

## The Doctrine of Necessity and Its Parameters

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## ARTICLES

### THE DOCTRINE OF NECESSITY AND ITS PARAMETERS

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#### I. INTRODUCTION

This Article gives form to a presently amorphous, but vital, legal concept: the Doctrine of Necessity ("Doctrine"). Skilled bankruptcy lawyers and judges often invoke this ill-defined Doctrine at the beginning of a reorganization case to authorize the postpetition payment of prepetition employee wages, benefits and services when the failure to make those payments would be catastrophic. A general rule in bankruptcy reorganizations requires payment of prepetition debts to be made solely through a confirmed plan of reorganization. The Doctrine permits payment of prepetition debts prior to confirmation of a plan of reorganization.

There is no reference in the Bankruptcy Code ("Code") to the Doctrine. There is no case, on any level, which states under what circumstances the Doctrine may or may not be used. The Doctrine is, however, well-established in bankruptcy common law. When used properly, it is one of the most important tools at the disposal of bankruptcy judges. This is particularly evident in the early stages of cases involving Chapter 11 reorganizations. Bankruptcy is a collective process, and the Doctrine comports with

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the underlying policies and goals of bankruptcy. Creditors realize that it is in their best interests to permit certain prepetition creditors to be paid immediately, for if those creditors are not paid at once, everyone will suffer.

This Article is based on a compendium of what is available from all possible sources, such as numerous unreported decisions, orders, motions, briefs, discussions with bankruptcy judges and lawyers experienced in the use of the Doctrine, and extensive personal experience. The authors have discussed the Doctrine with bankruptcy judges throughout the country. The use of the Doctrine throughout the United States is almost always within the parameters stated in this Article. Many of the cases referred to in this Article are from the bankruptcy courts for the Southern District of New York. Those courts have been active in the development of the Doctrine and have the greatest concentration of reported and unreported decisions and orders pertaining to the Doctrine.

This Article delineates common fact patterns and factors whose presence signals an appropriate use of the Doctrine. It also illustrates what notice is typically given prior to use of the Doctrine and identifies the persons who generally receive notice, for giving proper notice is of critical importance to the use of the Doctrine. The parameters of the Doctrine are explored and defined, cases are reviewed, and recommendations for use of the Doctrine are given. The authors conclude that the Doctrine, when properly understood and applied following appropriate notice, is supported by history, practice, case law, the Code and sound bankruptcy policy, and is properly a part of modern bankruptcy law.

## II. THE DOCTRINE DEFINED

The Doctrine of Necessity is a principle used in bankruptcy law which permits the use of certain provisions of the Code or common law ostensibly in contradiction to other law in order to accomplish a vital objective in a bankruptcy case. The Doctrine exists simply because it works. The proper use of the Doctrine helps to stabilize a debtor's business relationships without significantly hurting any party.

## III. BASES OF THE DOCTRINE

### A. *Historical Basis*

It is important to understand the history of the Doctrine of Necessity, since the parameters of the Doctrine are still undergoing active development in the bankruptcy courts. A related doctrine, the Necessity of Payment Rule, applies in railroad cases and has existed at least since 1882. Although the two doctrines are different, the Doctrine of Necessity is a

natural evolution of the Necessity of Payment Rule. The *principle* underlying both doctrines is the same: Sometimes immediate payment to a prepetition creditor will make the creditors as a group better off.

The United States Supreme Court first articulated the Necessity of Payment Rule in *Miltenberger v. Logansport Railway*.<sup>1</sup> In *Miltenberger*, interline railroads threatened to cease furnishing supplies and interline traffic exchanges unless the railroad receiver immediately paid pre-receivership claims.<sup>2</sup> The Supreme Court affirmed the circuit court order directing the railroad receiver to pay the pre-receivership claims prior to reorganization. The Court found that such payments are "necessary . . . where a stoppage of . . . [indispensable] business relations would be a probable result . . . ."<sup>3</sup>

Modern cases continue to apply the Necessity of Payment Rule in railroad reorganizations. In *In re Boston and Maine Corp.*,<sup>4</sup> the court defined the Necessity of Payment Rule as "the existence of a judicial power to authorize trustees in reorganization to pay claims where such payment is exacted as the price of providing goods or services indispensably necessary to continuing the rail service . . . ."<sup>5</sup>

Similarly, in *In re Lehigh and New England Railway Co.*,<sup>6</sup> the court declared that "the 'necessity of payment' doctrine . . . [permits] immediate payment of claims of creditors where those creditors will not supply services or material essential to the conduct of the business until their pre-reorganization claims shall have been paid."<sup>7</sup> The Third Circuit went on to note that "the *sine qua non* for the application of the 'necessity of payment' doctrine is the possibility that the creditor will employ an immediate economic sanction, failing such payment."<sup>8</sup>

The Necessity of Payment Rule is periodically confused with another principle of railroad reorganizations, the Six Months Rule, codified in subsection 1171(b) of the Code's railroad reorganization subchapter.<sup>9</sup> The Six Months Rule was recognized in subsection 77(b) of the Bankruptcy Act,<sup>10</sup> and Congress may have intended that subsection 1171(b) operate to continue the Six Months Rule.<sup>11</sup> The Six Months Rule permits claims for serv-

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1. 106 U.S. 286 (1882).

2. *Id.* at 311.

3. *Id.* at 311-12.

4. 634 F.2d 1359 (1st Cir. 1980), *cert. denied*, 450 U.S. 982 (1981).

5. *Id.* at 1382.

6. 657 F.2d 570 (3d Cir. 1981).

7. *Id.* at 581 (quoting *In re Penn Central Transp. Co.*, 467 F.2d 100, 102 n.1 (3d Cir. 1972)).

8. *Id.*

9. 11 U.S.C. § 1171(b) (1982).

10. 11 U.S.C. § 205(b) (repealed 1976).

11. *In re B & W Enterprises, Inc.*, 713 F.2d 534, 536-37 (9th Cir. 1983).

ices and goods supplied to a railroad six months before filing to be paid as administrative expense priority claims.<sup>12</sup> The Six Months Rule requires that "the creditor must have expected to be paid out of the current operating receipts of the railroad rather than from the general credit of the railroad" and that "a current debt fund must exist."<sup>13</sup> The debt fund is limited to "current or surplus earnings during the six months prior to reorganization and during reorganization; unmortgaged assets of the debtor; and income diverted for the benefit of mortgagees of the debtor during the reorganization or the six months prior to the reorganization."<sup>14</sup> These factors are rarely found in modern Chapter 11 cases.

There are important distinctions between the Doctrine of Necessity, the Necessity of Payment Rule and the Six Months Rule. The Six Months Rule and the Necessity of Payment Rule apply only to railroad reorganizations and not to businesses generally. They have no counterpart in Chapter 11 non-railroad reorganizations. Railroad reorganizations present a particular set of circumstances, such as the impact of Interstate Commerce Commission regulations and the Railway Labor Act, that is not wholly present in Chapter 11 business reorganizations.

The Necessity of Payment Rule applies only to essential goods or services and not to employee wages or benefits. It applies only to avoid creditors' threatened economic sanctions and not to avoid a harsh result on retirees, employees, or consumers. The Necessity of Payment Rule and its litigated cases dwell on payment to creditors, rather than to employees, and it does not involve the problems of foreign creditors or tort victims.

Whereas the Necessity of Payment Rule is a rule of payment, the Six Months Rule is one of priority. The rationale for the Six Months Rule is that suppliers' claims accruing postpetition will also receive an administrative expense priority. The rationale for the Necessity of Payment rule is that, unless the trustee pays a prepetition claim, the claimant will cease providing the railroad with essential goods or services indispensably necessary to continued operations.

Nonetheless, the Necessity of Payment Rule and the Doctrine of Necessity share the same underlying policy rationale. Both principles are premised on the bankruptcy goal of maintaining the prospects for a viable reorganization during the early stages of a case. Both principles embody the fact that there are some prepetition creditors who must be paid immediately because if they are not paid, everyone else will suffer. If payment of

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12. See 11 U.S.C. § 1171(b).

13. 2 W. NORTON, BANKR. L. & PRAC. § 48.16, at 48-23 (1981).

14. *Id.* at 48-23 to -24.

certain prepetition debts is necessary to achieve an effective early reorganization, both legal principles authorize payment. The Necessity of Payment Rule is not coextensive with the Doctrine of Necessity; rather, it is the historical basis from which courts have begun to fashion a legal principle responsive to the unique needs of parties in a Chapter 11 case.

### B. Statutory Provisions

Support for the use of the Doctrine can be found in various provisions of the Code. No Code provision, however, explicitly authorizes the use of the Doctrine.

#### 1. 11 U.S.C. § 105(a)

Subsection 105(a) is most commonly cited as authority for the Doctrine. It states in part: "The [bankruptcy] court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."<sup>15</sup> In practice, courts use Section 105 sparingly.

Collier takes a broad view regarding the utilization of subsection 105(a) to support paying prepetition debts with postpetition funds. It states that the purpose of subsection 105(a) is "to enable the court to do whatever is necessary to aid in its jurisdiction, i.e., anything arising in or relating to a bankruptcy case."<sup>16</sup> Former Bankruptcy Judge Robert L. Ordin addressed the issue directly when he wrote:

Prepetition debts of the same class are often treated differently in reorganization cases when the court is confronted with special circumstances. In many instances, particularly in the early stages of the case, a court may authorize the payment of prepetition debts in order to preserve the potential for rehabilitation. This is particularly true where the operation would otherwise terminate with disastrous effects.<sup>17</sup>

The broad grant of authority pursuant to subsection 105(a) is not limitless. Appellate courts repeatedly caution bankruptcy courts that equitable powers are constrained by the dictates of the Code.<sup>18</sup> The United States

15. 11 U.S.C. § 105(a) (1988).

16. 2 COLLIER ON BANKRUPTCY ¶ 105.02, at 105-4 (1988).

17. R. Ordin, *Finality of Order of Bankruptcy Court*, 54 AM. BANKR. L.J. 173, 177 (1980).

18. See, e.g., Levit, *Trustee of V.N. Deprizio Constr. Co. v. Ingersoll Rand Fin. Corp.*, 874 F.2d 1186, 1198 n.10 (7th Cir. 1989) ("Whatever force the assertion . . . that 'equitable principles govern the exercise of bankruptcy jurisdiction' may have had under the 1898 Act, this approach has no place under the Code to the extent the statute addresses the question."); *In re Longardner & Assoc.*, 855 F.2d 455, 462 (7th Cir. 1988), cert. denied, \_\_\_ U.S. \_\_\_, 109 S. Ct. 1130 (1988) (quoting *In re Chicago M., St. P. & Pac. R.R.*, 830 F.2d 758, 766 (7th Cir. 1987)) ("Although a reorganization court is indeed a court of equity . . . it is yet constrained by the dictates of the

Supreme Court stated that "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code."<sup>19</sup> The message from the higher courts is clear: Section 105 grants equitable powers to bankruptcy courts, but the courts must proceed with great caution. There are limits to this power, and a higher court can reverse the bankruptcy court should the higher court deem it appropriate to do so.

The analysis of the constraints seemingly imposed by other Code provisions distinguishes courts willing to rely on Section 105 and use the Doctrine from those who reject its use. Courts rejecting the use of Section 105 to authorize postpetition payments of prepetition obligations usually rule that such payments upset the priority scheme of Section 507 and fail to treat alike all similarly situated creditors in accordance with Section 1122.<sup>20</sup> Courts relying on Section 105 usually rule that the priority scheme of Section 507 is not inflexible and that Section 1122 only applies to plan confirmation.<sup>21</sup>

The Doctrine is a legal concept premised on a perception of the Code as a flexible mechanism to effectuate the rehabilitative purposes of bankruptcy. Although the Doctrine may seemingly conflict with some Code provisions, the inherent equitable powers of subsection 105(a) can, and should, support the Doctrine's use to achieve the goal of flexibility in the Code.

## 2. 28 U.S.C. § 1481

The attempted utilization of 28 U.S.C. § 1481<sup>22</sup> ("Section 1481") as a foundation for the Doctrine has been limited, other than as part of a "shotgun" approach in which every possible legal theory is applied. Section 1481 provides that "[a] bankruptcy court shall have the powers of a court of equity, law and admiralty . . ."<sup>23</sup> The utilization of subsection 105(a) has

Bankruptcy Act."); Official Comm. of Equity Sec. Holders v. Mabey ("*A.H. Robins*"), 832 F.2d 299, 302 (4th Cir. 1987), cert. denied, 485 U.S. 962, 108 S. Ct. 1228 (1988) ("While the equitable powers emanating from § 105(a) are quite important in the general bankruptcy scheme[,] . . . these equitable powers are not a license for a court to disregard the clear language and meaning of the bankruptcy statutes and rules.")

19. *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988).

20. See *A.H. Robins*, 832 F.2d at 302; *In re Structurlite Plastics Corp.*, 86 Bankr. 922, 929-33 (Bankr. S.D. Ohio 1988); *In re FCX, Inc.*, 60 Bankr. 405, 410-11 (E.D.N.C. 1986).

21. See *In re Chateaugay Corp.* ("*LTV*"), 80 Bankr. 279, 287 (S.D.N.Y. 1987) ("A rigid application of the priorities of [Section] 507 would be inconsistent with the fundamental purpose of reorganization and of the Act's grant of equity powers to bankruptcy courts, which is to create a flexible mechanism that will permit the greatest likelihood of survival of the debtor and payment of creditors in full or at least proportionately.")

22. 28 U.S.C. § 1481 (1982).

23. *Id.*

been considered to be a "cleaner" approach. Courts, in general, have disfavored the sole utilization of Section 1481.<sup>24</sup>

### 3. 11 U.S.C. § 365(b)

Subsection 365(b), which pertains to executory contracts, has been used by a number of bankruptcy courts to justify use of the Doctrine. Subsection 365(b) states in part:

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

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default;

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

(C) provides adequate assurance of future performance under such contract or lease.<sup>25</sup>

Pursuant to subsection 1107(a), a debtor in possession has all of the rights and powers, and performs all the functions and duties, of a Chapter 11 trustee. This includes decision-making as to executory contracts. The Code does not define an executory contract. One author defines an executory contract as "a contract under which (a) debtor and non-debtor each have unperformed obligations, and (b) the debtor, if it ceased further performance, would have no right to the other party's continued performance" ("Andrew definition").<sup>26</sup> The classic definition of an executory contract is "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other" ("Countryman definition").<sup>27</sup>

The use of the executory contract analogy is appealing due to its underlying theory of assumption of contract. One court stated that "[i]n order to

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24. The typical method of attempted utilization of Section 1481 is illustrated in *FCX*, 60 Bankr. at 408.

25. 11 U.S.C. § 365(b) (1982).

26. Andrew, *Executory Contracts in Bankruptcy: Understanding Rejection*, 59 U. COLO. L. REV. 845, 893 (1988).

27. Countryman, *Executory Contract in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973). Because Professor Countryman's definition at times is too rigid to achieve the purposes of the Bankruptcy Code, we have adopted the Andrew definition for this Article. See D. BAIRD & T. JACKSON, *CASES, PROBLEMS AND MATERIALS ON BANKRUPTCY* 455 (1985).



assume an executory contract under section 365, a debtor must satisfy the 'business judgment' test — i.e., it must be established that assumption represents a sound business judgment on the part of the debtor."<sup>28</sup> The sound business judgment of a debtor who desires to use the Doctrine is to make the proposed payment.

Furthermore, the debtor, as employer, and the employees may view the terms and conditions of employment as an executory contract which must be assumed for the employees to continue to work postpetition. The employment relationship falls within the Andrew definition of executory contract more smoothly than within the Countryman definition. Correctly or incorrectly, most bankruptcy courts, at least to date, use the Countryman definition of an executory contract, which can result in their failure to embrace the executory contract theory as a basis for utilizing the Doctrine.

#### 4. 11 U.S.C. § 507

Many courts approve a limited use of the Doctrine by oblique application of subsections 507(a)(3) and (4), which pertain to priorities of expenses and claims. Subsection 507(a)(3) gives a third priority to "unsecured claims for wages, salaries, or commissions, including vacation, severance and sick leave pay" limited to \$2,000 per individual earned within 90 days of the earlier of commencement of the case or cessation of the debtor's business.<sup>29</sup> Subsection 507(a)(4) gives a fourth priority to "unsecured claims for contributions to an employee benefit plan . . . arising from services rendered within 180 days before the date of the filing of the petition" and limited to \$2,000 per employee adjusted for payments under other subsections.<sup>30</sup> Courts which reject a broad use of the Doctrine often permit more limited payment pursuant to subsections 507(a)(3) and (4), if there are sufficient available funds to do so.<sup>31</sup> Although subsections 507(a)(3) and (4) state that wages, salaries and certain other benefits are entitled to priority, they do not authorize immediate payment of those benefits. Courts which use subsection 507(a) to authorize immediate payment often glide over this distinction.

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28. *Structurlite*, 86 Bankr. at 925 n.4 (citing *inter alia* Group of Institutional Investors v. Chicago, Milwaukee, St. Paul and Pacific R. Co., 318 U.S. 523 (1943)).

29. 11 U.S.C. § 507(a)(3) (1982).

30. 11 U.S.C. § 507(a)(4).

31. See, e.g., *Structurlite*, 86 Bankr. at 933 (permitting limited payment pursuant to subsection 507(a)(4)); *FCX*, 60 Bankr. at 412 (appearing to permit limited payment pursuant to subsection 507(a)(4)).

## 5. 11 U.S.C. § 363

Section 363 is often used as a basis for the application of the Doctrine, particularly in the Second Circuit. Subsection 363(b) states that “[t]he trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.”<sup>32</sup> Subsection 363(c)(1) permits a debtor who is authorized to operate a business to enter into transactions and to use property of the estate in the ordinary course of business, without notice or a hearing.<sup>33</sup>

Although an argument against using Section 363 in a manner which supersedes other provisions of the Code can be made, the use of Section 363 in the indicated cases has certainly resulted in pragmatic and equitable results, and it is difficult to argue against something which works smoothly, effectively and successfully. Another advantage of utilizing Section 363 is that it can be read clearly and literally to permit a court to authorize the debtor to use property other than in the ordinary course of business. With the swing of certain appellate courts to a literal interpretation of the Code, utilization of subsections 363(b) and (c) is becoming increasingly attractive, especially when combined with other bases.

## 6. Miscellaneous Bankruptcy Code Provisions

Courts have also utilized other provisions of the Code in ruling that the Doctrine may be applied. In *Eastern Air Lines*,<sup>34</sup> a Doctrine-based ticket-holder relief program was founded not only upon subsection 363(c)(1), but

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32. 11 U.S.C. § 363(b)(1) (1982).

33. These provisions are broad and attractive in the context of the Doctrine. As a result, they have been used with some regularity. See, e.g., *In re Eastern Air Lines, Inc.*, Case No. 89 B 10449 (BRL) (Bankr. S.D.N.Y. Mar. 9, 1989), and its companion case, *In re Ionosphere Clubs, Inc.*, Case No. 89 B 10448 (BRL) (Bankr. S.D.N.Y. Mar. 9, 1989). In *Eastern Air Lines* and *Ionosphere Clubs* the court stated:

A bankruptcy court is empowered pursuant to § 363 of the Bankruptcy Code to authorize a debtor to expend funds in the bankruptcy court's discretion outside the ordinary course of business. Section 363(b) gives the court broad flexibility in tailoring its orders to meet a wide variety of circumstances. *In re Lionel Corp.*, 722 F.2d 1063, 1069 (2d Cir. 1983). However, the debtor must articulate some business justification, other than mere appeasement of major creditors, for using, selling or leasing property out of the ordinary course of business, before the court may permit such disposition under § 363(b). *Id.* at 1070; *accord*, *In re Continental Air Lines [sic], Inc.*, 780 F.2d 1223, 1226 (5th Cir. 1986); *In re Baldwin-United Corp.*, 43 Bankr. 888, 905-06 (Bankr. S.D. Ohio 1984).

98 Bankr. 174, 175 (Bankr. S.D.N.Y. 1989) (These cases will be referred to collectively as “*In re Eastern Air Lines, Inc.*” or “*Eastern Air Lines.*”). Section 363 was also utilized effectively in the three *LTV* decisions, *In re Chateaugay Corp.*, 80 Bankr. 279 (S.D.N.Y. 1986); 76 Bankr. 945 (S.D.N.Y. 1986); 64 Bankr. 990 (S.D.N.Y. 1986), *appeals dismissed*, 838 F.2d 59 (2d Cir. 1988).

34. 98 Bankr. 174.

also upon sections 1107 and 1108. Subsection 1107(a) gives a debtor in possession the powers of a trustee. Section 1108 authorizes the trustee to operate the debtor's business unless the court orders otherwise. It is doubtful that either of these Code sections would be utilized in other than a supporting capacity when a court decides to use the Doctrine.

At least one court in the Seventh Circuit used the Doctrine relying entirely on subsection 549(a), which provides in part that, with limitations, "[t]he trustee may avoid a [postpetition] transfer of property of the estate . . . that is not authorized under this title or by the court."<sup>35</sup> The reasoning is simple. If the court authorizes the transfer in the form of payment pursuant to the Doctrine, the transfer may not be avoided. Whether subsection 549(a) can be read to confer upon a court the right to authorize a postpetition transfer not otherwise authorized by the Code is subject to debate. Nonetheless, this is an interesting approach.

### C. "Lien-Like" Theory

At legal seminars, more than one respected commentator has expressed the belief that employees who insist upon postpetition payment for prepetition services have a "lien-like" claim which entitles them to payment. A computer search failed to show any clear instance of the use of this theory in a reported decision. This theory could, under very limited circumstances, be of nominal help in Wisconsin. Wisconsin has a statute<sup>36</sup> which gives unpaid employees a super-priority lien on all assets of the employer for unpaid wages. A bankruptcy court recently held, however, that this statute is inapplicable when the employer is insolvent.<sup>37</sup>

The use of the term "lien-like" is not uncommon.<sup>38</sup> In *In re Hoffman*,<sup>39</sup> the court referred to a reading by the Ninth Circuit "as a lien-like limitation on the aggregate of rights which comprise a liquor license . . ." <sup>40</sup> The application of this theory is still in its infancy stage.

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35. 11 U.S.C. § 549(a) (1982).

36. WIS. STAT. § 109.09(2) (1988).

37. *In re Napco Graphic Arts, Inc.*, 51 Bankr. 757 (E.D. Wis. 1985), *rev'd on other grounds*, 83 Bankr. 558 (E.D. Wis. 1988).

38. *See, e.g., In re Lowery Bros., Inc.*, 589 F.2d 851 (5th Cir. 1979), which in reference to FLA. STAT. § 713.15 (1977) held that while the statute "does not create a lien on real property [it] still creates a lien-like right which we consider a lien." *Lowery Bros.*, 589 F.2d at 860.

39. 65 Bankr. 985 (D. R.I. 1986).

40. *Id.* at 993 (referencing R.I. GEN. LAWS § 3-7-24 (1987)).

#### D. Analogy to Related Law

A few courts have looked to related law for guidance. For example, the court in *Eastern Air Lines*<sup>41</sup> looked to the Railway Labor Act<sup>42</sup> and, specifically, to the Six Months Rule which permits payment to creditors for goods delivered within six months before the filing, where the goods were necessary to keep the railroad in business. The court found that these bankruptcy cases were "related in some aspects to the Railway Labor Act."<sup>43</sup> The court also looked to the Necessity of Payment Rule and continued:

Even if this case is not directly covered by the Railway Labor Act, the [necessity of payment] doctrine would still be applicable under the rationale of Judge Learned Hand who applied this rule to a non-railroad debtor in *Dudley v. Mealey*. In that case, Judge Learned Hand held that a court was not "helpless" to apply the rule to non-railroad debtors where the alternative was a cessation of operations.<sup>44</sup>

In *B & W Enterprises*,<sup>45</sup> the use of the Six Months Rule and/or the Necessity of Payment Rule in any case other than a Chapter 11 railroad reorganization was rejected. So much for uniformity. In many cases, no legal basis for utilization of the Doctrine was stated.<sup>46</sup>

#### E. Common Law

The most common basis for the use of the Doctrine is by utilization of common law, specifically, by reference to other cases where the Doctrine was used. Motions and supporting briefs regularly refer to the same cases in which the Doctrine was successfully applied. There is much to be said for *stare decisis*.

### IV. WHAT CAN BE PAID

Courts have authorized payment of numerous kinds of prepetition debts pursuant to the Doctrine. Although each use of the Doctrine is, and must

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41. 98 Bankr. at 174.

42. 45 U.S.C. §§ 151-1213 (1982) (cited in *Eastern Air Lines*, 98 Bankr. at 176).

43. *Eastern Air Lines*, 98 Bankr. at 176.

44. *Id.*

45. 713 F.2d at 537.

46. See *In re Global Marine*, Case Nos. 85-00771-H2-11 to 86-00782-H2-11 (Bankr. S.D. Tex. Feb. 13, 1986) (order authorizing prepetition payments to Scottish and English vendors); *In re Revere Copper and Brass Inc.*, Case Nos. 82 B 12073 to -12086 (Bankr. S.D.N.Y. Dec. 1, 1982) (order authorizing debtors-in-possession to reimburse employees' business expenses); *In re KDT Indus.*, Case Nos. 82 B 11453 to -11515, 82 B 11687 to -11718 (Bankr. S.D.N.Y. Sept. 16, 1982) (order authorizing debtors to reimburse travel expenses incurred by employees).

be, fact-specific, there is a pattern to the use of the Doctrine. Many orders contain authorization for more than one category of payment, e.g., wages and pension benefits. Other orders permit payment of only one category, e.g., wages. Many orders are variations on the same theme.

*A. Payments to, or on Behalf of, Employees*

The most common use of the Doctrine is to pay benefits related to employment. Eastern Air Lines was authorized "to pay the Prepetition Employee Obligations to *currently active* employees."<sup>47</sup> The Debtor's motion defined "Prepetition Employee Obligations" to include "wages, salaries, reimbursable business expenses and health benefits."<sup>48</sup>

In contrast, the same court, in deciding another employee issue,<sup>49</sup> denied a request of the International Association of Machinists and Aerospace Workers ("IAM") "for an order directing payment of certain prepetition wage, salary and medical benefits to IAM [which] represented striking employees."<sup>50</sup>

Allis-Chalmers Corporation and its related corporations were authorized:

to pay to their *current* employees and directors . . . all wages, fees, salaries and commissions . . . which have accrued . . . within the ninety (90) days immediately prior to the filing of the Debtors' Chapter 11 petitions, provided, however, that such accrued wage, salary and commission payments shall not exceed, in the aggregate, the sum of \$15 million.<sup>51</sup>

Continental Airlines and Texas International Airlines were permitted "to pay those employees on *permanent active payroll status* the amounts of their prepetition claims for salary, insurance benefits and out of pocket expenses."<sup>52</sup>

47. *In re Eastern Air Lines, Inc.*, Case No. 89 B 10449 (Bankr. S.D.N.Y. Mar. 9, 1989) (order authorizing payment of prepetition obligations to foreign creditors).

48. *Id.*

49. *In re Eastern Air Lines, Inc.*, 98 Bankr. 174, 174 (S.D.N.Y. 1989).

50. *Id.* at 179.

51. *In re Hartman Material Handling Sys. ("Allis-Chalmers")*, Case Nos. 87 B 11225, to -11242 (Bankr. S.D.N.Y. June 30, 1987) (amended order authorizing payment of pre-petition wages and salaries, business expenses and other employee benefits) (emphasis added).

52. *In re Continental Airlines Corp.*, Consolidated Case No. 83-04019-H1-5 (Bankr. S.D. Tex. Sept. 29, 1983) (order authorizing debtors to pay prepetition salary, insurance and expense claims) (emphasis added).

Courts have also permitted debtors to pay prepetition *business expenses* for currently active employees. In *In re KDT Industries, Inc.*,<sup>53</sup> the court authorized the Debtor:

to reimburse its employees' out-of-pocket expenses, relating to travel, moving and related business expenses incurred by said employees prior to the filing of the within Chapter 11 petitions in an aggregate amount not to exceed \$160,000 by paying to each employee entitled to reimbursement hereunder a sum not to exceed \$500.00 with and in addition to each payroll check hereafter received by such employee until all reimbursement to which such employee is entitled shall be paid in full.<sup>54</sup>

Other courts also have authorized the payment of prepetition expenses.<sup>55</sup>

In some cases, the authorization for payment to employees was stated in general terms. In *In re McLean Industries*,<sup>56</sup> the court authorized the Debtors "to pay wage, salary and employee business expenses, accrued but unpaid as of the commencement of these Chapter 11 cases, not to exceed in the aggregate the sum of \$3,871,000."<sup>57</sup> In addition, the Debtors were allowed "to implement and make deductions from payments of wages and salaries for union dues, savings plans, and other wage and salary 'check-offs' and deductions in accordance with past practices."<sup>58</sup>

In *In re Patrick Cudahy, Inc.*,<sup>59</sup> the court permitted payment to all prepetition employees holding uncashed payroll checks. This case was marked by extremely acrimonious and lengthy labor disputes. The Debtor was authorized to issue replacement checks to former, present and laid-off employees holding uncashed payroll checks for salary earned within ninety days of the date of the commencement of the case. The court authorized payment to holders of prepetition garnishment checks and tax lien checks which had not cleared the banks before the petition was filed.

The court authorized payment of subsection 507(a) priority claims in *In re Revere Copper and Brass*.<sup>60</sup> In *In re FCX, Inc.*,<sup>61</sup> the Debtor was not

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53. Case Nos. 82 B 11453 to -11515, 82 B 11687 to -11718 (Bankr. S.D.N.Y. Sept. 16, 1982).

54. *Id.*

55. *Eastern Air Lines*, Case No. 89 B 10449; *Allis-Chalmers*, Case Nos. 87 B 11225 to -11242; *In re McLean Indus.*, Case Nos. 86 B 12238, 12241 (Bankr. S.D.N.Y. Dec. 4, 1986); and *In re Revere Copper and Brass*, Case Nos. 82 B 12073 to -12086 (Bankr. S.D.N.Y. Dec. 1, 1982) (payment to employees for out-of-pocket business expenses incurred prepetition in an aggregate amount not to exceed \$50,000).

56. Case Nos. 86 B 12238, 86 B 12241.

57. *Id.* at 1.

58. *Id.* at 2.

59. Case No. 87-05413 (Bankr. E.D. Wis. Mar. 2, 1989).

60. Case Nos. 82 B 12073 to -12086 (Bankr. S.D.N.Y. Dec. 1, 1982).

61. 60 Bankr. 405 (E.D.N.C. 1986).

authorized to permit payment of unpaid payroll expenses or taxes, except to the extent wages were entitled to subsection 507(a)(3) priority. Payroll deductions, including employee benefit plan contributions and union dues for current employees, were paid in *Hartman*, the *Allis-Chalmers* cases.<sup>62</sup>

Payment of severance benefits for current employees and former employees was ordered of McLean Industries. The court permitted McLean Industries "to pay [its] employees and former employees severance or employment termination benefits which have accrued or will accrue by virtue of past service, in accordance with the debtor[']s existing severance policies, not to exceed in the aggregate the sum of \$100,000."<sup>63</sup>

One court has gone one step further in authorizing payments. Payment of *all* prepetition employee obligations of those employees who were still working postpetition appears to have been authorized in *Eastern Air Lines*.<sup>64</sup> Some courts have permitted the payment of vacation pay, as was done in *Allis-Chalmers*.<sup>65</sup>

Courts regularly approve payment of prepetition obligations for workers compensation, medical benefits, insurance claims, and insurance premiums for current employees. Payment of prepetition medical benefits and medical insurance for currently active employees is almost as common as payment of prepetition wage claims. Prepetition medical benefits of active employees were paid in both *Eastern Air Lines*<sup>66</sup> and *Allis-Chalmers*.<sup>67</sup>

Medical insurance for active and retired employees was paid in *McLean Industries*.<sup>68</sup> The Debtors were "authorized and empowered to continue in effect all medical insurance coverage for all active and retired employees in accordance with past practice and to provide such coverage for all laid off employees for a period not to exceed the later of (i) three months following the date of the lay off; or (ii) sixty (60) days following the date of the filing of the Debtors' Chapter 11 petitions."<sup>69</sup>

Life and disability insurance premiums for active and retired employees were also paid in *Revere Copper and Brass*.<sup>70</sup> The Debtors were "authorized and empowered to maintain in effect and pay all premiums in respect

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62. Case Nos. 87 B 11225 to -11242.

63. *McLean Indus.*, Case Nos. 86 B 12238, 86 B 12241.

64. Case No. 89 B 10449 (Bankr. S.D.N.Y. Mar. 9, 1989).

65. Case Nos. 87 B 11225 to -11242 (payment of all wages, fees, salaries and commissions including holiday pay).

66. Case No. 89 B 10449.

67. Case Nos. 87 B 11225 to -11242.

68. Case Nos. 86 B 12238, 86 B 12241.

69. *Id.*

70. Case Nos. 82 B 12073, 82 B 12086.

of the [D]ebtors' life and disability insurance coverage and to continue such coverage for their active and retired employees."<sup>71</sup> The court also approved payment of medical, life, disability and workers compensation benefits for past and present employees.<sup>72</sup>

In *In re Chateaugay Corp.* ("LTV"),<sup>73</sup> the court held that the bankruptcy court had the equitable power to authorize payment of some, but not all, prepetition workers' compensation claims. Payment of similar benefits appears to have been made in *Allis-Chalmers*.<sup>74</sup>

Insurance claims of former employees of Continental Airlines were paid when the court "authorized [Continental Airlines] to apply the amount of \$500,000.00 toward insurance claims in excess of \$2,500.00 of former employees that are not presently working for the Debtors."<sup>75</sup>

### B. Payments to Suppliers and Consumers

It is not uncommon for courts to authorize payments to vital suppliers and customers. In *Patrick Cudahy*,<sup>76</sup> the court authorized the Debtor to pay certain sellers of livestock, although payment in due course might have been authorized pursuant to 7 U.S.C. § 196<sup>77</sup> had the court found that the Debtor held funds in trust. Another bankruptcy court authorized Wilson Foods Corporation "to expend in its discretion a sum not to exceed five million in the aggregate to pay essential pre-chapter 11 obligations."<sup>78</sup>

The *Eastern Air Lines* case presented many unique problems, including what to do with angry passengers who purchased tickets prepetition and/or held air fare discount coupons. The court authorized Eastern Air Lines to implement a ticket-holder relief program whereby consumers holding tickets purchased prepetition could use those tickets on Eastern flights currently operating or could receive transferable air travel credits applicable towards the purchase price of new Eastern tickets when Eastern resumed service.<sup>79</sup>

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71. *Id.* at 3.

72. *Id.*

73. 80 Bankr. 279, 285-86 (S.D.N.Y. 1987).

74. Case Nos. 87 B 11225 to -11242; *see also McLean Indus.*, Case Nos. 86 B 12238, 86 B 12241.

75. *Continental Airlines* (Order of September 29, 1983), at 2.

76. Case No. 87-05413.

77. 7 U.S.C. § 196 (1988).

78. *In re Wilson Foods Corp.*, Case No. 83-01034A (Bankr. W.D. Okla. April 22, 1983) (order to maintain existing bank accounts, consolidate cash management and permit discretionary payments).

79. *Eastern Air Lines*, Case Nos. 89 B 10448, 89 B 10449 (order of March 14, 1989).



For a debtor to survive, it is often important to pay warranty claims. It is no surprise that the bankruptcy court authorized Allis-Chalmers and its related corporations "to honor and satisfy in their discretion all warranty claims relating to products which are currently sold by the debtors in their continuing business operations whether such claims were asserted prepetition or postpetition or related to sales consummated prepetition or postpetition."<sup>80</sup>

What about immediate reconstructive surgery which was necessary due to a faulty product of the debtor? The United States Court of Appeals for the Fourth Circuit held that the bankruptcy court lacked the discretion to permit A.H. Robins to establish a fund to make interim payments to Dalkon Shield victims.<sup>81</sup>

American Express Company received favorable treatment when a court authorized payment of amounts owed to it for the prepetition use of Crompton Company's American Express credit line.<sup>82</sup> Apparently membership has its privileges for Amex, as well as for its members. This case is uncharacteristic because an explanation for payment is not readily available.

### C. *Payments to Foreign Creditors*

Payments to foreign creditors, including foreign governments, are often paid pursuant to the Doctrine. The reason, in part, is pragmatic: It is not easy for courts to enforce the automatic stay in foreign countries, if the automatic stay in fact applies outside the United States. Who is to enforce the automatic stay in Colombia? It is no surprise that in *Eastern Air Lines*,<sup>83</sup> the court authorized the Debtor "to pay to foreign creditors prepetition liabilities of the [D]ebtor incurred in the ordinary course of business, as shall be necessary to protect and preserve assets of the estate or foreign operations, in an amount not to exceed \$13 million."<sup>84</sup>

*In re Global Marine*<sup>85</sup> is another example of authorization given to pay foreign creditors where "failure to satisfy such prepetition obligations will result in the creation by operation of law of maritime liens against such vessels, the disruption of the [D]ebtors' business and the dismemberment of

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80. *Allis-Chalmers*, Case Nos. 87 B 11225 to -11242 (order of August 24, 1987), at 2.

81. Official Comm. of Equity Sec. Holders v. Mabey ("*A.H. Robins*"), 832 F.2d 292, 302 (4th Cir. 1987).

82. *In re Crompton Co., Inc.*, Case No. 84 B 11496 (Bankr. S.D.N.Y. Feb. 1, 1985) (order authorizing debtor to pay pre-petition claims of American Express Co.).

83. Case No. 89 B 10449.

84. *Id.* at 1-2.

85. Case Nos. 85 B 00771-H2, 86 00782-H2-11 (Bankr. S.D. Tex. Feb. 13, 1986).

their estates.”<sup>86</sup> The bankruptcy court for the Southern District of Texas authorized Continental Airlines to pay foreign creditors an amount not to exceed \$2,000,000 for prepetition obligations, finding payment was “necessary and essential in order for Continental to continue its business operations in foreign jurisdictions and to avoid the risk of the seizure of its aircraft.”<sup>87</sup>

*McLean Industries*<sup>88</sup> followed a similar pattern. The court permitted the debtors to “pay supplemental compensation to employees in Europe, the Middle East and Japan, accrued but unpaid as of the commencement of these Chapter 11 cases, to the extent required by local law, not to exceed in the aggregate the sum of \$1,550,000.”<sup>89</sup>

In summary, and in general, what have been paid pursuant to the Doctrine are prepetition claims necessary to stabilize the debtor’s relationship with its current employees and service providers, or to avoid a harsh effect on innocent parties. As case law continues to develop, new applications of the Doctrine will emerge.

## V. EXTENT OF THE DOCTRINE

The Doctrine cannot be used by implication to enjoin a labor strike.<sup>90</sup> In the Fourth Circuit it cannot be used to pay creditors with unsecured claims prior to the confirmation of a plan, even when reconstructive surgery is urgently needed.<sup>91</sup> It cannot be used in the Eastern District of North Carolina to pay a farmer’s purchasing and marketing cooperative’s prepetition unpaid payroll expenses, unpaid payroll taxes and unpaid grain purchases.<sup>92</sup> It cannot be used in the Southern District of Ohio to pay prepetition medical claims of the Debtor’s employees.<sup>93</sup>

## VI. FACTORS CONSIDERED BY THE COURT

### A. *No Objection Following Appropriate Notice*

To no surprise, there is no consensus as to what factors or combinations of factors must be present for the Doctrine to be applied. The most com-

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86. *Id.* at 1.

87. *Continental Airlines*, Case No. 83 B 04019-H1-5 (Order of September 29, 1983), at 2.

88. Case Nos. 86 B 12238, 86 B 12241.

89. *Id.* at 1-2.

90. *In re Crowe & Assocs.*, 16 Bankr. 271 (E.D. Mich. 1981), *rev'd*, 20 Bankr. 225 (E.D. Mich. 1982), *aff'd*, 713 F.2d 211 (6th Cir. 1983).

91. *See A.H. Robins*, 832 F.2d 292.

92. *FCX*, 60 Bankr. 405.

93. *In re Structurlite Plastics*, 86 Bankr. 922 (Bankr. S.D. Ohio 1988).

mon rationale given in orders and asserted in motions is a lack of objection to proposed payments by any party with a substantial or meaningful interest in the case. The law is not settled as to when a lack of an objection constitutes an affirmative consent. Nonetheless, in the absence of an objection, relief is invariably granted. Case examples are *In re KDT Industries, Inc.*<sup>94</sup> and *In re Revere Copper and Brass*.<sup>95</sup> In *In re Eastern Air Lines, Inc.*,<sup>96</sup> the court noted that the United States trustee had no objection to proposed payments. In *In re Hartman Material Handling Systems ("Allis-Chalmers")*,<sup>97</sup> the court indicated that "no adverse interest . . . [was] represented."<sup>98</sup> That was also the case in *In re Wilson Foods Corp.*,<sup>99</sup> when relief was granted after the court indicated that there was "no adverse interest being represented and sufficient cause appearing therefor."<sup>100</sup> When the Unsecured and Secured Creditors' Committees and the United States trustee gave affirmative assent, the Doctrine was applied, and the requested relief granted in *In re Crompton Co, Inc.*<sup>101</sup>

If the bankruptcy process is to function at maximum efficiency, all parties must be pragmatic. It is logical for a court to grant reasonable relief if no interested party objects, provided that the court has jurisdiction and the relief requested is not patently prohibited by the Code or established law. On the other hand, when an objection is interposed, the court is less likely to grant the requested relief.<sup>102</sup>

### B. Location of the Debtor's Assets

The location of the debtor's assets can be important, especially if the assets are not in the United States. In *In re Global Marine*,<sup>103</sup> the court applied the Doctrine after expressing concern about the creation of maritime liens against vessels if payment was not made, with a resultant disruption of the Debtors' business, and, perhaps, the Debtors' demise. Payment was authorized also because "funds belonging to the [D]ebtors have been frozen in Scotland and England by operation of law."<sup>104</sup> The court pointed

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94. Case Nos. 82 B 11453 to -11515, 82 B 11687 to -11718 (Bankr. S.D.N.Y. Sept. 16, 1982).

95. Case Nos. 82 B 12073, 82 B 12086 (Bankr. S.D.N.Y. Dec. 1, 1982).

96. Case No. 89 B 10449 (Bankr. S.D.N.Y. Mar. 9, 1989).

97. Case Nos. 87 B 11225 to -11242 (Bankr. S.D.N.Y. June 30, 1987).

98. *Id.* at 1.

99. Case No. 83-01034A (Bankr. W.D. Okla. April 22, 1983).

100. *Id.* at 1.

101. Case No. 84 B 11496 (Bankr. S.D.N.Y. Feb. 1, 1986).

102. See Official Comm. of Equity Sec. Holders v. Mabey ("*A.H. Robins*"), 832 F.2d 299 (4th Cir. 1987).

103. Case Nos. 85-00771-H2-11, 86-00782-H2-11 (Bankr. S.D. Tex. Feb. 13, 1986).

104. *Id.* at 2.

out that accounts [receivable] owed to the Debtors were "subject to garnishment in Scotland and England."<sup>105</sup>

In *In re McLean Industries*,<sup>106</sup> the court found that failure to make payments on certain prepetition debts would cause severe disruptions in the Debtor's foreign work force and could subject the Debtor to criminal and civil penalties under foreign law.<sup>107</sup> In *In re Continental Airlines Corp.*,<sup>108</sup> the court authorized payment not to exceed \$2,000,000 "necessary and essential in order for Continental to continue its business operations in foreign jurisdictions and to avoid the risk of the seizure of its aircraft relative to Continental's foreign routes."<sup>109</sup> The court also noted that payment "is in the best interests of this estate and its creditors."<sup>110</sup>

In *Eastern Air Lines*,<sup>111</sup> the court authorized payment "to foreign creditors" to whom the Debtor had "prepetition obligations . . . incurred in the ordinary course of business, as shall be necessary to protect and preserve assets of the estate or foreign operations, in an amount not to exceed \$13,000,000 without prejudice to the Debtor's applying for an increase in the amount of such authorization."<sup>112</sup> "Foreign obligations" were defined in the Debtor's motion for the order to include, without limitation, "obligations to . . . employees in foreign countries, governmental authorities, airport authorities, taxing authorities, fuel suppliers, maintenance suppliers, advertising agencies, ground handling services and catering services . . . essential to . . . foreign operations."<sup>113</sup> (What about non-employee lawyers? Perhaps professional courtesy ends at the border.) The motion had asserted that the foreign routes "are a particularly important and highly valuable asset . . . and are subject to revocation if operations are not continued . . . and are subject to seizure by foreign governments and creditors in the event Eastern defaults in payment."<sup>114</sup>

In the motion counsel pointed out "an imminent risk that foreign creditors, including foreign governmental authorities . . . will seize or impound Eastern's aircraft or prevent such aircraft from entering into their respective jurisdictions."<sup>115</sup> Eastern's lawyers argued that "governmental author-

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105. *Id.*

106. Case Nos. 86 B 11238, 86 B 12241 (Bankr. S.D.N.Y. Dec. 4, 1986).

107. *Id.* at 2.

108. Case No. 83-04020-H1-5 (Bankr. S.D. Tex. Sept. 29, 1983).

109. *Id.* at 2.

110. *Id.*

111. Case No. 89 B 10449 (Bankr. S.D.N.Y. Mar. 9, 1989).

112. *Id.* at 2.

113. *Id.*

114. *Id.* at 2-3.

115. *Id.* at 4.

ities may seek to impose civil or criminal sanctions on Eastern and its officers and employees for non-payment of Foreign Obligations."<sup>116</sup> Eastern also made the usual allegations: "[P]ayment . . . is essential to the continued operation of Eastern's business and is in the best interest of Eastern and its creditors. . . . Nonpayment and the events which would follow would seriously jeopardize any successful reorganization."<sup>117</sup>

### C. *Best Interest of Creditors and the Debtor*

It is very common for courts to apply the Doctrine after making findings of fact to the effect that the use of the Doctrine is in the best interests of the debtor and its creditors. For example, in *Revere Copper and Brass*,<sup>118</sup> the court authorized the Debtors to reimburse their employees for prepetition out-of-pocket business expenses after finding that "the relief requested is for the best interests of the Debtors' respective estates and creditors."<sup>119</sup> Allegations pertaining to payment being in the best interests of the debtor and creditors can be found in almost all motions and orders pertaining to the use of the Doctrine.

### D. *General Business Considerations*

In *In re John B. Coleman*,<sup>120</sup> payment was requested and authorized, since: "Unless Coleman is authorized to pay the prepetition debt owed to the Travel Agents, the N.Y. Ritz will be unable to generate new business . . . and will consequently lose significant revenues and prestige among luxury hotel clientele."<sup>121</sup> In the motion it also was asserted: "It is vitally important for the N.Y. Ritz to maintain healthy relations with the Travel Agents to ensure that they will continue to refer business to the N.Y. Ritz after the petition date."<sup>122</sup> In essence, the Debtor claimed that payment was necessary for the "reorganization to succeed."<sup>123</sup>

In *Allis-Chalmers*,<sup>124</sup> the Debtors were authorized to honor all prepetition and postpetition warranty claims. The accompanying motion stated: "Abandonment of this policy . . . would cause confusion and dissatisfaction

116. *Id.*

117. *Id.* at 5.

118. Case Nos. 82 B 12073, 82 B 12086.

119. *Id.* at 2.

120. Case Nos. 86 B 12242 to -12244 (Bankr. S.D.N.Y.) (Motion of April 13, 1987 Order of April 20, 1987).

121. *Id.* at 2.

122. *Id.* at 3.

123. *Id.* at 5.

124. Case Nos. 87 B 11225 to -11242.

at a very critical time in the Debtors' history."<sup>125</sup> Needless to say, the motion also stated that "the relief requested herein is in their [Debtors'] best interests, the best interests of their estates and the best interests of their creditors."<sup>126</sup> An accompanying affidavit of Ronald J. Burns creatively added that the Debtors "cannot risk their future customer base by sending signals in the short term which could be interpreted by their customers as a lack of confidence in our long-range viability."<sup>127</sup> "[The] inability to meet our warranties will provide a strong impetus for our customers to patronize our competitors."<sup>128</sup>

The court in *Wilson Foods*<sup>129</sup> authorized the Debtor to maintain and continue to use prepetition bank accounts with the same account numbers; directed all banks to continue to service the prepetition accounts; authorized the Debtor "to transfer monies from affiliated entity to entity, including entities that are not debtors herein;" authorized the Debtor "to expend in its discretion a sum not to exceed five million in the aggregate to pay essential pre-chapter 11 obligations;" and authorized the Debtor "to continue to use its existing business forms without alteration or change."<sup>130</sup> The motion for that relief contained the statement: "It is imperative that it be permitted to continue its existing [bank] accounts in order to avoid interruption in the normal operations of its businesses."<sup>131</sup> Counsel also asserted that "[t]he returns of any [bank] item would have broad consequences in the marketplace . . . . Because of the special priority and secured position, the clearance of such checks will not prejudice other creditors."<sup>132</sup> Counsel for the Debtor alleged that the "Debtor had a net worth in excess of \$83 million" and that "[t]he Debtor ha[d] substantial cash balances in the various banks."<sup>133</sup> In the motion counsel stated, in part: "Debtor believes that the 'doctrine of necessity' amply justifies such expenditure, which represents about .49% of the almost \$2.5 billion in annual volume of business which Debtor generates. Such expenditure by this measure in these cases is *de minimus*."<sup>134</sup> The court did not appear to address the issue of whether it is appropriate to use the same rationale that justifies paying workers immediately because of subsection 507(a)(3) and because they will be paid in full

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125. *Id.* at 2.

126. *Id.* at 5.

127. *Id.* at 2.

128. *Id.*

129. Case No. 83-01034A.

130. *Id.* at 2.

131. *Id.*

132. *Id.*

133. *Id.* at 2-3.

134. *Id.* at 4.

upon confirmation of the plan in order to justify paying unsecured creditors immediately when the Debtor is solvent. *Wilson Foods*<sup>135</sup> may have contained bankruptcy abuses.

### E. Employee Concerns

In *Eastern Air Lines*,<sup>136</sup> relief was granted because "the relief requested is essential to the continued operation of the Debtor's business."<sup>137</sup> The court also found that "the relief requested . . . is in the best interests of the estate, creditors and equity security holders."<sup>138</sup> The motion stated: "It is essential that the undue hardships that said employees may suffer as a consequence of the Chapter 11 filing be minimized."<sup>139</sup> The motion for the March 9, 1989, Eastern Order was broadly drafted, which is not uncommon. It asserted that checks to employees will be dishonored due to the Chapter 11 filing, health benefits must be paid for the employees to receive future medical benefits for a "smooth transition into Chapter 11," and employee hardships must be minimized to maintain morale. The motion asserted that "the currently active employees . . . are among Eastern's most valued assets. [Their] continued cooperation and support . . . [is] essential to Eastern's operations and successful reorganization . . . [and] would be particularly inequitable in view of Section 1114" if the relief were not granted.<sup>140</sup>

In *In re Ionosphere Clubs, Inc.*,<sup>141</sup> the court granted a request for relief similar to the relief requested in *Eastern Air Lines*.<sup>142</sup> The motion for relief contained broad assertions such as payment to employees was necessary to maintain their goodwill and to safeguard them from a lack of funds, which would result in the employees suffering "extreme hardship" and a "likely deterioration in morale." In the motion it was pointed out that "many . . . if not . . . most . . . amounts proposed to be paid . . . relate to claims that are entitled to priority treatment over general unsecured claims by virtue of Section 507(a)(3)."<sup>143</sup>

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135. Case No. 83-01034A.

136. Case No. 89 B 10449.

137. *Id.* at 1.

138. *Id.*

139. *Id.* at 7.

140. *Id.* at 5-7.

141. Case No. 89 B 10448 (Bankr. S.D.N.Y. Mar. 9, 1989).

142. Case No. 89 B 10449.

143. Case No. 89 B 10448, Motion for Relief, at 3-4.

### F. Broad, General Allegations

In general, almost all motions pertaining to the use of the Doctrine contained general allegations concerning expected benefits to the debtor, the estate, creditors, employees and everybody else imaginable. A shot-gun approach was the rule, not the exception. That is no surprise in view of the dearth of reported cases pertaining to the Doctrine and the uncertainty of how a court will view the facts of each case.

### VII. NON-FACTORS

It is clear that certain factors do not determine whether the Doctrine can be applied. The size of the case is not a factor. The Doctrine was applied in *In re Chateaugay Corp.* ("LTV"),<sup>144</sup> a large case. It has been applied in small cases, such as those involving "ma and pa restaurants" where the sole "chef" threatened to quit unless paid for two days of prepetition services.

Another non-factor is the Code chapter under which the case is pending. The Doctrine has been used in Chapter 13 cases, as well as in Chapter 11 cases. There is no reason why it cannot be used in Chapter 12 cases as well. The nature of the debtor's business is not a factor. The debtor may be an airline, a restaurateur or a farmer.

The dollar amount involved is not a factor. In *LTV*, payment of up to \$70,000,000 was approved for health and life insurance benefits to retirees.<sup>145</sup> Although a dollar amount was not stated in *Eastern Air Lines*,<sup>146</sup> the motion stated that the "salary claims should not exceed approximately \$7,000,000"<sup>147</sup> plus a sum which "should not exceed approximately \$700,000" for prepetition medical benefits.<sup>148</sup> In *Ionsphere Clubs*, other amounts requested were as little as \$26,000 and \$10,000.<sup>149</sup> In *In re Hartman Material Handling Systems* ("*Allis-Chalmers*"),<sup>150</sup> there was no dollar cap in payment of prepetition warranty claims,<sup>151</sup> although there was a \$15,000,000 cap on accrued wage, salary and commission benefits.<sup>152</sup> Ap-

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144. 64 Bankr. 990 (S.D.N.Y. 1986).

145. *Id.* at 993-94. (Perhaps that's why New York City is called the "BIG apple," rather than the "LITTLE apple.")

146. *In re Ionsphere Clubs, Inc.* and *In re Eastern Air Lines, Inc.* ("*Eastern Air Lines*"), Case Nos. 89 B 10448, 89 B 10449 (Bankr. S.D.N.Y. Mar. 9, 1989).

147. *Id.* at 4.

148. *Id.* at 5.

149. *Ionsphere Clubs*, Case No. 89 B 10448.

150. Case Nos. 87 B 11225 to -11242 (Bankr. S.D.N.Y. Aug. 24, 1987).

151. *Id.*

152. *Id.* at 2.



proval of a category or class of persons without a cap is not the norm, but is far from being a rarity.<sup>153</sup>

The number of people receiving payment is not a factor. It is fact-specific to the case. In *LTV*,<sup>154</sup> approximately 66,000 retirees received payment. In small cases, only a few persons benefited from postpetition payments of prepetition wage claims. The net worth of the debtor is often a reference point,<sup>155</sup> but there are insufficient data at this time to determine if that factor is important.

## VIII. NOTICE REQUIREMENTS BEFORE AN ORDER IS SIGNED

### A. To Whom Notice Must Be Given

Notice may be "the name of the game," and its importance cannot be overly stressed. Every court in the cases cited in this Article required some form of notice to be given to someone before an order was signed utilizing the Doctrine. Notice is necessary to avoid due process concerns. No decision has been found specifically addressing the issue of due process and notice in the sole context of the Doctrine. Since a motion to use the Doctrine typically comes early in a case while a crisis is taking place, usually before a creditors' committee is appointed, it is no surprise that notice is generally limited to relatively few persons.

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153. See, e.g., *In re Structurlite Plastics*, 86 Bankr. 922 (S.D. Ohio 1988), where requested payment was rejected, but not due to the sums of money which were to be paid; involved \$65,019.81; *In re FCX, Inc.*, 60 Bankr. 405 (E.D.N.Y. 1986), where requested payment was rejected, but not due to the sums requested to be paid; involved \$15,000, \$1,171,245.67, \$43,294.27, \$1,230,727.25 and \$332,368.85; see also Official Comm. of Equity Sec. Holders v. Mabey ("*A.H. Robins*"), 832 F.2d 292 (4th Cir. 1987), where requested payment was rejected by the Fourth Circuit Court of Appeals; involved \$15,000,000. (Had *A.H. Robins* been pending in New York, payment may have been approved because the judge would have compared the \$15 million to the cost of a good breakfast in a New York hotel, and considered that sum to be not much more than petty cash.) Payment not to exceed \$2,000,000 was approved in *In re Continental Airlines Corp.*, Case No. 83-04019-H1-5 (Bankr. S.D. Tex. Sept. 29, 1983) (\$4,000,000 had been requested). In *In re McLean Indus.*, Case Nos. 86 B 12238, 86 B 12242 (Bankr. S.D.N.Y. Dec. 4, 1986), sums not to exceed \$3,870,000, \$1,550,000, \$3,200,000, \$100,000, an unlimited amount for self-insured workers compensation claims, and \$3,200,000 were approved. In *In re Revere Copper and Brass*, Case Nos. 82 B 12076, 82 B 12086 (Bankr. S.D.N.Y. Dec. 1, 1982), an "aggregate amount not to exceed \$50,000" was approved (Order of December 1, 1982). (Of course, back in 1982, a dollar was almost worth something.) Some cases limited payments per employee to \$2,000 earned within 90 days, to stay within the subsection 507(a)(3) priority. See, e.g., *In re Patrick Cudahy, Inc.*, Case No. 87-05413 (Bankr. E.D. Wis. Mar. 2, 1988). In contrast, in some cases, the sums paid were very small, e.g., less than a thousand dollars.

154. 64 Bankr. 990.

155. See *FCX*, 60 Bankr. 405.

In *In re Eastern Air Lines, Inc.*,<sup>156</sup> it appears that an order was signed on March 9, 1989, based upon the Doctrine with notice only to the United States trustee. The same was true in its companion case, *In re Ionosphere Clubs, Inc.*<sup>157</sup> The order was signed the same day the case was filed. The Debtor's motion stated:

In light of the emergency nature of the relief requested herein . . . and the irreparable harm to Eastern that will ensue if the relief requested herein is not granted, Eastern submits that it is not feasible to give any notice and requests that the Court waive and dispense with the requirement of any furtherance.<sup>158</sup>

In an Eastern motion brought by the Debtor for an order approving Eastern's Customer Ticket-Holder Relief Program, counsel for Eastern requested that notice of the postpetition payments be limited to the United States trustee and the "twenty largest creditors; and in light of the circumstances and the emergency nature of the relief requested it appearing that no other notice need be given."<sup>159</sup>

In *In re Patrick Cudahy, Inc.*,<sup>160</sup> notice was given to the United States trustee, all secured creditors, major unsecured creditors and all persons who may have been adversely affected directly by the payments. No creditors' committee had been formed at the time. In *In re Hartman Material Handling Systems ("Allis-Chalmers")*,<sup>161</sup> notice was given to the counsel for the Official Committee of Unsecured Creditors, OAR Lenders, Private Lenders, Manufacturers Hanover Trust Company and the Public Trustee, Official Labor/Retiree Committee, those parties in interest who filed a notice of appearance, the United States trustee and the Securities and Exchange Commission ("SEC").

In *In re Continental Airlines Corp.*,<sup>162</sup> notice was limited to the Official Creditors' Committees, secured creditors, the Internal Revenue Service and the SEC. This order antedated the inception of the United States trustee program. In *In re Global Marine*,<sup>163</sup> notice was given to "secured bank creditors, to the members of the Creditors' Committee appointed in [two of twelve] cases, to National Westminster Bank, and to those parties who have requested notice . . . ."<sup>164</sup> In *In re Revere Copper and Brass*,<sup>165</sup> notice was

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156. Case No. 89 B 10449 (Bankr. S.D.N.Y. Mar. 9, 1989).

157. Case No. 89 B 10448 (Bankr. S.D.N.Y. Mar. 9, 1989).

158. Case No. 89 B 10449 (order of Mar. 9, 1989, at 7-8).

159. *Id.* (motion of Mar. 14, 1989).

160. Case No. 87-05413 (Bankr. E.D. Wis. Aug. 24, 1987).

161. Case Nos. 87 B 11225 to -11242 (Bankr. S.D.N.Y. June 30, 1987).

162. Case No. 83-04019-H1-5 (Bankr. S.D. Tex. Sept. 29, 1983).

163. Case Nos. 85-00781-H2-11, 86-00782-H2-11 (Bankr. S.D. Tex. Feb. 13, 1986).

164. *Id.*

given to the Creditors' Committee and the United States trustee. In *In re Chateaugay Corp.* ("LTV"),<sup>166</sup> notice was given to certain creditors and to the United States trustee for an emergency hearing, with the right of interested persons to more fully address the issues in a full hearing.<sup>167</sup>

Without question, the trend is for the court to conduct an emergency hearing on limited notice, and then give broader notice to a larger group of interested persons, thus giving all persons an opportunity to be heard. The relief granted at the emergency hearing is limited as the circumstances require.

### B. How Much Notice Need Be Given

It is not uncommon for a hearing to be conducted the same day the case is commenced, the motion requesting payment pursuant to the Doctrine having been filed with the petition. It follows that time factors can be brief. Heaven help a creditor's counsel who decides to take an afternoon off to play golf or cricket.

In *Eastern Air Lines*,<sup>168</sup> notice was as short as several hours. Telephone notice of twenty-four hours and/or overnight courier service was used with certain motions. In *Allis-Chalmers*,<sup>169</sup> notice of ten days was given. In another *Allis-Chalmers* matter, apparently the court was asked to approve the giving of notice of one day "by personal service or by overnight courier."<sup>170</sup> In *Revere Copper and Brass*,<sup>171</sup> notice of eight days from the day the motion was filed and the order was signed was given to interested persons. In *Global Marine*,<sup>172</sup> the notice simply was "expedited." In *In re Wilson Foods*,<sup>173</sup> a motion to make payment pursuant to the Doctrine was filed contemporaneously with the petition (initiating the case). An order utilizing the Doctrine was signed the same day. The motion stated that creditors would have sixty days after the order was signed to file an objection to the order.

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165. Case Nos. 82 B 12073, 82 B 12086 (Bankr. S.D.N.Y. Dec. 1, 1982).

166. 64 Bankr. 990 (S.D.N.Y. 1987).

167. *Id.* at 992, 994.

168. Case No. 89 B 10449.

169. Case Nos. 87 B 11225 to -11242.

170. *Id.*

171. Case Nos. 82 B 12073, 82 B 12086.

172. Case Nos. 85-00781-H2-11, 86-00782-H2-11.

173. No. 83-0134A (Bankr. W.D. Okla. April 22, 1983).

## IX. THE RESULT IF THE DEBTOR FAILS TO OBTAIN COURT AUTHORITY

What happens if a debtor, without court authority, makes postpetition payment of prepetition debts? This was addressed in *In re B & W Enterprises, Inc.*,<sup>174</sup> and in a Strook & Strook & Lavan brief in *In re Chateaugay Corp.* (“LTV”).<sup>175</sup> In *B & W Enterprises*, the Debtor, “without notice, hearing, or authorization from the supervising bankruptcy court,”<sup>176</sup> decided that it should make postpetition payment of certain prepetition debts for valid business purposes. Later the Chapter 11 case was converted to Chapter 7. The bankruptcy court allowed the trustee to avoid the payments to prepetition creditors pursuant to subsection 549(a), which pertains to avoidance of postpetition transactions, and directed the prepetition creditors to return the funds to the trustee pursuant to Section 550, which pertains to liability of a transferee of an avoided transfer. Upon appeal the creditors argued that the Debtor was permitted to make payment pursuant to the Six Months Rule and the Necessity of Payment Rule.<sup>177</sup> The court rejected that argument, holding that the Six Months Rule and the Necessity of Payment Rule were limited to railroad reorganizations,<sup>178</sup> and the Necessity of Payment Rule may not have been retained in the Code for any purpose or use.<sup>179</sup>

## X. MATTERS TO CONSIDER WHEN THE DOCTRINE MAY BE APPLIED

Because the Doctrine is based in good part on equitable considerations, it is easy to abuse it. It is important to determine carefully the effect of all interested persons before the Doctrine is applied. What if there are insufficient funds to pay everyone on the same level or on a higher priority level than the people being paid? Will improper or unwise priorities within the same class be created?

Since, from a practical perspective, recoupment is rarely, if ever, possible, further questions need to be addressed. Are the payments being made for a legitimate and lawful purpose? Are the parties crossing over the line between the proper use of the Doctrine and caving in to the worst form of economic blackmail? Is the use of the debtor's funds inequitable to persons who are entitled to, but do not receive, payment? Is there any effect on non-

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174. 713 F.2d 534 (9th Cir. 1983).

175. 64 Bankr. 990 (S.D.N.Y. 1987).

176. *B & W Enterprises*, 713 F.2d at 535.

177. *Id.* at 537.

178. *Id.* at 537-38.

179. *Id.*

debtors who are guarantors of the debtor's obligations or who have personal liability, e.g., liability for taxes? How much discretion should the debtor be given in distributing the funds? Should there be a watchdog? Will the utilization make it more, or less, difficult for the debtor to confirm a plan? What will be the effect on the ability of the debtor to pay prepetition and postpetition taxes? Has sufficient attention been given to due process requirements? Will the use violate basic principles of bankruptcy law, i.e., the collectivization process and the avoidance of using economic muscle to obtain personal gains in getting one's claim paid to the exclusion of others?

A bankruptcy case is "a collective proceeding for the determination and payment of debts."<sup>180</sup> There is a policy against "grabbing by creditors."<sup>181</sup> "[T]he pickings of anyone less civil will be fetched back into the pool."<sup>182</sup> Will payment violate these basic policies?

#### XI. COMMENTS REGARDING SEVERAL CASES

*In re Chateaugay Corp.* ("LTV"),<sup>183</sup> which continues to wind its way through the courts, illustrates the proper application of the Doctrine. The Debtors and related corporations, with the support of the Official Committee of Unsecured Creditors ("Creditors Committee") to whom the Debtors owed in excess of \$3,500,000,000, asked the court on July 30, 1986, for authority to make payment of up to \$70,000,000 for health, medical, and life insurance benefits for approximately 66,000 retirees.<sup>184</sup> Earlier, on the day the petition was filed, July 17, 1986, the bankruptcy court had signed an order, over the objections of secured banks, which "authorized and empowered the [D]ebtors (collectively 'LTV') to pay certain prepetition wages and salaries, reimbursement expenses, and employee benefits" for current employees.<sup>185</sup> Because the obligation to make the retiree benefit payments was prepetition, the Debtors had stopped payment when the petition was filed. This "caused enormous stress for the many elderly retirees and their families who were left without medical or life insurance coverage."<sup>186</sup> Payments by the Debtors were their lifeline. Nonpayment by the Debtors pre-

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180. *Levit, Trustee of V.N. Deprizio Constr. Co. v. Ingersoll Rand Fin. Corp.*, 874 F.2d 1186, 1194 (7th Cir. 1989) (stating Professor Douglas G. Baird and Dean Thomas H. Jackson's philosophy).

181. *Id.*

182. *Id.*

183. 80 Bankr. 279 (S.D.N.Y. 1987), 76 Bankr. 945 (S.D.N.Y. 1986), 64 Bankr. 990 (S.D.N.Y. 1986), *appeals dismissed*, 838 F.2d 59 (2d Cir. 1988).

184. *LTV*, 64 Bankr. at 992.

185. *LTV*, 80 Bankr. at 280.

186. *LTV*, 64 Bankr. at 992.

cipitated a devastating strike. The court allowed the retiree payments in its July 30, 1986, order, after assurances that the Debtors had the cash to make the payments and with the support of two major unions and the Official Committee of Unsecured Creditors ("Creditors' Committee").<sup>187</sup>

In bankruptcy court, Chateaugay ("LTV") and the Creditors' Committee had successfully argued that payment was permitted pursuant to subsection 363(b), which permits the use of property other than in the ordinary course of business after notice and a hearing. There was "a sound business reason" for the use, as required by *In re Lionel Corp.*<sup>188</sup> Upon appeal of the July 30 order, the district court took no issue with the actions of the bankruptcy court, found that an appeal was "not appropriate at this time,"<sup>189</sup> and remanded "in order to enable the Bankruptcy Judge to make findings of fact and conclusions of law in completion of the decision-making process he initiated."<sup>190</sup>

A later Chateaugay ("LTV") appeal pertained to the State of Michigan, Bureau of Workers' Disability Compensation and Self-Insurers' Security Fund.<sup>191</sup> Michigan appealed because, although "LTV resumed payment of workers' compensation claims in some but not all states," payments were not made to Michigan claimants, and Michigan argued that the Debtor was required to "treat all prepetition workers' compensation claims alike."<sup>192</sup> On appeal, the district court held that the bankruptcy court's order was interlocutory and the bankruptcy judge "neither erred nor abused his discretion in issuing the order."<sup>193</sup> The court (in now often quoted language) stated:

A rigid application of the priorities of § 507 would be inconsistent with the fundamental purpose of reorganization and of the Act's grant of equity powers to bankruptcy courts, which is to create a flexible mechanism that will permit the greatest likelihood of survival of the debtor and payment of creditors in full or at least proportionately. The Supreme Court has emphasized the special nature of reorganization proceedings.<sup>194</sup>

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187. *Id.* at 992, 993, 998 n.15.

188. 722 F.2d 1063, 1069 (2d Cir. 1983).

189. *LTV*, 64 Bankr. at 999.

190. *Id.* at 992.

191. *LTV*, 80 Bankr. at 280.

192. *Id.*

193. *Id.*

194. *Id.* at 287.

*In re Eastern Air Lines, Inc.*<sup>195</sup> gives an in-depth analysis of a view of the Doctrine by two very fine bankruptcy judges skilled in all aspects of the Doctrine. Chief Judge Burton R. Lifland reviewed an order signed by Judge Tina L. Brozman and entered approximately two weeks earlier, "granting Eastern's motion to pay certain pre-petition wage, salary, medical benefit and business expense claims of its active employees."<sup>196</sup> The IAM, supported by the Air Lines Pilots Association, International ("ALPA") and the Transport Workers of America, moved for an Order authorizing and directing Eastern to pay similar benefits to union-represented striking employees for services rendered before the petition was filed; ALPA also asked for payment of prepetition sick leave benefits and medical expenses of the employees on sick or disability leave.

IAM argued that *all* prepetition wage and salary claims of active employees and IAM-represented employees then on strike were subsection 507(a)(3) priority claims which must be treated identically. The bankruptcy court disposed of that argument by applying subsection 363(b), by applying *Lionel Corp.*,<sup>197</sup> and by finding that the Debtor did "articulate some business justification, other than mere appeasement of major creditors, for using, selling or leasing property out of the ordinary course of business . . ."<sup>198</sup> The articulated business purposes were "to preserve and protect its business and ultimately reorganize, retain its currently working employees and maintain positive employee morale."<sup>199</sup>

Judge Lifland ruled that courts are empowered by subsection 105(a) to invoke the Doctrine.<sup>200</sup> The court drew a parallel between the Railway Labor Act and the Code, noting that railroad-related law contains the Necessity of Payment Rule recognizing judicial power to authorize payment of prepetition claims where it is essential to the continued operation of the Debtor, as well as the Six Months Rule which permits railroad debtors to pay for goods delivered within six months of the filing date of a railroad reorganization.<sup>201</sup> The court pointed out that Judge Learned Hand applied the Necessity of Payment Rule to a non-railroad debtor in *Dudley v. Mea-*

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195. 98 Bankr. 174 (S.D.N.Y. 1989) (This is the cite which refers to *In re Eastern Air Lines, Inc.*, Case No. 89 B 10449 (BLR) (Bankr. S.D.N.Y. Mar. 9, 1989), and its companion case, *In re Ionosphere Clubs, Inc.*, Case No. 89 B 10448 (BRL) (Bankr. S.D.N.Y. Mar. 9, 1989).

196. *Id.* at 174-75.

197. 722 F.2d at 1069 (cited in 98 Bankr. at 175).

198. *Eastern Air Lines*, 98 Bankr. at 175; accord *In re Continental Airlines, Inc.*, 780 F.2d 1223, 1226 (5th Cir. 1986); *In re Baldwin-United Corp.*, 43 Bankr. 888, 905-06 (Bankr. S.D. Ohio 1984).

199. *Eastern Air Lines*, 98 Bankr. at 175.

200. *Id.*

201. *Id.* at 176.

ley,<sup>202</sup> holding that a “court was not ‘helpless’ to apply the rule to non-railroad debtors where the alternative was a cessation of operations.”<sup>203</sup> Although Judge Lifland noted that railroad reorganization law supports the Doctrine of Necessity, he was careful not to transplant the Six Months Rule or the Necessity of Payment Doctrine directly into Chapter 11 non-railroad cases.

The *Eastern Air Lines* court responded to arguments that there must be equality among creditors, stating that such a policy “may be of significance in liquidation cases under Chapter 7, [sic] however, the paramount policy and goal of Chapter 11, to which all other bankruptcy policies are subordinated, is the rehabilitation of the debtor.”<sup>204</sup> The court relied on *NLRB v. Bildisco & Bildisco*,<sup>205</sup> “which stated, [t]he fundamental purpose of reorganization is to prevent the debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources.”<sup>206</sup> The court also looked to legislative history and stated: “[T]he Bankruptcy Court’s equitable power may be used to effectuate the purposes of Chapter 11, which include the ‘restructuring of a business’ finances to enable it to operate productively, provide jobs for its employees, pay its creditors and produce a return for its stockholders.”<sup>207</sup>

The *Eastern Air Lines* court disposed of arguments as to equity between persons of the same class by indicating that subsection 1123(a) applies “in the context of a plan of reorganization, and is of significance only when the debtor is ready to emerge from Chapter 11.”<sup>208</sup> This case was two weeks old when the order was entered, and the court believed that it was “premature” to consider the issue of equity “since it goes to the heart of a reorganization plan and not to which claims are necessary to be paid at this point in time to keep Eastern operating and to protect and preserve estate assets.”<sup>209</sup> The court pointed out that, “even in the context of reorganization, a majority of both cases and commentators have rejected the concept that all creditors of equal rank must receive equal treatment.”<sup>210</sup>

202. 147 F.2d 268 (2d Cir. 1945), *cert. denied*, 325 U.S. 873 (1945).

203. *Eastern Air Lines*, 98 Bankr. at 176 (citing *Dudley v. Mealey*, 147 F.2d 268 (2d Cir. 1945), *cert. denied*, 325 U.S. 873 (1945)).

204. *Id.*

205. 465 U.S. 513 (1984).

206. *Eastern Air Lines*, 98 Bankr. at 177 (quoting *Bildisco v. Bildisco*, 465 U.S. 513, 588 (1984)).

207. *Id.* (quoting H.R. REP. NO. 595, 95th Cong., 1st Sess. at 16 (1977), *reprinted in* U.S. CODE CONG. & ADMIN. NEWS 5787, 5963, 5977).

208. *Id.*

209. *Id.*

210. *Id.*



The court noted that Section 1123 "does require the same treatment for each claim or interest of a particular class. However, it does not automatically follow that all creditors of equal rank must be treated alike."<sup>211</sup> The court stated that "a debtor may place claimants of the same rank in different classes and thereby provide different treatment for each respective class,"<sup>212</sup> agreeing that a "plan should not arbitrarily classify or discriminate against creditors . . . ."<sup>213</sup> The court also noted that "[a] bankruptcy court can permit discrimination when the facts of the case justify it."<sup>214</sup> The court concluded by stating: "[T]his court has a duty to maintain the estate for the benefit of *all* creditors."<sup>215</sup> The court reasoned that payment to IAM members would benefit only IAM members, not the estate or its creditors. The fact that Eastern was sitting on more than \$200,000,000 in cash and had the ability to pay was insufficient; there was no *necessity* to pay. The main argument of the Unions, for "equity," would be dealt with at the proper time when a proposed plan would be before the court. The motion of IAM was denied.<sup>216</sup>

The court in *Lionel Corp.*<sup>217</sup> substantiated the Doctrine and set forth the following: "To further the purposes of Chapter 11 reorganization, a bankruptcy judge must have substantial freedom to tailor his orders to meet differing circumstances. This is exactly the result a liberal reading of section 363(b) will achieve."<sup>218</sup> This decision is helpful because it keeps judges out of a straitjacket and gives courts the ability to act within established bankruptcy law and practice.

Another case frequently cited in briefs as authority for the requested use of the Doctrine is *In re Southern Biotech, Inc.*<sup>219</sup> It states in part: "The fact that there is no express authorization in the Code [to purchase all corporate stock of a nondebtor corporation] should not preclude authorization to enter into the transaction unless there is specific prohibition against the proposed transaction."<sup>220</sup> Courts must be careful before relying on that language, however, as there are many improper actions which are not specifically prohibited by the Code. The Code is not drafted to detail every act which is permitted or is not permitted. What may or may not be done is

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211. *Id.*

212. *Id.* at 177-78.

213. *Id.* at 178 (quoting *In re LeBlanc*, 622 F.2d 872, 879 (5th Cir. 1980)).

214. *Id.*

215. *Id.*

216. *Id.* at 178-79.

217. 722 F.2d 1063.

218. *Id.* at 1069.

219. 37 Bankr. 318 (M.D. Fla. 1983).

220. *Id.* at 323.

often determined by the facts of a case. The Code does state with reasonable clarity most of the concepts and principles which are needed to resolve a typical case.

*In re Structurlite Plastics Corp.*<sup>221</sup> illustrates the reasoning of courts when use of the Doctrine is requested. When the Doctrine is invoked, objections are the exception, not the rule, as everyone acknowledges that its use is for the common good. In *Structurlite*, the Chapter 11 Debtor moved to assume an executory contract and to pay prepetition employee medical claims. The Official Committee of Creditors objected. A collective bargaining agreement was in effect when the petition was filed, and it contained a medical trust agreement provision which required payment to hourly employees of health, disability and life insurance benefits. Non-union salaried employees were entitled to the same self-funded benefits. Several employees faced collection efforts by medical providers due to nonpayment of medical expenses of catastrophic illnesses of dependents. The court refused to allow payment immediately, but it left open the possibility of future payment. The court held that the medical trust agreement was not an executory contract.<sup>222</sup>

The Debtor's only significant obligation was to fund the trust paying the bills. The court acknowledged that it may be possible in "rare instances" to pay prepetition debt, provided that it was "convinced . . . that authorizing the payment of the prepetition debt creates 'the greatest likelihood of . . . payment of creditors in full or at least proportionately.'"<sup>223</sup> The court permitted subsection 507(a)(4) to be used for payment within its limits. This decision does not state that the Doctrine can never be applied; it simply prohibited its use under the facts of this case.

On the other hand, the decision in *In re FCX, Inc.*<sup>224</sup> is disconcerting, since a district court reversed the bankruptcy court and indicated that subsection 105(a) cannot be used to create rights otherwise unavailable under applicable law in order to pay a total of \$1,214,539.94 to employees plus \$1,563,095.60 to grain producers.<sup>225</sup> The district court refused to authorize payment pursuant to subsection 105(a), subsection 365(b) or 28 U.S.C. § 1481. The court acknowledged that "[t]he bankruptcy court has the

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221. 86 Bankr. 922 (S.D. Ohio 1988).

222. *Id.* at 933, 927. Query: Would the result have been different if the court had used the Andrew definition of executory contract rather than the Countryman definition? See *supra*, note 25 and accompanying text.

223. *Structurlite*, 86 Bankr. at 932 (quoting *In re Chateaugay Corp. ("LTV")*, 80 Bankr. at 279, 287 (S.D.N.Y. 1987)).

224. 60 Bankr. 405 (E.D.N.C. 1986).

225. *Id.* at 407.

power to shift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate.’”<sup>226</sup> The court also said: “[T]he bankruptcy court has the ability to deviate from the rules of priority and distribution set forth in the Code in the interest of justice and equity . . . [but] cannot use this flexibility . . . to establish a ranking of priorities within priorities.”<sup>227</sup>

The *FCX* court was concerned that the effect of making these payments would be to subordinate a claim to other claims within the same class,<sup>228</sup> even though the Debtor had a net worth of \$12,000,000 and there was a reasonable “probability that all unsecured creditors eventually will be paid . . . .”<sup>229</sup> The payments were prohibited because “[i]t is simply inequitable to settle certain claims prior to the filing of a reorganization plan; such action may be detrimental to the remaining unsecured creditors if the reorganization fails and the estate has to be liquidated.”<sup>230</sup> The court stated that subsection 507(a)(3) claims could be paid to the extent of their priority.<sup>231</sup>

Since the use of the Doctrine is fact-specific and its use is well-founded in bankruptcy law, it is a little disconcerting for a court to take a position that there is no legal basis for its use. Perhaps the result would have been different if the facts of the case had been different, if the case would have been argued or presented in a different manner, or if some of the cases referred to in this Article had been decided prior to the time the district court rendered its decision in 1986.

*Official Committee of Equity Security Holders v. Mabey* (“*A.H. Robins*”)<sup>232</sup> is a controversial decision. The district court had directed the Debtor to establish a \$15,000,000 “emergency treatment fund” to defray the cost of providing tubal reconstructive surgery or in-vitro fertilization for women injured while using the Dalkon Shield.<sup>233</sup> The examiner, the committee of injured persons, and future claimants supported the motion. The district court’s order establishing the \$15,000,000 fund was reversed.<sup>234</sup>

The Fourth Circuit, rejecting the lower court’s reliance on subsection 105(a), said that equitable powers emanating from Section 105 “are not a

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226. *Id.* at 409 (quoting *Pepper v. Litton*, 308 U.S. 295 (1939)).

227. *Id.*

228. *Id.* at 410.

229. *Id.* at 408.

230. *Id.* at 412.

231. *Id.*

232. 832 F.2d 299 (4th Cir. 1987).

233. *Id.* at 300.

234. *Id.*

license for a court to disregard the clear language and meaning of the bankruptcy statutes and rules."<sup>235</sup> The Fourth Circuit stated: "[T]he fact that a proceedings [sic] is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be."<sup>236</sup> The court also held that a pre-confirmation "distribution to unsecured creditors in a Chapter 11 proceeding" was not permitted.<sup>237</sup> It held that the distribution violated sections 1122-1129 and Bankruptcy Rule 3021 which "allows distribution to creditors only after the allowance of claims and the confirmation of a plan."<sup>238</sup>

Some of our finest bankruptcy scholars have criticized the *A.H. Robins* decision. The most perceptive and insightful comments are those of Professor Douglas A. Baird at a recent seminar for bankruptcy judges:

[T]he Fourth Circuit suffered from a case of the 'naives.' Payments to creditors before confirmation of the plan of reorganization do happen in Chapter 11. The typical case that we hardly give any thought to is the payment of prepetition wages to workers. These payments are formally endorsed in the context of executory contracts through its requirement that the debtor cure defaults on executory contracts that it wants to assume. To be sure, payments to prepetition creditors are inherently suspicious. The whole point of bankruptcy is to force everyone to work together. People should not be able to opt out.

. . . .

. . . We do not have these tort victims exerting any hold-up power. It is not as if they are suppliers that the firm needs. But the people who we are talking about are in fact entitled to money. There seems little possibility that they will not get at least as much eventually as they are getting under the plan. Whatever they get now will count against what they get later. No one is likely to be hurt by paying them now. . . . [P]aying them now may be in everyone's interest. These women need the operation now and many will not have it unless they get the money now. If they do not get the operation now, but have to wait five years they may be too old to have children and the surgery will not do any good. In that event, their claims would not be for their difficulty in having children, but for being deprived of the ability to have any children at all. The owners of a firm prefer the first lawsuit to the second. If you give them the

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235. *Id.* at 302.

236. *Id.* (quoting *In re Chicago, M., St. P. and Pac. R.R.*, 791 F.2d 524, 528 (7th Cir. 1986)).

237. *Id.*

238. *Id.*

money now, you can reduce the exposure of the corporation to these tort claims.

The effect of providing the surgery to those who want it now may be to reduce the claim of these victims against the corporation later. All the owners of *Robins* may be better off if these payments are made. Of course, what has to happen is that you have to balance the cost of the operation and the possibility that the women will get a larger share than they would otherwise be entitled to against the potential savings to the estate.<sup>239</sup>

It is difficult to disagree with the critics of the *A.H. Robins* decision. The people who objected to the use of the Doctrine were not those persons who were most seriously injured when the Doctrine could not be used — the women who required immediate surgery and, perhaps, the unsecured creditors who may be required to accept a smaller percentage of their debt due to substantially increased claims of the injured women.

The *A.H. Robins* decision is all the more puzzling in view of the flexibility ordinarily granted to bankruptcy courts when the court takes action for the common good. *In re Longardner & Associates, Inc.*<sup>240</sup> is not a Doctrine of Necessity case, but it shows how bankruptcy courts can act in unusual circumstances. In *Longardner*, the bankruptcy court would not set aside a confirmed Chapter 11 plan at a creditor's request, even though the creditor had not received notice of entry of the order confirming the plan. The bankruptcy court strictly interpreted Section 1144. The district court and the court of appeals affirmed. The creditor wanted the bankruptcy court to exercise "its equitable powers to provide relief . . . in this case," notwithstanding Section 1144.<sup>241</sup> The Seventh Circuit Court of Appeals said: "*We agree that the bankruptcy court as a court of equity could have fashioned relief for the creditor.*"<sup>242</sup> The Seventh Circuit then went on to remind us of its earlier statement: "Although a reorganization court is indeed a court of equity, . . . it is yet constrained by the dictates of the Bankruptcy Act."<sup>243</sup> Yet, bankruptcy courts need and have the ability under appropriate reme-

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239. D. Baird, *Bankruptcy Decisionmaking in an Uncertain World*, SEMINAR FOR BANKRUPTCY JUDGES, A FEDERAL JUDICIAL CENTER PROGRAM, San Antonio, Texas, May 20, 1988, at 17-18.

240. 855 F.2d 455 (7th Cir.), cert. denied, 109 S. Ct. 1130 (1988).

241. *Id.* at 462.

242. *Id.* (emphasis added) (citation omitted).

243. *Id.* (quoting *In re Chicago M. St. P. & Pac. R.R.*, 830 F.2d 758, 766 (7th Cir. 1987)); see also *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988) ("[W]hatever equitable powers remain on the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.").

dies to fashion relief, and this understanding by a court of appeals of the unique needs of bankruptcy courts is refreshing.

## XII. CONSISTENCY

The same lawyers were involved in many of the cases referred to in this Article. The lawyers proceeded to use the theory that, if something works in one case, it should work in another case with relatively similar facts. There is a substantial amount of repetition in the briefs and pleadings, and cross references are common. For example, the Memorandum of Law in Support of Eastern Air Lines' Motion to Pay Foreign Creditors states: "All of the arguments raised by Continental Air Lines [sic], when its identical request was approved by a bankruptcy judge in Texas, apply equally to Eastern."<sup>244</sup> Similarly, the courts used consistent language in orders. Bankruptcy courts tend to believe that there is some benefit to adhering to precedents and not needlessly unsettling established law without a compelling reason to do so.

## XIII. PUTTING IT ALL TOGETHER — RECOMMENDATIONS ON THE USE OF THE DOCTRINE OF NECESSITY

There must be a specific positive purpose for use of the Doctrine. Each utilization of the Doctrine should begin with a quick review of the underpinnings of the Doctrine to make certain that the intended application is not outside its generally accepted scope. The Doctrine should not be used by default or merely because it is convenient to do so, nor should it be used when the problem can be resolved in a conventional manner. It is a Doctrine of *necessity*, not a Doctrine of *convenience*. Ability to pay is of little, if any, consequence.

Courts should be cautious and use the Doctrine sparingly. The Doctrine should not be used if there is no real emergency. Use of the Doctrine should be an exception, not a general rule. Provisions of the Code, such as subsection 507(a)(3), exist for a purpose. The farther the debtor is into a case, the less likely it is that the Doctrine should be applied. When the Code provisions are clear, they should be followed. Mr. Justice Holmes said, in *Missouri, Kansas & Texas Railway v. May*,<sup>245</sup> that "[s]ome play must be allowed for the joints of the machine . . . ."<sup>246</sup> This means that there must be some play *in* the system utilizing recognized law and concepts, not some play *with* the system. Playing with the system will result in

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244. *In re Eastern Air Lines, Inc.*, Case No. 89 B 10449 (Bankr. S.D.N.Y. Mar. 9, 1989).

245. 194 U.S. 267, 270 (1904).

246. *Id.* at 270; see also *In re Lionel Corp.*, 722 F.2d 1063, 1069 (2d Cir. 1983).

judicial anarchy and uncertainty of the law, both of which are highly destructive.

The Doctrine must not be used if, and/or when, the result is to sanction blackmail. Bankruptcy is structured so that "might" does not make "right." Improper "deals" should not be permitted. Professor Douglas G. Baird said: "The question you have to ask in every case is whether the Bankruptcy Code gives you the discretion to take account of the realities of the situation."<sup>247</sup> Only when the answer to the question is "yes" can the Doctrine be considered for use. It should be likely that the people receiving funds when the Doctrine is applied will receive at least as much as it is anticipated they will eventually get under the plan.<sup>248</sup> Furthermore, there must be no person "likely to be hurt" if the Doctrine is applied.<sup>249</sup> The Doctrine must not be applied unless the equities are clearly and strongly in favor of its use. The nature of the request should be reasonable under the existing circumstances.

When using the Doctrine, a detailed record with specific findings must be made. The findings should include, among other things: who received notice of the hearing; how much notice was given; who, if anyone, objected to the relief requested (since in the great majority of cases where the Doctrine has been applied, the court has proceeded with the consent of the parties or without great opposition, which remains good policy); the equities of all directly-affected persons; who, if anyone, is harmed, and the degree of harm; whether the use of the Doctrine was necessary to prevent the immediate collapse of the case; why the use of the Doctrine is in the best interests of the estate; and what the probable effects will be if the Doctrine is or is not applied. In addition, the court should inquire into whether the debtor is worth saving and the reasonable likelihood of a successful plan.

There should be a hearing in the nature of an emergency hearing pursuant to Bankruptcy Rule 4001(b) which is held at the outset of many Chapter 11 cases following a motion for the use of cash collateral. Testimony should be taken. Special care must be taken before payment is authorized, as the disbursement of funds pursuant to the Doctrine does not lend itself to simple controls.

Because of the emergency nature of the request, notice of the first hearing will necessarily be limited both as to time factors and the persons receiving notice. The notice should be in writing. It should clearly state the date, time and place of the hearing, the purpose of the hearing, the persons who

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247. D. Baird, *Bankruptcy Decisionmaking*, *supra* note 237, at 18.

248. *Id.*

249. *Id.*

are to benefit from the payments, in what amounts proposed payments are to be made, and the source of the funds. The amount of notice (time) for the hearing must be fact-specific. Notice must be given to as many persons as is reasonably possible. There is little reason why notice of even a few hours cannot be given to the United States trustee, major secured creditors, all taxing authorities, the SEC, Pension Benefit Guaranty Corporation, the twenty (more or less) largest unsecured creditors, and labor unions. In major cases most interested persons obtain counsel prior to the filing of the petition, and the names of their attorneys are known. Notice of a second hearing should be more broad both as to time and the mailing list of persons receiving notice.

The trend is for courts to schedule a second hearing, in the nature of a review. As was the case with the notice of the first hearing, the type of notice, time factors and persons receiving the notice must be fact-specific. When possible, a court should consider limiting the relief granted at the first hearing pending the completion of the second hearing.

#### XIV. CONCLUSION

Should there be a place in bankruptcy law for the Doctrine of Necessity? Yes. It is a vital tool if courts are to take seriously the purpose of Chapter 11, *i.e.*, "to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders."<sup>250</sup> The Doctrine carries with it tremendous power which must be harnessed in an intelligent manner. Its development is still in its infancy. Energies should be concentrated on setting guidelines, parameters and ground rules. While this Article is the first on the subject, undoubtedly it will not be the last.

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250. Pension Benefit Guar. Corp. v. LTV Corp., 875 F.2d 1008, 1015 (2d Cir. 1989) (quoting H.R. REP. NO. 595, 95th Cong., 2nd Sess. 220 (1978), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS, 5787, 5963, 6197).