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NOT JUST ANNA NICOLE SMITH: CLEAVAGE IN BANKRUPTCY

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ABSTRACT

This is an essay about the unwarranted erosion of two basic bankruptcy principles: the cleavage effect of a debtor's filing of a bankruptcy petition and the equality of treatment of prepetition unsecured claims. These are two of the most fundamental bankruptcy concepts. First courts and then Congress have fashioned rules favoring the prepetition unsecured claims of vendors and lessors that are inconsistent with these concepts. We explore the origins of such favored treatment, question the commonly offered policy justifications, and argue that the prepetition unsecured claims of vendors and lessors generally should be afforded the same treatment in bankruptcy as other prepetition unsecured claims.

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INTRODUCTION

There was testimony in the litigation that gave rise to *Stern v. Marshall*,¹ the most cited Supreme Court decision relating to bankruptcy in the twenty-first century, that Anna Nicole Smith's stepson's² lawyer referred to Ms. Smith as "Miss Cleavage."³ Cleavage is just as important to those who pursue bankruptcy as to those who pursued Ms. Smith.⁴

All bankruptcy cases start with the filing of a bankruptcy petition,⁵ regardless of whether the bankruptcy is the chapter 7 liquidation of the limited assets of Casey Ariail or the chapter 11 restructuring of the debts of Double Dave's Pizzaworks, Inc.⁶ ("Double Dave") or a chapter 9, 12, or 13 case.⁷ The filing of that bankruptcy petition effects a cleavage, separating the debts incurred before the filing of the petition from debts incurred after the filing of the petition.⁸

As Professor Laura Bartell has observed, "The Bankruptcy Code . . . divides the universe of claims into two basic categories—those that arise at or before the order for relief concerning the debtor, and those that do not—and

¹ 131 S. Ct. 2594 (2011).

² Understandably, J. Howard Marshall, III, did not refer to himself as Ms. Smith's stepson. Less understandable is why the Supreme Court referred to Ms. Smith, whose birth name was Vickie Lynn Hogan, as simply "Vickie." We do not regularly read Supreme Court decisions, but we cannot recall the Court's referring to Marbury as "William," *Marbury v. Madison*, 5 U.S. (1 Cranch) 137 (1803), or, more recently, the Court's referring to Jeffrey Chafin as "Jeffrey" or Lynne Chafin as "Lynne" in *Chafin v. Chafin*, 133 S. Ct. 1017 (2013).

³ *Marshall v. Marshall (In re Marshall)*, 275 B.R. 5, 32 (Bankr. C.D. Cal. 2002).

⁴ *Cf. Stalnaker v. DLC, Ltd. (In re DLC, Ltd.)*, 295 B.R. 593, 605 (B.A.P. 8th Cir. 2003) ("The date of the filing of the petition is important because it generally fixes the rights of the estate and other parties in interest. Congress and courts commonly refer to the date of the bankruptcy petition as the 'date of cleavage.'"). The authors have used the introductory signal "*cf*" because the Bankruptcy Court of Appeals for the Eighth Circuit does not expressly compare Ms. Smith and bankruptcy.

⁵ 11 U.S.C. §§ 301, 302(a), 303(b) (2012); *Berge v. Sweet (In re Berge)*, 37 B.R. 705, 706 (Bankr. W.D. Wis. 1983) ("A bankruptcy 'case' commences with the filing of a petition . . . and may include a number of adversary proceedings . . . and 'contested matters' . . .").

⁶ See DOUBLE DAVE'S PIZZAWORKS, <http://www.doubledaves.com/ourstory> (last visited Aug. 16, 2014). All characters and events in this essay—even those based on real people—are entirely fictional.

⁷ See generally 1 DAVID G. EPSTEIN, STEVE H. NICKLES & JAMES J. WHITE, *BANKRUPTCY* 18–38 (1992) (explaining the commencement of cases under the various chapters of the Code).

⁸ E.g., *Everett v. Judson*, 228 U.S. 474, 479 (1913) ("We think that the purpose of the [bankruptcy] law was to fix the line of cleavage with reference to the condition of the bankrupt estate as of the time at which the petition was filed . . ."); *Hollytex Carpet Mills v. Tedford*, 691 F.2d 392, 393 (8th Cir. 1982) ("Historically, the date of the filing on the petition in bankruptcy has been the cleavage date in defining rights of the debtor and his creditors." (quoting *In re Statmore*, 22 B.R. 37, 37–38 (Bankr. D. Neb. 1982))).

treats each class very differently.”⁹ The following examples of the effect of filing a chapter 7 petition and a chapter 11 petition support Professor Bartell’s observation of the cleavage resulting from a bankruptcy petition.

As an example of the cleavage effect of a bankruptcy petition in chapter 7, if Casey’s chapter 7 petition was filed on January 15, and he receives a discharge on April 5, only creditors holding claims incurred before January 15 would share in any potential bankruptcy distribution or be affected by that bankruptcy discharge. Casey would have no further personal liability for his January 14 credit card charges and other prepetition debts, but he would remain personally liable for his January 16 credit card charges and other postpetition debts.¹⁰

The date of the filing of the bankruptcy petition also serves as the date of cleavage in a chapter 11 case. If Double Dave’s chapter 11 petition was filed on July 13, 2014, and its chapter 11 plan was confirmed on February 18, 2015, Double Dave could not, in the interim between July 13, 2014, and February 18, 2015, make a payment on any debts incurred prior to July 13, 2014.¹¹ And Double Dave’s chapter 11 plan could be confirmed even though the payments to creditors holding prepetition claims were nominal or even non-existent.¹²

In chapter 11 cases, as in chapter 7 cases,¹³ postpetition claims are treated differently from prepetition claims.¹⁴ Double Dave could, at any time prior to plan confirmation, pay debts incurred after it filed the chapter 11 petition on

⁹ Laura B. Bartell, *Straddle Obligations Under Prepetition Contracts: Prepetition Claims, Postpetition Claims or Administrative Expenses?*, 25 EMORY BANKR. DEV. J. 39, 39 (2008). In the approximately 99% of the bankruptcy cases that are “voluntary cases,” i.e., cases commenced by the debtor’s filing of a bankruptcy petition, the date of the petition is the date of the order for relief—the date of cleavage. 11 U.S.C. § 301(b) (“commencement . . . constitutes an order for relief”); ADMIN. OFFICE OF THE U.S. COURTS, JUDICIAL FACTS AND FIGURES tbl.7.2 (2012), available at <http://www.uscourts.gov/uscourts/Statistics/JudicialFactsAndFigures/2012/Table702.pdf>.

¹⁰ See generally DAVID G. EPSTEIN & STEVE H. NICKLES, PRINCIPLES OF BANKRUPTCY LAW 174–224 (2007) (explaining the chapter 7 bankruptcy process).

¹¹ See *Ashland Petroleum Co. v. Appel (In re B & L Oil Co.)*, 782 F.2d 155, 158 (10th Cir. 1986) (“Once a petition is filed, debts that arose before the petition may not be satisfied through post-petition transactions.”).

¹² For example, the best interests test for confirming a chapter 11 plan requires that any impaired creditor who votes against a plan receives at least as much as it would receive in a chapter 7 liquidation of the debtor. 11 U.S.C. § 1129(a)(7)(A)(ii). In many cases, the liquidation of the debtor under chapter 7 results in nominal or nonexistent payments to classes of creditors, so the same result in chapter 11 is not an obstacle to plan confirmation. See *In re Best Prods. Co.*, 168 B.R. 35, 72 (1994).

¹³ 11 U.S.C. § 727(b) (granting a discharge to a chapter 7 debtor of debts that arose prepetition).

¹⁴ *Id.* § 1141(d)(1)(A) (granting a discharge to a chapter 11 debtor of debts that arose prepetition).

July 13, 2014. Moreover, Double Dave’s chapter 11 plan could not become effective unless the postpetition debts are paid in full.¹⁵

I. CLEAVAGE AND DISCHARGE

As the Casey hypothetical suggests, the cleavage effect of filing a bankruptcy petition—separating prepetition debts from postpetition debts—is an integral part of the basic bankruptcy policy of discharge. Recall that Casey’s discharge only affects prepetition debts.

A discharge is often described as a “fresh start.”¹⁶ However, that description is incomplete. It begs the question: a fresh start from what? It is more complete to say that a discharge is a fresh start from prepetition debts.¹⁷ The following statement by Judge Diane Wood, a Seventh Circuit judge and former University of Chicago law professor,¹⁸ is representative: “[B]ankruptcy is normally viewed as a process through which a debtor obtains relief from *pre-petition obligations* and gets a fresh start in life”¹⁹

While the concept of a fresh start is compelling, it only applies to consumer debtors. According to the leading bankruptcy scholar Thomas H. Jackson, “the fresh start policy has nothing to say about business bankruptcies.”²⁰ Professor

¹⁵ *Id.* § 1129(a)(9)(A). Postpetition trade claims are treated as administrative claims. *Id.* § 364. The priority for the administrative expense claim depends on whether the debt was incurred in the ordinary course of business and, in the case of claims arising outside the ordinary course of business, the court’s approval and the ability of the trustee to obtain unsecured debt. *Id.* The plan of reorganization must provide that these administrative expenses are paid in cash on the effective date of the plan. *Id.* § 1129(a)(9).

¹⁶ *E.g.*, Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393 (1985).

¹⁷ *E.g.*, 11 U.S.C. § 727(b) (“[A] discharge [granted under this chapter] discharges the debtor from all debts that arose before the date of the order for relief”); *id.* § 301 (defining the date of the order for relief in a voluntary case as the date the debtor files a bankruptcy petition with the bankruptcy court).

¹⁸ She is also a former student of this article’s senior author.

¹⁹ *In re Duke*, 79 F.3d 43, 44 (7th Cir. 1996) (emphasis added); *accord* *Boeing N. Am., Inc. v. Ybarra* (*In re Ybarra*), 424 F.3d 1018, 1026 (9th Cir. 2005) (stating that the question in the discharge context is whether to release the debtor from “pre-petition debts so that she can be given a fresh start.”); *Anthem Life Ins. Co. v. Izaguirre* (*In re Izaguirre*), 166 B.R. 484, 491 (Bankr. N.D. Ga. 1994) (“The rights of a debtor and a creditor with respect to liability on particular events or transactions are usually defined by determining on which side of the time ‘cleavage’ the events or transactions occurred. The purpose of the dividing line is primarily to give the debtor a fresh start.”). See generally F.H. Buckley, *The American Fresh Start*, 4 S. CAL. INTERDISC. L.J. 67 (1994) (“In bankruptcy, a person is given a fresh start: his pre-petition debts are discharged”).

²⁰ Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 730 n.16 (1986). See generally THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 225–52 (Beard Books 2001) (1986) [hereinafter JACKSON, *LOGIC AND LIMITS*] (discussing the fresh start policy in bankruptcy).

Jackson's statement is of course correct,²¹ albeit somewhat misleading.²² Corporations and other business entities do not receive a fresh start in chapter 7. Section 727, entitled "Discharge," provides that "[t]he court shall grant the [chapter 7] debtor a discharge, unless (1) the debtor is not an individual"²³ There are no discharges for business entities in chapter 7 cases; therefore, there is no fresh start for a business entity in a chapter 7 case. The paradigm for business entities in chapter 7 is not the fresh start; it is "orderly death."²⁴ But business entities are not entirely denied the opportunity to discharge debt through bankruptcy; business entities can receive a discharge in chapter 11.²⁵ But the discharge effected by the confirmation of a chapter 11 plan is not exactly a fresh start. A chapter 11 discharge in essence replaces the debtor's obligations created prepetition with the new, reduced obligations created by the plan.²⁶

While the discharge of a business entity in chapter 11, unlike the discharge of an individual in chapter 7, does not result in a fresh start from prepetition debts, both reflect the cleavage effect of the filing of a bankruptcy petition. Chapter 7 and chapter 11 discharges provide the debtor relief from prepetition debts but not from postpetition debts. After his chapter 7 discharge, Casey has no personal liability on his prepetition debts.²⁷ After its chapter 11 discharge, Double Dave's only liability on its prepetition debts is what it has agreed to pay under its chapter 11 plan.²⁸

II. CLEAVAGE AND EQUALITY OF DISTRIBUTION

Even more important than the cleavage effect of a bankruptcy petition on the rights of prepetition and postpetition creditors against the debtor is the

²¹ E.g., Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 363 (3d Cir. 2001) (Cowen, J., dissenting) ("Corporations do not get fresh starts.").

²² See Lawrence Ponoroff, *Vicarious Thrills: The Case for Application of Agency Rules in Bankruptcy Dischargeability Litigation*, 70 TUL. L. REV. 2515, 2521 (1996) ("[T]he bankruptcy fresh start does not mean the same thing in corporate and other entity bankruptcies as it does for the individual debtor.").

²³ 11 U.S.C. § 727(a)(1) (2012).

²⁴ COMM'N ON THE BANKR. LAWS OF THE U.S., REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. I, 72 (1973), reprinted in 2 BANKRUPTCY REFORM ACT OF 1978: A LEGISLATIVE HISTORY, Doc. 21 (Alan N. Resnick & Eugene M. Wypyski eds. 1979) ("[T]he bankruptcy process provides for the orderly death").

²⁵ 11 U.S.C. § 1141(d)(1)(A) ("[T]he confirmation of a plan—discharges the debtor from any debt that arose before the date of such confirmation").

²⁶ *Id.* § 1141(d).

²⁷ See *id.* § 727(b).

²⁸ See *id.* § 1141(d).

cleavage effect of a bankruptcy petition on the relative rights of creditors. As one bankruptcy court observed, “[T]he entire bankruptcy process is based upon a division in time, with claims that arose prepetition against the debtor being treated in one manner and claims that arose against the estate postpetition being treated in a different manner.”²⁹ The similar treatment of similarly situated creditors is a fundamental tenet of bankruptcy law, with the date of cleavage—i.e., the filing of a bankruptcy petition—being the most important method of grouping like with like.³⁰

The filing of a bankruptcy petition protects a prepetition creditor from other prepetition creditors. One early twentieth century commentator explained the elements of bankruptcy by stating: “All bankruptcy law . . . no matter when or where devised and enacted, has at least two general objects in view. . . . [It] seeks to protect the creditors, first, from one another and, secondly, from their debtor.”³¹

Bankruptcy remains a creditor’s remedy today. As Professor Thomas Jackson observed, “Bankruptcy, at first glance, may be thought of as a procedure geared principally toward relieving an overburdened debtor from ‘oppressive’ debt. Yet . . . most of the bankruptcy process is in fact concerned with creditor-distribution questions.”³² More specifically, it is concerned with questions relating to distributions to prepetition creditors. Unlike state debt collection law, which focuses on each individual creditor’s rights vis-à-vis the debtor, bankruptcy focuses on the rights of all prepetition creditors as a group.³³ That is to say, it is a *collective* remedy.³⁴

²⁹ *In re Sturgis Iron & Metal Co.*, 420 B.R. 716, 749 n.63 (Bankr. W.D. Mich. 2009).

³⁰ See Howard C. Buschman III, *Benefits and Burdens: Post-Petition Performance of Unassumed Executory Contracts*, 5 BANKR. DEV. J. 341, 341 (1988).

³¹ Louis Edward Levinthal, *The Early History of Bankruptcy Law*, 66 U. PA. L. REV. 223, 225 (1918).

³² Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain*, 91 YALE L.J. 857, 857 (1982); see also Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 785 (1987).

In bankruptcy, with an inadequate pie to divide and the looming discharge of unpaid debts, the disputes center on who is entitled to shares of the debtor’s assets and how those shares are to be divided. Distribution among creditors is not incidental to other concerns; it is the center of the bankruptcy scheme.

Id.

³³ JACKSON, LOGIC AND LIMITS, *supra* note 20, at 10 (“The basic problem that bankruptcy law is designed to handle, both as a normative matter and as a positive matter, is that the system of individual creditor remedies may be bad for the creditors *as a group* Bankruptcy law responds to this problem.”).

³⁴ E.g., Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 823 (2004) (“collective process that is bankruptcy”); Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*,

Under state law, the race for the debtor's assets goes to the swiftest.³⁵ The first creditors to obtain and execute a judgment by seizing the debtor's assets are satisfied in full, while the creditors who are late to the party often get nothing.³⁶ Thus, once the debtor is perceived to be in a financially shaky position, state "grab" law encourages the piecemeal and potentially wasteful dismemberment of the debtor's property.³⁷

Federal bankruptcy law takes a different approach to debt collection. It seeks to get the most value out of the debtor's assets for the benefit of all of the debtor's prepetition creditors.³⁸ This requires that individual collection efforts be held at bay while the debtor's assets are liquidated by a neutral trustee³⁹ in an orderly fashion (chapter 7), or while the debtor has the opportunity to rehabilitate and return to some semblance of financial viability and make payments to prepetition creditors under a court-approved plan (chapters 11, 12, and 13).⁴⁰ The filing of a bankruptcy petition results in an automatic stay,⁴¹ which protects each prepetition creditor from collection initiatives by other prepetition creditors against the debtor.⁴²

92 MICH. L. REV. 336, 370 (1993) ("collective process of bankruptcy"); see JACKSON, LOGIC AND LIMITS, *supra* note 20, at 17.

³⁵ See ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS: TEXT, CASES, AND PROBLEMS 46 (6th ed. 2009) ("In general, the rule in state collection law is the rule elsewhere in law: 'First in time, first in right,' or, in its earthier version, 'The fastest dog gets fed first.'").

³⁶ See *id.* ("In general, the state law system provides for no sharing, does not listen to hard luck stories about which creditor was out of town or was trying to help the debtor, and makes very little assessment of which creditors are more deserving.").

³⁷ Susan Block-Lieb, *Fishing in Muddy Waters: Clarifying the Common Pool Analogy as Applied to the Standard for Commencement of a Bankruptcy Case*, 42 AM. U. L. REV. 337, 355–56 (1993) ("Pursuit of various state law remedies such as execution, attachment, garnishment, levy, and the like may involve a 'race to the courthouse' by a debtor's creditors, with the creditors who win the race entitled to 'grab' the debtor's assets away from the debtor's slower creditors.").

³⁸ *In re Dow Corning Corp.*, 255 B.R. 445 (E.D. Mich. 2000) ("A chapter 7 trustee's fiduciary duty goes to both the creditors and the debtor in order to maximize the value of the estate." (citing *Myers v. Martin* (*In re Martin*), 91 F.3d 389, 394 (3d Cir. 1996)); *In re Atlanta Packaging Prods., Inc.*, 99 B.R. 124, 131 (Bankr. N.D. Ga. 1988) ("It is a well-established principle of bankruptcy law that the objective of bankruptcy sales and the trustee's duty with respect to such sales is to obtain the highest price or greatest overall benefit possible for the estate." (citing *In re Blue Coal Corp.*, 59 B.R. 157, 162 (Bankr. M.D. Pa. 1986))); JACKSON, LOGIC AND LIMITS, *supra* note 20, at 14–15.

³⁹ 11 U.S.C. § 704 (2012).

⁴⁰ 3 COLLIER ON BANKRUPTCY ¶ 362.03 (Alan N. Resnick & Henry J. Sommers eds., 16th ed. 2010).

⁴¹ 11 U.S.C. § 362(a), (c).

⁴² WARREN & WESTBROOK, *supra* note 35, at 407 ("Naturally creditors do all they can to avoid the effect of the [automatic] stay, but they have to remember that the Bankruptcy Code protects an 'estate' that represents a host of creditors and other interests, not just the debtor.").

For bankruptcy's collective process to work effectively, prepetition creditors are required to be treated with substantial equality not only in terms of what they can do during the bankruptcy but also in terms of what they receive from the bankruptcy case.⁴³ Indeed, equality of distribution is consistently described as an important, even the most important, purpose of bankruptcy.⁴⁴ The Supreme Court in *Bailey v. Glover* stated: "It is obviously one of the purposes of the Bankrupt law, that there should be a speedy disposition of the bankrupt's assets. This is *only second in importance* to securing equality of distribution."⁴⁵

While the Bankruptcy Code (the "Code") does not use the phrase "equality of distribution," most Code provisions⁴⁶ and most court orders in bankruptcy cases⁴⁷ are consistent with a *policy* of equality of distribution among prepetition creditors. There are also, however, provisions in the Code and court orders in bankruptcy cases that are consistent with the policy of equality of distribution only in the *Animal Farm* sense of that phrase: "All animals are equal but some animals are more equal than others."⁴⁸

This essay focuses on two such "more equal animals": vendors and lessors. The Code in essence treats the prepetition unsecured claims of vendors and lessors as if their prepetition claims are postpetition claims, which we submit is inconsistent not only with the cleavage effect of bankruptcy but also the policies of fresh start and equality of distribution.

III. WHICH CLAIMS OF VENDORS AND LESSORS ARE PREPETITION UNSECURED CLAIMS?

Because various Code sections treat prepetition unsecured claims differently from and less favorably than postpetition unsecured claims, a

⁴³ See JACKSON, LOGIC AND LIMITS, *supra* note 20, at 151–52.

⁴⁴ See *Begier v. I.R.S.*, 496 U.S. 53, 58 (1990) ("Equality of distribution among creditors is a central policy of the Bankruptcy Code."); H.R. REP. NO. 95-595, at 178 (1977) ("the prime bankruptcy policy of equality of distribution among creditors"), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138; see also JACKSON, LOGIC AND LIMITS, *supra* note 20, at 29–30 (describing the pro rata treatment of unsecured creditors as "the most common—and uncontroversial—of bankruptcy's policies"); Westbrook, *supra* note 34 ("[B]ankruptcy has as a major purpose equality of distribution to all those within a legal 'class' of creditors. That is, those with equal rights should receive equal treatment.").

⁴⁵ 88 U.S. 342, 346 (1874) (emphasis added).

⁴⁶ See, e.g., 11 U.S.C. §§ 547–51 (preferences and fraudulent transfers); *id.* §§ 1122(a), 1123(a)(4) (grouping "substantially similar" claims for similar treatment in chapter 11 plans).

⁴⁷ E.g., *In re Quigley Co.*, 377 B.R. 110, 116–17 (Bankr. S.D.N.Y. 2007).

⁴⁸ GEORGE ORWELL, *ANIMAL FARM* 133 (Signet Classic 50th Anniversary ed. 1996) (1946).

considerable body of law has developed as to which unsecured claims are prepetition and which unsecured claims are postpetition. The following two examples illustrate the point:

- (1) A day before filing his chapter 7 bankruptcy petition on January 15, Casey buys two pairs of underwear from Sears online, using his Sears card. Even though the underwear arrives on January 17, and the Sears bill arrives on January 30, Sears is a prepetition creditor. The Code's definition of "claim" includes an unmatured right to payment,⁴⁹ and Sears had an unmatured right to payment when Casey ordered the underwear on January 14.
- (2) In 2013, Libby leases a building to Double Dave for seven years, with rent payable at the end of each month. Double Dave files for bankruptcy on July 13, 2014. Double Dave's motion to reject (i.e., breach⁵⁰) the Libby lease is approved by the bankruptcy court as provided in § 365(a).⁵¹ Libby's claim for unpaid rent that accrued prior to filing for bankruptcy, rent that accrues after filing, and the remaining rent not yet accrued all become prepetition claims. Again, Libby had an unmatured right to payment when Double Dave signed the lease.

As these examples show, vendor orders and unexpired leases give rise to prepetition claims under the Code.⁵² However, the fact that they have prepetition claims tells us nothing about whether these claims are secured or unsecured.

Both vendors like Sears and lessors like Libby can have prepetition unsecured claims, prepetition secured claims, or both. Indeed, the same transaction can often give rise to both a secured claim and an unsecured claim. For example, assume that on December 7, 2013, Casey buys a Kenmore refrigerator from Sears on credit and grants Sears a security interest in the refrigerator. When Casey files for chapter 7 bankruptcy in 2014, he still owes

⁴⁹ 11 U.S.C. § 101(5)(A).

⁵⁰ *Badami v. Sears (In re AFY, Inc.)*, 461 B.R. 541, 549 (B.A.P. 8th Cir. 2012) ("Rejection of the agreement constitutes a breach.").

⁵¹ 11 U.S.C. § 365(a). Under § 365, Double Dave also has an opportunity to assume (i.e., keep) or assign (i.e., transfer) the lease. *Id.* § 365(a), (f).

⁵² *Id.* §§ 101(5)(A), 365(a).

Sears \$700 and the refrigerator has a value of \$300. In Casey's bankruptcy, Sears has a secured claim of \$300 and an unsecured claim of \$400.⁵³

Similarly, assume that Libby's lease required Double Dave to post a security deposit of \$10,000, which it did. In Double Dave's bankruptcy Libby would then have a \$10,000 secured claim.⁵⁴ The remainder of Libby's claim under the prepetition lease would then be a prepetition unsecured claim.⁵⁵ The remaining parts of this Article deal only with the prepetition unsecured claims of vendors and lessors in chapter 11 cases.

IV. PREPETITION UNSECURED CLAIMS OF VENDORS

The bankruptcy law with respect to prepetition unsecured claims of vendors is, in significant respects, inconsistent with both (1) the concept that a bankruptcy filing cleaves prepetition debts from postpetition debts and (2) the bankruptcy policy of equality of distribution. Outside of bankruptcy, a seller of goods for unsecured credit has no special claim to payment or to the goods.⁵⁶ The relative state law rights of an unsecured vendor and other unsecured creditors would depend on which creditor obtained its lien first⁵⁷—vendors get no special treatment. Bankruptcy law, however, treats certain prepetition unsecured claims of vendors as if they were postpetition claims. Those vendors receiving special treatment under the Code fall into two categories: critical vendors and § 503(b)(9) vendors (or “20-day vendors”). The claims of these “more equal animals” are treated differently and better than similarly situated unsecured creditors. The rest of this Part will outline the history of this special treatment and discuss their underlying policy rationales.

⁵³ *Id.* § 506(a).

⁵⁴ Even though Libby holds the security deposit, it becomes property of the estate under § 541, which brings into the bankruptcy estate all property “wherever located and by whomever held” in which the debtor has a legal or equitable interest as of the bankruptcy filing. 11 U.S.C. § 541(a). Since Double Dave has an interest in the return of its security deposit, the deposit becomes property of the estate, and Libby has a secured claim for the full amount. *Id.* § 506(a).

⁵⁵ *Id.* § 506(a) (granting an unsecured claim to the “extent that the value of such creditor’s interest . . . is less than the amount of [the] allowed [secured] claim”).

⁵⁶ Under the U.C.C., there is a limited reclamation exception for a seller who delivered goods to an insolvent buyer. *See generally* Lawrence Ponoroff, *Reclaim This! Getting Credit Seller Rights in Bankruptcy Right*, 48 U. RICH. L. REV. 733 (2014).

⁵⁷ WARREN & WESTBROOK, *supra* note 35.

A. Railroads

It all started with railroads. Railroads were the nineteenth century institutions viewed as “too big to fail.”⁵⁸ Nonetheless, in the nineteenth and into the twentieth century, railroads did fail—at least fail to pay their creditors.⁵⁹ When railroads were unable to pay their creditors, bankruptcy was not an alternative—railroads were expressly excluded from filing for bankruptcy until 1933.⁶⁰ Instead, railroads made use of receiverships.⁶¹

There are numerous books and law review articles that debate the importance of these railroad receiverships to the evolution of basic concepts of business bankruptcies.⁶² This essay does not go into them in depth. However, two important concepts arose during that period: the six months rule and the necessity of payment rule. This essay simply shows the connections between these two nineteenth century rules and the twenty-first century business bankruptcy’s critical vendor orders and § 503(b)(9). While the impetus for these rules is grounded in the evolution of nineteenth century bankruptcy policy, their usefulness for modern business bankruptcies is not justified.

1. Six Months Rule

The six months rule developed from the common practice by courts of initiating railroad receiverships with an order appointing a receiver and authorizing him to pay certain expenses incurred in the preceding six months. These expenses were paid prior to paying the claims of secured bondholders. This policy arose to combat the pervasive practice by failing railroad companies of paying the interest on their mortgages and ignoring bills for

⁵⁸ Joseph R. Mason & Daniel A. Schiffman, *Too Big to Fail, Government Bailouts, and Managerial Incentives: The Case of the Reconstruction Finance Corporation Assistance to the Railroad Industry During the Great Depression*, in *TOO BIG TO FAIL: POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS* 49, 50 (Benton E. Gup ed., 2003); see also *Louisville Trust Co. v. Louisville, New Albany & Chi. Ry. Co.*, 174 U.S. 674, 682 (1899) (“[A] railroad is not simply private property, but also an instrument of public service . . .”).

⁵⁹ See Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 *CORNELL L. REV.* 1420, 1435 (2004) (noting that over reliance on secured debt “increased the chances of default in times of economic disturbance”).

⁶⁰ Act of Mar. 3, 1933, Pub. L. No. 72-420, § 77, 47 Stat. 1467, 1474 (1933); see JAMES ANGELL MACLACHLAN, *HANDBOOK OF THE LAW OF BANKRUPTCY* 2 (1956).

⁶¹ See Lubben, *supra* note 59, at 1423 (noting that approximately half of the largest railroads “went through a receivership between 1890 and this country’s entry into World War I”).

⁶² See, e.g., DAVID A. SKEEL, JR., *DEBT’S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* 48–70 (2001); Daniel J. Bussell, *Coalition-Building Through Bankruptcy Creditors’ Committees*, 43 *UCLA L. REV.* 1547, 1552–59 (1996).

ongoing operating expenses such as labor and supplies.⁶³ This practice was seemingly based on the “hope . . . that a more favorable time in the business of the roads would enable them to make up the deficiency.”⁶⁴ Railroad companies would sometimes defer paying their operating expenses for many months before a receiver was appointed. In approving such an order, *Turner v. Indianapolis B. & W. Railway Co.* explicitly identified this practice as the rationale behind the six months rule. It stated:

[T]hose who had control of the railways, instead of paying the current operating expenses of the companies would postpone the payment of the same, sometimes for many months, in favor of the interest due on the mortgages It is for these and other like reasons that the court in the appointment of receivers in all cases of railroads in this circuit has required them . . . to pay for labor performed, or supplies or materials furnished during the time indicated.⁶⁵

The court in *Turner* invited a review of the six months rule by the Supreme Court.⁶⁶ One year later in 1879, *Fosdick v. Schall*⁶⁷ provided such a review. Under *Fosdick*, a court could condition the appointment of a receiver on the use of the railroad’s income during the receivership on “outstanding debts for labor, supplies, equipment, or permanent improvement of the mortgaged property.”⁶⁸ The Court in *Fosdick*, like the court in *Turner*, then noted that often debts for labor and supplies are deferred so that bond interest may be paid and foreclosure postponed.⁶⁹ The Court explained the legal importance of this common railroad practice:

⁶³ *Turner v. Indianapolis, B. & W. Ry. Co.*, 24 F. Cas. 366, 367 (C.C.D. Ind. 1878) (No. 14,258).

⁶⁴ *Id.*

⁶⁵ *Id.* The “time indicated”—six months—was based on an Illinois statute. *Id.* at 366 (“[R]easonable time . . . as by analogy, the rule of the statute in Illinois.”); *cf.* *S. Ry. Co. v. Carnegie Steel Co.*, 176 U.S. 257, 292–93 (1900).

[S]uch temporary credits accruing prior to the appointment of the receiver must be recognized by the mortgagees and such claims preferred. Now, for what time prior to the appointment of a receiver may these credits be sustained? There is no arbitrary time prescribed, and it should be only such reasonable time as, in the nature of things and in the ordinary course of business, would be sufficient to have such claims settled and paid. Six months is the longest time I have noticed as yet given. Ordinarily, I think that is ample. Perhaps, in some large concerns, with extensive lines of road and a complicated business, a longer time might be necessary.

Id. (quoting *Blair v. St. Louis, H. & K. Ry. Co.*, 22 F. 471, 474 (C.C.E.D. Mo. 1884)).

⁶⁶ *Turner*, 24 F. Cas. at 367 (“desirable to obtain from the [S]upreme [C]ourt a decision”).

⁶⁷ 99 U.S. 235 (1879).

⁶⁸ *Id.* at 251–52.

⁶⁹ *Id.*

In this way the daily and monthly earnings, which ordinarily should go to pay the daily and monthly expenses, are kept from those to whom in equity they belong, and used to pay the mortgage debt. . . . If for the convenience of the moment something is taken from what may not improperly be called the current debt fund, and put into that which belongs to the mortgage creditors, it certainly is not inequitable for the court, when asked by the mortgagees to take possession of the future income and hold it for their benefit, to require as a condition of such an order that what is due from the earnings to the current debt shall be paid by the court from the future current receipts before anything derived from that source goes to the mortgagees.⁷⁰

The six months rule, as stated in *Fosdick*, is based on a principle from mortgage law: “[T]hat the mortgagee’s interest attaches to net income, which arises only after the payment from gross earnings for all necessary operating and managing expenses, proper equipment, and useful improvements.”⁷¹ As such, *Fosdick*’s approval of the six months rule stems from equitable principles based on mortgage law—not reorganization policies. As stated by the First Circuit Court of Appeals in *In re Boston & Maine Corp.*:⁷²

The *Fosdick* rule is one of equitable restitution; in receivership the mortgagee must restore to operating creditors revenues diverted to the mortgagee’s advantage The receivership furnishes the occasion and judicial means of effecting the equitable restitution, but mortgage law, not the special principles governing the administration of railroad receiverships, is the source of the right to restitution.⁷³

Not all commentators have agreed with this characterization of the six months rule. A year after *Boston & Maine*, Robert W. Blanchette, a leader of the railroad bankruptcy bar who served as trustee in the Penn Central

⁷⁰ *Id.*

⁷¹ *In re Bos. & Me. Corp.*, 634 F.2d 1359, 1368 (1st Cir. 1980) (discussing *Fosdick*, 99 U.S. at 235). The court went on to state:

[T]o the extent that before or during receivership bonded interest has been paid, additional equipment provided, or lasting and valuable improvements in the mortgaged property have been made out of earnings which ought in equity to have been used to pay debts for labor, supplies and the like, the receivership court can use receivership income . . . to pay the debts that, but for the diversion of funds, would have been paid in the ordinary course of business. . . .

Id.

⁷² *Id.* at 1359.

⁷³ *Id.* at 1368–69, 1377; see also 8 COLLIER ON BANKRUPTCY, *supra* note 40, at ¶ 1171.02 (“The *Fosdick* rationale specifically rested on the debtor’s diversion of funds from the payment of current operating expenses in order to pay a mortgagee . . .”).

bankruptcy,⁷⁴ was less certain about the conceptual basis for the six months rule: “The rationale underlying the rule has been variously explained. . . . Frequently, the above rationales are combined or confused.”⁷⁵

The conceptual basis for the bankruptcy receivership’s six months rule is of limited, direct practical significance. Bankruptcy law has replaced receiverships for railroad reorganizations⁷⁶ and provides a statutory basis for the six months rule. In 1933, Congress enacted § 77 providing for the reorganization of interstate railroads under the Bankruptcy Act.⁷⁷ Section 77 did not promulgate a statutory version of the six months rule. Instead, the following language in § 77 was read as making the six months rule a part of railroad reorganizations in bankruptcy:

For all *purposes of this section* unsecured claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such *priority* and the holders of such claims shall be treated as a separate class or classes of creditors.⁷⁸

As the italicized words indicate, the Bankruptcy Act limited the application of the six months rule to railroad reorganizations under § 77 and limited the effect of the six months rule to a priority—not a right to immediate payment.

The modern iteration of the Code retains the language of § 77 of the prior Act. Referring to railroad reorganization, § 1171 of the present Code parallels the older language, stating:

Any unsecured claim against the debtor that would have been entitled to priority if a receiver in equity of the property of the debtor had

⁷⁴ Reg’l Rail Reorganization Act Cases, 419 U.S. 102, 106 (1974).

⁷⁵ Robert W. Blanchette & Clifford W. Losh, *Railroad Reorganization*, 1981 ANN. SURV. BANKR. L. 171, 188–89.

⁷⁶ See VERN COUNTRYMAN, CASES AND MATERIALS ON DEBTOR AND CREDITOR 302 (1964) (contending that after railroads were eligible for bankruptcy relief there was no need to “further resort to the federal consent receivership”).

⁷⁷ Lloyd K. Garrison, *Department of Current Legislation: The Recent Amendments to the Bankruptcy Act*, 19 A.B.A. J. 330, 330 (1933). The term “Bankruptcy Act” is generally used to refer to the bankruptcy statute first enacted in 1898 and amended significantly thereafter. Roger G. Evans, *Bankruptcy the American Way: An Introductory Guide*, 11 JUTA’S BUS. L. 173, 174 (2003).

⁷⁸ 11 U.S.C. § 205(b) (1976) (repealed 1978) (emphasis added). When first enacted in 1933, the provision appeared in § 77(c), and the first part of the sentence read: “For all purposes of this section claims against a railroad corporation which would have been entitled to priority over existing mortgages if a receiver in equity of the property of the debtor had been appointed by a Federal Court . . .” Act of Mar. 3, 1933, Pub. L. No. 420, § 77(c), 47 Stat. 1474, 1477 (repealed 1978).

been appointed by a Federal court on the date of the order for relief under this title shall be entitled to the same *priority* in the case under this chapter.⁷⁹

Note that § 1171 of the Code, like § 77 of the former Bankruptcy Act, provides a priority, not a right to payment.

And like Bankruptcy Act § 77, Code § 1171(b) provides no guidance as to when unsecured claims “would have been entitled to priority if a receiver in equity . . . had been appointed.”⁸⁰ As the legislative history of the Code explains, “As under [§ 77], the courts will determine the precise contours of the priority recognized by this subsection in each case.”⁸¹

The last reported opinion granting creditors priority under the six months rule is a 1988 opinion, *In re Michigan Interstate Railway Co.*,⁸² by Judge Steven Rhodes.⁸³ The opinion does not identify precise contours of the right to priority created by the six months rule. Instead, Judge Rhodes concluded that the courts had failed to coalesce around a meaningful standard, stating:

[I]t is difficult, if not impossible, to identify from the prior decisions any unified principle or group of principles to be applied when a claimant requests priority for a pre-petition claim in a railroad reorganization pursuant to 11 U.S.C. § 1171(b). Plainly, each case has been decided based upon its unique facts and based upon the court’s analysis of the equities asserted by each of the competing parties.⁸⁴

⁷⁹ 11 U.S.C. § 1171(b) (2012) (emphasis added); *see also* H.R. REP. NO. 95-595, at 424 (1977) (“Subsection (b) follows present section 77(b) of the Bankruptcy Act . . .”). While language limiting its application to railroad reorganizations is missing from § 1171, there is such limiting language in § 103(h), 11 U.S.C. § 103(h) (“Subchapter IV of chapter 11 of this title applies only in a case under such chapter concerning a railroad.”). As § 1171 falls under Subchapter IV of chapter 11, the limitation to railroad reorganizations applies.

⁸⁰ 11 U.S.C. § 1171.

⁸¹ H.R. REP. NO. 95-595, at 424 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6380.

⁸² 87 B.R. 921 (Bankr. E.D. Mich. 1988).

⁸³ *See generally* Tom Hals, *Steven Rhodes, Detroit Bankruptcy Judge, Has Strong Record, Known as a Stickler*, HUFFINGTON POST (July 24, 2013, 7:01 AM EDT), http://www.huffingtonpost.com/2013/07/24/steven-rhodes-judge-detroit-bankruptcy_n_3643284.html.

⁸⁴ *Michigan Interstate Ry. Co.*, 87 B.R. at 925 (citations omitted); *see also* S. Ry. Co. v. Carnegie Steel Co., 176 U.S. 257, 292 (1900) (noting each case “must depend largely on its special facts”). *But cf.* Russell A. Eisenberg & Frances F. Gecker, *The Doctrine of Necessity and its Parameters*, 73 MARQ. L. REV. 1, 4 (1989). The preceding article, co-authored by a bankruptcy judge, provided the following summary of case law on the six months rule:

The Six Months Rule requires that “the creditor must have expected to be paid out of the current operating receipts of the railroad rather than from the general credit of the railroad” and that “a

While courts and commentators are uncertain as to the present contours of the six months rule, they are certain that it now merely provides a priority and not a right to immediate payment.⁸⁵ Instead, the railroad receivership antecedent to any present day right to immediate payment of a prepetition unsecured claim is the “necessity of payment” rule.

2. *Necessity of Payment Rule*

Just as the term “six months rule” nowhere appears in *Fosdick*, the term “necessity of payment” nowhere appears in *Miltenberger v. Logansport Railway Co.*,⁸⁶ the seminal case on the necessity of payment rule.⁸⁷ *Miltenberger* involved an appeal of an order directing a railroad receiver’s immediate payment of certain pre-receivership claims. In approving the payments, the Court gave the following justification,

Many circumstances may exist which may make it necessary and indispensable to the business of the road and the preservation of the property, for the receiver to pay pre-existing debts . . . where a stoppage of the continuance of such business relations would be a probable result, in case of non-payment.⁸⁸

Miltenberger was decided after *Fosdick* but does not cite *Fosdick*. That is understandable. There are very different bases for the two decisions. Recall *Fosdick*’s focus on the relative rights of various creditors and on pre-receivership “diversion” from vendors and other unsecured creditors to secured creditors, i.e., using unencumbered operating income to pay interest on secured bonds instead of to pay vendors and other unsecured creditors.⁸⁹ By contrast,

current debt fund must exist.” The debt fund is limited to “current or surplus earnings during the six months prior to reorganization and during reorganization; unmortgaged assets of the debtor; and income diverted for the benefit of mortgagees of the debtor during the reorganization or the six months prior to the reorganization.”

Id. (citations omitted).

⁸⁵ See, e.g., *Alco Prods. v. Trs. of the Prop. of the N.Y., New Haven & Hartford R.R. Co.* (*In re N.Y., New Haven & Hartford R.R. Co.*), 405 F.2d 50, 51–52 (2d Cir. 1968) (“The six-months rule stated briefly, gives priority in payment to creditors . . .”); Alan N. Resnick, *The Future of the Doctrine of Necessity and Critical-Vendor Payments in Chapter 11 Cases*, 47 B.C. L. REV. 183, 188 (2005) (“[T]he six months rule directly changes the priority of claims . . .”).

⁸⁶ 106 U.S. 286 (1882).

⁸⁷ *Eisenberg & Gecker*, *supra* note 84, at 3 (“The United States Supreme Court first articulated the Necessity of Payment Rule in *Miltenberger v. Logansport Railway*.”).

⁸⁸ *Miltenberger*, 106 U.S. at 311–12.

⁸⁹ *Fosdick v. Schall*, 99 U.S. 235, 252–53 (1879).

Miltenberg's focus was on what payments were necessary to keep the railroad operating, not the relative rights of secured and unsecured creditors.⁹⁰

And, in *Miltenberg* as in *Fosdick*, the Court emphasized that the debtor was a railroad and emphasized the public interest in and need for a railroad.⁹¹ The Court compared a railroad with a public highway.⁹² Grounded in this public interest rationale, it would seem that the necessity of payment rule, like the six months rule priority, would be limited to cases in which the debtor was a railroad. And, courts consistently so held until 1945.⁹³

B. Non-Railroad Business Debtors

1. From Necessity of Payment Rule in Railroad Cases to Critical Vendor Orders in Chapter 11 Business Cases

In 1945, *Dudley v. Mealey*, a Second Circuit panel of Judges Jerome Frank, August Hand, and Learned Hand held that these railroad receivership concepts could also be used by courts in business bankruptcy cases.⁹⁴ In *Dudley*, the court first expressly acknowledged that in “a number of instances courts have refused to extend this doctrine to private corporations” and that the “priority primarily rested” on “the interest of the public in the continued operation of railroads.”⁹⁵ Then the court pivoted, switching from the interest of the public to the interest of the secured creditors. According to the court, protecting the “interest of the lienors” necessitates protection of the supply creditors.⁹⁶ This justification is all the more compelling in a reorganization of the business, because the “very purpose of the action is to continue the existing business in

⁹⁰ *Miltenberger*, 106 U.S. at 311 (“Many circumstances may exist which may make it necessary . . . for the receiver to pay preexisting debts of certain classes, out of the earnings of the receivership, or even the corpus of the property, under the order of the court, with a priority of lien.”).

⁹¹ *Id.* at 311–12; *Fosdick*, 99 U.S. at 251–52.

⁹² *Miltenberger*, 106 U.S. at 313 (the “public interest in such a highway for public use as a railroad”). A year earlier, the Court had stated that a “railroad is authorized to be constructed more for the public good to be subserved, than for private gain. . . . It is, therefore, a matter of public right by which the courts . . . authorize the receiver . . . so that the public may not suffer detriment . . .” *Barton v. Barbour*, 104 U.S. 126, 135 (1881).

⁹³ See, e.g., *In re Bos. & Me. Corp.*, 634 F.2d 1359, 1377 (1st Cir. 1980) (“peculiarly a principle of railroad receivership”); *Int’l Trust Co. v. Decker Bros.*, 152 F. 78, 82–83 (9th Cir. 1907) (“The reasons, however, for the authority are peculiar to railroad corporations . . . the most salient of which are that railroads are quasi public concerns, through which the public interest and convenience, as well as private ownership, are largely subserved . . .”).

⁹⁴ 147 F.2d 268 (2d Cir. 1945).

⁹⁵ *Id.* at 271.

⁹⁶ *Id.*

the interest of the secured creditors”⁹⁷ The court then held that “so far as the supply creditors furnished their goods of their services within a short period of the receivership—six months is the limit—and so far as these were necessary to keep the [business] open, they were proper preferred claims.”⁹⁸

Notice that *Dudley*, like *Fosdick*, the Supreme Court’s six months rule decision, focuses on the needs of the secured creditors—the importance of preserving the going concern value for the secured creditors.⁹⁹ And notice, the court’s reference to both “six months” and “necessary.” Commentators are divided as to whether *Dudley* extends the six months rule or the necessity of payment rule to businesses other than railroads.¹⁰⁰

While other scholars were still debating which rule formed the basis for the *Dudley* opinion, it was clear to Judge Burton Lifland¹⁰¹ that the *Dudley* opinion extended the necessity of payment rule. The next reported opinion with a reasoned extension of the necessity of payment rule to non-railroad businesses was a 1989¹⁰² opinion by Judge Lifland in the bankruptcy case involving Eastern Air Lines and its affiliates.¹⁰³

The opinion acknowledges¹⁰⁴ but does not rely on the obvious similarity of railroads and airlines.¹⁰⁵ Instead, Judge Lifland refers to and relies on *Dudley*,

⁹⁷ *Id.* (emphasis added).

⁹⁸ *Id.*

⁹⁹ Compare *id.* (“to continue the existing business in the interest of secured creditors”), with *Fosdick v. Schall*, 99 U.S. 235, 251 (1879) (“[The receiver] holds, pending the litigation, for the benefit of whomsoever in the end it shall be found to concern”).

¹⁰⁰ Compare Shirley S. Cho, *The Intersection of Critical Vendor Orders and Bankruptcy Code § 503(b)(9)*, 29 CAL. BANKR. J. 7, 8 (2007) (“Judge Learned Hand’s decision in *Dudley v. Mealey* extended applicability of the doctrine of necessity to non-railroad bankruptcy cases”), with Resnick, *supra* note 85 (“In *Dudley v. Mealey*, a 1945 decision written by Learned Hand and joined by Jerome Frank and Augustus Hand, involving the application of the six months rule, the Court of Appeals for the Second Circuit for the first time extended the six months rule to a nonrailroad reorganization case with the goal of encouraging successful reorganization.”) (emphasis added).

¹⁰¹ See generally Seth Lubove, *A Bankrupt’s Best Friend*, FORBES, Apr. 1, 1991; Douglas Martin, *Burton R. Lifland, Bankruptcy Judge in Big Cases, Dies at 84*, N.Y. TIMES (Jan. 14, 2014), <http://www.nytimes.com/2014/01/15/business/burton-r-lifland-bankruptcy-judge-dies-at-84.html>.

¹⁰² In that time gap, there were reported cases refusing to extend the necessity of payment doctrine to non-railroad debtors. See, e.g., *B & W Enters. Inc. v. Goodman Oil Co. (In re B & W Enters. Inc.)*, 713 F.2d 534, 537 (9th Cir. 1983) (“would decline to apply it beyond the context of railroad reorganizations”); *In re Yale Express Sys., Inc.*, 342 F. Supp. 972, 973 (S.D.N.Y. 1972) (“Subsequent cases have indicated that *Dudley* should be limited to its or closely analogous facts.”).

¹⁰³ *In re Ionosphere Clubs, Inc.*, 98 B.R. 174 (Bankr. S.D.N.Y. 1989).

¹⁰⁴ *Id.* at 176 (“Clearly, the ‘necessity of payment doctrine’ is applicable to the instant dispute which is related in some aspects to the Railway Labor Act.”).

stating that the necessity of payment doctrine would be “applicable under the rationale of Judge Learned Hand who applied [the necessity of payment doctrine] to a non-railroad debtor in *Dudley v. Mealey*.”¹⁰⁶ He then described the rationale of *Dudley* and of chapter 11 as the rehabilitation of the debtor.¹⁰⁷ Unlike the *Dudley* decision, there is no mention of the “interests of the lienors”¹⁰⁸ or to “continue the existing business in the interest of the secured creditors—and, as here, of them alone.”¹⁰⁹ The opinion instead emphasizes the importance to all creditors in all chapter 11 cases of the survival of the debtor as an operating business—not similarities between airlines and railroads.¹¹⁰

Of course, as any air traveler knows, Eastern Air Lines did not survive.¹¹¹ And, unlike the holders of prepetition unsecured claims paid in full in 1989 under the necessity of payment doctrine, all of the other creditors in the Eastern Air Lines bankruptcy with prepetition unsecured claims received plan distributions valued at 11 cents on the dollar in 1994.¹¹²

Nonetheless, after the Eastern Air Lines bankruptcy, other bankruptcy judges (primarily, but not exclusively,¹¹³ in the Southern District of New York and Delaware) issued similar orders approving the immediate payment in full of prepetition claims of not only employees but also vendors, for the same reason—survival of the debtor as an operating business.¹¹⁴ Many of them did

¹⁰⁵ See Charles Jordan Tabb, *Emergency Preferential Orders in Bankruptcy Reorganizations*, 65 AM. BANKR. L.J. 75, 100 (1991) (“Perhaps an Eastern Airlines case is sufficiently similar to the railroad cases to merit the exercise of the same type of extraordinary power But even Judge Lifland does not rely on an overriding public interest rationale”)

¹⁰⁶ *Ionosphere Clubs, Inc.*, 98 B.R. at 176.

¹⁰⁷ See *id.*

¹⁰⁸ Compare *Dudley v. Mealey*, 147 F.2d 268, 271 (2d Cir. 1945) (“interests of the lienors”), with *Ionosphere Clubs, Inc.*, 98 B.R. at 174 (containing no comparable language).

¹⁰⁹ Compare *Dudley*, 147 F.2d at 271, with *Ionosphere Clubs, Inc.*, 98 B.R. at 176 (discussing the necessity of payment doctrine as being in the interest of “all parties” and not specifically for the benefit of secured creditors).

¹¹⁰ *Ionosphere Clubs, Inc.*, 98 B.R. at 176.

¹¹¹ See generally AARON BERNSTEIN, *GROUNDING: FRANK LORENZO AND THE DESTRUCTION OF EASTERN AIRLINES* (1990).

¹¹² See Scott Thurston, *Eastern, Unsecured Creditors OK Plan, 11 Cents to Be Paid on Each Dollar*, ATLANTA J. & CONST., Sept. 28, 1994, at D1 (reporting that five and one-half years after Eastern Air Lines entered bankruptcy, unsecured creditors had finally approved an 11 cents on the dollar payment plan). See generally Robert K. Rasmussen, *The Efficiency of Chapter 11*, 8 BANKR. DEV. J. 319 (1991) (describing the Eastern Air Lines bankruptcy as a “fiasco”).

¹¹³ See, e.g., *In re Payless Cashways, Inc.*, 268 B.R. 543 (Bankr. W.D. Mo. 2001) (approving payment of prepetition claims of lumber vendors).

¹¹⁴ See, e.g., *In re Just for Feet, Inc.*, 242 B.R. 821, 826 (Bankr. D. Del. 1999).

not have published opinions or appeals.¹¹⁵ In a widely cited law review article, Judge Russell Eisenberg and Frances Gecker concluded that the use of the doctrine of necessity in non-railroad business cases was “well-established in bankruptcy common law.”¹¹⁶ They based their conclusion on “all possible sources, such as numerous unreported decisions, orders, motions, briefs, discussions with bankruptcy judges and lawyers experienced in the use of the Doctrine, and extensive personal experience.”¹¹⁷

Some lawyers and judges used the term “doctrine of necessity,” instead of “necessity of payment” to distinguish non-railroad cases from railroad cases.¹¹⁸ Some lawyers and judges used the term “critical vendor orders”¹¹⁹ to distinguish orders approving payment of claims of prepetition vendors from payments of prepetition claims of employees.¹²⁰ Regardless of what they were called, the practice of paying certain privileged unsecured creditors in cash at the start of the bankruptcy case became widespread. As Professor Douglas Baird has observed:

The Debtors need a continuous supply of inventory from athletic footwear and apparel vendors such as Nike, New Balance, Fila, Reebok, Adidas, Asics, K-Swiss and Converse. [The debtor’s CEO] testified that without new merchandise from these vendors, Just For Feet will not survive. Therefore, the court finds that payment of the pre-petition claims of certain trade vendors—the athletic footwear and apparel vendors—is essential to the survival of the debtor during the chapter 11 reorganization.

Id.; see also Philippe Belanger, *Critical Suppliers: What Does Section 11.4 CCAA Mean?*, 26 BANKING & FIN. L. REV. 1, 7 (2010) (“The matter of Just for Feet constitutes a good example of the rationale often followed by U.S. [c]ourts to justify critical vendor payments.”).

¹¹⁵ See, e.g., Order Confirming Amended Plan of Liquidation, *In re Acme Metals Inc.*, No. 98-02179(MFW) (Bankr. D. Del. May 1, 2002); Order Confirming Second Amended Plan or Reorganization of Goss Realty LLC under Chapter 11 of the Bankruptcy Code, *In re Goss Graphic Sys., Inc.*, No. 99-02756-PJW (Bankr. D. Del. Nov. 4, 1999); *In re Discovery Zone, Inc.*, No. 99-00941(JJF) (Bankr. D. Del. Apr. 20, 1999); *In re WSR Corp.*, No. 98-1241(MFW) (Bankr. D. Del. June 10, 1998); *In re FF Holdings Corp.*, No. 98-37(JJF) (D. Del. Jan. 7, 1998).

¹¹⁶ Eisenberg & Gecker, *supra* note 84, at 1.

¹¹⁷ *Id.* at 2.

¹¹⁸ *Id.* at 2–3; see also *In re CoServ*, 273 B.R. 487, 492–93 (Bankr. N.D. Tex. 2002) (distinguishing the doctrine of necessity from the necessity of payment rule).

¹¹⁹ *In re Wehrenberg, Inc.*, 260 B.R. 468, 469 (Bankr. E.D. Mo. 2001), is the first opinion reported on Westlaw to approve a motion to pay the prepetition claims of “critical vendors.” Professor Richard Aaron provides this explanation of critical vendors: “Critical vendor. ‘You don’t pay, I don’t ship. I don’t ship, you close down.’ A creditor who claims to be essential to the reorganization of the debtor and demands full payment for pre-bankruptcy debt.” Richard I. Aaron, *Hooray for Gibberish!: A Glossary of Bankruptcy Slang for the Occasional Practitioner or Bewildered Judge*, 3 DEPAUL BUS. & COM. L.J. 141, 151 (2005).

¹²⁰ Bruce H. White & William L. Medford, *The Doctrine of Necessity and Critical Trade Vendors: The Impracticality of Maintaining Post-Petition Business Relations in Mega-Cases*, AM. BANKR. INST. J., Sept. 2002, at 24.

Over time, lawyers and judges grew increasingly accustomed to issuing critical-vendor orders, even when the amounts involved were quite substantial. Astute suppliers began to lobby the debtor before the bankruptcy petition to be treated as critical vendors. The debtor's managers had little incentive to resist. . . . In the absence of objection, bankruptcy judges were not likely to push back. Some feared that they would be labeled 'toxic judges' and find themselves out of the business of hearing large Chapter 11 cases. But for others it was far simpler. They were inclined to grant motions many support and none oppose. Over the course of the 1990s, the number and size of critical-vendor payments grew, but little effort was made to ground them in the Bankruptcy Code.¹²¹

As Baird points out, critical-vendor orders proliferated in the 1990's as more and more creditors requested them. Many judges were happy to oblige—either out of fear of losing out on future chapter 11 cases or out of a desire to grant motions supported by both debtors and their most vocal creditors.

The bankruptcy of retail chain Kmart marked a sea change for critical vendor orders. Judge Easterbrook's opinion in this case is the most referenced appellate court decision on payment of claims of critical vendors.¹²² In that case, the bankruptcy judge approved Kmart's use of about \$300 million of its \$2 billion of debtor-in-possession financing to pay in full the prepetition unsecured claims of 2,330 vendors.¹²³ At the end of the case, the 45,000 other holders of prepetition unsecured claims were not paid in full nor paid in cash.¹²⁴ Instead, they eventually received about 10 cents on the dollar, mostly in Kmart stock.¹²⁵

On appeal, the district court reversed the bankruptcy court's critical vendor order authorizing the \$300 million dollar payment, and the Seventh Circuit Court of Appeals affirmed.¹²⁶ In affirming, Judge Easterbrook described the doctrine of necessity as "just a fancy name for a power to depart from the Code" and questioned whether there was any statutory support for critical vendor orders authorizing early payment of prepetition unsecured claims of

¹²¹ Douglas G. Baird, *Bankruptcy From Olympus*, 77 U. CHI. L. REV. 959, 962–63 (2010).

¹²² *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004).

¹²³ *Id.* at 869.

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ *Id.* at 869, 874.

certain vendors.¹²⁷ Ultimately, Judge Easterbrook decided that the question of statutory support for critical vendors was one that the court did not need to decide because the record did not support a finding that Kmart's immediately making the \$300 million dollar payment to vendors was critical.¹²⁸

In re Kmart was the last big business bankruptcy case involving substantial prepetition unsecured vendor claims filed in a bankruptcy court in the Seventh Circuit. However, *Kmart* was not the last case in which a bankruptcy court approved immediate payments in cash for the prepetition unsecured claims of "critical vendors."¹²⁹ Courts in Delaware¹³⁰ and the Southern District of New

¹²⁷ *Id.* at 871. The bankruptcy court used § 105(a) as the basis to confirm the critical vendor order. *Id.* at 869. Section 105(a) states "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." *Id.* at 871 (quoting 11 U.S.C. § 105(a) (2012)). The Seventh Circuit Court of Appeals explained that § 105(a) does not provide a court with the authority "to authorize full payment of any unsecured debt, unless all unsecured creditors in the class are paid in full." *Id.* (internal citations omitted). The court further explained that § 364(b) and § 503 of the Code are not valid bases for the doctrine either. Section 364(b) allows a debtor to obtain postpetition credit, but "has nothing to say about how the money will be disbursed or about priorities among creditors." *Id.* at 872. Section 503 authorizes a bankruptcy court to categorize certain payments as administrative expenses, but "[t]reating pre-filing debts as 'administrative' claims against the post-filing entity would impair the ability of bankruptcy law to prevent old debts from sinking a viable firm." *Id.* Thus, none of these sections could be the statutory basis for the doctrine of necessity.

Finally, the court identified § 363(b)(1) of the Code as "more promising." *Id.* Section 363 (b)(1) states that "[t]he trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . ." *Id.* (quoting 11 U.S.C. § 363(b)(1)). The court likened this use of § 363(b)(1) to a cramdown in the sense that paying critical vendors will "make even the disfavored creditors better off." *Id.* In order for a cramdown to be accepted, however, the impaired class must do just as well as it would have done in a chapter 7 liquidation. Thus, two elements had to be satisfied in order to use § 363(b)(1) in this fashion. First, the debtor in possession must show that the disfavored creditors will be better off, and second, the debtor in possession must prove that those favored vendors would have ceased deliveries or services. Neither of these elements was proved in this case. Thus, the court did not need to reach the question of whether § 363(b)(1) would be a proper statutory foundation for the doctrine of necessity.

¹²⁸ *Id.* at 873–74 ("The court did not find that any firm would have ceased doing business with Kmart if not paid for pre-petition deliveries, and the scant record would not have supported such a finding had one been made.")

¹²⁹ *But cf.* Anthony Michael Sabino, *The Death of Critical Vendor Motions and the Potential Demise of the Doctrine of Necessity: Farewell to Two Misbegotten Doctrines*, 6 TRANSACTIONS TENN. J. BUS. L. 47, 91 (2004) ("[O]ne can forecast Kmart as the new landmark that sweeps away the debris and hubris of decades of misconceived 'Doctrines of Necessity' and its misbegotten offspring of critical vendor relief.")

¹³⁰ *See, e.g.*, Official Comm. of Unsecured Creditors of Motor Coach Indus. Int'l v. Motor Coach Indus. Int'l (*In re* Motor Coach Indus. Int'l, Inc.), No. 09-078-SLR, 2009 U.S. Dist. LEXIS 10024, at *9 (D. Del. Feb. 10, 2009) ("[T]he 'doctrine of necessity' has not been brought into serious question by courts in the Third Circuit"); *cf.* Friedman's Inc. v. Roth Staffing Cos. (*In re* Friedman's Inc.), No. 09-10161 (CSS), 2011 Bankr. LEXIS 4500, at *7–8, *8 n.13 (Bankr. D. Del. Nov. 30, 2011) (acknowledging the current critical vendor debate but declining to rule on it because neither party called the critical vendor order into question).

York¹³¹ and, to a lesser extent, middle-America¹³² have continued to authorize immediate cash payments to vendors holding prepetition unsecured claims.¹³³ By authorizing such payments, courts are disregarding the cleavage effect of bankruptcy.

2. Section 503(b)(9)

Prior to 2005, administrative expense priority was reserved for postpetition debts¹³⁴—except for the six months rule in railroad reorganization cases. However, as part of the comprehensive amendments to the Code in 2005, Congress added § 503(b)(9), further blurring the cleavage effect of filing a bankruptcy petition. Section 503(b)(9) grants a vendor an administrative expense priority for the value of any goods received by the debtor within twenty days before the petition date, as long as the vendor sold the goods to the debtor in the “ordinary course of [the] debtor’s business.”¹³⁵

Like the six months rule in railroad reorganization cases, § 503(b)(9) does not give or create a right to immediate payment. Instead, § 503(b)(9) creates a priority.¹³⁶ Administrative expense priorities such as § 503(b)(9) claims must be paid in full when the chapter 11 plan is confirmed.¹³⁷

In some chapter 11 cases, courts will not confirm the plan until years after the petition is filed. In even more chapter 11 cases, courts will not ever confirm the plan. Instead, the case is converted to chapter 7 or dismissed. And, in many

¹³¹ See, e.g., Motion of the Debtors for Entry of Interim and Final Orders Authorizing the Debtors to Maintain Existing Insurance Coverage and to Pay Obligations with Respect Thereto at 5, 6, *In re RHI Entm’t, Inc.* (Bankr. S.D.N.Y. Dec. 10, 2010) (No. 10-165365), 2010 WL 6434460; *In re Great Atl. & Pac. Tea Co.*, No. 11-CV-01512-UA, 2011 WL 5546954, at *4–5 (S.D.N.Y. Nov. 14, 2011).

¹³² See, e.g., *In re O & S Trucking, Inc.*, No. 12-61003, 2012 Bankr. LEXIS 32713271, at *4–5 (Bankr. W.D. Mo. June 29, 2012).

¹³³ *But cf.* Baird, *supra* note 121, at 974 (“Many of the critical-vendor payments that flourished before *Kmart* were in no sense ‘critical.’ After *Kmart*, debtors found it easier to push back and call the bluffs of supposedly critical vendors.”).

¹³⁴ See Resnick, *supra* note 85, at 204 (“This new provision is a radical departure from the general rule that only postpetition expenses are afforded administrative priority.”).

¹³⁵ 11 U.S.C. § 503(b)(9) (2012). There has been considerable litigation over the application of § 503(b)(9), especially the words in quotes. See generally Paul R. Hage & Patrick R. Mohan, *Recent Developments in Section 503—Administrative Expenses*, 2012 ANN. SURV. BANKR. L. 25 (“In the seven years since 503(b)(9) became effective . . . courts continue to deal with litigation with respect to nearly every part of the statutory language . . .”).

¹³⁶ 11 U.S.C. §§ 507(a)(2), 503(b).

¹³⁷ *Id.* §§ 507(a)(2), 1129(a)(9)(A); Resnick, *supra* note 85, at 204.

of these cases, the estate is administratively insolvent, i.e., administrative priority claims are not paid in full.

Understandably, vendors prefer the immediate payment from a critical vendor order to the administrative priority from § 503(b)(9). And so, just as the six months rule has not replaced the necessity of payment doctrine, § 503(b)(9) has not replaced critical vendor orders. Indeed, vendors have referenced § 503(b)(9)'s special treatment of vendors as statutory support for critical vendor orders.¹³⁸

If the replacement of critical vendor orders is not the reason for Congress's addition of § 503(b)(9), what is? The legislative history is not helpful to understanding Congress's reasons. There is no meaningful legislative history.¹³⁹ That, however, has not stopped law professors and law students from ascribing policy reasons to Congress. According to Collier, "The ostensible reason for according administrative priority to such obligations was to prevent debtors from acquiring goods at a time where the debtor knew that bankruptcy was imminent and that the debtor would not be able to pay for such goods."¹⁴⁰

An outstanding student note by Brendan Gage labels Collier's explanation for § 503(b)(9) the "stockpiling theory" and points out various flaws with this theory.¹⁴¹ Gage's most persuasive argument requires a reference back to the language of § 503(b)(9): "in the ordinary course of [the] debtor's business."¹⁴² Gage argues that a debtor's intentional stockpiling of goods that it anticipates

¹³⁸ See, e.g., *In re News Publ'g Co.*, 488 B.R. 241, 243 (Bankr. N.D. Ga. 2013) ("The Motion seeks authority to pay the pre-petition claims of certain critical vendors . . . pursuant to 11 USC §§ 105(a), 363(b), 364, 503(b)(9) . . ."); Cho, *supra* note 100, at 8 ("The section is now increasingly used as an added justification for granting critical vendor motions.")

¹³⁹ See *S. Polymer, Inc. v. TI Acquisition, LLC* (*In re TI Acquisition, LLC*), 410 B.R. 742, 746 (Bankr. N.D. Ga. 2009) (explaining that no legislative history exists for § 503(b)(9)); *In re Plastech Engineered Prods., Inc.*, 397 B.R. 828, 838 (Bankr. E.D. Mich. 2008) (noting debtor relied on scant legislative history of § 503(b)(9)); William J. Lafferty, *A Concern in Search of a Policy Why Paying Claims Under Section 503(b)(9) and Allowing Claimants to Use the Same Invoices as 'New Value' May Not Be 'Double Counting'*, WESTLAW J. BANKR., Nov. 12, 2010, at 1, 2 ("The legislative history behind these amendments is sparse It is unclear to what extent, if any, Congress gave thought to a myriad of issues that the enactment of Section 503(b)(9) created.")

¹⁴⁰ 4 COLLIER ON BANKRUPTCY, *supra* note 40, at ¶ 503.16; see also Resnick, *supra* note 85, at 189 (stating apparent congressional intent behind § 503(b)(9) was to curb intentional orders in preparation for bankruptcy).

¹⁴¹ Brendan M. Gage, Note, *Should Congress Repeal Bankruptcy Code Section 503(b)(9)?*, 19 AM. BANKR. INST. L. REV. 215, 232-34 (2011) (citing *In re Plastech Engineered Prods., Inc.*, 394 B.R. 147, 151 (Bankr. E.D. Mich. 2008)).

¹⁴² 11 U.S.C. § 503(b)(9); Gage, *supra* note 141, at 233.

will help it get through a bankruptcy is not in the ordinary course of the debtor's business and so is not even covered by § 503(b)(9).¹⁴³ Gage discusses and dismisses other possible policy bases for § 503(b)(9).¹⁴⁴ We are inclined to think that the answer to the question of why did Congress add § 503(b)(9) can be found in politics, not policy: the lobbying power of vendors.¹⁴⁵

The answer to the more important practical question of whether § 503(b)(9) benefits struggling businesses and their creditors generally or only those 20-day vendors depends on whom you represent. In the bankruptcy of Hostess bakery, one of the company's suppliers continued to ship goods to the bakery, even as it knew Hostess was on the verge of bankruptcy.¹⁴⁶ According to the supplier's manager, § 503(b)(9) keeps businesses operating:

Section 503(b)(9) has encouraged [the supplier] to sell on credit to potential debtors, knowing that the deliveries made within 20 days will be protected [by] an administrative claim. . . . As Hostess Brands edged closer to [its] second filing, [the supplier] was managing our exposure very closely and continued to extend credit to Hostess Brands, knowing that we had § 503(b)(9) available to us. At the time of Hostess Brands' second filing, [the supplier] was owed \$1.6 million, of which \$1.2 million was covered by § 503(b)(9). Without the availability of [a] § 503(b)(9) administrative claim, we would have withdrawn credit to Hostess Brands.¹⁴⁷

From the perspective of the supplier, which benefited from § 503(b)(9) administrative priority, the provision allowed the supplier to continue shipping to the debtor, and potentially kept the debtor in business. On the other hand, creditors who do not benefit from a § 503(b)(9) priority may be wary of debtors that have significant priority claimants. For example, Circuit City's attorneys cited the company's extensive § 503(b)(9) liability as sounding the "final death knell" for its attempt at reorganization.¹⁴⁸

While there may be uncertainty as to § 503(b)(9)'s policy rationale or its practical ramifications, it is certain that § 503(b)(9), like critical vendor orders,

¹⁴³ Gage, *supra* note 141, at 233 n.94; *see also* Ponoroff, *supra* note 22, at 2552 n.146.

¹⁴⁴ Gage, *supra* note 141, at 228–38.

¹⁴⁵ *See* WARREN & WESTBROOK, *supra* note 35, at 467 (blaming trade creditor lobbyists for the enactment § 503(b)(9)).

¹⁴⁶ *ABI Commission Field Hearing Focuses on Unsecured Trade Creditor Issues*, AM. BANKR. INST. J., Aug. 2013, at 8, 8.

¹⁴⁷ *Id.*

¹⁴⁸ *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?*, AM. BANKR. INST. J., Apr. 2009, at 10, 10 (testimony of Richard M. Pachulski, lead counsel to the creditors' committee of Circuit City).

is a dramatic departure from the concept that the bankruptcy filing results in a cleavage between prepetition debts and postpetition debts. Section 503(b)(9) does more than simply move the date of cleavage from the date of the filing of the bankruptcy petition to twenty days earlier—§ 503(b)(9), like critical vendor orders, encroaches on established bankruptcy equality concepts. Section 503(b)(9) vendors are treated much more favorably than both (1) other unsecured creditors who provide value *during* the twenty days before bankruptcy and (2) unsecured creditors who provided value *more than* twenty days before the bankruptcy filing.

This is not the first law review article to make these criticisms of favoring the prepetition claims of certain vendors.¹⁴⁹ Surprisingly, at least to us, there have not been similar criticisms of bankruptcy law favoring the prepetition claims of certain lessors and licensors, which is where we turn next.

V. PREPETITION UNSECURED CLAIMS OF LESSORS

A. *Where Are We Now?*

Bankruptcy law treats a debtor's leases, licenses, and other executory contracts differently from the debtor's other transactions.¹⁵⁰ Section 365 is 3,830 words long¹⁵¹ and uses familiar words in unfamiliar ways.¹⁵² Happily,

¹⁴⁹ See, e.g., Kara J. Bruce, *Rehabilitating Bankruptcy Reform*, 13 NEV. L.J. 174, 212 (2012) (“[T]he best course of action is simply to repeal section 503(b)(9).”).

¹⁵⁰ E.g., 11 U.S.C. § 365 (2012) (laying out the Code provisions relating to executory contracts and unexpired leases).

¹⁵¹ *Id.*

¹⁵² In addition to the text of the Code, this area of the law has been particularly influenced by law professors—a few of the more notable being James MacLachlan, Vern Countryman, and Jay Westbrook. See David G. Epstein & Lisa Normand, “*Real World*” and “*Academic*” Questions About “*Nonmonetary Obligations*” Under the 2005 Version of 365(b), 13 AM. BANKR. INST. L. REV. 617, 617 (2005); David G. Epstein & Steve H. Nichles, *The National Bankruptcy Review Commission’s Section 365 Recommendations and the “Larger Conceptual Issues”*, 102 DICK. L. REV. 679, 682 (1998). A law professor, James Angell MacLachlan, is generally credited for inventing the bankruptcy law of leases and licenses and other “executory contracts,” and for drafting § 70b of the Bankruptcy Act, the predecessor of § 365. See generally James Angell McLaughlin, *Amendment of the Bankruptcy Act*, 40 HARV. L. REV. 583 (1927). Leading law professors of their generations—Vern Countryman and Jay Westbrook—are best known for their articles on § 70b and § 365. David A. Skeel, Jr., *Vern Countryman and the Path of Progressive (and Populist) Bankruptcy Scholarship*, 113 HARV. L. REV. 1075, 1128 (2000). Professor Vern Countryman’s law review articles based on work he did for the Commission to Study the Bankruptcy Laws of the United States led to the widely used “Countryman definition” of executory contracts. See, e.g., *Lewis Bros. Bakeries v. Interstate Brands Corp.* (*In re Interstate Bakeries Corp.*), 690 F.3d 1069, 1073 (8th Cir. 2012), *vacated*, No. 11-1850, 2013 U.S. App. LEXIS 12463 (8th Cir. June 18, 2013); Skeel, Jr., *supra*, at 1076. As stated by Professor Skeel of the University of Pennsylvania Law School:

this essay requires a familiarity only with the first part of § 365(b)(1)(A) which is set out below:

(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—

- A) cures, or provides adequate assurance that the trustee will promptly cure, such default [and] . . .
- C) provides adequate assurance of future performance¹⁵³

For our purposes, “assume” simply means continue, keep, or retain. To illustrate, suppose that Double Dave leases a building and its lease is set to end eleven months after the time of its chapter 11 filing. Under § 365, Double Dave can continue to use the leased premises by satisfying § 365(b)’s requirements for assumption, i.e., cure any default and provide “adequate assurance of future performance.”¹⁵⁴ Similarly, if at the time of Double Dave’s chapter 11 filing, Double Dave is leasing a pizza oven and the lease ends in twenty-two months, Double Dave can continue to use the leased equipment only by satisfying § 365(b)’s requirements for assumption. Or, if Double Dave is the licensee under a software contract and the license expires in thirty-three months, Double Dave can continue to use the licensed software only by satisfying § 365(b)’s requirements for assumption. While other parts of § 365 distinguish leases of personal property from leases of real property and from licenses, § 365(b) does not. In this essay, we discuss § 365(b)’s requirements for assumption of an equipment lease. Section 365(b)’s requirements would be the same for assumption of a building lease.

Again, one of § 365(b)’s requirements for assumption is curing any prepetition defaults. If Double Dave’s equipment lease provides for monthly rental payments of \$100 and, before filing its chapter 11 petition, Double Dave

If bankruptcy scholars playing a word association game were asked what words came to mind when they thought of Vern Countryman, nearly every one would respond with the same two words: executory contracts. In 1973, Countryman wrote an article concluding that a contract should be viewed as executory (a designation that has enormous consequences in the technical world of bankruptcy)

Id. Additionally, law journals have widely cited Professor Jay Westbrook’s article urging the elimination of the term “executory contract” and a clarification of the consequences of rejection.

¹⁵³ 11 U.S.C. § 365(b)(1).

¹⁵⁴ *Id.* § 365(b)(1)(A), (C).

missed three monthly \$100 payments, Libby¹⁵⁵ would have a \$300 prepetition unsecured claim. Under § 365(b)(1)(A), Double Dave would have to pay that \$300 prepetition unsecured claim in cash in full promptly¹⁵⁶ even though Double Dave's lenders, service providers, and others holding prepetition unsecured claims would not be paid until confirmation of Double Dave's chapter 11 plan. In most chapter 11 cases, no plan is ever confirmed,¹⁵⁷ and when a plan is confirmed it rarely provides for full cash payments to holders of unsecured claims. Additionally, under § 365(b)(1)(C), Double Dave would also be required to continue making postpetition lease payments as they become due.¹⁵⁸ For example, if there were twenty-two monthly payments of \$100 remaining, Double Dave would have to make those payments as each becomes payable.

That part of § 365(b) makes sense to us. The Code's requirement of payment of rent that becomes due after the petition was filed seems consistent with the cleavage effect of a bankruptcy filing. But why should a lessor's unsecured claim for rent that accrued prepetition be treated more favorably than other prepetition unsecured claims against Double Dave?

This disparate treatment of a prepetition unsecured claim arising from a lease seems especially problematic when compared with the treatment of a prepetition unsecured claim arising from a sale of equipment to Double Dave on credit. Assume that instead of leasing the equipment from Libby, Double Dave bought the equipment on credit from *S*, granting *S* a security interest in the equipment. The credit sale payments are \$150 a month. Double Dave failed to make the payments for the two months immediately preceding the bankruptcy filing, and, after filing for bankruptcy, there are ten monthly payments of \$150 that will accrue postpetition. Again, assume that Double Dave wants to keep the equipment. In this situation, *S* has a claim for \$300 that accrued prepetition in the Double Dave credit sale hypothetical, the same as Libby had in the lease hypothetical. And, if as almost always happens in the real world, the replacement cost of comparable equipment is \$1,500 or less,

¹⁵⁵ Recall from Part III that Libby is Double Dave's lessor.

¹⁵⁶ The statute uses the word "cure." 11 U.S.C. § 365(b)(1)(A).

¹⁵⁷ Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603, 615 (2009) (showing confirmation rates of 30.3% in 1994 and 33.4% in 2002 from empirical studies).

¹⁵⁸ The requirement of future performance, as laid out in § 365(b)(1)(C), requires continuing payments of rent as each payment becomes due. 11 U.S.C. § 365(b)(1)(C).

that claim for \$300 is an unsecured prepetition claim.¹⁵⁹ In sum, *S* has a secured claim measured by the value of its collateral and an unsecured claim for the difference between the amount owed and the value of the collateral.

Double Dave's ability to keep the equipment it is buying on credit from *S* depends solely on its ability to satisfy *S*'s secured claim. To keep the equipment, Double Dave is not required to pay that \$300 unsecured prepetition claim in full in cash.¹⁶⁰ Instead, to satisfy *S*'s secured claim and keep the equipment, Double Dave is required only to make payments under its chapter 11 plan to *S* that have a present value equal to the replacement cost of the equipment.¹⁶¹ *S*'s unsecured claim will be treated no differently from any of the other prepetition unsecured claims against Double Dave, except for Libby's unsecured claim for rent that accrued prepetition.

Again, we question why § 365(b)(1)(A) always treats the unsecured prepetition claim of a lessor, like Libby, differently from other unsecured prepetition claims?

B. How Did We Get to Where We Are Now?

1. The Bankruptcy Act of 1898

The Bankruptcy Act of 1898 did not say anything about leases until the 1938 amendments added § 70b.¹⁶² Like § 365(b) of the 1978 Code, § 70b provided for the possibility of assumption.¹⁶³ Unlike § 365(b), § 70b does not say anything about the requirements for assumption nor do any of the few reported judicial decisions under § 70b.¹⁶⁴

More important than what § 70b did not say about the requirements for assumption is what § 70b did say about the enforceability of provisions in

¹⁵⁹ Under the first sentence of § 506 of the Code, the amount of *S*'s secured claim depends on the value of *S*'s collateral. *See id.* § 506(a)(1). And under the second sentence of § 506(a)(1) and *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 953–54 (1997), the value of equipment that the debtor wants to retain is measured by what it would cost to replace with comparable equipment. Here, if the value of the collateral is less than \$1,500, then the postpetition payments that accrue will exceed the value of the collateral. Thus, the remaining \$300 prepetition claim is unsecured for the amount that it exceeds the value of the collateral.

¹⁶⁰ 11 U.S.C. § 365(b)(1)(A) (“promptly cure . . . such default”).

¹⁶¹ *See id.* § 1129(b)(2)(A)(i)(II).

¹⁶² Act of June 22, 1938, ch. 575, Pub. L. No. 696, § 70b, 52 Stat. 840, 880–81 (repealed 1978).

¹⁶³ *Id.*

¹⁶⁴ Until West started publishing its West's Bankruptcy Reporter in January 1980, bankruptcy judges' opinions were not generally available.

leases that terminated the lease when the lessee filed for bankruptcy. Section 70b expressly made such bankruptcy termination clauses, also known as ipso facto clauses, enforceable in bankruptcy.¹⁶⁵

Such ipso facto clauses were common in commercial leases and, in essence, left the bankrupt¹⁶⁶ with nothing to assume. Accordingly, bankruptcy court opinions regarding the requirements for assumption not only were not reported but were virtually non-existent. Responding to the effect of lease termination as a result of bankruptcy filing, dictum in the Fifth Circuit Court of

¹⁶⁵ The words of § 70b are clear: “[A]n express covenant that . . . the bankruptcy of a specified party . . . shall terminate the lease or give the other party an election to terminate the same shall be enforceable.” Act of June 22, 1938, ch. 575, 52 Stat. 840, 880–81. The case law, particularly in the Second, Third and Fourth Circuits became less clear in the 1960’s and 1970’s. All three circuits refused to enforce ipso facto clauses in bankruptcy. In so ruling, these cases relied on dicta from Supreme Court decisions rather than statutory language. *See, e.g.,* *Queens Boulevard Wine & Liquor Corp. v. Blum*, 503 F.2d 202 (2d Cir. 1974); *Weaver v. Hudson*, 459 F.2d 741 (4th Cir. 1972); *In re Fleetwood Motel Corp.*, 335 F.2d 857 (3d Cir. 1964). In *Finn v. Meighan*, 325 U.S. 300 (1945), the Supreme Court determined that § 70b was applicable to Chapter X reorganization proceedings, making the bankruptcy termination clause in the lease enforceable. The Court went further to note that bankruptcy courts are not favorable to forfeiture clauses, which should be construed liberally to avoid depriving the estate of a valuable asset. While *Finn* stands for the enforceability of ipso facto clauses, the Court in dicta also discussed three important equity considerations: (1) the lack of favor shown to forfeiture provisions, (2) the detriment that enforcement poses to reorganization, and (3) the need to apply § 70b so as to be consistent with other provisions in the Act. *Id.* at 301–02.

A year later the Supreme Court found that § 70b was applicable in railroad reorganizations, but because § 77(l) required a determination to be made by the Interstate Commerce Commission (“ICC”), the enforceability of the forfeiture clause was not automatic. *Smith v. Hoboken R.R., Warehouse & S.S. Connecting Co.*, 328 U.S. 123, 131–33 (1945). The ICC was tasked with considering the public interest affected by the enforcement of the ipso facto clause, as well as the feasibility of the plan. These considerations imposed by § 77 were such that they could have “prevent[ed] enforcement of the engagements of the debtor pursuant to their terms.” *Id.* at 133.

The Supreme Court’s decision in *Smith* in declining to enforce valid ipso facto provisions was followed by the circuit courts in *In re Fleetwood Motel* and *Weaver*. The court in *Fleetwood Motel*, mentioning the inherent equity powers of the court, drew from *Smith*’s consideration of both public interest and the slim possibility of a successful reorganization following a forfeiture in declining to enforce an ipso facto clause. *Fleetwood Motel Corp.*, 335 F.2d at 861–62. Similarly, the *Weaver* court denied the petitioner’s request to enforce an ipso facto clause because a “forfeiture would remove the entire res from the estate of the debtor.” *Weaver*, 459 F.2d at 744.

In 1974, the Second Circuit Court of Appeals tackled a similar question and relied not only on *Finn* and *Smith* but also on *Fleetwood* and *Weaver*. *Queens Boulevard Wine & Liquor Corp.*, 503 F.2d at 205–07. The majority in *Queens Boulevard Wine & Liquor Corp.* held that a lease termination provision was invalid in bankruptcy “when compelling equitable and policy considerations so require.” *Id.* at 206. There was a strong dissent in *Queens Boulevard*; Judge Hays wrote: “[Section 70b] states clearly that a covenant like the one used here is enforceable. . . . The claim that a liquor store involves the public interest is frivolous. . . . If [70b] does not apply here, it is hard to imagine a case where it would apply.” *Id.* at 207 (Hays, J. dissenting).

¹⁶⁶ Under the Bankruptcy Act of 1898, unlike present day bankruptcy law, there were “bankrupts.” Bankruptcy Act of 1898, ch. 541, § 1(4), Pub. L. No. 696, 30 Stat. 544, 544 (repealed 1978) (“‘Bankrupt’ shall include a person . . . who has filed a voluntary petition.”).

Appeals opinion in *Good Hope Refineries, Inc. v. Benavides*,¹⁶⁷ counseled: “[A] prudent man who plans to file a Chapter XI petition tomorrow, uses a cashier’s check to make an important payment today.”¹⁶⁸

2. *The Bankruptcy Code of 1978*

The Brookings Institution established a task force to study bankruptcy laws in 1965.¹⁶⁹ The Brookings report, published in 1971, concluded, “The total bankruptcy system gets its job done according to the literal requirements of the law, but it is a dreary, costly, slow and unproductive process.”¹⁷⁰ With those concerns in mind, in 1970, Congress created the Commission on the Bankruptcy Laws of the United States to study and report on existing law.¹⁷¹ According to Professor Frank Kennedy, the executive director of the Commission, the Brookings report’s findings and recommendations were “inputs of value and influence in the preparation of the Commission’s report.”¹⁷²

The Brookings report does not address the law of leases, licenses, and other executory contracts. The Commission’s report does. The Commission filed its two-part report in 1973. The first part of the report included an evaluation of the then-present bankruptcy system and general recommendations of changes.¹⁷³ The second part of the report included a completely new bankruptcy law with explanatory notes.¹⁷⁴ Section 4-602(b)(2) of the Commission’s proposed law expressly required past defaults be cured before a debtor could assume a lease that had a bankruptcy termination clause:

(b) *Unenforceability of Certain Contract Provisions.* A provision in a contract or lease . . . which terminates . . . the contract or lease because of . . . the commencement of a case under this Act . . .

¹⁶⁷ 602 F.2d 998 (5th Cir. 1979).

¹⁶⁸ *Id.* at 1003.

¹⁶⁹ See David T. Stanley, *The Brookings Institution Study of Problems of Bankruptcy*, 71 COM. L.J. 136, 136 (1966).

¹⁷⁰ DAVID T. STANLEY & MARJORIE GIRTH, *BANKRUPTCY: PROBLEM, PROCESS, REFORM* 197 (1971).

¹⁷¹ Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468.

¹⁷² Frank R. Kennedy, *The Background of the Bankruptcy Reform Act of 1978*, 1979 ANN. SURV. BANKR. L. 1, 5.

¹⁷³ COMM’N ON THE BANKR. LAWS OF THE U.S., *supra* note 24.

¹⁷⁴ COMM’N ON THE BANKR. LAWS OF THE U.S., REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. II (1973), *reprinted in* 2 *BANKRUPTCY REFORM ACT OF 1978: A LEGISLATIVE HISTORY*, DOC. 22 (Alan N. Resnick & Eugene M. Wypyski eds. 1979).

(1) is enforceable in a case under Chapter V [Liquidations],
but

(2) is not enforceable in case under Chapter . . . VII
[Reorganizations] . . . to prevent assumption . . . if, when the
contract or lease is assumed . . . or within a reasonable time
thereafter, any defaults in prior performance of the debtor are
cured¹⁷⁵

Notice that under the Commission’s proposed law, (1) ipso facto clauses were valid in liquidation cases (modern chapter 7 cases) and invalid in reorganization cases (modern chapter 11 cases) and (2) the debtor was only required to cure defaults if the lease, license, or other executory contract contained an ipso facto clause.

This link between the elimination of ipso facto clauses and imposition of an obligation to cure defaults was reinforced by the Commission’s note 11 to § 4-602. It provides in pertinent part: “Clause 2 of subdivision (b) does impose, *in place of* any rights a nonbankrupt party may or may not have under the contract or lease or under applicable nonbankruptcy law, certain obligations. In order to assume a contract or lease, past defaults must be cured”¹⁷⁶ Notice the italicized phrase “in place of.” In effect, the Commission traded payment of missed prepetition rents in full for invalidation of ipso facto clauses.

The law enacted by Congress in 1978 differs significantly from the law proposed by the Commission on the Bankruptcy Laws of the United States. With respect to assumption of leases, licenses and other executory contracts, (1) the Code invalidates ipso facto clauses in all bankruptcy cases—liquidation as well as reorganization¹⁷⁷—and (2) the Code requires payment in full of missed prepetition rent even if the assumed lease or contract did not have an ipso facto clause.¹⁷⁸ Nonetheless, Congress’s “explanation” of § 365(b), like the explanation for § 4-602, links payment of the prepetition claim to invalidation of ipso facto clauses. The limited, relevant legislative history states:

The unenforceability of ipso facto or bankruptcy clauses proposed under this section will require courts to be sensitive to the rights of the nondebtor party to executory contracts and unexpired leases. If

¹⁷⁵ *Id.* at 152–53.

¹⁷⁶ *Id.* at 156 (emphasis added).

¹⁷⁷ 11 U.S.C. § 365(e) (2012).

¹⁷⁸ *Id.* § 365(b)(1)(A).

the trustee is to assume a contract or lease, the courts will have to insure [sic]¹⁷⁹ that the trustee's performance under the contract or lease gives the other contracting party the full benefit of his bargain.¹⁸⁰

Again, we can understand the politics of give and take. We just cannot understand the policy basis for requiring that unsecured claims for prepetition missed rent must be paid in full. We cannot understand why a lessor must get the "full benefit of his bargain" when no other holder of a prepetition unsecured claim gets the full benefit of its bargain.

3. *Subsequent Review Commissions*

Since 1978, there have been two different organizations—the National Bankruptcy Review Commission ("Second Commission) and the National Bankruptcy Conference ("NBC")—that engaged in comprehensive review of the Code and published lengthy reports.¹⁸¹ The more frequently cited report is the 1997 Report of the Second Commission.

In 1994, Congress created the Second Commission as a part of what was called the Bankruptcy Reform Act of 1994.¹⁸² In 1997, the Second Commission published a 1,028-page report with more than two hundred additional pages of individual commissioners' views.¹⁸³ The Second Commission's only recommendation with respect to assumption of leases and contracts was that "[a]ssumption' should be replaced with 'elect to perform' in Section 365."¹⁸⁴ Congress ignored this recommendation, like virtually all of the Second Commission's recommendations.

The NBC began a Code review project in 1988 that culminated in a published report in 1997.¹⁸⁵ While the NBC's report is significantly shorter

¹⁷⁹ The author probably meant "assure." *In re Luce Indus., Inc.*, 8 B.R. 100, 107 n.7 (Bankr. S.D.N.Y. 1980).

¹⁸⁰ H.R. REP. NO. 95-595, at 348 (1977); S. REP. NO. 95-989, at 59 (1978).

¹⁸¹ A third organization, the American Bankruptcy Institute ("ABI"), is currently conducting a comprehensive review of chapter 11 of the Bankruptcy Code. See Press Release, House Judiciary Committee to Hold Hearing on Chapter 11 Bankruptcy (Mar. 25, 2014), <http://judiciary.house.gov/index.cfm/2014/3/house-judiciary-committee-to-hold-hearing-on-chapter-11-of-the-bankruptcy-code>.

¹⁸² Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (amending Bankruptcy Act of 1978).

¹⁸³ 1 NAT'L BANKR. REVIEW COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS 1029-1303 (2007).

¹⁸⁴ *Id.* at 463.

¹⁸⁵ The NBC is a non-profit voluntary association of judges, professors, and practicing attorneys from all parts of the United States. The Conference was founded in the mid-1930's to promote the improvement of the

than the Second Commission's report, it provides a much more complete set of recommendations relating to leases and licenses.

The NBC report recommends “[s]ection 365(b)’s requirements for assumption of executory contracts should be retained.”¹⁸⁶ The NBC provided two separate justifications for § 365(b)’s requiring payment of a lessor’s prepetition unsecured claim. The first justification differentiates creditors who are parties to executory contracts from other unsecured creditors based on the requirement of future performance under the contract. The second justification focuses on the normative claim that the estate should not be allowed to take the benefit of the contract without also assuming the burdens entailed in its original agreement. As stated by the NBC, the two justifications run together:

A nondebtor party to an executory contract is, with respect to *prepetition amounts* owed to it, different from other unsecured creditors of the debtor. The difference is that, under state contract law, typically the non-debtor party has no duty to continue performing its obligation under the contract if the debtor falls into default. Thus, to permit the estate to ‘assume’ the contract without curing existing defaults would be precisely the equivalent of forcing the non-debtor (or any other third party) to enter into an entirely new contract to furnish new value to the estate, on terms to which it does not agree. The estate should not have such a right to take the benefits of a contract without its burdens.¹⁸⁷

We have three problems with the NBC’s first justification for § 365(b)’s requiring payment of prepetition defaults: (1) the idea that assumption of an executory contract provides new value to the estate; (2) the reference to other third parties; and (3) the idea that debtors would take the benefit of the bargain without its burdens. First, we disagree with the idea that the nondebtor party to an executory contract provides “new value . . . on terms to which it does not agree.”¹⁸⁸ The lessor is simply providing the “value” agreed upon in the prepetition lease, on the terms agreed upon in the prepetition lease. The Code expressly conditions assumption on “future performance under such contract or

bankruptcy laws and their administration. Since then, the Conference, which meets twice a year, has been consistently active in the bankruptcy legislative process. See Alan N. Resnick, *Symposium Mass Torts: Bankruptcy as a Vehicle for Resolving Enterprise-Threatening Mass Tort Liability*, 148 U. PA. L. REV. 2045, 2047 n.8 (2000).

¹⁸⁶ NAT’L BANKR. CONFERENCE, REFORMING THE BANKRUPTCY CODE, THE NATIONAL BANKRUPTCY CONFERENCE CODE REVIEW PROJECT 137 (rev. ed. 1997).

¹⁸⁷ *Id.*

¹⁸⁸ *Id.*

lease.”¹⁸⁹ Moreover, cases and commentary consistently construe that quoted phrase as barring the debtor from varying from the agreed upon lease terms.¹⁹⁰ The concern identified by the NBC is properly addressed by the Code and its point is moot.

Second, the NBC’s addition of the phrase “any other third party”¹⁹¹ when admonishing any rule that would require a nondebtor to furnish new value to the estate suggests that the Code prohibits all changes to contractual terms. Prepetition sellers on credit would disagree with any such suggestion. Recall that Double Dave’s contract with *S* obligated Double Dave to make ten more monthly payments of \$150 and empowered *S* to repossess the equipment if Double Dave did not fulfill that contract obligation.¹⁹² In bankruptcy, Double Dave can retain the equipment without fulfilling its prepetition contract obligations.¹⁹³ Moreover, Double Dave can cramdown changes in its contract payment obligations to credit sellers.¹⁹⁴

We are not arguing that Double Dave should be empowered to make similar changes in its postpetition obligations to lessors, such as Libby.¹⁹⁵ Rather, we are simply questioning why lessors’ claims based on prepetition rent defaults should be treated differently from other prepetition unsecured claims.

Third, we reject the NBC’s suggestion that, if the Code did not require debtors such as Double Dave to cure prepetition lease defaults, debtors would “take the benefits of a contract without its burdens.”¹⁹⁶ As noted previously

¹⁸⁹ 11 U.S.C. § 365(b)(1)(C) (2012).

¹⁹⁰ *E.g., In re Smith*, 449 B.R. 35, 40 (Bankr. E.D. Pa. 2011) (“[W]hile the Bankruptcy Code permits a . . . debtor to modify the rights of certain holders of secured claims, since the Movants are parties to an unexpired lease . . . , the Debtor is not entitled to modify the terms of the Lease . . .”).

¹⁹¹ NAT’L BANKR. CONFERENCE, *supra* note 186.

¹⁹² *See supra* Part V.A.

¹⁹³ *See* 11 U.S.C. § 1129(b)(2)(A)(i)(I).

¹⁹⁴ *See id.* § 1129(b).

¹⁹⁵ Professor Ken Klee has made such an argument:

[I]t seems unfair to permit the proponent of a plan to rewrite the covenants in a secured debt instrument to change the payment periods and interest rates for a secured creditor, but not to permit that to be done for a party with a contractual right under a contract or a true lease.

ALI-ABA WILLIAMSBURG CONFERENCE ON BANKRUPTCY: CONCLUSIONS OF THE PANELS AND TRANSCRIPT OF PROCEEDINGS 82 (1989). *See also* Margaret Howard, *Equipment Lessors and Secured Parties in Bankruptcy: An Argument for Coherence*, 48 WASH. & LEE L. REV. 253 (1991) (arguing that “analysis of the various interests of lessors and secured parties demonstrates no differences between them sufficient to justify the divergent treatment bankruptcy accords.”).

¹⁹⁶ NAT’L BANKR. CONFERENCE, *supra* note 186.

(and, we acknowledge, repeatedly), the Code conditions a debtor's assumption of a lease on "future performance."¹⁹⁷ If Double Dave wants the benefit of retaining the leased equipment, then Double Dave must continue making the remaining twenty-two monthly rent payments of \$100 each. That is the burden commensurate with the benefit. Just as we are unpersuaded by the NBC's first justification for requiring payment of lessors' prepetition unsecured claims, we are also unpersuaded by its second. The NBC's second justification for § 365(b)'s requiring payment of a lessor's prepetition unsecured claim is premised on the possibility that the postpetition burden will not always be commensurate with the postpetition benefit. For its second justification, the NBC asks, "What if the bulk of the debtor's performance was to have already occurred (prepetition) and most of the nondebtor party's performance is yet to occur (postpetition)?"¹⁹⁸

The NBC is hypothesizing that Double Dave's lease agreement with Libby does not provide for equal monthly payments of \$100. Instead the lease is "front-loaded." An example of a front-loaded lease is a lease requiring four monthly payments of \$2,000 and then twenty-two payments of \$30. If Double Dave files for bankruptcy four months after entering into such a lease, after missing three of the first four monthly payments of \$2,000, then Double Dave's postpetition burden would indeed not be commensurate with Double Dave's postpetition benefits.

We cannot definitively state how often such front-loaded leases and contracts are used. However, even without any empirical research, we can definitely state that such front-loaded leases and contracts are the exception. And in this situation, the exception does not *prove* the rule.¹⁹⁹

¹⁹⁷ See 11 U.S.C. § 365(b)(1)(C).

¹⁹⁸ NAT'L BANKR. CONFERENCE, *supra* note 186, at 137–38.

¹⁹⁹ See Dana Ziker, *What Lies Beneath: An Examination of the Underpinnings of Dietary Supplement Safety Regulation*, 31 AM. J.L. & MED. 269, 282 n.102 (2005). According to Ms. Ziker, the common expression "the exception proves the rule" is actually a misstatement of the original Latin *exceptio probat regulam*, which translates to the more logical maxim "the exception probes the rule." The Latin *probare*, a root for both the "prove" and "probe," means to test or examine. Ms. Ziker relies on Dr. Madsen Pirie who explains:

The origin of the fallacy lies in the changing uses of language. The word "prove," which is now taken to refer to establishing something beyond doubt, used to mean "test." Something would be "proved" to establish its quality; and this is the sense which has passed down to us in this fallacy. The exception puts the rule to test and, if it is found to be a valid exception, refutes it instead of proving it in the modern sense of the word.

Id. (citing MADSEN PIRIE, *HOW TO WIN EVERY ARGUMENT: THE USE AND ABUSE OF LOGIC* 63 (2006)); cf. Michael G. Walsh, *Lawyerly Clichés and Their Origins (A-G)*, EXPERIENCE, Spring 2006, at 23, 26; Philip

Section 365(b)'s requirement that prepetition defaults be cured, like § 503(b)(9)'s priority rule regarding twenty-day vendors and like critical vendor orders,²⁰⁰ is inconsistent with the basic bankruptcy building blocks of (1) the filing of a bankruptcy petition as effecting a cleavage and (2) the principle of equality of distribution.

VI. NU?²⁰¹

We believe that Congress should consider business bankruptcy reform. More importantly, so do the 150-plus leading bankruptcy professionals²⁰² who are spending tens of thousands of non-billable hours on the ABI's Commission to Study the Reform of Chapter 11.²⁰³

When Congress focuses on business bankruptcy, it should consider the question of whether the prepetition unsecured claims of vendors and lessors should always be treated more favorably than other prepetition unsecured claims. Congress should consider this as part of the broader question of

Bobbitt, *American Exceptionalism: The Exception Proves the Rule*, 3 U. ST. THOMAS L.J. 328 (2005) ("As a statement about proof, the phrase 'the exception proves the rule is nonsense.'").

The expression *the exception proves the rule*, which I confess never made a great deal of sense to me, means that although something may not conform to the general rule, the rule is still valid. The term is thought to have originated in the 1500s. Playwright Thomas Heywood used it in *The Rape of Lucrece* (1608) when he wrote, "If the general rule have no exceptions, thou wilt have an empty consistory."

Walsh, *supra*. But cf. Christopher C. French, *Debunking the Myth that Insurance Coverage Is Not Available or Allowed for Intentional Torts or Damages*, 8 HASTINGS BUS. L.J. 65, 67 (2012) ("As Cicero is often quoted as saying, the exception proves the rule.").

²⁰⁰ See *supra* Part IV.

²⁰¹ For any readers who are culturally challenged the Yiddish term *nu* (which rhymes with you) is very hard to define because it has so many meanings. Probably the most common meanings of *nu* are "and so?" and "so what?" Michael Wex, *Just Say 'Nu?': Nu!*, JEWISH DAILY FORWARD (Feb. 20, 2008), <http://forward.com/articles/12736/just-say-nu->. But cf. Macmillan Audio, *Just Say Nu by Michael Wex—Audiobook Excerpt*, YOUTUBE (Apr. 12, 2012), <https://www.youtube.com/watch?v=IphFag2jYDU>.

²⁰² See *Chapter 11 Commission Continues Work*, AM. BANKR. INST. J., Oct. 2012, at 10, 10 (listing 138 bankruptcy professionals working on committee reports for the Commission); Michelle M. Harner, *ABI Commission to Study Reform of Chapter 11 Will Meet in April*, AM. BANKR. INST. J., Apr. 2012, at 12, 124 (listing seventeen other bankruptcy professionals working on committee reports for the Commission).

²⁰³ The ABI's Commission was formed in 2012 and issued reports on its findings in 2014. A more cynical explanation of the Commission's willingness to spend this time is the continuing decline in the number of chapter 11 cases and the lack of billable work opportunities. But see *Commission Hears Testimony on CROs, Trustees and Management Retention*, AM. BANKR. INST. J., Dec. 2013, at 10, 91 (quoting Brady C. Williamson, "I think that [the ABI Commission's Chapter 11 reform project] may be a very frustrating, if not futile, endeavor because the fact remains that this Congress and the next Congress and the next Congress are, I want to be kind, highly unlikely to pass any legislation.").

whether fewer bankruptcy issues should be resolved by the application of statutory mandates and, instead, should be resolved by the exercise of judicial discretion.²⁰⁴

With all due respect to Congress, the question of whether the prepetition unsecured claims of vendors and lessors should be treated more favorably than other prepetition unsecured claims should be left to the discretion of bankruptcy judges. Permitting bankruptcy judges to deviate from basic bankruptcy concepts in a particular case because of the special facts of that case is more defensible than Congress's creation of blanket rules for all cases that are inconsistent with basic bankruptcy concepts. Close observers of the bankruptcy process praise the quality of today's bankruptcy judges²⁰⁵ and the selection process that facilitates the selection of highly qualified judges who are free from bias.²⁰⁶ We are not aware of similar complimentary comments about today's Congress or the process by which members of Congress are selected.

There will probably be people who protest our reform agenda. We are aware of the critical comments about Congress's last major bankruptcy initiative in the 2005 amendments, which is commonly referred to as BAPCPA. The 2005 amendments focused on consumer bankruptcy law. Among the more temperate criticisms were the comments of Harvey Miller, who is generally regarded as the dean of the bankruptcy bar.²⁰⁷

Perhaps the biggest special interest victory is the ill-conceived Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") The BAPCPA was enacted after four or more years of intensive and expensive lobbying by the credit card industry,

²⁰⁴ Cf. Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 698 (2010) ("[T]he standard academic critique of bankruptcy judges is that they exercise too much discretion and are too quick to depart from the strict letter of the law.").

²⁰⁵ See, e.g., Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 92 (2004) ("Modern bankruptcy judges have become effective and highly competent professionals."). But cf. Ted Janger, *Crystals and Mud in Bankruptcy Law: Judicial Competence and Statutory Design*, 43 ARIZ. L. REV. 559, 561 (2001).

This distrust of judges is evident in the recent bankruptcy reform efforts and in recent bankruptcy scholarship of the 'Law and Economics' stripe. These legislators and scholars use the supposed incompetence of bankruptcy judges as a principal basis for arguments in favor of limiting the goals of bankruptcy law and curbing the discretion of bankruptcy judges.

Id.

²⁰⁶ Rafael I. Pardo, *The Utility of Opacity in Judicial Selection*, 64 N.Y.U. ANN. SURV. AM. L. 633 (2009).

²⁰⁷ Nelson D. Schwartz & Julie Creswell, *Who Knew Bankruptcy Paid So Well?*, N.Y. TIMES (May 2, 2010), http://www.nytimes.com/2010/05/02/business/02workout.html?pagewanted=all&_r=0.

estimated at \$50 to \$60 million. . . . The BAPCPA fulfilled a long-standing desire on the part of special interest groups to limit the discretion of the bankruptcy court and thereby reduce the flexibility of the court to meet the needs of rehabilitation and reorganization of a debtor.²⁰⁸

We are aware of the body of work of Professor LoPucki alleging that some bankruptcy judges are under substantial pressure to attract big cases to their courts, as some judges have changed substantive rules to attract cases.²⁰⁹ Also, we are aware of the many responses countering Professor LoPucki's allegation.²¹⁰ We acknowledge that there is at least a chance that some bankruptcy judges will be influenced by a drive to get more big cases.²¹¹

In sum, it all comes down to the chance of some²¹² bankruptcy judges being influenced by what it takes to get big cases or the certainty of Congress being influenced by lobbyists. Those who are mindful of Anna Nicole Smith's body of work, and not just the work on her body, will remember her immortal line from the classic motion picture, *To the Limit*, in which Smith starred as CIA agent Collette DuBois and said, "I will take that chance."²¹³

²⁰⁸ Harvey R. Miller, *Chapter 11 in Transition—From Boom to Bust and into the Future*, 81 AM. BANKR. L.J. 375, 388 (2007).

²⁰⁹ See LYNN M. LOPUCKI, *COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS* 250 (2005).

²¹⁰ See, e.g., Robert D. Martin, Commentary, *Courting Failure? The Effects of Venue Choice on Big Bankruptcies*, 54 BUFF. L. REV. 503–04 (2005) (describing the character of the bankruptcy bench as too high for incentives to get big cases to sway their decisions).

²¹¹ Cf. Lynn M. LoPucki, Response, *Where Do You Get off? A Reply to Courting Failure's Critics*, 54 BUFF. L. REV. 511, 514–15 (2006).

²¹² And how many is some? The overwhelming majority of the 10,000 or so chapter 11 cases filed each year are small business cases—local restaurants, plumbing subcontractors, and theaters. Most bankruptcy judges never see any other kind of chapter 11 cases. See Rafeal Efrat, *The Tax Burden and the Propensity of Small-Business Entrepreneurs to File for Bankruptcy*, 4 HASTINGS BUS. L.J. 175, 177–78 (2008).

²¹³ *TO THE LIMIT* (Retro Media 1995). Ms. Smith recites the line after being warned about the risks of her confronting the villain, Arthur Jameson (who looks sort of a like a bald, bearded, and tattooed Governor Rick Perry—with a better memory, of course). That line can be heard one hour and twenty-eight minutes into the movie. If you stop after hearing the line and verifying that we did not make this up, then you will miss the unintentionally poignant last bit of "dialogue" in the film in which Anna Nicole Smith says, "The name is not DuBois, it is Vickie Lynn." *Id.*