore shifts in account balances and changes in the identity of the collateral. This balances competing goals: It encourages inventory and receivables financing that would otherwise most likely be obliterated in bankruptcy, and it discourages the inventory and receivables lender from eve-of-bankruptcy pressure on the debtor to run up collateral values to protect the creditor's bankruptcy position.

Policy Considerations

While the voidable preference provisions are lengthy and detailed, the conceptual bases for them are not nearly so complicated.

---

26. The oversecured inventory or accounts lender can always have a greater oversecurity during the period preceding the bankruptcy filing, just as any other oversecured creditor can become more oversecured before filing. Since the creditor can only collect the outstanding amount owed, the increase in oversecurity is not technically an improvement in position. That view is, of course, the view of a lawyer and not of the businessperson who sweats out the shifts in collateral value.

Principles that have shown up elsewhere in the Code are reiterated throughout these provisions. Moreover, these provisions illustrate a clear view of how bankruptcy may affect the commercial relations between parties when a debtor is in trouble.

If the Code permitted all pre-bankruptcy transactions to stand after the filing, creditors would be encouraged to engage in a "feeding frenzy" of collection activities when companies were rumored to be in trouble. Quick, aggressive creditors would receive payment in full, whereas those who worked with the debtor and extended more unsecured credit would lose everything. The push by creditors might be enough to sink some debtors that otherwise would survive their economic crisis, increasing the cost of economic stumbles by turning them into economic failures. Of course, some creditors may simply push the debtor earlier, but the debtor has control over the bankruptcy filing date. Debtors that have been subjected to aggressive collection efforts can choose bankruptcy before the preference period has run. By examining pre-bankruptcy collection efforts and by avoiding those collection transactions that permit the creditors to receive more than a pro rata distribution of the estate, the bankruptcy system reduces the incentive to act individually and aggressively when a debtor is in trouble. In doing so, it exercises some restraint on the activities of creditors to dismantle ongoing businesses and to dissipate the value of the estate through piecemeal liquidation.

Although it may be important to protect a failing company from being dismantled, such a policy will not enhance the value of failing companies generally if all transactions can subsequently be undone. Other businesses might conclude that it is unwise to engage in any transaction with a faltering company, even a cash sale, if the company can later reverse the transaction if it files for bankruptcy. This observation provides a balancing element to the preference set-aside provisions. Transactions that are useful to the business must be encouraged.

Avoiding certain pre-bankruptcy collection efforts also has the effect of equalizing the distribution among creditors over a longer period of time. Voidable preference law has the effect of treating all unsecured creditors alike, whether they have received payments shortly before bankruptcy or not. Setting aside a transaction that permits one party to receive more than similarly situated parties would receive in the collective liquidation is deemed a preferential transfer. This provision clearly illustrates the fairness norm that underlies the equality of treatment the Code strives to accomplish.

Voidable preference provisions also equalize the distribution among creditors by reducing the power of old management to choose the creditors that get paid and the ones that do not. Voidable preference law gives the DIP the power to reexamine the payments made and interests granted shortly before bankruptcy—when the old debtor faced no constraint to act on behalf of all the creditors. The DIP, obligated to enhance the estate, can use voidable preference provisions to bring assets back into the estate for the benefit of all the creditors.

Finally, it is worth noting that voidable preference provisions have a practical impact on many reorganizations. Recovery of payments often provides a source of funding for the reorganization effort. When security interests are set aside, the debtor is relieved of the obligation to provide adequate protection in order to keep using property during the reorganization. Moreover, the property that is now freed from a security interest may become collateral in postpetition refinancing. In addition, the ability of the debtor to recover voidable preferences may affect the willingness of various creditors to assist the DIP's reorganization effort. Creditors who thought they were paid in full now find they are pro rata participants in the reorganization effort and that their best prospect for payment in full is to cooperate in the reorganization effort. In other situations in which the application of voidable preference law is more questionable, the debtor may use the threat of such provisions as a basis for negotiating for a creditor's treatment in bankruptcy. Because voidable preference law gives the debtor a valuable tool for setting aside transactions, that tool can be used effectively by the debtor trying to negotiate a successful reorganization.

Summary

The DIP has the power to set aside both certain transfers to creditors that occur within ninety days before the bankruptcy filing and certain transfers to insiders that occur within a year before the filing. This power permits the DIP to pull assets back into the bankruptcy estate that may have been wrenched out of the business shortly before filing by zealous creditors or flung out of the estate by a debtor hoping to prefer some creditors. Voidable preference law gives the creditors who cooperate with the debtor the right to participate pro rata with their more aggressive colleagues.

Statutory Liens

Sometimes a creditor enjoys an enhanced position not by its own actions to collect a payment or negotiate for a security interest, but by virtue of state-law provisions that give it preferential treatment. Such grants of priority repayment rights from state law are grouped together under the rubric of statutory liens. The extent to which the bankruptcy system recognizes such state-law preferences will determine whether those creditors receive better treatment in bankruptcy than the general creditors do.

Basic Structure

Not all liens imposed by state law are voided in bankruptcy. Instead, the Code focuses on certain disfavored liens that are likely to be invoked only in the bankruptcy process. The DIP has the power to set aside liens that first become effective when the debtor files for bankruptcy, becomes insolvent, suffers the appointment of a custodian or the initiation of insolvency proceedings, or fails to meet certain financial conditions. (section 545(1)) In addition, the DIP may set aside statutory liens that would not be enforceable against a bona fide purchaser. (section 545(2)) Landlords' liens for rent are also set aside. (section 545(3), (4))

Statutory liens vary from state to state. Some states protect materialmen and suppliers in the construction industry. Others protect repair people who work on personal property. Most states provide some sort of landlord's lien. Personal injury victims get liens in some states, and attorneys benefit from charging liens that protect the proceeds of successful litigation. The liens that fall within the provisions of section 545 of the Code are voided, whereas all other liens are preserved.

One lien that is triggered by insolvency has deliberately been preserved in the Code scheme. A seller's right under the Uniform Commercial Code to reclaim goods from an insolvent buyer within ten days after shipment is preserved in bankruptcy. (U.C.C. § 2-702(2); § 546(c)) Although the Uniform Commercial Code provision functions much like a statutory lien, its uniformity and its entrenchment in commercial practices evidently persuaded Congress that it should be preserved in bankruptcy.

Policy Issues

The distributional consequences of recognizing state-law statutory liens are clear: Such liens are designed to prefer one group of creditors over another, taking the benefited creditors out of competition with the remaining creditors. To the extent they are voided, the goal of equality among creditors is enhanced.

Why aren't all statutory liens voided? The rationale for this may be similar to the justification for preserving secured credit. Some liens may be sufficiently a part of commerce that the drafters of the Code did not want to disturb their use. Moreover, one justification for the original passage of a number of statutory liens is that they protect creditors that are unable to get security interests for one reason or another, suggesting that the statutory lien operates as a de facto security interest for these creditors.

When a state lien is triggered by the insolvency of the debtor or by the debtor's filing a bankruptcy petition, it poses a threat to the uniformity and supremacy of the Code. State laws providing for such liens are usually an obvious attempt by the local legislatures to determine the priority of repayment in the bankruptcy system. If these liens were given full effect in bankruptcy, the distributional scheme of federal bankruptcy would be supplanted by varying state distribution systems.

If statutory liens that operate only in bankruptcy were given effect, the general creditors would lose collection rights when the bankruptcy petition was filed. In effect, the general creditors do not have to contend with those liens that are triggered by bankruptcy so long as there is no filing. By avoiding these liens in bankruptcy, the Code permits the creditors to succeed to the collective collection rights they would have enjoyed outside bankruptcy.

Summary

The DIP may set aside improvements in creditor positions on the eve of bankruptcy. The provisions on voidable preferences and those on statutory liens work together to permit the DIP to avoid both the negotiated collection efforts and statutory collection relief that some creditors enjoy shortly before filing. By recovering these benefits for the estate, the debtor forces these creditors to share pro rata in the debtor's failure.

Fraudulent Conveyances

Fraudulent conveyance law was first introduced into debtor–creditor law with the passage of the Statute of Elizabeth in 1571. The statute was designed to prevent debtors in distress from conveying away their property to keep it beyond the reach of their creditors. American jurisdictions adopted fraudulent conveyance law, either by statute or by incorporation into the common law. During the eighteenth and nineteenth centuries, case law became somewhat confused and contradictory. In 1915, the National Conference of Commissioners on Uniform Laws drafted a uniform act. The Uniform Fraudulent Conveyance Act was adopted by the conference in 1918 and subsequently enacted in twenty-four states. The conference has since redrafted the fraudulent conveyance provisions, proposing a new Uniform Fraudulent Transfer Act, which has been adopted by fourteen states (ten of which switched from the old UFCA). States that did not adopt either uniform law adopted somewhat similar provisions either by statute or by common law. Today, bankruptcy law incorporates state fraudulent conveyance law and provides for a federal fraudulent conveyance law in bankruptcy as well.

Basic Structure

The Code incorporates fraudulent conveyance law into its structure by giving the DIP two alternatives: The DIP can exercise all the state-law recovery rights of unsecured creditors, or it can use a federal fraudulent conveyance law. (sections 544(b), 548) This double-barreled attack on fraudulent conveyances permits the DIP to use the laws that favor the surest recovery. For example, the Uniform Fraudulent Transfer Act gives creditors—and hence the DIP—four years to bring an action after a transfer. (UFTA § 9) This would obviously permit recovery in some cases that would be missed under the one-year statute of limitations in the federal statute. (section 548(b)) Moreover, the UFTA also creates an alternative one-year statute of limitations that begins to run only when the transfer "was or could reasonably have been discovered by the claimant," which is not available in the federal statute. (UFTA § 9(a)) Federal fraudulent conveyance law also carries benefits not found in state law. Many state laws, for example, permit only extant creditors to sue in constructive fraud cases, whereas the federal provisions permit the DIP to sue even if no estate creditor was owed an obligation at the time the fraudulent transfer occurred. The DIP can choose how it will proceed. It gets whatever the creditors collectively could have gotten at state law, as well as whatever the Code grants the estate.

Federal fraudulent conveyance law covers two kinds of potentially fraudulent transfers. If the DIP can show that the debtor had "actual intent to hinder, delay, or defraud" existing or future creditors by making the transfer, the DIP can set the transfer aside. (section 548(a)(1)) Historically, fraudulent conveyance law turned on whether the debtor had engaged in certain transactions that had "badges of fraud." The enumerated badges grew through the years, but so did the creativity of debtors who made transfers to escape paying their creditors. The Code now uses an actual-intent standard, which does not require any particular element or badge of fraud. Actual intent is subjective, but it may be inferred from the behavior of the debtor. If such intent is proven, the transfer is a fraud on the creditors, and the DIP can set it aside.

Federal fraudulent conveyance law covers all transfers by a debtor within a year of the bankruptcy filing. (section 548(a)) Once again, transfers are defined broadly to include a wide range of activities. (section 101(50)) The fraudulent conveyance provision reiterates that both voluntary and involuntary transfers are within the ambit of this provision, and it thus gives the DIP the right to challenge judicial sales that disposed of the debtor's property, if the other elements of fraudulent conveyance are met. (section 548(a)) The circuit courts are split over whether this means that a DIP can challenge a lawful judicial sale of the debtor's pre-bankruptcy property as an involuntary fraudulent conveyance. The UFTA explicitly provides that such a transfer is not a fraudulent conveyance, but it remains to be seen whether the Code's fraudulent conveyance provisions will be interpreted the same way. (UFTA § 3(b))

The second kind of fraudulent transfer in the federal system is a transfer that is constructively fraudulent. These transactions require no showing of the debtor's intent. The Code provides that a transfer is fraudulent if the debtor receives less than a reasonably equivalent value in exchange for the transfer, if the debtor is insolvent at the time of the transfer. (section 548(a)(2))

Whether a transaction is incurred for less than reasonably equivalent value is, of course, fact-specific. Paying off an antecedent debt constitutes receipt of reasonable value, although such payments may trigger scrutiny under the voidable preference laws. (sections 548(d)(2)(A), 547(b)(2)) The critical question in most litigation on this issue is whether the debtor received reasonably equivalent value for the transfer. Sometimes it is a simple case of selling an item at a price that is too low. At some point, the sale becomes a constructive fraud on the creditors. Alternatively, sometimes the difficulty is that the nondebtor party to the transaction gave adequate consideration, but the consideration went to someone other than the debtor. If, for example, the debtor business guaranteed a loan to a parent corporation and the loan proceeds went only to the parent, the debtor business would not have received reasonably equivalent value for its guaranty. Both the guaranty and the loan contracts would be enforceable under contract law, but they could be set aside in bankruptcy if the other elements of fraudulent conveyance law were met.

The DIP must also show that the debtor was insolvent at the time of the transaction or became insolvent as a result of the transfer. (section 548(a)(2)(B)(i)) The insolvency provisions in fraudulent conveyance law take a number of forms. The Code defines insolvency using a balance-sheet test, exclusive of any property transferred with intent to hinder, delay, or defraud. (section 101(31)(a)(i)) In addition, if the business is left with "unreasonably small capital" after the transaction, the conveyance is deemed fraudulent. (section 548(a)(2)(ii)) Finally, if the business believed it would incur debts that would be beyond its ability to repay as the debts matured, the conveyance could be set aside. (section 548(a)(2)(iii)) By using multiple approaches to the question of insolvency, the Code preserves maximum flexibility for the DIP to set aside transactions when the transactions injured the estate.

A transfer for less than reasonably equivalent value when the debtor was insolvent can be set aside by the DIP under federal fraudulent conveyance law without any showing that the creditors in bankruptcy are in fact the same creditors as those existing at the time of the transfer. This differs from a state-law fraudulent conveyance action, which typically requires that the action be brought by a creditor existing at the time of the transfer, if the action is based on constructive fraud. This illustrates once again the broad reach of the powers of the DIP—here the DIP is given rights that are somewhat greater than those at state law.

Finally, the Code provides some protection for the transferee. If the transferee acts in good faith, it is given a lien against the property transferred to the extent it gave value. (section 548(c)) This completes the balancing of interests between the transferee and the creditors and attempts to make the transferee whole. The good faith transferee must disgorge the value transferred from the debtor, but it may deduct the value it had already given to the debtor.

The most powerful—and controversial—application of fraudulent conveyance law has followed in the wake of leveraged buyouts (LBOs) that have crashed into bankruptcy. In a typical LBO, the buyers of a target business offer the shareholders money for all the outstanding shares. The money comes from a lender, who takes a security interest in the shares. When the sale is consummated, by prearrangement the buyers commit the business to repay the debts and cause it to create a security interest in all the business's unencumbered assets to secure the purchase loan. This creates new owners of the business who have invested very little (hence the term *leveraged*). It also leaves the target business with huge debt obligations and virtually no unencumbered assets. If the business cannot meet its obligations, it goes into bankruptcy. If the security interest is valid, only the secured creditors will be likely to see any recovery. Some courts have permitted the DIP to use fraudulent conveyance law to set aside the security interests in all the debtor's unencumbered property and to avoid the promises to pay on the LBO loans. They reason that the debtor business received nothing for its promise to pay and its security interest, making the transaction a classic fraudulent conveyance. Other courts permit the set aside on alternative fraudulent conveyance grounds, ruling that the parties to the LBO had actual intent to hinder, delay, or defraud outstanding creditors.

The various forms that LBOs may take are limited only by the imagination of investment bankers and eager investors. In some fact settings, courts have found that the elements of a fraudulent conveyance have not been proven. Moreover, some courts have found that the transaction can be undone with respect to some parties, such as the financer, but not others, such as the buyer who did not understand the leveraged nature of the financing purchase.

Policy Issues

Until a business files for bankruptcy and puts its property under the control of the bankruptcy court, it has a generally unfettered right to dispose of assets as it sees fit. It may agree by contract not to alienate certain property, or it may give lenders the right to supervise certain of its activities. Those transactions are private, contractual arrangements, individually negotiated and enforced. There is, however, one baseline obligation imposed on all debtors and enforceable by their creditors: Insolvent debtors may not make "fraudulent transfers."

Fraudulent conveyance law restricts the right of the insolvent debtor to injure the creditor by conveying value from the business. State fraudulent conveyance laws are an exception to the usual pattern of individual creditor rights. Fraudulent conveyance law places collective creditor interests above the interests of the recipients of the debtor's assets. Once again, the DIP succeeds to the rights of the creditors collectively under both the state-law fraudulent conveyance laws and the federal fraudulent conveyance provisions of the Code.

By avoiding transactions in which debtors show an intent to hinder, delay, or defraud their creditors, the law polices debtors that would avoid repaying their creditors by making themselves insolvent. Although very little debtor–creditor law turns on the intent of the parties, this intent provision is a central element of the ability to monitor the behavior of debtors. Fraudulent conveyance law operates as a sort of baseline of debtor behavior. Even when the creditors negotiated for no special deal, the insolvent debtor is obligated not to act to injure its creditors.

By curbing transfers made with intent to hinder, delay, or defraud, the law once again denies the debtor the opportunity to choose the creditors it will pay. This provision thereby enhances the equality of treatment among creditors that is prized by the Code.

When the debtor has no intent to injure the creditors with its prefiling transfers, fraudulent conveyance law serves a somewhat different function. By restricting certain transfers that do not return fair consideration to the estate, the law provides some control over distress sales and piecemeal liquidations that dissipate the value of the estate. Fraudulent conveyance law makes some deals with faltering companies just too good to be true. Deals with insolvent debtors for very low consideration can be set aside by the debtor's other creditors.

The value-enhancement norm of this provision is clear. Regardless of the intent of the insolvent debtor, it cannot dissipate value by conveying it away. By recapturing property that has been transferred for less than fair consideration, the DIP enlarges the estate and the distribution to creditors grows. Also, by scrutinizing transactions that occurred one or more years before filing, fraudulent conveyance law is another device for monitoring the behavior of all troubled debtors.

Summary

One of the oldest debtor–creditor provisions in our legal system is incorporated into the Code twice. Creditors can use state fraudulent conveyance law or federal fraudulent conveyance law. A conveyance may be fraudulent if it is made with intent to injure the creditors or if it conveys value without a reasonably fair exchange. Property pulled back into the estate by a fraudulent conveyance action is used to enhance the value of the estate and to benefit the creditors collectively. Like other avoidance provisions, fraudulent conveyance actions are frequently used to provide funding for the reorganization effort.

State Avoidance Laws

In addition to state fraudulent conveyance laws, other state statutes give creditors rights to recover certain transfers of the debtor. State corporation laws, for example, may provide that creditors may set aside a company's dividends if they have been paid from any source other than retained earnings. The DIP, acting on behalf of the creditors, is able to enforce those state-law rights.

General Operation

The Code provides that the DIP may avoid any transfer of an interest of the debtor that can be avoided at state law by an unsecured creditor. (section 544(b)) By limiting the application to rights given unsecured creditors, the Code permits recovery only of collective rights.

The primary use of the Code's section 544 is to incorporate state fraudulent conveyance law into the federal scheme, which was discussed earlier. But the provision is not limited to enforcement of such laws. State restrictions on declarations of dividends or on usurpation of corporate opportunities, for example, may be used by the DIP to recover assets in bankruptcy. Similarly, in appropriate circumstances, the DIP may use state bulk sales laws to recover assets on behalf of the creditors.

In proving the elements of the state-law creditors' claim, the status of the DIP is not hypothetical, as it was with the strong-arm clause. (section 544(a), (b)) This means that the DIP must meet every requirement of the state-law action or represent a creditor that meets the qualifications. If, for example, state law provides that only creditors extant at the time of a challenged transaction can enforce these state-granted rights, the DIP must find such a creditor among the estate's creditors. If no creditor qualifies, the DIP has no case.

If the DIP finds such a creditor, however, the DIP can act on behalf of the estate to set aside the entire transaction—effectively doing more than any individual creditor might have done. This principle, obliquely articulated in *Moore v. Bay*,[27] was incorporated into the bankruptcy system both by legislative history and by subsequent case law. A DIP that can find one qualifying creditor that was owed as little as one dollar can set aside a million-dollar transaction. Moreover, when the DIP recovers, it does so on behalf of all the creditors. The million dollars will be divided pro rata among all the claims against the estate. Once again, the DIP has collection rights rooted in state law, but the rights are enhanced when they are exercised on behalf of all the creditors in bankruptcy.

Policy Issues

The DIP succeeds to the collective rights of the creditors, including their state-law rights to set aside certain transactions. Bankruptcy does not require that the general creditors give up collection rights

27. 284 U.S. 4 (1931).

they might have exercised against the debtor and the debtor's transferees. This provision emphasizes the collective nature of a bankruptcy proceeding, ultimately enforcing a distributive norm. It also provides another means to enhance the value of the estate.

Summary

The DIP exercises collective rights of the creditors to enhance the estate and equalize the distribution of estate assets. In general, the DIP has the same rights and must meet the same burdens as a creditor suing in state court. But once a DIP can set aside a transaction, it can recover all the benefit of the avoided transaction, not just the benefit that could have been recovered by the complaining creditor. This gives the DIP collective rights better than those of the creditors.

Equitable Subordination

Even if a creditor does not run afoul of any of the specific provisions that could cause a transfer to be set aside, it may still face a problem in bankruptcy. If the creditor has acted "inequitably," it may find that its otherwise-valid security interest is lost or that its unsecured claim in bankruptcy is subordinated to the claims of all the other creditors. The basis for the judgment that a creditor's conduct was inequitable is that the creditor behaved in a way to injure the debtor and, in turn, to injure other creditors. In such cases, the bankruptcy court may equitably subordinate the creditor's claims.

Operational Details

Equitable subordination is a common-law principle that establishes the baseline relationships in debtor–creditor law. The Code ratifies the judicial concept announced in *Pepper v. Litton.*[28] (section 510(c)) The bankruptcy court may subordinate a claim or it may preserve creditors' liens for the benefit of the estate. (section 510(c)) The court is instructed to use "principles of equitable subordination." (section 510(c))

Two kinds of activities are generally covered by subordination: the activities of an owner hoping to benefit from claiming creditor

28. 308 U.S. 295 (1939).

status, and the activities of a creditor that has exercised control over the business to the detriment of the other creditors. Both are developed through case law, and the case law is, unsurprisingly, tangled.

The owner that hopes for creditor status may have operated the business with no capital investment, characterizing the initial contributions as "loans." If the business fails, equity holders retain ownership only after all outstanding debt has been paid. (section 1129(b)(2)) These owner–creditors hope to avoid that inferior state by demanding treatment as creditors. If they are secured, they want a priority distribution, and if they are unsecured, they want pro rata participation with the business's other creditors. Owners can, of course, lend money to their businesses, taking both equity and debt positions. But at some level of greed the owners risk too little as working capital, and the courts will treat their loans as equitably subordinated to the claims of the outside creditors.

Sometimes creditors who are outsiders take over the managerial role of the owner, and directly or indirectly exercise their power to divert assets to themselves. When this exercise of control injures other creditors, particularly if it drains the estate of much-needed assets, the courts may determine that the outside creditors should be equitably subordinated to the other creditors of the estate.

The impact of equitable subordination is powerful. For the lender that loses a security interest, the demotion from secured to unsecured status can make an enormous difference in its recovery. Sometimes the court will order not only that the secured creditor lose its security interest, but also that the interest be demoted to subordinated debt. Sometimes unsecured creditors' interests will also be demoted to subordinated debt. The effect of such demotion will usually be to deny any recovery at all to the creditor. Unless the estate has sufficient assets to pay all the other creditors in full, equitable subordination can mean that the creditor loses all possibility of recovery during the bankruptcy process.

In recent years, equitable subordination has begun to cover new ground. Leveraged buyouts have left debtor businesses burdened with more debt than they can possibly meet while all their assets have been locked up in security agreements in favor of those involved in the buyouts. When these LBOs have pushed companies into bankruptcy, the loan arrangements have sometimes become the subject of subordination actions. Moreover, the kinds of creditor behavior that have led to lender-liability actions are also covered by equitable subordination. Claims that the creditor has unreasonably cut off a line of credit and thereby caused the business to fail may give a court a reason to subordinate the lender's debt. The doctrine seems to be covering a wider variety of cases as parties create new ways to put their collection rights ahead of those of other creditors.

In determining whether a creditor's interests should be equitably subordinated, some courts examine whether the debtor promised the creditor the right to exercise such control or to call a loan without notice. Whether the debtor agreed to such behavior is only part of the inquiry. An inquiry into the relationship between the pre-bankruptcy debtor and this creditor is a starting point, but bankruptcy is a collective proceeding that implicates the rights of all the creditors as well. Equitable subordination is about injury to the other creditors stemming from a violation of principles of corporate management. The debtor's willingness to give up rights to a single creditor should provide no insulation if the creditor has behaved inequitably vis-à-vis other creditors.

Equitable subordination may free assets for the reorganization effort by avoiding security interests that encumber the debtor's property. Subordination will also reduce the number of creditors that must be satisfied during the distribution and will limit the subordinated creditor's right to vote on plan confirmation. Not surprisingly, threats to subordinate debt form a significant part of the negotiations of many Chapter 11 reorganizations.

Policy Issues

Creditors generally specify collection rights against a debtor, but few creditors specify the underlying conditions for running the business. Corporate law generally holds that creditors shall be paid ahead of equity holders.[29] Corporations are to be run to profit the corporate entity, not some third party. If the principles are violated, the corporate officers may be liable.[30] The question here is whether a creditor's participation in activities that violate the principles

---

29. *See, e.g.,* William Fletcher, Fletcher Cyclopedia of the Law of Private Corporations § 8219 (rev. perm. ed. 1962).

30. *See, e.g.,* Harry Henn, Law of Corporations § 231 (2d ed. 1970).

subjects the creditor to subordinated treatment if the company files for bankruptcy.

To the extent that bankruptcy law subordinates the obligations of nominal creditors that exercise managerial functions or of those creditors that participate in schemes to the benefit of others at a cost to the business, it once again exerts some influence over the activity of parties dealing with troubled corporations. Equitable subordination reduces the insider position or the leverage some creditors may exercise to improve their position.

By forcing creditors to give up security interests and other advantages, equitable subordination serves to enhance the wealth of the estate. Similarly, by reducing the number of general claimants and forcing some creditors to wait for collection until the general creditors have been paid, equitable subordination enhances the estate for the benefit of the general creditors.

The provisions on equitable subordination pose a jurisprudential issue that crops up throughout the bankruptcy system: To what extent should the provisions of the Code mandate its requirements, giving clear guidance to the parties and the courts, and to what extent should the Code authorize the courts to apply loosely articulated general principles of equity to counter the effects of unanticipated or unarticulated wrongs? Following hard on the heels of fraudulent conveyances, strong-arm statutes, and voidable preferences, the equitable subordination provisions seem to be the final, catchall weapon in the DIP's arsenal.

The use of general equitable principles in the Code may simply be a call for the development of a common law to fill in the necessary details. A series of cases, grounded in specific facts and articulating relevant principles, may guide future parties and ultimately inject predictability into the law. Nonetheless, the power given to the bankruptcy courts remains open-ended, designed to deal with new wrongs not covered by either current principles or applications. Unpredictability reigns, but the creative creditor can be hemmed in as quickly as it figures out new approaches to diminish the estate. Once again, the Code balances the advantages of certainty against the need for flexibility and responsiveness.

Summary

If the court finds appropriate grounds exist, the DIP can use yet another device to reshape the estate—subordination of some creditors' interests. Subordination may involve losing a priority repayment status, such as forgoing a security interest and consequently participating merely as a general, unsecured creditor. Or subordination may result in a creditor's demotion to receipt of payment only after all other creditors have been paid, which frequently means no repayment at all. In either case, assets of the estate are redistributed from the subordinated creditor to all the other creditors.

Conclusion

The bankruptcy system gives the DIP wide latitude to reshape the debtor business. The DIP can pick among the debtor's obligations, choosing which contracts shall become contractual obligations of the estate and which shall be mere claims for pro rata repayment. The DIP can also review the activities of the pre-petition debtor to determine whether payments of outstanding debts and assets that the debtor conveyed away should be recovered for the use of the estate. Sometimes, value is drawn back into the estate, particularly when the estate assumes profitable contracts or recovers fraudulent conveyances or voidable preferences. At other times, individual creditors lose their security interests and their resulting leverage to insist on something better than collective treatment in bankruptcy. The estate grows, and the DIP either has greater assets for distribution to the creditors collectively or has a better opportunity to create a viable business.

The powers of the DIP also tend to equalize the treatment of many creditors. Individual creditor rights must withstand collective attack. For example, those interests that are not superior to those of a judgment creditor under nonbankruptcy laws can be set aside in bankruptcy. Similarly, differences among creditors are diminished, so that creditors that have received immediate pre-petition payments are often in the same position as creditors that have not, and creditors whose contracts have been breached pre-petition will be treated like creditors whose contracts are rejected post-petition. The DIP uses the leverage created by the power to set aside transactions and to accept or to reject contracts to negotiate with the creditors for a workable reorganization plan.

The DIP succeeds to the rights of the old debtor, but it also succeeds to the rights of the creditors. In addition to the specifically delineated rights that give the DIP the power to set aside certain transactions or terminate particular contract provisions, the Code permits the debtor to seek the assistance of the court to counteract a broad—and unspecified—range of inequitable conduct by its creditors. Such far-reaching grants of power are designed to effectuate the goals of the bankruptcy system. The DIP represents the estate, an entity that is more powerful than the pre-petition debtor or the pre-petition creditors.

6 Negotiating and Confirming the Chapter 11 Plan

Experts estimate that fewer than one in five filed Chapter 11 cases survive to confirm a reorganization plan.[31] For the more than 80% that do not confirm a plan, often the business cannot generate an adequate cash flow to maintain its operations, and it simply collapses. In other cases, the death knell for the business is sounded when a secured creditor succeeds in lifting the automatic stay and repossesses property critical to the operation of the business. In some cases, failure to secure post-petition financing or inability to settle a labor dispute will force the business to close. Even for the cases that confirm a reorganization plan, portions of the business may have been liquidated to generate cash and the surviving business may be little more than a shadow of its pre-filing self.

For the businesses that make it to the plan-confirmation process, the overwhelming majority of those that confirm a plan do so with the consent of their creditors.[32] If all the creditors consent, there are few restrictions on the shape the plan may take. The Code provides for confirmation over the objection of the creditors in limited

---

31. Edward Flynn, Administrative Office of the U.S. Courts, Statistical Analysis of Chapter 11, at 10–11 (1989) (estimating a 17% confirmation rate). LoPucki and Whitford found a much higher confirmation rate—about 90%—among the biggest cases filed during 1979–1988, but they concluded that size was an important factor in pushing up the rates. *See* LoPucki & Whitford, *supra* note 8. Because the publicly traded companies that file for bankruptcy are only a tiny portion of the Chapter 11 cases, the overall confirmation rate remains low.

32. LoPucki & Whitford, *supra* note 8, at 138–41. In small cases, only a few creditors may take the trouble to vote on a plan. The consent of the creditors in such cases is obviously more attenuated, perhaps meaning only that they did not object enough to record a negative vote. *See* LoPucki, *supra* note 22, at 266–69.

circumstances; however, few debtors actually litigate and successfully confirm a plan over the vigorous opposition of their creditors.

Notwithstanding the infrequency of a case's surviving to the plan-confirmation stage and the even greater infrequency of debtors' confirming a contested plan, the provisions for plan confirmation are central to the Chapter 11 process. Confirmation is the final settlement of the rights of the parties. After the opening moments of a Chapter 11 filing, every negotiation with every creditor takes place with sharp awareness of what the creditors can—and cannot—demand in a plan confirmation. While the parties may decide to deviate from the Code provisions for other business reasons, the plan-confirmation requirements set the baseline requirements.

Sometimes the difficulties a business faces in trying to confirm a plan will manifest themselves long before a confirmation hearing. If a creditor can demonstrate that the business has little likelihood of meeting the Chapter 11 plan requirements, the creditor can derail the Chapter 11 case much earlier in the process and the business can be liquidated. For example, a creditor may file a motion to lift the automatic stay within minutes after the petition is filed. If the creditor can demonstrate that the debtor has no equity in the collateral and that the debtor has no reasonable prospect for an "effective reorganization," the Chapter 11 proceeding may be over before it starts. (section 362(d)(2)) In effect, the court may hold an early mini-hearing to determine whether the debtor is likely to meet the plan-confirmation requirements later on.

The confirmation of a Chapter 11 plan completes the process begun at filing. When the Chapter 11 petition was filed, a new entity, the Chapter 11 estate, was created. If the Chapter 11 case is successfully concluded with the reorganization of the debtor, the estate will cease to exist and its assets will become those of the post-reorganization business. The new business will go on to operate without the continuing protections or burdens of the Code.[33]

---

33. The plan will, of course, reorder the relationship between the debtor and its creditors by discharging debt, reissuing stock, and so on. The plan may also call for some continuing protection of the debtor, such as a continuing injunction against certain creditor collection actions. But the automatic stay, the restrictions on post-

The plan-confirmation process sets the terms by which the bankruptcy estate will be converted to a post-reorganization business. Conceptually, when a plan is confirmed, the estate transfers its going-concern operation to the emerging post-reorganization business. The plan outlines the obligations of the emerging business, including the payout schedules and the discharge of debt of various classes of creditors. The plan also details the financing arrangements made for the proposed payouts and for the continuing operation of the business. In addition, the plan establishes the ownership of the new business. The owners may be new buyers, recently arrived on the scene. Or they may be the old owners of the business, who hope that their new efforts will be more successful. Or they may be the creditors of the old business, who take equitable ownership as part of the payback on their outstanding debts. All elements of the plan are open to negotiation—and dispute, if the parties cannot agree.

The rules of plan confirmation determine who may propose a plan, how the creditors may vote on plans, what happens to dissenting parties, and when plans can be confirmed without unanimous consent. These rules allocate negotiating power during the Chapter 11 process and guide the parties in shaping a consensual plan.

Power to Propose the Plan

The power to propose a reorganization plan to be voted on by the creditors is widely perceived as a critical control element in the Chapter 11 negotiations. The party who can propose a plan has much control over both the shape of the post-reorganization business and the operation of the business in Chapter 11. To control the timing of the presentation of the plan is to control the progress of the Chapter 11 case. To propose the terms for the sale of the estate to the post-reorganization business and the final distribution of the assets is to have a profound influence on the outcome of the Chapter 11 process. The DIP wants exclusive power to propose a plan, whereas reluctant creditors may want to propose plans of their own that require higher, quicker payouts or immediate liquidation of the business.

---

petition operation, and other essential elements of Chapter 11 that have already been discussed cease at confirmation.

Basic Structure

The Code provides that any party in interest—including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or an indenture trustee—may propose a plan. (section 1121(c)) Each party with an interest in the case can offer its proposal for how the business should be reorganized, for adoption by the other interested parties.

Notwithstanding the clear statutory language, the DIP has significant informational advantages in putting together a coherent reorganization plan and the necessary disclosure statements. Most plans are proposed by the DIP, particularly in the smaller cases. In some cases, courts are willing to force debtors to reveal enough for creditors to develop alternative plans. Some creditors are becoming more familiar with the bankruptcy process and are learning to exercise their powers more strategically. Not surprisingly, with more money at stake and perhaps more experience with a larger number of debtors, creditors in large Chapter 11 cases are more active and more likely to propose reorganization plans than are creditors in small cases. In all cases, however, creditor plans remain more the exception than the rule.

For the first period after the filing of the bankruptcy petition, only the DIP may file a plan. (section 1121(a), (b)) This period of exclusivity gives the DIP 120 days from the filing to propose a plan, and 180 days from the filing to get the plan accepted. (section 1121(b), (c)) If the DIP cannot successfully propose a plan and get it accepted during this time, any other party in interest may propose its own plan.

The court may extend or shorten the period of exclusivity for cause. (section 1121(d)) Once again, the Code offers no statutory guidance to the court on the grounds for altering the period of exclusivity. Although such cases are rare, some courts will shorten the period of exclusivity in obviously hopeless cases in which the value of the assets is declining. More often, courts extend the period of exclusivity if they see such a move as preserving the value of the estate and likely to lead to a successful reorganization. Exclusivity practices vary dramatically among courts. In large, complex cases, extensions of exclusivity usually run for the entire case, which may be years. Sometimes, the court will condition extension of exclusivity on tangible signs that the DIP is making progress toward a confirmable plan. The variation in exclusivity practices reflects very different views about what constitutes the scope of the reorganization opportunity that should be available to the DIP.

Policy Issues

The business in Chapter 11 is typically fighting for its corporate life. Around the time the petition is filed, there is often a realignment of the debtor's business relationships. Frequently, trade credit is drying up and customers are turning skittish. The DIP may be in court to ask for approval to use cash collateral, and creditors may be demanding more information about the operation of the business and its long-term prospects. Employees may look for more secure jobs. Management's attention is divided between the legal details of operating a business in Chapter 11 and the business details of operating a business in serious trouble. Early conditions in most Chapter 11 cases are chaotic, so that keeping a business afloat during a Chapter 11 proceeding is a challenging process.

An early plan calling for a liquidation of the business obviously puts the DIP on the defensive quickly to prove it can come up with a more attractive payout scheme for the creditors. A DIP may make unwise promises on the business's behalf to stave off such attacks. At the same time, if the DIP can delay a plan proposal indefinitely while it operates comfortably in Chapter 11, pre-petition creditors see the value of their claims sinking lower and lower and their willingness to agree to any repayment proposal rises. The hand that controls the plan proposal has great power in the Chapter 11 process.

If creditors could propose plans—particularly liquidation plans—from the instant of filing, there would be a risk that assets of the business would be dissipated. The value obtained from imposing an automatic stay on the creditors' collection of debts would be lost in many cases. The Chapter 11 debtor would spend a substantial portion of its resources fighting to survive before it had an opportunity to examine what could be accomplished to reshape the ongoing business. It would not have the opportunity to explore the implications of either the legal devices, such as assumption and assignment of executory contracts and avoiding preferential payments, or the business devices, such as dropping certain product lines and cutting back particular operations. In many cases, a period of exclusivity is necessary to protect the powers granted the DIP elsewhere in the Code to run the business for the benefit of the creditors.

An indefinite period of exclusivity would not enhance the value of the estate if it permitted the DIP to run the business in Chapter 11 indefinitely, however. The creditor that can make a credible threat to propose a plan is better able to influence the DIP's operation of the business. If the DIP is wasting estate assets, the creditors can propose a liquidation plan. Alternatively, creditors may have different—and better—views about how the business can be structured to yield a better payout. When creditors can propose a plan, they are not put to the limited choice between voting yes and voting no on the DIP's plan. Instead, by proposing a plan, they can make asset-deployment judgments or reach going-concern values that the DIP might not develop. This permits the creditors to develop value-enhancing strategies for the debtor.

The ability to control the timing of a plan proposal has important distributional consequences as well. If a creditor that is likely to be paid in full, such as a fully secured creditor, could force the business into an early fight for its survival, the distributional consequences are obvious: The creditors with guaranteed repayments because of their interests in hard collateral could collect quickly and in full, and the other creditors would be paid less. If, instead, the DIP has unimpeded control over the reorganization process, other distributional consequences follow. The DIP management seeking to protect a future job and facing the likelihood of liquidation may offer only high-risk strategies that would reward the unsecured creditors if they paid off and consume the secured creditors' collateral if they did not.

The ability to shape the plan is also a powerful tool in the Chapter 11 reorganization. In any given case, the proposed plan might incorporate a number of different elements and still meet the Code requirements. Plans typically propose debt repayment terms, which contracts will be assumed and which will be rejected, who will own the post-bankruptcy business on what terms, and so on. Creditors rarely have the opportunity to vote on competing plans. Instead, they are faced with an up-or-down vote on the plan proposed, and the resulting delay if that proposal is rejected. Because the Code permits wide latitude in the shaping of the post-reorganization business, the power to propose the plan, to circulate it among creditors, and to solicit votes for it enables the proposing party to shape the reorganization effort.

It is worth noting that not all plan negotiations will follow similar—or even recognizable—patterns. In large Chapter 11 cases, the amounts of money at stake and the sophistication of the parties involved encourage both active participation and vigorous negotiation among competing interests. Disputes over the plan may involve a group of professional managers, and shareholders may be active in demanding a role in the reorganization. In small Chapter 11 cases, by contrast, the DIP may simply operate the business with little effective challenge from any party. The owner and manager may be the same person, and the unsecured creditors may be effectively unrepresented. These differences of fact also impinge on the courts when they must decide whether to extend exclusivity, dismiss a case, or approve a disclosure statement.

Like most policy questions in the Code, the question of control ultimately involves a fact-specific balancing. If the DIP is not using the interim period to enhance the estate's opportunities for survival, then it is neither value enhancing nor distributionally defensible for the DIP to avoid proposing a plan, and the possibility of dismissal or liquidation arises. At the same time, the Code outlines a mechanism to give the bankrupt business an opportunity to survive. If the DIP is denied the chance to reshape the business in a way that benefits the creditors collectively, the policies of the Code are thwarted. The bankruptcy court is charged with maintaining a dynamic balance, resolving the conflicts among parties with only general guidance from the Code.

Summary

The Code gives the DIP the exclusive right to file a reorganization plan during the first 120 days following the bankruptcy filing. If the plan is not accepted by 180 days into the proceeding, other parties may file their own plans. This gives creditors another opportunity to contest the control of the DIP and to monitor the DIP's proposed reorganization plans. Courts may, however, extend the period of exclusivity to maintain the DIP's control over the reorganization process.

Plan Process

Plans may be confirmed consensually, and parties may waive their rights in a reorganization if they determine that it is in their interests to do so. Even in a nonconsensual plan, some creditors may voluntarily waive their rights and support confirmation, giving the debtor the opportunity to confirm a plan over the objections of other creditors. It is not uncommon for a creditor to agree to less than full payment, based on its conclusion that partial payment in reorganization is likely to be better than partial or nonexistent payment in liquidation. Some creditors—particularly trade creditors, suppliers, and employees—may see the continuation of the business as being in their long-term economic interests, and they may prefer to forgive old debts in order to continue working with a viable company. While parties may waive their rights, the delineation of these rights is nonetheless important because it stakes out each party's bargaining position and determines each party's leverage to halt confirmation of a reorganization plan.

Consensual Plans

Creditors are permitted to vote on reorganization plans, and consensual plans are generally confirmed by the court. Plans can be confirmed with less than full creditor approval. Chapter 11 sets out the process by which creditors vote on plans and certain minimal protections are offered to dissenting creditors.

Plans deal with creditors by classes. (section 1122(a)) Each creditor is placed in a class with other creditors with substantially similar claims or interests. (section 1122(a)) Secured creditors have rights based on their collateral and their rights are strictly ordinal—a first-secured creditor on the property, a second-secured creditor on the same property, a secured creditor on a different property, and so on. As a result, each secured creditor's legal rights differ from those of all other creditors—including those of other secured creditors—and each is usually in a class by itself. Secured claims are bifurcated into their secured portions and unsecured portions. An undersecured creditor may participate in two classes—in a secured class up to the value of the collateral and in an unsecured class for the remainder of the claim. (section 506(a)) Priority claims are grouped with other claims of the same priority, so that, for example, all qualified employee-wage claims are grouped together (a section 507(b)(3) priority). Unsecured claims without priority are segregated from the secured and priority claims. Unsecured creditors are usually grouped together for pro rata treatment, although the plan may separate them into different classes. (section 1123(a)(1)) Within a class, all creditors are treated alike. (section 1123(a)(4))

To confirm a plan, a plan proponent must submit a proposed disclosure statement and a proposed plan to the court for approval before circulating them to the creditors. (section 1125(b)) The disclosure statement must contain adequate information about the business and the proposed plan for a "hypothetical reasonable investor" to make an informed judgment about the plan. (section 1125(a), (b)) The plan must specify the classes and the proposed treatment of each class, the disposition of assets, the recovery of estate assets, the assumption and rejection of executory contracts, settlements of various disputes, and the general plan for the business's operation. (section 1123(b)) The plan may provide for liquidation of the business. (section 1123(b)(4)) After the disclosure statement has been approved and the plan and statement have been circulated to all parties in interest, the creditors and shareholders vote on the plan. (section 1125(b))

Voting Rights

Creditors vote by class. A class is deemed to have accepted a plan if creditors constituting more than one-half of the members of the class and representing at least two-thirds of the amount of debt have voted in favor of the plan. (section 1126(c)) Most courts base the one-half and two-thirds calculations on those creditors who actually vote. Voting must be "in good faith." (section 1126(e)) A creditor's dissenting vote may not be counted, for example, if the plan proponent can prove that the creditor voted no because it is a business competitor and is attempting to tie up the reorganization effort to cause the business to collapse. If the plan meets other Code restrictions set out *infra* and all classes accept the plan, the plan will be confirmed, notwithstanding the dissenting votes of a number of creditors within each class. (section 1129(a)(7), (8))

Because of the importance of voting by classes, the DIP and the creditors often dispute the composition of the unsecured classes. The DIP would like to have unrestrained power to group creditors in a way that increases the likelihood that all classes will consent to the plan it proposes, or it may hope to isolate the dissenting creditors for treatment in a nonconsensual plan. Creditors reverse the strategy, arguing for the treatment that permits them to resist the DIP's gerrymandering efforts and thereby to increase their negotiating leverage. The Code provides little guidance. The plan may designate a separate class of claims grouped together for administrative convenience. (section 1122(b)) And creditors in the same class must have substantially similar interests. (section 1122(a)) The latitude permitted the plan proponent to create separate classes of legally similar claimants is currently disputed in the courts.

Some creditors are denied the opportunity to vote on the plan. Those creditors whose claims are not impaired under the plan proposal are deemed to have accepted the plan without a vote. (section 1129(a)(8)) If the treatment proposed under the plan "leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles" the creditor, the creditor's claim is deemed unimpaired. (section 1124(1)) Some collection rights can be lost and the claim is nonetheless deemed unimpaired for voting purposes. (section 1124(2)) The plan may propose to cure pre-plan defaults, to pay damages for those defaults, and to reinstate the maturity of the claims without impairing the creditor's interest. (section 1124(2)) Obviously, reinstatement of the original loan agreement denies the creditor its right to accelerate the loan and demand payment, but the reinstatement leaves the creditor's interest unimpaired under the Code. The creditor's interest is also deemed unimpaired if the plan provides that the creditor is to receive cash equal to the amount of its claim. (section 1124(3)) In effect, this provision permits the DIP to cash out a recalcitrant creditor by paying that creditor its claim value and proceeding with the reorganization for the benefit of the remaining creditors. Only creditors whose rights are altered by the plan and who are expected to wait for compensation during the course of the plan have the opportunity to vote with their class on whether the plan should or should not be confirmed.

The creditors' primary protection is in their voting rights, and it is not surprising that a great deal of informal negotiation goes on in putting together a plan proposal that will receive adequate votes for confirmation. At the same time, the Code sharply limits the powers of dissenting creditors. If they are unable to control their class, they lose most of their power in a reorganization. Except on very limited grounds, these creditors cannot wreck a reorganization that the majority of creditors support.

In large cases, much of the negotiation goes on through the creditors' committee, which is discussed in Chapter 2 *supra*. The creditors' committee is composed of the seven largest unsecured creditors that are willing to serve. (section 1102(b)(1)) The committee will often take an active role in shaping the plan and in lobbying other creditors for or against its acceptance. Additional committees of unsecured creditors, secured creditors, or equity holders may be formed as well, particularly in a complex case. (section 1102(a)2)) Acceptance of a Chapter 11 plan by the creditors' committee is often regarded as practically—although not officially—critical to the successful confirmation of the plan. The debtor's need to get the creditors' committee's votes—and to win the votes of other creditors—gives the committee strong leverage in many plan negotiations.

In small cases, by contrast, a creditors' committee is rarely formed. No creditor has sufficient interest, and the estate may not generate assets to cover the expenses of the committee. As a result, plan negotiations are something of a misnomer. The DIP generally proposes the reorganization plan. If opposition surfaces, it generally comes from an individual creditor or two, often a secured creditor acting on its own. A strong objection can derail a Chapter 11 plan in a small case, as demonstrated by the fact that small cases have much lower confirmation rates than do large cases. The negotiation dynamic in a small case is very different from that in a large case: Often the DIP tries to negotiate a deal with one creditor rather than working with the collective interests of the creditors represented by committees.

Other Creditor Protections

Although their power is limited, dissenting creditors enjoy a few basic protections granted to all creditors. These protections permit dissenting creditors to stop a reorganization that does not meet certain minimal standards—even if the majority of creditors are in favor of the plan.

The central protection offered each creditor individually is that, unless the creditor consents to lesser treatment, it must receive at least as much in the Chapter 11 reorganization as it would receive in a Chapter 7 liquidation. (section 1129(a)(7)(ii)) This provision is generally referred to as the "best interest test," that is, the plan cannot be confirmed if it is not in the best interest of each creditor. The calculation for the best interest test accounts for the time value of money, so that the creditor that would receive $100 at liquidation on the date of the confirmation hearing would be entitled to $100 plus interest if it had to wait for payment over time under the plan process. The best interest test illustrates a basic requirement of the Chapter 11 process: If Chapter 11 does not produce at least as much value as a Chapter 7 liquidation for each creditor, any dissenting creditor can prevent confirmation of the plan.

In addition, even if all parties consent to the Chapter 11 plan, the court must find that the plan is feasible. (section 1129(a)(11)) The court has an independent obligation to confirm a plan only if confirmation is not likely to be followed by liquidation or further proceedings in bankruptcy, unless such an alternative is specified in the plan. (section 1129(a)(11)) This means that the court exercises some supervisory control over the debtor, refusing to confirm plans that are unlikely to succeed. In practice, the court is likely to have little reason to question the feasibility of a plan if all the parties consent to it, and the court's limited time and resources give little opportunity for an independent judgment. However, this provision requires the plan proponent to offer some evidence about feasibility in its initial proposal, and it permits any dissenting party to bring the question of feasibility before the court.

To maintain the distributional scheme of Chapter 11, some priority claimants must be repaid in full, unless they agree to lesser treatment. Administrative-expense priorities—including attorneys' fees—receive the best treatment in Chapter 11. They must be paid in full on the date the plan goes into effect. (section 1129(a)(9)(A)) Other priority claimants may be paid over time, but repayment in full includes the time value of money, so these claimants receive interest to compensate them for the delay involved in being paid over time. The present value of employee priority wage claims, contributions to employee benefit plans, grain and fishing priorities, priority deposit claims, and the claims of interim creditors in involuntary bankruptcies may be repaid over the life of the plan. (section 1129(a)(9)(B)) Tax claims must be paid in full within six years. (section 1129(a)(9)(C)) This scheme means that claimants who are paid first in a liquidation are paid in full in a Chapter 11 reorganization.

The plan must also meet a number of technical requirements of disclosure and conformity with other regulatory laws. The plan must disclose the identity and affiliation of the post-confirmation officers, directors, or affiliates, and parties can object to the appointment or continuation of such individuals. (section 1129(a)(5)(A)) The proponent must disclose whether any insider will be employed or retained by the reorganized business. (section 1129(a)(5)(B)) By specifically requiring such disclosure in addition to the general admonitions on the adequacy of information necessary to make an informed investment decision, the Code gives the creditors another opportunity to discover the conflicting interests of the plan proponents and to increase their monitoring efforts. If there are creditor classes with impaired claims, at least one of these classes must accept the plan, demonstrating the support of creditors who are sharing some of the losses in bankruptcy. (section 1129(a)(10))

Finally, the court is given another ground on which to reject a consensual plan: If the plan is not proposed in good faith, it cannot be confirmed. (section 1129(a)(3)) Once again, the court is given little guidance on the meaning of the term. A small minority of courts, for example, have used this provision to refuse confirmation of plans in single-asset real estate cases that may otherwise meet confirmation requirements. These courts reason that such single-asset cases, involving only the debtor and one creditor, are inappropriate candidates for the collective proceeding of bankruptcy and should be resolved under state law. Other courts have used the good-faith provision to terminate repeat filings. The bankruptcy system gives the courts wide powers to reject a plan, once again moving from a fairly detailed technical analysis of plan requirements to an equity-based concept of giving the courts wide discretion to do justice.

Creditors may be entirely passive throughout this process, and the Code will nonetheless protect their rights. The DIP lists the claims against the estate in its filing schedules. If a claim is not listed as contingent, disputed, or unliquidated, the listing will constitute a claim against the estate and all the rights listed will attach, even if the creditor never files a claim with the court. (section 1111(a)) If the creditor challenges the DIP's listing, the court will determine the amount and the security of the claim. (section 502(b)) This permits creditors to ride through a bankruptcy, spending no money on additional collection or monitoring efforts, and still collect a pro rata distribution. It also permits a creditor to become active at any point in the process when the issues under consideration hold a particular interest for it.

Nonconsensual Plans

One or more groups of creditors may vote against the confirmation of a plan, but the Code sets forth conditions under which the plan may nonetheless be confirmed. The procedure by which a plan is confirmed over the objection of one or more classes is colorfully referred to as a "cramdown." In a cramdown, all of the provisions already discussed must be met, except for the requirement of consent of all the classes. If one or more classes dissent, the plan can be confirmed if it meets the additional cramdown requirements.

Absolute Priority

The additional protection offered to dissenting classes of unsecured creditors in a Chapter 11 cramdown is referred to as the "absolute priority rule": A reorganization plan cannot provide for compensation for junior classes unless the senior classes either accept the plan or are compensated in full. In most plans, the secured creditors will have received the value of their collateral and the priority claimants will have been repaid in full. The next claimants, usually the unsecured creditors, can invoke the absolute priority rule, demanding repayment in full as a condition of any inferior class receiving any distribution from the estate. (section 1129(b)) In practice, this usually means the unsecured creditors want to be paid in full before the old stockholders can have the equity ownership of the new business. The provision applies to multiple classes, so that preferred stockholders, for example, retain rights in the Chapter 11 proceeding ahead of general stockholders. (section 1129(b)(2)(C)) This provision codifies the principle of corporate law that, when a business is dissolved, creditors are paid ahead of equity holders.[34]

If unsecured creditors as a class do not accept the plan or get paid in full, they prevent old equity holders from participating in the plan. In a large business reorganization with publicly traded stock, this might mean that the dissenting class of unsecured creditors would be paid under the plan in part with cash distributions and in part with distributions of the stock of the newly emerging business. In the reorganization of a small business with an owner–manager, a new purchaser of the business might not emerge and the manager might not want to continue to work in the business without an equity interest, so that a dissenting class of creditors could force the liquidation of the business.

The absolute priority rule has only limited application. If, for example, the reorganization plan proposed a sale of the going-concern business to a disinterested buyer and full distribution of the sale price to the creditors, the plan could be confirmed over the objections of the unsecured creditors that would still receive only partial payment. The unsecured creditors would receive all the cash distribution, and the old equity holders would receive nothing, so there would be no violation of the absolute priority rule.

New Value

The plan-confirmation process terminates the estate under the protection of the Code and sets the terms for establishing the post-reorganization business. If the plan proposes a sale of the going-concern business either to the creditors by way of a distribution of the stock or to a third party for assets to be distributed to the creditors, the plan can be confirmed despite the presence of a dissenting class of creditors. If, however, the plan proposes the sale of the going-concern business to the old equity holders, the court will have to determine whether such a sale violates the absolute priority rule by giving the equity holders an interest "on account of" their earlier interest in the pre-filing debtor. (section 1129(b)(2)(C))

If a cramdown plan proposes retention of equity ownership by the old equity holders, it clearly violates the absolute priority rule.

34. *See, e.g.*, Fletcher, *supra* note 29, at § 8219.

If, however, old equity holders buy the new business on the same terms as a third party might do so, they retain no interest "on account of" their earlier interest and the plan can be confirmed over the objections of dissenting classes. When old equity holders propose to purchase the post-filing business for new value, the courts must determine whether the proposed purchase violates the absolute priority rule or whether it fits within a so-called "new value exception" for equity purchasers.

The power of the absolute priority rule is solely in the leverage that comes from denying lower classes—usually equity holders—a place in the post-reorganization business. If old equity holders retain no interest in the post-reorganization business, there is little protection for dissenting unsecured classes. If old equity holders hope to participate, however, they will either negotiate for a consensual plan or try to convince a court that they are taking nothing "on account of" their earlier position, but are, instead, purchasing the post-reorganization business for new value.

The 1111(b) Election

There is one more provision regarding plan confirmations that can affect either consensual or cramdown plans. The undersecured creditor has special rights to elect how it will be treated under the plan. The device is called the "1111(b) election," named after the Code section that provides for it.

The nonrecourse secured creditor can, by contract, look only to its collateral for satisfaction of its debt. In bankruptcy, this means that it has an allowed secured claim to the value of the collateral, but no deficiency claim if it is undersecured. The 1111(b) election permits this nonrecourse creditor to convert its loan to recourse against the estate, so that it has a participating unsecured claim as well. (section 1111(b)(1)(A)) Congressional debates over this provision focused on whether a debtor business organized as a single-asset entity, such as an apartment building or office building, would take advantage of Chapter 11 to reorganize when real estate prices were depressed, promise to pay the liquidation value of the building over time in the Chapter 11 plan, and profit handsomely if the market rebounded after the plan confirmation. Because the nonrecourse creditor has rights to recourse against the estate, it has voting rights in the plan confirmation, a right to absolute priority if it dissents and controls its unsecured class, and pro rata participation in plan distributions.

Other undersecured creditors can use the 1111(b) election to accomplish a different end. The undersecured creditor whose claim is bifurcated into its secured and unsecured portions for treatment under the plan is permitted to waive its unsecured claim and demand instead full repayment of its total claim. (section 1111(b)(1)(B)) The election does not permit the creditor to demand the present value of the claim, simply the actual number of dollars to be paid under the claim. The dollars may be paid over the entire life of the plan without giving the creditor any interest to compensate for the delay in repayment. (section 1129(b)(2)(A)(i)(II))

This means, for example, that a secured creditor owed a debt of $100,000 and having a security interest in collateral valued at $60,000 can waive its unsecured claim for $40,000 and demand that the plan pay the full $100,000 on its claim. The plan must still provide for the present value of the allowed secured claim (which is the present value of only $60,000—the value of the collateral). This means that if the claim is to be paid off in one year, the plan must provide at least $66,283 to satisfy the allowed secured claim or, if it is to be paid off in ten years, the plan must provide for payments totaling $162,422 (based on a hypothetical present value calculated at 10% interest compounded annually). These payments meet the requirements of section 1129(b)(2)(A)(i)(II).

If the debtor made the 1111(b) election, an additional requirement is imposed: In the one-year payout case, the plan would have to provide for $100,000 (the total claim), not just $66,283 (the allowed secured claim). But in the ten-year payout case, the 1111(b) election would impose no new requirements. Section 1111(b) would have been satisfied because the plan provides for repayment of $162,422 (the allowed secured claim), which exceeds $100,000 (the total claim). This 1111(b) election yields something to the creditor only in certain factual cases. Its primary protection is to give a creditor the opportunity to resist a short "cash out" of the undersecured creditor's interest.

The 1111(b) election is rarely invoked, perhaps because of the inordinate difficulty of reading the provision. The election provides undersecured creditors with a strategic choice that has its greatest effect if the plan proposes a quick payout of secured debt. The threat to invoke an 1111(b) election can dramatically change the shape that a DIP's proposed plan takes, sometimes causing an adjustment from a short plan to a long plan to cope with the higher secured debt.

Discharge

The debts of corporations and partnerships are not discharged in Chapter 7. (section 727(a)(1)) But businesses that can successfully confirm a reorganization plan do receive a discharge of all debt that arose before the confirmation. (section 1141(d)(1)) For those businesses that confirm a Chapter 11 plan that liquidates the business, however, the discharge remains unavailable. (section 1141(d)(3)) Individual debtors using Chapter 11 follow the discharge rules laid out for them elsewhere in the Code. (section 1141(d)(2))

The scope of the debtor's discharge is broad. When the Chapter 11 plan is confirmed, the claims of creditors, equity security holders, and partners are discharged, and the debtor is vested with the property of the estate "free and clear of all claims and interests" on those claims. (section 1141(a)) Claims are discharged regardless of how the claimant voted on the plan or whether the creditor even filed a proof of claim. (section 1141(d)(1)(A))

The Code is clear that discharge is only for the Chapter 11 debtor. Guarantors, partners, sureties, insurers, co-debtors, and others who may be liable on the discharged debt may seek a discharge, but they must file their own bankruptcies to accomplish that end. (section 524(e)) Some courts have used their equitable powers under section 105 to enjoin permanently any collection against a named party, such as a partner or a guarantor, which has the same effect as a discharge of the co-debtor, if such a move withstands appellate review.[35] Generally, courts refuse to extend the automatic stay for such permanent injunctions unless they believe it is essential to do so to confirm a successful reorganization. The court will generally demand that the party profiting from such a move put as much into the reorganization as it would have if it had filed its own

35. The tax treatment of such a move would undoubtedly be tangled. Debt forgiveness in bankruptcy enjoys some tax relief, but permanent injunctions may not receive such favored treatment. Internal Revenue Code § 108(e).

bankruptcy. Even in such circumstances, there is considerable controversy over the appropriateness of permitting such a nondebtor party to enjoy a permanent injunction from debt collection.

Discharge is granted at confirmation in a Chapter 11 proceeding, rather than being withheld until the debtor completes the payments proposed under the plan. (section 1141(d)) The Code mandates that the debtor and any successor carry out the plan, presumably making the debtor liable under nonbankruptcy law for breach of any obligation. (section 1142(a)) The court may order the debtor or any other party to do what is necessary to consummate the plan, such as issue securities or relinquish control of property. (section 1142(b))

The court may revoke an order of confirmation. If the confirmation was secured by fraud, the court may issue new orders revoking the plan and the discharge and protecting any parties who relied on the plan in good faith. (section 1144) The statute of limitations for this action is brief, however, extending only 180 days after the confirmation order has been entered.

Policy Issues

Nowhere is the collective nature of the Chapter 11 proceeding clearer than in plan confirmation. Each party works to ensure that its own individual interests are protected, but the Code enforces a kind of cooperation designed to enhance the collective interests of the creditors and to give the business the best opportunity to survive. The Code reduces the holdout power of each creditor by restricting voting to classes and by permitting majorities to silence dissenting minorities within classes. Secured creditors have some powers to demand repayment in Chapter 11, but their powers are sharply limited for the collective good. They can be forced to participate in a Chapter 11 proceeding, taking payments over time and thereby involuntarily extending credit to the post-reorganization business. Unsecured creditors have less power. They may see part or even all of their outstanding debts discharged, and they may wait for payments for years.

The best-interest test imposed by the Code is an example of a technical requirement for confirmation that demonstrates the pervasiveness of a value-enhancement norm. The creditors in a Chapter 11 confirmation must do at least as well as they would have done in a Chapter 7 confirmation. If, for example, the liquidation of the estate would have brought a pro rata distribution of 15¢ for each dollar of unsecured debt, a plan proposing a 20% repayment to the unsecured creditors is confirmable. But if the liquidation would have yielded 30¢ for each dollar of unsecured debt, a single objecting creditor can stop the confirmation of the plan. If a Chapter 11 plan will reduce the payout to creditors, then it cannot be confirmed without the consent of those injured. The best-interest test reinforces the goal of using reorganization to enhance value, not to diminish it.

The best-interest test also demonstrates the distributive values provided in Chapter 11. While the test establishes a baseline promise to the creditors, it does not require that creditors alone capture all the benefits of a reorganization. If the creditors get at least as much as they would have gotten in a liquidation, the Code requirement is satisfied. This leaves open the possibility that additional assets generated by the reorganizing business may be retained by the business to enhance its stability and long-term survival prospects. This suggests that successful reorganization—with its consequent effects on employees, taxing authorities, suppliers, and a host of other entities—is itself a permissible goal. The value-enhancing benefits of Chapter 11 are not restricted to creditor repayments.

Although the technical rules for confirmation of a plan are fairly straightforward (with some notable exceptions), a great deal of flexibility necessarily inheres in the Code structure. Virtually every Code requirement depends on valuation of the going-concern business or valuation of its individual assets. The legal rules for the treatment of undersecured and oversecured debt, for example, are unambiguous. For example, a creditor with an outstanding loan of $10,000 and a security interest in a machine now valued at $6,000 will participate as an unsecured creditor for $4,000 and will receive the present value of its $6,000 secured claim in a confirmed plan. But if the machine is valued at $12,000, the plan must offer the same creditor the present value of the full $10,000 loan amount plus interim interest on the loan, calculated from the time of filing until confirmation, and the creditor has no vote in plan confirmation.

Much of the flexibility in the plan process comes from the fact that the exact value of the machine or of the going-concern business or of any other property, interest, or obligation is unknown.

Valuation is subject to estimation, to conjecture, to guess—to everything but a real sale. Except when the plan proponent deliberately uses liquidation to reshape the business and to generate cash, the assets stay in the business and are "valued." As a result, the statutory guarantees—and the resulting negotiating positions—are necessarily based on uncertain projections of value. A creditor's rights are not nearly so certain as the Code would suggest, nor can it be completely clear when the plan proponent has met the Code's obligations.

To compound the difficulties of valuation, the value of a going-concern business may fluctuate. The business may recover simply because the market has gotten better or because business operations have improved. The DIP may enhance the value of the estate by exercising the Code-granted powers to reshape the business. The plan negotiation process may go well and thus convince more people that the business will survive. All these possibilities affect the value of the going-concern business, the price for which it should be sold, and the amount it can reasonably promise to repay after confirmation. As the parties negotiate around these uncertainties, tentative plans may emerge, reform, and emerge again.

The concept that underlies the consensual plan is that the parties in Chapter 11 are granted certain rights that they may demand in court and that those rights, in turn, will shape the power the parties will exercise in plan negotiations. But most of those rights are based on uncertain and shifting valuations. In a world of uncertainty, the Bankruptcy Code puts a premium on reshaping the bankrupt business through negotiation and consent.

Legal rights are rarely disputed in consensual plans, but the payouts that the parties finally settle on clearly reflect their rights. The settlements reflect a number of economic and business realities as well. The secured creditor with some rights who is also willing to serve as a post-petition financer, and the trade creditor who has some collection rights as an unsecured creditor but who is also essential to the long-term survival of the business both exercise a combination of economic and statutory powers. A consensual plan is likely to be based on those powers. At the same time, the statutory rights granted to creditors who have no extraneous economic powers serve distributional objectives. For example, the right of tort victims to share pro rata in distributions with other unsecured creditors in their class or the right of a secured creditor to get at least the present value of its collateral are minimal guarantees that prevent the creditors with other leverage from taking everything. These statutory guarantees make certain that creditors collectively profit from the reorganization, as opposed to having just a handful of creditors capture all the value.

The cramdown plan fits a similar pattern. It incorporates all the requirements of the consensual plan—and all its normative values—except the plan can be confirmed even if some classes vote against it. By permitting confirmation without the consent of all classes, the Code necessarily realigns the power of participants in the bankruptcy process. Cramdowns diminish the power of creditors, particularly their power to hold out for better treatment than the minimum amounts guaranteed elsewhere in the Code. The availability of cramdown also increases the number of bankrupt businesses that are reorganized rather than liquidated, demonstrating once again a bias in the Code toward reorganization.

The absolute priority rule restricts the DIP's use of cramdown by requiring that equity holders retain no ownership in the reorganizing business unless superior classes either have accepted the plan or have received payment in full. This fine-tunes the balance of power among the parties. If the DIP wants to confirm a plan that includes retaining equity ownership, it will either have to pay the creditors in full or negotiate for their cooperation. If, however, the DIP wants to sell the business and distribute the assets to the creditors, a dissenting class cannot block that action unless some other Code requirement has been violated. Thus, the power of creditors if they choose to dissent is restricted—they can block some actions but not others. The balance achieved is one that is designed to enhance reorganization, but to provide some creditor protection as well.

The Code establishes a rough allocation of power among the parties in interest in a bankruptcy case, and the courts refine that allocation with their interpretations of the statutory provisions. Whenever a court redefines the requirements of a Chapter 11 plan, it necessarily redistributes power among the parties. Some Code provisions are interpreted on a case-by-case basis, such as the extension or contraction of the period of exclusivity for the proposal of a plan. Other provisions require uniform interpretations notwithstanding the ambiguity of the Code language, such as the question of the DIP'S power to classify its creditors to enhance adoption of the plan. The courts refine the balance that affects the terms on which plans are confirmed and determines whether some plans are confirmed at all.

Finally, it is worth noting that the issues that arise in plan confirmation highlight particularly the policy to keep the bankruptcy system voluntary. Although the bankruptcy goals of enhancing the value of the estate and making deliberate distributional decisions are evident throughout virtually every aspect of the Code, it is easy to overlook the impact of these provisions on whether bankruptcy is made sufficiently attractive that debtors will choose to use it when their businesses are faltering. Every aspect of plan confirmation that deals with those who make the decision to file—management in large businesses and owner–managers in small businesses—has an effect on whether debtors will find Chapter 11 a plausible alternative to a nonbankruptcy workout.

One of the principal objections to the old Chapter X was that it always ousted management from power. Regardless of the other benefits of such a move, the drafters of the 1978 Code knew that if they continued in that direction, few managements would choose bankruptcy even when the business and the creditors could profit from such a move. The same concerns are implicated in the plan-confirmation rules. If management fears an immediate loss of control over running the business because it cannot count on a reasonable period of exclusivity within which to propose a plan, it is likely to be more reluctant to file. If an owner–manager of a small business faces automatic loss of its business in a Chapter 11, it will feel an even more acute reluctance to file.

In any case, plan-confirmation provisions, with their necessary impact on how management and owners see the progress of the Chapter 11 proceeding and on their participation in an eventual reorganization, implicate another careful bankruptcy balance: the balance between the interests of the decision makers who file for bankruptcy and the interests of other parties in the case. Although the Code sharply restricts the power of management and owners during the bankruptcy proceedings and in plan reorganizations, it offers them sufficient protection that most who enter bankruptcy fully expect to make a number of concessions to their creditors but also to maintain control over the business. If this careful balance were upset, bankruptcy policy goals would be compromised.

Conclusion

The bankruptcy system provides a forum for parties to decide together who must share the losses of a business failure. These parties will be forced to yield some collection rights for the collective benefit of the creditors and to implement the distributional norms of the Code. The Chapter 11 plan provisions set the technical rules for plan confirmation and allocate negotiating power to the creditors, but the parties generally negotiate their own conclusion to the business. They may ultimately negotiate a consensual plan that the court confirms, a liquidation of the business, or a dismissal of the bankruptcy case and a return to general collection law. In bankruptcy, perhaps more than any other area of commercial law, the parties bargain for a new future in the shadow of the legal rules that can be enforced in court.

7 Bankruptcy Jurisdiction and Procedure

One of the principal problems with bankruptcy practice under the 1898 Bankruptcy Act was the complex jurisdictional labyrinth that developed. Notwithstanding the constitutional grant of power to Congress to establish "uniform Laws on the subject of Bankruptcies throughout the United States,"[36] the Bankruptcy Act of 1898 gave the bankruptcy system only a sliver of jurisdiction to resolve the problems facing the bankrupt debtor. Most related disputes were resolved in state courts, unless the district court had independent, nonbankruptcy jurisdiction, such as diversity jurisdiction. Bankruptcy jurisdiction was deemed "summary jurisdiction," whereas matters outside summary jurisdiction were deemed "plenary" and left to state courts or other federal courts for resolution. An elaborate jurisprudence developed to determine which disputes would be heard under bankruptcy jurisdiction and which would await resolution in other courts.

The system was unsatisfactory for a number of reasons. It was extraordinarily confusing, particularly for the nonbankruptcy specialist. A creditor might find that it had some claims against the debtor that would be resolved in bankruptcy court while it also had other claims that would be resolved in state or other federal courts. But the creditor might also discover that by filing a claim against the debtor, it had submitted to bankruptcy jurisdiction for resolution of all disputes between the parties—even those unrelated to the claim filed. Such "jurisdiction by ambush" heightened the sense that

36. U.S. Const. art. I, § 8.

technical rules with little substantive merit awaited anyone doing business with a debtor.

Because the lines between "summary" and "plenary" were hazy, enormous resources of both the bankrupt estate and other parties to the litigation were consumed by disputes over jurisdiction—depleting the resources available in liquidation or those that might be spent on a reorganization of the business. Moreover, the constrained jurisdiction of the bankruptcy court frequently made successful administration of the estate impossible. The trustee was forced to wait for resolution of state court actions before it could determine the scope of the estate and begin to formulate a sensible liquidation or reorganization plan.

During the 1970s, while jurisdictional disputes continued to complicate the bankruptcy process, bankruptcy rules became deeply entangled with the substantive law of bankruptcy. The Supreme Court promulgated the Rules of Bankruptcy Procedure during this time, revising the practices and procedures of the bankruptcy courts. The Supreme Court acted under 28 U.S.C. § 2075 (now repealed), which provided that the promulgated court rules would supersede any inconsistent statutory provision of the 1898 Bankruptcy Act. While the Supreme Court's authority extended only to rules of practice and procedure, there was a flurry of litigation over whether provisions of the Act were "substantive," and therefore survived the new rules, or were procedural and therefore were invalidated when the new rules were adopted.

At the same time that the rules of procedure were in great flux, the role of the bankruptcy court began to change. Bankruptcy referees, who had originally served as administrative assistants to the district judges, began to exercise greater power in bankruptcy cases. During the 1970s, "referees" became "judges," exercising virtually all of the original jurisdiction of the bankruptcy laws that had once resided with the district courts. At the same time, the new bankruptcy judges retained their functions as administrators of the bankruptcy estates. They appointed receivers or trustees, countersigned checks, received operating reports, and performed a number of other functions requiring substantial ex parte communication with debtors. Questions arose about whether a single person could fill both roles, and doubts about the fundamental fairness of the bankruptcy system were raised.

The jurisdictional and procedural snares of the 1898 Act were widely perceived as directly affecting the efficient liquidation and reorganization of bankrupt businesses. By consuming assets in prolonged and expensive litigation over jurisdictional disputes and by deflecting the attention of the parties from negotiating an effective resolution of the case, the jurisdictional maze of the old Act was a hindrance to implementation of the policy objectives of the bankruptcy system. Bankruptcy procedures were confusing, resulting in much litigation over the substantive and procedural rules. Perhaps worse were the pervasive questions about the fairness of the system. Pressure mounted to rationalize the jurisdictional rules and to provide a fair, efficient system for administering bankruptcy estates.

The Code Solution—and Problem

By 1978, both the House and the Senate agreed on a solution to the jurisdictional and procedural problems of the bankruptcy system: expand bankruptcy jurisdiction to include all disputes related to the bankruptcy proceeding. Any disputes affecting the estate would be swept into the bankruptcy courts for timely resolution. There would be no more litigation over jurisdiction and delays for other proceedings, and cases could proceed expeditiously.

But the House and the Senate differed over the structure of the bankruptcy courts. They agreed on the central principle that the bankruptcy courts should be run by judges who functioned only as judicial officers, not as case administrators. They differed sharply, however, about the constitutional status of these judges. The House proposed the creation of separate bankruptcy courts in which the bankruptcy judges would be appointed for life by the President under Article III of the Constitution, using a process much like the one used in the appointment of district court judges. The Senate, however, proposed to leave the bankruptcy judges in an inferior role as assistants to the district judge, serving for an appointed term.

The 1978 Bankruptcy Code reflects a compromise of these views. Bankruptcy courts were created with broad jurisdictional authority to hear controversies and to issue orders that would affect bankruptcy estates. The bankruptcy judges were empowered to exercise virtually all bankruptcy jurisdiction. But the courts were denominated as "adjuncts" to the district court, not independent federal courts—a distinction that seemed to have little substantive consequence. The Code provided that bankruptcy judges would be appointed by the President, but they would not have life tenure.

In 1982, the Supreme Court ruled that the compromise in the 1978 Code was unconstitutional. In *Northern Pipeline Construction v. Marathon Pipe Line*,[37] Justice Brennan, writing for a plurality of four Justices, held that the creation of non-Article III courts to handle cases within a broad jurisdictional range in the bankruptcy system was constitutionally impermissible. The adjunct relationship between the district courts and the bankruptcy courts was insufficient to overcome this defect. The Court recognized that certain aspects of the jurisdiction might permissibly be given to the bankruptcy courts, but it ruled that the entire system was unconstitutional because it vested the "judicial power" under Article III of the Constitution in judges who did not have life tenure as Article III requires. Justice Rehnquist, joined by Justice O'Connor, concurred on the narrower ground that the dispute presented in the *Marathon* case was a traditional common-law contract suit brought by a DIP against a party unrelated to the case and was therefore beyond the constitutional scope of the bankruptcy court's jurisdiction. Dissenting Justices White and Powell and Chief Justice Burger would have upheld the constitutionality of the 1978 Code. The Chief Justice also wrote a separate dissent in which he outlined how the constitutional defects identified by the majority could be corrected—an analysis sharply disputed by Justice Brennan.

The Supreme Court twice stayed application of its *Marathon* holding to give Congress time to recast bankruptcy jurisdiction, but Congress failed to act. In the meantime, the Judicial Conference of the United States, acting through the Administrative Office of the U.S. Courts, developed a model "Emergency Rule" to be used if Congress did not amend the defective Bankruptcy Code before the Supreme Court's stay expired. On Christmas Eve, 1982, *Marathon* went into effect. The Emergency Rule was promptly adopted by the judges of each district to govern referral of matters to bankruptcy judges. The rule remained in effect until Congress amended the jurisdictional scheme in 1984.

---

37. 458 U.S. 50 (1982).

Under the Emergency Rule, bankruptcy judges could hear and make final orders in all "core proceedings," a phrase adopted from Justice Brennan's observation that "the restructuring of debtor–creditor relations . . . is at the core of the federal bankruptcy power."[38] In "related proceedings," bankruptcy judges could hear matters and recommend findings, conclusions, and proposed orders to the district court, which could then make a de novo review and enter a final order. The constitutionality of the Emergency Rule was upheld by the courts of appeals that considered it, but the scheme was never reviewed by the Supreme Court.

The 1984 Amendments

After *Marathon*, Congress faced the same split in trying to cure the constitutional defects of the Bankruptcy Code that it had faced when the Code was originally drafted. The House wanted to create Article III bankruptcy judges, while the Senate wanted the judges to remain adjuncts to the district court judges. A number of substantive amendments to the Code were also proposed, including those to restrict consumer debtors' rights in bankruptcy and to alter the treatment of collective bargaining agreements in Chapter 11. Compromises were achieved only in the final hours, with the result that there is little useful legislative history and the language of the amendments is somewhat inartful.

The Senate approach prevailed once again. Under the 1984 amendments, bankruptcy judges would not become Article III judges. Instead, they "constitute a unit of the district court to be known as the bankruptcy court for that district." (28 U.S.C. § 151) They "serve as judicial officers of the United States district court." (28 U.S.C. § 152(a)(1)) They are appointed by the courts of appeals for their respective circuits for 14-year terms. (28 U.S.C. § 152(a)(1)) They are subject to removal "only for incompetence, misconduct, neglect of duty, or physical or mental disability and only by the judicial council of the circuit." (28 U.S.C. § 152(e))

In an attempt to correct the constitutional defects of the 1978 Code, the 1984 amendments curtail the jurisdiction of the bankruptcy courts. The statute places bankruptcy jurisdiction in the

---

38. 458 U.S. at 71.

district court, then permits the district court to refer cases to the bankruptcy court. All "original and exclusive jurisdiction of all cases under (the Bankruptcy Code)" is vested in the district court. (28 U.S.C. § 1334(a)) The district court also has exclusive jurisdiction over all property of the debtor as of the commencement of the case and over all property of the estate, regardless of where such property is located. (28 U.S.C. § 1334(d)) In addition, the district court has "original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11." (28 U.S.C. § 1334(b)) The term "civil proceedings" is chosen to give the broadest possible sweep. The legislative history of the provision encompasses both action during the pending case and resolution of issues that arise after the case is closed. This means, for example, that actions to determine the validity of securities issued under a reorganization plan might remain within the bankruptcy jurisdiction of the district court. Not surprisingly, the district court's "original but not exclusive" jurisdiction has complicated the bankruptcy scheme.

Despite this broad grant of jurisdiction to the district courts, they do not hear all proceedings in bankruptcy cases. Further complicating the jurisdictional scheme are provisions that make jurisdiction in the district court rest on the types of proceedings to be heard. There is no provision for a district court to abstain in a bankruptcy case, which means that the district court may not, for example, refuse to take bankruptcy filings. (28 U.S.C. § 1334) But if a proceeding "arises under" or "arises in" a case once it has been filed, a district court may abstain "in the interest of justice, or in the interest of comity with State courts or respect for State law." (28 U.S.C. § 1334(a), (c)(1)) In addition, a district court *must* abstain in a proceeding based on a state-law claim or cause of action "related to," but not arising under or arising in, a bankruptcy case, if the state-law claim has commenced and can be timely resolved in a state-law forum. (28 U.S.C. § 1334(c)(2)) There is, of course, an exception to mandatory abstention if there are independent grounds (such as diversity) for federal jurisdiction. Finally, the district court's decision to abstain is not reviewable. (28 U.S.C. § 1334(c)(2))

Whether the district court has exclusive jurisdiction, permissive jurisdiction, or no jurisdiction depends on whether the proceeding "arises under" or "arises in" a case or is "related to" a case.

Unfortunately, precise definitions of the key terms are lacking. The terms first appeared in the broad grant of jurisdiction in the 1978 Bankruptcy Code, but before *Marathon* there was little reason to differentiate among the categories because the bankruptcy courts exercised jurisdiction in all cases. There are now reasons for differentiation, but the distinctions remain elusive.

Even when the district court has exclusive jurisdiction, the 1984 amendments do not contemplate that the court will actually hear every issue in every case. For actions that are "core proceedings," the district court may refer the case to the bankruptcy judge for hearing and determination. (28 U.S.C. § 157(a), (b)) In fact, every district court in the country has adopted a policy of automatic referral, although occasionally a district court will withdraw the referral in a particularly difficult case or a case of unusually widespread implications.

The bankruptcy court sits as the trial court, issuing final orders which can be appealed to the district court. (28 U.S.C. §§ 157(b)(1), 158(a)) For actions that are not core proceedings but "are otherwise related to a case under title 11," the district court may refer the case to the bankruptcy judge for proposed findings of fact and conclusions of law *if* the district court has jurisdiction (note the limitation imposed by mandatory abstention). (28 U.S.C. § 157(c)) Appeals from the bankruptcy court's proposed orders are reviewed de novo, and final orders issue from the district court. (28 U.S.C. § 157(c)) The parties may consent to jurisdiction in the bankruptcy courts over a noncore proceeding, in which case review will be in the district court as if the matter were a core proceeding. (28 U.S.C. § 157(c)(2))

Bankruptcy courts routinely hear both core matters and matters related to a case. The distinction between the two is important for determining when the district court reviews final orders of the bankruptcy court on a clearly erroneous standard and when it only considers the bankruptcy court's proposed findings of fact and law and makes its own findings. The distinction between the types of cases and between the appropriate scope of review turns on whether the proceedings are "core proceedings" or "noncore proceedings." A bankruptcy judge determines whether a proceeding is a core proceeding. (28 U.S.C. § 157(b)(3))

Once again, the definitions of the critical categories are somewhat elusive. The 1984 amendments list examples of core proceedings. They include matters concerning administration of the estate, allowance of claims, counterclaims against creditors of the estate, orders for obtaining credit, turnover of property of the estate, preference avoidance, automatic-stay violations, recovery of fraudulent conveyances, validity of liens, objections to discharge, confirmation of plans, and similar matters. (28 U.S.C. § 157(b)(2)) But the list is only suggestive, not exhaustive. The Code leaves open the possibility that other matters may be core proceedings, thus blurring the distinction between core and noncore proceedings.

Just as the district court may refer a case to the bankruptcy court, the district court also retains the power to "withdraw, in whole or in part, any case or proceeding" so referred. (28 U.S.C. § 157(d)) The court may withdraw its referral to the bankruptcy court on its own motion or on the motion of any party, and it may do so at any point in the proceeding. (28 U.S.C. § 157(d)) The 1984 amendments require the district court to withdraw proceedings that require "consideration of both title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce." (28 U.S.C. § 157(d)) Notwithstanding this seemingly broad requirement to withdraw proceedings from the bankruptcy courts, such withdrawals seem to be rare in practice, particularly in many Chapter 11 cases.

Personal-injury and wrongful-death claims against the estate receive special treatment. They are not within the core jurisdiction of the bankruptcy judge via the district court, nor are they subject to the mandatory abstention accorded other state-law claims. (28 U.S.C. §§ 157(b)(4), 1334(c)(2)) Instead, these claims are tried by the district court, unless the parties consent to the jurisdiction of the bankruptcy court or unless the district court exercises its discretionary abstention and permits a state court to try the case. (28 U.S.C. §§ 157(c)(2), 1334(c)(1))

The 1984 amendments have made the jurisdictional structure complex, but the grant of power remains broad. Much of the language granting jurisdiction to the district courts is the same as that used in the 1978 Code. Even when jurisdiction is nonexclusive, it is generally greater than the jurisdiction of any competing court. For example, litigation in other courts is stayed automatically when a petition is filed, even though the district court may be called on later to make a decision to abstain or to remand the case. (sections 362, 105; 28 U.S.C. §§ 1334(c)(2), 1452(b)) The 1984 provisions dividing jurisdiction on the basis of whether proceedings are core or arising under, arising in, or related to the bankruptcy case have not yet been sufficiently tested in the Supreme Court to determine whether they cure the constitutional infirmities identified in *Marathon*.

Appeals from the Bankruptcy Court

Appeals from the bankruptcy court have become an increasingly important part of the federal judicial workload. The number of bankruptcy cases disposed of after a hearing has risen by nearly 300% since the adoption of the 1978 Code.[39] More critically, these appeals result in a high rate of reversal. The court of appeals reversed lower court decisions in 17.2% of bankruptcy appeals, second only to appeals in the leftover category of "other."[40] In five circuits, reversals in bankruptcy cases led reversals in all other types of cases. From the other end of the spectrum, this means that about 18% of all appeals taken in bankruptcy cases result in a reversal, and 25% to 30% of the bankruptcy cases in some circuits result in reversals.

The process by which so many bankruptcy cases find their way to the district courts and courts of appeals is somewhat complex. As noted earlier, the district court reviews the proposed findings of fact and conclusions of law regarding noncore matters referred to the bankruptcy court. As a jurisdictional matter, the district court makes a de novo review of any matters "to which any party has timely and specifically objected" and then enters final orders. (28 U.S.C. § 157(c)(1)) In effect, the district court is acting as the court of original, not appellate, jurisdiction.

In core matters referred to the bankruptcy court and in matters heard by consent of the parties, the district court operates as an ap-

39. Statistics are compiled by the Administrative Office of the U.S. Courts for distribution to federal judges.

40. The Administrative Office of the U.S. Courts categorizes cases for their own analyses.

pellate court. It hears appeals from final judgments, orders, and decrees of the bankruptcy court, and reviews them on a "clearly erroneous" basis. (28 U.S.C. § 158(a)) The district court may also grant motions to hear appeals from interlocutory orders and decrees from the bankruptcy court. (28 U.S.C. § 158(a))

Since the district courts' responsibility to hear appeals is mandatory rather than permissive if the matter at issue is a final order rather than an interlocutory order, the distinction between final and interlocutory orders becomes crucial to the appellate process. The general concept of finality embodied in other appellate litigation applies in the bankruptcy system as well, but bankruptcy cases present special problems. Bankruptcy cases often consist of one large case in which a number of proceedings must be resolved. Waiting to resolve one dispute until all are resolved would involve extraordinary delay and, potentially, a great waste of both the litigants' and the courts' resources.

The concept of finality in bankruptcy generally does not require that the entire case be resolved. Instead, the "unit of litigation" is smaller, resolving more limited questions. A unit of litigation in a bankruptcy case might involve a dispute over whether a debtor could be adjudicated an involuntary bankrupt or whether a creditor received a voidable preference which it is now obligated to disgorge. Finality is resolved by applying generally applicable principles to these smaller units of litigation. Not surprisingly, a conflicting body of case law has grown up regarding the question of finality in bankruptcy cases. Nonetheless, the process of treating some decisions as final before the whole case is resolved facilitates quicker final resolution of cases. Perhaps more important, it also permits key elements of a pending case (such as the resolution of a claim against the estate or the estate's recovery against another party) to be resolved so that the other elements of a workable plan can be negotiated without difficult contingency planning.

The Code provides an alternative route for appeal of a bankruptcy court order. The judicial council of a circuit may establish a bankruptcy appellate panel (BAP) composed of a group of bankruptcy judges from districts within the circuit, and the district judges may by majority vote authorize referral of appeals to these panel judges. (28 U.S.C. § 158(b)(1)) If the parties then consent in a particular case, the BAP exercises appellate jurisdiction. (28 U.S.C.

§ 158(b)(1)) At the time of this writing, only the Ninth Circuit had established a BAP system.

After a district court or a BAP has issued a final order, judgment, or decree, an appeal may be taken to the court of appeals. (28 U.S.C. 158(d)).There is no grant of jurisdiction for appeals from interlocutory orders. If the district court exercised original jurisdiction in a case, the court of appeals is the first appellate court. On an appeal from a BAP or from an appellate district court order, the court of appeals is the second level of appellate jurisdiction.

The Supreme Court exercises jurisdiction in bankruptcy cases in the same manner as it exercises jurisdiction in ordinary civil actions. It generally reviews judgments of the court of appeals by writ of certiorari, but the jurisdictional grounds for review by appeal also apply. (28 U.S.C. § 1254(1))

Jury Trials

Does a party subject to the jurisdiction of the district court and, by referral, to that of the bankruptcy court, have a right to a jury trial in a bankruptcy proceeding? If so, will it be heard by the district court judge or by the bankruptcy judge? The Code furnishes little guidance on these fundamental questions.

The only statutory provision directly on point prescribes that bankruptcy laws "do not affect any right to trial by jury that an individual had under applicable nonbankruptcy law with regard to a personal injury or wrongful death tort claim." (28 U.S.C. § 1411) Since those cases are heard in the district court, the provision suggests that the district court may conduct jury trials in such cases. (28 U.S.C. § 157(b)(5)) The bankruptcy laws are otherwise silent on the question of jury trials.

The U.S. Constitution governs the right to jury trials, providing that "(i)n suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved."[41] The right to jury trial guaranteed by the Constitution usually has been restricted to suits at common law, as opposed to actions in equity or those seeking equitable remedies. Since bankruptcy law is generally equitable in nature, some commentators

41. U.S. Const. amend. VII.

conclude that there is no guaranteed right to a trial by jury in bankruptcy matters.

The Supreme Court has recently addressed the question of jury trials in bankruptcy actions. In *Granfinanciera, S.A. v. Nordberg,*[42] the Court held that when an estate sues someone for recovery of money for a fraudulent conveyance, the suit should be characterized as legal rather than equitable, thereby triggering the protection of the Seventh Amendment. *Granfinanciera* involved a defendant who had not filed a claim against the estate, and the Court ruled that the defendant could claim its right to a jury trial, despite the Code's classification of the proceeding as a core proceeding. Had the trustee asserted the fraudulent conveyance action as a counterclaim to a proof of claim filed by the creditor, the Court concluded, the whole matter would have been equitable and no right to a jury trial would have existed.

In *Granfinanciera,* the Supreme Court expressly reserved the questions of whether Congress had authorized bankruptcy judges to conduct jury trials and whether such an authorization would be constitutionally permissible. At the time of this writing, the courts of appeals are split on the question of whether bankruptcy courts can conduct jury trials.

Contempt Powers

The clearest statement delineating the bankruptcy courts' use of contempt powers is found in the Bankruptcy Rules. They provide that the bankruptcy judge may summarily issue an order of contempt for actions committed in the presence of the court and also may issue an order, after notice and a hearing, for other contempt actions. (Bankruptcy Rule 9020(a), (b)) The rules delay enforcement of contempt orders for ten days, which leaves time for review by the district court. (Bankruptcy Rule 9020(c)) If the contemnor appeals in a timely fashion, the district court will make a de novo review. (Bankruptcy Rule 9033)

There is some dispute over the power of a bankruptcy judge to exercise contempt powers in core or noncore proceedings. The general grant of power to the bankruptcy court to "issue any order,

42. 942 U.S. 33 (1989).

process, or judgment that is necessary or appropriate to carry out the provisions of this title" seems to support a grant of contempt powers. (section 105(a)) Moreover, in granting the bankruptcy judges power to hear and determine core proceedings, Congress gave the judges power to "enter appropriate orders and judgments, subject to review" of the district court, which seems to reinforce that view. (28 U.S.C. § 157(b)(1))

There are doubts, however, whether Congress intended a non-Article III court to exercise contempt powers in the absence of more explicit Code language. Some courts distinguish between civil and criminal contempt orders; other courts distinguish the power to determine a contempt committed in the presence of the bankruptcy judge from the power to determine those committed elsewhere.

Even without contempt power, it seems noncontroversial that the bankruptcy court may impose sanctions on parties who violate Code provisions. Bankruptcy courts routinely impose sanctions on creditors for violations of the automatic stay and on attorneys for violations of Bankruptcy Rule 9011 (similar to Rule 11 of the Federal Rules of Civil Procedure).

Venue

A bankruptcy case may be commenced in the district court "in which the debtor's domicile, residence, principal place of business in the United States, or principal assets in the United States" have been for 180 days preceding filing. (28 U.S.C. § 1408(1)) A case also may be commenced in the district court in which an affiliate, general partner, or partnership of a debtor has a bankruptcy case pending. (28 U.S.C. § 1408(2))

These alternative grounds for venue afford the party initiating a case—the debtor, in the overwhelming proportion of cases—a degree of choice. Business debtors that are incorporated in one state, have corporate headquarters in another, and have principal operating facilities in yet another may have a number of choices. If troubled affiliates are incorporated in other states or they operate in still other states, the possibilities for venue multiply. The complexities can be extended by the only guidance in the bankruptcy laws about transfer of venue. A court may transfer a case to another district "in the interest of justice or for the convenience of the parties." (28 U.S.C. § 1412)

The effects of these venue choices are beginning to be felt as debtors scrutinize the practices and decisional law of different federal districts and make their filing decisions accordingly. Throughout the 1980s, very large business filings were concentrated in the Southern District of New York, sometimes to the consternation of parties who believed the filings should be made elsewhere. Smaller businesses obviously have fewer filing options, although venue choice is still a consideration for a number of debtors.

The bankruptcy court in which the case is pending is the proper venue for any litigation in the case, and in the overwhelming majority of cases all litigation is heard where the case is pending. Once again, however, the statute provides that "in the interest of justice or for the convenience of the parties," the court may transfer an action to another district. (28 U.S.C. §§ 1409(a), 1412) Moreover, when the estate pursues very small claims (for less than $1,000 against a nonconsumer debtor or less than $5,000 against a consumer debtor), venue is proper only in the district where the defendant resides. (28 U.S.C. § 1409(b), (d)) Claims that arise out of the business of the post-petition estate are not governed by bankruptcy venue proceedings, so they must follow applicable nonbankruptcy law. (28 U.S.C. § 1409(d))

Policy Issues

Time is a critical element in most business reorganizations. Unlike many court actions which involve disputes over liability for injuries suffered long ago, the bankruptcy case involves active monitoring of a going concern. As a result, many of the problems brought before a bankruptcy court require quick resolution. For the debtor that cannot get a hearing on post-petition financing before payday next Friday and for the creditor that cannot get the automatic stay lifted before the debtor destroys the collateral, justice delayed is truly justice denied. Delay in bankruptcy proceedings has a large, substantive impact on the course of the case.

Accommodating the need for speed is particularly difficult in business bankruptcy cases because they nearly always involve a number of complex factual (and sometimes complex legal) disputes. Although lawsuits in a number of fields are growing ever more intricate, the bankruptcy case remains notable for both the variety and the number of issues and legal actions that may arise during the course of a reorganization. Again, because the case involves an ongoing business, the court may be called on to resolve issues requiring the valuation of property, the intent of parties with respect to allegedly fraudulent transactions occurring years earlier, the advisability of long-term financing proposals, the necessity of termination of employee health insurance plans, and so on. Not only are the issues diverse, but the parties that come forward to litigate them may change from issue to issue. Alliances among parties may form, break up, and re-form as parties see potential gain or loss in proposed resolutions of different disputes.

Finally, in all bankruptcy cases there is acute awareness that money spent wrangling over the rights of the parties is not money spent to move the debtor toward a successful reorganization or money distributed to the creditors. Many observers believe that some portion of the debtors that fail in Chapter 11 do so because resources that were essential to the reorganization were dissipated in litigation. Other observers note that estates often consume enormous resources that would have gone to the creditors in an early liquidation. In both instances, the value-enhancement norms of the Code are directly implicated in the practices and procedures used in bankruptcy cases.

Once again, the Code's value-enhancement norms become intertwined with its distributional values. To the extent that a party has the power to delay proceedings or otherwise to derail a pending reorganization or liquidation, that party can negotiate for better treatment in return for not holding up the works. The ability to delay proceedings when there is no underlying legal basis for any claim has been blamed, for example, on payments being made to shareholders in publicly traded corporations in plan confirmations (so-called "hostage payments" to reflect their origin not in law, but in the power to hold up the progress of the case).[43]

Because of the need to negotiate multiparty settlements that can break apart in an instant and because of the premium on consensual plans, bankruptcy is an area particularly susceptible to the influence

---

43. *E.g.*, Lynn LoPucki & William Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. Pa. L. Rev. 125, 145–57 (1990).

of holdout positions. Procedural rules or jurisdictional maneuvering may be used to squeeze a better deal for a negotiating party, thereby implicating the distributive norms of the bankruptcy scheme.

In part to control the costs of a reorganization and to prevent the dissipation of assets, the Code gives the courts not only the power to make summary dispositions of creditor actions, but also sweeping powers to monitor the debtor's expenses directly. One of the most powerful is the court's ability to monitor the debtor's legal expenses. The debtor can engage counsel only with the approval of the court, and it can pay its legal bills only if the court approves such payments. (11 U.S.C. §§ 327(a), 328) The court can review the attorney's bills at any level of specificity, from cutting back on photocopying to refusing reimbursement for counsel's hourly charges. Many courts review fees *sua sponte*, noting that the Code requires approval from the court (and hence an independent inquiry) before such fees can be paid, even if no creditor objects to the attorney's request for payment from the estate. Similarly, the court also monitors any expenditures by the debtor for employment of any other professionals or experts. (11 U.S.C. §§ 327, 328) Even with such extraordinary power vested in the bankruptcy courts to review the expenses of the debtor, there is a growing sense that administrative expenses, particularly attorney's fees, consume an excessive portion of the debtor's assets in a reorganization effort.

The practical realities that inhere in the resolution of a bankruptcy case shape the policy issues that arise in determining bankruptcy jurisdiction and procedure. The statute and the courts are necessarily concerned with finding an appropriate balance between protecting the rights of parties to disputes and maintaining procedures that do not themselves reduce the value of the estate. Concerns over the time, complexity, and resource consumption in parties' maneuvering in bankruptcy arise throughout the cases and have a very real impact on the resources available and on the distributions that occur in bankruptcy cases.

Conclusion

The 1978 Code was designed to rationalize the jurisdictional rules and to provide a fair, efficient system for administering bankruptcy estates. The changes were designed to focus the bankruptcy process on speedy liquidation or reorganization, rather than have time and assets wasted on jurisdictional and procedural disputes. The bankruptcy courts were given more independent status, and the role of the bankruptcy judges was reshaped to make it similar to the role of other trial court judges. The subsequent constitutional and political disputes and the resulting 1984 amendments have produced a more complex structure. Even so, the grant of jurisdictional power to the district courts and through them to the bankruptcy courts is broad, and the bankruptcy courts resolve, subject to review, the bulk of the issues that arise in bankruptcy cases.

The bankruptcy system still has a number of important, unresolved procedural and jurisdictional issues. The most critical unresolved question is whether the 1984 amendments have created a constitutionally acceptable bankruptcy jurisdiction. A number of other subsidiary questions persist as well, including those concerning jury trials, contempt orders, and distinctions among kinds of bankruptcy proceedings. The system functions without full resolution of these questions, but its operations could change dramatically following future court decisions.

Bibliography of Bankruptcy Policy Articles

Charles W. Adams, *An Economic Justification for Corporate Reorganizations,* 20 Hofstra L. Rev. 117 (1991).

Barry E. Adler, *Bankruptcy and Risk Allocation,* 77 Cornell L. Rev. 439 (1992).

Barry Adler, *Financial and Political Theories of American Corporate Bankruptcy,* 45 Stan. L. Rev. 311 (1993).

Philippe Aghion, Oliver Hart & John Moore, The Economics of Bankruptcy Reform (MIT Working Paper, Department of Economics, 1992).

Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question,* 39 J. Fin. 1067 (1984).

James S. Ang, Jess Chua & John J. McConnell, *The Administrative Costs of Corporate Bankruptcy,* 37 J. Fin. 219 (1982).

Douglas G. Baird, *Fraudulent Conveyances, Agency Costs, and Leveraged Buyouts,* 20 J. Legal Stud. 1 (1991).

Douglas G. Baird, *The Initiation Problem in Bankruptcy,* 11 Int'l Rev. L. & Econ. 223 (1991).

Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren,* 54 U. Chi. L. Rev. 815 (1987).

Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations,* 15 J. Legal Stud. 127 (1986).

Douglas G. Baird, *A World Without Bankruptcy,* 50 Law & Contemp. Probs. 173 (1987).

Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy,* 51 U. Chi. L. Rev. 97 (1984).

Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations,* 20 J. Legal Stud. 311 (1991).

Carliss Y. Baldwin & Scott P. Mason, *Bankruptcies, Workouts, and Turnarounds: A Round Table Discussion,* 4 J. Appl. Corp. Fin. 34 (1991).

Carliss Y. Baldwin & Scott P. Mason, *The Resolution of Claims in Financial Distress: The Case of Massey Ferguson,* 38 J. Fin. 505 (1983).

Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations,* 101 Harv. L. Rev. 775 (1988).

Lucian A. Bebchuk & Howard F. Chang, *Bargaining and the Division of Value in Corporate Reorganization,* 8 J. L. Econ. & Organ. 253 (1992).

Yaacov Z. Bergman & Jeffrey L. Callen, *Opportunistic Underinvestment in Debt Renegotiation and Capital Structure,* 29 J. Fin. Econ. 137 (1991).

Elazar Berkovitch & E. Han Kim, *Financial Contracting and Leverage Induced Over- and Under-Investment Incentives,* 45 J. Fin. 765 (1990).

James W. Bowers, *Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure,* 88 Mich. L. Rev. 2097 (1990).

James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution,* 26 Ga. L. Rev. 27 (1991).

William J. Boyes & Roger L. Faith, *Some Effects of the Bankruptcy Reform Act of 1978,* 29 J. L. & Econ. 139 (1986).

Michael Bradley & Michael Rosenwig, *The Untenable Case for Chapter 11,* 101 Yale L.J. 1043 (1992).

David T. Brown, *Claimholder Incentive Conflicts in Reorganization,* 2 Rev. Fin. Stud. 109 (1989).

Jeremy I. Bulow & John B. Shoven, *The Bankruptcy Decision,* 9 Bell J. Econ. 437 (1978).

Truman A. Clark & Mark I. Weinstein, *Behavior of the Common Stock of Bankrupt Firms,* 38 J. Fin. 489 (1983).

Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy,* 38 Vand. L. Rev. 713 (1985).

David M. Cutler & Lawrence H. Summers, *The Costs of Conflict Resolution and Financial Distress: Evidence from the Texaco-Pennzoil Litigation,* 19 Rand J. Econ. 157 (1988).

Kevin J. Delaney, *Power, Intercorporate Networks, and "Strategic Bankruptcy,"* 23 L. & Soc'y Rev. 643 (1989).

Jochen Drukarczyk, *Secured Debt, Bankruptcy, and the Creditors' Bargain Model,* 11 Int'l Rev. L. & Econ. 203 (1991).

Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?,* 27 J. Fin. Econ. 411 (1990).

Allan C. Eberhart, William T. Moore & Rodney L. Roenfeldt, *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings,* 45 J. Fin. 1457 (1990).

Theodore Eisenberg, *Bankruptcy in the Administrative State,* 50 Law & Contemp. Probs. 3 (1987).

Theodore Eisenberg, *Bankruptcy Law in Perspective,* 28 U.C.L.A. L. Rev. 953 (1981).

Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization,* 44 J. Fin. 747 (1989).

Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law,* 46 J. Fin. 1189 (1991).

Ronald M. Giammarino, *The Resolution of Financial Distress,* 2 Rev. Fin. Stud. 25 (1989).

Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Control When Firms Default,* 27 J. Fin. Econ. 355 (1990).

Stuart C. Gilson, *Management Turnover and Financial Distress,* 25 J. Fin. Econ. 241 (1989).

Stuart C. Gilson, *Managing Default: Some Evidence on How Firms Choose Between Workouts and Chapter 11,* 4 J. Appl. Corp. Fin. 62 (1991).

Stuart C. Gilson, John Kose & Larry H. P. Lang, *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default,* 27 J. Fin. Econ. 315 (1990).

Devra L. Golbe, *The Effects of Imminent Bankruptcy on Stockholder Risk Preferences and Behavior,* 12 Bell J. Econ. 321 (1981).

Richard C. Green, *Investment Incentives, Debts, and Warrants,* 13 J. Fin. Econ. 115 (1984).

Milton Harris & Artur Raviv, *The Theory of Capital Structure,* 46 J. Fin. 297 (1991).

Thomas H. Jackson, *Of Liquidation, Continuation, and Delay: An Analysis of Bankruptcy Policy and Nonbankruptcy Rules,* 60 Am. Bankr. L.J. 399 (1986).

Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditor's Bargain,* 75 Va. L. Rev. 155 (1989).

Michael C. Jensen, *Corporate Control and the Politics of Finance,* 4 J. Appl. Corp. Fin. 13 (1991).

J. Bradley Johnston, *The Bankruptcy Bargain,* 65 Am. Bankr. L.J. 213 (1991).

Frank R. Kennedy, *Creative Bankruptcy? Use and Abuse of the Bankruptcy Law—Reflection on Some Recent Cases,* 71 Iowa L. Rev. 199 (1985).

Jerome R. Kerkman, *The Debtor in Full Control: A Case for Adoption of the Trustee System,* 70 Marq. L. Rev. 159 (1987).

Donald R. Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law,* 71 Tex. L. Rev. 541 (1993).

Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy,* 91 Colum. L. Rev. 717 (1991).

Donald R. Korobkin, *Value and Rationality in Bankruptcy Decisionmaking,* 33 Wm. & Mary L. Rev. 333 (1992).

Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System,* 1982 Wis. L. Rev. 311 (1982).

Lynn LoPucki & William Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies,* 139 U. Pa. L. Rev. 125 (1990).

Lynn LoPucki & William Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Traded Companies,* 141 U. Pa. L. Rev. 669 (1993).

Lynn LoPucki & William Whitford, *Venue Choice,* 1991 Wis. L. Rev. 11 (1991).

William H. Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State,* 41 Law & Contemp. Probs. 13 (1977).

Merton H. Miller, *The Wealth Transfers of Bankruptcy: Some Illustrative Examples,* 41 Law & Contemp. Probs. 39 (1977).

Dale Morse & Wayne Shaw, *Investing in Bankrupt Firms,* 43 J. Fin. 1193 (1988).

Randal C. Picker, *Security Interests, Misbehavior, and Common Pools,* 59 U. Chi. L. Rev. 645 (1992).

Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy,* 71 Tex. L. Rev. 51 (1992).

Robert K. Rasmussen, *The Efficiency of Chapter 11,* 8 Bankr. Dev. J. 319 (1991).

Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization,* 83 Colum. L. Rev. 527 (1983).

Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice,* 20 J. Legal Stud. 277 (1991).

Clifford W. Smith & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants,* 7 J. Fin. Econ. 117 (1979).

Teresa Sullivan, Elizabeth Warren & Jay Westbrook, *The Role of Empirical Data in Formulating a National Bankruptcy Policy,* 50 Law & Contemp. Probs. 195 (1987).

Sheridan Titman, *The Effect of Capital Structure on a Firm's Liquidation Decision,* 13 J. Fin. Econ. 137 (1984).

J. Ronald Trost, *Business Reorganizations Under Chapter 11 of the New Bankruptcy Code,* 34 Bus. Law. 1309 (1979).

Jerold B. Warner, *Bankruptcy Costs: Some Evidence,* 32 J. Fin. 337 (1977).

Elizabeth Warren, *Bankruptcy Policy,* 54 U. Chi. L. Rev. 775 (1987).

Elizabeth Warren, *A Theory of Absolute Priority,* 1991 N.Y.U. Ann. Surv. Am. L. 9.

Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11,* 102 Yale L.J. 437 (1993).

Elizabeth Warren, *Why Have a Federal Bankruptcy System?,* 77 Cornell L. Rev. 2401 (1992).

David C. Webb, *The Importance of Incomplete Information in Explaining the Existence of Costly Bankruptcy,* 54 Economica 279 (1987).

Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference,* 39 Stan. L. Rev. 3 (1986).

Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims,* 27 J. Fin. Econ. 285 (1990).

Lawrence A. Weiss, *The Bankruptcy Code and Violations of Absolute Priority,* 4 J. Appl. Corp. Fin. 71 (1991).

John C. Weistart, *The Costs of Bankruptcy,* 41 Law & Contemp. Probs. 107 (1977).

Michelle J. White, *The Corporate Bankruptcy Decision,* 3 J. Econ. Persp. 129 (1989).

Karen H. Wruck, *Financial Distress, Reorganization, and Organizational Efficiency,* 27 J. Fin. Econ. 419 (1990).

Karen H. Wruck, *What Really Went Wrong at Revco,* 4 J. Appl. Corp. Fin. 79 (1991).

David Gray Carlson, *Philosophy in Bankruptcy,* 85 Mich. L. Rev. 1341 (1987) (book review).

Theodore Eisenberg, *A Bankruptcy Machine That Would Go of Itself,* 39 Stan. L. Rev. 1519 (1987) (book review).

Robert E. Scott, *Through Bankruptcy with the Creditors' Bargain Heuristic,* 53 U. Chi. L. Rev. 690 (1986) (book review).

Index

*U.S GOVERNMENT PRINTING OFFICE 1993 .343 -258/93328

About the Federal Judicial Center

The Federal Judicial Center is the research, education, and planning agency of the federal judicial system. It was established by Congress in 1967 (28 U.S.C. §§ 620–629), on the recommendation of the Judicial Conference of the United States.

By statute, the Chief Justice of the United States chairs the Center's Board, which also includes the director of the Administrative Office of the U.S. Courts and six judges elected by the Judicial Conference.

The Court Education Division provides educational programs and services for non-judicial court personnel such as those in clerks' offices and probation and pretrial services offices.

The Judicial Education Division provides educational programs and services for judges. These include orientation seminars and special continuing education workshops.

The Planning & Technology Division supports the Center's education and research activities by developing, maintaining, and testing technology for information processing, education, and communications. The division also supports long-range planning activity in the Judicial Conference and the courts with research, including analysis of emerging technologies, and other services as requested.

The Publications & Media Division develops and produces educational audio and video programs and edits and coordinates the production of all Center publications, including research reports and studies, educational and training publications, reference manuals, and periodicals. The Center's Information Services Office, which maintains a specialized collection of materials on judicial administration, is located within this division.

The Research Division undertakes empirical and exploratory research on federal judicial processes, court management, and sentencing and its consequences, often at the request of the Judicial Conference and its committees, the courts themselves, or other groups in the federal system.

The Center's Federal Judicial History Office develops programs relating to the history of the judicial branch and assists courts with their own judicial history programs.

The Interjudicial Affairs Office serves as clearinghouse for the Center's work with state–federal judicial councils and coordinates programs for foreign judiciaries, including the Foreign Judicial Fellows Program.