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The rights of creditors and equity security holders to share in a distribution of the debtor's estate or otherwise participate in the bankruptcy case depend, under the new Bankruptcy Code, upon whether their claims or interests are "allowed." The authors explain all the various aspects of the question of allowability of claims under the new Code by focusing on such issues as the procedures for the allowance of claims and equity interests; the grounds for disallowance of claims, expenses, and secured claims; the seller's right to reclaim goods; and the types of unsecured claims and expenses which are entitled to priority in distribution over other unsecured claims.

Provability Concept Eliminated

The former Bankruptcy Act employed the concept of *provability* of claims to determine whether particular creditors might participate in the bankruptcy case.[1] If a claim was not provable, the creditor was not permitted to play any significant role in the case. A creditor with a nonprovable claim was not entitled to share in a distribution of the estate[2] or to file an involuntary bank-

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This article is based on a chapter of the authors' forthcoming book on bankruptcy and debtor relief to be published by Warren, Gorham and Lamont. The Bankruptcy Code, which is Title 11 of the United States Code, was created by the Bankruptcy Reform Act of 1978 (Pub. L. 95-598) and governs all bankruptcy cases commenced on or after October 1, 1979. The Code is cited as "11 U.S.C. § ———."

[1] See Section 63(a) of the former Bankruptcy Act (hereinafter referred to and cited as Former B.A.) which was repealed by the Bankruptcy Reform Act of 1978.

[2] The former Bankruptcy Act provided that dividends be distributed only on "allowed" claims, and that a claim could not be allowed unless it was provable. See Former B.A. §§ 65(a), 57(d).

ruptcy petition.[3] Moreover, a creditor without a provable claim was not affected by the debtor's discharge.[4] Whether or not a claim was provable depended on the nature of the claim; provability did not relate to ability to prove the claim by competent evidence. The former Act listed nine categories of debts which qualified as provable claims.[5]

To illustrate, let us assume that the debtor caused injury to a person as a result of negligence prior to the debtor's bankruptcy. Did the injured party have the right to share in the debtor's estate? Did the person have the right to file an involuntary petition? Was the debt dischargeable? The answers to these questions depended, under the former Act, on whether the negligence claim was provable. The Act provided that negligence claims were provable only if the claimant commenced a negligence action which was pending when the bankruptcy petition was filed.[6] If no action was commenced at that time, the injured party would not be affected by the bankruptcy and could not participate in the case. Other examples of nonprovable claims were intentional tort claims which were not reduced to judgment[7] and contingent or unliquidated claims not capable of liquidation or reasonable estimation without undue delay.[8]

Today, the concept of provability is eliminated. The Bankruptcy Code does not even mention the concept and, therefore, makes it possible for more creditors to be affected by, and to participate in, the bankruptcy case. Whether a creditor may share in a distribution of the estate or otherwise participate in the case depends on whether its claim is *allowed*—not whether it is provable.

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[3] See Former B.A. § 59(b).

[4] See Former B.A. § 17(a).

[5] See Former B.A. § 63(a).

[6] Former B.A. § 63(a)(7).

[7] There were exceptions to the rule that intentional tort claims were not provable in bankruptcy. Tort claims which also gave rise to quasi-contractual claims, such as when a person was unjustly enriched by wrongfully converting property of another, were provable. Torts committed by persons in contractual relationships, such as a doctor-patient relationship, were considered provable. See Schall v. Camors, 251 U.S. 239, 40 S. Ct. 135, 64 L. Ed. 247 (1920).

[8] See Former B.A. §§ 57(d); 63(d); Thompson v. England, 226 F.2d 488 (9th Cir. 1955). See also State of New York v. Wilkes, 41 N.Y.2d 655, 394 N.Y.S.2d 849 (1977), in which the court held that a student loan was not provable or dischargeable because of various conditions attached to the repayment provisions of the loan which made it too contingent.

What Is a Claim?

An entity is not considered a creditor for bankruptcy purposes unless it holds a claim.[9] The Bankruptcy Code defines "claim" in a manner which makes the term broader than the term "debt" or "claim" under the former Bankruptcy Act.[10] Any right to payment, whether or not it is reduced to judgment, is a claim which may enable the holder of it to participate in the bankruptcy case. It does not matter if the right to payment is liquidated or unliquidated, fixed or contingent, matured or unmatured, disputed or undisputed, or secured or unsecured. In addition, if the debtor's breach of performance results in the right to an equitable remedy, the creditor has a claim so long as the breach also gives rise to a right to payment.[11] For example, in certain states a judgment for specific performance may be satisfied by an alternative right to payment in the event performance is refused. In these states, the person who is entitled to specific performance will have a claim for bankruptcy purposes if the debtor files a petition. However, a right to an equitable remedy which does not give the holder a right to the payment of money is not a "claim" in the context of the Bankruptcy Code.

The practical consequence of having such a broad definition of "claim" in the Bankruptcy Code is to permit the most comprehensive relief in the bankruptcy court.

Equity Security Holders and Their Interests

Creditors are not the only ones who may wish to participate in a bankruptcy case. Equity security holders, including those persons who hold shares of stock in a debtor corporation, interests of a limited partner in a limited partnership debtor, or warrants or other rights to purchase, sell, or subscribe to such securities, may also wish to participate in the case.[12] This is especially true

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[9] See 11 U.S.C. § 101(9) for the definition of "creditor."

[10] Compare the definition of "claim" in 11 U.S.C. § 101(4), with the definitions of "claim" and "debt" in Former B.A. §§ 1(14), 106(1), 307(2), 406(2), 606(1).

[11] 11 U.S.C. § 101(4).

[12] See 11 U.S.C. §§ 101(15), 101(16) for definitions of "equity security" and "equity security holder." A convertible debenture that is convertible into an equity security, but that was not so converted, is itself not an equity security for bankruptcy purposes. See H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 311 (1977) (hereinafter referred to and cited as House Report).

in reorganization cases in which equity security holders will want to vote on, and benefit from, the reorganization plan. The Bankruptcy Code permits equity security holders to participate in the case according to their *allowed interests*.[13]

Filing Proofs of Claims or Interests

The Bankruptcy Code gives creditors the right to file proofs of claims in a bankruptcy case.[14] Although the provision is permissive and not mandatory, any creditor who wishes to have an allowed claim in a liquidation case or in a Chapter 13 debt adjustment must file a proof of claim with the court.[15] Otherwise, the creditor may be unable to share in the distribution of the estate.

There are certain situations in which filing a proof of claim may not be warranted. In no-asset liquidation cases or when the estate is so insubstantial that priority creditors will consume the estate,[16] there may be no need for the general creditors to file proof of claim forms. Likewise, if a creditor is fully secured and wishes to rely solely on the value of the collateral, there will be no purpose in filing a proof of claim unless a party in interest requests that the secured claim be allowed or disallowed.[17] It is important to note, however, that creditors may not avoid the debtor's discharge by failing to file proofs of claims because unfiled claims are dischargeable in the same manner as allowed claims.[17a] Thus, in the usual case, general creditors, partially secured creditors, secured creditors requested to file, creditors seeking a priority, and creditors with post-petition allowable claims[18] will file proofs of claims in order to protect their rights against the estate in a liquidation case.

Although a proof of claim must be filed before a claim will be allowed in a liquidation case or in a Chapter 13 debt adjustment, a different rule governs reorganization cases. Chapter 11 of the

[13] See 11 U.S.C. § 1126(a).

[14] 11 U.S.C. § 501(a). An indenture trustee also has the right to file a proof of claim. See 11 U.S.C. §§ 101(22) and 101(23) for definitions of "indenture" and "indenture trustee."

[15] See 11 U.S.C. § 502.

[16] See 11 U.S.C. § 507. Priority claims are discussed later in this article.

[17] See 11 U.S.C. § 506(d)(1) which provides, in effect, that a lien securing a claim which is not an allowed secured claim is valid nonetheless if a party in interest has not requested that the court rule on its allowability.

[17a] See 11 U.S.C. § 727(b).

[18] See the discussion on allowable post-petition claims later in this article.

Code provides that a proof of claim is "deemed filed" if the claim appears on the schedules filed by the debtor or the trustee, unless it is scheduled as disputed, contingent, or unliquidated.[19] Accordingly, only creditors who are not listed on the schedules or those listed as having disputed, contingent, or unliquidated claims need file a proof of claim to have the claim allowed so as to permit participation in the case. If a proof of claim is executed and filed in accordance with the Bankruptcy Rules, it will supersede any listing. Moreover, even though the listing may be correct, an attorney-in-fact may want to file a proof of claim so that notices and dividends will be sent directly to the attorney-in-fact.

A creditor's failure to file a timely proof of claim may unfairly jeopardize the rights of other parties in certain situations. For example, a person who guaranteed an obligation owed by the debtor would benefit by having the creditor receive as much money as possible from the estate. If the creditor's claim is not allowed because of failure to file a proof of claim, the guarantor may be liable for the entire debt.[20] Similarly, if the creditor has a nondischargeable claim, the debtor has an interest in having that creditor receive a distribution in bankruptcy. If the creditor receives no distribution because of the failure to file a proof of claim, the entire nondischargeable debt will survive bankruptcy to be collected against the debtor at some future date. For these reasons, the Bankruptcy Code and the Suggested Interim Bankruptcy Rules provide that a co-debtor[21] as well as a person who secured the debtor's obligation, may file a proof of claim if the creditor fails to do so within applicable time limits.[22] In addition, the debtor

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[19] 11 U.S.C. § 1111(a), which is derived from Rules 10-401 and 12-30 of the Bankruptcy Rules of Procedure (hereinafter cited as B. Rules). See Rule 3001 of the Suggested Interim Rules (hereinafter referred to as Sugg. Int. B. Rules) on the proof of claim or interest in a Chapter 11 reorganization case.

[19a] See B. Rule 301(b) and Sugg. Int. B. Rule 3001(b)(4) on the evidentiary effect of the filing. Note that Sugg. Int. B. Rule 3001 applies only in cases filed under Chapter 11. Sugg. Int. B. Rule 3001(g).

[20] The Bankruptcy Code follows Section 16 of the Former B.A. by providing that the liability of co-debtors is unaffected by the debtor's discharge. 11 U.S.C. § 524(e). However, see 11 U.S.C. § 1301 and Chapter 9 (Debt Adjustments for Individuals) of the authors' forthcoming book for a discussion concerning the stay of actions against co-debtors in Chapter 13 cases.

[21] The term "co-debtor" means any entity that is liable to the creditor with the debtor, whether it has primary liability with the debtor, such as a co-maker of a promissory note, or secondary liability as a guarantor only.

[22] 11 U.S.C. § 501(b). Sugg. Int. B. Rule 3002. See B. Rule 304.

or the trustee may file a proof of claim if the creditor does not.[23]

The Bankruptcy Rules of Procedure and, where applicable, the Suggested Interim Bankruptcy Rules govern the form and procedural requirements for filing a proof of claim.[24] The proof must be in writing and executed by the creditor or by an authorized agent of the creditor,[25] unless it is filed by either a trustee, a debtor, or a co-debtor upon the creditor's failure to file. The official proof of claim forms should be utilized for filing purposes.[26] If the creditor wishes to appoint an attorney-in-fact in the case, a general or special power of attorney may be filed together with the proof of claim.[27] When the claim or a security interest in connection with the claim is founded on a writing, such as when the debt is evidenced by a promissory note, the original or duplicate of the writing must be filed with the proof of claim. However, if the writing was lost or destroyed, a statement explaining the loss or destruction must be filed instead. In the case of a secured claim, satisfactory evidence that the security interest was perfected, such as a copy of a financing statement stamped as a receipt by the Secretary of State, must accompany the proof of claim form.[28]

A proof of claim is filed timely in a liquidation case if it is filed within six months after the first date set for the first meeting of creditors.[29] The Suggested Interim Bankruptcy Rules provide as to reorganization cases that a proof of claim is filed timely as long as it is filed prior to the approval of the disclosure statement.[29a]

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[23] 11 U.S.C. § 501(c). See B. Rule 13-303. See also Sugg. Int. B. Rule 3004 which applies to cases under Chapters 7 and 11. An indenture trustee may also file for all holders of securities, known or unknown, issued pursuant to the instrument under which it is trustee. Sugg. Int. B. Rule 3001(b)(6).

[24] See B. Rules 301 and 302; Sugg. Int. B. Rules 3001 to 3004; Sugg. Int. B. Form Nos. 14 and 15, which are set forth in the Appendix of the author's forthcoming book.

[25] B. Rule 301(a). See B. Rule 302(d) for special rules dealing with claims which are assigned either unconditionally or as security.

[26] See Official Form 15 which should be used until new official forms are promulgated. For wage claims, Sugg. Int. B. Form No. 14 or 15 should be used. These forms are set forth in the Appendix of the authors' forthcoming book.

[27] Official Form 13 or 14 should be used for this purpose. It is customary for the power of appointment to be added to the end of the proof of claim form.

[28] B. Rule 302(c).

[29] B. Rule 302(e). The rule contains several exceptions to the six month rule. For example, the court may grant an extension to an infant or incompetent person, or to the United States or other governmental body.

[29a] Sugg. Int. B. Rule 3001(b)(3), but note that the court on notice may fix a different time. See Sugg. Int. B. Rule 2002. See also Sugg. Int. B. Rule 3001 (b)(2), which provides that any creditor that fails to file a claim before approval

This requirement appears to be sound since that is the first time when creditor identification is important. It would also appear that an earlier date should be required for disputed, contingent, or unliquidated claims so that they may be resolved prior to the approval of the disclosure statement.[30] In Chapter 13 debt adjustment cases, the creditor should file a claim within six months after the first date set for the first meeting of creditors, unless it is a secured claim, in which case it should be filed before the conclusion of the first meeting of creditors.[31]

In liquidation cases, limited partners or shareholders of the debtor usually will not participate in a distribution of the estate. Nonetheless, the Bankruptcy Code permits such equity security holders to file proofs of interest to obtain allowed interests.[32] In the unlikely event that there are assets remaining after all allowed claims of creditors are paid in full, a distribution may be made to allowed interest holders. It is advisable, therefore, for a limited partner or shareholder to file a proof of interest when the debtor is solvent or when the estate has substantial assets.

In contrast to liquidation cases, in reorganization cases it is *always* advisable for equity security holders to have their interests allowed. Only those equity security holders who have allowed interests may vote to accept or reject a plan of reorganization.[33] If the interest was scheduled by the debtor or the trustee, filing a proof of interest form is not necessary for allowance unless it was scheduled as disputed, contingent, or unliquidated.[34]

The Suggested Interim Bankruptcy Rules permit a creditor to withdraw a claim as of right unless certain events have occurred. Specifically, once an objection is filed, a complaint is filed against the creditor in an adversary proceeding, or the creditor has accepted or rejected a reorganization plan or otherwise has participated significantly in the case, the claim may not be withdrawn unless the court orders it withdrawn after a hearing on notice.[34a]

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of the disclosure statement or other time fixed by the court is not to be treated as a creditor for voting or distribution purposes. See 11 U.S.C. § 1125 on disclosure statements in reorganization cases.

[30] If a creditor in this group does file a proof of claim, of course, a hearing should be held prior to approval of the disclosure statement to estimate the dollar amount of the claim.

[31] B. Rule 13-302(e). See the rule for several exceptions to these time limits.

[32] 11 U.S.C. § 501(a).

[33] 11 U.S.C. § 1126(a).

[34] 11 U.S.C. § 1111(a).

[34a] Sugg. Int. B. Rule 3003, which is derived from B. Rule 10-404.

The Allowance of Claims or Interests

If a proof of claim or interest is filed, it will be deemed allowed automatically unless a party in interest objects.[35] In essence, the mere filing of the proof of claim or interest constitutes prima facie evidence of its validity and amount. In reorganization cases, this automatic allowability rule also applies to any scheduled claim and interest without the filing of a proof if the claim or interest is not listed as disputed, contingent, or unliquidated.[36]

It is the duty of the trustee to examine proofs of claims and to object to the allowance of improper ones.[37] The debtor is obligated to assist the trustee in this endeavor.[38] In reorganization cases in which the debtor remains in possession, the debtor has the duty to object to improper claims or interests.[39] Any objection to a claim or interest must be made in writing and a copy of the objection and at least ten days' notice of a hearing must be mailed or delivered to the claimant.[40] The court, after the notice and a hearing, will determine the validity and amount of the claim or interest as of the date of the filing of the petition.[41] Since the claim will be allowed for the amount owed as of the date the petition is filed, post-petition debts generally will not give rise to allowable claims.[42]

Grounds for Disallowance

The Bankruptcy Code contains several grounds for dissallowance of a claim in whole or in part. To the extent that any of the grounds are found to exist, the court will not allow the claim.

Unenforceability Against the Debtor

To the extent that the claim is unenforceable against the debtor and the debtor's property under nonbankruptcy law or by virtue

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35 11 U.S.C. § 502(a); B. Rule 306(b).

36 See 11 U.S.C. § 1111(a).

37 See 11 U.S.C. §§ 704(4), 1106(a)(1), 1302(b)(1).

38 See 11 U.S.C. § 521(2).

39 See 11 U.S.C. § 1107(a).

40 B. Rule 306(c). If the claim is for taxes, at least thirty days' notice of a hearing must be given. *Id.* See Sugg. Int. B. Rules 3001(d) and 3001(f).

41 11 U.S.C. § 502(b). Before a case is closed, however, a claim that has been allowed may be reconsidered for cause, and reallowed or disallowed according to the equities of the case. See 11 U.S.C. § 502(j), which is derived from Former B.A. § 57(k). See also B. Rule 307 and Sugg. Int. B. Rule 3001(e).

42 11 U.S.C. § 502(b). See the discussion of allowable post-petition claims later in this article.

of an agreement, the claim will not be allowed.[43] For example, if the claim is unenforceable pursuant to applicable usury law or because of failure of consideration, it may not be allowed. The same rule applies to claims barred by the statute of frauds or the statute of limitations as of the date the petition was filed. Any claim for a deficiency by a partially secured creditor on a nonrecourse loan must be disallowed because it is unenforceable against the debtor personally or the debtor's property.[44] In short, any defense which the debtor could have raised against the claimant immediately before the bankruptcy case commenced may be raised as an objection to allowance of the claim.

There are two situations, however, when a claim will be allowed despite unenforceability against the debtor. The first situation deals with contingent claims which are not enforceable under nonbankruptcy law. If, for example, an obligation is conditioned on the occurrence of an event which has not yet occurred, the claimant will not have a cause of action to enforce it until the condition is satisfied. Nonetheless, the Bankruptcy Code provides that such contingent obligations are allowable in bankruptcy even though they are not enforceable in the absence of bankruptcy.[45] Second, claims which are unenforceable against the debtor because they have not matured, such as a debt which is not due until several years after the petition is filed, are allowable in bankruptcy nonetheless.[46] In essence, the debtor's obligations are accelerated upon the filing of a bankruptcy petition.

Claims for Unmatured Interest

The creditor's allowable claim may include interest which accrues on the obligation up to the date when the petition is filed. For purposes of allowability, however, interest stops accruing at that time. The Code provides that any claim for interest which is unmatured as of the date the case commences may not be al-

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[43] 11 U.S.C. § 502(b)(1). Compare the approach of Section 70(c) of the Former B.A., which gave the trustee the benefit of the defenses available to the debtor.

[44] However, see 11 U.S.C § 1111(b) and Chapter 8 (Reorganizations) of the authors' forthcoming book for a discussion on nonrecourse claims in reorganization cases.

[45] 11 U.S.C. §§ 502(b)(1), 502(c)(1). See the discussion on contingent claims later in this article.

[46] 11 U.S.C. § 502(b)(1).

lowed.[47] The legislative history of the Code makes it clear that whether interest is matured or unmatured on the date of bankruptcy is to be determined without reference to any clause in an agreement calling for acceleration of the debt upon bankruptcy of the debtor.[48] These so-called ipso facto or bankruptcy clauses do not affect the allowability of the claim for interest.

Unmatured interest includes post-petition interest which is not due and payable at the time when the petition is filed. It also includes that portion of prepaid interest which results from discounting the debt at the time the credit is originally advanced. To illustrate, let us assume that the debtor signed and delivered a $1,000 promissory note the day before filing a bankruptcy petition. The allowability of the claim represented by the note will depend on the amount of cash actually advanced by reason of a discount rate. If the original discount was 10 percent so that the cash advanced was only $900, then only $900 will be allowed as the claim. The remaining $100 of the face amount of the note represents prepaid, but unmatured, interest. If $900 was advanced several months or years prior to bankruptcy, the interest portion of the note would have to be prorated and disallowed to the extent that it is for interest accruing after the petition is filed.[49]

It is important to understand that the commencement of the bankruptcy case automatically accelerates the total amount of principal due on the obligation.[50] The entire principal, whether due in the past or future, is allowable despite the fact that the unmatured interest is not.

Claims Subject to Offset

Under certain situations, the creditor may offset against his claim any debt which the creditor owes to the debtor from a separate transaction.[51] For example, if the debtor owes $1,000 to the bank

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[47] 11 U.S.C. § 502(b)(2), which derives from Former B.A. §§ 63(a)(1), 63(a)(5). See New York v. Saper, 336 U.S. 328 (1949), which held that tax claims bear interest only until the date of bankruptcy and not until payment. Note, however, that claims for post-petition interest may be paid in liquidation cases at the legal rate if all allowed claims are paid in full. See 11 U.S.C. § 726(a)(5).

[48] House Report, note 12 *supra*, at 352.

[49] *Id.* at 352-353.

[50] See 11 U.S.C. § 502(b)(1).

[51] See 11 U.S.C. § 553 and the detailed analysis of the right of setoff and its limitations later in this article.

on an unsecured loan, and the debtor has $1,000 in a checking account at the same bank, the bank as creditor may offset the balance of the account (which the bank "owes" the debtor) from the claim based on the loan. Since the creditor may offset the debt owed to the debtor against the creditor's claim, resulting in a zero balance, the creditor's claim may not be allowed.[52] The disallowance of the claim to the extent that the creditor may offset it against the debt owed to the debtor prevents double recovery by the creditor. The claim may be allowed only to the extent of the balance remaining due to the creditor after the creditor's obligations to the debtor are offset.

Excess Property Tax

Claims for property taxes are not allowable to the extent that they exceed the value of the estate's interest in the property which is the subject of the tax.[53] This disallowance rule only applies when the tax is ad valorem, which means that the tax obligation is based on the value of the property.[54]

Services of an Insider or Attorney

Claims of the debtor's attorney are subject to close scrutiny by the bankruptcy court. The Bankruptcy Code expressly provides that a claim for attorney's fees is not allowable to the extent that such claim exceeds the reasonable value of the legal services.[55] Claims for services rendered by an insider are also subject to close examination by the court and may be disallowed to the extent that they are found unreasonable.[56] Insiders include relatives or partners of the debtor and officers or directors of a debtor corporation, as well as others who have a sufficiently close relationship with the debtor.[57] The purpose of requiring disallowance of unreasonable claims of insiders is to prevent collusive conduct as a means of diverting assets from the estate to a person who is close to the debtor.

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[52] 11 U.S.C. § 502(b)(3).

[53] 11 U.S.C. § 502(b)(4).

[54] See House Report, note 12 *supra*, at 353.

[55] 11 U.S.C. § 502(b)(5). See Chapter 6 (Bankruptcy Courts and Officers) of the authors' forthcoming book for a discussion of attorney compensation in bankruptcy cases.

[56] 11 U.S.C. § 502(b)(5).

[57] See 11 U.S.C. § 101(25) for the definition of "insider."

Post-Petition Alimony, Maintenance, and Support

As discussed above, the filing of a bankruptcy petition accelerates the principal due on an obligation so that an unmatured debt is allowable.[58] However, an exception to this rule is contained in the Bankruptcy Code for the purpose of disallowing claims for unmatured alimony, maintenance, or support which are excepted from discharge.[59] Since these claims are not dischargeable, they are to be paid from property to be acquired by the debtor after bankruptcy and not from the bankruptcy estate. Claims for alimony, maintenance, and support which are payable prior to the filing of the petition are allowable despite the fact that they are non-dischargeable.

Employment Tax Claims Against Employers

A debtor who is an employer may have an obligation to the federal government arising out of a reduction of the Federal Unemployment Tax Act credit on account of a tardy contribution to a state unemployment fund. If state unemployment insurance taxes are paid late, the federal tax credit is reduced or disallowed.[60] In such cases, however, the federal claim against the employer's bankruptcy estate will be disallowed as if the federal tax credit had been granted in full.[61] By providing for the disallowance of this claim, the bankruptcy estate will not be penalized for the debtor's tardy payment of state unemployment insurance taxes.

Allowance of Landlord's Claims

The Bankruptcy Code follows the policy of the former Act[62] by limiting the allowability of a landlord's claim for damages resulting from breach or termination of a lease. Congress is concerned about landlords with long-term leases submitting huge claims for unpaid rent which accrues in the future. If a landlord on a twenty-year lease, for example, had the right to recover damages for unpaid

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[58] See note 46 *supra* and accompanying text.

[59] 11 U.S.C. § 502(b)(6). See 11 U.S.C. § 523(a)(5) and Chapter 3 (Discharge) of the authors' forthcoming book for a discussion of the alimony exception to discharge.

[60] See I.R.C. § 3302; 124 Cong. Rec. H.11,110 (daily ed. Sept. 28, 1978); 124 Cong. Rec. S.17,426 (daily ed. Oct. 6, 1978).

[61] 11 U.S.C. § 502(b)(9).

[62] See Former B.A. §§ 63(a)(9), 202, 353, 458.

rent for the remainder of the lease, say sixteen years, the landlord would receive a substantial portion of the estate at the expense of other creditors.[63]

A landlord's claim for loss of future rent resulting from the termination of a lease on real estate may be allowed for an amount not to exceed the rent reserved by the lease for the greater of one year or 15 percent of the remaining lease term, not to exceed three years.[64] The one- or three-year period begins to run on the date the petition is filed, when the landlord repossesses the premises, or when the tenant surrenders the lease, whichever occurs first. For the purpose of determining the amount of rent reserved in the lease for this period, any acceleration clause is to be ignored.[65] It should be remembered, however, that this formula provides only a ceiling on the allowability of a claim for future rent and that the claim may be reduced further if the landlord's actual damages are less.

For example, assume that there is a lease with ten years remaining at an annual rental of $100,000 or a total rental of $1 million. Expert testimony estimates the value of the premises over ten years at $600,000, leaving a claim for damages of $400,000. This claim, however, is further reduced by the Code to one year of rent ($100,000) or 15 percent of $1 million ($150,000), whichever is greater, but not exceeding three years rent ($300,000). The landlord's claim will, therefore, be allowed for $150,000. If the value of the remaining ten-year lease is $950,000, however, the allowed claim would be only $50,000.

In addition to the allowance of the claim for future rent subject to these limits, the court may also allow the landlord's claim based on any unpaid rent which accrued, without acceleration, prior to the time when either the petition is filed, the landlord repossesses, or the lease is surrendered, whichever is earliest.[66] In sum, the landlord's allowable claim is limited to any rent due prior to bankruptcy or loss of possession of the premises, plus rent which

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[63] See 11 U.S.C. § 365, dealing with the debtor's right to reject an unexpired lease and the landlord's rights upon termination of an unexpired lease. See also 11 U.S.C. § 502(b)(1), dealing with the allowability of unmatured claims which may be applicable to claims for future rent.

[64] 11 U.S.C. § 502(b)(7). The term "lease" as used in this context means a "true" or "bona fide" lease, not a lease intended solely as security or as a financing device. See 124 Cong. Rec. S.17,410 (daily ed. Oct. 6, 1978).

[65] 11 U.S.C. § 502(b)(7)(A).

[66] 11 U.S.C. § 502(b)(7)(B).

accrues after that time for a period not to exceed one year or 15 percent of the remaining term up to three years.

It is worth noting at this point that a landlord's statutory lien pursuant to state law will not help the landlord in bankruptcy. Any statutory lien for rent may be avoided by the trustee.[67]

In the usual case, the landlord may be holding a security deposit pursuant to the lease. What effect does the security deposit have on the landlord's claim? May the landlord keep the security deposit when the tenant files a bankruptcy petition? These questions were discussed and answered in *Oldden v. Tonto Realty Corp.*[68] If the security deposit is less than the amount of the landlord's allowable claim, the claim will be considered a secured claim to the extent of the security deposit and an unsecured claim for the balance of the landlord's allowable claim. The security deposit must be applied, however, in satisfaction of the total allowable claim. For example, if the total allowable claim in the above illustration is $150,000 and the landlord holds a $25,000 security deposit, the allowed secured claim will be $25,000 and the allowed unsecured claim will be $125,000. In the unlikely event that the security deposit exceeds the total allowed claim, the landlord must pay the excess into the estate.

In many situations, the debtor or trustee will remain in possession of the leased premises after the bankruptcy petition is filed. This is especially common in reorganization cases. The debtor in possession or trustee may elect to assume the lease or to continue using the premises until a decision is made with respect to assuming or rejecting the unexpired lease.[69] In either event, the landlord is entitled to be paid for use and occupation of the premises accruing after the date the petition is filed as an administrative expense.[70] Ordinarily, the rental rate in the lease will be used to determine the amount of the claim. Aside from obtaining an administrative expense priority in distribution, the landlord's claim for post-petition occupancy of the premises is not subject to the limitations on allowability applicable to other landlord's claims. Moreover, the

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[67] 11 U.S.C. §§ 545(3), 545(4), which are derived from Former B.A. § 67(c)(1)(C). See Chapter 7 (Trustees' Avoiding Powers) of the authors' forthcoming book for a discussion on statutory liens for rent.

[68] 143 F.2d 916 (2d Cir. 1944). See House Report, note 12 *supra*, at 353-354.

[69] See 11 U.S.C. § 365.

[70] See 11 U.S.C. § 503(b)(1)(A).

cost of removing debris from the premises after the petition is filed may be allowed as an administrative expense.[71]

Allowance of Employee's Claims

Claims of employees who have long-term employment contracts with the debtor present the same potential problems as do claims based on long-term leases. Under the former Bankruptcy Act, there were no limitations on employees' claims. If an employee with several years remaining on a favorable employment contract was unable to mitigate damages caused by termination because of the inability to find other employment, the resulting claim against the estate might have been so large as to unduly limit the distribution to other creditors.

The Bankruptcy Code departs from the former Act by restricting the allowability of any claim for damages resulting from termination of an employment contract.[72] The employee's allowable claim may include all unpaid compensation which accrues under the contract prior to the filing of the petition or termination of employment, whichever occurs first.[73] However, any claim based on the loss of earnings which accrues after the date of bankruptcy or termination of employment may not be allowed for more than a one-year period at the rate of compensation provided in the contract.[74] Damages resulting from loss of earnings for more than one year after bankruptcy or termination of employment may not be included in the employee's claim. Of course, acceleration clauses in employment contracts are not effective for the purpose of computing the employee's allowable claim. It should be remembered that these restrictions are ceilings on an employee's claim and that the claim may be reduced further if the employee mitigates the damages by obtaining other employment.

Contingent or Unliquidated Claims

Certain claims are very difficult to convert to specific dollar amounts. Obligations may be contingent on the occurrence of a

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[71] See *In re* Furniture-in-the-Raw, Inc., 4 Bankr. Ct. Dec. 519 (S.D.N.Y. 1978).

[72] 11 U.S.C. § 502(b)(8).

[73] 11 U.S.C. § 502(b)(8)(B).

[74] 11 U.S.C. § 502(b)(8)(A).

future event or may be difficult to liquidate for other reasons. For example, if the debtor is the guarantor on a $1,000 promissory note which has not matured, what is the amount of the claim against the debtor? Of course, if the principal obligor is solvent at the time of the debtor's bankruptcy, there is a good chance that the debtor will never be required to pay the note because it is unlikely that the maker will default. In any event, the debtor's liability may not be determined with certainty until the maturity of the note which may not occur for several years.

The former Bankruptcy Act dealt with the problem of contingent or unliquidated claims by recognizing them as provable and allowable unless the court determined either that they were not capable of liquidation or of reasonable estimation, or that liquidation or estimation would unduly delay the administration of the estate.[75] The result of this approach was that some contingent or unliquidated claims were discharged and others were not. Consequently, some creditors with these claims were permitted to share in the distribution of the estate and others were deprived of that right.

The treatment of contingent or unliquidated claims under the former Act is illustrated in *Thompson v. England*.[76] A wife loaned her husband $12,000 to be repaid from the proceeds of his business "as soon as said business is in a sound financial position." [77] When the husband filed a bankruptcy petition, the wife filed a claim. The court held that the claim was not subject to reasonable estimation and, therefore, the wife could not participate in a distribution of the estate. The appellate court noted that to allow this claim the bankruptcy judge would have to estimate the probability that the debtor would start his business anew after bankruptcy and would arrive at a sound financial condition. That event was so fortuitous that there was no way to determine whether liability would ever attach in the future.

The Bankruptcy Code rejects the approach taken in the former Act with respect to contingent and unliquidated claims. The new law requires that the court estimate the dollar amount of any claim

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[75] See Former B.A. §§ 57(d), 63(d). Paradoxically, if a Chapter XI arrangement was confirmed, creditors with these nonprovable and nondischargeable claims would collect in full from the reorganized debtor.

[76] 226 F.2d 488 (9th Cir. 1955). See also Maynard v. Elliott, 283 U.S. 273 (1931); State of New York v. Wilkes, 41 N.Y.2d 655, 394 N.Y.S.2d 849 (1977).

[77] Thompson v. England, note 76 *supra*, at 490.

that is disputed, contingent, or unliquidated, even if administration of the estate or the closing of the case would be delayed.[78] An estimate is possible in contingencies which mathematical computation can resolve, but it is difficult to perceive how an estimate can be made, for example, in cases involving disputed allegations of negligence, antitrust or stockholder class actions.[78a] The court is required to put a dollar value on every claim, including any claim which gives the claimant the alternative right to an equitable remedy as well as monetary relief.[79]

This requirement is consistent with the Code's general policy of expanding the bankruptcy court's jurisdiction and ability to give complete relief in bankruptcy cases. For example, if the facts of *Thompson v. England* occurred under the Bankruptcy Code, the court would be required to hold a hearing to arrive at an estimation of the present value of the wife's claim against the debtor despite the realization that the husband's debt may never mature. Apparently, this task involves a difficult analysis of many factors, but at least one court in a case under the former Act found a method of making a determination of the value of a contingent claim. In *In re Frederick N. Zucker*[79a] the court held that a note that was guaranteed by the debtor and that obligated the debtor to pay "solely and only in the event of the death of the maker" was not too contingent to be reasonably estimated despite the fact that the maker was alive and well at the time of the bankruptcy.

Transferees of Voidable Transfers

The Bankruptcy Code gives the trustee or debtor in possession the right to avoid certain transfers of property. Property belong-

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[78] 11 U.S.C. § 502(c)(1). But see 28 U.S.C. § 1471(d) and Chapter 6 (Bankruptcy Courts & Officers) of the authors' forthcoming book for a discussion of the court's right to abstain from hearing a proceeding which may result in a delay of the allowance.

[78a] Conceivably, bankruptcy rules will be promulgated to provide a method of procedure, such as arbitration or preferences on calendars, to expedite the estimation of contingent and unliquidated claims. Of course, settlement is always available as a means of resolving the dispute. Abstention is also possible, but expedition is important in moving toward confirmation in a reorganization case. See Sugg. Int. B. Rule 3001(b)(3) requiring the filling of a proof of claim prior to approval of the disclosure statement.

[79] *Id.* See 11 U.S.C. § 502(c)(2).

[79a] 5 Bankr. Ct. Dec. 433 (S.D.N.Y. 1979). Although this case was decided under Section 57(d) of the Former Act, the court referred to Section 502(c) of the Code.

ing to the estate may be recovered from the hands of a custodian or other third party.[80] Post-petition transfers of estate assets may be reversed.[81] In addition, fraudulent conveyances, voidable preferences, and some other kinds of transfers and liens may be avoided by the trustee or debtor in possession.[82] Certain setoffs are also voidable.[83] The effect of avoiding or reversing such transfers is the creation of an obligation on the part of the transferee to return property or to pay money to the estate.[84]

It is not uncommon for creditors or equity security holders to be on the receiving end of voidable transfers or otherwise to be obligated to restore property to the estate. To compel such persons to fulfill their obligations to the estate, the Code follows the policy of the former Act by requiring the disallowance of their claims until they perform their obligations.[85] The Code provides that the court must disallow any claim of a creditor or equity security holder from whom property is recoverable by the estate or who has received a voidable transfer, unless the claimant has paid an amount or turned over property in full compliance with the Code.[86]

The purpose of this disallowance provision is to achieve restoration to the estate—not to punish the transferee.[87] Moreover, the Code requires total disallowance regardless of the magnitude of the voidable transfer or the amount of the claim.[88] If a creditor receives a voidable preference worth $25,000 and thereafter files a claim for $100,000, the entire claim will be disallowed unless $25,000 is paid back to the estate. Of course, the trustee will file an objection to the claim. However, the objection may also be joined with a demand for relief against the claimant based on the claimant's liability to the estate. If such a demand is interposed,

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80 See 11 U.S.C. §§ 542, 543, and Chapter 4 (Property of the Estate) of the authors' forthcoming book.

81 See 11 U.S.C. § 549.

82 See Chapter 7 of the authors' forthcoming book on the trustee's avoiding powers.

83 See 11 U.S.C. § 553 and the discussion of setoffs later in this article.

84 See 11 U.S.C. § 550.

85 11 U.S.C. § 502(d), derived from Former B.A. § 57(g).

86 In addition, this provision applies when a claimant is holding property which is recoverable by the debtor, or by the trustee acting on the debtor's behalf, on the ground that there was a preferential transfer of exempt property. See 11 U.S.C. §§ 522(f), 522(g), 502(d).

87 See *In re* George M. Hill Co., 130 Fed. 315, 321 (7th Cir. 1904), in which the court stated that "restoration, not punishment, is the object of this law."

88 See House Report, note 12 *supra*, at 354.

the matter becomes an adversary proceeding and triggers the procedural requirements of Part VII of the Bankruptcy Rules of Procedure.[89]

Rights of Co-Debtors

As previously discussed, a co-debtor has the right to file a proof of claim if the creditor fails to do so.[90] This rule benefits co-debtors because it assures that creditors will realize as much money as possible from the estate so as to diminish the balance due or secured by the co-debtor. The co-debtor may file the claim if the creditor does not do so by the first date set for the first meeting of creditors or, in reorganization cases, at any time prior to the approval of the disclosure statement.[90a] If the creditor files a proof of claim after the co-debtor files, the creditor's proof of claim supersedes the previous one.[91]

Problems often arise with respect to a co-debtor's rights against the debtor for contribution or reimbursement. For example, a joint obligor who co-signed a promissory note with the debtor may be called upon to pay the entire amount of the note to the holder. What right to contribution or reimbursement will the co-signer have if the debtor files a bankruptcy petition? What right of contribution is there if the co-debtor has not been called upon to pay the note because it matures after the debtor's bankruptcy?

The Bankruptcy Code has specific provisions dealing with the rights of co-debtors and the allowance of their claims. Basically, the co-debtor has the choice of seeking reimbursement or contribution by filing a proof of claim for it, or of being subrogated to the rights of the original creditor.[92]

There are certain restrictions on the allowance of a co-debtor's claim for contribution or reimbursement. First, if the creditor's claim is disallowed for a reason other than payment, the co-debtor's claim must be disallowed also.[93] The policy behind this provision

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[89] B. Rules 306(c), 701.

[90] See 11 U.S.C. § 501(b) and B. Rule 304. The term "co-debtors" is used to include co-makers, guarantors, sureties, and persons who secured the debtor's obligations. See also Sugg. Int. B. Rule 3002 on claims by co-debtors in Chapter 11 cases.

[90a] Sugg. Int. B. Rule 3001(b)(3).

[91] B. Rule 304.

[92] See 11 U.S.C. §§ 502(e), 509. See also 124 Cong. Rec. H.11,094 (daily ed. Sept. 28, 1978).

[93] 11 U.S.C. § 502(e)(1)(A).

is that the co-debtor's claim for contribution or reimbursement is entitled to no better status than the principal claim. Second, the co-debtor's claim is allowed only to the extent that the principal claim has been paid by the co-debtor.[94] If a guarantor has paid $10,000 of a $30,000 debt, and is entitled to 100 percent reimbursement pursuant to an agreement with the debtor, the guarantor will have an allowable claim for $10,000 and the original creditor will have an allowable claim for $20,000.

As an alternative to filing a proof of claim for reimbursement or contribution, the co-debtor may elect to be subrogated to the rights of the original creditor to the extent of the payments made by the co-debtor.[95] The co-debtor is subrogated automatically subject to certain exceptions.[96] The co-debtor will not be subrogated to the rights of the creditor to the extent that a claim for contribution or reimbursement was allowed. In essence, the co-debtor may enjoy either subrogation or reimbursement/contribution—but not both. Also, if the court disallows the co-debtor's claim for reimbursement or contribution, such as when the surety's rights against the debtor are not enforceable under applicable nonbankruptcy law, subrogation is not permitted. Moreover, if the court exercises its equitable powers to subordinate the co-debtor's claim for contribution or reimbursement, the co-debtor may not elect to be subrogated to the creditor's right because subrogation would defeat the purpose of subordination.[97] Finally, the co-debtor is not entitled to be subrogated to the creditor's rights to the extent that the co-debtor received the consideration for the creditor's claim. The purpose of this final restriction is to prevent the "real" debtor who is ultimately liable on the debt and who received the consideration for it from recovering against the co-debtor who winds up in bankruptcy. This situation may arise when the debtor's partner, who received all of the consideration for a loan, tries to be subrogated to the rights of the creditor against the debtor who co-signed on the loan but who received none of the consideration.

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[94] See 124 Cong. Record H.11,094, note 92 *supra*, where it is reported that a "surety or codebtor is generally permitted a claim for reimbursement or contribution to the extent the surety or codebtor has paid the assured party at the time of allowance."

[95] 11 U.S.C. § 509(a).

[96] These exceptions are contained in 11 U.S.C. § 509(b).

[97] See 11 U.S.C. § 510 and the discussion later in this article dealing with the subordination of claims.

In general, giving the co-debtor an allowable claim for contribution or reimbursement or, in the alternative, giving the co-debtor the right to be subrogated to the creditor's claim to the extent of the amount paid to the creditor appears to be equitable to other creditors. For example, let us assume that a surety paid $10,000 of a $30,000 debt and is entitled to 100 percent reimbursement from the debtor pursuant to an agreement between them. The surety may have an allowed claim of $10,000 for reimbursement and the creditor would have an allowed claim of $20,000. The rights of other creditors are not affected unfairly. However, this approach could create inequities between the creditor on the loan and the surety. It would be unjust to give the surety's $10,000 claim the same priority as the creditor's $20,000 claim. After all, the surety guaranteed the debt and, therefore, should not be permitted to diminish the creditor's distribution by sharing equally in the estate. Likewise, the surety should not obtain equal priority by asserting the rights of the creditor through subrogation. The Code deals with this problem by treating the co-debtor's allowed claim or right of subrogation as being equal in priority with other unsecured claims, but subordinated to the claim of the original creditor until the creditor is paid in full from the bankruptcy estate or elsewhere.[98] In the above example, therefore, the surety's claim for $10,000 is subordinated to the $20,000 claim of the creditor until the creditor is paid in full.

When should a co-debtor elect subrogation instead of filing a proof of claim for contribution or reimbursement? The answer to this question may depend on whether there is collateral securing the claim. If the creditor's claim is secured by the debtor's assets, the co-debtor will be put in a more favorable position by asserting subrogation rights. Since the creditor's claim is secured, the co-debtor may obtain through subrogation a secured claim against the estate. Assume, however, that the creditor's claim is unsecured but the surety's rights against the debtor are secured; that is, the debtor and the surety have agreed that the debtor's assets will secure the surety's right to reimbursement. In this situation, the surety should file a proof of claim seeking allowance of a secured claim for reimbursement. If the surety relied on the right of subrogation alone, the surety would have only the unsecured claim of the creditor.[99]

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[98] 11 U.S.C. § 509(c).

[99] See 124 Cong. Record H.11,094, note 92 *supra*.

Allowable Post-Petition Claims

In general, only those claims which exist at the time that the petition is filed may be allowed.[100] The commencement of the bankruptcy case marks the beginning of the debtor's fresh start and, accordingly, claims which first arise after the petition is filed are not affected by the bankruptcy.

There are several exceptions, however, to the general bar on allowability of post-petition claims. Specifically, the following post-petition claims may be allowed:

Gap Claims in Involuntary Cases

In an involuntary bankruptcy case, there is a period of time between the filing of the petition and the order for relief. The debtor in the involuntary case is entitled to defend against the petition and has the right to a trial on questions of fact. In order to protect the debtor prior to the order for relief in an involuntary case, the Bankruptcy Code permits the debtor to continue to operate in business pending trial.[101] It will be pointless, however, to permit the debtor to continue to do business if trade suppliers and others who extend credit to the debtor during that time in the ordinary course of business are not permitted to share in the estate or to participate in the case. Those creditors who are aware of the pending case are not likely to do business with the debtor on a credit basis, and those creditors who are unaware of it will be unfairly discriminated against if their post-petition claims are disallowed, unless some priority position is afforded these claims.

For this reason, the Code provides that a claim arising in the ordinary course of the debtor's business or financial affairs after the commencement of an involuntary case, but before the order of relief or appointment of a trustee, may be allowed the same as if it had arisen before the date of the filing of the petition.[102] In addition to allowing these claims, the Code gives them priority over all other

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100 See 11 U.S.C. § 502(b) which provides that the court shall allow a claim in the "amount of such claim as of the date of the filing of the petition. . . ."

101 See 11 U.S.C. § 303(f) and Chapter 2 (Liquidation as a Creditor's Remedy: The Involuntary Case) of the author's forthcoming book for a discussion of involuntary bankruptcies.

102 11 U.S.C. § 502(f), derived from Former B.A. § 63(b). This provision does not apply to the extension of credit while a voluntary case is pending. See Lignacraft, Inc. v. Automation Servs., Inc., 37 A.D.2d 786, 324 N.Y.S.2d 521 (3d Dept. 1971).

unsecured claims except for administrative expenses.[103] By allowing and giving priority to these involuntary gap claims, the Code permits the debtor to continue doing business in the usual way without much damage to its credit until the trial on the petition is over and a ruling is made.

Claims Arising From the Rejection of Executory Contracts or Unexpired Leases

The Bankruptcy Code gives the trustee or debtor in possession the right to reject executory contracts and unexpired leases.[104] Alternatively, an executory contract or lease may be rejected as part of a plan of reorganization in a Chapter 11 case[105] or a debt adjustment plan in a Chapter 13 case.[106] When such rejection occurs, damages may be caused which give rise to a claim against the debtor. Since these claims for damages first arise when the contract or lease is rejected, they are post-petition claims.

It would be unjust to permit rejection of executory contracts and leases without permitting persons who are damaged thereby to participate in the bankruptcy case. For this reason, claims arising out of such rejection may be allowed the same as if they had arisen before the date of the filing of the petition.[107]

Claims Arising From the Recovery of Property

During the pendency of the bankruptcy case, it is common for the trustee or debtor in possession to recover property for the estate.[108] For example, the trustee may recover property transferred prior to bankruptcy as a voidable preference or fraudulent conveyance. Whenever the recovery of property gives rise to a claim against the estate, the claim will be treated and allowed the same as if it had arisen prior to bankruptcy.[109]

Let us assume, for example, that a creditor who was owed $50,000 received payment in full as a voidable preference. As of the date of bankruptcy, the creditor has no claim because of the

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[103] 11 U.S.C. § 507(a)(2). See the discussion on priorities later in this article.
[104] See 11 U.S.C. § 365.
[105] 11 U.S.C. § 1123(b)(2).
[106] 11 U.S.C. § 1322(b)(7).
[107] 11 U.S.C. § 502(g).
[108] See 11 U.S.C. §§ 522(i), 550, 553.
[109] 11 U.S.C. § 502(h).

payment. If the trustee recovered the $50,000 payment as a preference after the bankruptcy petition was filed, it would be unfair to deprive the creditor of the original $50,000 claim. Accordingly, the creditor's $50,000 claim would be allowed as a prepetition claim as if the preference was never made.

Priority Tax Claims

Certain unsecured tax claims which are entitled to priority may arise after the filing of the petition.[110] A discussion of these priority tax claims will be found later in this article.[111] For the purpose of allowability, however, it is important to note that those priority tax claims which arose before but are assessable after the petition is filed are treated as prepetition claims.[112]

Post-Petition Claims in Chapter 13 Cases

When an individual debtor files a petition for debt adjustment under Chapter 13, the debtor usually retains possession of all assets while a trustee distributes a portion of future income to creditors. What rights do creditors have when a new debt is incurred after the petition is filed but while the case is still pending? The Bankruptcy Code provides that only two types of post-petition claims may be allowed. First, a governmental body may file a proof of claim for taxes that first become payable after the case was commenced and while it is still pending.[113] Second, post-petition consumer debts are allowable if they are liabilities for property or services necessary for the debtor's performance under the plan.[114] For example, liabilities incurred in connection with repairing the debtor's automobile are allowable if the car is needed for job-related transportation. Post-petition medical bills which relate to an injury of the debtor may be allowed if the debtor was incapacitated. Persons who extend consumer credit to the Chapter 13 debtor while the case is pending must, however, obtain the trustee's approval in advance whenever feasible. The Code mandates the disallowance of post-petition consumer debt claims if the creditor knew

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[110] 11 U.S.C. § 507(a)(6).

[111] See the discussion on the sixth-level priority later in this article.

[112] 11 U.S.C. § 502(i).

[113] 11 U.S.C. § 1305(a)(1), derived from B. Rules 13-305(1), 13-305(2), and from Former B.A. § 680.

[114] 11 U.S.C. § 1305(a)(2), derived from B. Rule 13-305(3).

or should have known that prior approval by the trustee was practicable and was not obtained.[115]

Allowance of Administrative Expenses

During the course of a bankruptcy proceeding, the trustee or debtor in possession may find it necessary to expend money or incur indebtedness for the purpose of administering the estate. These expenses and liabilities arise after the case is commenced. The Code permits any entity to file a request for payment or reimbursement of these administrative expenses from the bankruptcy estate.[116]

The court may not allow a claim for an administrative expense unless it first conducts a hearing on notice to determine allowability.[117] The Bankruptcy Code enumerates several types of administrative expenses which may be allowed. It is important to note, however, that involuntary gap claims which arise in the ordinary course of business between the filing of the petition and the order for relief in involuntary cases are not treated as administrative expenses because of their separate treatment elsewhere in the Code.[118]

The following types of administrative expenses claims may be allowed by the court:

Expenses of Preserving the Estate

The actual and necessary costs and expenses of preserving the estate may be allowed as administrative expenses.[119] The cost of storing, repairing, or towing property of the estate, for example, may be included in this category.

The Code expressly includes in this category wages, salary, and commissions for services rendered after the commencement of the case for the purpose of preserving the value of estate assets.[120] In fact, actual payments to an individual debtor for services rendered to the estate are administrative expenses and may be retained as

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[115] 11 U.S.C. § 1305(c).

[116] 11 U.S.C. § 503(a), derived from Former B.A. §§ 62, 64.

[117] 11 U.S.C. § 503(b).

[118] See 11 U.S.C. §§ 502(f), 503(b).

[119] 11 U.S.C. § 503(b)(1)(A). See Former B.A. § 64(1).

[120] 11 U.S.C. § 503(b)(1)(A). Severance pay which is allocable to the post-petition period also qualifies as an administrative expense, but not severance pay based on prepetition employment. Compare *In re* Unishops, Inc., 553 F.2d 305 (2d Cir. 1977), which is overruled by the Code.

such by the debtor. If the debtor is the sole proprietor of a going concern, upon filing a petition for reorganization the debtor actually would be employed by the estate and would be entitled to compensation for running the business while it is in Chapter 11.[121] The corporate debtor in possession also may hire personnel to operate the business while the case is pending, thereby giving rise to an administrative expense.[122]

Another common expense which is necessary to preserve the estate in most bankruptcy cases is rent. If the trustee or debtor in possession rejects an unexpired lease but continues in possession, the reasonable value of the actual use and occupation of the premises is an expense of administration.[123] Similarly, if the trustee or debtor in possession elects to assume the lease as an asset of the estate, the rent payable to the landlord during the case becomes an administrative expense.

Taxes Incurred by the Estate

In general, tax obligations incurred by the estate, as opposed to the debtor, may be allowed as administrative expenses.[124] For example, withholding taxes attributable to wages earned by employees during the post-petition period are administrative expenses.[125] Also, tax obligations caused by overestimation of a tentative loss carryback adjustment which the estate received after the petition

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121 See House Report, note 12 *supra*, at 355. See also Local Loan Co. v. Hunt, 292 U.S. 234, 243 (1933), in which the court quoted: "The wages earned after the adjudication became the property of the bankrupt clear of the claims of all creditors."

122 See *In re* Patterson-MacDonald Shipbuilding Co., 288 Fed. 546 (9th Cir. 1923), in which the court allowed a $20,000 administrative expense claim in favor of the former vice-president and manager of the debtor corporation for services rendered to the trustee during the case.

123 The amount of rent recoverable as an administrative expense is determined by the reasonable value of the trustee's actual use and enjoyment. Usually, the amount of rent specified in the lease agreement is presumed to be the reasonable value. However, the court may determine, if circumstances warrant, that the fair and reasonable worth of the premises is higher or lower than the rent specified in the rejected lease. See *In re* First Research Corp., 457 F.2d 331 (5th Cir. 1972); S & W Holding Co. v. Kuriansky, 317 F.2d 666 (2d Cir. 1963).

124 See 11 U.S.C. § 503(b)(1)(B). However, priority tax claims specified in 11 U.S.C. § 507(a)(6) are not considered administrative expenses.

125 See Otte v. United States, 419 U.S. 43 (1974), where the court said that "the withholding taxes are, in full effect, part of the claims themselves and derive from and are carved out of the payment of those claims." See also House Report, note 12 *supra*, at 355.

was filed may be allowed as an administrative expense.[126] Fines, penalties, or reduction of credit relating to these administrative tax expenses are also allowable as costs of administration.[127]

Compensation of Officers

Professionals, including attorneys, accountants, appraisers, and auctioneers, who render services to the trustee or to a creditors' committee during the case are entitled to reasonable compensation as administrative expenses.[128] The court also may award to the trustee, the examiner, and the debtor's attorney reasonable compensation for their services.[129] Moreover, the Bankruptcy Code expressly permits the awarding of compensation to paraprofessionals employed by these officials.[130] The amount of compensation which may be paid to these persons is supervised by the court and is subject to strict limitations.[131] The court also may order the reimbursement of the actual and necessary expenses incurred by such officers and professional persons.[132]

Expenses of Certain Creditors and Other Entities

It is not uncommon for certain creditors to incur expenses by performing a service which benefits the estate or the other creditors. In order to encourage creditors to take certain actions which further the policies of the Bankruptcy Code, certain expenditures may be recouped as administrative expenses.[133] Specifically, the expenses incurred by a creditor who files an involuntary petition against the debtor may be allowed.[134] Similarly, expenses of a creditor who, after the court's approval, recovers for the estate property concealed or transferred by the debtor are allowable.[135] Expenses of a creditor incurred in connection with the prosecution of a criminal offense

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126 11 U.S.C. § 503(b)(1)(B)(ii).

127 11 U.S.C. § 503(b)(1)(C).

128 See 11 U.S.C. §§ 327, 330, 503(b)(2), 1103(a). See also B. Rules 215, 606(c).

129 See 11 U.S.C. § 330(a)(1).

130 *Id.*

131 See Chapter 6 (Bankruptcy Courts and Officers) of the authors' forthcoming book. See also 11 U.S.C. § 504 which restricts the sharing of compensation by professionals.

132 11 U.S.C. § 330(a)(2).

133 These provisions are derived from Former B.A. § 64(1).

134 11 U.S.C. § 503(b)(3)(A).

135 11 U.S.C. § 503(b)(3)(B).

relating to the case or to the business or property of the debtor also qualify as administrative expenses.[136]

The Code contains a separate catch-all category which gives administrative expense status to any expenditures which are incurred by a creditor, an indenture trustee, an equity security holder, or a committee representing any of these groups other than a committee appointed under Chapter 11, in making a "substantial contribution" in a reorganization case.[137] For the contribution to be "substantial," it is not necessary that it lead to confirmation of a plan. In fact, the discovery of fraud or some other fact that results in denial of confirmation may be substantial enough.[138] When an indenture trustee makes a "substantial contribution" in the case, the court may award reasonable compensation for services as well as expenses.[139]

Wherever these expenses of creditors, committees, or others are allowed as administrative expenses, the court also may award as administrative expenses reasonable compensation for services rendered by their attorneys or accountants. However, the compensation must be based on the time, nature, extent, and value of such services and the cost of comparable services in nonbankruptcy cases.[140] These expenses must, of course, be actual and necessary to qualify as administrative expenses.[141]

Compensation and Expenses of a Custodian

When the bankruptcy petition is filed, the debtor's estate may be in the hands of an assignee for the benefit of creditors, a court-appointed receiver, or some other person designated as a custodian. The Code requires the custodian in the usual case to deliver estate assets to the bankruptcy trustee or debtor in possession and to file an accounting with respect to the property or its proceeds.[142] The

136 11 U.S.C. § 503(b)(3)(C).

137 11 U.S.C. § 503(b)(3)(D).

138 See House Report, note 12 *supra*, at 355.

139 The compensation payable to the indenture trustee must be based on the time, the nature, the extent, and the value of such services, and the cost of comparable services if performed in a nonbankruptcy setting. See 11 U.S.C. § 503(b)(5).

140 See 11 U.S.C. § 503(b)(4). See also 11 U.S.C. § 504, which restricts the sharing of fees paid to professionals.

141 See 11 U.S.C. § 503(b), overruling United Merchants & Manufacturers, Inc. v. J. Henry Schroeder Bank & Trust Co., 5 Bankr. Ct. Dec. 241 (2d Cir. 1979).

142 See 11 U.S.C. § 543 and Chapter 4 (Property of the Estate) of the authors' forthcoming book.

court, after notice and hearing, may order the payment of reasonable compensation for services rendered and costs and expenses incurred by the custodian before or after the petition. The compensation and expenses of the custodian are allowable as administrative expenses.[143]

Witness Fees and Mileage

Federal law provides for fees and mileage to be paid to witnesses in U.S. courts.[144] These expenses are treated as administrative expenses in bankruptcy cases.[145]

Determination of Tax Liabilities

Debtors in financial trouble usually are burdened with substantial tax liabilities. The ordinary tax problems of the debtor, especially the business debtor, may become even more complex once a bankruptcy petition is filed.[146] If the trustee or debtor in possession cannot determine with relative certainty and swiftness the amount of tax liabilities of the estate, it is not difficult to imagine that the administration of the estate or formulation of a plan of reorganization may be unduly delayed. The Internal Revenue Service procedures, Tax Court litigation, audit procedures of various taxing authorities, and other administrative and judicial activity may hold up a final determination of tax liability for a substantial period of time.

The Bankruptcy Code is sensitive to this problem. Accordingly, it contains provisions which are designed to expedite the determination of tax liability of the debtor or the estate. One of these provisions follows the practice under the former Bankruptcy Act in giv-

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[143] 11 U.S.C. §§ 543(c)(2), 503(b)(3)(E). See Randolph v. Scruggs, 190 U.S. 533 (1903).

[144] See 28 U.S.C. §§ 1821-1825.

[145] 11 U.S.C. § 503(b)(6).

[146] See the special tax provisions of the Bankruptcy Code contained in 11 U.S.C. §§ 346, 728, 1146. Further reform with respect to tax aspects of bankruptcy was anticipated during the Ninety-fifth Congress, but that process was not completed. It is expected that a special bankruptcy tax bill will be enacted in the near future. See Hearings on H.R. 9973 Before the Committee on Taxation, 95th Cong., 2d Sess. (1978). See also Plumb, "The Tax Recommendations of the Commission on the Bankruptcy Laws Tax Procedures," 88 Harv. L. Rev. 1360 (1975); House Report, note 12 *supra*, at 274-284; Newton, "Tax Planning Factors to Be Considered by Debtors and Creditors—In and Out of Court," 83 Comm. L.J. 513 (1978).

ing the bankruptcy court jurisdiction over certain tax questions.[147] The court may determine the amount or legality of any tax or tax-related fine or penalty, unless the issue was contested and fully adjudicated by an administrative or judicial tribunal of competent jurisdiction, such as the U.S. Tax Court, prior to bankruptcy.[148] The bankruptcy court's jurisdiction over such tax issues is broad and exists whether or not the tax was previously assessed or paid. Furthermore, if the debtor files a bankruptcy petition while a tax case is pending before the Tax Court, the automatic stay provisions of the Code require that the Tax Court proceeding be halted until the stay is lifted.[149] If the bankruptcy court decides to permit the Tax Court proceeding to continue, the trustee may desire to intervene in the Tax Court.[150]

The bankruptcy court also has jurisdiction to determine any right which the estate may have to a tax refund. However, for the purpose of giving the taxing authorities time to act on a refund request, the bankruptcy court may not determine the tax refund question until at least 120 days after the trustee properly requests the tax refund from the appropriate governmental authorities. If the governmental unit makes a determination on the request before the 120-day period expires, the bankruptcy court may rule on this issue at that time.[151]

Another provision of the Bankruptcy Code gives the trustee the right to request that the taxing authorities make a determination with respect to tax liability of the estate. The trustee may request a determination of the estate's liability for any unpaid tax obligation incurred during the bankruptcy administration. The trustee makes this request by submitting a tax return to the appropriate governmental authorities and asking them to determine the estate's liability.[152] Unless the tax return is fraudulent

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147 11 U.S.C. § 505(a), derived from Former B.A. § 2(a)(2A).

148 11 U.S.C. § 505(a)(2)(A).

149 11 U.S.C. § 362(a)(8).

150 The Bankruptcy Code follows Arkansas Corp. Comm'r v. Thompson, 313 U.S. 132 (1941), by permitting the Bankruptcy Court to abstain where uniformity of assessment by appropriate tax authorities is of significant importance. See 11 U.S.C. § 362(d)(1) with respect to termination of the automatic stay. See also House Report, note 12 *supra*, at 356.

151 11 U.S.C. § 505(2)(B).

152 With respect to federal taxes, this request should be made to the District Director in the district where the bankruptcy case is pending. See 124 Cong. Rec. H.11,111 (daily ed. Sept. 28, 1978).

or contains material misrepresentations, the debtor, any successor to the debtor, and the trustee will be discharged from any liability for such tax if any one of three events occurs.

First, if the tax authority determines the amount of tax due, the payment of that amount results in a discharge. Second, there is a discharge upon payment of the amount set by the bankruptcy court as the amount of tax due after an audit is completed and after notice and a court hearing. The third event which results in a discharge of these tax obligations is the most important one for the purpose of expediency. If the trustee pays the sum shown on the return as the amount due and the taxing authorities do not notify the trustee within sixty days after the trustee's request for a determination that the return has been selected for an audit, the tax obligation is discharged. Moreover, if the governmental unit notifies the trustee that there will be an audit but does not complete the audit and give notice of the tax due within 180 days after the trustee first made the request for a determination, the tax is discharged nonetheless unless the court extends the 180-day period for cause.[153]

It is important to note that the filing of a bankruptcy petition automatically stays any act to collect or assess any claim against the debtor.[154] Accordingly, tax authorities may not assess a tax during the bankruptcy case. The stay, however, does not prevent the determination of tax liability upon the trustee's request or the adjudication of tax claims in bankruptcy court. Moreover, if the bankruptcy court renders a final judgment with respect to a tax obligation, the taxing authority may disregard the stay and may make an assessment as otherwise permitted by law.[155]

The Right to Setoff

Let us assume that a creditor has a $10,000 unsecured claim against the debtor for manufactured goods sold and delivered. As a result of a separate transaction, assume that the debtor sold other goods to the creditor on credit for $4,000. In essence, the creditor owes the debtor $4,000 and the debtor owes the creditor $10,000. If the debtor files a bankruptcy petition, the Bankruptcy

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[153] 11 U.S.C. § 505(b).
[154] 11 U.S.C. § 362(a)(6).
[155] 11 U.S.C. § 505(c).

Code permits the offsetting of prepetition mutual debts so that the creditor will have, in essence, a $6,000 unsecured claim against the debtor. This general recognition of the right to set off mutual debts is not new in bankruptcy law, although the Bankruptcy Code makes several changes with respect to setoffs.[156]

It is important at the outset to understand why the right to set off mutual debts is to the advantage of the creditor. Assume that the debtor's estate is large enough to pay only 10 percent of all nonpriority unsecured claims in liquidation. If the creditor discussed above did not have the right of setoff, the unsecured claim allowable in bankruptcy would be $10,000 and, accordingly, the creditor would receive $1,000 as a dividend. Also, since the debtor's $4,000 claim against the creditor would become property of the estate, the trustee would be able to recover $4,000 from the creditor. The net effect of this would be a loss of $3,000 for the creditor. On the other hand, because the Bankruptcy Code permits a setoff, the real net effect is that the creditor has an unsecured claim for $6,000 and would receive $600 as a dividend without having to pay anything to the estate. As one court commented: "A setoff has the effect of paying one creditor more than another. Despite the preferential advantages bestowed upon certain creditors by virtue of section 68 [of the former Bankruptcy Act], setoffs are accepted and approved because they are based upon long-recognized rights of mutual debtors." [157]

It is not surprising that most rights of setoff are exercised by banks. In a typical case, the debtor has funds on deposit in a checking or savings account at a certain bank. In addition, the debtor has an outstanding loan from the same bank. Even if the bank does not require the debtor to maintain a compensating balance in the accounts to secure the loan, the bank may succeed in setting off the balance of the debtor's accounts against the balance due on the loan if the debtor files a bankruptcy petition. Courts have viewed bank account balances as debts owed by the bank to its customers. Accordingly, this "debt" owed to the customer may be set off against the loan.[158]

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[156] See 11 U.S.C. § 553, derived from Former B.A. § 68. See also Loyd, "The Development of Setoff," 64 U. Pa. L. Rev. 541 (1916), for a discussion of the historical roots of the right of setoff.

[157] *In re* Bohack Corp., — F.2d —, 5 Bankr. Ct. Dec. 232,235 (2d Cir. 1979).

[158] The leading case which supports the bank's right to set off the balance of a bank account is New York County Nat'l Bank v. Massey, 192 U.S. 138 (1903).

When the Right of Setoff Is Denied

Despite the general recognition of the right of banks and other creditors to set off mutual debts, there are certain situations in which the right of setoff may be denied by the court. First, the right only applies to mutual debts which arose prior to the commencement of the bankruptcy case. Thus, the creditor may not improve its position by buying goods from the debtor on credit after the petition is filed.[159] Second, the right to set off a mutual debt may not be exercised to the extent that the creditor's claim against the debtor is disallowed.[160] For example, if the creditor's claim violates the statute of frauds or is otherwise unenforceable, there is no right of setoff and the trustee may recover payment on the debt owed by the creditor to the debtor. Third, the right of setoff will be denied if the creditor received the claim against the debtor by means of an assignment by someone else after the petition is filed or within ninety days prior to the filing while the debtor was insolvent.[161] The reason for this limitation is to prevent the person who owes money to the debtor from buying for nominal consideration almost worthless claims against the debtor on the eve of bankruptcy for the purpose of effectuating a setoff.

The final ground for the denial of the right to set off mutual debts also involves deliberate manipulation by the creditor. To illustrate, let us assume that the creditor has an unsecured claim against the debtor for $10,000. The creditor, knowing that the debtor is insolvent, orders $10,000 worth of goods from the debtor on credit. The creditor does not need the goods, but wants to have the right to set off mutual debts in case the debtor files a

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See also *In re* Applied Logic Corp., 576 F.2d 952 (2d Cir. 1978), in which a bank was permitted to set off certificates of deposit held by the bank against a debt owed to it; of added interest is the discussion of special accounts and the application of the debtor's payments where the creditor has secured or guaranteed open accounts. Compare, however, Goldstein v. Franklin Square Nat'l Bank, 107 F.2d 393 (2d Cir. 1939), which held that the deposit of funds by the insolvent debtor in a checking account for the deliberate purpose of permitting the bank to offset the deposit against an antecedent debt constituted a voidable preference and was not protected by the setoff provision of the Bankruptcy Act.

159 11 U.S.C. § 553(a).

160 11 U.S.C. § 553(a)(1). Of course, this limitation does not apply if the claim was disallowed solely because the creditor has the right of setoff. See 11 U.S.C. § 502(b)(3).

161 11 U.S.C. § 553(a)(2). The debtor is presumed to have been insolvent during the ninety-day period prior to bankruptcy. 11 U.S.C. § 553(c).

bankruptcy petition. When bankruptcy becomes a reality, the creditor has $10,000 worth of goods instead of a $10,000 claim against a hopelessly insolvent estate. Similarly, an insolvent debtor may adhere to a bank's request to deliberately build up the balance of a bank account so that the bank may obtain a greater setoff upon the debtor's bankruptcy. The Code deals with these situations by providing for the denial of a setoff to the extent that the debt owed to the debtor was incurred by the creditor within ninety days prior to the commencement of the case, while the debtor was insolvent, for the purpose of obtaining a right of setoff against the debtor.[162]

Trustee's Power to Recover Certain Setoffs Made Within Ninety Days of Bankruptcy

Another limitation on the right of setoff relates to the creditor who exercised the right of setoff before the commencement of the bankruptcy case and whose position was improved within the ninety-day period prior to the filing of the petition. Specifically, if the creditor offsets mutual debts on or within ninety days before the commencement of the case, the trustee may recover from the creditor the amount set off to the extent that any insufficiency on the date of the setoff is less than the insufficiency ninety days before the petition is filed or, if there is no insufficiency ninety days before bankruptcy, when there is an insufficiency for the first time within the ninety-day period.[163] The term "insufficiency" means the amount by which a claim against the debtor exceeds the amount of the mutual debt owed to the debtor.[164] The rationale for giving the trustee the power to recover these setoffs is to prevent creditors from effectuating a preference by making a prepetition setoff. This apparently complicated rule, which is new in bankruptcy law, should not be left without illustration.

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[162] 11 U.S.C. § 553(a)(3). This provision follows Goldstein v. Franklin Square Nat'l Bank, discussed in note 158 *supra*. Notice that the trustee is added by the fact that the debtor is presumed to have been insolvent during the ninety-day period prior to bankruptcy. 11 U.S.C. § 553(c).

[163] 11 U.S.C. § 553(b)(1). For a discussion of this provision, see Orr & Klee, "Secured Creditors Under the New Bankruptcy Code," 11 U.C.C.L.J. 312, 335-338 (1979).

[164] 11 U.S.C. § 553(b)(2). A similar concept is used to determine the extent of a preference with respect to inventory and accounts receivables financing. See Chapter 7 (Trustee's Avoiding Powers) of the authors' forthcoming book.

Illustration 1. The debtor owed the bank $10,000 at all times during the past year. Ninety days before the petition was filed, the debtor had $6,000 in a bank account at the same bank. The insufficiency at that time is $4,000 ($10,000 less $6,000). Prior to the commencement of the case, the bank set off the account balance which was $5,000 at that time. Because the insufficiency ninety days prior to bankruptcy ($4,000) is less than the insufficiency when the setoff occurred ($5,000), the trustee may not recover any of it. In essence, the bank's position did not improve during the ninety-day period because it could have set off more ($6,000) if it made the setoff ninety days prior to bankruptcy.

Illustration 2. The debtor owed the bank $10,000 at all times during the past year. Ninety days before the petition was filed, the debtor had $6,000 in a bank account. Immediately before bankruptcy, the bank set off the balance of the debtor's account which was $7,000 at that time. The insufficiency ninety days prior to bankruptcy was $4,000 ($10,000 less $6,000), and was $3,000 ($10,000 less $7,000) on the day of the setoff. The trustee may recover $1,000 from the bank because the bank's position improved by $1,000 during the ninety-day period.

Illustration 3. The debtor owed the bank $10,000 at all times during the past year. Ninety days before bankruptcy the debtor had $13,000 in a bank account. Thirty days prior to bankruptcy, the debtor withdrew funds for the first time which reduced the account balance to $6,000. Ten days prior to the filing of the petition, the bank set off $7,000 which was the account balance at that time. The trustee may recover $1,000 from the bank. The first time during the ninety-day period when there was an insufficiency was thirty days before the petition was filed. The insufficiency then ($4,000) was less than the insufficiency at the time of the setoff ($3,000). Accordingly, the bank's position improved by $1,000 during that time.[165]

If the trustee recovers a setoff because of the improved position of the creditor within the ninety-day period prior to bankruptcy, the creditor's unsecured claim against the estate will be increased accordingly.[166]

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[165] For similar illustrations, see Orr & Klee, note 162 *supra*.
[166] 11 U.S.C. § 502(h).

Setoffs and the Automatic Stay Rule

There are procedural hurdles which affect the creditor's exercise of a valid right of setoff once the bankruptcy petition is filed. Of course, if the creditor has already exercised the right of setoff prior to bankruptcy, the creditor may simply submit a proof of claim for the deficiency owed. If the trustee has the right to recover all or part of the amount of the prepetition setoff because of the improvement of position within the crucial ninety-day period, a proceeding may be commenced by the trustee for that purpose or the creditor's claim for a deficiency may be disallowed until recovery is made.[167]

Assume, however, that the creditor who has a valid right of setoff has not exercised it prior to bankruptcy. What are the rights of the bank that has the right to set off the balance of a bank account against an unsecured loan balance? The bank or other creditor who wants to exercise setoff rights is confronted by the automatic stay provision of the Bankruptcy Code which applies to setoffs.[168]

The rationale behind the automatic stay of setoff rights is to prevent the situation in which the debtor's cash-flow problem becomes fatal to its operations because of the loss of bank accounts and accounts receivable. This is especially important in reorganization cases. If the bank could freeze all bank accounts upon the filing of the petition, whatever chances the debtor may have had for rehabilitation would probably vanish without the use of its bank balances. Even in liquidation cases, the continuation of business for a temporary period of time may be appropriate to maintain the value of the business as a going concern. The use of cash deposits and the collection of accounts receivable without interruption can be important for the preservation of the estate.

The automatic stay rule does not, however, strip the creditor of the substantive right of setoff. The creditor whose right of setoff is stayed is entitled to adequate protection.[169] This protection may be in the form of periodic cash payments by the trustee, giving the creditor a lien on specific assets, granting an administrative expense priority in asset cases, or any other appropriate mechanism. If the creditor wants relief from the stay or believes that there is no

[167] 11 U.S.C. § 502(d).

[168] 11 U.S.C. § 362(a)(7). See Chapter 1 (Liquidation as a Debtor's Remedy: The Voluntary Case) of the authors' forthcoming book for a discussion of the automatic stay provisions of the Code.

[169] See 11 U.S.C. §§ 362(d)(1), 361.

adequate protection to secure the right to setoff, an adversary proceeding may be instituted for that purpose.[170]

When the unsecured creditor's right of setoff is stayed, the creditor's claim will be allowed as a secured claim to the extent of the setoff.[171] For example, the creditor who has a $10,000 unsecured claim and a $2,000 right of setoff may be treated as having a secured claim for $2,000 and an unsecured claim for $8,000. This treatment further protects the setoff rights of the unsecured creditor.

Secured Claims

There are three types of liens which creditors may have obtained with respect to the debtor's property prior to bankruptcy. The first type of lien is the consensual lien which is created by agreement between the debtor and the creditor, including real estate mortgages and security interests in personal property.[172] Second, creditors may have judicial liens which are those created by judgment, levy, sequestration, or other legal or equitable judicial proceeding.[173] The third category includes statutory liens which arise solely by force of a statute on specific circumstances.[174] Examples of statutory liens are the landlord's lien for rent, the garageman's lien, the artisan's lien, the warehouseman's lien,[175] and the tax lien.[176]

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[170] The procedures for this proceeding are discussed in Chapter 1 (Liquidation as a Debtor's Remedy: The Voluntary Case) of the authors' forthcoming book.

[171] 11 U.S.C. § 506(a).

[172] These consensual liens are included in the definition of "security interest" in 11 U.S.C. § 101(37). Article 9 of the Uniform Commercial Code contains the body of state law which governs security interests in personal property in every state except for Louisiana. For a detailed analysis of Article 9, see White & Summers, *Uniform Commercial Code* 754-1007 (1972); Henson, *Secured Transactions Under the Uniform Commercial Code* (2d ed.; 1979); Coogan, Hogan & Vagts, *Secured Transactions Under the Uniform Commercial Code* (1978).

[173] 11 U.S.C. § 101(27) defines "judicial lien."

[174] 11 U.S.C. § 101(38) defines "statutory lien."

[175] See U.C.C. §§ 7-209, 7-210, which govern the warehouseman's lien. Section 7-210 of the UCC was upheld by the Supreme Court in a recent constitutional attack. Flagg Bros., Inc. v. Brooks, 436 U.S. 149 (1978). Compare Sharrock v. Dell Buick, 45 N.Y.2d 152 (1978), in which the court of appeals held that the New York garageman's lien statute is unconstitutional with respect to its sales provisions.

[176] For a discussion of tax liens with respect to federal income taxes, see Maule, "Collection of Federal Income Taxes by Levy," 64 A.B.A.J. 1439 (1978). See 11 U.S.C. § 724(b), derived from Former B.A. § 67(c)(3), which subordinates tax liens to the rights of certain unsecured priority claims.

The Bankruptcy Code gives the trustee or debtor in possession the power to avoid liens in certain situations. For example, liens obtained as voidable preferences or fraudulent conveyances may be avoided. Statutory liens may be avoided to the extent that they first become effective upon the filing of a bankruptcy petition. These are only a few of the numerous situations in which liens may be avoided under the Code.[177]

The policy of the Bankruptcy Code is to recognize and give effect to those liens which are not avoided by the trustee or debtor in possession.[178] In fact, most liens will remain effective against the estate in the typical bankruptcy case. To the extent that a claim is secured by a valid consensual, judicial or statutory lien, the Code treats it as a *secured claim.*[179] As discussed above, to the extent that an unsecured creditor has a right of setoff, the creditor's claim also is treated as a secured claim.[180]

A creditor with a secured claim does not have to file a proof of claim to maintain its lien.[181] However, the creditor that does not file a proof of claim may lose its lien if one of two possible actions occur. First, if the trustee or debtor in possession commences a proceeding to invalidate the lien pursuant to an avoiding power, the lien may become void. Second, if any party in interest requests that the court determine and allow or disallow the creditor's claim, the lien will survive only to the extent that the secured claim is allowed by the court.[182] Of course, if the creditor's claim is disallowed, the lien will not survive.[183]

Allowance of the Secured Claim and Valuation

Although the secured creditor may take a "wait and see" attitude without filing a proof of claim, the failure to have the claim allowed may deprive the creditor of an opportunity to participate

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177 See Chapter 7 (Trustees' Avoiding Powers) of the authors' forthcoming book.

178 See 11 U.S.C. § 506 which follows the policy of the Former B.A. in recognizing valid liens in bankruptcy. See Straton v. New, 283 U.S. 318 (1930). For a discussion concerning priorities among secured claims, see Jackson & Kronman, "Secured Financing and Priorities Among Creditors," 88 Yale L.J. 1143 (1979).

179 11 U.S.C. § 506(a).

180 *Id.*

181 See Orr & Klee, note 163 *supra*, at 315.

182 See 11 U.S.C. § 506(d)(1).

183 However, if a secured claim held by a co-debtor is disallowed on certain grounds, the lien may still remain effective. See 11 U.S.C. §§ 506(d)(2), 502(e).

in the bankruptcy case. For example, assume that a creditor has a $10,000 claim secured by collateral worth $6,000. The creditor whose claim is not allowed is not permitted to share in the distribution of the estate upon liquidation with respect to the $4,000 deficiency.[184] Similarly, in a reorganization case the secured creditor may not vote to accept or reject a plan if its claim is not allowed.[185] Therefore, the secured creditor who wants to participate in the bankruptcy case will have to file a proof of claim to have the claim allowed. As discussed earlier, the proof of claim is "deemed filed" in a reorganization case if it is properly scheduled, unless it is scheduled as disputed, contingent, or unliquidated.[186]

Once the creditor's claim is allowed under the Code, it becomes a secured claim to the extent of the value of the collateral or the amount subject to setoff. To the extent that the value of the collateral or right of setoff is less than the total allowed claim, the creditor is deemed to have an unsecured claim.[187] In essence, the undersecured creditor whose collateral is worth less than the debt is treated as having two claims, one secured and one unsecured. For the purpose of determining the value of the collateral, the court usually will hold a hearing.[188] Valuation must be determined on a case-by-case basis and in light of the purpose of the valuation and the proposed disposition or use of the collateral. The value placed on the collateral for this purpose is not binding with respect to any other purpose. For example, valuation to determine the extent of adequate protection needed to continue the automatic stay against lien foreclosure does not preclude a subsequent valuation for the purpose of a "cram down" confirmation in a reorganization case or for the purpose of determining the extent of a partially secured creditor's lien.[189]

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184 See the above discussion on the allowability of claims.

185 11 U.S.C. § 1126(a). In addition, if the secured claim is not allowed, the creditor in a reorganization case may not elect to be treated as a fully secured creditor under 11 U.S.C. § 1111(b)(2).

186 11 U.S.C. § 1111(a).

187 11 U.S.C. § 506(a). However, see 11 U.S.C. § 1111(b)(2) and Chapter 8 (Reorganizations) of the authors' forthcoming book for a discussion of the right of partially secured creditors to be treated as fully secured creditors in reorganization cases.

188 See B. Rule 306(d) and Former B.A. § 57(h), which dealt with valuation of collateral.

189 See 11 U.S.C. § 506(a); House Report, note 12 *supra*, at 356. The court has considerable discretion in determining the appropriate method of valuation. See, e.g., *In re* American Kitchen Foods, Inc., 2 Bankr. Ct. Dec. 715 (D. Me. 1976). See also 11 U.S.C. § 1129(b) on "cramdown" confirmations.

What Happens to the Collateral During the Case?

The secured creditor is stayed automatically from the enforcement of its lien and, therefore, may not proceed to foreclose on the collateral after the petition is filed.[190] The stayed creditor, however, is entitled to adequate protection to assure that it will not be damaged by the stay.[191]

While the secured creditor is stayed from lien enforcement, the trustee or debtor in possession may use the collateral in the ordinary course of business or, if the court approves, not in the ordinary course of business.[192] The only collateral which may not be used without either consent or court approval is "cash collateral."[193] Furthermore, collateral may be sold free and clear of liens under certain circumstances.[194] However, whether collateral is used or sold during the case, the creditor's right to adequate protection may not be jeopardized.[195]

Expenses Relating to the Collateral

It is not uncommon for the trustee to incur expenses with respect to protecting the collateral. When this occurs, the secured creditor often is the beneficiary of these expenses. For this reason, the Bankruptcy Code gives the trustee the right to recover from the collateral the reasonable and necessary costs and expenses of preserving or disposing of the collateral to the extent of any benefit to the secured creditor.[196]

Interest on Secured Claims

As a general proposition, interest which accrues after the petition is filed is not allowable in bankruptcy. The running of interest stops when the case is commenced.[197] However, the Code contains an exception when post-petition interest may be recovered by the

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[190] 11 U.S.C. § 362(a)(4).

[191] The secured creditor's right to adequate protection is discussed in Chapter 1 (Liquidation as a Debtor's Remedy: The Voluntary Case) of the authors' forthcoming book.

[192] 11 U.S.C. §§ 363(b), 363(c).

[193] 11 U.S.C. §§ 363(a), 363(c)(2).

[194] 11 U.S.C. § 363(f).

[195] 11 U.S.C. § 363(e).

[196] 11 U.S.C. § 506(c).

[197] See the above discussion on post-petition interest.

holder of a secured claim. Whenever the value of the collateral, after deducting expenses which may be recovered from the property, exceeds the amount of the allowed claim, the claimant is entitled to an allowable claim for post-petition interest to the extent of the excess collateral value. In addition, such oversecured creditors may receive an allowance for any reasonable fees, costs, or charges, including attorney's fees, as provided in the security agreement.[198] In no event, however, may the creditor's claim for interest and fees exceed the excess value of the collateral over the amount of the claim.[199]

Security Interests on After-Acquired Property

Article 9 of the Uniform Commercial Code provides that a security agreement may give the creditor a lien on after-acquired property.[200] For example, a creditor may obtain a security interest on "all inventory presently owned and hereafter acquired." Because the lien attaches to new collateral as soon as the debtor acquires it, this type of security interest is commonly referred to as a "floating lien."[201] Due to the frequent turnover of inventory and accounts receivable, after-acquired property clauses are common in security agreements dealing with these types of collateral.

The Bankruptcy Code limits the effect of such after-acquired property clauses by making them inoperative with respect to post-petition property of the estate or the debtor.[202] Accordingly, the inventory financier whose security interest is in after-acquired inventory may not assert a lien in any inventory purchased after the petition is filed. The effect of the bankruptcy petition is to stop the lien from floating to new collateral.

This limitation with respect to after-acquired collateral pur-

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198 See Textile Banking Co. v. Widener, 265 F.2d 446 (4th Cir. 1959), in which the court stated that the trustee's expenses incurred in selling the collateral may be charged against the proceeds, but such charge may not exceed the costs of selling the collateral through a state court foreclosure proceeding.

199 11 U.S.C. § 506(b). See *In re* Black Ranches, Inc., 362 F.2d 8 (8th Cir. 1966).

200 U.C.C. § 9-204.

201 See, e.g., Coogan, Hogan & Vagts, 11 *Secured Transactions Under the Uniform Commercial Code*, Ch. 2 (1978); White & Summers, *Uniform Commercial Code* 876-883 (1972); DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1969).

202 11 U.S.C. § 552(a), codifying *In re* Sequential Information Sys., Inc., CCH Bankr. Dec. ¶ 63,848 (S.D.N.Y. 1970).

chased after the case commences does not, however, apply to the secured party's lien on proceeds, rents or profits from the original collateral.[203] Let us assume that the creditor has a security interest in the debtor's inventory and its proceeds.[204] After the bankruptcy petition is filed, the debtor's inventory is sold on credit, thus creating accounts receivable. Since the accounts receivable are proceeds of the inventory, the creditor has a lien on the accounts, which may be worth more than the inventory. Similarly, if the inventory is destroyed by fire after the case is commenced, proceeds of the fire insurance policy will become the collateral. The security interest may also attach to post-petition profits, rents, produce, or offspring of the collateral to the same extent that it would attach in the absence of bankruptcy. Accordingly, if a mortgage agreement gives the creditor a lien on rents to be collected from an office building, the creditor's claim is deemed secured by future rents. It is important to note, however, that post-petition proceeds, profits, rents, offspring, and produce are subject to the lien only if they derive from prepetition collateral.[205]

The extension of the prepetition security interest to post-petition proceeds, profits, rents, offspring, and produce is not absolute and automatic. The Code provides that the court may, after a notice and hearing and based on the equities of the case, order that proceeds and profits shall not be subject to the lien.[206] It is anticipated that the court will take into account any related expenses of the estate which may have depleted funds available for unsecured creditors. For example, if the trustee converts raw materials into inventory at considerable expense, it is doubtful that the creditor with a lien on the raw materials will be given a lien on all of the inventory as proceeds or the profits on the sale of the inventory without an adjustment made to avoid depletion of funds for unsecured claimants due to the related expenses.[207]

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203 11 U.S.C. § 552(b). Whether or not the security interest attaches to rents depends on state law. See Butner v. United States, — U.S. —, 4 Bankr. Ct. Dec. 1259 (1979). This provision does not apply, however, where it would be inconsistent with other sections of the Bankruptcy Code. See 11 U.S.C. §§ 363, 506(c), 544, 545, 547, 548.

204 Section 9-306 of the UCC governs the secured party's rights with respect to proceeds.

205 11 U.S.C. § 552(b).

206 *Id.*

207 See S. Rep. No. 95-989, 95th Cong. 2d Sess. 91 (1978).

The Seller's Right to Reclaim Goods

At common law, the unpaid seller who was defrauded into extending unsecured credit to a buyer had the right to rescind the sale and recover the goods. The mere purchase of goods on credit was considered as an implied representation that the buyer was solvent and able to pay for the goods. Accordingly, when a buyer ordered goods on credit while insolvent, the seller had the right to rescind on the grounds of fraud upon discovery of the insolvency.[208]

The Uniform Commercial Code codifies and limits the unpaid seller's right to reclaim goods. Section 2-702(2) provides as follows:

> Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply. Except as provided in this subsection the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.

Let us assume that the seller delivers goods to a buyer on credit. Within ten days after delivery, the seller discovers that the buyer is insolvent and demands the return of the goods.. Pursuant to the UCC, the seller has the right to reclaim the goods. However, assume that the buyer files a bankruptcy petition before the seller takes possession of the goods. Is the seller's right to reclaim the goods effective against the trustee in bankruptcy?

This issue had been litigated extensively under the former Bankruptcy Act. Trustees have argued that Section 2-702 of the UCC creates a statutory lien which is effective upon the buyer's insolvency only, thereby creating an invalid statutory lien.[208a] It has been argued that Section 2-702 is an improper interference with the priority rules under the former Act.[209] Despite these arguments,

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[208] See Gordon v. Spalding, 268 F.2d 327 (5th Cir. 1959); Braucher, "Reclamation of Goods From a Fraudulent Buyer," 65 Mich. L. Rev. 1281, 1282-1284 (1967).

[208a] See 11 U.S.C. § 545(1) and Former B.A. § 67(a)(1)(A).

[209] See, e.g., Sebert, "The Seller's Right to Reclaim: Another Conflict Between the Uniform Commercial Code and the Bankruptcy Act," 52 Notre Dame Law. 219 (1976); Weintraub & Edelman, "Seller's Right to Reclaim Property Under Section 2-702(2) of the Code Under the Bankruptcy Act: Fact or Fancy," 32 Bus. Law. 1165 (1977).

most courts have held that the seller's right to reclaim was effective against the trustee under the former Act because it created a valid right of rescission.[210] Several courts, however, refused to allow the unpaid seller to reclaim.[211]

The Bankruptcy Code clears up any confusion with respect to the rights of the unpaid seller by expressly adopting, in part, Section 2-702 of the UCC. Specifically, the Bankruptcy Code provides that the trustee's avoiding powers are subject to any reclamation rights of the seller who sold goods to the debtor in the ordinary course of business while the debtor was insolvent.[212] The seller's right to reclaim may derive from the common law or from a statute, such as the Uniform Commercial Code. There are, however, strict limitations on the seller's right to reclaim in bankruptcy. First, the sale of goods must have been in the ordinary course of the seller's business.[213] Second, the seller may not reclaim goods unless reclamation is demanded in writing within ten days after the debtor received the goods.[214] It is important to note that Section 2-702 of the Uniform Commercial Code relieves the seller of the ten-day demand rule if the buyer made a written misrepresentation as to solvency within three months. The Bankruptcy Code, however, does not adopt this part of Section 2-702. Despite any written misrepresentation, the seller's right to reclaim is lost against a debtor in bankruptcy if demand is not made within ten days.

The bankruptcy court is given a choice with respect to the treatment of the seller's right to reclaim goods when a proper demand is made within the ten-day period.[215] The court may grant the seller's request for possession of the goods. Alternatively, the court may deny reclamation and grant the seller's claim as an administrative expense priority.[216] A third way to treat the right of reclamation is to grant the seller a lien on the goods or on some

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[210] See *In re* Federal's, Inc., 553 F.2d 509 (6th Cir. 1977); *In re* Telemart Enterprises, Inc., 524 F.2d 761 (9th Cir. 1975), *cert. denied* 424 U.S. 969 (1976); *In re* Farmers Market Assoc., 4 Bankr. Ct. Dec. 747 (8th Cir. 1978).

[211] See *In re* Wetson's Corp., 17 U.C.C. Rep. 423 (S.D.N.Y. 1975); *In re* Giltex, 17 U.C.C. Rep. 887 (S.D.N.Y. 1975).

[212] 11 U.S.C. § 546(c).

[213] *Id.*

[214] 11 U.S.C. § 546(c)(1).

[215] These choices are set forth in 11 U.S.C. § 546(c)(2).

[216] See the discussion below with respect to the administrative expense priority.

other property of the estate. The reason for allowing the court to deny reclamation by giving the seller an administrative expense priority or lien is to accommodate a debtor in possession that requires the use of the goods in reorganization cases. Permitting the debtor to use the goods purchased on credit may benefit the estate or increase the likelihood of a successful rehabilitation.

Priority Claims

The Bankruptcy Code sets forth certain types of unsecured claims and expenses which are entitled to priority in distribution over other unsecured claims. It is important to appreciate, however, that on the priority ladder these claims and expenses rank below allowed secured claims,[217] but above all other unsecured claims. Moreover, the six categories of priorities are ranked among themselves. For example, administrative expenses rank as the first priority and, therefore, must be paid in full upon the debtor's liquidation before the second priority, involuntary gap claims, receive any dividend. Similarly, involuntary gap creditors must be paid in full before the third priority, wage claims, receives a dividend, and so on.[218]

First Priority: Administrative Expenses

It is important that the estate pay for expenses of bankruptcy administration. Thus, the Code continues the policy of the former Act in giving administrative expenses a first priority.[219] In addition to administrative expenses,[220] the first priority also includes any court fees and charges assessed against the estate.[221]

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[217] However, see 11 U.S.C. § 724(b) which provides for the subordination of tax liens to certain unsecured priority creditors. See also Former B.A. § 67(c)(3).

[218] It should be noted, however, that an entity that is subrogated to the rights of a holder of a third-, fourth-, fifth-, or sixth-level priority claim is not entitled to benefit from the priority status. 11 U.S.C. § 507(d).

[219] 11 U.S.C. § 507(a)(1). See Former B.A. § 64(1). Notice that the Code gives the court authority to grant superpriority status over other administrative expenses to encourage new postpetition financing. 11 U.S.C. § 364(c). Compare *In re* Texlon Corp., — F.2d —, 5 Bankr. Ct. Dec. 109 (2d Cir. 1979). See Chapter 8 (Reorganization) of the authors' forthcoming book for a discussion of superpriority claims.

[220] See the above discussion on administrative expenses.

[221] 11 U.S.C. § 507(a)(1). See 28 U.S.C. Ch. 123 which governs court fees and charges.

Second Priority: Involuntary Gap Claims

As discussed above, claims which arise in the ordinary course of the debtor's business after an involuntary case is commenced but before the order for relief or appointment of a trustee are allowable as if they arose prior to the petition.[222] In order to encourage persons to do business as usual with the debtor who has not had a day in court to challenge the involuntary petition, these unsecured "involuntary gap claims" are given a second priority.[223]

Third Priority: Wage Claims

The Bankruptcy Code follows the former Act in that it gives a priority to certain unsecured claims for wages, salary, or commissions earned by the debtor's employees who suffer by a loss of their jobs as a result of the filing of a bankruptcy petition.[224] As Judge Learned Hand once commented: "The statute was intended to favor those who could not be expected to know anything of the credit of their employer, but must accept a job as it comes. . . ." [225]

The wage priority includes claims for vacation, severance, and sick leave pay as well as claims for basic wages, salary, and commissions. However, this priority is not without limits. The wage priority applies to claims for compensation earned by an individual within ninety days before the filing of the petition or the cessation of the debtor's business, whichever occurs first. Moreover, the priority may not exceed $2,000 for each employee. Thus, an employee who is owed $5,000 for wages earned during the ninety-day period plus $5,000 for wages earned more than ninety days before bankruptcy may obtain a $2,000 priority claim and an $8,000 nonpriority claim.[226]

Fourth Priority: Contributions to Employee Benefit Plans

Under the former Bankruptcy Act, courts have not granted wage priority status to claims based on employees' rights to fringe benefits, such as claims for unpaid contributions to employee

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[222] See 11 U.S.C. § 502(f).

[223] 11 U.S.C. § 507(a)(2).

[224] 11 U.S.C. § 507(a)(3). See Former B.A. § 64(2). See also Sugg. Int. B. Form Nos. 14 and 15 for proofs of claims for wages.

[225] *In re* Lawsam Elec. Co., Inc., 300 Fed. 736 (S.D.N.Y. 1924).

[226] Compare Former B.A. § 64(2), which limited the employee's priority claim to $600.

annuity plans. The Supreme Court construed the wage priority provision of the former Act very narrowly.[227] When enacting the new Code, however, Congress recognized the realities of modern labor contract negotiations which result in increased fringe benefits as a substitute for substantial wage demands. Accordingly, the Bankruptcy Code now gives employees certain protection with respect to their fringe benefits. Specifically, claims for unpaid contributions to employee benefit plans, such as pension, health, or life insurance plans are given a fourth priority.[228]

The priority given to claims for unpaid contributions to employee benefit plans are not unlimited. First, the claims for unpaid contributions must arise from services rendered by employees within 180 days before the commencement of the case or cessation of the debtor's business, whichever occurs first.[229] Second, there is a monetary limitation on this priority. For each benefit plan, the priority may not exceed the number of employees covered by the plan multiplied by $2,000, minus the total amount paid to other benefit plans or to employees under the wage priority.[230] The effect of this limitation is that the aggregate amount of claims paid to or for the benefit of employees for wages and fringe benefits pursuant to the third and fourth priorities shall not exceed $2,000 per employee. Of course, the balance of these types of claims are allowable as general unsecured claims without priority.

Fifth Priority: Consumer Deposits

It is common for consumers to pay money to a retailer as a deposit for merchandise to be delivered at a future date. Similarly, customers often prepay for services, such as when a consumer buys a contract for dance lessons or a health club membership. If the business does not deliver the goods or services, these consumers have nothing but unsecured claims against the business. Moreover, many consumers who make such deposits or prepayments are under

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227 See Joint Indus. Bd. v. United States, 391 U.S. 224 (1968); United States v. Embassy Restaurant, Inc., 359 U.S. 29 (1959). But see *In re* E. Moore of Cal., Inc., 447 F.2d 1106 (9th Cir. 1971), *cert. denied* 404 U.S. 995 (1971), in which the court afforded wage priority status to amounts required to be paid by the debtor, a painting contractor, into a union's vacation pay trust fund.

228 11 U.S.C. § 507(a)(4).

229 11 U.S.C. § 507(a)(4)(A).

230 11 U.S.C. § 507(a)(4)(B).

the mistaken belief that their money becomes part of a trust fund and that they will be protected in the event of insolvency.[231]

The Bankruptcy Code departs from prior law in that it gives each of these consumer creditors a fifth priority status to the extent of $900 to cover any deposit made prior to the bankruptcy of the retail establishment.[232] To benefit from this priority, the consumer's claim must be based on a cash deposit in connection with either the purchase, lease, or rental of property or the purchase of services which were not delivered or provided. Furthermore, it is required that the property or services are for personal, family, or household use—not for use in a commercial context. It is clear, therefore, that this priority is for the protection of consumers only.

Sixth Priority: Tax Claims

Governmental claims for taxes are given a preferred status in bankruptcy in several ways. Tax liens are recognized and give rise to a secured claim in favor of the government.[233] If the taxing authority has not obtained a lien prior to the filing of the petition, the tax claim will be entitled only to a sixth-level priority.[234] Furthermore, most tax claims in a typical bankruptcy case will survive as nondischargeable debts in the event that there are not sufficient assets to pay these priority claims in full.[235] In fact, the reason for giving the tax claimant a priority above other unsecured creditors is to benefit the debtor. Since these tax claims are nondischargeable, it is in the debtor's best interest to maximize the amount distributed to the tax claimant.[236]

Not all tax claims are entitled to the sixth priority, although most federal, state, and local tax obligations in the usual bankruptcy case are included. The categories of taxes entitled to a sixth priority are set forth with specificity in the Bankruptcy Code.[237] In general, the following kinds of tax claims are included in the priority:

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231 See Schrag & Ratner, "Caveat Emptor, Empty Coffer: The Bankruptcy Law Has Nothing to Offer," 72 Colum. L. Rev. 1147 (1972).

232 11 U.S.C. § 507(a)(5).

233 However, see 11 U.S.C. § 724(b) with respect to the subordination of tax liens to certain priority claims.

234 11 U.S.C. § 507(a)(6), which derives from Former B.A. § 64(4). Certain tax claims are entitled to a first priority as administrative expenses.

235 See 11 U.S.C. § 523(a)(1). The nondischargeability of tax claims is discussed in Chapter 3 (discharge) of the authors' forthcoming book.

236 See House Report, note 12 *supra*, at 190.

237 See 11 U.S.C. § 507(a)(6).

(1) Income or gross receipts tax if any one of the following conditions is met: (a) it is for a taxable year which ends on or before the filing of the bankruptcy petition and the tax return is last due either after the commencement of the bankruptcy case or three years before that time; (b) the tax is assessed within 240 days before the filing of the bankruptcy petition[238]; or (c) the tax is not assessed before, but is assessable under applicable tax law, the statute of limitations, or by agreement after the filing of the bankruptcy petition.

(2) Property tax which is assessed before the filing of the bankruptcy petition and last payable without penalty within one year before the petition is filed.

(3) Tax which the debtor is required to collect or withhold for which the debtor is liable, such as income taxes and social security taxes which the debtor employer is required to withhold from employees' paychecks. This category covers the so-called trust fund taxes.

(4) Employment tax on the wages which are entitled to a third priority and which were earned before bankruptcy if a tax return for them is last due within three years before the commencement of the case.

(5) Excise tax on a prepetition transaction which occurs within three years prior to the bankruptcy if no return is required, or on any prepetition transaction for which a return is due within three years before the bankruptcy.

(6) Customs duty arising out of the importation of merchandise under certain circumstances.[239]

(7) Penalties related to any of these priority tax claims in compensation for actual pecuniary loss.

Subordination of Claims

There are three situations which may result in the subordination of a claim to others of the same type. The most common situation involves the subordination agreement among creditors. When a debtor is experiencing financial difficulty and needs additional credit, it is not uncommon for the new lender to insist on an agree-

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[238] See 11 U.S.C. § 507(a)(6)(A)(ii) which provides for a greater period of time in cases when a settlement offer is made within the 240-day period.

[239] See 11 U.S.C. § 507(a)(6)(F).

ment with existing creditors under which other claims are voluntarily subordinated to that of the new lender. Existing creditors may be willing to subordinate their claims for the purpose of encouraging the new lender to furnish needed capital. Subordination agreements among creditors are enforceable in bankruptcy to the same extent as they are valid in nonbankruptcy situations.[240] Of course, the senior creditor may waive the right to full payment above subordinated claims by accepting a reorganization plan which provides for equal treatment.

The second situation which may give rise to subordination of claims occurs when an equity security holder has a claim against the debtor for rescission or damages. For example, if a shareholder was defrauded into purchasing shares in violation of the securities laws[241] and the corporation files a bankruptcy petition, the shareholder may attempt to bootstrap his status by filing a claim as a general creditor based on fraud and rescission. The problem with permitting the defrauded shareholder to rise to the level of a general creditor is that all other creditors would be adversely affected. Congress examined existing case law on this issue, which generally favored the rescinding shareholder,[242] but decided to adopt the position that such shareholders should not be able to improve their status. The Code provides that any rescission or damage claim of a security holder shall be subordinated to all claims or interests that are senior or equal to the interest represented by the security.[243] Thus, a defrauded stockholder or limited partner who rescinds the purchase of the security based on fraud may not share in a distribution of the estate on equal footing with general creditors. The

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[240] 11 U.S.C. § 510(a). See *In re* National Discount, 212 F. Supp. 929 (W.D.S.C. 1963), *aff'd* 322 F.2d 928 (4th Cir. 1963), holding subordination by creditors in common-law settlement binding in a subsequent bankruptcy. See also Golin, "Debt Subordination as a Working Tool," 7 N.Y. L. Forum 370 (1961); Rome, "The Business Workout—A Primer for Participating Creditors," 11 U.C.C.L.J. 183 (1978).

[241] See the antifraud provisions of federal securities laws contained in Section 17(a) of the Securities Act (15 U.S.C. § 779) and in Rule 10b-5 promulgated under the Securities Exchange Act of 1934 (17 C.F.R. § 240.10b-5).

[242] See Oppenheimer v. Harriman Nat'l Bank & Trust Co., 301 U.S. 206 (1937). But see *In re* Stirling Homex Corp., 579 F.2d 206 (2d Cir. 1978), in which claims of rescinding shareholders were subordinated. See also *In re* Cartridge Television, Inc., 535 F.2d 1388 (2d Cir. 1976), in which fraud claims were denied because their liquidation would unduly delay administration of the estate.

[243] 11 U.S.C. § 510(b).

rationale for this provision relates to the allocation of risk with respect to the unlawful issuance of securities. "While both security holders and general creditors assume the risk of insolvency, . . . the risk of illegality in securities issuance should be borne by those investing in securities and not by general creditors."[244]

The third situation which may lead to the subordination of claims involves the principle of *equitable subordination*. The bankruptcy court may either subordinate a claim below other claims of the same type or order that a lien securing a claim be transferred to the estate when there exists conduct by the claimant which makes it inequitable to permit a pro rata sharing with others.[245]

An illustration of the equitable subordination doctrine is found in the case of *In re Trimble Co.*[246] The controlling shareholders of a close corporation loaned $85,000 to the business and received demand promissory notes. At the time of the loan, banks were unwilling to extend credit and the business was found to be a "hopelessly insolvent corporate structure."[247] Upon the bankruptcy of the corporation, the shareholders who were holding the notes asserted claims as general creditors for the sum of $85,000. The court refused to permit the shareholders to participate as general creditors despite the fact that they held promissory notes. Because of the poor financial condition of the corporation when the loan was made, the court relied on equitable powers to categorize these advances as contributions of capital—not loans. "In such a situation, a test which may be used to decide whether a contribution by a proprietary interest is a loan or an additional injection of capital is whether the advance was made at a time when a bank or other ordinary commercial agency would be willing to lend it funds."[248]

Despite the result in *Trimble*, most courts have held that equi-

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[244] House Report, note 12 *supra*, at 195. For an historical analysis of this issue and the policies involved, see Slain & Kripke, "The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors," 48 N.Y.U. L. Rev. 261 (1973). See also Note, "Securities Claims in Bankruptcy: Provability and Priority," 53 N.Y.U. L. Rev. 1056 (1978).

[245] 11 U.S.C. § 510(c). See Herzog & Zweibel, "The Equitable Subordination of Claims in Bankruptcy," 15 Vand. L. Rev. 83 (1961).

[246] 479 F.2d 103 (3d Cir. 1973). See also Pepper v. Litton, 308 U.S. 295 (1939).

[247] *In re* Trimble Co., note 246 *supra*, at 118.

[248] *Id.* at 116.

table subordination of an insider's claim is not justified unless there is evidence of fraud, inequitable conduct, or unjust enrichment; the extension of loans to a failing business usually is not, in and of itself, sufficient to justify subordination.[248a] Nonetheless, insiders[248b] who are desirous of lending money to a troubled business may have second thoughts about making such loans. Rather than risk subordination, insiders often consider making loans with court approval after the business files a petition for reorganization. By proceeding in this manner, the insider not only avoids the risk of subordination, but also may obtain a first priority as an administrative expense,[248c] or even a superpriority above all other administrative expenses.[248d] In addition, the utilization of funds during the reorganization may be more conducive as an aid to rehabilitation.

Distribution of the Estate in a Liquidation Case

Creditors who have valid liens against property of the estate are entitled to the value of their allowed secured claims in liquidation cases.[249] The remaining property of the estate is to be distributed in accordance with the scheme set forth in the Bankruptcy Code.[250] The following order of distribution must be adhered to in liquidation cases, except to the extent that claims are subordinated by the court:

[248a] See, e.g., *In re* Mid-Town Produce Terminal, Inc., 5 Bankr. Ct. Dec. 759 (10th Cir. 1979); *In re* Ultimate Corp. 207 F.2d 427, 429 (2d Cir. 1953), citing *In re* Madelaine, Inc., 164 F.2d 419 (2d Cir. 1947), stating that "in the absence of fraud or unfair advantage it is not wrongful for an officer or director of a corporation to lend money to it."

[248b] Although the doctrine of equitable subordination is not limited to claims of insiders, most subordination cases involve such claims. The Code defines "insider" so as to include an individual, partnership, or corporation "in control of the debtor." 11 U.S.C. § 101(25). See *In re* Prima Co., 98 F.2d 952 (7th Cir. 1938), *cert denied* 305 U.S. 658 (1939), involving an unsuccessful attempt to hold a bank liable for what creditors alleged was the bank's control over the affairs of the debtor. It is conceivable, however, that a lender which exercises control over the management of the debtor may be considered an insider and, accordingly, may risk equitable subordination.

[248c] 11 U.S.C. § 507(a)(1).

[248d] 11 U.S.C. § 364(c).

[249] However, tax liens may be subordinated to certain priority claims pursuant to 11 U.S.C. § 724(b).

[250] This scheme is set forth in 11 U.S.C. § 726. For special rules on the order of distribution with respect to community property, see 11 U.S.C. § 726(c).

(1) Priority claims, which are discussed earlier in this article, must be paid in order of their respective rank.[251]

(2) Allowed unsecured claims must be paid, but only with respect to those claims which were timely filed by the creditor, an indenture trustee, a co-debtor, or the trustee. Also, an allowed unsecured claim which was filed late is included in this category if the creditor had no notice or actual knowledge of the bankruptcy in time to make a timely filing and the proof of claim is filed in time to permit payment of the claim.

(3) Allowed unsecured claims which are not timely filed are then paid if the creditor had notice or actual knowledge of the case in time to file a timely proof of claim but failed to do so.

(4) Payment is made on allowed secured or unsecured claims which are for the recovery of fines, penalties, forfeitures, or exemplary or punitive damages arising before the order for relief or appointment of a trustee. Multiple-damage awards, such as a treble-damage recovery in an antitrust action, also are in this category to the extent that they are not compensation for actual pecuniary loss. By subordinating these penalty awards, which include prepetition tax penalties, to other classes of claims, the Code makes sure that they are paid out of estate assets only to the extent that there is a surplus after paying those claims which are based on actual pecuniary loss.

(5) To the extent that there remains a surplus after the above claims are paid in full, creditors may be paid interest on their claims which accrue after the petition was filed. Although generally post-petition interest is not allowable, it will be paid before returning a surplus to the debtor. It is important to note, however, that post-petition interest is paid at the legal rate, not at the agreed rate.

(6) In the rare case when there is a surplus remaining after all of the above claims are paid, the surplus must be paid to the debtor.

In the event that there are inadequate funds to pay the holders of claims of a particular class in full, the claims within that class are paid on a pro rata basis.[252]

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[251] If the case was converted from Chapter 11 or Chapter 13, administrative expenses incurred in the liquidation case have priority over administrative expenses incurred prior to the conversion. 11 U.S.C. § 726(b). In addition, administrative expenses caused by the inadequate protection of a secured creditor have priority over all other administrative expense claims. 11 U.S.C. § 507(b).

[252] 11 U.S.C. § 726(b).