CREDITORS' RIGHTS IN BANKRUPTCY

SECOND EDITION

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Preface to Second Edition

The first edition of this text was written after adoption of the Bankruptcy Reform Act on November 6, 1978, but before its effective date on October 1, 1979, and was by necessity directed to what the law would be as a result of the impact of the new statutes on existing practice. This second edition was written after years of experience in working with the Bankruptcy Code and the related provisions of the Reform Act and is directed to law and practice as it has developed in cases and in subsequent legislation.

Recently Eric E. Sagerman and David Neier have become co-authors of this text at my suggestion. We have been law partners for many years and are looking forward to a collaborative effort with respect to updates and revisions of this text and to the preparation of annual supplements.

Certain aspects of the bankruptcy law have proved troublesome and at least one is likely to remain so. The high hopes for an independent bankruptcy court have faded as a result of the Marathon decision of the Supreme Court and the subsequent refusal of Congress to create Article III bankruptcy judges. The reference system that was adopted in 28 U.S.C.A. § 157 leaves bankruptcy judges as second class judicial citizens. There appears, however, to be little prospect of change. Section 365 of the Code, which deals with executory contracts and unexpired leases, has been amended a number of times at the request of special interest groups urging concerns of varying degrees of legitimacy. The result is a hodge-podge that does not fully address some important questions in bankruptcy administration.

To a great extent the problem concerning bankruptcy legislation has been exacerbated by the way the Congress has operated in recent years. The partial collapse of the committee system and the influence of campaign contributions have resulted in bankruptcy legislation that has not been reviewed by committees that understand the basic policies in bankruptcy law and the various constituencies to be served. The result has been a number of one-dimensional amendments with unfortunate side effects that were inadvertently or intentionally not thought through prior to enactment. The most recent significant legislative effort is

the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. In addition to being an example of the tendency of Congress to name legislation with questionable accuracy, the 2005 Act fell far short of addressing some of the shortcomings of the Bankruptcy Code and the Reform Act and added a few new shortcomings of its own. These remain to be considered on another day.

Notwithstanding these problems, in the main the Bankruptcy Reform Act and the Bankruptcy Code, as amended, have worked well. Uncertainty concerning the treatment of secured creditors at the outset of the case has been replaced by a workable system involving the automatic stay, the right to use collateral, and the right to obtain new credit secured by a lien with a priority over existing liens. These intrusions upon the rights of secured creditors have been balanced by a requirement that the rights of the secured creditor in its collateral be adequately protected. The combination of three business rehabilitation chapters into Chapter 11 has been generally successful, with Chapter 11 meeting the needs of both small business entities and some of the largest corporations in the country, although the courts are still developing approaches to emergency sales of substantial business as going concerns where there is insufficient time to go through the plan process. The consumer bankruptcy reforms of the Code and the 2005 Act have generally served to enhance the availability of relief to honest debtors who are willing and able to make payments to their creditors.

In the preparation of much of this edition and of the supplements and revisions we have had the able assistance of our administrative assistant, Cindy Paulus. We are grateful for her efforts.

Finally, we would like to express our thanks to our partners and associates, professional colleagues and friends, and worthy opponents in cases. All have helped to develop our thinking on what the bankruptcy law is, and should be.

Patrick A. Murphy

Eric E. Sagerman

David Neier

October 2013

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Preface to First Edition

During my participation in numerous continuing legal education programs on insolvency law over the last half-dozen years, I could not help but notice that, while most programs were directed to the topic of insolvency generally and included extended discussion of matters of interest only to counsel for debtors, the vast majority of the audience had represented and were likely to represent only creditors. The disproportionate number of lawyers who represent creditors results from the nature of a major reorganization case which involves only one debtor but many hundreds or thousands of creditors. While there are a number of books and treatises on the subject of insolvency law, none to my knowledge is directed toward the problems of creditor representation. This text is an attempt to fill that void.

The reader is advised that I was involved in the drafting and legislative process with respect to the Reform Act and the new Bankruptcy Code on behalf of lenders and served as co-counsel to the American Banker's Association Task Force on Bankruptcy.

However, experience has taught me that an insolvency problem almost always involves two people who have made a mistake, the debtor and the creditor. Further, we have come a long way from the days when collateral consisted of fixed assets subject to a single lien or mortgage in favor of a creditor. Today, floating liens on shifting masses of collateral are present in virtually every case, often in several layers. There can be little doubt that the ease and flexibility of modern secured transactions made possible by the general adoption of the Uniform Commercial Code has been a positive development, making financing available to a much wider range of business ventures. In the majority of cases, these developments have required that secured and unsecured creditors develop means of realizing upon going concern values. Accordingly, counsel for creditors must recognize that rehabilitation of a business will often be the only way to recover their client's loan and that blind insistence on a liquidation and rigid enforcement of contractual remedies will seldom serve their client's interests.

I have made no attempt in this text to offer a general survey of all insolvency law. Some specialized subjects such as railroad reorganization and commodity broker and stockbroker liquidations are not covered at all. The emphasis of this text is on matters of interest to counsel for creditors. The text offers a general approach to be taken when representing creditors under the Bankruptcy Code and discusses the relevant substantive law. Reference to cases and other authorities will frequently be necessary.

In the preparation of this text, I had the able assistance of my long-time secretary, Lorraine Peterson, who typed the entire manuscript. My wife, Gail, and son, Alexander, were very patient and provided needed moral support and encouragement. Two of my associates, Dwight Cary and Margaret Sheneman, read the text and made many valuable suggestions concerning both style and substance. Professor William T. Laube, who is counsel to my firm, was most helpful on the subject of bankruptcy court jurisdiction and procedure.

In addition, this text is in part the product of hundreds of discussions with professional friends and colleagues, too numerous to mention, with whom I have debated the merits and demerits of the provisions of the new Reform Act and Code since 1971. I found the deliberations of the National Bankruptcy Conference to be particularly helpful. Finally, readers familiar with the work of Peter F. Coogan, lawyer, professor, lecturer and writer, will no doubt recognize his influence. Much of what I have learned concerning the representation of creditors in insolvency cases originated with him and I owe a great debt to him.

Patrick A. Murphy
October 19, 1979

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§ 1:1 Historical antecedents of the Bankruptcy Code

The idea of giving relief to debtors whose financial difficulties are not necessarily of their own making is as old as recorded history, involving a recognition that financial difficulties have to do with both a debtor and a creditor and that, at least where bad luck has been the precipitating event, both should contribute something to a resolution of the problem. Bankruptcy law developed more formally in the Italian city-states during the Renaissance and involved statutes that assumed that, where financial distress resulted in bankruptcy it was a form of criminal behavior.[1] The emphasis in early English insolvency laws was on equality of distribution. Discharge of indebtedness first appeared in English law in 1705 and then in a bankruptcy law available only to commercial debtors.[2] The principal purpose of the bankruptcy law was long assumed to be a just or equal distribution of the debtor's property among creditors with the debtor's discharge a secondary objective.[3] Only in relatively recent years has relief under the bankruptcy laws become available to most individuals, with a general discharge from debt available to honest debtors without regard to how foolish they may have been as long as fraudulent behavior is not present.

The Constitution of the United States reserves to Congress

[Section 1:1]

[1]MacLachlan on Bankruptcy § 26 (1956); Levinthal, Early History of Bankruptcy Law, 66 U. Pa. L. Rev. 223 (1918); The History of the Bankruptcy Laws of the United States, 3 Am. Bankr. Inst. L. Rev. 5 (1995); Brunstad, Bankruptcy and the Problems of Economic Futility: A Theory on the Unique Role of Bankruptcy Law, 55 Bus. Law. 499 (2000).

[2]MacLachlan, on Bankruptcy Law § 21. The first English bankruptcy act was 34 and 35 Hen 8 c 4 (1542), followed by 13 Eliz c 7 and a series of enactments to present date.

[3]See discussion in 1 Remington on Bankruptcy § 1 (5th ed. 1950) and *Wilson v. City Bank of St. Paul*, 84 U.S. 473, 21 L. Ed. 723, 1873 WL 15888 (1873).

the right to enact uniform laws respecting bankruptcy,[4] but if Congress fails to act, then the matter is at least in some respects open to the states. For much of the 19th century no federal bankruptcy act was in effect, which led to a confusing array of state bankruptcy and debt moratorium statutes.

§ 1:2 Historical antecedents of the Reform Act and the Bankruptcy Code—Early bankruptcy legislation

Professor Warren noted, in his classic 1935 study *Bankruptcy in United States History*,[1] that the trail of the bankruptcy clause of the Constitution was "strewn with a host of unsuccessful objections based on constitutional grounds against the enactment of various provisions, all of which are now regarded as perfectly orthodox features of a bankruptcy law."[2]

The first exercise of the bankruptcy power was the Bankruptcy Act of 1800, which by its terms was to last five years and, in fact, lasted only three.[3] It largely followed English law and applied only to traders. During the long interval before a replacement law was adopted there were two significant decisions of the Supreme Court, *Sturges v. Crowninshield*[4] and *Ogden v. Saunders*,[5] answering the question of whether a state bankruptcy law might impair an existing contract in the negative and that of whether such a law might impair a future contract in the affirmative. The latter decision was crucial if a discharge was to be possible under a state insolvency statute, the only form of relief available to debtors during the extended periods in which there was no federal statute.

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[4]U.S. Const. Art I, § 8, cl. 4.

[Section 1:2]

[1]The original edition was published by Harvard. Da Capo brought out a reprint in 1972.

[2]Warren, Bankruptcy in United States History 9 (1935).

[3]Warren, Bankruptcy in United States History 19 (1935). Remington suggests that the unpopularity of the statute can be attributed to popular resistance to federal laws. 1 Remington on Bankruptcy § 7 (5th ed. 1950).

[4]*Sturges v. Crowninshield*, 17 U.S. 122, 4 L. Ed. 529, 1819 WL 2136 (1819).

[5]*Ogden v. Saunders*, 25 U.S. 213, 6 L. Ed. 606, 1827 WL 3055 (1827).

After nearly 40 years, a second bankruptcy act, the Bankruptcy Act of 1841,[6] was enacted after a protracted congressional struggle. While the new Act worked reasonably well, it rapidly became unpopular and was repealed in little more than a year.[7] At least one decision of the Supreme Court in connection with the Bankruptcy Act of 1841 is of interest in a study of the treatment of secured creditors in bankruptcy. In *Ex parte Christy*,[8] the Court faced the question of whether the bankruptcy court might stay enforcement action by a secured creditor, a power which was not mentioned in the Act. The Court held that the power did exist, noting that:

> From this brief review of these enactments it is manifest that the purposes so essential to the just operation of the bankrupt [sic] system could scarcely be accomplished; except by clothing the courts of the United States sitting in bankruptcy with the most ample powers and jurisdiction to accomplish them; and it would be a matter of extreme surprise if, when Congress had thus required the end, they should have at the same time withheld the means by which alone it could be successfully reached.[9]

Ex parte Christy was decided after the repeal of the Act, as were all of the other Supreme Court decisions concerning the 1841 Act, at which time, as Professor Warren has noted, the Act "had done its work and disappeared."[10]

The next attempt at federal bankruptcy legislation, the Bankruptcy Act of 1867,[11] was the product of political compromise; this was the first such statute to contain a recognition of state exemption laws, the validity of which was not finally resolved until the decision of the Supreme Court in *Hanover National Bank v. Moyses*.[12] The Act of 1867 "from

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[6]5 Stat. 1440.

[7]Warren, Bankruptcy in United States History 81, 82 (1935).

[8]*Ex parte Christy*, 44 U.S. 292, 3 How. 292, 11 L. Ed. 603, 1845 WL 5996 (1845).

[9]*Ex parte Christy*, 44 U.S. 292, 312, 3 How. 292, 11 L. Ed. 603, 1845 WL 5996 (1845).

[10]Warren, Bankruptcy in United States History 85 (1935).

[11]5 Stat. 227.

[12]*Hanover Nat. Bank v. Moyses*, 186 U.S. 181, 22 S. Ct. 857, 46 L. Ed. 1113 (1902); see Warren, Bankruptcy in United States History 100 note 7 (1935).

the outset proved a failure and unpopular everywhere"[13] and was amended materially by the Act of 1874[14] which, among other changes, introduced language providing for compositions.[15] This raised the question of the limits of constitutional bankruptcy power, since compositions were unknown at the time of the adoption of the Constitution. That matter was not settled until the decision of the Supreme Court in *Wilmot v. Mudge*[16] in 1881. In the meantime, the Bankruptcy Act of 1867 was repealed in 1878 response to overwhelming public sentiment.

§ 1:3 Historical antecedents of the Reform Act and the Bankruptcy Code—The Bankruptcy Act of 1898

In 1898, a Bankruptcy Act[1] was passed which, with substantial amendment, remained in effect until the 1978 adoption of the Reform Act as a substantive reenactment of the bankruptcy law. By the time the Bankruptcy Act of 1898 was adopted, many of the early questions concerning constitutionality of the bankruptcy laws had been resolved. "Inclusion of corporations, extensions of bankruptcy to all classes of individual debtors, compositions, state exemptions of property—all were now fully recognized as within the Constitutional power of Congress."[2] This Act was amended some 50 times. The Great Depression produced three major amendments to it in the form of § 77 dealing with railroad reorganizations, § 77B dealing with corporate reorganizations, and the Frazier-Lemke Act dealing with farmer debtor

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[13]Warren, Bankruptcy in United States History 112 (1935). Part of the problem has been attributed to excessive costs of administration. *In re Oakland Lumber Co.*, 174 F. 634, 637 (C.C.A. 2d Cir. 1909).

[14]18 Stat. 969.

[15]A composition is an arrangement among a debtor and creditors where the principal of the debtor's obligations is reduced in some amount and the balance paid in cash or over time. The alternative is an extension whereby principal, and sometimes interest, are paid over time.

[16]*Wilmot v. Mudge*, 103 U.S. 217, 4 Ky. L. Rptr. 82, 26 L. Ed. 536, 1880 WL 18784 (1880).

[Section 1:3]

[1]30 Stat. 544 to 66. The Bankruptcy Act of 1898, as amended, will hereinafter be referred to as the Act.

[2]Warren, Bankruptcy in United States History 144 (1935).

relief. The Act and its amendments recognized, albeit inadequately, a new policy in bankruptcy law, the recognition in business cases that many businesses could be rehabilitated rather than liquidated, and the recognition in consumer cases that the most important objective was a fresh start for honest but unfortunate bankrupts. In business cases, this led to a belief that it was preferable to reorganize rather than to liquidate business debtors as long as that objective could be accomplished without an impermissible invasion of the rights of creditors. The tension between the rights of creditors on one hand and the reorganization policy on the other has been played out over much of the 20th Century.

§ 1:4 The Chandler Act

The last pervasive revision of the bankruptcy laws before the enactment of the Reform Act was the Chandler Act of 1938.[1] The Chandler Act was an amendment to the Bankruptcy Act of 1898 and made a number of substantive changes in the straight bankruptcy provisions of Chapters I through VII. By far its most sweeping changes were in the rehabilitative provisions for business and consumer debtors set forth as Chapters X through XIII of the amended Act.

Chapter X was an descendant of § 77B, containing much of the same language together with new investor protection provisions in response to some obvious shortcomings of § 77B. Chapter X was restricted to corporate debtors, was intended for situations where a major restructuring was necessary, and was not available where Chapter XI would suffice.[2]

Somewhat different in its origins, Chapter XI was based on § 12 of the 1898 Act and was an attempt to apply the principles of simple compositions and extensions to business debtors, whether or not corporate in form. Chapter XI had a rather simple concept, and, at least in theory, it did not permit the rights of secured creditors and shareholders to be altered or modified. While Chapter XI did not have an

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[Section 1:4]

[1]Pub. L. No. 696, 52 Stat. 884 to 940.

[2]See *Securities and Exchange Commission v. American Trailer Rentals Co.*, 379 U.S. 594, 85 S. Ct. 513, 13 L. Ed. 2d 510 (1965).

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