BANKRUPTCY SOLUTIONS IN THE UNITED STATES: AN OVERVIEW

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I. INTRODUCTION

A country's treatment of its distressed businesses speaks volumes about the oft-times unarticulated views of that country's perceptions of risk taking, market structure, human nature, social mores and religious beliefs. Hopefully, this symposium, through the use of a master hypothetical (the "Hypothetical") and dialogue among the participants, will provide a mechanism for allowing the represented countries' views to emerge. This article presents the United States' response to the questions raised by the Hypothetical. By necessity, the answers are limited as one could easily write a book or teach a semester long course from the Hypothetical.1

II. ANSWER TO QUESTION 1
OF THE HYPOTHETICAL

Heavy Duty, our hypothetical debtor, has options under both state and federal law. While this article focuses on the comprehensive federal statute, title 11 of the United States Code (the "Bankruptcy Code" or the "Code"),2 three non-federal alternatives are noteworthy: an assignment for the benefit of creditors ("ABC"), an out-of-court workout through a composition or other extension agreement ("Workout") and a receivership.
An ABC is a form of liquidation under state law. The debtor executes a voluntary assignment of ownership of its non-exempt assets to an assignee who holds the property in trust for the benefit of its creditors.3 The assignee liquidates the assets and makes a pro rata distribution among those creditors who file claims with the assignee.4 Continuing to run a business or rehabilitate a distressed debtor is beyond the scope of an ABC.5 Although there are analogies between an ABC and a liquidation under Chapter 7 of the Code, an ABC does not provide many of the protections Chapter 7 debtors enjoy. For example, creditors are not stayed from pursuing unassigned assets;6 the assignee does not have the same powers as a bankruptcy trustee,7 most particularly the avoiding powers; and the assignment is only binding on consenting creditors.8 While non-participating creditors are prohibited from levying upon assigned property (as ownership has transferred), their debts are not discharged by the assignment.9 Further, because there are fewer administrative expenses, an ABC may be less costly than a Chapter 7 case.

A Workout may be a very successful tool in times of temporary difficulty. It enables a company to continue operating its business and is less expensive than its federal counterpart, a Chapter 11 case. A financially troubled debtor and all or some of its creditors can voluntarily negotiate a Workout agreement.10 The Workout is a contract that provides for the reduction of indebtedness or an extension of the payment term, or

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3. RICHARD I. AARON, BANKRUPTCY LAW FUNDAMENTALS § 1.02 (1996).
4. Id.; see generally ALEXANDER M. BURRILL, A TREATISE ON THE LAW AND PRACTICE OF VOLUNTARY ASSIGNMENTS FOR THE BENEFIT OF CREDITORS (5th ed. 1887).
7. The Code provides a Chapter 7 trustee with "avoiding powers." For example, the trustee has the power to avoid a preference under § 547 of the Code.
8. See International Shoe Co. v. Pinkus, 49 S. Ct. 108 (1929), in which the Supreme Court held that state statutes cannot grant discharges as the statute would be invalid under the Supremacy Clause of the United States Constitution because the power to discharge debts is part of Congress' bankruptcy power. Thus, a creditor must consent to the assignment in order for that creditor's rights to be affected.
9. Id.
both. Voluntary acceptance by substantially all creditors of a like kind is essential for the success of a Workout. Non-consenting creditors are not bound by the Workout; these creditors can be expected to proceed with collection efforts, thereby preventing the preservation of the debtor’s estate and discouraging the cooperating creditors from forbearing on their own collection proceedings. Without widespread creditor acceptance of the Workout, it is almost impossible for the debtor and consenting creditors to achieve their desired end.

A Workout is also impractical if the debtor has a large number of creditors or if creditors do not trust the debtor. In some Workout situations, the creditors create a committee, whose members are fiduciaries to similarly situated creditors. The committee’s duties include monitoring, investigating, negotiating with the debtor and recommending to its constituency a moratorium on debt collection efforts. This moratorium provides the debtor with breathing space free of creditor harassment while it attempts to improve its financial prospects. Unlike a Chapter 11, a Workout does not provide for recovery of preferences or assumption or rejection of executory contracts or leases. In recent years, some debtors have completed a Workout which is then intentionally followed by a Chapter 11 case. In essence, this approach, termed a “pre-pack,” enables the debtor to get the benefits of a Workout and the Code without excessive cost and delay.

A receiver is an impartial, ministerial officer appointed by a state court, with powers prescribed by said court. A receiver is commonly

11. See Epstein, supra note 6, §§ 6-11 & 9-17.
12. Id.
13. Id.
14. See Aaron, supra note 3, § 1.02[4].
15. Id.
17. Id.
18. Id.; see also 11 U.S.C. §§ 547 & 365, respectively.
20. See Charles Fisk Beach, Jr., Commentaries on the Law of Receivers § 1 (1887).
appointed when there is a demonstrated need for protection, preservation, or orderly liquidation of real property. A receivership allows the property actively to be administered or conserved to prevent deterioration or maintain its value.\textsuperscript{21} However, a receiver does not possess the wide range of powers held by a trustee or debtor-in-possession in Chapter 11 cases.

None of the state law options seem beneficial to Heavy Duty, save perhaps a Workout. However, a Workout would require all or many of Heavy Duty’s creditors to cooperate and, given their number and diversity, a Workout seems unlikely. Thus, bankruptcy seems to be Heavy Duty’s best alternative to obtain relief from its financial strain.

Despite the appeal of nonbankruptcy alternatives, many financially distressed businesses in the United States chose the federal bankruptcy system to garner relief from economic woes.\textsuperscript{22} The Code basically provides distressed businesses with two options: liquidation or reorganization. Chapter 7 is the liquidation chapter, although a liquidating plan can be filed under Chapter 11. Reorganization for businesses is usually achieved through Chapter 11. Chapters 9, 12 and 13 also provide for reorganization of particular categories of debtors. Chapter 9 is available for municipalities;\textsuperscript{23} Chapter 12 is utilized by family farmers with debts below one million dollars;\textsuperscript{24} and Chapter 13 is only available to individuals with regular income and debt within prescribed limits.\textsuperscript{25}


\textsuperscript{22} Filings for calendar year 1996 were 1,178,555. See “96 Filings up 27 Percent,” 11 BANKR. CT. DEC. A11 (April 1, 1997); see also GEORGE PUTNAM, III, 1997 BANKRUPTCY YEARBOOK & ALMANAC 31-40 (7th ed. 1997).

\textsuperscript{23} See 11 U.S.C. § 109(c) for eligibility requirements of a Chapter 9 debtor. See also § 101(40) which defines “municipality” as a “political subdivision or public agency or instrumentality of a State.” Chapter 9 is housed at 11 U.S.C. §§ 901-46 and is titled “Adjustment of Debts of a Municipality.”

\textsuperscript{24} See 11 U.S.C. § 109(f) for eligibility requirements of a Chapter 12 debtor. Chapter 12 is housed at 11 U.S.C. §§ 1201-31 and is titled “Adjustment of Debts of a Family Farmer with Regular Annual Income.” Chapter 12 is only available to family farmers with regular income who actually conduct farming operations. See 11 U.S.C. §§ 109(f) & 101(18)(B). Chapter 12 is designed to give family farmers an opportunity to reorganize their debts and keep their land. It is largely based on Chapter 13, but includes some elements of Chapter 11 and some special provisions for smaller, family-owned operations. See generally DANIEL R. COWANS, COWANS BANKRUPTCY LAW & PRACTICE § 21.1 (1994).

\textsuperscript{25} See 11 U.S.C. § 109(e) for eligibility requirements of a Chapter 13 debtor. See also 11 U.S.C. § 101(30), which defines “individual with regular income” as an “individual whose income is sufficiently stable and regular to enable such individual to make payments under a plan under chapter 13. . . .other than a stockbroker or a commodity broker.” The Chapter 13 debtor must also have unsecured debts below $250,000 and secured debts
One of the remarkable features of United States law is that a business does not need to be insolvent to access the federal bankruptcy system. Although courts have created a good faith requirement, the existence of net worth is not an example of bad faith. In the United States, the vast majority of bankruptcy cases are voluntary, and most business cases involve liquidations rather than reorganizations.

A. Liquidation: Relief for Businesses under Chapter 7 and the Chapter 11 Liquidating Plan.

A liquidation generally is the final disposition of a business. The aim of Chapter 7 is the surrender and dissolution of the debtor’s estate for the purpose of generating a fund to repay creditors. A Chapter 7 trustee is appointed by the United States Trustee (from a panel of trustees) and is responsible for collecting the debtor’s unencumbered assets, converting them into cash and making a distribution to creditors who have allowed claims against the estate. Creditors are usually passive and rely on the

below $750,000. Chapter 13 is housed at 11 U.S.C. §§ 1301-30 and is titled “Adjustment of Debts of an Individual with Regular Income.” Chapter 13 is designed to enable an individual to keep all or most of his or her assets and to use future income to pay creditors at least as much as they would receive under a Chapter 7 liquidation. A Chapter 13 case must be commenced voluntarily because “short of involuntary servitude, it is difficult to keep a debtor from working for his or her creditors when he does not want to pay them back.” See S. REP. NO. 95-989 (1978), reprinted in 1978 U.S.C.C.A.N. 5787. In all Chapter 13 cases, a trustee is appointed to collect and disburse payments under the plan, account for the property of the estate, investigate the debtor’s affairs, examine and object to proofs of claims, help the debtor formulate a plan, and participate in the confirmation and discharge hearings.

26. However, it should be noted that under § 303(h)(1), involuntary filings, the petitioning creditor(s) must demonstrate that the debtor is generally not paying its debts as they become due. This test is not a balance sheet insolvency test nor an equity insolvency test, although it is close. See 11 U.S.C. § 303(h)(1).


29. See KAREN GROSS, FAILURE AND FORGIVENESS: REBALANCING THE BANKRUPTCY SYSTEM (1997), for a breakdown and analysis of data on bankruptcy filings released by the Administrative Office.

30. EPSTEIN, supra note 6, § 7-1.

trustee to administer the estate in their best interest. Funds are distributed to unsecured creditors in accordance with the Code’s order of priority. Commonly, there are insufficient funds to repay all creditors in full; this means that creditors receive only a pro rata payment of their claim. Sometimes creditors receive no distribution at all. Unlike an individual debtor, a business is not granted a discharge under Chapter 7. This is to prevent debtors from trafficking in corporate shells for tax purposes. Although a business is technically still liable for the unsatisfied balance of a claim with no discharge in place, the claim is virtually uncollectible.

A business can also liquidate through a Chapter 11 liquidating plan. Chapter 11 liquidating plans have been used when more funds can be generated for creditors through a slow wind-down of the business through the efforts of management rather than a fire sale of the assets conducted by a Chapter 7 trustee. Although available and employed by default, Chapter 11 liquidating plans are not commonly employed as most companies in Chapter 11 aim for their businesses to reorganize, not liquidate.

A voluntary liquidation is not an appropriate remedy for Heavy Duty, our hypothetical debtor. Heavy Duty has a viable business that is experiencing temporary financial trouble due to a shortage of raw materials. The owners/shareholders do not want to shut Heavy Duty’s door. Rather, with some debt adjustment, there appears to be a future for Heavy Duty. Thus, liquidation is not the avenue for Heavy Duty to pursue at this time.

B. Rehabilitation: Relief for Businesses under Chapter 11

Chapter 11 enables a business with considerable debt to reorganize. This prevents the loss of jobs and preserves assets. Although there is

32. AARON, supra note 3, § 12.02.
35. EPSTEIN, supra note 6, § 7-3 & 7-9.
37. See 11 U.S.C. § 1123(a)(5)(D) which states that a plan of reorganization may provide for the “sale of all or any part of the property of the estate” and for the distribution of the proceeds to creditors or interest holders. See also BENJAMIN WEINTRAUB & ALAN N. RESNICK, BANKRUPTCY LAW MANUAL ¶ 8.19[3][c] (1996).
38. BROUDE, supra note 16, § 7.03[2].
39. Id.
considerable academic controversy regarding the goals and success of Chapter 11, there is general consensus that it provides a mechanism for preserving a business and enabling creditors to receive at least as much as they would receive in a Chapter 7 case. There is also, depending on one's perspective, a sense that Chapter 11 serves the interests of community.

When the Code was enacted in 1978, Chapter 11 was a one size fits all chapter. However, because of the vast differences among debtors and the belief that some debtors should proceed more rapidly through the system, two major changes were made. In October 1994, Congress amended the Code to provide small businesses and single asset real estate debtors different treatment under Chapter 11.

The small business amendments afford a debtor having noncontingent, liquidated, secured and unsecured debt aggregating no more than $2 million, the opportunity to elect to be treated as a small business. This election provides the debtor with some benefits over a standard Chapter 11 debtor. First, upon a showing of cause, the debtor may avoid the formation of a creditors’ committee; and secondly, the court may combine the plan and disclosure hearings to expedite the reorganization process. In exchange

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43. See 11 U.S.C. § 101(51C) for the definition of “small business.”

44. See Karen Gross & Patricia Redmond, *In Defense of Debtor Exclusivity: Assessing Four of the 1994 Amendments to the Bankruptcy Code*, 69 AM. BANKR. L.J. 287, 289-301. Case law suggests, however, that the 1994 Amendments have not been without problems. For example, the provisions regarding creditors’ committees has created, not eliminated, litigation. *Id.*

for these benefits, the period in which the debtor has the exclusive right to file a plan is shortened to 100 (rather than 120) days after the commencement of the case, and all plans must be filed within 160 days of the commencement of the case (rather than at any time during the case).46

The single asset real estate debtor is also treated differently. The Code defines a "single asset real estate" debtor as one with a single project, other than one with four or less residential units, with aggregate debts of no more than $4 million.47 Section 362(d) of the Code provides relief from the automatic stay in single asset real estate cases unless the debtor files a viable plan of reorganization or commences making payments to the secured real estate lender within ninety days of the date of filing of the petition.48 These provisions create a "make it or break it" scenario for single asset real estate cases within ninety days after the order for relief is entered.49

The filing of a Chapter 11 petition gives the debtor immediate relief in the form of an automatic stay.50 The automatic stay, one of the most important benefits accorded debtors,51 insulates debtors from the pressures of debt collection. This enables management to concentrate on developing a plan free from creditor collection efforts including pending litigation.52

One of the key features of Chapter 11, which distinguishes the United States' system from that which exists in other countries, is that the debtor

46. 11 U.S.C. § 1121(e).

47. See 11 U.S.C. § 101(51B) which specifically defines "single asset real estate" as "real property constituting a single property or project, other than residential real property with fewer than four residential units, which generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto having aggregate noncontingent, liquidated secured debts in an amount no more than $4,000,000." This definition has already generated controversy, and there is legislation pending to eliminate the debt ceiling.


49. See Gross & Redmond, supra note 44, at 303.

50. 11 U.S.C. § 362(a). It should be noted that if the debtor is a small business, it is likely that the principal owner(s) gave personal guarantees of business obligations. Section 362's automatic stay does not protect the guarantors from collection actions. COWANS, supra note 24, §20.1. However, on rare occasions, courts stay such actions against the guarantor if rehabilitation of the debtor is threatened. See, e.g., In re Lamar Estates, Inc., 5 B.R. 328 (Bankr. S.D.N.Y. 1980). See infra part VI.


52. Id.
is permitted to remain in control of its business and operate as a "debtor-in-possession" ("DIP"). The DIP can be removed and a trustee appointed only in limited circumstances. The DIP has all the rights of a trustee under the Code and has the exclusive right to file a plan of reorganization within 120 days of the filing. If the debtor does not file a plan within the exclusive period, which is commonly extended by the court beyond the initial 120 day period, any party in interest has the right to file a plan.

The United States Trustee is required to appoint a committee of unsecured creditors in each Chapter 11 case, and other committees, such as a bondholders' committee and an equity-holders' committee, may also be appointed. These committees represent and safeguard the interests of their constituents. A committee may employ legal counsel or other professionals, confer with the DIP in the administration of the estate, conduct investigations into the debtor's financial affairs and participate in plan formation.

A Chapter 11 plan may modify the rights of secured and unsecured creditors or equity security holders. Additionally, a plan may be confirmed over the objections of one or more classes of creditors or equity holders. However, this is not to say that the Code does not protect creditors and there are no restrictions on a debtor. For example, the court cannot confirm a plan of reorganization if the holder of an impaired claim or interest has not accepted the plan and the plan does not provide that

54. Id.
55. 11 U.S.C. § 1121(a). As noted, Congress has specified two particular types of debtors that must file a plan of reorganization sooner than 120 days: small businesses and single asset real estate debtors. See Gross and Redmond, supra note 44, at 298-304.
57. See 11 U.S.C. §1109 which defines a "party in interest" as including "a debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee. . . ." The court is also recognized as a "party in interest." See, e.g., In re Johns-Manville Corp., 36 B.R. 727, 743 (Bankr. S.D.N.Y. 1984).
58. 11 U.S.C. § 1121(c).
61. See Epstein, supra note 6, §§ 1-4, 10-11 & 10-12.
64. 11 U.S.C. § 1129(b).
holder with at least what it would have received if the debtor liquidated under Chapter 7 of the Code (known as the "best interest of creditors' test"). The court cannot confirm a plan that pays a junior creditor unless a more senior class of creditors is paid in full or the more senior class consents to such payment (known as the "absolute priority rule"). Further, a court cannot confirm a plan of reorganization unless the court determines that the plan is feasible, in the sense that confirmation is not likely to be followed by liquidation or the need for further financial reorganization. If a plan meets the statutory requirements, the court confirms the plan, and it becomes binding upon creditors even if they voted against it.

Heavy Duty is a good candidate for relief under Chapter 11. The Code does not require that a debtor be equitable or balance-sheet insolvent as a precondition to filing for voluntary relief. Generally, businesses having a place of business in the United States are eligible for Chapter 11 relief. Heavy Duty would likely file a voluntary case, although creditors could seek to file an involuntary case.

65. See generally Collier on Bankruptcy, ¶ 1102.01 (1996); see also 11 U.S.C. § 1129(a)(7).
66. See generally Collier on Bankruptcy, supra note 65, ¶ 1102.01; see also 11 U.S.C. § 1129(a)(7).
67. See Collier on Bankruptcy, supra note 65, ¶ 1102.01; see 11 U.S.C. § 1129(a)(11).
69. Heavy Duty is eligible for Chapter 11 relief. Section 109(d) provides that a Chapter 11 debtor must be eligible to be a Chapter 7 debtor under § 109(b), except that a railroad may be a Chapter 11 debtor and a stockbroker or commodity broker may not. See also Toibb v. Radloff, 501 U.S. 157, 166 (1991) ("The plain language of the Bankruptcy Code permits individuals not engaged in business to file for relief under Chapter 11"). Heavy Duty is not eligible for relief under Chapter 12. Heavy Duty does not satisfy the requirements to be classified as a family farmer. Even if farming operations was broadly defined to include the manufacturing of farming equipment (i.e. bulldozers), Heavy Duty has over $9,500,000 in debt arising from its operations, more than the debt limitation of § 101(18)(B). Therefore, Heavy Duty is not eligible for relief under Chapter 12.
72. See 11 U.S.C. §§ 301 & 303 for requirements to file voluntary and involuntary petitions. Creditors can file an involuntary Chapter 11 against a business debtor that may be a voluntary Chapter 11 debtor that is not a farmer, family farmer, or a not-for-profit business. See 11 U.S.C. § 303(a). Section 303 of the Code sets forth the number of
A voluntary Chapter 11 is commenced by the filing of a petition with the bankruptcy court by an entity that may be a debtor under Chapter 11 and the payment of a filing fee.\textsuperscript{73} Heavy Duty's corporate officers would not be empowered to file voluntary bankruptcy petitions on behalf of the corporation because state law delegates corporate management to the board of directors.\textsuperscript{74} Most likely, the act of filing a Chapter 11 petition would require approval by Heavy Duty's board of directors. Without such approval, the petition will be dismissed.\textsuperscript{75}

Chapter 11 is Heavy Duty's best choice for relief\textsuperscript{76} because it is experiencing temporary financial difficulty, mainly due to a shortage of raw materials. Due to the Heavy Duty's performance over the past forty-

creditors, as well as the quantity and quality of their claims, needed for a properly filed involuntary petition. For example, if the debtor has 13 creditors, at least 3 or more creditors holding claims that are neither contingent nor the subject of bona fide disputes, and that total at least $10,000 more than the value of any lien against the debtor's encumbered property, can file an involuntary Chapter 11. If the debtor has 11 creditors, at least 1 creditor, meeting the same requirements as previously stated, can file the involuntary petition. Upon the debtor's objections, the court must determine whether to enter an order for relief, thereby commencing the bankruptcy case, or sustain the debtor's objections (if any) to the petition. See 11 U.S.C. § 303(h). The debtor may plead, among other things, that an insufficient number of creditors joined the petition or that the standard for filing an involuntary petition has not been established. See Block-Lieb, \textit{supra} note 28, at 820-21; see also \textit{Collins} on \textit{Bankruptcy}, \textit{supra} note 65, § 303.23 for a more complete list of requirements, defenses and objections to an involuntary petition.

For an involuntary petition to be sustained, the debtor must be generally not paying its bona fide debts as they become due, or a receiver or custodian must have been appointed or took possession of less than substantially all of the debtor's property. See 11 U.S.C. § 303(h). However, creditors must be careful when they file an involuntary petition. Courts have authority to impose punitive damages for bad faith filings. See 11 U.S.C. § 303(i). Bad faith has been found where the petition was motivated by malice or ill will and where it was used as a collection device. See Camelot, Inc. v. Hayden, 30 B.R. 408 (E.D. Tenn. 1988); \textit{In re Godroy Wholesale, Inc.}, 37 B.R. 496 (Bankr. D. Mass 1984). The courts may also require the petitioning creditor(s) to file a bond to indemnify the debtor "for such amounts as the court may later" award in the event of the dismissal of the involuntary petition. See Block-Lieb, \textit{supra} note 28, at 828; 11 U.S.C. § 303(e).

Theoretically, if three or more of Heavy Duty's more than 50 trade creditors or any other creditors get together and have more than $10,000 in undisputed debt, Heavy Duty's creditors can file an involuntary petition. Practically, creditors rarely file involuntary proceedings, although it remains a useful threat.

73. 11 U.S.C. §§ 109(d) & 301. The current fee for a Chapter 11 case is $800.

74. Melnik, \textit{supra} note 70 (citing Marks v. Grassmuch (\textit{In re Park Towers Corp.}), 387 F.2d 948 (2d Cir. 1967)).

75. \textit{Id}.

76. Heavy Duty does not qualify for the small business election under Chapter 11 because it has more than $2 million in debt.
five years, Heavy Duty is arguably a viable business that can once again be a successful business with some debt readjustment. Heavy Duty's future depends on its ability to obtain raw materials. Heavy Duty can use Chapter 11 to (a) negotiate with its landlord, the City of Hope; (b) deal with its potential environmental liability; (c) find breathing space from litigious creditors; and (d) continue to operate its business. Further, even though Heavy Duty's manufacturing plant is old, it still functions and will be adequate in the short term.

III. ANSWER TO QUESTION 2 OF THE HYPOTHETICAL

Having determined that Heavy Duty should proceed to reorganize under Chapter 11, we turn to an analysis of the many crucial players who oversee and participate in a business reorganization. Depending on the case, the players can range from the debtor and creditors and their respective counsel to investment bankers, appraisers and accountants. Usually, the debtor and its attorney(s) are the lead players in the reorganization process. In theory and less often in practice, particularly in small Chapter 11 cases, one or more creditors' committees provide oversight.77

A. Debtor-in-Possession

To the shock and consternation of some observers, upon the filing of a Chapter 11 petition, management of the debtor ordinarily continues to operate the business. In this capacity, the debtor is known, some would say very appropriately, as the "debtor-in-possession" or "DIP". Although the Code and the courts place some restrictions on the DIP's activities,78 by and large, the debtor continues its normal business activities.79 The rationale for leaving the DIP in place is that this will provide continuity and increase the going concern value of a business.80 Despite the views of

78. 11 U.S.C. §§ 362 to 364.
80. See, e.g., ELIZABETH E. WARREN & JAY L. WESTBROOK, THE LAW OF DEBTOR AND CREDITORS 190 (2d ed. 1991) ("The principal benefit [of revised Chapter 11] might be that companies will enter Chapter 11 earlier and therefore will be healthier and more likely to survive when they do. . . [T]here may be an important benefit in jobs saved and
some that Chapter 11 entrenches management, studies have shown that management is commonly replaced pre-filing, during the course of the case, or as part of the plan process. Moreover, a DIP can be removed for incompetence and dishonesty, and there is a recent movement to appoint examiners and business managers.

The DIP ordinarily controls both the business and reorganization. The DIP acts as the representative of the estate and, with limited restrictions, is required to "perform all of the functions and duties . . . of a trustee." As such, the DIP also is a fiduciary and has the duty to protect and conserve the estate's property for the benefit of the creditors. Thus, upon filing its petition, Heavy Duty's management will most likely remain in control of the business and also control Heavy Duty's reorganization efforts.

B. Neutral Third Parties: Trustee and Examiners

Trustees play a quite limited role in Chapter 11 cases. Since there is a "strong presumption" in favor of permitting a DIP to continue operation of the business, the appointment of a trustee is typically described as an investment protected").


83. See generally Barry L. Zaretsky, Trustees and Examiners in Chapter 11, 44 S.C. L. REV. 907 (1993); see also PUTNAM, supra note 22, at 273-86.


The United States Supreme Court has held that "the willingness of courts to leave debtors in possession 'is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee'." See Harvey R. Miller et al., The Chapter 11 Players in Contemporary Bankruptcy Practice: Roles, Obligations, and Ethical Considerations of Debtors in Possession, Trustees, Examiners and Committees, 656 P.L.I./COM. 673 (citing Commodity Futures Trading Comm'n v. Weintraub, 477 U.S. 343, 355 (1985)).


86. See In re Ionosphere Clubs, Inc., 113 B.R. 164 (Bankr. S.D.N.Y. 1990); In re North
"extraordinary remedy" to be granted only after a showing of clear and convincing evidence that the remedy is warranted.\textsuperscript{87} Practically, it is difficult to convince a court that a trustee is justified unless the DIP is dishonest or incompetent. "Congress contemplated that when a trustee is appointed, he [or she] assumes control of the business, and the debtor's directors are 'completely ousted.'"\textsuperscript{88} Thus, as should be obvious, the appointment of a trustee can have severe ramifications to a debtor's business.

Trustees are independent third parties who replace the DIP in a Chapter 11 and run both the business and the case.\textsuperscript{89} Since the trustee is disinterested, he or she may be able to investigate more fully insider transactions, commence avoidance or preference actions, and, when necessary, investigate the debtor's wrongdoing.\textsuperscript{90} As detailed in §1104 of the Code, a request for the appointment of a trustee may be brought by any party-in-interest at any time prior to confirmation of a plan.\textsuperscript{91} The party requesting the appointment must demonstrate cause or show that the removal of the DIP or the appointment of the trustee is in the best interests of parties holding an interest against the estate.\textsuperscript{92} Additionally, the appointment of a trustee terminates the debtor's exclusive period to file a plan of reorganization.\textsuperscript{93}

The duties of a Chapter 11 trustee are set out in §1106(a) of the Code. These duties include, but are not limited to, operating the debtor's

\begin{footnotes}
87. See Zaretsky, supra note 83, at 916 (citing In re Ionosphere Clubs, Inc., 113 B.R. 164).
89. See Zaretsky, supra note 83, at 916; see generally Gail L. Russel, Recent Developments in Bankruptcy Law: Administration of the Estate, 2 BANKR. DEV. J. 81 (1985).
90. Miller, supra note 88.
93. The value of terminating exclusivity has been challenged. If exclusivity were not terminated, debtors might be less opposed to appointment of a trustee. See Curtin et al., supra note 77, at 96.
\end{footnotes}
business; filing reports and schedules; investigating the debtor’s affairs; and filing a plan of reorganization as soon as practicable.\textsuperscript{94} The trustee owes, like a DIP, a fiduciary duty to all parties with an interest in the estate and can be held liable for acts of negligence occurring in the discharge of his or her duty.\textsuperscript{95}

A Chapter 11 trustee’s fees are governed by §§ 326 and 330 of the Code. The general rule is that trustees are entitled to reasonable compensation for services, based on the nature, time spent, and market rate for those services.\textsuperscript{96} The trustee’s fees are an expense of the administration of the estate and given first priority upon the commencement of a plan or distribution (discussed below).\textsuperscript{97} Additionally, the trustee is entitled to, and virtually always employs legal counsel and other professionals, and their fees also enjoy administrative status.\textsuperscript{98} Some trustees, who are attorneys, act as their own lawyer. Some retain their own law firm. Still others retain outside counsel.\textsuperscript{99}

There are costs, although perhaps somewhat overstated in the extant literature, involved with the appointment of a trustee. Beyond fees, there is delay as the trustee familiarizes him or herself with the debtor’s business and selects professionals, who likewise must be educated.\textsuperscript{100} Furthermore, the debtor’s customers, suppliers, and employees must also become familiar with the new leadership.\textsuperscript{101}

Another type of independent third party used in Chapter 11 cases is an examiner.\textsuperscript{102} The court may appoint an examiner to investigate an aspect of a case or the debtor’s business operations and file a report of his or her findings.\textsuperscript{103} Unlike a trustee, the examiner does not displace the

\textsuperscript{94} 11 U.S.C. § 1106(a)(5); see also Zaretsky, supra note 83, at 926.

\textsuperscript{95} See, e.g., In re Western World Funding, Inc., 52 B.R. 743, 762-63 (Bankr. D. Nev. 1985).

\textsuperscript{96} It should be noted, that the trustee’s rates may be lower than that of an attorney. Janet A. Flaccus, Bankruptcy Trustee’s Compensation: An Issue of Court Control, 9 Bankr. Dev. J. 39, 65 (1992).

\textsuperscript{97} 11 U.S.C. § 507(a)(1). See infra part IV.

\textsuperscript{98} 11 U.S.C. §§ 328 & 507(a)(1).

\textsuperscript{99} Compensation becomes tricky since a trustee is only entitled to be paid at the trustee’s rate, not that of a lawyer. So, fee applications require a careful assessment of what work can, is, and should be, done by the trustee as distinguished from a lawyer. See generally Flaccus, supra note 96.

\textsuperscript{100} Miller, supra note 88, at 459.

\textsuperscript{101} Id.

\textsuperscript{102} See Zaretsky, supra note 83, at 910.

\textsuperscript{103} Id.
DIP, nor does such an appointment terminate the debtor's exclusive right to file a plan of reorganization. A court may order the appointment of an examiner if it is in the best interests of creditors, any equity security holder, and other interests of the estate. A party requesting the appointment of an examiner must demonstrate that the benefit to the estate outweighs the cost. However, an examiner must be appointed, on request of a party-in-interest, if the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or debts owing to an insider, exceed $5 million. The examiner will be compensated for time spent, and if the examiner employs professionals, they will also be compensated. This compensation will enjoy administrative expense priority status under § 507(a)(1). However, like trustees, examiners are rarely used in Chapter 11 proceedings.

In recent years, courts have approved the appointment of examiners with duties remarkably similar to those of a trustee. In essence, these examiners act like trustees but do not divest the DIP of all power. Indeed, in some cases where the court (or creditors) are concerned about the debtor's ability to run its business, a business manager is appointed. Such an appointment leaves the debtor in place and can be made without satisfying the stringent standards for appointing an examiner or a trustee. The growth of this trend merits further evaluation and suggests that the standards for appointment and consequences of trustee appointment may be too stringent.

For trustees, examiners and business managers, there is a question of who gets appointed and how the parties (most particularly creditors) can advise the United States Trustee (discussed below) as to their choices for appointment. Unless a trustee is elected by the creditors, the appointee is selected by the United States Trustee subject to the Bankruptcy Court's approval. Since there are no allegations of any wrongdoing on the part

104. Id. at 934.
105. 11 U.S.C. § 1104(c)(1).
106. Zaretsky, supra note 83, at 935.
108. Zaretsky, supra note 83, at 935.
109. Id.
111. Zaretsky, supra note 83, at 916. See 11 U.S.C. § 1104(b) which was added by the 1994 Amendments and provides, in relevant part, that "on the request of a party in interest
of Heavy Duty, it is unlikely that a trustee will be appointed in this case. Additionally, it is also unlikely that an examiner or a business manager would be appointed in this case due to the size of the case and the typical nature of the issues involved.

C. Committees

A statutory protection afforded creditors, and at times equity holders, is the formation of committees.\textsuperscript{112} Under § 1102(a)(1), the United States Trustee must appoint at least one unsecured creditors' committee in every Chapter 11 case and may appoint any other committee he or she deems appropriate to represent an interest adequately.\textsuperscript{113} In practice, multiple committees are uncommon, except in mega cases.\textsuperscript{114}

A creditors' committee ordinarily consists of persons willing to serve, drawn from the debtor's largest unsecured creditors.\textsuperscript{115} Besides that, there are no requirements for a person or entity to qualify to sit on a creditors' committee. The person or entity can hold the unsecured deficiency portion of a secured claim, be the debtor's landlord, a trade creditor, or the union representative. These persons are reimbursed for their expenses incurred in connection with their participation on the committee.\textsuperscript{116} The creditors' committee is a separate entity, distinct from any specific creditor sitting on the committee,\textsuperscript{117} and the committee owes a fiduciary duty to all of its constituency.\textsuperscript{118} In theory, the committee safeguards the interests of its constituents by monitoring and negotiating with the debtor in an attempt

\textsuperscript{112} 11 U.S.C. § 1102(a).

\textsuperscript{113} 11 U.S.C. § 1102(a)(1).


\textsuperscript{116} 11 U.S.C. § 503(b)(3)(D) provides administrative status under § 507(a)(1) for such expenses.


\textsuperscript{118} See \textit{In re Celotex Corp.}, 123 B.R. 917 (Bankr. M.D. Fla. 1991). Individual members incur liability if they breach their duty which has given rise to issues regarding what committees should do and how members should protect themselves. See generally Dennis S. Meir and Theodore Brown, Jr., \textit{Representing Creditors' Committees Under Chapter 11 of the Bankruptcy Code}, 56 AM. BANKR. L.J. 217 (1982).
to devise a consensual reorganization plan. A committee employs professionals to assist it in the reorganization process. The appointment of the committee professionals is subject to court approval, and approved professionals are entitled to reasonable compensation as administrative expenses. To determine reasonableness, courts look at the time, nature, extent, and value of the services, and the cost of comparable services in a non-bankruptcy case.

Creditors' committees have played a vital role in some reorganizations; however, the majority of committees have fallen short of Congress' expectations. In smaller cases, committees sometimes are not even formed due to an absence of creditor interest. In others, the committee is formed but largely dysfunctional. In larger cases, although their functioning has not been well studied, there is a sense that the broad powers available to them are not always utilized. Many have criticized the use of creditors' committees because of the substantial cost to the estate. Composition of committees have also been challenged in terms of the diversity (or lack thereof) of their appointment. Issues have also arisen regarding "split" committees and the difficulties of altering committee composition.

D. Judges and the United States Trustee

Prior to the enactment of the Code, bankruptcy judges were actively involved in the administration and day-to-day affairs of a Chapter 11 case. This caused some to believe that judges would not be able to

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120. 11 U.S.C. § 1103(a).
123. See Peter S. Blain & Diane Harrison O'Gawa, Creditors' Committees Under Chapter 11 of the United States Bankruptcy Code: Creation, Composition, Powers, and Duties, 73 MARQ. L. REV. 581, 582 (1990); Curtin et al., supra note 77, at 88; Lynn M. LoPucki, supra note 81, at 745 (First Installment).
125. See generally GROSS, supra note 29, for a discussion of how the committee members are selected by United States Trustees and providing suggestions for change.
126. See "Why Creditors Don’t Want to Serve on Creditors’ Committees,” 30 BANKR. CT. DEC. 10 (July 17, 1997); “Representing a Split Committee: What Are Your Obligations?” 30 BANKR. CT. DEC. 20 (June 10, 1997).
127. Miller, supra note 88, at 433.
decide litigated matters impartially given their involvement in the debtor's affairs and business.\textsuperscript{128} Therefore, basic administrative duties were removed from the bankruptcy judge and the office of the United States Trustee ("UST") was established to handle same.\textsuperscript{129}

The UST, an arm of the Justice Department, is a public official who serves as the watchdog over bankruptcy proceedings to prevent overreaching, fraud, and dishonesty. The UST's duties include: supervising the administration of cases and trustees; monitoring fee applications; evaluating Chapter 11 plans and disclosure statements; ensuring that all fees, schedules, and reports are properly filed; monitoring creditors' committees; notifying the United States Attorney of bankruptcy crimes and participating in their prosecution; and preventing undue delay by supervising the progress of a case.\textsuperscript{130} The UST also has powers under the Code to participate in litigation and other proceedings, including, but not limited to, recommending the dismissal of a case and objecting to discharge. The UST is funded by a complex system with various fees to be paid by debtors.\textsuperscript{131} The UST system has been criticized since its inception. There has been concern that the offices of the UST spend their time on those cases that least require their attention. Moreover, the bifurcation has not proved as successful as many anticipated, in that removing judges from the day-to-day administration has made it difficult for them to manage case progress. In 1994, Congress amended the Code and injected judges back into administration of cases.\textsuperscript{132}

There are approximately 320 bankruptcy judges in 90 judicial districts in the United States.\textsuperscript{133} Theoretically, since the administration and supervision of bankruptcy cases is now in the hands of the UST, bankruptcy judges primary function is to deal with matters that require judicial supervision, determination, or approval during the course of a case\textsuperscript{134} and to adjudicate disputes.\textsuperscript{135} Most importantly, judges are

\textsuperscript{128} Id.


\textsuperscript{130} 28 U.S.C. § 586.

\textsuperscript{131} \textit{See} 28 U.S.C. § 1930(a)(6).

\textsuperscript{132} \textit{See generally} Gross & Redmond, \textit{supra} note 44, at 295-98.

\textsuperscript{133} PUTNAM, \textit{supra} note 22, at 31, citing Ed Flynn, "Bankruptcy Statistical Update for 1996".

\textsuperscript{134} \textit{See} EPSTEIN, \textit{supra} note 6, § 1-4.

\textsuperscript{135} Stephen A. Stripp, \textit{An Analysis of the Role of the Bankruptcy Judge and the Use}
responsible for reviewing any proposed plan, ensuring compliance with statutory requirements, and entering confirmation orders. However, bankruptcy judges have once again become involved in the administration of bankruptcy cases due to the "less than stellar and uniform performance throughout the United States by the United States Trustee in formulation and implementation of administrative rules and practices." Furthermore, the recent amendment to § 105 of the Code grants bankruptcy judges, sua sponte, the authority to hold status conferences regarding any case or proceeding. Bankruptcy judges are also authorized to enter orders to ensure that a case is being handled expeditiously and economically. These amendments show that Congress acknowledged that bankruptcy judges active case management and involvement often benefits all parties, increases efficiency and curbs costs. Practically, these amendments reverse the bifurcation of the administrative and adjudicative functions in the bankruptcy system, and bankruptcy judges are once again taking a more active role in case administration.

E. Professionals

Attorneys representing Chapter 11 debtors must be "disinterested" persons and normally will not be disqualified unless there is an objection by a creditor or the UST. The debtor must file an application with the court stating facts demonstrating the necessity for the employment, why the particular attorney was selected, what services will be rendered, and any

137. See Miller, supra note 88, at 435. According to Judge Stripp, bankruptcy judge for the District of New Jersey, the UST program is not performing well:

The problems with the United States trustee system are pervasive and severe, and part of the ultimate solution may well be to transfer the system to the Judicial Branch. Regardless of where the United States trustee system is placed, however, the Congressional intention to remove the bankruptcy judge from supervision of bankruptcy cases will not be fulfilled until the United States trustee assumes such responsibility. To the extent that the United States trustees do so, the bankruptcy judge will be able to devote more of their scarce time to their primary function of dispute resolution.
Stripp, supra note 135, at 1343-44.
139. See Gross & Redmond, supra note 44, at 295.
140. Id. at 296; see also Miller, supra note 88, at 439.
141. See Gross & Redmond, supra note 44, at 296.
connection the attorney has with the debtor, creditors, or any other party-in-interest. The attorney must disclose all conflicts of interest and non-disclosure may justify the denial of all fees earned in the case. Professionals must file an application with the court for payment of fees and out-of-pocket expenses. The application for fees must be accompanied by accurate, detailed time records sufficient to enable the court to make an informed decision as to the reasonableness of the requested fees. Attorney's fees are administrative expenses under § 507(a)(1) of the Code and given first priority status.

If the estate requires the services of professionals to provide advice and assistance in the reorganization process, § 327 of the Code authorizes the DIP or trustee, with court approval, to engage the services of disinterested professionals, such as accountants, appraisers, brokers, liquidators, and investment bankers. If the court approves such retention, reasonable fees for such services rendered are also an administrative expense of the estate and receive first priority status. Like all professionals, approved fees are paid before other unsecured creditors and deplete the amount of money available to creditors.

Many who criticize the costs of Chapter 11 cases question the costs associated with professionals. Although the cost of professionals may be high, it is unfair to criticize the costs solely because the services are being rendered in a Chapter 11 case. To combat the costs, some have suggested alternative approaches, including the parties sharing the costs of professionals.

IV. ANSWER TO QUESTION 3 OF THE HYPOTHETICAL

The United States' bankruptcy system establishes a hierarchy in which a debtor must handle the claims of parties holding an interest in the estate. The claims of creditors are repaid in an order specified by the Bankruptcy

143. 11 U.S.C. § 327(a).
145. 11 U.S.C. §327. See also § 1103(a) (allowing committees to employ professionals).
147. See GROSS, supra note 29, at 122-3 (citing Learned Hand, Historical and Practical Considerations Regarding Expert Testimony, 15 HARV. L. REV. 40, 56 (1901)).
Code: first, the claims of secured creditors; second, superpriority unsecured claims; third, priority unsecured claims; fourth, general unsecured claims; and lastly, equity holder claims and equitably subordinated claims. Obviously, when there are limited assets available, the higher the priority, the greater the likelihood of repayment. However, a priority is not a guaranty of payment; rather, it is a guaranty of an order of payment. In answering question three, we have focused on priority unsecured claims, and secured creditors claims will be assessed in our response to question four.

For a Chapter 11 plan of reorganization to be confirmed, it must (1) designate classes of claims and interests, (2) specify which classes and claims remain unimpaired, and (3) explain the proposed treatment of any impaired class. The Code does not require that all unsecured creditors, other than those with de minimis claims, be placed in the same class and treated similarly. However, the plan must not unfairly discriminate against any class of claims, and all members of a designated class must be treated similarly.

Under the Code, certain unsecured claims are treated more favorably than others. These claims are priority claims under § 507(a) of the Code, and they are given special treatment under Chapter 11 plans. Since the Code fixes priority claims by statute, courts may not vary from the prescribed hierarchy. Section 507(a) recognizes nine classes of unsecured claims that are payable, in descending order, before general unsecured claims. These claims range from fees of attorneys and professionals utilized in the administration of the case to claims for child support, maintenance and alimony. There are also claims, aside from secured claims, that enjoy higher status than priority claims. These claims are termed “superpriority” claims. They include claims of postpetition financiers and a secured creditor’s claim for insufficient adequate protection.


149. See Patrick A. Murphy, Creditors’ Rights in Bankruptcy § 17.03 at 17-8 (2d ed. 1993). The grouping of these de minimis claims establishes a “convenience class” of claims.


152. See 11 U.S.C. §§ 507(a)(1) & (a)(7), respectively.


After superpriority claims are paid,\textsuperscript{155} priority claims under § 507(a) are paid in full prior to payment of any non-priority unsecured creditor or equity holder.\textsuperscript{156} For example, administrative expenses and involuntary gap creditors under § 507(a)(1) and (2), respectively, must be paid in full and in cash on the effective date of the plan.\textsuperscript{157} Priority tax claims under § 507(a)(8) must be paid in full in installments over a period of not more than six years from the date of assessment of the claim.\textsuperscript{158} Unless priority creditors consent to payment over the life of the plan of reorganization, all other priority claims must be paid in cash on the effective date of the plan.\textsuperscript{159} Therefore, the classification of an unsecured claim as priority as opposed to general unsecured status has tremendous impact. Priority holders expect to be paid in full;\textsuperscript{160} in contrast, general unsecured creditors need only be paid more than the present value of what they would have received in a Chapter 7 liquidation.\textsuperscript{161} If there is an abundance of priority claims, most likely there will be insufficient assets available for a 100% distribution to non-priority unsecured creditors.

First priority status is given to expenses incurred in the administration of the debtor's estate. Administrative expenses include expenses incurred after filing a petition that are necessary for the continuation of debtor's operations.\textsuperscript{162} The assumption is that without providing such parties with top priority, no one would render services or deliver supplies to the debtor after it files for bankruptcy. Therefore, postpetition wages and salaries of employees and management and postpetition services by bankruptcy professionals are afforded administrative expense status.\textsuperscript{163} Although the amount of administrative expenses in Chapter 11 cases has been

\begin{itemize}
\item 155. Normally, these claims are paid in full. If superpriority claims cannot be paid in full, they will be paid on a pro-rata basis. However, this would mean that no one else will be paid at all.
\item 156. See W. Norton, Bankruptcy Law and Practice, §12.02 (1987).
\item 158. 11 U.S.C. § 1129(a)(9)(C).
\item 159. 11 U.S.C. § 1129(a)(9)(B).
\item 160. See Gross, supra note 29, at 145-6, 149-55 for a discussion of proliferation of priorities.
\item 161. See 11 U.S.C. § 1129(a)(7), which has come to be known as the "Best Interest Test." The court must determine what the claim holder would receive in a Chapter 7 liquidation and compare it to value of what the claim holder is receiving under the plan of reorganization. See generally Collier on Bankruptcy, supra note 65, ¶ 1129.02[7].
\item 162. See In re Chicago, Rock Island & Pac. R.R. Co., 756 F.2d. 517, 519 (7th Cir. 1985) (quoting Collier on Bankruptcy, supra note 65, ¶ 507.04[1]).
\item 163. 11 U.S.C. § 507(a)(1).
\end{itemize}
resoundingly criticized, payment of administrative expenses may not unnecessarily prejudice the debtor’s prepetition unsecured creditors because they benefit from the administration of the estate and continuation of the debtor’s business.

Administrative claims in Heavy Duty’s Chapter 11 will consist of claims of any and all professionals that assist in the administration of the estate. For example, Heavy Duty’s attorney and accountant and any professional employed by the creditors’ committee, such as an attorney or an accountant, will be paid as first priority. In addition, any postpetition taxes and claims of employees, pension holders or creditors extending services after the filing of the petition will enjoy first priority status. Unpaid postpetition wages of Heavy Duty’s employees would also be a first priority. If a lender advanced monies to Heavy Duty postpetition and was ultimately unpaid, it would also have a priority (and perhaps even a superpriority) claim.

The next applicable priority in respect of Heavy Duty’s Chapter 11 is the prepetition unpaid wages of its employees. Section 507(a)(3) provides third priority status to Heavy Duty’s employees for unpaid wages, salary and commissions (including vacation, severance, or sick-leave pay) earned within ninety days preceding the filing of the petition to the maximum extent of $4000 per employee. If an employee’s claim exceeds these limits, it is treated as a general unsecured claim. The purpose of § 507(a)(3) is to give employees a chance to receive wages earned immediately preceding the filing, so as not to deprive them of their livelihood and insure their continued work for the troubled business. Heavy Duty owes its employees for one week’s salary. As long as the amount owed each employee does not exceed $4000 (the facts already state that the salary was earned within the ninety days preceding the filing), the employees will have claims with third priority status. If all or any part of


165. EPSTEIN, supra note 6, § 7-11. See also Reading Co. v. Brown, 391 U.S. 471, 479 (1968).


167. See Northwest Eng’g Co. v. United Steelworkers of Am., 863 F.2d 1313, 1315 (7th Cir. 1988) (“If employees were treated in all respects as unsecured creditors, they would be inclined to desert a leaky ship, speeding up the firm’s collapse”).
a claim does not satisfy these requirements, the non-qualifying portion will be treated as a general unsecured claim. Problematically, a priority for back wages does not mean the employee gets repaid during the Chapter 11 case. By statute, repayment is due upon confirmation. However, as a practical matter, courts commonly permit early repayments of employees (under the "doctrine of necessities") to assure continuity and support of the debtor's labor force.

With certain limitations, pension benefit contributions are provided fourth priority status. The priority is limited to contributions arising from services rendered by employees within the 180 days preceding filing and are, as with wages, capped at $4000 for each employee covered under the employee benefit plan. Throughout. Fourth priority status will be afforded to claims of Heavy Duty's employees for contributions into its pension plan. However, the Code's limitations are only protective of current or recent retirees. Therefore, Heavy Duty's retirees' pension contribution (some portion of the $250,000) will not reap the benefit of the priority under § 507(a)(4).

However, Congress, concerned about the plight of retirees whose companies sought relief under Chapter 11, created § 1114(e)(2) which mandates payment for retiree benefits prior to the effective date of a confirmed plan of reorganization as an administrative expense with first priority status. "All retiree benefits—whether insured, self-insured, prepetition or post-petition—must be paid in full by the company" if a plan of reorganization is to be confirmed. Therefore, retiree claims against Heavy Duty's estate will be treated as an administrative expense under Heavy Duty's plan of reorganization.

Taxing authorities enjoy eighth priority status as § 507(a)(8) of the Code covers a variety of taxes owed to governmental units. Stated most simply, priority is given (among other items) to income taxes for the three years prior to filing; property taxes payable in the year before the filing; and interest on such taxes that accrues before the commencement of the

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168. 11 U.S.C. § 507(a)(4) also provides that the amount paid is reduced by any amount paid for wages, salaries, or commissions under § 507(a)(3) priority.


171. See 11 U.S.C. § 101(27), which defines "governmental unit" to include federal, state, and local governments.
case.\textsuperscript{172} Unless the taxing authority agrees otherwise, the priority tax claim must be paid in full and within six years from the date of assessment of the tax.\textsuperscript{173} Heavy Duty owes taxing authorities $1 million. If this amount is within the ambit of § 507(a)(8), the government will enjoy eighth priority status. However, any portion that does not fit within § 507(a)(8) will be a general unsecured claim. One word of caution: under the Internal Revenue Code, unpaid taxes for employee contributions are a personal liability of corporate officers and directors.\textsuperscript{174}

All other unsecured claims, as well as any portion of a claim that is not a priority, are general unsecured claims. Thus, to the extent that Heavy Duty’s suppliers are unsecured, they hold general unsecured claims aggregating $3 million. Under a plan of reorganization, general unsecured claims must get at least as much as they would get in a Chapter 7 liquidation (termed the “best interest test”).\textsuperscript{175} In contrast to the treatment of priority creditors, the Code does not require payment of general unsecured creditors in cash. Unsecured creditors can receive stock or notes of the reorganized company, as long as the value thereof exceeds any available distribution under Chapter 7. Payments of cash can be stretched out over a period of years (including beyond the six year stretch out period for taxes), provided that the time value of money is taken into account in determining satisfaction of the best interest test.

The treatment of Heavy Duty’s environmental obligation is the most problematic and the claim does not fit easily into any of the existing categories.\textsuperscript{176} First, there is a question as to whether there even is a claim because the obligation has not been determined (i.e., is there liability?). Second, the pollution is ongoing, suggesting that some portion of the claim may be a “future” claim which is not actually a claim that is dischargeable under Chapter 11 of the Code. Third, there is a question as to whether the claim should be treated as a pre or post-petition obligation (or both), and this affects whether the claim is unsecured (and paid along with all other

\begin{itemize}
  \item \textsuperscript{172} See generally Block-Lieb, supra note 170, at 710-20.
  \item \textsuperscript{173} 11 U.S.C. § 1129(a)(9)(C).
  \item \textsuperscript{174} Note that we would need to assess what, if any, portion of the unpaid tax liability was for fiduciary taxes. If a company does not repay them, officers and directors will need to pay them personally. See Gross, supra note 29, at 126.
  \item \textsuperscript{175} See supra note 161 for a discussion of the best interest test.
\end{itemize}
unsecured claims) or an administrative claim (entitled to priority under § 507(a)(1)).

The inherent conflicts between the environmental law notion that economic enterprises bear the cost of environmental and public health protection and the underlying policy in bankruptcy of discharging claims that exist at the time of confirmation, has lead to the creation of different treatment for environmental claims. This treatment stems from courts trying to balance the competing interests.¹⁷⁷ For a debt to be discharged in a bankruptcy, it must be considered a "claim" by the bankruptcy court. The classification of potential environmental liability as a claim that arose prepetition in contrast to postpetition has tremendous ramifications. A prepetition or administrative claim will be addressed in the reorganization and discharged; a "future" claim will survive bankruptcy and remain an obligation of the reorganized debtor.¹⁷⁸

Congress intended that the Code define a "claim" broadly to ensure that "all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case."¹⁷⁹ Thus, Heavy Duty’s current liability (if any) for clean up costs of the pollution, as of the date of filing, even if unliquidated, constitutes a claim as contemplated by the Code and must be dealt with under Heavy Duty’s plan of reorganization. Such a claim arises when the debtor released or threatens to release the hazardous substance.¹⁸⁰ The fact that the appropriate agency has not gathered information or assessed damages, merely renders the claim "contingent;" it does not prevent the obligation from being a claim.¹⁸¹ Thus, since at least a major portion of Heavy Duty’s environmental liability arose prepetition, it is a recognizable claim in Heavy Duty’s Chapter 11 and can be handled and discharged under the plan.¹⁸² Having determined that a claim exists, the next step is to

¹⁷⁷. See generally Spracker & Barnette, supra note 51.
¹⁷⁹. In re Chateauguay Corp., 944 F.2d 997, 1003 (2d Cir. 1991); see also 11 U.S.C. § 101(5) (which broadly defines a claim as the "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured").
¹⁸¹. Id. at 1005.
¹⁸². However, the claim may not be discharged if the debtor does not give the appropriate agency specific notice of the environmental problem prior to confirmation. If there is no notice, the claim may survive the bankruptcy case. Some have argued that the debtor should carefully weigh the benefits of disclosing the possible liability as disclosure might adversely affect the debtor’s ability to reorganize. See Spacker & Barnette, supra
determine its status, as the treatment depends on the nature of the claim.\textsuperscript{183} For example, if the appropriate agency cleaned the site and secured a lien, it will enjoy secured status; however, if the agency has taken no action, the claim will be a general unsecured prepetition claim.\textsuperscript{184} Generally, an environmental claim that arises prepetition is deemed a general unsecured claim.\textsuperscript{185} If Heavy Duty continues to pollute postpetition, at least a portion of the claim may be an administrative expense claim.

Another possible claim in Heavy Duty’s Chapter 11 case relates to its ninety-nine year lease of the land and dock facilities. A lease is treated under § 365 of the Code. Section 365 of the Code allows the DIP or trustee to assume, reject, or assume and assign executory contracts and unexpired leases. Heavy Duty has the right to reject, assume, or assume and assign the unexpired lease.\textsuperscript{187} If Heavy Duty assumes the lease, its obligations become a postpetition obligation and an administrative expense of the estate entitled to first priority.\textsuperscript{188} If Heavy Duty decided to reject the lease, the breach would be treated as a prepetition breach by the debtor, and the City of Hope would have a general unsecured claim for damages under § 502(g) of the Code.\textsuperscript{189}

In deciding whether to assume or reject a lease, the debtor must look at what is in the best interests of the estate. Thus, if it is advantageous and will advance Heavy Duty’s plans for economic recovery to retain the ninety-nine year lease, it should assume it. If Heavy Duty decides to assume the lease, which it should, it must do so within sixty days of the

\begin{footnotes}
\item 183. See \textit{id.} at 100-107 (discussing the different categories of claims and their status).
\item 184. \textit{Id.}
\item 185. \textit{Id.} at 101.
\item 186. The Code does not define an executory contract but the definition given by Professor Vern Countryman in his 1973 law review article has become (with some recent inroads) the accepted definition. Thus, a contract is executory if the obligations of both parties are so far unperformed that the failure of either party to perform would be a material breach. \textit{But see} Jay Lawrence Westbrook, \textit{A Fundamental Analysis of Executory Contracts}, 74 M\textsc{inn.} L. \textsc{rev.} 227, 229-31 (1989); Michael T. Andrews, \textit{Executory Contracts in Bankruptcy: Understanding “Rejection.”} 59 U. COLO. L. \textsc{rev.} 845 (1988).
\item 187. See 11 U.S.C. § 365(c)(3), which prohibits the assumption of an lease of nonresidential real property that had been terminated under nonbankruptcy law prior to the order for relief.
\item 188. \textsc{Epstein}, \textit{supra} note 6, §§ 5-1 & 5-5.
\item 189. Such a damages claim would be treated as a general unsecured claim and receive payment, if at all, most likely on a pro-rata basis with the other general unsecured creditors. Such claims are capped pursuant to § 502(b)(6) of the Code. 11 U.S.C. § 502(b)(6).
\end{footnotes}
order for relief unless the court extends that period for cause.¹⁹⁰ If Heavy Duty is in default under the lease, it must cure all defaults within a reasonable time in order to assume. Assumption or rejection within the sixty day period must be approved by the court which will scrutinize the decision under the business judgment rule and will not interfere with the decision if based on good faith and appears beneficial to the estate.

Provisions of a contract or a lease that permit the nondebtor party to declare default or termination of the contract or lease because of the insolvency, financial condition, or bankruptcy of the debtor are ineffective in bankruptcy.¹⁹¹ These ipso facto clauses are given no effect in order to prevent states or private parties from undermining the bankruptcy process through laws or contractual terms that are designed to take effect on bankruptcy. However, the bar on enforcing ipso facto clauses exists only after the debtor has filed its petition. Therefore, if the nondebtor party had exercised its right prior to bankruptcy, it may be able to effectively terminate the contract or the lease prior to bankruptcy, subject to provisions, if any, of the automatic stay.¹⁹²

An additional option available to Heavy Duty if the ninety-nine year lease is particularly valuable, and Heavy Duty wants to relocate elsewhere, is the assumption and assignment of the lease. An assignment would require Heavy Duty to cure all defaults; compensate the City for pecuniary losses resulting from the default; and provide adequate assurance of future performance by the new lessee under the lease.¹⁹³ Additionally, like ipso facto clauses, any clause in the lease that prohibits alienation of the property due to the debtor's insolvency, financial condition, or filing for bankruptcy is ineffective and void under the Code.¹⁹⁴

There is one group of claims below general unsecured creditors: equity holders of the debtor. In a Chapter 11 case, the absolute priority rule provides that a non-accepting class of unsecured creditors must be paid in full before any junior class (i.e., equity holders) can receive or retain any property under a reorganization plan. Thus, until unsecured creditors are satisfied under the plan, equity holders are not permitted to retain any interest or receive any money. However, there is a significant exception

¹⁹². See infra part V.
to this rule. The "new value" exception allows equity holders of a business to obtain an interest in the reorganized debtor in exchange for a capital infusion that is (1) new, (2) substantial, (3) money or money's worth, (4) necessary for a successful reorganization, and (5) reasonably equivalent to the value or interest received.\textsuperscript{195} Thus, the plan cannot be confirmed pursuant to § 1129 of the Code unless all senior classes (including secured creditors) are fully repaid (or consent to a lesser payment). This means the owners are unlikely, absent a new infusion of cash, to recoup their equity contribution, including the new $1 million recently contributed.

One possible class of creditors that fall even below equity holders is the claims of the debtor's principals (owed $250,000). Under § 510 of the Code, depending on the circumstances of the loan, the amounts may be subordinated (termed equitable subordination). This means that, in addition to losing their equity position, the owners could lose the $250,000 they lent to the estate unless all senior creditors (including equity holders) are repaid in full.

The choice of priorities and the treatment of unsecured creditors reveals serious policy choices. Assuming there are rarely sufficient funds to repay all creditors, the higher the priority, the greater the chance of repayment. Thus, we consider administrative claims (which include bankruptcy professionals) to be "more important" (more worthy) than employees. Similarly, we consider the government's right to taxes to be worthy of priority status, but also less worthy than professional fees and employee wages.

\section*{V. ANSWER TO QUESTION 4 OF THE HYPOTHETICAL}

A lien that is valid under nonbankruptcy law and unavoidable under the Code\textsuperscript{196} is enforceable in bankruptcy but only to the extent of the value of the underlying collateral.\textsuperscript{197} Thus, the claim of a creditor whose claim

\textsuperscript{195} In re Bonner Mall Partnership, 2 F.3d 899 (9th Cir. 1993) (citing Case v. Los Angeles Lumber Prod. Co., 60 S.Ct. 1, 10-11 (1939)). See also Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 203, 206 (1988), which held labor and expertise were not money or money's worth and insufficient to satisfy the new value exception.

\textsuperscript{196} For example, a lien that is fully perfected cannot be avoided by the trustee or DIP under § 544 of the Code.

\textsuperscript{197} See 11 U.S.C. § 506(a). Section 506(a) of the Code defines an allowed secured claim as a "claim of a creditor secured by a lien on property in which the estate has an interest... to the extent of the value of such creditor's interest in the estate's interest in
exceeds the value of his or her collateral is an undersecured creditor. As such, the claim is bifurcated into a secured portion to the extent of the collateral's value and an unsecured portion as to any deficiency. The secured portion of the claim will enjoy the status of a secured creditor, and the unsecured portion will be grouped together and paid alongside other general unsecured claims. The bank lenders, who are collectively owed $5 million, are Heavy Duty's only known secured creditors.  

A secured creditor may negotiate with the debtor to formulate its treatment under a plan of reorganization. If a consensual arrangement cannot be reached, the plan may still be confirmed over the objection of the secured creditor if the plan is fair and equitable. This is proverbially known as cramdown. The Code provides that (1) the secured creditor may retain its lien and receive deferred cash payments equal to the value of the lien; (2) the secured creditor's collateral may be sold free and clear of the lien, with the lien attaching to the proceeds; or (3) the secured creditor can receive the indubitable equivalent of its claim. Payments stretched over time must also take into account the time value of money (i.e., paying the secured creditor interest).

When a petition is filed, "one of the fundamental debtor protections provided by bankruptcy law," the automatic stay, comes into existence. The automatic stay gives the debtor a breathing spell from its creditors; it stops all collection efforts, foreclosure actions, and debtor harassment by creditors. The automatic stay promotes the reorganization process by preventing secured and unsecured creditors from dismantling the debtor's estate and by giving the debtor temporary relief from financial pressures.

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such property." The meaning of the term "value" has been addressed in the recent Supreme Court decision in Assocs. Commercial Corp. v. Rash, 65 U.S.L.W. 4451, 1997 U.S. LEXIS 3688 (June 16, 1997).

198. Various searches should be conducted by the creditors' committee to confirm the exact number of secured creditors and to evaluate whether such creditors are perfected.

199. 11 U.S.C. §§ 1129(b)(1) and (2).

200. Cramdown can be used to refer to the treatment of secured and unsecured creditors, although it is a term more commonly employed in the context of secured creditors.


206. BROUDE, supra note 16, § 4.01[1].
Specifically, a secured creditor cannot (a) enforce a security agreement according to its terms; (b) accelerate the debt (notwithstanding an ipso facto clause); (c) obtain possession of or exercise control over property in which the secured creditor has an interest; and (d) sue the debtor. The automatic stay also precludes secured creditors from using state law remedies to realize on their collateral. Thus, the remedies for a secured creditor provided in Part 5 of Article 9 of the Uniform Commercial Code (UCC) are not operative in bankruptcy. The secured party’s right to take possession of the collateral upon the debtor’s default through self-help and to dispose of the property in satisfaction of its claim, usually without court supervision, is barred. The secured party’s right to foreclose on the collateral, obtain a judgment and levy upon debtor’s property, take possession of and retain the collateral in satisfaction of the debt, or garnish the debtor’s wages is also barred. If the secured party acts in violation of the automatic stay, such action will be void and can have serious consequences for the creditor, such as being found in contempt of court and fined.

The power of the stay is not permanent. A secured creditor may make a motion to lift or modify the stay pursuant to §§ 362(d) and 105(a) of the Code. This would enable the creditor to utilize its nonbankruptcy remedies. A lift stay motion may be granted “for cause” or by a showing that the debtor does not have any equity in the collateral and the collateral is not needed for an effective reorganization. An example of “cause” is the lack of “adequate protection” of a secured creditor’s collateral due to the ongoing decrease in the value of the collateral without compensating the secured creditor for such diminution. Since adequate

209. See generally UCC §§ 9-501 to 9-507.
211. See 11 U.S.C. §§ 105(a) & 362(d). Section 362(d) is the primary section under the Code to seek relief from the automatic stay. If the secured creditor does not satisfy the requirements of § 362(d), the secured creditor can look to §105(a) of the Code. Section 105 of the Code gives the courts equitable powers and can be invoked to lift the automatic stay. See also 11 U.S.C. §§ 362(e), (f), and (g) which provide other grounds of relief from the automatic stay, including, but not limited to, lifting the stay as is necessary to prevent irreparable damage to the creditor’s interest in the property.
213. 11 U.S.C. § 361. As noted in the legislative history:
protection protects the present value, oversecured creditors (those creditors whose claim is less than the value of their collateral) are entitled to interest.\textsuperscript{214} We do not know in the Hypothetical whether Heavy Duty's secured creditors are over or under-secured. It would be necessary to value each secured creditor's collateral. It is clearly possible for one secured creditor to be secured fully while another is undersecured depending on the nature of their collateral. Once each secured creditor's position is assessed, we would need to see whether the value of the collateral in question was increasing, decreasing or remaining the same, thereby assessing the likelihood that the stay would be lifted. As a practice pointer, a secured creditor should move to lift or modify the automatic stay or seek adequate protection early in a case. This is because the Code accords a priority claim to a secured creditor for any shortfall that occurs for the period from the date adequate protection is granted.\textsuperscript{215} Thus, if adequate protection is not sought and the secured claim diminishes in value, the secured creditor may not recover the diminution as a priority.

\section*{VI. Answer to Question 5 of the Hypothetical}

Because of the concept of limited liability, and subject to limited exceptions, officers and directors of corporate entities are not liable for the debts of the company.\textsuperscript{216} That means that if a company files for bankruptcy and discharges its liabilities, officers and directors can commence a new business the next day. The same is true for shareholders. Because of limited liability, shareholders can lose their investment but, beyond that, they have no personal liability for corporate debts. They, too, can reinvest in a new business, unimpaired, by prior failure. Several of the

\begin{footnotesize}
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\item The concept of adequate protection is derived from the Fifth Amendment protection of property interests. . . .Secured creditors should not be deprived of the benefit of their bargain. There may be situations in bankruptcy where giving a secured creditor an absolute right to his [or her] bargain may be impossible or seriously detrimental to the bankruptcy laws. Thus, this section recognizes the availability of alternate means of protecting a secured creditor's interest. Though the creditor might not receive his [or her] bargain in kind, the purpose of this section is to insure that the secured creditor receives in value essentially what he [or she] bargained for.


\item \textsuperscript{214} \textit{See} BROUDE, \textit{supra} note 16, at § 4.06[3].

\item \textsuperscript{215} \textit{See} 11 U.S.C. § 507(b).

\item \textsuperscript{216} \textit{See generally} GROSS, \textit{supra} note 29, at 27-9 & 125-27.
\end{itemize}
\end{footnotesize}
key exceptions are worth noting. First, if the shareholders, officers, or directors commit a fraud or other crime, they can be sued in their individual capacities.\textsuperscript{217} If there are unpaid fiduciary taxes, officers and directors can also be held responsible.\textsuperscript{218} Certain unpaid environmental liabilities can lead to personal responsibility.\textsuperscript{219} Finally, officers, directors, or shareholders can guaranty the corporate debt. It is important to note that if the individual officer, director, or shareholder incurs liability, they can file personal bankruptcies, and the debt can commonly be discharged unless it fits within one of the exceptions to discharge under § 523 of the Code (such as willful and malicious conduct or fraud).\textsuperscript{220}

Generally, the Code does not protect guarantors or corporate officers and directors from suits for obligations for which they may be held secondarily liable. However, the bankruptcy court can utilize its equity powers pursuant to § 105(a)\textsuperscript{221} to enjoin creditor action against guarantors who are officers or directors under certain circumstances.\textsuperscript{222} For example, if the guarantor can prove that the debtor corporation would be irreparably harmed if the proceedings against the guarantor continued, the court may enjoin the action.\textsuperscript{223} The court will consider whether the debtor’s directors and officers need a breathing spell to formulate the debtor’s plan of reorganization free from the encumbrance of defending personal lawsuits.\textsuperscript{224} The court will also consider whether there is an identity of interest between the debtor and the guarantor such that the debtor may be said to be the real party defendant. If so, a judgment against the guarantor effectively would be a judgment against the debtor (i.e., when the guarantor is entitled to absolute indemnity by the debtor).\textsuperscript{225}


\textsuperscript{218} See generally Kimberly Colby Harris, \textit{The Impact of Bankruptcy on Liability of Corporate Directors}, 5 BANK. DEV. J. 289 (1987).

\textsuperscript{219} \textit{Id}.

\textsuperscript{220} 11 U.S.C. § 523(a).

\textsuperscript{221} The bankruptcy court may “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.” 11 U.S.C. § 105(a). \textit{See supra} note 50.

\textsuperscript{222} \textit{See} Harris, \textit{supra} note 218, at 290-94.

\textsuperscript{223} \textit{Id}.


Further, § 362 of the Code stays any action to obtain possession or to exercise control over property of the debtor, whether against the debtor or a third person.\textsuperscript{226} Property of the estate is broadly defined under the Code to include "all legal and equitable interests of the debtor in property as of the commencement of the case," wherever located.\textsuperscript{227} Therefore, since insurance policies are considered property of the estate,\textsuperscript{228} if the guarantor may be covered under the debtor's insurance policy, the action against the guarantor may be stayed.\textsuperscript{229}

Nothing precludes officers, directors, or shareholders from commencing a new business subsequent to the bankruptcy. They are entitled to vote in governmental elections; they cannot be imprisoned; and failure is not seen as a bar to future ventures. Indeed, forgiveness rests at the heart of American bankruptcy law.\textsuperscript{230} Whether the extent of limited liability should remain as part of our bankruptcy system is a worthwhile question, although its resolution is beyond the scope of this article.\textsuperscript{231}

\textbf{VII. CONCLUSION}

Advising Heavy Duty requires more detail than provided in the fact pattern. However, even without that detail, it should be evident that access to the bankruptcy law does not guaranty a successful reorganization. Instead, it provides an opportunity to reorganize. Many people who evaluate statistics on confirmation rates in the United States say that a twenty percent confirmation rate is evidence of failure. Quite to the contrary.\textsuperscript{232} While the rate is lower than we would like, one-fifth of companies that would have failed will be given new life. In lots of fields, a twenty percent success rate is cause for celebration. Saving Heavy Duty would benefit a number of individuals and businesses. Even if it ultimately fails, it will be a more peaceful, organized and humane demise. Perhaps we would do well to see the glass as one-fifth full in bankruptcy, not four-fifths empty.

\textsuperscript{227} 11 U.S.C. § 541.
\textsuperscript{228} See \textit{In re} Johns-Manville Corp., 40 B.R. 219, 229 (Bankr. S.D.N.Y. 1984); \textit{In re Davis}, 730 F.2d 176, 184 (5th Cir. 1984).
\textsuperscript{230} See generally \textsc{Gross}, supra note 29, at 93-98.
\textsuperscript{231} Id.
\textsuperscript{232} Id.