Timbers, Ahlers, and Beyond

By Kenneth N. Klee, Esq.

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Dedication

The 1989 Annual Survey is dedicated to two preeminent scholars in the bankruptcy field who have contributed so much during their long careers to the improvement of the bankruptcy process:

Professor Vern Countryman, Harvard University, Law School
Professor Frank R. Kennedy, Univ. of Michigan, Law School

The Annual Survey of Bankruptcy Law salutes the career-long significant and varied contributions of these two premier scholars and leaders in bankruptcy education and legislation.

Professor Kennedy was the Executive Director of the Commission on Bankruptcy Laws of the United States 1970-1973. Professor Countryman was a Reporter to the Advisory Committee on Bankruptcy Rules 1970-1973, and contributed significantly to several task forces for the Bankruptcy Commission. Both testified extensively in the Congress during the consideration of the Bankruptcy Reform Act of 1978. Their leadership in the framing of the bankruptcy laws and procedures is unexcelled. Each has been blessed with exceptional intelligence, scholarship, teaching talents, practical experience, boundless energy and drive, and dedication to uplifting the bankruptcy bar.

William L. Norton, Jr.
Editor-in-Chief

Professors Frank R. Kennedy and Vern Countryman have contributed immeasurably to the understanding and evolution of commercial law in the United States, and in particular that branch of commercial law which is all encompassing, bankrupt-
They have been the dominant figures in the latter field,

Professor Kennedy, among other accomplishments has been a teacher of English, Latin and public speaking. He has been a Sterling Fellow at Yale University and a Commander in the United States Naval Reserve. He is presently counsel to Sidley & Austin and Thomas M. Cooley Professor of Law Emeritus at Michigan University. He was also a Member of the Council of the Section of Corporation, Banking & Business Law of the American Bar Association, 1977–81; Chairman of Section's Subcommittee on Secured Transactions 1971–73, and Section's Committee on the Uniform Commercial Code, 1974–76; Reporter for the Uniform Exemptions Committee of the National Conference of Commissioners on Uniform State Laws, 1974–76 and 1978–79, and for its Committee to Revise the Uniform Fraudulent Conveyance Act, 1982–84; Consultant to the United States Department of Justice, 1979 and 1984; to the Department of the Treasury, 1979–80; and ART Associates of Cambridge, Mass., 1982–83, in connection with contract study of United States Trustee System for the Department of Justice; to the World Bank (International Bank for Reconstruction and Development) in re: Philippines debt recovery, 1987. Needless to say, his law review articles concerning bankruptcy are extensive and exhaustive. For a wonderful collection of tributes to Professor Kennedy, see 82 Mich L Rev 189–203 (1983).

Professor Countryman was Assistant Regional Attorney, NLRB, 1942; Clerk to Mr. Justice William O. Douglas, 1942–1943; United States Army Air Forces, 1943–1946; Assistant Attorney General, State of Washington, 1946; Instructor, University of Washington School of Law, 1946–1947; Sterling Fellow, Yale Law School, 1947–1948; Assistant and Associate Professor, Yale Law School, 1949–1955; Private Practice, Shea Greenman & Gardner, Washington, D.C., 1955–1959; Dean, University of New Mexico School of Law, 1959–1964; Professor, Harvard Law School from 1964 to retirement in 1987. He was also a major participant in The Brookings Institution's study of bankruptcy. See Stanley & Girth, Bankruptcy: Problems, Process, Reform (Brooking Institution 1976). Professor Countryman is a prolific writer. Examples of books he has written alone or with others in the commercial/bankruptcy field include Debtors' and Creditors' Rights, 1951 (with J.W. Moore); Debtor and Creditor, 1964; Commercial Law, 1971 (with Andrew Kaufman); Debtor and Creditor, (2d Ed 1974); Commercial Law (2d Ed 1982) (with Andrew Kaufman and Zipporah Wiseman). He has also written extensively on individual liberties, ethics, the role of the lawyer and Justice Douglas. UnAmerican Activities in the State of Washington, 1951; The States and Subversion, 1952 (with Walter Gellhorn and others); Douglas of the Supreme Court, 1959; The Lawyer in Modern Society, 1966 (with Ted Finman); The Judicial Record of Justice William O. Douglas; 1974; The Lawyer in Modern Society, (2d Ed 1976 with Ted Finman and Theodore
Certainly for the last three decades. Both have been Conferees of
the National Bankruptcy Conference since the 1950's. For years
Frank was Chairman of the Drafting Committee and Vern was
Vice Chairman of the Conference.

Having said the foregoing, I suppose I bear the burden of
demonstrating its truthfulness, but I leave this to others. With
me it is a matter of faith.

My faith has come about as a result of having known Frank
and Vern over the last 20 years. It was my good fortune to work
with them in 1973 in connection with the efforts of the
Commission on the Bankruptcy Laws of the United States.

Frank Kennedy was selected as the Executive Director of
the Commission on the Bankruptcy Laws and served in that
role while on leave of absence from his teaching position at the
University of Michigan Law School. Professor Kennedy was
then nearing completion of his fifteen-year tenure as Reporter
for the Advisory Committee on Bankruptcy Rules of the
Judicial Conference of the United States. As Reporter, Frank
Kennedy served tirelessly and contributed immeasurably to the
practice. Although Frank would be the first to downplay his role,
the soundness and elegance of the rules were very much the
work of Professor Kennedy.

As monumental as was the task Professor Kennedy took on
as Reporter for the Rules, it was not the physical impossibility
of his task as Executive Director of the Commission on the
Bankruptcy Laws. From first rough draft to completion of the
Commission's two volume report, the incredible efforts of
Professor Kennedy took six months. Toward the end of his

Schneyer); and The Douglas Opinions, 1977. Needless to say, his law review
articles concerning bankruptcy are extensive and exhaustive.

But most important, Professors Countryman and Kennedy are hopefully
nearing completion of their two volume treatise on bankruptcy law to be
published by Little, Brown & Co.

Indeed, the Bankruptcy Rules and Official Bankruptcy Forms, along
with the Chapter XIII Rules and Official Chapter XIII forms, were promulgat-
ed by the United States Supreme Court by its order of April 24, 1973.

Report of the Commission on the Bankruptcy Laws of the United
States, 93d Cong, 1st Sess, HR Doc No. 93-137, Part I (301 pages of text) and
Part II (300 pages) (July 1973).
grueling effort, he was rushed to the hospital as a result of physical exhaustion, but returned to his effort the next day!

Although Professor Countryman is as accomplished and as well known as Professor Kennedy in the broad field of commercial law, and bankruptcy law in particular, he would probably like to be remembered primarily for his contributions to individual liberties. His work in that field as a writer, adviser and lawyer have been significant.

Professor Countryman's contributions to bankruptcy are monumental. He was the Associate Reporter for the Bankruptcy Rules responsible for the Chapter XIII Rules and contributed enormously to the Rules for Chapters X, XI, and XII. As far as the work of the Commission on the Bankruptcy Laws of the United States, Professor Countryman's contributions were major. Professor Kennedy leaned heavily on Professor Countryman, who prepared two seminal papers for the Commission, one concerning property of the estate and the other executory contracts. Few judges confronted with an executory contract case fail to commence the analysis without mentioning Professor Countryman's definition of executory contract and the bankruptcy law has been greatly simplified and rationalized as a result of his suggestions as to property of the estate.

But it was just almost too much for Professor Countryman when I asked him to draft statutory language implementing the Commission's recommendations as to modification of the Absolute Priority Rule. In a few hours Professor Countryman returned with a draft faithfully tracking the Commission's recommendations. I am sure this was an unwelcome task, since Professor Countryman doubted the soundness of the recommendations.6

Judge Norton has chosen to make the first dedication of the Annual Survey wisely; Frank and Vern are the most deserving.

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4 Countryman, The Use of State Law in Bankruptcy Cases (Part I), 47 NYUL Rev 407 and (Part II) 691 (1972).
6 Professor Victor Brudney wrote an article criticizing the Commission's recommendations. Brudney, Bankruptcy Commission Proposed "Modifications" of the Absolute Priority Rule, 48 Am Bankr LJ 305 (1974). I have often accused Vern of ghostwriting the article.
ANNUAL SURVEY OF BANKRUPTCY LAW

It is fitting that they should be corecipients. They are coequals without peers.

Gerald K. Smith
Preface


The 1990 Annual Survey will continue to focus commentary about the successes and shortcomings of the Bankruptcy Reform Act. Our objective is to provide our readers with input from some of our leading bankruptcy scholars and to suggest improvements in the bankruptcy process. We invite commentary on the following and other similar issues for future issues of the Annual Survey.

For example, although the legislative study, hearings and enactment process preceding the Bankruptcy Reform Act of 1978 evolving over a period of at least eight years was a model of Congressional enactment of complex laws, there have been substantial individual Congressional tinkering with the Bankruptcy Code during the decade following 1978 that have not received the same degree of legislative study and attention. Criticisms of such individual amendments opine that these amendments were initiated by individual members of Congress to reflect the desires of a vocal segmented constituency, and that the committee inquiry and attention of a broad spectrum of Congress was inadequate to the importance of the legislation. Some observers have been disappointed at the quickness of the Congressional process in respect to some provisions of the Bankruptcy Reform Act since 1978 in contrast to the depth and breadth of the attention of Congress and participating scholars in the legislative process prior to 1978. Some observers feel that continued ad hoc, quick revisions of the Bankruptcy Code reflecting the desires of special interest segments of the economy will erode and perhaps eliminate the delicate balance of the Bankruptcy Code which evolved from the 1969-1978 legislative process.

Additionally, the effect of the United States Trustee System is to exert a strong influence on negotiating leverages which the
Bankruptcy Code gives to creditors and debtors in an adversarial context. The United States Trustee offices at times assume the role of representing the creditors against debtors even when the creditors are already represented by Creditors Committees and individual counsel. The Congressional intention that debtors-in-possession should be the norm with the trustee being the exception in Chapter 11 cases is being attacked by numerous motions by the United States Trustee offices for appointment of trustees and examiners when such motions would not normally be filed by the creditor body.

Finally, decisions by the Courts are imposing a threshold on the filing of a petition in Chapter 11 cases despite the fact that Congress deliberately rejected the old Chapter X good faith standard on the filing of a Chapter 11 petition.

This year also marks the 10th anniversary of the Annual Survey of Bankruptcy Law. We would like to take this opportunity to thank all of the lawyers, judges and professors who have taken the time to contribute their ideas and articles over the last ten years. Your support has helped make the Annual Survey the success it is today.

This year’s volume brings a collection of outstanding articles on various topics of interest to bankruptcy lawyers and scholars. Part I of this year’s volume is devoted to articles on topics such as the Supreme Court’s recent rulings in the area of adequate protection and Chapter 11 plans, proposed reform of the treatment of executory contracts, tax considerations for individual debtors, an analysis of Section 1110 of the Code dealing with the right of secured lenders in aircraft, consolidation of cases involving subsidiaries and their parents and recommendations for improving the resolution of cash collateral disputes.

Part II covers recent case law developments of the significant Code Sections. The material is arranged by Bankruptcy Code Sections for easy reference. There are separate sections covering Chapters 11 and 13 as entitities. Judges, law clerks and distinguished bankruptcy practitioners have all contributed material to this Part which is written so as to provide you with insight into the most important recent developments.

William L. Norton, Jr., Editor-in-Chief
Gerald L. Blanchard, Assistant Editor-in-Chief
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TIMBERS, AHLERS, AND BEYOND

By Kenneth N. Klee, Esq.*

I. INTRODUCTION

During the first three months of 1988, the Supreme Court rendered the two most significant business bankruptcy cases decided in the ten years after enactment of the 1978 Bankruptcy Code. On January 20, 1988, the Supreme Court decided United Savings Ass'n v. Timbers of Inwood Forest Associates,¹ holding that an undersecured creditor "is not entitled to interest on its collateral during the stay to assure adequate protection under 11 U.S.C. §362(d)(1)."² Thereafter, on March 7, 1988, the Supreme Court decided Norwest Bank Worthington v. Ahlers,³ holding that in the context of a contested Chapter 11 plan, the absolute priority rule applies and the debtor's promise of future contributions of labor, experience, and expertise "warrants no exception to its operation."⁴ The full impact of Timbers and Ahlers is yet to be determined but the repercussions of these opinions should be felt, far beyond their narrow holdings, throughout the fabric of Chapter 11 cases.

*Kenneth N. Klee is a member of the firm, Stutman, Treister & Glatt, Los Angeles, California.
II. SUMMARY OF HOLDINGS

A. TIMBERS

Since not every reader is familiar with the facts and reasoning of Timbers and Ahlers, a summary is in order. Timbers involved a debtor who executed a note secured by a lien encumbering an apartment project and by an assignment of rents. Nearly three years following execution of the note, the debtor filed a voluntary petition under Chapter 11 and the creditor moved for relief from the automatic stay under Section 362(d)(1) alleging a lack of "adequate protection" of its interest. The evidence established that the collateral was appreciating slightly in value and that the creditor was undersecured, i.e., the value of the collateral was less than the amount of the debt. Although the debtor agreed to pay the creditor net rents, the creditor wanted additional compensation as adequate protection for the delay caused by the automatic stay in foreclosing upon its collateral. The Bankruptcy Court agreed with the creditor and conditioned continuance of the automatic stay on the debtor making monthly payments (inclusive of net rents) totalling 12 percent of the amount the creditor would have realized on foreclosure. The District Court affirmed, the Court of Appeals for the Fifth Circuit en banc reversed, and the Supreme Court affirmed the Fifth Circuit's judgment that the undersecured creditor is not entitled to interest on its collateral for the additional delay in foreclosure caused by the automatic stay.5

Justice Scalia, writing for a unanimous Court, reached the holding in Timbers following a rigorous statutory analysis. Section 362(d)(1) specifies that lack of adequate protection of an "interest in property" constitutes cause for relief from stay. Faced with the task of determining whether "interest in property" included the secured creditor's rights to foreclose the debtor's equity of redemption and take immediate possession of the collateral, Justice Scalia examined other provisions of the Bankruptcy Code. He noted that under Section 506(a), a creditor's allowed secured claim is measured by an "interest in property" which was interpreted to mean a security interest.
"without taking account of his right to immediate possession on default." Justice Scalia's conclusion was buttressed by Section 506(b) which grants postpetition interest to oversecured creditors only to the extent of the value of the collateral, and, by implication, denies postpetition interest to undersecured creditors. Justice Scalia also noted that Section 552 permits the encumbrance of postpetition rents only to the extent the creditor has a perfected security interest in the rents. Since rents reflect the use value of collateral, it would be inconsistent with Section 552 to compensate the undersecured creditor who lacks a perfected security in rents for the loss of use of collateral. He concluded by reasoning that compensating undersecured creditors for delay caused by the automatic stay would render Section 362(d)(2), another provision of the automatic stay, "a practical nullity and a theoretical absurdity" since it would only apply to a creditor who was receiving at least a market rate of interest and whose collateral was not depreciating.

After supporting his conclusion that the undersecured creditor is not entitled to interest on its collateral during the stay to assure adequate protection, Justice Scalia refutes several arguments propounded by the secured creditor to support the contrary position. Several points are interesting. Section 361(3) specifies that adequate protection may be provided by granting such relief as will result in realization by the secured creditor of "the indubitable equivalent" of the creditor's interest in the collateral. The creditor contended that the Court should examine the cram down provision in Section 1129(b)(2)(A)(iii) which also uses the term "indubitable equivalent." Since "indubitable equivalent" in the cram down context clearly requires interest if the claim is to be paid over time, the creditor argued the same should be true in the adequate protection context. Justice Scalia made short shrift of this argument noting that the entitlement to interest in the cram down context arises not from the phrase "indubitable equivalent" but from the requirement that deferred payments must be present valued "as of the effective date of the plan." In dictum Justice Scalia pointed out that the entire concept of "indubitable equivalence" refers not to protection of interest but to protection of principal, which
was jeopardized in the Murel case from which "indubitable equivalence" was derived. He also recognized that the law may treat differently a permanent alteration of rights under a plan of reorganization from a temporary alteration of rights during the case. In dictum on a different point, Justice Scalia, citing United States Nat. Bank v. Chase Nat. Bank, reaffirmed that an undersecured creditor is entitled to "surrender or waive his security and prove his entire claim as an unsecured one." This dictum is discussed in further depth below.

B. AHLERS

Like Timbers, Ahlers also involved motions for relief from the automatic stay by undersecured creditors. The debtors operated a family farm and obtained several loans secured by liens encumbering farmland, machinery, crops, livestock, and farm proceeds. The debtors defaulted and one creditor filed a replevin action to gain possession of the farm equipment. The debtors filed a voluntary joint petition under Chapter 11 which automatically stayed lien enforcement after which the secured creditors moved for relief from stay and for adequate protection. The undersecured creditors alleged lack of adequate protection under Section 362(d)(1) and asked for alternative relief under Section 362(d)(2) in that the debtors had no equity in the collateral and the collateral was not necessary to an effective reorganization because no reorganization was possible. The Bankruptcy Court held that the debtors would be required to make monthly adequate protection payments as a condition to maintaining the stay, and since they were unable to do so, relief from stay was granted. The debtors appealed to the District Court which affirmed and found that the debtors' plan had no reasonable prospect for success. In order to prevent mootness of the appeal, the debtors removed the replevin action to the Bankruptcy Court and challenged the constitutionality of the state replevin statute. Ultimately, appeals were taken to the Court of Appeals for the Eighth Circuit which held, among other things, in a 2-1 opinion, that the debtors might be able to propose a feasible plan of reorganization under which a dissenting class of unsecured creditors could be forced to accept less
than payment in full even though the debtors retained their proprietorship interest in the family farm. The court premised its holding on the legal conclusion that the modified absolute priority rule permits debtors to retain an ownership interest if they make a new contribution in future labor, experience, and expertise reasonably equivalent in value to the ownership interest at maturity.\textsuperscript{13}

The Supreme Court reversed. Justice White, writing for a unanimous Court, held that the absolute priority rule applies when the debtor retains property and a dissenting class of unsecured claims is provided for less than in full; the debtor's "promise of future labor warrants no exception to its operation."\textsuperscript{14} The holding was based on an analysis of dictum in Case \textit{v. Los Angeles Lumber Products Co.},\textsuperscript{15} that permitted stockholders of an insolvent corporation to participate in a plan of reorganization "based on a contribution in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder." Justice White rejected the conclusion of the Court of Appeals for the Eighth Circuit that the debtors' "future contributions of 'labor, experience, and expertise' in running the farm—because they have 'value' and are 'measurable'—are 'money or money's worth' within the meaning of Los Angeles Lumber."\textsuperscript{16} He noted that Los Angeles Lumber itself had "rejected an analogous proposition, finding that the promise of the existing shareholders to pledge their 'financial standing and influence in the community' and their 'continuity of management' to the reorganized enterprise was '[in]adequate consideration' that could not possibly be deemed 'money's worth.'"\textsuperscript{17} The same was found to be true of the debtors' pledge of future labor and management skills because "[u]nlike 'money or money's worth,' a promise of future services cannot be exchanged in any market for something of value to the creditors today."\textsuperscript{17}

Moreover, the Court found that the Code and its legislative history "clearly bar any expansion of any exception to the absolute priority rule beyond that recognized in our cases at the time Congress enacted the 1978 Bankruptcy Code."\textsuperscript{18} Of greater significance Ahlers was decided based on the assumption (without deciding) that the Los Angeles Lumber exception to
the absolute priority rule survived enactment of the Bankruptcy Code. The Solicitor General, as amicus curiae, had argued that the 1978 Bankruptcy Code "dropped the infusion-of-new-capital exception to the absolute priority rule." Justice White was clear that the Ahlers decision "should not be taken as any comment on the continuing vitality of the Los Angeles Lumber exception—a question which has divided lower courts since passage of the Code in 1978."\(^{18}\)

Justice White next considered and rejected "equitable arguments" supporting the judgment of the Eighth Circuit. In so doing, he commented that "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code."\(^{20}\) Thus, he concluded that "it is up to the creditors—and not the courts—to accept or reject a reorganization plan which fails to provide them adequate protection or fails to honor the absolute priority rule . . . ."\(^{21}\)

He further considered the contention that the absolute priority rule has no application where the property to be retained by the owners has no value because the creditors are deprived of nothing. In rejecting this "no value" theory, Justice White concluded that "[e]ven where debts far exceed the current value of assets, a debtor who retains his equity interest in the enterprise retains 'property'. . . . Indeed, even in a sole proprietorship, where 'going concern' value may be minimal, there may still be some value in the control of the enterprise . . . ."\(^{22}\)

III. GLOBAL ISSUES

A. EQUITY POWERS

Timbers and Ahlers are cases with simple holdings based on simple facts decided by a unanimous Supreme Court. Yet the cases raise more questions than they answer. Most of the issues relate to the balance between the rights of debtors, unsecured, undersecured, and oversecured creditors during the case and under a Chapter 11 plan. But a few issues are broader in scope. For example, to what extent will the Ahlers statement limiting the equitable powers of the Bankruptcy Court be applied across the board? While some courts have recognized that the Bank-
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Bankruptcy Court does not have a "roving commission to do equity."23 Many bankruptcy judges have operated under a principle of "reorganization uber alles" reminiscent of Professor Festersen's article Equitable Powers in Bankruptcy Rehabilitation: Protection of the Debtor and the Doomsday Principle.24 If the Bankruptcy Code contains a provision providing a rule, Ahlers may be cited for the proposition that it is not within the purview of the courts to engraft an exception that engulfs or eviscerates the rule.25

B. RETROACTIVITY

One facet of the Timbers decision that is of transitory value, particularly in the Fourth and Ninth Circuits, where adequate protection payments were required to compensate an undersecured creditor for delay caused by the automatic stay, is the "retroactivity" of the decision. Unlike enactment of a bankruptcy statute which is presumed not to apply retroactively to alter property rights in the absence of "an explicit command from Congress,"26 whether a Supreme Court opinion construing the bankruptcy law will be applied retroactively is determined only after three factors are considered.27 In Northern Pipeline, Justice Brennan read Huson to require the Court to first consider "whether the holding in question decided an issue of first impression whose resolution was not clearly foreshadowed by earlier cases; second, whether retrospective operation will further or retard the operation of the holding in question; and third, whether retroactive application could produce substantial inequitable results in individual cases."28

The Timbers Court did not address the retroactivity issue. Purporting to apply Huson, the Court of Appeals for the Ninth Circuit held that Timbers should apply retroactively, at least in pending cases where the issue has been preserved on appeal.29 Actually applying Huson, two bankruptcy courts concluded that Timbers should not apply retroactively,30 but one court permitted the debtor to credit adequate protection payments to the first installment payments due to the secured creditor under the plan.31
While Timbers will undoubtedly apply in pending cases where the issue of adequate protection is raised for the first time following January 20, 1988, the date of the Timbers decision, it remains to be seen whether retroactive application of Timbers will permit modification of pending adequate protection orders under Bankruptcy Rule 9024, recovery of adequate protection payments made under an order entered before January 20, 1988 from which no appeal was taken, or recharacterization of the application of adequate protection payments to principal rather than interest or costs.

C. ADMINISTRATION OF REORGANIZATION CASES

Another aspect of Timbers should have more than a temporary effect on the administration of Chapter 11 cases. The en banc decision of the Court of Appeals for the Fifth Circuit contained much dictum regarding administration of Chapter 11 cases. Notably, the Supreme Court's opinion in Timbers does not comment on this dictum.

On appeal, the undersecured creditor argued that if the collateral was not declining in value, the automatic stay might never be lifted. Rejecting this facile argument, Judge Randall, writing the majority opinion for the en banc court, stated that "[t]his assertion ignores important provisions of the Bankruptcy Code which are designed to protect the secured creditor." She then described at length several secured creditor protections.

Under Section 362(d)(2) an undersecured creditor may obtain relief from the stay where the collateral is not necessary to an effective reorganization. To prevent relief from the stay the debtor must show that there is "a reasonable prospect for a successful reorganization within a reasonable time." Judge Randall noted that bankruptcy courts apply this standard "with somewhat more indulgence" early in the case than "if the motion were made at a later stage" in the case or in the context of a Section 1112 motion to dismiss or convert. She also recognized that "there may be circumstances under which the debtor is able to satisfy the 'effective reorganization' test . . . by
showing that the property at issue is necessary to an effective liquidation of the debtor under Chapter 11 . . . ."35

Next, Judge Randall focused on the Section 1112 motion for dismissal or conversion which she characterized as the "prime avenue for relief, for both the secured and unsecured creditors of a debtor who is not reorganizable or who is unreasonably delaying . . . ."36 "In the case of most chapter 11 debtors a plan of reorganization can be effectuated, if at all, within a matter of months, not years . . . . The charge to the bankruptcy judge under § 1112 . . . . is to evaluate each debtor's viability and rate of progress in light of 'the best interest of creditors and the estate.'"37

Finally, Judge Randall focused on the exclusive period during which only the debtor may file a plan under Section 1121. In deciding whether to extend the exclusivity period for cause under Section 1121(d), she cautioned bankruptcy judges to "be mindful of the legislative goal behind § 1121." Judge Randall stated that "[t]he bankruptcy court must avoid reconstituting the imbalance between the debtor and its creditors that characterized proceedings under the old Chapter XI. Section 1121 was designed and should be faithfully interpreted, to limit the delay that makes creditors the hostages of chapter 11 debtors."38

Judge Randall's dictum provides a clear direction to bankruptcy courts to interpret Sections 362(d)(2), 1112, and 1121 to counterbalance the cost of delay imposed on an undersecured creditor whose collateral is not depreciating under Section 362(d)(1). To the extent bankruptcy courts follow this advice, debtor's will have far less time to reorganize than was the practice prior to Timbers. On the other hand, it remains to be seen if Justice Scalia's failure to acknowledge this dictum will neutralize its effect. Maintenance of the delicate balance in Chapter 11 cases among the rights of debtors, unsecured creditors, undersecured creditors, and oversecured creditors depends on the outcome.
IV. RELATIVE RIGHTS

By far, the most dramatic effect of Timbers and Ahlers will be on the relative forces motivating parties in interest in Chapter 11 cases.

A. THE NEGOTIATION IMPERATIVE

Chapter 11 was drafted with the purpose of motivating the parties in a Chapter 11 case to negotiate a division of the debtor's reorganization value under a plan as soon as the debtor's business problems were solved. In order to give undersecured and unsecured creditors an incentive to negotiate, the Bankruptcy Code allocates the cost of delay of the bankruptcy process equally by preventing the accrual of postpetition interest as a general rule. These creditors may also have a plan confirmed over their dissent in certain circumstances. If the debtor is insolvent, only the oversecured creditor is entitled to accrue postpetition interest on account of the allowed secured claim, and then only up to the amount by which the value of the collateral exceeds the allowed secured claim. While the oversecured creditor is insulated theoretically from sharing the cost of delay, a plan may be confirmed over the dissent of the oversecured creditor in certain circumstances. While delay may induce undersecured creditors and unsecured creditors to negotiate, it may serve the purposes of ownership interests and junior debt to delay negotiations in hopes of increasing reorganization value. And if retrenchment is in the offing, the debtor's management and unions may want to prolong the negotiating process to enable employees to extract benefits for the longest period possible before retrenchment occurs.

To combat this incentive to delay, the Bankruptcy Code provides creditors with the opportunity to obtain the appointment of a trustee or examiner under Section 1104 as well as the remedies identified by Judge Randall, i.e., dismissal or conversion under Section 1112; and loss of plan exclusivity under Section 1121; and, for undersecured creditors, relief from the automatic stay under Section 362(d)(2). Chapter 11 will serve its purpose only if these relative rights remain balanced to
encourage prompt negotiations to achieve a plan once the reorganization value of the debtor is ascertainable.\textsuperscript{45}

Timbers restores the negotiating balance that was disrupted by the improvident decisions In re American Mariner Industries, Inc.,\textsuperscript{46} and Grundy Nat. Bank v. Tandem Min. Corp.\textsuperscript{47} American Mariner and Grundy required an undersecured creditor to be compensated for interest on its collateral during the automatic stay to assure adequate protection. As a result, the undersecured creditor was compensated for the delay of the bankruptcy process by receiving property of the estate that would otherwise be allocable to unsecured creditors (or owners if the debtor were solvent). American Mariner and Grundy thus skewed the distribution of the burden of the cost of delay and reduced the incentive of undersecured creditors to participate constructively in negotiating a Chapter 11 plan of reorganization. In the wake of Timbers, undersecured creditors will once again have incentives to negotiate.

Ahlers also does much to restore the balance of the reorganization process. Had the view of the Eighth Circuit Court of Appeals prevailed, debtors could have acquired equity ownership values that historically belonged to creditors in the absence of a consensual plan. Under Ahlers an insolvent debtor who desires to retain an ownership interest must obtain consensual confirmation under Section 1129(a) unless the Los Angeles Lumber infusion-of-new-capital exception applies. This holding should encourage the debtor and its owners to participate in the negotiating process. Where the debtor is insolvent on a reorganization basis, unless the owners have new capital to contribute, they will lose their ownership interests in the absence of a consensual plan or a plan in which the dissenting class is provided for in full.

B. THE INFUSION-OF-NEW-CAPITAL EXCEPTION

While the holding in Ahlers was beneficial to the Chapter 11 process, the dictum regarding the Los Angeles Lumber exception was not. Before Ahlers few bankruptcy practitioners, judges, and scholars doubted that the Los Angeles Lumber exception, as well as other exceptions, remained part of the "fair
and equitable standard of Section 1129(b)(1). Indeed, Section 1129(b)(2) is drafted to include certain requirements that as a matter of construction are not exclusive of others. The legislative history of the 1978 Bankruptcy Code also evidences a clear intention to incorporate uncodified aspects of the fair and equitable rule with respect to a dissenting class. It remains to be seen whether the Ahlers dictum will lead courts to question the viability of the uncodified exceptions to the fair and equitable test.

C. UNCODIFIED COMPONENTS OF THE FAIR AND EQUITABLE TEST

The fair and equitable test contained at least four components that were not codified in 1978. First, if a junior class dissents, a senior class cannot be provided for more than in full. This principle is so fundamental that it would undoubtedly be found to be part of the fair and equitable standard even if courts ignore the other uncodified exceptions to the test.

Second, as a matter of fairness, a dissenting class of senior creditors cannot be paid in stock while junior classes receive cash and notes. This too is part of fairness and is not an "exception" to the rule.

Third, if senior creditors are forced to share securities of equal priority as those issued to junior creditors, the senior creditors must be compensated for their loss of relative priority (usually by receiving securities in excess of their claim or by receipt of an equity "kicker" because the "bundle of rights" of senior creditors includes the right to priority). If the dictum in Ahlers leads courts to conclude that exceptions to the absolute priority rule were not incorporated into Section 1129(b)(1), then this exception might disappear. On its face, Section 1129(b)(2)(B)(i) limits a class of unsecured claims to receipt of property equal to the allowed amount of the unsecured claims. Nevertheless, it is unlikely that courts will ignore specific rules of statutory construction and legislative history designed to preserve the "equity kicker" exception.

Fourth is the infusion-of-new-capital exception as mentioned above. If a senior dissenting class is not provided for in
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full, then a junior class may receive or retain no property under a plan, except that a stockholder may retain or acquire new equity "based on a contribution in money or money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder."54 While it is clear that a contribution of future labor will not suffice to meet this exception, the amount of capital that must be infused to constitute a reasonable equivalent in compliance with this exception is open to question.55 One court has confirmed a plan where the new capital contributed was only $16,000 plus further sums as needed.56 At the other extreme, a different court has required an infusion of new capital that would pay creditors in full.57

The issue should not be the survival of this exception but its application. One of the major purposes of bankruptcy reform was to shift the risk of valuation from the creditors to the debtor.58 The vice of the infusion-of-new-capital exception is that it enables the debtor's owners to purchase an ownership interest based on a court approved valuation without validation of the market place. This, of course, is the norm for distribution of reorganization values under the fair and equitable test.59 But when a reorganization security is to be sold, rather than distributed in satisfaction of claims or interests to a class of creditors or owners under a plan, perhaps a market test should be applied as would be done with the sale of any other asset of the estate. At the very least, to maintain the balance of relative rights, Chapter 11 creditors who argue that the proposed capital contribution is too low should have the opportunity to match or exceed the pending offer.

D. THE OVERSECURED CREDITOR

Taken together, Timbers and Ahlers will influence the resolution of open questions of Chapter 11 law. Prior to Timbers, many courts required the value cushion or equity cushion of an oversecured creditor to reach a certain percentage level before the cushion would be found to adequately protect the creditor's interest in the collateral.60 Because postpetition interest could accrue at the contract rate up to the extent of the
cushion under Section 506(b), the rationale of American Mariner requiring payments at the market rate for delay did not apply where the creditor was oversecured. Even so, the death of American Mariner should lead to the demise of the equity cushion doctrine as well where the value of the collateral is not depreciating.

Under Timbers, the senior undersecured creditor is not compensated for delay in foreclosure caused by the automatic stay. The value of the undersecured creditor’s "interest in property" is the "value of the collateral." Thus, if the value of the collateral is constant or appreciating, the senior undersecured creditor will not obtain relief from stay based on the lack of adequate protection. It makes no sense that a creditor that is oversecured by a one percent cushion should obtain relief from stay while a creditor undersecured by one percent cannot.

The oversecured creditor bargains for a cushion subject to erosion through the accrual of interest, including postpetition interest in a bankruptcy case. Nothing in the Bankruptcy Code suggests that the cushion on the date of the filing of the petition is an interest in property to be protected against erosion any more than was the delay in foreclosure rights under Timbers. In fact, the property interest requiring protection is the lien that encumbers the collateral to secure repayment of the allowed secured claim, and the value of the lien cannot exceed the amount of the debt owed, i.e., the allowed secured claim.

Under the Bankruptcy Code, an allowed claim is determined on the date of the filing of the bankruptcy petition, and the accrual of postpetition interest under Section 506(b) is a right separate and apart from the allowed secured claim that is allowed to the holder of the secured claim "[t]o the extent that an allowed secured claim is secured by property the value of which . . . is greater than the amount of such claim." As Timbers suggests, the value of the creditor's interest in property is not intended to vary over time, and Section 506(b) "permits postpetition interest to be paid only out of the 'security cushion'" not as claim against the estate. Therefore, it appears that the security cushion is not an interest in property that is subject to adequate protection at all, and even if it were, the cushion becomes a property interest only upon the accrual
of interest which increases the creditor's interest in the collateral as the debt increases.

Perhaps, however, it would be appropriate to consider the creditor's interest in property entitled to adequate protection as being comprised of the allowed secured claim plus, to the extent the security cushion is adequate, a contingent right to postpetition interest that would accrue for the anticipated duration of the case. In this manner the debtor in possession will lose any incentive to erode the cushion before the postpetition interest accrues, and courts will be able to evaluate use of collateral on a fair basis. In conclusion, it is not the cushion that is entitled to protection, but the foreseeable accrual of postpetition interest based on the estimated duration of the case.

E. VALUATION OF COLLATERAL

The question remains for purposes of adequate protection at what reference point and on what basis is value of the collateral determined? Timbers and Ahlers provide little help in finding answers. Bankruptcy Rule 3012 permits any party in interest to request the court to determine the value of the secured claim, but provides no guidance to answer this question. Case law is divided on both issues. It makes sense to consider the likelihood of reorganization or liquidation in selecting a basis of valuation. Timbers should not influence this issue since the method of valuing the collateral is unimportant under Timbers. Nor should Ahlers influence this issue since Ahlers considered possible outcomes under a plan. As the Court noted in Timbers, "The reorganized debtor is supposed to stand on his own two feet. The debtor in process of reorganization, by contrast, is given many temporary protections against the normal operation of the law." By the time confirmation is reached, reorganization value should be used unless liquidation value is greater or a liquidating plan is proposed. During the case the outcome is uncertain, and Congress intended different methods of valuation to be applied based on the facts of each case. The basis of valuation may be important, however, because only an oversecured creditor will have the right to accrue interest under Section 506(b), and the
method of valuing the collateral may determine whether or the extent to which a creditor is oversecured during the case.

F. FLUCTUATION IN VALUE OF COLLATERAL

Determining the time at which the collateral is valued for purposes of adequate protection is related to determining who bears the risk in fluctuation of the value of the collateral. Certainly allowance of claims is determined as of the date of the filing of the petition. And the extent to which a claim is secured should be measured on that date. If the secured creditor promptly seeks adequate protection of its property interest it is protected theoretically on the downside from fluctuations caused by the stay by the protection provided or by the superpriority administrative claim granted under Section 507(b). If the secured party sleeps on its rights and does not request adequate protection of its interest in the collateral, then there is no downside protection absent tortious conduct on the part of the estate or a third party. Even Grundy provided protection only from the date of the motion for relief from stay as postponed to take account of normal foreclosure delays not caused by the stay.

But if the collateral increases in value does the allowed secured claim of the undersecured or marginally secured creditor increase as well? Certainly to the extent the increase constitutes net proceeds, product, offspring, rents, or profits in which the creditor has a perfected security interest, the allowed secured claim will increase except to the extent the collateral has been depleted or the equities of the case otherwise require. Beyond the express language of Section 552(b), it is doubtful whether the increase in value of collateral increases either the allowed secured claim of the undersecured creditor or, in the event it is found to be a property interest, the cushion for accrual of postpetition interest for the oversecured creditor for purposes of adequate protection.

If the increase in value of the collateral is due to a market fluctuation and the creditor has failed to seek adequate protection, the outcome is uncertain. Certainly if a secured creditor has possession of collateral it should not be able to speculate on
fluctuations in value to the detriment of the estate. The result should not necessarily vary where the debtor is in possession of the collateral.

Where the creditor has not sought adequate protection of its interest in property then perhaps the allowed secured claim should be frozen as of the date of the filing of the petition. Under Section 506(a) the bifurcation of the undersecured claim into an allowed secured claim and allowed unsecured claim is performed, and under Section 506(d) the lien is void except to the extent it secures the allowed secured claim. Thus, any increase in value will benefit the estate. This is consistent with the observation in Timbers that no one would suggest that the proportions of the claim that are secured and unsecured would be altered during the course of the case. If the value of collateral is frozen as of the date of the filing of the petition, the same result would apply to the oversecured creditor who has not sought adequate protection. Freezing the value of the collateral as of the filing date freezes the cushion against which postpetition interest may accrue.

The foregoing analysis should likewise apply to the creditor who seeks adequate protection whether the creditor is undersecured or oversecured. The creditor who receives adequate protection of an interest in property is protected on the downside; to give the creditor the upside as well, increases the value of the creditor's property interest unfairly. Value is essentially reflective of the mean of the present value of all possible future dispositions that reduce the collateral or its component parts to cash, multiplied by the likelihood that each future disposition will occur. When downside risk is eliminated or made remote, as under Sections 361 and 507(b), the upside must be eliminated or the creditor will receive a windfall. This conclusion is supported by the analysis in Ahlers which rejected the "no value" argument of the debtor on the basis that retention of equity in an insolvent company would deprive the creditors of potential upside value to which they were entitled under the modified absolute priority rule. The same can be said of that portion of the fair and equitable test that prohibits the issuance of "worthless" securities unsupported by reorganization value because to do otherwise would deprive senior
classes of upside value to which they are entitled. Finally, the result is supported by Timbers which recognizes implicitly that the Chapter 11 negotiating process is benefited when the secured creditors are forced to incur some of the cost of delay. To the extent the secured creditor cannot gain by realizing upside in the event of delay, it will have every incentive to move quickly to negotiate before a bankruptcy is filed, and if the case is filed to move quickly to confirm a plan where it might be able to capture the upside for its own benefit after the effective date of the plan.

Is it possible that the foregoing argument proves too much? Certainly to the extent the secured creditor does not seek adequate protection of its interest in property and is not protected against downside risk, the creditor must retain the upside in order to keep the balance of possible future realizations of value that inhere in the present value of the collateral. The theory that supports stripping the creditor of the upside appears to be analogous to the "no value" argument condemned in Ahlers. And if the creditor who sleeps on his rights is entitled to the upside then can the creditor who vigilantly seeks adequate protection be worse off?

While superficially appealing, the fallacy of the arguments in the preceding paragraph is that the creditor who fails to seek adequate protection of an interest in property will and should run the risk of loss on the downside. Such a creditor should incur that risk because the risk can be reduced or eliminated if adequate protection is sought promptly.

G. UNDERSECURED JUNIOR LIENS

The foregoing discussion has focused primarily on the oversecured creditor and the undersecured creditor secured by a senior lien. The analysis becomes more complex where the undersecured creditor holds a lien junior to other liens encumbering the collateral.

Suppose that the allowed secured claim of the junior undersecured creditor is determined as of the date of the filing of the petition and that such creditor promptly requests adequate protection of its interest in property. Must the
interest in property of the junior undersecured creditor be protected from the accrual of interest (or taxes) payable to senior secured creditors to the extent the property fails to appreciate in value to absorb those accruals?

The answer is unclear. Cases following the "equity cushion" analysis will not permit the cushion to be eroded by senior accruals. But cases which reject the equity cushion analysis in the wake of Timbers and focus on decrease in the creditor's interest in property attributable to the automatic stay should reach a contrary result because the erosion of the junior creditor's position may not be attributable to the stay. In the absence of bankruptcy, the junior creditor may foreclose and be subject to the same accruals of interest and taxes by senior creditors as occur in bankruptcy. In the absence of foreclosure this would certainly occur. This erosion is part of the junior creditor's bargain to be subject to the entire bundle of rights of senior lienors. Indeed, payment of the interest and taxes from free assets of the debtor during the 90 days prior to bankruptcy will constitute a preference recoverable from the undersecured junior lienor. What is recoverable as a preference if paid prepetition should not be required to be paid to maintain adequate protection postpetition.

The contrary conclusion yields strange results. Suppose the erosion of the junior secured creditor's interest in property due to the accrual of interest and taxes by senior creditors is entitled to adequate protection. Then if the value of the collateral remains constant, as the oversecured senior creditors accrue interest the estate must pay the interest, or provide liens encumbering equivalent assets of the estate to secure the claim of the junior lienor, in order to provide adequate protection of the junior creditor's interest in property. The senior secured creditors may be better off by the existence of the junior lien to the extent it is paid interest rather than accruing the same. Moreover, payment of interest to the senior creditors preserves its cushion to accrue additional interest aggregating more than the amount of its value cushion on the date of the filing of the bankruptcy petition—a result condemned by Timbers.

The implication is more bizarre if the same creditor holds a first lien that is oversecured and a second lien that is under-
secured encumbering the same collateral. Assuming no merger of liens, the lender can accrue postpetition interest on its oversecured first lien and demand adequate protection based on the erosion of the interest in property of its junior lien! On the other hand, if the liens merge, the creditor holds an undersecured first lien entitled to no postpetition interest under Section 506(b) and no relief from stay because the value of the collateral is not depreciating. Unless the equity cushion analysis is rejected and the interest in property of the junior creditor is not entitled to adequate protection based on the accrual of senior interest and taxes, secured creditors can structure all secured loans so that one entity holds the first lien and an affiliate holds the second lien. The "oversecured" first lien would accrue postpetition interest and the holding of Timbers would be subverted.

H. DISTRIBUTIONS UNDER A PLAN OF REORGANIZATION

1. Value of Securities

Timbers and Ahlers should also influence the confirmation of Chapter 11 plans of reorganization. If the debtor files a plan in which the business survives as a going concern, the securities or property to be distributed under the plan should be based on reorganization value, particularly where an impaired class does not accept the plan and the modified absolute priority rule of Section 1129(b) is involved. In this regard, it has long been recognized that securities distributed under a plan of reorganization need not be convertible immediately into cash in the market. 88

Ahlers may be read to cast doubt on this precept by dictum that in measuring the suitability of a contribution of future services, "[u]nlike 'money or money's worth,' a promise of future services cannot be exchanged in any market for something of value to the creditors today." 89 This reading of Ahlers would be incorrect since the Court in Ahlers was analyzing the dictum of Los Angeles Lumber which required a contribution "in money or money's worth" whereas under Section 1129(b)(2)(B) creditors are only entitled to receive "property" and unable to
demand money or money's worth. To require the reorganization securities distributed to unsecured creditors under a Chapter 11 plan of reorganization plan to be marketable for cash would limit severely the flexibility of Chapter 11 and overturn the practice of 50 years of reorganization law. It is unlikely that Ahlers will be read to require such a result.

2. Indubitable Equivalent

If an impaired class of secured claims does not accept the plan, the plan may be confirmed over the dissent of the secured class under Section 1129(b)(2)(A).100 One of the treatments permitted is to provide for the realization of the holders of secured claims of "the indubitable equivalent" of such claims.101 The legislative history states that "[a]bandonment of the collateral to the [secured] creditor would clearly satisfy indubitable equivalence . . .."102 Timbers may be read to limit the utility of this treatment by its dictum that "an undersecured creditor is entitled to 'surrender or waive his security and prove his entire claim as an unsecured one.'"103

It is not at all clear that Timbers should be so read. First, Timbers permits the waiver of security to avoid the inequitable result under Section 726(a)(5) when the debtor is solvent in a Chapter 7 case where undersecured creditors would not receive postpetition interest on their allowed secured claim. This rationale does not apply in the case of a solvent Chapter 11 debtor. In a Chapter 11 case, Section 726(a)(5) does not apply directly, although it may apply indirectly to an impaired class under the best interest of creditors test.104 Moreover, a class of unsecured claims that is paid in cash and in full on the effective date is unimpaired under Section 1124(3) and the best interests test does not apply.105 Thus, based on the uncertain entitlement of unsecured creditors to receive postpetition interest, the Timbers dictum need not be read to apply to the Chapter 11 plan of a solvent debtor.

Second, Section 725, which had no antecedent under the Bankruptcy Act, empowers a Chapter 7 trustee to deliver collateral to a secured creditor in a Chapter 7 case. It is not at all
clear that a secured creditor with a lien as of the date of the filing of the petition can "waive" its security and thereby deprive the trustee of this right. To the extent the allowed secured claim is determined as of the date of the filing of the petition, retention of the lien would be required to avoid the variance in the proportion of secured and unsecured claims which "[n]o one suggests . . . was intended."\textsuperscript{107}

V. CONCLUSION

Timbers and Ahlers are significant cases that do much to advance Chapter 11 law. The impact of these decisions should transcend their holdings to shape the course of bankruptcy jurisprudence well into the second decade of the Bankruptcy Code. The foregoing discussion highlights but a few of the issues that can be expected to arise from these landmark Supreme Court cases.

\textsuperscript{1}United Savings Ass'n v. Timbers of Inwood Forest Associates, 108 S Ct 626 (1988) (hereinafter referred to as "Timbers").
\textsuperscript{2}Timbers, 108 S Ct at 635.
\textsuperscript{3}Norwest Bank Worthington v. Ahlers, 108 S Ct 963 (1988) (hereinafter referred to as "Ahlers").
\textsuperscript{4}Ahlers, 108 S Ct at 968.
\textsuperscript{5}Timbers, 108 S Ct at 628–629.
\textsuperscript{6}Timbers, 108 S Ct at 630–631.
\textsuperscript{7}Timbers, 108 S Ct at 631–632. It is likewise inconsistent with the holding of Timbers to permit an undersecured creditor with a perfected security interest in rents to apply net postpetition rents to interest rather than principal. Apparently Timbers overruled sub silentio Sexton v. Dreyfus, 219 US 339 (1911), to whatever extent it survived enactment of § 502(b)(2) of the Bankruptcy Code.
\textsuperscript{8}Timbers, 108 S Ct at 632.
\textsuperscript{9}Timbers, 108 S Ct at 633 (emphasis in original).
\textsuperscript{10}Id.
\textsuperscript{11}Timbers, 108 S Ct at 634.
\textsuperscript{13}Ahlers, 108 S Ct at 965–966.
\textsuperscript{14}Ahlers, 108 S Ct at 968.
\textsuperscript{15}Case v. Los Angeles Lumber Products Co., 308 US 106, 121–122, 60 S Ct 1, 10 (1939) (hereinafter referred to as "Los Angeles Lumber").
\textsuperscript{16}Ahlers, 108 S Ct at 967.
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17 Ahlers, 108 S Ct at 967 (emphasis in original).
18 Ahlers, 108 S Ct at 968.
19 Ahlers, 108 S Ct at 967 n 3.
20 Ahlers, 108 S Ct at 968–969.
21 Ahlers, 108 S Ct at 969.
22 Ahlers, 108 S Ct at 969.
See, e.g., Johnson v. First Nat. Bank, 719 F2d 270, 273 (CA8 1983), cert
den 104 S Ct 1015 (1984); In re Texas Consumer Finance Corp., 480 F2d 1261,
1265 (CA5 1973) (Bankruptcy Act Case).
25 Ahlers, 108 S Ct at 968–969.
28 See United States v. Security Industrial Bank, 459 US 70, 81 (1982);
27 Northern Pipeline Const. Co. v. Marathon Pipe Line Co., 458 US 50,
87–89, 102 S Ct 2858, 2880 (1982) (Brennan, J. plurality opinion) (hereinafter
referred to as "Northern Pipeline").
Cf. Chevron Oil Co. v. Huson, 404 US 97, 106–107, 92 S Ct 349, 355
(1971) (hereinafter referred to as "Huson").
28 Northern Pipeline, 458 US at 88, 102 S Ct at 2880 (citations omitted).
29 In re Clamarron Investors, 848 F2d 974 (CA9 1988) (suit to recover
adequate protection payments).
30 In re Rivers, 89 BR 1006 (BC ND Ga 1988); In re Sherwood Square
Associates, 87 BR 388, 392–393 (BC Md 1988) (hereinafter referred to as
"Sherwood Square").
31 Sherwood Square, 87 BR at 394.
32 In re Timbers of Inwood Forest Associates, Ltd., 808 F2d 363 (CA5
1987).
33 Id. at 370.
34 Id. at 371.
35 Id. at 371 n 14.
36 Id. at 371.
37 Id. at 372.
38 Id. at 372.
39 See HR Rep No. 595, 95th Cong, 1st Sess 224 (1977) (hereinafter
referred to as "House Report").
40 See 11 USC § 502(b)(2).
41 11 USC § 1129(a)(7) and (b).
42 11 USC § 506(b).
44 See Blum & Kaplan, Corporate Readjustments and Reorganizations, at
485–486 "Note: The Strategy of Stalling by Juniors in Reorganization
Proceedings." (1st Ed 1976); Brudney, The Bankruptcy Commission's Pro-


49 In re American Mariner Industries, Inc., 734 F2d 426, 432–435 (CA9 1984) (hereinafter referred to as "American Mariner").


48 See 11 USC §§ 102(3) and 1129(b)(2).

49 See House Report at 414 (senior creditor not deprived of "kicker" for loss of priority); 124 Cong Rec S2407 (Sept. 28, 1978 Statement of Rep. Don Edwards) and 124 Cong Rec S17420 (Oct. 6, 1978 Statement of Sen. DeConcini) (hereinafter referred to as "Floor Statements") (factors omitted from codification would undoubtedly be found by a court to be fundamental to fair and equitable treatment).

50 See Floor Statements at 32407 and S17420.

51 See In re Central R. Co. of New Jersey, 411 F2d 1178 (CA3 1969).


53 See 11 USC §§ 102(3) and 1129(b)(2); House Report at 414.

54 Los Angeles Lumber, 308 US at 121–122, 60 S Ct at 10 (dictum).

55 See, e.g., In re U.S. Truck Co., Inc., 800 F2d 581, 587–588 (CA6 1986) ($100,000 contribution substantial and essential); In re Potter Material Service, Inc., 781 F2d 99 (CA7 1986) (new capital investment must be a substantial contribution that equals or exceeds value of retained ownership interest in corporation); In re Jartran, Inc., 44 BR 331, 379 (BC ND Ill 1984) (shareholder was most feasible source of new capital and contribution was necessary to assure debtor's viability).

56 In re Eaton Hose & Fitting Co., 73 BR 139, 140 (BC SD Ohio 1987).

57 In re Rudy Debruycker Ranch, Inc., 84 BR 187, 190 (BC Mont 1988).

58 See In re Sandy Ridge Development Corp., 77 BR 69, 72 (BC MD La 1987). On appeal argument on rehearing was heard by the Court of Appeals for the Fifth Circuit on December 5, 1988.


60 E.g., In re Mellor, 734 F2d 1396, 1401 (CA9 1984) (20% cushion sufficient) (hereinafter referred to as "Mellor"); In re McGowan, 6 BR 241, 243 (BC ED Pa 1980) (10% cushion sufficient); In re Rogers Development Corp., 2 BR 679, 685 (BC ED Va 1980) (15%-20% cushion sufficient).
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61 In re Anderson, 833 F2d 834, 836 (CA9 1987).
62 Timbers, 108 S Ct at 630.
63 Accord In re Apex Oil Co., 17 BCD 568 (BC ED Mo 1988).
64 11 USC §506(b).
66 Timbers, 108 S Ct at 630.
68 11 USC §502(b).
69 11 USC §506(b).
70 Timbers, 108 S Ct at 630.
71 Timbers, 108 S Ct at 631.


72 Under §506(b) the oversecured creditor is entitled to "any reasonable fees, costs, or charges provided for under the agreement" as well as postpetition interest. Such fees, costs and charges should be part of the property interest to be adequately protected to the extent they can be estimated at the beginning of the case and the cushion is sufficient to cover them as well as interest. If the cushion is insufficient to cover both fees, costs, or charges and postpetition interest, then the postpetition interest should be protected first and the fees, costs, or charges treated as part of the creditor's unsecured claim. Unless the debtor were solvent, the contrary result would result in the disallowance of interest due to the presence of fees, costs, or charges. See 11 USC §502(b).

73 E.g., compare Grundy, 754 F2d at 1441 (liquidation value); with Mellor, 734 F2d at 1401 (market value); with In re George Ruggiere Chrysler-Plymouth, Inc., 727 F2d 1017, 1020 (CA11 1984) (wholesale value, being the "amount which the creditor would receive by its customary or commercially reasonable means of disposition"); and with In re Phoenix Steel Corp., 39 BR 218, 226–227 (DC Del 1984) (averaging going concern and liquidation value given uncertainties of possible outcomes) (hereinafter referred to as "Phoenix Steel").

74 See Phoenix Steel, 39 BR at 226.
75 Timbers, 108 S Ct at 634.
76 House Report at 355.
77 11 USC §502(b).
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79 See Alyucan, 12 BR at 808-809.
80 Grundy, 764 F2d at 1441.
81 11 USC §552(b).
See, e.g., In re Dahquist, 34 BR 476, 483 (BC D SD 1983).
82 See In re Pennyrich International, Inc., 473 F2d 417, 423 (CA5 1973)
(adjudicated case under Bankruptcy Act).
83 See 11 USC §502(b).
84 Timbers, 108 S Ct at 630.
85 See Timbers, 108 S Ct at 630-631.
86 See Bradney, 48 Am Bankr LJ at 331-334.
87 Ahlers, 108 S Ct at 969.
88 See Group of Institutional Investors v. Chicago, M., St. P.& P.R. Co.,
318 US 523, 541-542, 63 S Ct 727, 738-739 (1943); 6A Collier on Bankruptcy
¶11.06 at 219-220 (14th Ed 1977).
89 See Timbers, 108 S Ct at 631.
90 See Bradney, 48 Am Bankr LJ at 332.
91 Ahlers, 108 S Ct at 969.
92 11 USC §§361, 507(b).
93 11 USC §§361, 502(b), 506(a), (d).
94 E.g., In re American Properties, Inc., 8 BR 68, 71-72 (BC Kan 1980); In
re Pleasant Valley, Inc., 6 BR 13, 17 (BC Nev 1980) (debtor required to bring
current senior taxes and assessments).
See In re Pol ries Bros., 49 BR 669, 674 (BC ND 1985) (junior interest
entitled to protection from decline of value of collateral as well as from accrual
of interest by senior liens); Alyucan, 12 BR at 810 n 14 (dictum).
95 See Alyucan, 12 BR at 808-809.
96 E.g., In re Prescott, 805 F2d 719, 732 (CA7 1986).
97 Timbers, 108 S Ct at 630-631.
98 See In re Nite Lite Inns, 17 BR 367, 373 (BC SD Cal 1982) (rejecting
claim of creditor that in order to receive present value under §1129(b) creditor
had to receive note that could be sold for face value); 6A Collier on Bankruptcy
¶11.06 at 223 (14th Ed 1977) ("[t]he requirement of 'full compensation'
heretofore considered, does not imply that if new securities are offered they
must have a 'market value' equivalent to the old claims."); Bradney, 48 Am
Bankr LJ at 316 ("this does not mean that the new securities being distributed
must have an immediate cash value equal to their face amount.").
99 Ahlers, 108 S Ct at 967 (emphasis in original).
100 See generally Klee, All You Ever Wanted To Know About Cram Down
102 Floor Statements at 32407 and S17420.
103 Timbers, 108 S Ct at 634, citing United States Nat. Bank v. Chase
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104 11 USC §§103(b) and 1129(a)(7).
105 But see In re Shaffer Furniture Co., 68 BR 827 (BC BD Pa 1987) (court has power to order payment of postpetition interest by solvent Chapter 11 debtor).
107 Timbers, 108 S Ct at 630.
REDESIGNING A CHESHIRE CAT: LEGISLATIVE REFORM FOR TREATMENT OF EXECUTORY CONTRACTS IN BANKRUPTCY

By Mark E. MacDonald and Camille R. McLeod*

I. INTRODUCTION

After ten years of experience since the Bankruptcy Code's enactment in 1978, a substantial consensus is developing that the Code's treatment of executory contracts is not working properly. The primary complaints are that the Code has created a statutory monster which defeats legitimate expectations, is used as an instrument of oppression against other contracting parties, and is far too unpredictable. A contrary minority theme is that the Code's provisions are not sufficiently flexible to permit modification of classes of executory contracts in businesses such as television stations, in which the primary assets of the business consist of masses of somewhat similar executory contracts.1 Inability to modify those contracts by class, rather than to choose to assume or reject those contracts individually, may lead to failure of a reorganization. This article only proposes principles to attempt a solution for the primary complaints concerning the arbitrary and oppressive use of the executory contract powers. Accordingly, discussions of the minority complaint of the need for class treatment of executory contracts will be left to other forums.

Whether one agrees with the conclusion that Section 365 created a statutory monster, it is clearly true that Section 365 has been the provision of the Bankruptcy Code most attacked

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by various special interest groups which have either wished to exempt themselves entirely from its provisions or substantially modify the impact of those provisions. These various legislative exemptions include the landlord protection provisions in 1984, the protection of the interests of purchasers of time shares, the protection of various securities, commodities and future contracts, the sale of grain to an elevator, the protection for licensees of intellectual property, the modification of provisions involving repurchase agreements, creation of a separate procedure under Section 1113 for collective bargaining agreements, and the provision of special procedures under Section 1114 for pension and welfare benefit agreements. Currently pending are requested changes to effectively exempt interest rate swaps as well as to prevent working interest owners in oil and gas or royalty interest owners from being rejected prior to the time that the farmout rights have been "earned."

Thus, Congress, by dealing with special interest groups, has created multiple categories for treatment under Section 365. Irrespective of the individual policy judgments concerning the individual exemptions, the problems created by the multiple categories can be simply stated: (1) the more numerous the categories, the greater the definitional problems; (2) the more numerous the categories, the greater the complexity; (3) increase in complexity also increases ambiguity. Thus, the more draconian that executory contracts treatment is perceived, the greater the pressure for piecemeal legislative exemption. For these reasons, the authors suggest a series of changes which should provide a basis for simplifying an inherently complex area and should reduce the pressure for piecemeal change.

The exemptions and special exceptions are in the Code from a combination of policy arguments and political muscle; they will not be removed en masse even if the bankruptcy bar believes that some of them should be. The overall objective should be to create a reasonable and flexible set of provisions which can deal with the wide range of contract relationships in a manner which both preserves bankruptcy estates from contract forfeiture, and treats the other parties fairly so that the numerous exceptions and exemptions become functionally less important.
II. SECTION 365 AND THE REORGANIZATION PROCESS

The current treatment of executory contracts in bankruptcy aids the reorganization process. The essence of the reorganization process, which is basically slanted toward "let's make a deal," is negotiation and bargaining. The creation of an intentionally ambiguous statute such as Section 365 serves to force the parties to reach a reasonable consensual bargain between themselves, because of the difficulty in predicting which way any court is going to rule.

The reorganization process generally emphasizes continuity of bargaining. The parties establish the parameters of the bargaining early in the case and then seek to narrow their differences by incremental changes of position. If foreclosure can be likened to a switch, with an on/off feature, the reorganization process can be analogized to a rheostat, with an infinite number of settings through which judicially-blessed workouts may be structured. Adequate protection for the fully secured creditor may have changes from time to time in a particular budgeted number, but the general protections such as substituted lien, insurance on collateral, collateral ratios, formulas for usage, and conditions for termination often provide the framework for the long term "deal" contained in the plan of reorganization.

The treatment of executory contracts is similar to other parts of the reorganization process in encouraging negotiation by vagueness in concepts and inconsistency in practical application; however, the executory contract weapon differs substantially from the other weapons of the debtor. The time of exercise is uncertain, the effect of rejection or assumption is retroactive, and the impact is "either/or." The impact of assumption is to create a status unimpaired by the bankruptcy with all monetary defaults promptly cured and assurance of continued future performance. The impact of rejection is a breach as of the date of filing. In either event, part performance or no performance during the intervening time may have seriously modified the underlying economic bargain.
This disparate treatment of executory contracts in the reorganization process is especially significant because it tends to follow several of the principal lines of demarcation in the common law. These principal divisions of the common law are: property, contracts, trusts, and torts. It is not an accident that the American Law Institute chose to organize the Restatements in this fashion; however, the lines of demarcation among property rights, contract rights and beneficial interests in trust have not been terribly clear even in the common law. Generations of lawyers have exercised ingenuity to create hybrids: the contract for deed, the trust deed, and the sale-leaseback are three simple examples. The distinction between "repo" and "reverse repo" agreements provides an important modern example. Thus, the dichotomy in treatment between executory contracts and other rights in bankruptcy exists at the core of an important set of distinctions in underlying state-created rights.

Moreover, the state-created rules of property are inevitably modified when they collide with equity. Just as equity courts modified substantive property rights through creation of express and implied trusts, the interaction of contracts with the powers of equity courts inevitably has profound results. This basic truth was recognized more than a half century ago in Continental Illinois Nat. Bank & Trust Co. v. Chicago, R.I. & Pac. Ry. Co., which recognized that an injunction could defer receipt of benefits even to a secured creditor. In a nonbankruptcy context the creation of the law of trusts by the English chancellors effectively created a new form of property not recognized by the law courts.

Traditionally, even under the old Bankruptcy Act, bankruptcy courts have been courts of equity, developed from the old concept of equity receivers. They work entirely differently from courts of law, reasoning from general principles or maxims which are necessarily internally inconsistent. The two equitable maxims, "Equality is Equity," and "Equity aids the vigilant, not those who slumber on their rights," have coexisted happily in equity courts for years. When the court opted for one result, it would invoke one rule instead of the other. Equity courts do not necessarily follow rigidly logical reasoning; they use broad
maxims invoked in a practical way, and balance among overlapping but inconsistent principles.

The common law has been primarily concerned with precedent; Equity is fact-intensive and fairness-oriented. Because Equity is also oriented toward compromise, it relies heavily on inductive rather than deductive reasoning. Writers such as Jackson, who reason from major premises of "proper" economic policy under the law and economics approach, fail to describe what really happens in bankruptcy courts because they fail to adequately emphasize that the bankruptcy process is not rigidly logical. The bankruptcy process arises from a balancing of inconsistent and inexact truths. The imprecision of the process is not its weakness but its strength.

The statutory changes suggested in this article attempt to follow a pragmatic and inductive approach to recognize that the statute will be applied by a court of equity. The wealth of decisions involving treatment of executory contracts, which the authors have described as Cheshire cats mysteriously appearing and disappearing, as in "Alice in Wonderland," were inductively reviewed to attempt to identify the specific problem areas and then seek a practical solution. The solution was then sought which would be consistent with a court of equity interpreting and administering the ultimate statutory language. The authors reject any general principle that either federal or state-created rules dictate the definition of enforcement of executory contracts in bankruptcy. Forum shopping and federalism should not be the key consideration; state-created rights will be affected in a court of equity so long as there is an automatic stay. The key questions should be, when to be clear and when to be fuzzy, in order to obtain a practical result in most circumstances. In order to reach this optimal understanding it is next necessary to understand the differences between rhetoric and reality in the current treatment of executory contracts.

III. WHAT WE SAY WE DO, UNDER SECTION 365

An executory contract or lease must be assumed in its entirety. In order to obtain the benefits, one must assume the
burdens. The other party must receive adequate assurance of future performance, which is to be determined in a reasonably practicable manner. The standard for assumption or rejection is the "business judgment" of the debtor. Unfairness to the other contracting party is not a consideration for the court in authorizing assumption or rejection. In determining whether a contract is executory, courts either purport to follow the Countryman definition or they "work backward, proceeding from an examination of the purposes that rejection is expected to accomplish. If those objectives have already been accomplished, or if they can't be accomplished through rejection, then the contract is not executory within the meaning of the Bankruptcy Act."

IV. WHAT WE REALLY DO UNDER SECTION 365

Focusing on compromise, the debtor tries to negotiate for the modification of the agreement, not the assumption or rejection of the agreement in its entirety. Treatment of executory contracts is sometimes used as a carrot and a stick. The carrot is that by assumption, the friendly debtor can effectively enable a creditor with an unsecured claim to be placed in a statutorily-blessed priority or preferential position over all other unsecured creditors. The stick arises in three ways:

First, many contracts are drafted with little attention to integration clauses, and fail to give detailed consideration to how the "deal" might be rebalanced if some of the promises had already been performed and others had not, or how the contract might be affected as the positions and relationships of the parties themselves change through time. The compromise may be concerned with the amount of the claim, or the results of the rejection—how much of the claim is administrative? If the debtor assumes the contract, what does it have to perform, especially in view of the fact that, since the case has been pending for six months to two years, the time for performance may have materially changed. Thus, the contract can be "cherry picked," in a manner in which the debtor divides the overall deal into multiple contracts, accepts the good and rejects the bad.
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Second, irrespective of the automatic stay, the benefits and burdens of many contracts change over time. The flexible provisions for time of assumption and rejection are like a chessboard with one player blindfolded and the other player getting to call the last move, to say when the game is over.\textsuperscript{46} The fact that the blindfolded player has his hands tied behind his back by the automatic stay and the threat of contempt hanging over his head, maximizes the effect of the stick in a business deal, particularly when the "seeing" player has the sole decision when to stop play. The stick is very unique and powerful, especially when added to the notion that unfairness is not a consideration for the court in allowing the debtor to reject.\textsuperscript{47}

Third, the doctrine that rejection is the equivalent of termination of the right to continued use or possession of an asset adds to the basic leverage since it is usually more profitable to sell an asset twice than it is to sell it once.\textsuperscript{48} This third aspect of the carrot and stick has been powerfully attacked in a recent article by Andrew.\textsuperscript{49} Andrew’s argument is so important that it is extensively discussed in Part VI below.

V. HOW THE 1978 CODE CHANGED EXECUTORY CONTRACT TREATMENT

The 1978 Code made two legislative changes; the courts made two more. The biggest change occurring under the 1978 Bankruptcy Code was that bankruptcy clauses in leases and contracts don’t automatically work; indeed, they don’t work at all.\textsuperscript{50} The whole history of the creditor’s ability to make claims in receivership proceedings related to his ability to demonstrate that he could show an equitable claim at the time of filing.\textsuperscript{51} A bankruptcy clause in a lease or contract therefore made it possible to declare the lease or contract forfeited and measure damages back to the filing—to show a group of interests incurring after the filing but retroactive to the filing. Section 70(b) of the Bankruptcy Act provided, in pertinent part, that bankruptcy lease termination clauses worked:

* A general covenant or condition in a lease that it shall not be assigned shall not be construed to prevent the trustee from assuming the same at his election and subsequently assigning
the same, but an express covenant that an assignment by
operation of law or the bankruptcy of a specified party
thereof or of either party shall terminate the lease or give the
other party an election to terminate the same is enforce-
able."52

The Queens Boulevard Wine & Liquor Corp. v. Blum53 case
announced the then revolutionary notion that the Court could
exercise its equitable powers to prevent a forfeiture.54 Congress
codified that notion, creating a great shield that permitted the
sword or stick to strike, because the debtor sits protected
by the stay virtually impervious to the creditor's action,55 with
the ability to let time wear upon the other party.56 Indeed, some
courts have gone so far as to say that the lessor is not even
entitled to adequate protection for the use of its property57 and
that the stay cannot be vacated before the debtor decides to
assume or reject.58

Another key legislative change which the 1978 Code made
in executory contract law, rendered limitations on assignability
of leases or executory contracts invalid.59 The power to assign is
subject to the same exceptions as the power to assume, i.e., a
nonassignable contract may not be assigned.60 Although the
Third Circuit became badly confused in a government contracts
case and read the provisions exactly backward, most courts have
correctly interpreted the provisions to substantially increase the
debtor's power to transfer leases and contracts without third
party consents.61 This result has enormously benefitted debtor's
estates.

Other changes in executory contract treatment have arisen
judicially. Under prior bankruptcy law, many courts asserted
that a contract had to be burdensome to be rejected. The
standard of "business judgment" was much closer to the concept
of burdensome than it is today.62 The standard of "business
judgment" has relaxed to the point that the Court in In re
Summit Land Co.,63 stated that "except in extraordinary
situations, approval under §365 should be granted as a matter of
course."64

The question, "What is an executory contract?" has evoked
streams of judicial opinion since 1978 and represents the
principal judicially created change.65 This judicial activism
arose when Congress made a conscious decision not to adopt a definition of executory contract in the 1978 Code. The courts promptly filled the void left by Congress. Professor Countryman's definition, which was referred to in the 1978 legislative history, defining an executory contract as "A contract under which the obligations of both the bankrupt and the other party are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other," has been adopted by many courts.

Viewing the Countryman definition as too restrictive, other courts have stretched to hold executory a contract "which include[s] an obligation for the debtor to do something in the future," or "which requires substantial performance by either party to the agreement other than the payment of money . . ." The question would lose importance, and people would lose the fear precipitating all this litigation, if the impact of a finding that a contract was "executory" were not as dire. Similarly, if treatment of executory contracts and leases were more equitable, Congress might not so often yield the pressure of special interest groups, in modifying the section.

VI. ANDREW AND THE MEANING OF REJECTION

A major new article by Michael Andrew entitled Executory Contracts in Bankruptcy: Understanding "Rejection" must be considered and discussed prior to the formulation of new legislation for a number of reasons. The article is very well researched and extremely creative. Most importantly, it offers an entirely new perception about the concepts underlying rejection of executory contracts.

The Andrew viewpoint is also useful as a counterpoint to the approach taken in this article. Andrew's view is predominantly concerned with doctrine; his mode of argumentation is the vigorous use of a revisionist stare decisis. This article is primarily concerned with how the bankruptcy process really works. Whether the approach of this article is characterized as pragmatism or legal realism, the authors believe that the process is a negotiation and that the doctrines are not used in a logically consistent manner in the cases. For example, Andrew asserts
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that confusion over rejection has "yielded wasteful litigation, absurd results, and dramatic distortions in bankruptcy law." The authors concur with the conclusion that doctrines of rejection are extremely vague and flexible and that the case law is horribly inconsistent; however, vagueness in the proper degree can assist the reorganization process by encouraging compromise. Litigation is not necessarily wasteful so long as experienced bankruptcy practitioners know how to settle and readjust the underlying business deal in a manner which the parties select and so long as business lawyers can sufficiently grasp the rules so that parties have some ability to predict the legal consequence of a structure.

Like any brilliant bankruptcy argument, Andrew selectively evokes inconsistent major premises, i.e., the footnotes acknowledge that various cases and commentators reach conclusions which conflict with the text of the principal argument. The fact that Andrew is not rigorous in logical consistency is not a flaw in the concepts created. They simply mean that the arguments cannot be taken as rigorously correct for all purposes. Andrew forcefully asks a number of excellent questions which should be answered in a functional approach.

The authors' difficulty with Andrew is that the concepts utilized by him, which emphasize the importance of transfer of title and the distinction between the debtor and the estate, become as arcane as the confusion created by the current mass of conflicting decisions. Andrew simply invokes a different set of demons in attempting to solve admittedly difficult questions in a brilliant and thoughtful manner. Andrew faults Countryman for ignoring the historical relationship between the election to assume or reject and the vesting of title to property in a bankruptcy estate. Yet, excepting selected footnotes, Andrew ignores the fact that the United States Supreme Court in NLRB v. Bildisco expressly rejected the distinction between the debtor and the debtor in possession as a basis for analyzing rights upon contract rejection. The distinction between the debtor and the estate is clearly a sensible distinction on which the law could have grown, but did not.

The vesting of title approach utilized by Andrew is also inherently inconsistent with the theory of Section 541 of the
Bankruptcy Code.\textsuperscript{80} Section 541 rejects the concept of assignability or transferability as a basis for what assets can reach the estate. Section 541 now deals with assets of the estate on a basis of intransitive verbs. The debtor is; the estate is; the successor under a plan of reorganization will be. The closest analogy in the law is to a springing use, in which a party declares himself a trustee for the benefit of another. There is no assignment, but, nonetheless, an equitable estate exists upon the declaration.\textsuperscript{81} The question is not whether prior Bankruptcy Acts provided for vesting of property by operation of law;\textsuperscript{82} the question is whether the theory of that vesting relies upon concepts of transfer. Clearly, it does not. Without the concept of transfer between a debtor and its estate, a number of the concepts asserted by Andrew appear strained.

Despite these relatively minor criticisms, Andrew clearly reached the aim of his article "to help foment discussion that may lead ultimately to a more comprehensible successor to §365 . . ."\textsuperscript{83} It is questionable whether he was similarly successful in his second aim which was to "contribute to an understanding of the section as it exists today."\textsuperscript{84}

Andrew's statement that "because the estate acquires its property from the debtor, the estate's rights in and to the property are in general no greater than were the debtor's"\textsuperscript{85} is a serious over-simplification in the context of executory contracts. The footnote allegedly supporting this assertion invoking the legislative history to Section 541(d) does not support the proposition asserted.\textsuperscript{86} Similarly, the invocation of Butner v. United States,\textsuperscript{87} which asserted: "property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interest should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding"\textsuperscript{88} begs the question in the context of executory contracts. The question is whether some federal interest requires a different result.

In determining what an appropriate bankruptcy policy \textit{should} be, it is essential to recognize that the Bankruptcy Code has created an alternate theory of property law of which the law of executory contracts is a part. For example, a creditor may start a reorganization proceeding secured by inventory and
accounts receivable; an order may then be entered substituting a lien on Blackacre and permitting the consumption of the inventory and accounts receivable. Although the Code under Section 1129 requires that the lien on the effective date be preserved as to collateral existing on the effective date, the concept of the ability to involuntarily exchange types or items of collateral is wholly foreign to state law. Under Section 364 a secured creditor may start a proceeding with a first lien on real estate and, after a borrowing under Section 364(d), end up with a second lien on that real estate together with additional collateral elsewhere. A fully secured creditor with an equity cushion of 50 percent at the commencement of the proceeding may depart on the effective date with a collateral cushion value of ten percent securing a new note which contains substantially fewer covenants and conditions than the existing note. A less than fully secured creditor accrues no interest on the secured portion of his lien claim during the pendency of a proceeding even though as a matter of state law his lien continues to grow against the subject property and cannot be discharged except through payment in full or a bid at a foreclosure sale.

Differences between the state law theory of property rights and the bankruptcy law theory of property rights are especially acute in those states which follow a title theory of real estate mortgages rather than a lien theory. Although as a matter of state law such parties are "owners" of title to an asset, as a matter of federal bankruptcy law, so long as the obligation is in the nature of a mortgage, it will typically be treated under Sections 1129 and 541 as property of the estate subject to a lien and thus capable of modification.

This basic disagreement with Andrew (i.e., that federal bankruptcy executory contracts doctrine need not follow state law contract rights and remedies) is important in the context of treatments of installment sales, financing leases, and other transactions executory in form which may be intended as security. While Andrew then argues that bankruptcy law's "avoiding powers are a significant exception to the recognition of such rights in property" which "... will in some circumstances allow otherwise valid pre-bankruptcy transfers of interest in property by the debtor to be recovered by the estate,
thereby giving the estate better rights than had the debtor,
there is not necessarily any reason graven in stone under the
existing statute why executory contracts cannot properly pro-
vide the functional equivalent of a bankruptcy avoiding power
under §§ 544–550. Emphasis upon variations of state property
and contract law has led us to the mess of wildly inconsistent
cases involving real estate lease terminations, oil and gas
"leases," and installment land contracts. This legal mish-
mash could be substantially clarified if we would only remind
ourselves that the Constitution authorizes a uniform system of
bankruptcy laws.

Andrew sets forth a thoughtful and detailed description of
pre-1978 law concerning the nature and effect of rejection.
Andrew nowhere mentions either the key change in 1978 in
which insolvency clauses became unenforceable for the purpose
of forfeiting or modifying contracts or the theory of estate
creation embodied in Section 541. The amendments proposed in
Part VIII of this article attempt to accommodate a number of
Andrew's conclusions concerning proper policy. Nevertheless, in
utilizing those policy conclusions and the historic experience set
forth in the cases discussed by him, we reject as excess baggage,
title concepts which have been largely repudiated under the
Uniform Commercial Code.

One of Andrew's central themes is that a trustee or debtor
in possession does not reject the liability reflected in a contract
but rather declines to accept the transfer of title to the asset,
thus excluding the asset from the estate. This viewpoint is
consistent with the statement from Bildisco that prior to
assumption the contract is not currently enforceable and may
never be enforceable again. The Andrew viewpoint is also
consistent with the notion that Bildisco meant to say that the
contract is mutually nonenforceable whether against the debtor
by or the debtor until assumption.

One logical problem created by Andrew's argument that the
asset portion of a contract does not become part of the debtor's
estate until assumption, is that the automatic stay would not
prevent notice of termination or physical eviction prior to
assumption since the right under the contract was not the
property of the estate. This conclusion is wholly inconsistent
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with a mass of decisions concerning the automatic stay\textsuperscript{107} and even Andrew acknowledges that the case law is inconsistent with this result.\textsuperscript{108}

Two very thoughtful opinions which demonstrate the extreme difficulty of pressing executory contract theories too rigorously arose from the Chapter 11 proceedings filed by the world-famous heart surgeon, Dr. Denton Cooley. Under Section 541(a)(6) of the Code, the earnings of an individual from wages and services do not become part of the Chapter 11 estate. The court was asked to allocate the value of those services not only personally performed by Dr. Cooley but also the benefits generated by Dr. Cooley as a "rainmaker," when as a sole proprietor he employs four other surgeons and numerous other support personnel. In the first decision by Judge Mahoney,\textsuperscript{109} she rejects the decision of the Ninth Circuit in FitzSimmons v. Walsh,\textsuperscript{110} which limited the exception to those assets personally earned by the debtor's efforts as a professional. Judge Mahoney also rejected the notion advanced by the debtor that because the employment contracts with the associate surgeons had not been assumed by him acting in his role as debtor in possession, the income from their services did not become property of the estate. Since Dr. Cooley had manifested an intention to ultimately assume those contracts as a part of his plan of reorganization which had been filed but not yet confirmed, Judge Mahoney asserted that the contracts were not at issue. The only issue was the income derived from the postpetition services of the associate surgeons and to whose benefit such income accrues. The authors believe that Judge Mahoney's refusal to become enmeshed in concepts of either the passage of title or assumption and rejection demonstrates an appropriate approach free from the technical preconceptions of the type asserted by Andrew.

The second Cooley decision\textsuperscript{111} dealt with a fascinating outgrowth of the contractual relations with the associate surgeons. The contracts with the surgeons expired on the date the plan of reorganization became effective. The plan purported to liquidate Dr. Cooley's estate over a period of five years. Dr. Cooley rehired the surgeons in his new postconfirmation sole proprietorship. Judge Mahoney rejected concepts of theft of
advantageous business relationship and any proprietary relationship between the estate, which got the benefits of the post-filing preconfirmation services of those surgeons, and the surgeons. Dr. Cooley's right of association, the need for a fresh start, and the dilemma of establishing new business relationships all caused the court to reject an analysis which used "title" as the major premise.

The most unusual aspect of the Andrew argument arises in connection with the relationship between rejection and breach of an executory contract. Countryman contends that the concern of the courts about the existence of a breach, when the debtor had not breached the contract at the moment of bankruptcy, simply reflected confusion over the rule that claims must be in existence at the time of bankruptcy. Countryman suggests that the simple answer to the problem was that claims may be provable even though not mature. Andrew asserts a very different view: "the concern was that neither the debtors' nonperformance nor the other party's performance were certain as of the crucial time, the moment of bankruptcy, because the contract or lease still remained alive outside of the estate." A key problem with the Andrew view that the contract continues outside the estate can be stated simply: if an estate fails to assume a contract which was not in breach at the time of filing, is the contract abandoned to the debtor who would then be entitled to call upon the other party for enforcement? Despite the "riding through" cases cited by Andrew, such a view creates monstrous problems under both Section 365(c) and (e). Section 365(e)(1) prohibits the termination or modification of any right or obligation under a contract solely because of a provision that is conditioned upon insolvency, financial condition, or the commencement of the case. That prohibition exists irrespective of assumption by the estate or rejection. Assume an individual licensee of rights as a franchisee who files Chapter 7. His Chapter 7 trustee fails to assume the executory contract because the trustee has no desire to have that asset within the estate. Under the Andrew argument, the individual should logically be capable of requesting performance of the obligation even though his reciprocal duty to perform may have been discharged or be subject to discharge in the future. Although
under this hypothetical the provisions of Section 365(g) could be read to say that the rejection constitutes a breach of the contract not only as to the estate but as to the debtor, Andrew clearly asserts that the relationship between the debtor and the nondebtor is left open. 116

An even more interesting example arises under a contract to make a loan to the debtor under Section 365(c). As a matter of statute, the trustee is prohibited from assuming this contract. Nonetheless, Section 365(e)(1) teaches that rights and obligations under a contract may not be terminated solely because of insolvency or financial condition. The bizarre result which would be reached if the obligation of the third party were permitted to pass through to the debtor would be that the debtor in his individual capacity would be able to compel a post discharge loan irrespective of his financial condition. The authors feel confident that Congress has never contemplated stretching the debtor's "fresh start" to this degree.

The notion that the debtor would be permitted to succeed to performance of a contract, after abandonment by failure to assume, was rejected in the early leading decision of Central Trust Co. v. Chicago Auditorium Ass'n. 117 It would be truly strange to interpret Chicago Auditorium to hold that the obligation of the debtor to the other contracting party is discharged but the debtor would be entitled to unilaterally enforce performance where the other party has no rights. It should be noted that the 1973 Bankruptcy Commission Report to Congress suggested that any vestiges of case law such as the decision in Chicago Auditorium whereby commencement of a case itself terminates an agreement to which the debtor is a party, without reference to any non-bankruptcy law or provision in the Act, should be overruled. 118 That change occurred in the context of Section 365(e) to prevent bankruptcy termination and anti-assignment clauses from taking assets of the estate. The discussion and footnotes of Andrew 119 still make no sense in the context of a nonassumable contract which is nonforfeitable as to a debtor due to unenforceability of bankruptcy clauses. Andrew's discussion of Chicago Auditorium with its attendant attempts to distinguish between bankruptcy as a breach, as opposed to rejection as a breach, 120 appears to be a