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Co-Debtor Stays in Chapter 11 Bankruptcy

Barry L. Zaretsky

CO-DEBTOR STAYS IN CHAPTER 11 BANKRUPTCY

Barry L. Zaretsky†

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After a debtor files a bankruptcy petition, creditors may seek to collect their claims from individuals who are liable along with the debtor. Relatives or friends may have guaranteed some of the debtor's obligations. Principals may have guaranteed some of a corporation's obligations[1] or may be liable to the creditors of the corporation on other grounds.[2] General partners are liable to

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1 *See, e.g., In re* Keyco, Inc., 49 Bankr. 507 (Bankr. E.D.N.Y. 1985); *In re* Otero Mills, Inc., 21 Bankr. 777 (Bankr. D.N.M.), *aff'd*, 25 Bankr. 1018 (D.N.M. 1982).

2 The most common "other" ground bases personal liability on I.R.C. § 6672 (1982). This section addresses the liability of persons responsible for collecting and paying over withholding and other "trust fund" taxes. *E.g.*, Slodov v. United States, 436 U.S. 238 (1978). Personal liability can also arise under other circumstances. *See, e.g., In*

partnership creditors.[3] In addition, the debtor's insurers may be liable in a direct action for some of the debtor's obligations.[4]

The Bankruptcy Code protects the Chapter 11 debtor from direct actions by creditors through the automatic stay in section 362.[5] The filing of a bankruptcy petition stays virtually all actions to collect pre-petition claims from the debtor and all efforts to pressure a

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re Ozark Restaurant Equip. Co., 816 F.2d 1222 (8th Cir.) ("alter ego" action), *cert. denied sub nom.* Jacoway v. Anderson, 108 S. Ct. 147 (1987); *In re* S.I. Acquisition, Inc., 817 F.2d 1142 (5th Cir. 1987) ("piercing the corporate veil"); Cumberland Oil Corp. v. Thropp, 791 F.2d 1037 (2d Cir.) (fraud action), *cert. denied,* 107 S. Ct. 436 (1986); Delgado Oil Co. v. Torres, 785 F.2d 857 (10th Cir. 1986) (breach of fiduciary obligation); *In re* Johns-Manville Corp., 26 Bankr. 420 (Bankr. S.D.N.Y. 1983) (violations of securities laws), *aff'd,* 40 Bankr. 219 (S.D.N.Y.), *rev'd in part on other grounds,* 41 Bankr. 926 (S.D.N.Y. 1984). For some additional "other" grounds, see *infra* note 19.

3 Bankruptcy Code § 723, 11 U.S.C. § 723 (1982) [hereinafter Bankruptcy Code]; UNIF. PARTNERSHIP ACT § 15, 6 U.L.A. 174 (1914).

A prefatory note on taxonomy may aid the reader. Congress enacted the current Bankruptcy Code in the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978). Congress later substantially amended the Bankruptcy Code with the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1984), and again with the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3088 (1986). The Bankruptcy Code is codified at title 11 of the United States Code. Bankruptcy Code citations followed by a parenthetical reference to "West" indicate U.S.C.A.

4 *See, e.g., In re* Johns-Manville Corp., 40 Bankr. 219 (Bankr. S.D.N.Y.), *rev'd in part on other grounds,* 41 Bankr. 926 (S.D.N.Y. 1984).

5 Bankruptcy Code § 362 (West 1979 & Supp. 1987). Section 362 states:

> (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78eee(a)(3)), operates as a stay, applicable to all entities, of—
>
> (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;
>
> (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
>
> (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
>
> (4) any act to create, perfect, or enforce any lien against property of the estate;
>
> (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;
>
> (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;
>
> (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and
>
> (8) the commencement or continuation of a proceeding before the United States Tax Court conceruing the debtor.
>
> (b) The filing of a petition under section 301, 302, or 303 of this title, or

debtor into payment. As Congress made clear, the stay is "one of

of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78eee(a)(3)), does not operate as a stay—

(1) under subsection (a) of this section, of the commencement or continuation of a criminal action or proceeding against the debtor;

(2) under subsection (a) of this section, of the collection of alimony, maintenance, or support from property that is not property of the estate;

(3) under subsection (a) of this section, of any act to perfect an interest in property to the extent that the trustee's rights and powers are subject to such perfection under section 546(b) of this title or to the extent that such act is accomplished within the period provided under section 547(e)(2)(A) of this title;

(4) under subsection (a)(1) of this section, of the commencement or continuation of an action or proceeding by a governmental unit to enforce such governmental unit's police or regulatory power;

(5) under subsection (a)(2) of this section, of the enforcement of a judgment, other than a money judgment, obtained in an action or proceeding by a governmental unit to enforce such governmental unit's police or regulatory power;

(6) under subsection (a) of this section, of the setoff by a commodity broker, forward contract merchant, stockbroker, financial institutions, or securities clearing agency of any mutual debt and claim under or in connection with commodity contracts, as defined in section 761(4) of this title, forward contracts, or securities contracts, as defined in section 741(7) of this title, that constitutes the setoff of a claim against the debtor for a margin payment, as defined in section 741(5) or 761(15) of this title, or settlement payment, as defined in section 741(8) of this title, arising out of commodity contracts, forward contracts, or securities contracts against cash, securities, or other property held by or due from such commodity broker, forward contract merchant, stockbroker, financial institutions, or securities clearing agency to margin, guarantee, secure, or settle commodity contracts, forward contracts, or securities contracts;

(7) under subsection (a) of this section, of the setoff by a repo participant, of any mutual debt and claim under or in connection with repurchase agreements that constitutes the setoff of a claim against the debtor for a margin payment, as defined in section 741(5) or 761(15) of this title, or settlement payment, as defined in section 741(8) of this title, arising out of repurchase agreements against cash, securities, or other property held by or due from such repo participant to margin, guarantee, secure or settle repurchase agreements;

(8) under subsection (a) of this section, of the commencement of any action by the Secretary of Housing and Urban Development to foreclose a mortgage or deed of trust in any case in which the mortgage or deed of trust held by the Secretary is insured or was formerly insured under the National Housing Act and covers property, or combinations of property, consisting of five more [sic] living units;

(9) under subsection (a) of this section, of the issuance to the debtor by a governmental unit of a notice of tax deficiency;

(10) under subsection (a) of this section, of any act by a lessor to the debtor under a lease of nonresidential real property tbat has terminated by the expiration of the stated term of the lease before the commencement of or during a case under this title to obtain possession of such property; or [sic]

(11) under subsection (a) of this section, of the presentment of a negotiable instrument and the giving of notice of and protesting dishonor of such an instrument;

(12) under subsection (a) of this section, after the date which is 90 days after the filing of such petition, of the commencement or continua-

the fundamental debtor protections provided by the bankruptcy

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tion, and conclusion to the entry of final judgment, of an action which involves a debtor subject to reorganization pursuant to chapter 11 of this title and which was brought by the Secretary of Transportation under the Ship Mortgage Act, 1920 (46 App. U.S.C. 911 et seq.) (including distribution of any proceeds of sale) to foreclose a preferred ship or fleet mortgage, or a security interest in or relating to a vessel or vessel under construction, held by the Secretary of Transportation under section 207 or title XI of the Merchant Marine Act, 1936 (46 App. U.S.C. 1117 and 1271 et seq., respectively), or under applicable State law; or

(13) under subsection (a) of this section, after the date which is 90 days after the filing of such petition, of the commencement or continuation, and conclusion to the entry of final judgment, of an action which involves a debtor subject to reorganization pursuant to chapter 11 of this title and which was brought by the Secretary of Commerce under the Ship Mortgage Act, 1920 (46 App. U.S.C. 911 et seq.) (including distribution of any proceeds of sale) to foreclose a preferred ship or fleet mortgage in a vessel or a mortgage, deed of trust, or other security interest in a fishing facility held by the Secretary of Commerce under section 207 or title XI of the Merchant Marine Act, 1936 (46 App. U.S.C. 1117 and 1271 et seq. respectively).

The provisions of paragraphs (12) and (13) of this subsection shall apply with respect to such petition filed on or before December 31, 1989.

(c) Except as provided in subsections (d), (e), and (f) of this section—

(1) the stay of an act against property of the estate under subsection (a) of this section continues until such property is no longer property of the estate; and

(2) the stay of any other act under subsection (a) of this section continues until the earliest of—

(A) the time the case is closed;

(B) the time the case is dismissed; or

(C) if the case is a case under chapter 7 of this title concerning an individual or a case under chapter 9, 11, 12, or 13 of this title, the time a discharge is granted or denied.

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or

(2) with respect to a stay of an act against property under subsection (a) of this section, if—

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization.

(e) Thirty days after a request under subsection (d) of this section for relief from the stay of any act against property of the estate under subsection (a) of this section, such stay is terminated with respect to the party in interest making such request, unless the court, after notice and hearing, orders such stay continued in effect pending the conclusion of, or as a result of, a final hearing and determination under subsection (d) of this section. A hearing under this subsection may be a preliminary hearing, or may be consolidated with the final hearing under subsection (d) of this section. The court shall order such stay continued in effect pending the conclusion of the final hearing under subsection (d) of this section if there is a reasonable likelihood that the party opposing relief from such stay will prevail at the conclusion of such final hearing. If the hearing under this subsection is a preliminary hearing, then such final hearing laws."[6] The automatic stay gives the debtor "a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy."[7] The stay also protects creditors from each other, preventing a "race of diligence by creditors for the debtor's assets"[8] and encouraging "an orderly liquidation procedure under which all creditors are treated equally."[9]

Although the section 362 automatic stay protects the debtor and its creditors, it does not appear to offer the same protection to co-debtors.[10] By its terms, the stay in section 362 applies only to actions against the debtor.[11] Thus, unless a court enjoins the action, creditors may generally proceed against co-debtors without interference.[12] Nevertheless, some co-debtors have sought to prevent actions against them when debtors have sought to reorganize under

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> shall be commenced not later than thirty days after the conclusion of such preliminary hearing.
>
> (f) Upon request of a party in interest, the court with or without a hearing, shall grant such relief from the stay provided under subsection (a) of this section as is necessary to prevent irreparable damage to the interest of an entity in property, if such interest will suffer such damage before there is an opportunity for notice and a hearing under subsection (d) or (e) of this section.
>
> (g) In any hearing under subsection (d) or (e) of this section concerning relief from the stay of any act under subsection (a) of this section—
>
> (1) the party requesting such relief has the burden of proof on the issue of the debtor's equity in property; and
>
> (2) the party opposing such relief has the burden of proof on all other issues.
>
> (h) An individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages.

Id.

6 H.R. REP. No. 595, 95th Cong., 1st Sess. 340 (1977), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6296. The Senate Report contains identical language. S. REP. No. 989, 95th Cong., 1st Sess. 54, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5840.

7 H.R. REP. No. 595, *supra* note 6, at 340, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6296-97.

8 *Id.*, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6297.

9 *Id.*

10 *But see* A.H. Robins Co. v. Piccinin, 788 F.2d 994 (4th Cir.) (applying section 362 stay to actions against third parties), *cert. denied*, 107 S. Ct. 251 (1986).

11 *E.g.*, *In re* Johns-Manville Corp., 26 Bankr. 405 (Bankr. S.D.N.Y. 1983) (denying extension of automatic stay to cover co-debtors), *aff'd*, 40 Bankr. 219 (S.D.N.Y. 1984); *In re* Johns-Manville Corp., 26 Bankr. 420 (Bankr. S.D.N.Y. 1983), *aff'd*, 40 Bankr. 219 (S.D.N.Y.), *rev'd in part on other grounds*, 41 Bankr. 926 (S.D.N.Y. 1984).

12 One exception to this proposition is an action that concerns property of the estate. If a nondebtor is in possession of property of the estate, or if the action itself is property of the estate, enabling the debtor or trustee to bring it on behalf of creditors, the action may be stayed by section 362. Bankruptcy Code section 362(a)(3) (West Supp. 1987). *See, e.g.*, *In re* S.I. Acquisition, Inc., 817 F.2d 1142 (5th Cir. 1987); A.H. Robins v. Piccinin, 788 F.2d 994 (4th Cir.), *cert. denied*, 107 S. Ct. 251 (1986).

Chapter 11 of the Bankruptcy Code. In seeking to stay these actions, co-debtors have echoed many of the same justifications that underlie the section 362 automatic stay. Principals of debtor corporations have maintained that actions against them would interfere with the debtors' reorganizations because the actions would divert their attention from the debtors' businesses or prevent them from infusing capital into the debtors. Partners of debtor partnerships have made similar claims. Insurers have justified the issuance of stays because they will have only limited funds to distribute among all claimants.

Although there are limited co-debtor stays in Chapters 12 and 13,[13] Chapter 11 of the Bankruptcy Code does not contain a co-debtor stay provision. The absence of an explicit co-debtor stay in Chapter 11, however, has not prevented some courts from staying actions against co-debtors.[14] These courts have found the authority to issue co-debtor stays in their general equitable power under section 105, which empowers the court[15] to "issue any order . . . that is necessary or appropriate to carry out the provisions of this title."[16]

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13 Bankruptcy Code §§ 1201, 1301 (West Supp. 1987).

14 *See, e.g.*, *In re* Monroe Well Serv., 67 Bankr. 746 (Bankr. E.D. Pa. 1986); *In re* Rustic Mfg., 55 Bankr. 25 (Bankr. W.D. Wis. 1985); *In re* Kasual Kreation, Inc., 54 Bankr. 915 (Bankr. S.D. Fla. 1985); *In re* Arrow Huss, Inc., 51 Bankr. 853 (Bankr. D. Utah 1985); *In re* Johns-Manville Corp., 26 Bankr. 420 (Bankr. S.D.N.Y. 1983), *aff'd*, 40 Bankr. 219 (S.D.N.Y.), *rev'd in part on other grounds*, 41 Bankr. 926 (S.D.N.Y. 1984); *In re* Otero Mills, Inc., 21 Bankr. 777 (Bankr. D.N.M.), *aff'd*, 25 Bankr. 1018 (D.N.M. 1982).

15 The Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333, deleted the references to "bankruptcy" court and granted the power to "[t]he court." By deleting the word "bankruptcy," Congress intended to conform to the jurisdictional amendments that placed bankruptcy jurisdiction in the district court, subject to reference to the bankruptcy court. Congress did not intend to deprive bankruptcy courts of their traditional equity power; rather, Congress merely indicated that the district court exercising bankruptcy jurisdiction also has equity power. 2 L. King, Collier on Bankruptcy ¶ 105.01, at 105-2 (15th ed. 1986) [hereinafter Collier on Bankruptcy (15th ed.)]. This reasoning is supported by section 105(c), which specifically refers to "district court," indicating that when Congress meant district court it knew how to say that. The deletion of "bankruptcy," suggests therefore, that Congress intended the section 105 power to be available to bankruptcy courts as well as to district courts which, under the 1984 amendments, have jurisdiction over bankruptcy matters. In 1986 Congress further amended section 105 to permit the court to act *sua sponte*. Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 203, 100 Stat. 3088, 3097.

16 Bankruptcy Code § 105 (West Supp. 1987). The full text of section 105 states:

> (a) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provision of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.
>
> (b) Notwithstanding subsection (a) of this section, a court may not appoint a receiver in a case under this title.
>
> (c) The ability of any district judge or other officer or employee of a

Many courts, however, have refused to issue co-debtor stays, either because the facts did not seem to justify such an extraordinary remedy[17] or because they believed that the Bankruptcy Code does not authorize such a stay in Chapter 11.[18]

However, few courts have carefully analyzed the interests involved or attempted to articulate and apply meaningful standards to co-debtor stay requests. Indeed, few courts have attempted even to offer a principled basis for such an extraordinary remedy. Consequently, reaction to co-debtor stay requests remains unpredictable at best, and the lack of a clear basis for the issuance of co-debtor stays has made the search for meaningful standards difficult.

In Section I of this article I demonstrate that section 105 of the Bankruptcy Code does indeed authorize a co-debtor stay in Chapter 11. I next identify, in Section II, the most significant bankruptcy and nonbankruptcy interests that a co-debtor stay implicates, and present a general framework for balancing these often competing interests, allocating burdens among the parties, and determining the proper scope of a stay. The balance of this article, Sections III(A)-(D), applies this general framework of analysis to four situations in which co-debtor stay issues have arisen: debt guarantees by principals of a debtor; liability of general partners for debts of the partnership; liability of "responsible persons" for "trust fund" taxes owed by a debtor; and liability of insurers of a debtor.[19]

> district court to exercise any of the authority or responsibilities conferred upon the court under this title shall be determined by reference to the provisions relating to such judge, officer, or employee set forth in title 28. This subsection shall not be interpreted to exclude bankruptcy judges and other officers or employees appointed pursuant to chapter 6 of title 28 from its operation.

Id.

17 *See, e.g.*, *In re* Philadelphia Gold Corp., 56 Bankr. 87 (Bankr. E.D. Pa. 1985); *In re* Elec. Theatre Restaurants Corp., 53 Bankr. 458 (N.D. Ohio 1985); *In re* Brookfield Tennis, Inc., 29 Bankr. 1 (E.D. Wis. 1982).

18 *See, e.g.*, *In re* Aboussie Bros. Constr. Co., 8 Bankr. 302 (E.D. Mo. 1981); *In re* Venture Properties, 37 Bankr. 175 (Bankr. D.N.H. 1984). *See also*, Austin v. Unarco Indus., 705 F.2d 1 (1st Cir.) (rejecting applicability of Bankruptcy Code section 362 to co-defendants and alluding to section 1301 as evidence of legislature's ability explicitly to authorize co-debtor stay when so intended), *cert. dismissed*, 463 U.S. 1247 (1983).

19 Co-debtor stay requests typically arise in these situations. Other situations may raise co-debtor stay or analogous issues. For example, a section 362 stay may implicate actions against co-defendants. *E.g.*, A.H. Robins Co. v. Piccinin, 788 F.2d 994 (4th Cir.) (debtor A.H. Robins obtained stay of actions against nonbankrupt co-defendants in products liability action after plaintiffs sought to sever action against A.H. Robins and proceed against co-defendants), *cert. denied*, 107 S. Ct. 251 (1986); *In re* Johns-Manville Corp., 26 Bankr. 405 (Bankr. S.D.N.Y. 1983) (refusing to extend stay to actions against nonbankrupt co-defendants), *aff'd*, 40 Bankr. 219 (S.D.N.Y. 1984). *See also In re* S.I. Acquisition, Inc., 817 F.2d 1142 (5th Cir. 1987) (staying "alter ego" action against non-debtors); *In re* Ozark Restaurant Equip. Co., 816 F.2d 1222 (8th Cir.) (refusing to stay "alter ego" action), *cert. denied sub nom.* Jacoway v. Anderson, 108 S. Ct. 147 (1987); Mitchell Excavators, Inc. v. Mitchell, 734 F.2d 129 (2d Cir. 1984) (stockholders' deriva-

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Authority to Issue Co-Debtor Stays

A. Co-Debtor Stays Under the Prior Bankruptcy Act

Section 2(a)(15) of the current Bankruptcy Code's predecessor, the Bankruptcy Act of 1898, empowered the bankruptcy court to "make such orders, issue such process, and enter such judgments, in addition to those specifically provided for as may be necessary for the enforcement of the provisions of this Act."[20] Through this provision, Congress expressly affirmed the bankruptcy court's inherent power as a court of equity.[21] The test that developed for applying the broad authorization of section 2(a)(15) to nonbankruptcy actions was whether "the proceeding in the non-bankruptcy court interferes with the possession or custody of the bankruptcy court, or unduly impedes or embarrasses the court in its administration under the Act."[22]

Bankruptcy courts generally used their section 2(a)(15) power to protect property of the estate and to aid in estate administration. They rarely enjoined actions against nonbankrupt co-debtors, with most courts expressing some doubt about their jurisdiction to enjoin actions that involved neither the debtor nor its property.[23]

In part, this doubt related to the limited jurisdiction of the bankruptcy court under the Bankruptcy Act of 1898. The court's

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tive action stayed); Gold v. Johns-Manville Sales Corp., 723 F.2d 1068 (3d Cir. 1983) (refusing to stay actions against nonbankrupt co-defendants); Lynch v. Johns-Manville Sales Corp., 710 F.2d 1194 (6th Cir. 1983) (same); Wedgeworth v. Fibreboard Corp., 706 F.2d 541 (5th Cir. 1983) (vacated in part on reh'g, 706 F.2d 541, 548) (same). Principals may also expose themselves to criminal liability for actions taken on behalf of a debtor. This in turn raises issues similar to those in a direct creditor action. *E.g.*, *In re* Dettler Farms, 58 Bankr. 404 (D.S.D. 1986) (barring creditor from using criminal prosecution to obtain preference); *In re* Heart of the City, 52 Bankr. 108 (Bankr. S.D. Fla. 1985) (refusing to enjoin state criminal action because criminal proceeding not being used to obtain payment of debt).

20 Bankruptcy Act of 1898, ch. 541, § 2(a)(15), 30 Stat. 544, 546 (1898) (formerly codified at 11 U.S.C. § 11 (1976)), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 401(a), 92 Stat. 2549, 2682.

21 1 J. Moore & L. King, Collier on Bankruptcy ¶ 2.61, at 323 (14th ed. 1974) [hereinafter Collier on Bankruptcy (14th ed.)].

22 *Id.* at 327.

23 *See, e.g.*, *In re* Magnus Harmonica Corp., 233 F.2d 803 (3d Cir. 1956); McGinnis Lumber Co. v. Belser, 385 F. Supp. 390 (D.S.C. 1974). *See also In re* Adolf Gobel, Inc., 80 F.2d 849 (2d Cir. 1936) (court has no jurisdiction to enjoin action against subsidiary); *In re* Beck Indus., 338 F. Supp. 1369 (S.D.N.Y. 1972) (same); *In re* Patten Paper Co., 86 F.2d 761 (7th Cir. 1936) (same result in action against stockholder of bankrupt). *But see In re* Equity Funding Corp. of Am., 396 F. Supp. 1266 (C.D. Cal. 1975) (court has inherent jurisdiction under section 2(a)(15) to enjoin actions against debtor's subsidiaries where actions would interfere with court's valuation of debtor and determination of whether debtor's plan is fair, equitable and feasible, and actions would delay reorganization and cause loss of value of subsidiary as going concern), *aff'd*, 519 F.2d 1274 (9th Cir. 1975); *In re* Old Orchard Inv. Co., 31 Bankr. 599 (W.D. Mich. 1983).

summary jurisdiction encompassed only actions involving property in the actual or constructive possession of the court, and the administration of the estate.[24] Even the district court's plenary jurisdiction extended only to other actions involving the bankrupt or property of the estate.[25] Because actions against co-debtors only indirectly affected the bankrupt, courts found it difficult to justify an extension of their section 2(a)(15) power to those actions.

B. Section 105 of the Current Bankruptcy Code

Section 105 of the Bankruptcy Code is the successor to section 2(a)(15) of the prior Act. It empowers the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."[26] Under this provision, courts have found the authority to grant co-debtor stays in appropriate cases.[27] Interestingly, however, few courts have explicitly reconciled their broader construction of section 105 with the pre-Code cases that construed a similarly worded statute as barring co-debtor stays.[28]

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24 Bankruptcy Act of 1898, ch. 541, § 2, 30 Stat. 544, 545 (1898) (formerly codified at 11 U.S.C. § 11 (1976)), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 401(a), 92 Stat. 2549, 2682 (1978) *See* 1 COLLIER ON BANKRUPTCY (14th ed.), *supra* note 21, at ¶ 2.09.

25 Bankruptcy Act of 1898, ch. 541, § 23, 30 Stat. 544, 552-53 (1898) (formerly codified at 11 U.S.C. § 46 (1976)), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 401(a), 92 Stat. 2549, 2682 (1978).

26 Bankruptcy Code § 105 (West Supp. 1987).

Before the 1984 amendments, 28 U.S.C. § 1481 (1982) (repealed 1984) provided the bankruptcy courts with the general powers of a court of equity, law, and admiralty. Section 113 of the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333, 343, rendered ineffective the statutory provision that had created 28 U.S.C. § 1481 (Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 241, 92 Stat. 2549, 2671). However, section 121(a) of the 1984 Act also provided that the amendments made in 1978 are effective as of July 10, 1984, including, apparently, the addition of 28 U.S.C. § 1481. Notwithstanding the conflicting provisions, Congress probably intended to repeal 28 U.S.C. § 1481. *See,* 2 COLLIER ON BANKRUPTCY (15th ed.), *supra* note 15, ¶ 105.02, at 105-3.

Similarly, the 1978 Act amended 28 U.S.C. § 451 to include bankruptcy courts in the term "court of the United States," giving them the authority of the All Writs Act, 28 U.S.C. § 1651 (1982). Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 213, 92 Stat. 2549, 2661 (1978). As with section 1481, the 1984 Act probably repealed this section.

Thus, the sole remaining authority for the issuance of an injunction staying litigation against nondebtors is probably section 105.

27 *E.g., In re* Kasual Kreation, Inc., 54 Bankr. 915 (Bankr. S.D. Fla. 1985) (guarantor); *In re* Comark, 53 Bankr. 945 (Bankr. C.D. Cal. 1985) (partner); *In re* Arrow Huss, Inc., 51 Bankr. 853 (Bankr. D. Utah 1985) (guarantor); *In re* Otero Mills, Inc., 21 Bankr. 777 (Bankr. D.N.M.) (guarantor), *aff'd,* 25 Bankr. 1018 (D.N.M. 1982).

28 In *In re* Venture Properties, 37 Bankr. 175 (Bankr. D.N.H. 1984), the court alluded to the similarity between section 2(a)(15) of the prior Bankruptcy Act and section 105 of the Bankruptcy Code as supporting its assertion that stay protection should not extend to co-debtors.

1. *Expanded Jurisdiction Under the Code*

Perhaps the broader construction of section 105 derives from the expanded jurisdiction of the bankruptcy court under the Code. Although the prior Act confined the court's jurisdiction to "the debtor and his property, wherever located,"[29] the Bankruptcy Code contains a significantly broader jurisdictional grant to the district court, covering "all civil proceedings arising under title 11, or arising in or related to cases under title 11."[30] The district court in turn may refer any or all proceedings to the bankruptcy judges in the district under a complex set of rules.[31]

A civil proceeding is "related to a case under title 11" if the

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29 Act of June 22, 1938, ch. 575, § 311, 52 Stat. 906 (1938). *See In re* Monroe Well Serv., 67 Bankr. 746, 753 (Bankr. E.D. Pa. 1986) ("the court's jurisdiction [under the previous Act] was *in rem*").

30 28 U.S.C.A. § 1334(b) (West Supp. 1987). The Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978), had placed this broad jurisdiction in the district court but provided that the bankruptcy court "shall exercise all of the jurisdiction conferred by this section on the district courts." 28 U.S.C. § 1471(c), *superseded by* 28 U.S.C.A. § 1334 (West Supp. 1987). In addition, 28 U.S.C. § 1471(e) provided the bankruptcy court with jurisdiction over all property of the debtor as of the commencement of the case. In response to the Supreme Court's opinion in Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982), finding the bankruptcy courts established by the 1978 Act unconstitutional, Congress enacted a different jurisdictional scheme in 1984. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1984). The 1984 amendments placed bankruptcy jurisdiction in the district court, 28 U.S.C.A. § 1334 (West Supp. 1987), which may refer any and all cases and proceedings under title 11 to the bankruptcy court. 28 U.S.C.A. § 157 (West Supp. 1987). The district court also has exclusive jurisdiction over property of the debtor as of the commencement of the case, and over property of the estate. 28 U.S.C.A. § 1334(d) (West Supp. 1987).

31 28 U.S.C.A. § 157 (West Supp. 1987).

Bankruptcy judges to whom cases and proceedings are referred may "hear and determine . . . all core proceedings . . . and may enter appropriate orders and judgments." 28 U.S.C.A. § 157(b)(1) (West Supp. 1987). A bankruptcy judge may also hear a noncore proceeding that is related to a bankruptcy case that was filed under title 11, but, absent consent of all the parties, he must submit proposed findings of fact and conclusions of law to the district court, which alone has the power to enter orders and judgments on noncore matters, and may review the bankruptcy judge's findings *de novo*. 28 U.S.C.A. § 157(c)(1) (West Supp. 1987).

A suit by a creditor against a co-debtor who is not himself in bankruptcy is a noncore proceeding under section 157(c). *See* 1 COLLIER ON BANKRUPTCY (15th ed.), *supra* note 15, ¶ 3.01[2][b][ii]. An attempt by the debtor to stay the creditor's action, however, is not intended to resolve the parties' state law rights. *See In re* Monroe Well Serv., 67 Bankr. 746, 754 (Bankr. E.D. Pa. 1986); *In re* Rustic Mfg., 55 Bankr. 25, 28-29 (Bankr. W.D. Wis. 1985). If the basis for obtaining a co-debtor stay is prevention of interference with the reorganization process, arguably the stay is part of the administration of the debtor's estate, or at least a type of "other proceedings affecting . . . the adjustment of the debtor-creditor or the equity security holder relationship." 28 U.S.C.A. § 157(b)(2)(O) (West Supp. 1987). The stay is not the type of proceeding that the Supreme Court found objectionable in Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 488 U.S. 50 (1982). Therefore, the co-debtor stay proceeding constitutes a core proceeding that a bankruptcy court may hear and determine.

outcome of the proceeding would affect the estate being administered in bankruptcy.[32] Because the co-debtor often justifies a stay request with the argument that staying the direct action will aid the debtor's reorganization effort, the outcome of the direct action against the co-debtor will have an effect on the bankruptcy case. Thus, the bankruptcy court has jurisdiction to hear the co-debtor stay request.[33] If lack of jurisdiction formed the basis for denying co-debtor stays under the Bankruptcy Act, then the expanded jurisdiction in the Code may have encouraged courts to construe section 105 to permit co-debtor stays in some circumstances, notwithstanding the pre-Code cases.[34]

Interpreting section 105 in light of the Code's expanded jurisdiction is consistent with the legislative intent to expand the power as well as the jurisdiction of the bankruptcy courts.[35] The theme running through the legislative history of the Code is one of enabling the bankruptcy courts to do virtually anything necessary and appropriate to effectuate the purposes of the bankruptcy law.[36] This would include, in the reorganization context, appropriate action to aid the debtor's reorganization effort.

2. *Co-debtor Stays Elsewhere in the Code*

Before accepting the proposition that section 105 and the broadened jurisdiction of the bankruptcy court expands the availa-

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32 *See, e.g.*, Pacor Inc. v. Higgins, 743 F.2d 984, 994 (3d Cir. 1984).

33 Although the court has jurisdiction based on the effect on the debtor's estate, the court could not appropriately issue an injunction under section 105 unless the action caused a significant adverse effect on the estate. *See infra* Section II(A). A court also could conceivably assert jurisdiction using the section 1334 "arising under" language—the debtor seeks the co-debtor stay under section 105, therefore the stay may "aris[e] under" that section.

34 *See, e.g.*, *In re* Monroe Well Serv., 67 Bankr. 746, 753 (Bankr. E.D. Pa. 1986); *In re* Lion Capital Group, 44 Bankr. 690, 701 (Bankr. S.D.N.Y. 1984). *But see In re* Aboussie Bros. Constr. Co., 8 Bankr. 302 (E.D. Mo. 1981) (finding no jurisdiction under 1978 Bankruptcy Code to stay actions against nonbankrupt debtors).

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> Section 105(a) is a major departure from pre-Code law in that it is in no way circumscribed by possession or custody of a *res*. The basic purpose of the section is to enable the court to do whatever is necessary to aid its jurisdiction, *i.e.*, anything arising in or relating to a bankruptcy case. This might affect third parties who pose a threat to the bankruptcy case, even if there is no *res* involved and no state court suit pending.

2 COLLIER ON BANKRUPTCY (15th ed.), *supra* note 15, ¶ 105.02, at 105-03.

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> A major impetus underlying this reform legislation has been the need to enlarge the jurisdiction of the bankruptcy court . . . .
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> [E]xcept where the bankruptcy court abstains from hearing an action or proceeding . . . all cases under title 11 and all civil actions and proceedings arising under or related to cases under title 11 are to be before the bankruptcy judge.

S. REP. No. 989, *supra* note 6, at 17-18, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 5803-04.

bility of co-debtor stays to Chapter 11, it is necessary to reconcile the absence of an explicit co-debtor stay provision in Chapter 11 with the limited co-debtor stay provisions of section 1301 for Chapter 13 consumer cases[37] and section 1201 for Chapter 12 family farmer cases.[38] The existence of these express stay provisions indicates that Congress was aware of the possibility of a co-debtor stay and knew how to authorize one when it thought it appropriate. The absence of co-debtor stay language in Chapter 11 may be viewed as implying, therefore, that Congress had no desire to overrule pre-Code cases and enact a co-debtor stay outside of Chapters 12 and 13.[39]

The different operation of a co-debtor stay in Chapters 12 and 13 as compared to a Chapter 11 co-debtor stay may lend some support to the belief that Chapter 11 does not authorize such a stay. Section 1201 and 1301 co-debtor stays generally remain operative

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[37] Bankruptcy Code § 1301 (West 1979 & Supp. 1987). The full text of section 1301 is as follows:

> (a) Except as provided in subsections (b) and (c) of this section, after the order for relief under this chapter, a creditor may not act, or commence or continue any civil action, to collect all or any part of a consumer debt of tbe debtor from any individual that is liable on such debt with the debtor, or that secured such debt, unless—
> (1) such individual became liable on or secured such debt in the ordinary course of such individual's business; or
> (2) the case is closed, dismissed, or converted to a case under chapter 7 or 11 of this title.
> (b) A creditor may present a negotiable instrument, and may give notice of dishonor of such an instrument.
> (c) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided by subsection (a) of this section with respect to a creditor, to the extent that—
> (1) as between the debtor and the individual protected under subsection (a) of this section, such individual received the consideration for the claim held by such creditor;
> (2) the plan filed by the debtor proposes not to pay such claim; or
> (3) such creditor's interest would be irreparably harmed by continuation of such stay.
> (d) Twenty days after the filing of a request under subsection (c)(2) of this section for relief from the stay provided by subsection (a) of this section, such stay is terminated with respect to the party in interest making such request, unless the debtor or any individual that is liable on such debt with the debtor files and serves upon such party in interest a written objection to the taking of the proposed action.

Id.

[38] Bankruptcy Code § 1201 (West Supp. 1987). The text of section 1201 is almost identical to that of section 1301. *See supra* note 37. The only difference is the omission from section 1201 of language concerning conversion of the case to a case under Chapter 11. This omission recognizes that a Chapter 12 case may not be converted to Chapter 11. Bankruptcy Code § 1208. *See In re* Cbristy, 80 Bankr. 361 (Bankr. E.D. Va. 1987).

[39] *See* Austin v. Unarco Indus., 705 F.2d 1 (1st Cir.) (rejecting applicability of section 362 to co-defendants and alluding to section 1301 as evidence of legislature's ability to authorize co-debtor stay explicitly when intended), *cert. dismissed*, 463 U.S. 1217 (1983).

only to the extent that the debtor proposes a plan that calls for payment of the obligation.[40] In the Chapter 11 context, however, the debtor will not yet even have proposed a plan when the co-debtor stay request arises, and will not yet have begun making payments on the obligation.[41] Thus, the creditor of a Chapter 11 debtor is in a much worse position if the court stays the creditor's action against co-debtors than a creditor stayed by section 1201 or 1301. In Chapter 11 the creditor is unlikely to be receiving payments while the stay is in effect; nor can it be certain that the plan will provide for full payment of its claim. When a court issues a co-debtor stay in Chapter 11, therefore, the court is not only expanding upon pre-Code law, but it is doing so in a manner that goes beyond even the express co-debtor stays that Congress did enact in sections 1201 and 1301.

Nevertheless, Congress did not explicitly reject the concept of a co-debtor stay in proceedings other than Chapters 12 and 13, and the broad language of section 105, coupled with the court's expanded jurisdiction, provides some basis for such a stay.[42] Indeed, the legislative history of the Bankruptcy Code shows that Congress intended courts to construe their section 105 power broadly.[43]

Furthermore, the different way in which a Chapter 11 co-debtor stay takes effect lends support to the belief that the explicit stays in sections 362, 1201, and 1301 are not evidence of an intention to bar a co-debtor stay in Chapter 11. The explicit debtor and co-debtor stay provisions in the Bankruptcy Code operate automatically. To obtain a co-debtor stay in Chapter 11, on the other hand, the debtor (or trustee)[44] must seek the co-debtor stay. Thus, a creditor of a

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40 A creditor may obtain relief from the section 1301 stay to the extent that the debtor's plan does not propose payment of the claim. Bankruptcy Code § 1301(c)(2). The stay is automatically terminated 20 days after a request for relief under section 1301(c)(2) unless the debtor or co-debtor files a written objection to such termination. Courts may also grant relief from the stay if, inter alia, the creditor's "interest would be irreparably harmed by continuation of such stay." Bankruptcy Code § 1301(c)(3). This would seem to require a showing of an imminent adverse change in the co-debtor's circumstances. *See* H.R. REP. No. 595, *supra* note 6, at 426, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6381-82.

41 *Cf. In re* A.J. Mackay Co., 50 Bankr. 756 (C.D. Utah 1985) (Chapter 11 co-debtor stay unavailable in confirmed plan; only basis for stay is to ease plan proposal and confirmation process).

42 *See* H.R. REP. No. 595, *supra* note 6, at 342, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6298; S. REP. No. 989, *supra* note 6, at 51, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 5837 ("The court has ample other powers to stay actions not covered by the automatic stay. Section 105, of proposed title 11, derived from Bankruptcy Act § 2a(15), grants the power to issue orders necessary or appropriate to carry out the provisions of title 11."). *See also infra* note 154.

43 *See* H.R. REP. No. 595, *supra* note 6, at 342, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6298.

44 Bankruptcy Code section 1107 authorizes a debtor in possession to exercise

Chapter 11 debtor may generally take action against co-debtors, unless the court has specifically forbidden such actions.

In omitting an explicit co-debtor stay from Chapter 11, therefore, Congress may simply have been rejecting any automatic bar to actions against co-debtors. Congress may also have intended to put the burden of moving for a stay on the debtor, rather than requiring the creditor to show why a court should modify or dissolve a stay.[45] Neither the rejection of an automatic bar nor the different distribution of burdens should prevent a court from using its broad section 105 injunctive power when appropriate.[46]

However, the omission of an explicit co-debtor stay provision from Chapter 11, the explicit Chapter 12 and 13 co-debtor stays, and the pre-Code cases limiting the court's power to enjoin actions against co-debtors, do suggest that a court should use its section 105 power sparingly and in only the clearest cases.[47] Moreover, because the debtor must take affirmative action to obtain a co-debtor stay, a court has the opportunity to limit the scope and effect of the

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most of the powers of a trustee. *See also* Bankruptcy Code § 1106. The court may order the appointment of a trustee either for cause or if the appointment is in the interest of creditors, equity security holders, and other interests of the estate. Bankruptcy Code § 1104(a).

45 *See* Bankruptcy Code §§ 362(d), 1201(c), 1301(c) (West 1979 & Supp. 1987). *But see* Bankruptcy Code § 362(g) (party requesting relief has burden of proving lack of equity in property but party opposing relief (debtor) has burden of proof on all other issues). Section 1301 originally required notice and a hearing before a party in interest could obtain relief from a co-debtor stay under that section. In 1984 Congress added subsection (d), which provides for automatic termination of the stay 20 days after a request for relief based on the absence of a payment provision in the debtor's plan, unless the debtor timely objects to termination of the stay. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, §§ 313, 524, 98 Stat. 333, 355-56, 388. The creditor seeking relief must still initiate the process, however, and the stay remains in effect until it is properly terminated.

46 Congress made clear that a court may stay actions exempted from the section 362 automatic stay using its general injunctive power:

> Stays or injunctions issued under [section 105] will not be automatic upon the commencement of the case, but will be granted or issued under the usual rules for the issuance of injunctions. By excepting an act or action from the automatic stay, the bill simply requires that the trustee move the court into action, rather than requiring the stayed party to request relief from the stay. There are some actions . . . that generally should not be stayed automatically upon the commencement of the case, for reasons of either policy or practicality. Thus, the court will have to determine on a case-by-case basis whether a particular action which may be harming the estate should be stayed.

H.R. REP. No. 595, *supra* note 6, at 342, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6298.

47 In addition, the jurisdictional problems raised in Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982), and the Congressional response to those problems in the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333, suggest that bankruptcy courts should not overextend the reach of their injunctive power.

stay in order to reduce the interference with nonbankruptcy interests.[48]

II
A Framework for Analyzing Co-Debtor Stay Requests

A. Identifying Competing Bankruptcy and Nonbankruptcy Interests

As a general rule, bankruptcy should not affect a creditor's rights against nonbankrupt third parties.[49] In many cases, the creditor will have relied on expected rights against third parties in extending credit to the debtor; any interference with the creditor's actions against the parties may well frustrate these expectations. For example, when a creditor requires a guaranty from a third party as a condition for extending credit, the creditor protects itself against the principal debtor's bankruptcy as well as other defaults. Similarly, in extending credit to a partnership, creditors may be relying on the unlimited liability of the general partners as well as the business assets and future income of the partnership. Presumably the creditor agrees to extend credit or sets the terms of the loan at least in part in reliance upon this additional avenue of recovery. This additional avenue of recovery, however, loses much of its value if a court later delays or prevents its enforcement.

Even if a creditor did not rely on a co-debtor's liability, interfering with the direct action will often implicate other interests. For instance, the tax collector will not have relied on co-debtor liability in "permitting" a debtor to incur tax liability, but society's interest in collecting taxes and preventing tax avoidance—interests that lead us to impose certain tax liabilities on principals of a corporate debtor—will suffer if a court stays actions against those corporate principals. Similarly, although tort claimants do not rely on the existence of insurance when they incur claims against a debtor, if bankruptcy interferes with the enforcement of claims against insur-

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48 Other potential statutory bases for a co-debtor stay exist, but none is as strong section 105. Some courts have held that they may stay certain actions against co-debtors under section 362. *E.g.*, A.H. Robins Co. v. Piccinin, 788 F.2d 994 (4th Cir.), *cert. denied*, 107 S. Ct. 251 (1986). These include actions against parties who are so identified with the debtor as to make the action in effect one against the debtor. *Id.* at 999; Seybolt v. Bio-Energy of Lincoln, 38 Bankr. 123 (Bankr. D. Mass. 1984). They also include actions that affect property of the debtor. *A.H. Robins*, 788 F.2d at 1001; *In re* Davis, 730 F.2d 176 (5th Cir. 1984). In addition, the bankruptcy court is a court of equity, 28 U.S.C. § 1334 (Supp. III 1985), and as such has inherent power to grant a stay as part of the "efficient management of its docket." *A.H. Robins*, 788 F.2d at 1003.

49 *E.g.*, Bankruptcy Code § 524(e) (1982) ("Except as provided . . . discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.").

ers it may frustrate society's interest in compensating such claimants.

Yet, in reality, bankruptcy does interfere with many of the rights and expectations of creditors. Bankruptcy is a collective proceeding intended to maximize the assets available to all creditors and to distribute those assets equitably among creditors. In reorganization, where most co-debtor stay requests arise, a plan for the continued operation of the debtor and the satisfaction of creditor claims will often best serve the maximization and distribution goals. Bankruptcy law protects the debtor from individual creditors in order to more equitably benefit all of the creditors. The emphasis, however, is on protection of the debtor for the benefit of creditors. Thus, any interference with creditors' rights against third parties should be limited to furthering bankruptcy's goals of maximizing the assets available to creditors and equitably distributing those assets among creditors.

The co-debtor stay blocks the nonbankruptcy remedy normally available to, and often relied upon by, the creditor and thus disrupts the nonbankruptcy scheme for protecting creditors. Therefore, the stay—an extraordinary equitable remedy—is appropriate only if the benefit to the bankruptcy system outweighs the interference with the nonbankruptcy system. In deciding whether to stay actions against co-debtors, a court's first consideration must be whether permitting the direct action to proceed will significantly interfere with the bankruptcy process or its underlying policies.

One underlying bankruptcy goal in a reorganization "is 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."[50] To that end, "[t]he stay gives the

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50 H.R. REP. No. 595, *supra* note 6, at 220, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6179.

Professor Jackson has argued that the notion of keeping firms in business is not a bankruptcy policy, and that firms should be kept in business only when the value to creditors and shareholders of maintaining the business as a going concern, with consideration of the risks imposed, exceeds the value of liquidating the firm. The calculation should be no different within bankruptcy than without. *See* T. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 23-25 (1986). Professor Jackson maintains that the purpose of bankruptcy law is to maximize the pool of assets available for distribution and to distribute those assets in accordance with nonbankruptcy rules. *Id.* Although some commentators have disagreed with this characterization of bankruptcy law, *see, e.g.*, Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987); Carlson, *Philosophy in Bankruptcy*, 85 MICH. L. REV. 1341 (1987) (reviewing T. JACKSON, *supra*); *but see* Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987), all seem to agree that maximization of the available assets will often require preservation of the going concern value of the business. Co-debtor stay issues arise after the decision has been made to attempt to preserve the operating business, regardless of the standard applied to reach that decision.

debtor the opportunity to bring all of its creditors together for discussion, explanation of the debtor's financial problems, and negotiation. Creditors are prevented from acting unilaterally to gain an advantage over other creditors or to pressure the debtor into action."[51] As the case proceeds, the business may continue to operate and the debtor, under the supervision of the court, takes actions necessary to reduce losses and preserve the value of the business.[52] All of this, of course, requires the attention of the principals of the debtor.

If related litigation against the principals of a debtor prevents them from devoting their undivided time and energy to the debtor's reorganization effort, the litigation will interfere with the bankruptcy goals. Collateral litigation may thwart the policy of encouraging the parties to negotiate and implement a reorganization plan. If the principals of the debtor cannot devote the proper energy to manage the debtor, liquidation, rather than successful reorganization, may be more likely. Moreover, related litigation against the principals may drain resources from the debtor if the debtor must aid the principals with discovery requests or provide essential information.

Similarly, if the debtor is relying on its principals to fund a reorganization plan, direct actions against co-debtor principals may reduce their ability to provide funds to the debtor. If the litigation against the principals is successful, funds earmarked for the reorganization, which would presumably benefit all creditors, would instead ultimately benefit only the creditor directly suing the principals.

If a particular creditor "grabs" assets that would have been available for the benefit of creditors generally, or to a class of creditors, then that too will interfere with bankruptcy policy. If the assets are "property of the estate," then the trustee will be able to recover them from the overreaching creditor.[53] Yet, even if the assets are not technically property of the estate, permitting the trustee to oversee their use or distribution instead of relegating the creditors to a race to the courthouse may better serve bankruptcy's equitable distribution policy.

The degree to which litigation against a co-debtor interferes with bankruptcy goals will vary with the particular facts of the case.

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51 H.R. REP. No. 595, *supra* note 6, at 220, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6180.

52 *Id.*

53 Bankruptcy Code § 549 (West 1979 & Supp. 1987) (authorizing trustee to avoid post-petition transfers). *Cf.*, Bankruptcy Code § 547 (West Supp. 1987) (authorizing avoidance of certain pre-petition transfers that interfere with equitable distribution of debtor's assets).

To some extent, any litigation against a principal will divert some of his attention from the business and may adversely affect his ability to fund a plan. For that matter, a divorce or death in the family may have a similar effect. The bankruptcy court is simply not an appropriate forum for stopping the clock on a principal's life in an effort to retain his undivided energy and attention. The principal can obtain the benefit of a bankruptcy stay by filing his own bankruptcy petition and submitting himself to the jurisdiction of the bankruptcy court.[54] Absent such submission, the court should not interfere with nonbankruptcy remedies against the principal except in extraordinary circumstances.

Thus, the debtor, not the co-debtor, properly has standing to seek a co-debtor stay. Because the co-debtor has not submitted himself to the jurisdiction of the bankruptcy court through his own bankruptcy filing, the co-debtor has effectively foregone that protection.[55] Any co-debtor stay is strictly for the protection of the debtor, not the co-debtor. This is easily overlooked because, as a practical matter, the co-debtor often seeks the stay, notwithstanding that he does so through the debtor. Nevertheless, keeping the two parties separate is important in order to focus on the debtor's need for the stay rather than the co-debtor's desire for protection.

Furthermore, bankruptcy should not interfere with actions unrelated to the debtor in bankruptcy. For example, the mere fact that a principal must deal with other aspects of his life while the debtor's reorganization proceeds fails to justify extending the protection of the bankruptcy court. Entities who dealt with the principal in his capacity as principal may have assumed some risk that the adverse financial condition of the debtor would affect their dealings. Those who dealt with the principal as an individual unrelated to the debtor, however, assumed no such risk and should not suffer adverse consequences flowing from the unrelated bankruptcy of the debtor.

If a direct action against a co-debtor does not significantly interfere with underlying bankruptcy policies, then the court should permit the action to proceed. If the action does cause significant interference, then the court must determine whether any policy underlying the nonbankruptcy action is strong enough to override the

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54 *See, e.g.*, *In re* Juneau's Builders Center, 57 Bankr. 254, 256-57, 258-59 (Bankr. M.D. La. 1986); *In re* Kalispell Feed and Grain Supply, 55 Bankr. 627 (Bankr. D. Mont. 1985).

55 The court emphasized this in *In re* Venture Properties, 37 Bankr. 175 (Bankr. D.N.H. 1984). *See also* Rosenberg, *Partnership Reorganization Under the Bankruptcy Reform Act: Filling in the Interstices*, 56 N.Y.U. L. REV. 1173, 1194 (1981) (partner always free to file for bankruptcy as individual, but until he does so, both individual and partnership creditors can pursue him).

bankruptcy policies. Where there are strong political or economic reasons for permitting the nonbankruptcy action to proceed, then a court must balance these against the interference with bankruptcy policies.[56] In addition, where criminal laws or tax laws are involved, a court must consider whether the importance of the bankruptcy policies outweighs the public policies underlying those laws.

In this regard it is important to remember that any co-debtor stay is, by its nature, temporary. Section 524(e) of the Bankruptcy Code states that discharge of a debtor does not affect the liability of third parties on an obligation.[57] Thus, the stay will expire either on its own terms or upon the close of the case, and the creditor may proceed against the co-debtor.

Notwithstanding the temporary nature of the stay, however, the delay that a stay causes may be substantial, and may adversely affect the creditor's rights. Thus, only when the balance clearly favors the bankruptcy goals should a court consider granting a co-debtor stay.

The court will have to strike this balance based on all of the facts and circumstances before it. As the next section of this Article shows, a variety of factors may reasonably come into play. Certainly a court must compare the benefit to the debtor with the actual cost to the creditor. Similarly, a court must carefully consider the importance of the bankruptcy and nonbankruptcy policies that the stay request implicates. In addition, a court should consider the underlying basis for the co-debtor's liability. If the debtor is to receive the protection of a co-debtor stay—albeit indirect protection—then the debtor should have received the benefit originally. Moreover, it is reasonable for the court to consider the debtor's general business practices, the purpose of its Chapter 11 filing, and whether the debtor and co-debtor have dealt fairly and openly with the creditor in the particular transaction at issue.[58] In other words, because any co-debtor stay is an equitable remedy, the court should consider all the equities inherent in the positions of the various parties.

B. Assigning Burdens

A court will have difficulty determining with mathematical precision most of the factors involved in balancing the bankruptcy and nonbankruptcy policies. Because a co-debtor stay in Chapter 11 is an extraordinary remedy, the debtor should bear the burden of ini-

56 *E.g.*, Kelly v. Robinson, 107 S. Ct. 353 (1986) (criminal law); Penn Terra Ltd. v. Dep't of Envtl. Resources, 733 F.2d 267 (3d Cir. 1984) (environmental law).

57 Bankruptcy Code § 524(e) (1982).

58 Nimmer, *Secured Creditors and the Automatic Stay: Variable Bargain Models of Fairness*, 68 Minn. L. Rev. 1, 17 (1983).

tially going forward with evidence and of proving the need for a co-debtor stay.

Because the basis of the stay is the interference with the bankruptcy process, the debtor's initial burden is to show that pursuit of the action against the co-debtor would severely and adversely affect the reorganization effort. In making this showing, the debtor must prove both that interference would result, and that without such interference there would be a reasonable probability of a successful reorganization. After all, if the reorganization effort is likely to fail regardless of whether the action against the co-debtor proceeds, there is little reason to stay the action.[59]

When the debtor seeks a stay early in the case, showing the probability of a successful reorganization plan will be difficult, because the debtor is unlikely to have effectively sorted out its affairs at that point. In that case, some leniency would be appropriate.[60] Perhaps early in the case it would suffice to show that a successful effort is not impossible.[61] As the case proceeds, however, the court should review this finding, and if success appears less likely, the court may lift any co-debtor stay that was previously imposed.

Once the debtor has met the threshold burden of showing the interference and the probability of a successful reorganization, the burden should shift to the creditor to provide evidence showing that a co-debtor stay would seriously interfere with nonbankruptcy policies underlying the creditor's claim. Assigning this burden to the creditor is appropriate because the creditor best understands the basis of its claim and can best determine the manner of interference with the policies underlying that claim. Nevertheless, because a co-debtor stay is an extraordinary remedy, once the creditor introduces some evidence, the burden of proving that the bankruptcy policies outweigh the nonbankruptcy policies should be on the debtor. Thus, the debtor should show that the court's failure to grant a stay would impede the reorganization process more than a stay would impede the nonbankruptcy policies involved.

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59 *Cf.* United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 108 S. Ct. 626, 632 (1988) ("What [section 362(d)(2)] requires is not merely a showing that if there is conceivably to be an effective reorganization, this property will be needed for it; but that the property is essential for an effective reorganization *that is in prospect*. . . . [T]here must be 'a reasonable possibility of a successful reorganization within a reasonable time.' " (quoting *In re* Timbers of Inwood Forest Assocs., 808 F.2d 363, 370-71 & nn.12-13 (5th Cir. 1987) (en banc), *aff'd sub nom.* United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 108 S. Ct. 626 (1988)).

60 *See, e.g., In re* Monroe Well Serv., 67 Bankr. 746, 755 (Bankr. E.D. Pa. 1986); *In re* Dore & Assocs. Contracting, 54 Bankr. 353, 359 (Bankr. W.D. Wis. 1985).

61 If such an effort is not possible, the appropriate course for creditors is to convert the case to a liquidation. *See* Bankruptcy Code § 1112 (West 1979 & Supp. 1987).

C. Protecting the Creditor

Even if the debtor carries its burden, and the court stays the creditor's action against the co-debtor, the extraordinary nature of the remedy may require that the debtor provide the creditor with some protection of the creditor's rights against the co-debtor. This is analogous to the position of a secured creditor of the debtor. Both the secured creditor and the creditor with a right of action against a co-debtor have rights separate from their in personam right against the debtor. Both look to those rights as an additional, and at times a preferable, means of collecting their claims. Just as bankruptcy law protects the secured creditor[62] similar protection is appropriate when a court imposes a co-debtor stay.

In some cases, the creditor will have only an unsecured claim against the co-debtor, with no particular right to any of the co-debtor's property. A stay would prevent the creditor from obtaining the judgment necessary to establish a right to that property, as well as prevent the creditor from enforcing any pre-existing judgment.[63] While a co-debtor stay remains in effect, other creditors of the co-debtor—perhaps creditors with claims unrelated to the debtor—might obtain judgments against the co-debtor and interests in the co-debtor's property that would take priority over the stayed creditor's claim.[64] Moreover, the co-debtor might transfer or encumber his property, putting it beyond the reach of the creditor. Finally, the co-debtor might simply dissipate his assets, leaving nothing for the creditor when the stay expires.[65]

In view of these potential adverse effects, protection for the creditor should accompany the co-debtor stay. If the creditor be-

62 Bankruptcy Code §§ 361, 362(d), 363(e) (West 1979 & Supp. 1987) (all requiring adequate protection of secured party's interest). *See also* United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 108 S. Ct. 626 (1988) (discussing scope of protection required when secured party delayed in asserting state law remedies against debtor's property); *In re* Briggs Transp. Co., 780 F.2d 1339 (8th Cir. 1985); Grundy Nat'l Bank v. Tandem Mining Corp., 754 F.2d 1436 (4th Cir. 1985); *In re* American Mariner Indus., 734 F.2d 426 (9th Cir. 1984).

63 In the tax context, it would prevent the Internal Revenue Service from obtaining a tax lien on the co-debtor's property. *See* I.R.C. §§ 6321-23 (West 1979 & Supp. 1987).

64 In general, the rule in debtor-creditor relations is first in time, first in right. Thus, if other creditors obtain interests in the co-debtor's property while a court stays one creditor, the other creditors will normally have priority to that property. *See, e.g.*, N.Y. Civ. Prac. L. & R. 5202 (McKinney 1978 & Supp. 1987). *See also* U.C.C. §§ 9-201, 9-301(1)(b) (1972) (perfected secured party has priority over subsequent lien creditor).

65 Fraudulent conveyance law will offer the creditor some protection, permitting a creditor to recover from a transferee property transferred for inadequate consideration. Unif. Fraudulent Conveyance Act §§ 4, 5, 7A U.L.A. 474 (1918); Unif. Fraudulent Transfer Act § 4, 7A U.L.A. 652 (1984). This would not help the creditor if the creditor cannot locate the transferred property, or if the dissipation involved consumption of the property.

lieves that protection of his interest is appropriate, he should demand the protection when the debtor requests a stay. Because the debtor and co-debtor best know how they might protect the creditor, the debtor should propose the means of adequate protection, which the court may approve or reject.[66] Such protection might take the form of a lien on the co-debtor's property during the pendency of the stay, an injunction barring the co-debtor from transferring or encumbering his assets, the posting of some bond to protect the creditor, or other appropriate relief.[67]

If the creditor has already obtained an interest in the co-debtor's property, then protection would assure that the value of the creditor's interest does not decrease while the stay remains in effect.[68] Certainly the creditor with a secured claim against a third party should receive at least as much protection as a creditor with a secured claim against the debtor.[69] When the co-debtor is an individual, the type of assets involved will usually not rapidly depreciate in value.[70] In that case, a court should have no difficultly devising appropriate protection for the creditor. In the event that the property is rapidly depreciating, a court may require periodic payments to the creditor to protect the value of the creditor's interest in the collateral.[71]

The extraordinary nature of the co-debtor stay also dictates that

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66 This would parallel the procedure for providing adequate protection in other bankruptcy contexts. *See, e.g.*, Bankruptcy Code §§ 362(d)(1) (automatic stay), 363(e) (use, sale, or lease of property) (West 1979 & Supp. 1987).

67 *Cf.* Bankruptcy Code § 361 (West 1979 & Supp. 1987). Because the co-debtor is not in bankruptcy, interest should continue to accumulate against him, and the question of whether the creditor is entitled to recover its "opportunity cost" should not arise. *See also* United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 108 S. Ct. 626 (1988); Grundy Nat'l Bank v. Tandem Mining Corp., 754 F.2d 1436 (4th Cir. 1985); *In re* Briggs Transp. Co., 780 F.2d 1339 (8th Cir. 1985); *In re* American Mariner Indus., 734 F.2d 426 (9th Cir. 1984). *American Mariner* may, however, provide a basis for requiring that the co-debtor make periodic interest payments when a stay delays payment of the principal. *American Mariner*, 734 F.2d at 435. Because the adequate protection requirement in these co-debtor stay cases is not directly derived from Bankruptcy Code sections 361 and 362, such interest payments are apparently not barred by the *Timbers of Inwood* case.

68 *Cf.* Bankruptcy Code § 361 (West 1979 & Supp. 1987).

69 *See* Bankruptcy Code § 362(d)(1) (West Supp. 1987).

70 When adequate protection problems arise in the business context, the collateral is usually inventory, accounts, or equipment, the value of which may change significantly during the pendency of the stay. This problem should not arise with respect to the most common personal assets that co-debtors likely have given as security.

71 It is unclear whether the debtor or the co-debtor should more appropriately make these payments. The justification for a co-debtor stay is that the *debtor* benefits; therefore, the debtor might reasonably pay for that benefit. This is particularly true if the co-debtor's property will help fund the reorganization effort. If the property remains with the co-debtor, however, the co-debtor more directly benefits. As a general rule, the co-debtor is the more appropriate party to make the periodic payments both because the co-debtor's property is encumbered, and because the co-debtor owes the debt.

its scope and duration be no greater than necessary. Unlike the section 362 stay, which may last for the duration of the case,[72] the co-debtor stay should expire as soon as the extraordinary protection of the co-debtor is no longer necessary to further the debtor's reorganization.[73] Thus, for example, if a court issues a stay because a principal's efforts are necessary to enable a debtor to adjust to operations under Chapter 11, the stay should expire upon completion of that adjustment.[74] If at that time another basis for such a stay exists, the debtor must persuade the court of that new basis.

III
APPLYING CO-DEBTOR STAY PRINCIPLES

The balance of this article applies the general analysis developed above to the four most common situations in which a debtor will seek a co-debtor stay. This extended analysis will clarify and develop the competing interests a co-debtor stay implicates, as well as provide parties and courts with further, more concrete guidance when co-debtor stay issues arise. The first section considers co-debtor stays when a guarantor will provide funds for the overall reorganization of the debtor, and when the direct action against the co-debtor will otherwise interfere with the debtor's effort to reorganize. The next section analyzes stays of actions against general partners of a debtor partnership. The third section discusses the right of the Internal Revenue Service to recover "trust fund" taxes from a principal of a debtor. Although much of the analysis developed in the context of guarantors applies, there are several additional issues that merit separate treatment. The final section analyzes co-debtor stay requests where the direct action is against an insurer of the debtor.

A. Personal Guaranties

1. *Guarantor to Provide Funding for Reorganization*

Probably the most common situation in which a debtor seeks a co-debtor stay in Chapter 11 involves an action on a personal guaranty given by a principal of a debtor corporation. Because claims against a corporation can generally be satisfied only out of corporate assets,[75] when there is any doubt about a corporation's future

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72 Bankruptcy Code § 362(c)(2) (West 1979 & Supp. 1987).

73 *E.g., In re* A. J. Mackay Co., 50 Bankr. 756 (C.D. Utah 1985) (although temporary co-debtor stay during plan formulation court may issue, permanent co-debtor stay in reorganization plan is impermissible).

74 *E.g., In re* Arrow Huss, Inc., 51 Bankr. 853 (Bankr. D. Utah 1985).

75 H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 73 (3d ed. 1983).

ability to satisfy its obligations, creditors may seek guaranties from the principals. If the corporation subsequently petitions for bankruptcy, the creditors holding guaranties naturally will want to proceed against the guarantors immediately.[76]

Bankruptcy of a corporation should not normally interfere with a creditor's action against a guarantor. The very purpose of obtaining a guaranty is to enable the creditor to collect from the guarantor if the corporation defaults. And, indeed, in most cases enforcement of the guaranty will not interfere with the corporation's bankruptcy. Property of the individual guarantor, not of the corporate debtor, will go to satisfy any judgment on the guaranty. Under suretyship law the guarantor will receive a right of reimbursement or indemnification from the corporation whose debt the guarantor pays,[77] and he will also receive a right of subrogation to the creditor's rights against the debtor.[78] The practical effect of these rights, however, is essentially to substitute the guarantor for the original creditor.[79] The section 362 automatic stay will prevent the guarantor from enforcing his rights against the corporate debtor just as it stayed the creditor from acting against the corporation or its property.[80]

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[76] Typically, the bankruptcy filing will constitute a default under the loan agreement and will trigger the guarantor's liability. If the creditor recovers from the guarantor, the guarantor will have an action for reimbursement against the debtor corporation and, in addition, may be subrogated to the rights of the creditor. *See* Carl, *Fraudulent Transfer Attacks on Guaranties in Bankruptcy*, 60 AM. BANKR. L.J. 109 (1986). The guarantor is, in effect, substituted for the creditor in the bankruptcy. *See also* Bankruptcy Code §§ 502(e), 509 (West 1979 & Supp. 1987). Thus, from the debtor's point of view, the liability remains the same and the debtor should have no interest in whether the guarantor must pay. As a practical matter, however, because the guarantor is a principal of the debtor, the debtor does have an interest in the collateral litigation.

Guaranties also arise outside the corporate context. An individual may guarantee partnership obligations or obligations of another individual. Similar issues may arise when there is a close connection between the principal debtor and the guarantor. The guarantee of corporate debts presents the clearest example of the co-debtor stay issues that arise in this context, however, because the guarantor is so often the moving force behind the corporation.

[77] *See, e.g.*, RESTATEMENT OF SECURITY § 104 (1941). *Cf.* Bankruptcy Code § 502(e) (West Supp. 1987) (court shall disallow contribution claim where subrogation asserted).

[78] *See, e.g.*, RESTATEMENT OF SECURITY § 141 (1941). *Cf.* Bankruptcy Code § 509 (1982 & Supp. III 1985).

[79] *But see In re* Metal Center, 31 Bankr. 458 (Bankr. D. Conn. 1983) (guarantor entitled by contract to indemnity; suit against guarantor stayed because outcome of suit would bind debtor).

[80] The guarantor seeking reimbursement may be in a better position than the creditor if the guaranty, but not the creditor's loan, is secured. Under sections 502 and 509 of the Bankruptcy Code, the guarantor may elect subrogation, in which case he receives the creditor's (unsecured) rights against the debtor, or reimbursement, in which case he enforces his own (secured) rights against the debtor. Bankruptcy Code §§ 502, 509 (West 1979 & Supp. 1987). The guarantor may choose whichever remedy is more advantageous to him. If the guaranty is secured, therefore, the guarantor may enforce the

Nevertheless, there are instances when enforcing a guaranty may interfere with the successful reorganization of the debtor corporation. The prime example of this occurs when the guarantor is also planning to fund a reorganization plan out of his individual assets. If the creditor enforces the guaranty, he may prevent implementation of a Chapter 11 plan that is dependent on the additional funding. The creditor may also, in effect, receive preference[81] to assets that would otherwise be available to all of the debtor's creditors through the principal's funding of the reorganization plan. Thus, immediate enforcement of the guaranty may adversely affect both the bankruptcy policies of encouraging the reorganization effort and of equitably distributing available assets.

In one sense, the creditor is entitled to a "preference" because he had the foresight to require a guaranty as a condition for extending credit to the corporation.[82] The creditor's position is analogous to that of a secured creditor. Both the creditor holding the guaranty and the secured creditor obtained an alternative method of satisfying the obligation if the debtor defaulted. In addition, both the guaranty and the security interest are consensual security upon which the creditor relied in extending credit. Thus, the guaranty is, in effect, simply another form of security for repayment of a debt.

There are significant differences, however, between the security interest and the guaranty. The security interest is a lien on property that becomes property of the bankruptcy estate,[83] and is, therefore, directly within the court's jurisdiction. Moreover, the security interest directly affects the *debtor's* assets and reduces the value of those assets to other creditors. The guaranty, on the other hand, is an obligation of a third party, and is neither itself an interest in property of the estate nor directly subject to bankruptcy court jurisdiction.[84] In other words, the security interest represents an enforceable property interest in bankruptcy while the guaranty rep-

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security interest pursuant to his right of reimbursement. *See* 3 COLLIER ON BANKRUPTCY (15th ed.), *supra* note 15, ¶ 502.05.

81 I use the term "preference" according to the lay definition. *E.g.*, RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 1524 (2d ed. 1987) ("the act of preferring . . . a practical advantage given to one over others"). Enforcement of the guaranty would not, of course, be considered a bankruptcy preference because the property sought is not property of the estate while it belongs to the guarantor, and any transfer occurs after, not before, the commencement of the bankruptcy case. *See* Bankruptcy Code § 547 (West 1979 & Supp. 1987) (identifying preferences for purposes of bankruptcy law). *Cf.* Bankruptcy Code § 549 (West Supp. 1987) (once property becomes property of estate, trustee in bankruptcy may void any unauthorized transfer).

82 *See, e.g.*, *In re* Sondra, Inc., 44 Bankr. 205 (Bankr. E.D. Pa. 1984).

83 Bankruptcy Code § 541(a) (West 1979 & Supp. 1987). *See, e.g.*, United States v. Whiting Pools, 462 U.S. 198 (1983) (property belongs to estate even after repossession).

84 *See* Bankruptcy Code § 541(a) (West 1979 & Supp. 1987) (only debtor's legal or equitable interest in property is property of estate).

resents an *in personam* right against a party who has not submitted himself to bankruptcy court jurisdiction.[85]

These differences are meaningful when the guarantor is not financing a reorganization by the debtor. In that case, the guarantor's assets are wholly separate from those of the debtor and would not be available in any case for creditors who do not hold guaranties. Thus, there is generally little reason to delay enforcement of such guaranties.[86]

If the guarantor is financing the reorganization, however, the situation more closely resembles that of a security interest. The guarantor's assets still do not belong to the debtor or to the creditors, but the assets will be available to support a reorganization effort if the creditor holding the guaranty does not acquire them first. Here, as with a secured creditor, any preferred position the creditor holding a guaranty might gain should not be allowed to unduly interfere with the successful implementation of a reorganization plan.[87] Thus, if enforcement of the guaranty would interfere with the funding of a reorganization plan, the bankruptcy court may consider delaying enforcement of the guaranty.

If a court delays or prevents creditors from enforcing the guaranties they receive, then creditors will place less value on personal guaranties. In many cases, inducing a creditor to lend to a less credit worthy entity requires an effective guaranty by a solvent entity. At the very least, the effectiveness of the guaranty may affect the cost of credit because a creditor will increase the interest rate as the risk involved increases.[88] Thus, although delaying enforcement of a guaranty may aid a particular debtor, it may harm debtors generally.

Of course, debtors generally will suffer harm only if the ability

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85 Another difference between the security interest and the guaranty is that the debtor grants the security interest, while the guaranty is given by a third party for the benefit of the debtor.

86 *But see infra* text accompanying notes 117-34.

87 *See, e.g.*, Bankruptcy Code § 362(d) (Supp. III 1985) (court may lift or modify stay only if property not necessary for effective reorganization).

88 *See* Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 875 (1982). Unlike the secured credit situation in which the price of unsecured credit can be expected to decrease if effective security is unavailable, *see* Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981), because the guaranty does not drain assets from the debtor's estate, other creditors are unaffected by the guaranty and will be unlikely to change their rates in response to the enforceability or unenforceability of the guaranty. The only effect on other creditors is the likelihood that the guaranteed loan will be at a lower rate if the guaranty is effective, and the lower rate enables the debtor to devote less of its income stream to the payment of interest on that obligation, freeing up income for other uses. Thus, unlike secured credit, an enforceable guaranty actually benefits unsecured creditors, albeit indirectly.

to use personal guaranties to obtain credit otherwise benefits them. I believe that it does. With respect to corporate debtors, because guaranties impose personal liability on principals who serve as guarantors, principals presumably will willingly guarantee corporate obligations only when they reasonably believe that the venture will succeed. In effect, the guarantee may serve as a filtering mechanism that will enable the corporate debtor to avoid ventures in which the risks outweigh potential benefits. The burden of evaluating the opportunity, and the risk of failure, is to some extent shifted from the creditor to the corporate principals, who presumably have more and higher quality information about the opportunity. Moreover, the personal liability undertaken through the guaranty may increase the principals' incentive to diligently pursue and succeed in the venture. The guarantee, therefore, enables the debtor to obtain the financing, often at a lower rate of interest, necessary to undertake a venture that has a reasonable likelihood of success. In addition, the benefit obtained through the guaranty imposes no direct cost on the debtor's other creditors.[89]

The additional contingent liability the guarantor incurs as a result of the guaranty may adversely affect other creditors of the guarantor. Yet the guarantor usually receives the chance to participate in the venture and in the potential of reward from that participation. Absent overt fraud, this should constitute sufficient consideration to justify the guarantor's additional liability.[90] Creditors of the guarantor could reasonably expect the guarantor to undertake this type of risk. Thus, from the point of view of both the corporate debtor and the guarantor, as well as from their respective creditors' points of view, guaranties are worth protecting.

The effectiveness of a guaranty is reduced to the extent that a creditor is delayed in enforcing it. Thus, just as the Bankruptcy Code seeks to minimize the damage to the secured party's interest that any delay in the enforcement of a security interest may cause, a court granting a co-debtor stay request must also take pains to protect the creditor who holds a guaranty. In the secured party's case, section 362(d) authorizes the court to lift or modify the stay of enforcement of the security interest: (1) for cause, including the lack of adequate protection of the secured party's interest; or (2) when

89 This assumes that the corporation's reimbursement obligation is not secured. If the obligation is not secured, then enforcement of the guaranty will entitle the guarantor to substitute itself for the creditor in enforcing rights against the corporate debtor, *see supra* notes 77-78, but courts will treat the guarantor as an unsecured creditor. If the reimbursement obligation is secured, then the potential cost to other creditors is similar to the costs imposed on them by secured credit. *See generally* Schwartz, *supra* note 88.

90 *See, e.g.*, Blumberg, *Intragroup (Upstream, Cross-Stream, and Downstream) Guaranties Under the Uniform Fraudulent Transfer Act*, 9 CARDOZO L. REV. 685, 689 (1987).

the debtor has no equity in the property and the property is not necessary for a successful reorganization.[91]

Analogously, if the need for the guarantor's assets to fund the reorganization justifies staying enforcement of the guaranty, then the court could condition the stay on the debtor (or the guarantor) providing adequate protection of the creditor's interest.[92] While the creditor's interest, unlike that of a secured party, is often not in particular property, if the creditor can show that it could enforce and collect on the guaranty but for the stay, then the court should protect that potential recovery.

Section 361 suggests three means by which the debtor or guarantor might protect a creditor's interest against a decrease in value. The debtor may make periodic payments to the creditor, offer the creditor an additional or replacement lien on property, or otherwise offer the creditor relief that will enable the creditor to realize "the indubitable equivalent" of its interest.[93] Because the theory behind staying the action against the co-debtor is that the debtor receives some tangible benefit from the stay, it would not be inappropriate to view the debtor as responsible for protecting the creditor's interest, at least to the extent of that benefit.

For example, when the guarantor is supplying funding to the debtor's reorganization effort, the creditor might receive a lien on the assets the guarantor is providing to the debtor or on other assets of equivalent value. If the assets are decreasing in value, the debtor, who now has use of the assets provided by the guarantor, could make periodic payments to maintain the value of the "collateral."[94]

Alternatively, a court might grant the creditor an administrative priority in the bankruptcy proceeding to the extent that he can show

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91 Bankruptcy Code § 362(d) (West Supp. 1987). *See also id.* § 363(e) (calling for adequate protection when trustee uses, sells, or leases property subject to interest of another entity).

92 *See supra* notes 62-74 and accompanying text.

93 Bankruptcy Code § 361(3) (1982 & Supp. III 1985).

94 *See supra* note 71. These payments, as well as other costs of adequate protection, would presumably come out of assets that otherwise would be available to the debtor's other unsecured creditors. The justification for this transfer from the other creditors to the creditor holding the guaranty is that the forbearance by the creditor enables the debtor to use assets to maintain the going concern value of the business, thus affording all of the creditors a larger pie from which to receive satisfaction of their claims. In effect, the obligation would be analogous to one incurred in a section 364 post-petition financing. Although the financing would initially come from the guarantor, protection of the creditor is appropriate because the creditor would have obtained the assets but for the stay. If the guarantor had paid the creditor on the guaranty and the creditor had thereafter loaned money to the debtor under section 364, the creditor could obtain an enforceable lien on property of the estate or be entitled to other protection. Thus, it is really the creditor's interest in the guarantor's assets that is protected when the creditor in this situation receives protection from the debtor.

that the delay interfered with his ability to obtain satisfaction from the guarantor. Because sections 361 and 362 do not directly cover protection of a guarantor's interest, the section 361 prohibition of the use of an administrative priority for the secured creditor as adequate protection would not apply.[95] Again, if the debtor and its creditors are receiving a benefit from the co-debtor stay, the cost of the stay properly rests with them.[96]

Protection of the creditor's interest through a lien, periodic payments, or an administrative priority would be justified because the creditor could presumably have obtained a lien on or otherwise asserted a claim to those assets in the hands of the guarantor but for the stay.[97] To the extent that the lien or administrative priority approximates the value of the assets provided to the debtor by the guarantor as part of the postpetition financing, protection of the creditor's claim to those assets does not adversely affect other creditors of the debtor. In effect, the guarantor may be viewed as providing postpetition financing in which the security interest or administrative priority authorized by section 364 runs to the creditor of the guarantor rather than to the guarantor himself.[98]

Of course, if the guarantor is solvent, an injunction to prevent the guarantor from dissipating his assets may suffice to protect the creditor. Alternatively, if assets are available, then the guarantor could grant a lien on his available assets, retaining use and possession of them and putting off litigation over the effectiveness of the guaranty. Or the court might require the guarantor to post a bond

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95 124 CONG. REC. 32,395 (1978) (statement of Rep. Edwards); *id.* at 33,994-95 (statement of Sen. DiConcini); *cf.* Bankruptcy Code § 364 (1982 & Supp. III 1985).

96 *See supra* note 94.

97 Even if the guarantor transferred the assets to the corporate debtor before the creditor could obtain a lien on them, the creditor might reach those assets under fraudulent conveyance law if the guarantor was insolvent or rendered insolvent by the transfer and did not receive reasonably equivalent value for the transfer. If the guarantor was neither insolvent nor rendered insolvent by the transfer, the transfer of assets to the debtor would not interfere with the creditor's collection effort. Moreover, no need for staying that effort would exist because the creditor's effort would not deprive the guarantor of assets needed for the reorganization.

98 Provision of a lien or priority to the creditor would mean that the net addition of assets to the estate could be zero. However, as with any post-petition secured financing, the value to the debtor would be in increased liquidity that presumably could enable the debtor to overcome its financial difficulty.

Note that the lien or priority that the creditor receives arises because the guarantor has provided new value to the estate. Thus, although in other circumstances the provision of a lien to a creditor holding a guaranty could be considered a preference, here the lien is effectively coming from new value provided by the guarantor rather than simply from property of the estate. The payment by a guarantor of a guaranteed debt is not considered a preference because there is no transfer of property of the debtor. *See* Bankruptcy Code § 547(b); *cf.* Bankruptcy Code § 524(e). To the extent that the lien or priority approximates the new value provided to the debtor, the creditor is, in effect, receiving its lien or priority from the guarantor rather than from the debtor.

to protect the creditor, similar to posting a bond pending appeal.[99]

Even if adequate protection is available, however, a court should not necessarily stay a creditor action on a guaranty. Section 362(d)(2) requires relief from the automatic stay of an act against property if the debtor has no equity in the property and the property is not necessary for an effective reorganization. A debtor has no equity in the guarantor's property. Analogizing the co-debtor stay to the automatic stay, a court should not stay the creditor's action against the guarantor's property unless the property is necessary for an effective reorganization.[100]

There are two parts to the "necessary for an effective reorganization" requirement. First, the property must be necessary[101] and, second, an effective reorganization must be possible.[102] Thus, if the creditor can show either that the reorganization effort could succeed even without the financing from the guarantor, or that even with the financing a successful reorganization is unlikely, a co-debtor stay is inappropriate.

Of course, in addition to carefully reviewing a debtor's claim that the guarantor's assets will be necessary to fund a plan and that a successful plan is feasible, a court must determine that the guarantor will in fact devote substantial assets to the reorganization should

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99 *See, e.g.*, Fed. R. Civ. P. 62(d) (appellant may obtain stay of enforcement by posting supersedeas bond); N.Y. Civ. Prac. L. & R. 5519 (McKinney 1978 & Supp. 1987) (bond required in most instances in which order for payment of money stayed while on appeal).

100 If this ground were being applied literally, it would affect only enforcement of the guaranty against property, not a lawsuit on the guaranty. However, because a lawsuit may drain the guarantor's assets and otherwise interfere with the guarantor's ability to fund a plan, this ground should not be applied literally in the guaranty context. In other words, if an effective reorganization is possible with the guarantor's assets, any action tbat interferes with the provision of those assets to the debtor may be stayed. Similarly, if the assets are unnecessary or an effective reorganization is not possible, there is no reason to interfere with any action against the guarantor.

101 *See, e.g.*, *In re* Tracy, 194 F. Supp. 293 (N.D. Cal. 1961).

102 *See, e.g.*, Grundy Nat'l Bank v. Tandem Mining Corp., 754 F.2d 1436, 1440 (4th Cir. 1985); *In re* Albany Partners, Ltd., 749 F.2d 670, 673 (11th Cir. 1984); *In re* A.J.N. Enters., 464 F. Supp. 394, 395 (E.D. La. 1978) ("the fact that the secured creditor is adequately protected does not justify an indefinite stay absent some reasonable prospect that the debtor can be reorganized"). The Supreme Court has described the required showing as follows:

> What this requires is not merely a showing that if there is conceivably to be an effective reorganization, this property will be needed for it; but that the property is essential for an effective reorganization *that is in prospect*. This means, as many lower courts, including the en banc court in this case, have properly said, that there must be 'a reasonable possibility of a successful reorganization within a reasonable time.'

United Sav. Ass'n v. Timbers Inwood Forest Assocs., 108 S. Ct. 626, 632 (1988) (quoting *In re* Timbers of Inwood Forest Assocs., 808 F.2d 363, 370 (5th Cir. 1987) (en banc), *aff'd sub nom.* United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 108 S. Ct. 626 (1988)).

the court grant an injunction. It is not sufficient that the guarantor may intend to devote the assets; he must actually do so.

Providing adequate protection, requiring a showing that the funding is necessary for the reorganization, and requiring a showing of the likelihood of a successful reorganization reduces the interference with the nonbankruptcy interests underlying guaranties. By reducing this interference, the likelihood that any bankruptcy interest benefitted by a co-debtor stay may outweigh the nonbankruptcy interest increases. Even with such protection, however, enjoining a creditor from enforcing a guaranty is a severe remedy.

Thus, a court authorizing an interference with a creditor's rights against a guarantor should make the interference as narrow as possible[103] to further reduce the interference with nonbankruptcy policies that results from a co-debtor stay. Consequently, any injunction should be limited in duration and scope to assure that the interference is minimal.[104] Grounding the co-debtor stay in section 105 assures a court the necessary flexibility to fashion an appropriately limited remedy.

If the court recognizes that although the need for the guarantor's assets to fund a corporate reorganization plan may justify interference with the *enforcement* of the guaranty, it does not justify interference with the creditor's right to obtain a judgment against the guarantor, then the court can further reduce interference with the creditor's rights.[105] The judgment would enable the creditor to

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103 If the creditor had not yet obtained an interest in any of the guarantor's property, one might argue that as an unsecured creditor of the guarantor the creditor has no greater right to the guarantor's property than other creditors and that the guarantor may transfer property to the debtor corporation without interference by the creditor. Under this approach, the guarantor may fund the plan and the creditor holding the guaranty would receive no special treatment in the corporation's plan. However, because the creditor holding the guaranty has a claim against the guarantor that other corporate creditors do not have, he has a greater interest in the disposition of the guarantor's assets and courts should treat him accordingly. Moreover, any failure to recognize the creditor's right against the guarantor may run into problems under fraudulent conveyance law. *See*, UNIF. FRAUDULENT CONVEYANCE ACT § 4, 7A U.L.A. 474 (1985); UNIF. FRAUDULENT TRANSFER ACT §§ 4, 5, 7A U.L.A. 652 (1985).

104 For example, in *In re* Otero Mills, Inc., 21 Bankr. 777 (Bankr. D.N.M.), *aff'd*, 25 Bankr. 1018 (D.N.M. 1982), the court enjoined enforcement of a judgment against a principal of the debtor on his guaranty but indicated that if the value of the principal's property on which the creditor held a lien decreased and thereby inadequately protected the creditor, the creditor could request reconsideration of the injunction. *Id.* at 779-80.

105 In *Otero Mills* the court enjoined a creditor from executing or otherwise collecting on its judgment against a principal of the debtor who had guaranteed two loans to the debtor. *Id.* at 779. The court permitted the creditor to obtain a judgment against the guarantor and to enter it in the county records, creating a lien against the guarantor's real property. If the debtor needs the guarantor's energy, time, and effort in addition to his funding to effectuate a successful reorganization, this may provide an independent basis for staying actions against the guarantor. In that event, the process of defending the lawsuit might so distract the principal as to interfere with the reorganiza-

ensure priority to future assets that the guarantor obtains. The court would stay enforcement of the judgment only as long as the guarantor's assets are necessary for funding the plan. However, if the guarantor has other assets, not necessary to fund the reorganization plan, those assets should be made available to satisfy the judgment on the guaranty.[106]

The court must protect against guarantors using the corporate bankruptcy to avoid enforcement of otherwise valid guaranties. If it is clear that courts will limit any interference with enforcement so that it does not taint guaranties generally, the benefit to the bankruptcy process may outweigh the interference with the underlying policies of suretyship law. By assuring the commercial viability of guaranties, courts can enhance the ability of other debtors to obtain needed financing.

The seminal case granting an injunction based on the need to preserve a principal's assets to enable him to finance a reorganization plan is *In re Otero Mills, Inc.*[107] In that case, the debtor sought to enjoin enforcement of a judgment on a guaranty against its president. The debtor contended that the president intended to contribute personal assets to the debtor's reorganization and that enforcement of the judgment would lead to a foreclosure sale of those assets, yielding siguificantly less for all creditors than an orderly property sale in the ordinary course of business.

The court found that section 105 of the Bankruptcy Code empowered it to enjoin a creditor's action against a third party "under appropriate circumstances."[108] In determining whether appropriate circumstances existed, it applied the test used to determine whether a preliminary injunction may issue,[109] requiring the debtor to show: (1) irreparable harm to the bankruptcy estate if the injunction does not issue; (2) strong likelihood of success on the merits; and (3) no harm or minimal harm to the other party or parties.[110] The court held that, based on the facts before it, an injunction could issue.[111]

Interestingly, although the court acknowledged the strict test

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tion. If this independent ground exists, it may provide sufficient reason to stay both litigation and the enforcement of any judgment. *See infra* Section III(A)(2).

106 *See, e.g.*, *In re* Otero Mills, 25 Bankr. at 1022 (bankruptcy court should determine whether enforcement against assets not necessary for plan implementation would harm debtor).

107 21 Bankr. 777 (Bankr. D.N.M.), *aff'd*, 25 Bankr. 1018 (D.N.M. 1982).

108 *Id.* at 778.

109 *See, e.g.*, FED. R. CIV. P. 65. *See also* H.R. REP. No. 595, *supra* note 6, at 342, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6298 (stays of, or injunctions against, actions excepted from automatic stay by section 362(b) may "be granted or issued under the usual rules for the issuance of injunctions").

110 *Otero Mills*, 21 Bankr. at 779.

111 *Id.*

for granting an injunction, it appears to have granted the injunction on rather thin grounds. The court found irreparable harm based solely on the debtor's contention that an orderly sale by the guarantor would yield more money than a foreclosure sale by the creditor, and on the debtor's bare assertion that other creditors would not cooperate if they believed that one creditor—the creditor holding the guaranty—was executing on assets earmarked for the satisfaction of all creditor claims. The court made no attempt to determine the likelihood of success on the merits—which it defined as the probability of a successful reorganization plan—because the debtor's plan was not yet due, making it impossible to evaluate this component of the injunction test. Instead, the court found that the debtor was entitled to present a plan and that an injunction was proper at least until the time for filing a plan expired or until the court denied confirmation of the debtor's plan. Finally, the court found that the creditor would suffer no harm from an injunction because the creditor had already transcripted its judgment; therefore, the creditor now possessed a lien on the guarantor's real property and enjoyed adequate protection at least for the next two months.

The district court ruled on the appeal of the bankruptcy court's injunction over five months later.[112] By that time, the debtor had apparently filed a reorganization plan that used only a portion of the president's property to fund the plan; moreover, the period during which the creditor's protection was found to be sufficient had expired. Nevertheless, the district court affirmed the injunction and permitted it to continue, noting that the creditor could always move for a narrowing or lifting of the injunction if appropriate.[113] The district court also indicated that even if some of the president's property was not used to fund a plan, the bankruptcy court should consider whether "enforcement will affect reorganization by detrimentally pressuring the bankrupt."[114] It thus introduced a new test of irreparable harm—detrimental pressure on the bankrupt—that a court could apply even more liberally than the bankruptcy court's test.

The two opinions in *Otero Mills* fail to inspire confidence in the courts' ability to apply the injunctive power narrowly and in only the clearest cases of siguificant interference with the debtor's reorganization. Neither court made any attempt to determine how much of the president's property was necessary to the reorganization, or whether the president's contribution was necessary at all. There

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112 *In re* Otero Mills, Inc., 25 Bankr. 1018 (D.N.M. 1982).
113 *Id.* at 1022.
114 *Id.*

was no evidence on the likelihood that a contribution by the president would enable the debtor to reorganize successfully. There was little evidence that the creditor had adequate protection and that the protection would continue for the life of the injunction. In essence, both courts seemed to simply take the debtor's word that the injunction was necessary.

Both the bankruptcy and district courts indicated that the creditor failed to introduce evidence on the harm to the debtor or to the creditor. Perhaps these courts meant that they would grant the debtor's request for an injunction unless the creditor provided some evidence indicating that the request was unfounded. However, in view of the serious interference a co-debtor stay poses to the rights of the creditor, courts should demand more of the debtor before they issue an injunction, even if the creditor fails to produce sufficient evidence. In other words, the debtor bears the burden of proving the grounds for an injunction and the creditor's burden of going forward should not arise until the debtor proves its case.

Although other courts have applied the standards for issuance of co-debtor stays more strictly than the courts in *Otero Mills*,[115] the failure to clearly distribute the burdens and to recognize the competing policies involved has resulted in inconsistent outcomes and unpredictable results.[116] Thus, a clearer articulation of the policies involved and more judicious application of the standards for issuance of a co-debtor stay are needed.

2. *Interference with Reorganization Efforts*

The other common justification for a stay of actions against guarantors is that the guarantor is a principal whose efforts are necessary for the successful development and implementation of a reorganization plan, and that litigation on the gnaranty would interfere with the guarantor's effort on behalf of the debtor's reorganization.[117] Here the debtor faces a more difficult task. After all, indi-

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115 *See, e.g., In re* Juneau's Builders Center, 57 Bankr. 254 (Bankr. M.D. La. 1986); *In re* Kalispell Feed and Grain Supply, 55 Bankr. 627 (Bankr. D. Mont. 1985); *In re* Philadelphia Gold Corp., 56 Bankr. 87 (Bankr. E.D. Pa. 1985); *In re* Keyco, Inc., 49 Bankr. 507 (Bankr. E.D.N.Y. 1985).

116 *Compare Juneau's Builders*, 57 Bankr. 254 (injunction denied; court required showing of undue pressure on debtor) *and Philadelphia Gold*, 56 Bankr. 87 (denying injunction) *with In re* Monroe Well Serv., 67 Bankr. 746 (Bankr. E.D. Pa. 1986) (rejecting "restrictive" approach of *Juneau's Builders* and similar cases) *and In re* Kasual Kreation, Inc., 54 Bankr. 915 (Bankr. S.D. Fla. 1985) (granting injunction).

117 *See, e.g., In re* Kasual Kreation, Inc., 54 Bankr. 915 (Bankr. S.D. Fla. 1985); *In re* Arrow Huss, Inc., 51 Bankr. 853 (Bankr. D. Utah 1985); *cf. In re* A.H. Robins Co., 828 F.2d 1023 (4th Cir. 1987) (suit against insurer stayed in part because it would subject debtor's principals to extensive discovery), *cert. denied sub nom.* Oberg v. Aetna Casualty & Sur. Co., 56 U.S.L.W. 3648 (U.S. Mar. 21, 1988) (No. 87-1208); A.H. Robins, Co. v.

viduals always run corporate debtors and the individuals will usually have a significant role in the formulation and implementation of a plan. If the mere fact that the creditor is proceeding against a principal as guarantor justifies an injunction, creditors could never enforce their guaranties.

Most courts have recognized the limited nature of this ground for co-debtor stays. They have required that the debtor or its principals show real and potentially severe interference before enjoining litigation against principals merely because the litigation may divert their attention from the reorganization. Because this is difficult to prove, most courts have refused injunctions on this basis.[118]

Those courts that have granted injunctions have strictly limited their scope and duration. For example, in *In re Arrow Huss, Inc.*[119] the court enjoined litigation against principals of the debtor where creditors had filed an involuntary petition less than a month before the debtor sought an injunction and the principals were still sorting out the effect of the bankruptcy filing. Even there, however, the court limited the injunction to forty-five days.[120] The court apparently felt that this sufficed for the principals to get the debtor's affairs in order. Similarly, in *In re Johns-Manville Corp.*[121] the court limited its injunction to the period during which the debtor had the exclusive right to propose a plan, reasoning that during the plan formulation period the debtor needed the undivided attention and energy of its key officers and directors. The court also limited the injunction's protection to twenty-five key employees of the debtor.[122]

Most courts considering whether to enjoin actions on guaranties in order to protect key employees have adopted the four-part test for the issuance of an injunction under Rule 65 of the Federal

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Piccinin, 788 F.2d 994 (4th Cir.), (same) *cert. denied*, 107 S. Ct. 251 (1986); *In re* Johns-Manville Corp., 26 Bankr. 420 (Bankr. S.D.N.Y. 1983) (tort claimants enjoined from suing or deposing key officers and directors while plan being formulated), *aff'd*, 40 Bankr. 219 (S.D.N.Y.), *rev'd in part on other grounds*, 41 Bankr. 926 (S.D.N.Y. 1984).

118 In *In re* Keyco, Inc., 49 Bankr. 507 (Bankr. E.D.N.Y. 1985), the court found that because the debtor's plan contemplated funding out of operations and did not propose use of the officers' funds, a state court action against the officers on their guaranties would not significantly interfere with the debtor's reorganization. That the officers would divert part of their energy to defense of the state court action was insufficient, by itself, to justify a stay. To hold otherwise would require that bankruptcy courts always stay actions against non-debtor principals, a result that the court was unwilling to accept. *Accord, In re* Kalispell Feed and Grain Supply, 55 Bankr. 627 (Bankr. D. Mont. 1985).

119 51 Bankr. 853 (Bankr. D. Utah 1985).

120 *Id.* at 859.

121 26 Bankr. 420 (Bankr. S.D.N.Y. 1983), *aff'd*, 40 Bankr. 219 (S.D.N.Y.), *rev'd in part on other grounds*, 41 Bankr. 926 (S.D.N.Y. 1984).

122 *Id.* at 426-28.

Rules of Civil Procedure.[123] Under that test, the moving party must establish: (1) a substantial likelihood of success on the merits; (2) that the movant will suffer irreparable injury unless an injunction issues; (3) that the threatened injury to the movant outweighs any damage the injunction may cause the opposing party; and (4) that the injunction would not adversely affect the public interest.[124] Likelihood of success on the merits is the probability of an ultimately successful plan of reorganization.[125] Irreparable harm exists where a failure to enjoin a creditor would adversely affect, influence, or pressure the debtor. Whether the injury to the movant outweighs the damages an injunction may cause requires a balancing of the harm to the debtor that enforcement of the guaranty imposes against the harm to the creditor caused by delaying enforcement. Of course, if the court takes proper measures to protect the creditor's interest, it can decrease the harm to the creditor and tilt the balance toward a stay.[126] When a court considers the public interest, it balances the bankruptcy policies that a stay might further with the nonbankruptcy policies with which a stay would interfere.

In *In re Arrow Huss, Inc.*[127] the court listed three relevant considerations in determining whether an injunction is proper:

> (1) Whether continuation of the litigation against the nondebtor would frustrate the ability of the debtor to develop and go forward with its plan of reorganization.
>
> (2) Whether the debtor is close to having a confirmable plan that will fully satisfy the affected creditor's claims.
>
> (3) Whether the nondebtors' continuing efforts on behalf of the debtor are essential to prepare and carry out the provisions of the plan.[128]

In *Arrow Huss*, because the debtor was in the early stages of a "fairly large" case, the court found that there was sufficient reason to free the key employees from the burdens of related personal litigation so they could devote their full energy to running the business and formulating a reorganization plan.[129] In view of the seriousness of interfering with creditors' rights, however, the court limited the

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123 *E.g.*, *In re* Arrow Huss, Inc., 51 Bankr. 853 (Bankr. D. Utah 1985); *In re* Anje Jewelry Co., 47 Bankr. 485 (Bankr. E.D.N.Y. 1983); *In re* Johns-Manville Corp., 33 Bankr. 254 (Bankr. S.D.N.Y. 1983), *aff'd* 40 Bankr. 219 (S.D.N.Y. 1984); *In re* Otero Mills, Inc., 21 Bankr. 777 (Bankr. D.N.M.), *aff'd*, 25 Bankr. 1018 (D.N.M. 1982).

124 Lundgrin v. Claytor, 619 F.2d 61, 63 (10th Cir. 1980). *See also* cases cited *supra* note 123.

125 *Arrow Huss*, 51 Bankr. 853.

126 *See supra* notes 91-99 and accompanying text.

127 51 Bankr. 853 (Bankr. D. Utah 1985).

128 *Id.* at 859.

129 *Id.*

duration of the injunction to forty-five days.[130]

Comparing *Arrow Huss* with *In re Keyco*[131] highlights the difficulty in seeking a co-debtor stay to avoid interfering with reorganization efforts. In *Keyco* the court refused to enjoin a suit against a principal who was a guarantor of corporate obligations. The court found that the principal was not funding a reorganization plan and that any litigation on the guaranty would not adversely affect the principal's ability to aid the debtor in its reorganization effort.

The difference between *Keyco* and *Arrow Huss* appears to be the stage of the Chapter 11 case at which the debtor sought the injunction. In *Keyco* the debtor apparently had been operating in Chapter 11 for some time and had already formulated a plan. Enjoining creditor action against co-debtors at that time would effectively enjoin such action indefinitely, depriving the creditor of an important, bargained for right. In *Arrow Huss*, on the other hand, the debtor had only recently entered Chapter 11 involuntarily, and was in a difficult period of adjustment, requiring the undivided attention of its key employees.

Interestingly, neither *Keyco* nor *Arrow Huss* considered whether some means might exist for protecting the creditor during the effective period of a co-debtor stay. Perhaps the *Arrow Huss* court thought that the short duration of the stay sufficed. But seemingly an injunction against dissipation of assets by the principal while the stay is in effect is the minimum protection required, because a person can easily squander assets, even in a period as short as forty-five days.[132]

Perhaps the *Keyco* court determined that the bankruptcy need did not justify interference with the nonbankruptcy policies. This would indicate that even when a court can reduce the interference with the nonbankruptcy policies, the bankruptcy need must be truly substantial before it can sanction interference. Because the court's section 105 power to enjoin is based on the need to protect the reorganization effort, the court appropriately exercises that power only when the debtor can clearly show that need.

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130 *Id.*

131 49 Bankr. 507 (Bankr. E.D.N.Y. 1985).

132 One would normally expect that the creditor would affirmatively ask for protection if a court issues a stay prohibiting the creditor from enforcing its guaranty. *See* Bankruptcy Code § 362(d)(1) (Supp. III 1985). The creditor is, however, in an awkward position. If it asks for protection, it raises the possibility of reducing the adverse effect on it and on nonbankruptcy policies, thus potentially tipping the balance in favor of the granting of a stay. Failing to ask for protection may mean, as in *Arrow Huss*, that it receives none. Because the court is exercising an equitable power under section 105, it would be appropriate for the court to raise the adequate protection issue on its own, even if the creditor has failed to do so.

Thus, the cases suggest two general reasons for a court to enjoin actions against guarantors of the debtor's obligations. First, if the guarantor is to help fund a reorganization plan, then a court should protect his assets from the reach of any particular creditor of the debtor. A stay is also proper if the guarantor must use his undivided energy and attention to help the debtor through a critical period in the reorganization. Most courts agree, however, that an injunction is not available "simply to 'assist' the debtor in reorganizing or to relieve general 'pressure' on the debtor."[133] In effect, then, most courts have at least implicitly recoguized that enjoining enforcement of a guaranty seriously interferes with nonbankruptcy policies and that a court must limit any such interference to the clearest cases and even then they must limit the scope of the stay to minimize any disruption.[134]

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133 *Arrow Huss*, 51 Bankr. at 858 (citing *In re* A.J. Mackay Co., 50 Bankr. 756 (C.D. Utah 1985)).

Apparently no court has stayed litigation unrelated to the debtor's reorganization. Although conceivably a court could stay any litigation against a principal because that litigation may interfere with his ability to fund or aid the reorganization effort, courts seem to recognize that personal creditors, as opposed to creditors whose claims arose out of the debtor's operations, should not be subject to any interference arising from the debtor's bankruptcy.

134 One other basis for enjoining suits against guarantors involves the guarantors' right of indemnification that may arise by contract and usually arises under the law of suretyship. The gnarantor may have an *absolute* right of indemnity against the principal debtor if the guarantor is called upon to honor the guaranty. If that is so, then successful litigation against the gnarantor will, as a practical matter, bind the debtor who will remain liable to the guarantor regardless of the debtor's liability on the underlying obligation. *See, e.g.*, Seybolt v. Bio-Energy of Lincoln, 38 Bankr. 123 (Bankr. D. Mass. 1984); *In re* Metal Center, 31 Bankr. 458 (Bankr. D. Conn. 1983); *cf.* A.H. Robins Co. v. Piccinin, 788 F.2d 994 (4th Cir.), *cert. denied*, 107 S. Ct. 251 (1986). In such a situation any action against the guarantor will have the same effect as an action against the debtor because the debtor will have a direct interest in the outcome of any litigation. The debtor will want to participate in the litigation, leading to the same drain on the debtor's time and resources as if it were a direct action.

An even more direct effect on the debtor may result from litigation against the gnarantor if courts follow the result in *In re* M. Frenville Co., 744 F.2d 332 (3d Cir. 1984), *cert. denied sub nom.* Frenville Co. v. Avellino & Bienes, 469 U.S. 1160 (1985). In *Frenville* the court held that a non-contractual indemnity claim against the debtor that arose from litigation instituted after the debtor filed its bankruptcy petition was a post-petition claim not subject to the automatic stay. In other words, a guarantor who is liable on his guaranty may be able to sue the debtor free of the section 362 automatic stay and obtain a judgment (although he would still be stayed from executing on property of the estate). A court treating the claim as having arisen post-petition either would permit the guarantor to receive first priority as an administrative claim or would create a nondischargeable claim in the bankruptcy proceeding. Thus the guarantor would have a better claim to the debtor's assets than the original creditor! *But see, e.g.*, *In re* A.H. Robins Co., 63 Bankr. 986 (Bankr. E.D. Va. 1986) (claim arose prior to bankruptcy filing and thus stay applied to claim); *In re* Edge, 60 Bankr. 690 (Bankr. M.D. Tenn. 1986) (claim arose out of pre-petition conduct and thus stay prohibited post-petition action). A stay of the action against the guarantor would protect the debtor from this litigation and liability.

Several courts have rejected the holding of *Frenville* and have considered the indem-

B. General Partners of a Debtor Partnership

A partnership is a person under the Bankruptcy Code[135] and is entitled to file a bankruptcy petition under Chapters 7 or 11.[136] Under partnership law, the general partners are liable for partnership debts.[137] Each partner must contribute any amount necessary to satisfy the partnership liabilities.[138] Although the partnership agreement usually governs the allocation of losses among partners, a creditor is not bound by the agreement and may obtain satisfaction from any of the general partners, leaving them to seek contribution from the others.[139] The right of the partnership itself to seek from individual partners contributions towards losses[140] becomes property of the estate under section 541 of the Bankruptcy Code,[141] and the bankruptcy trustee may enforce the right.

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nity claim as a pre-petition claim subject to the automatic stay as long as all of the events underlying the claim occurred prepetition. *See, e.g.*, *In re* Johns-Manville Corp., 57 Bankr. 680 (Bankr. S.D.N.Y. 1986); *In re* Baldwin-United Corp., 48 Bankr. 901 (Bankr. S.D. Ohio 1985). These courts give effect to the broadened definition of claim in the bankruptcy code which is a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." Bankruptcy Code § 101(4) (1982 & Supp. III 1985). Courts that have adopted this view are on surer footing in view of the Congressional intent to deal with "all legal obligations of the debtor, no matter how remote or contingent". H.R. REP. No. 595, *supra* note 6, at 309, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6266.

In any event, it appears that *Frenville* would only apply to noncontractual indemnity claims. Where the principal debtor contractually obligated itself prior to the petition to indemnify the guarantor, the guarantor's claim is a prepetition claim subject to the automatic stay.

When a colorable basis exists for contesting the creditor's claim, it may entitle the debtor to a stay of the litigation against the guarantor. A court could base the stay on the identity of interest between the debtor and the guarantor, and the need of the debtor to protect its interest by intervening in the suit against the guarantor. In most cases this issue will not arise because there will be little question that the debtor has defaulted under the loan agreement, particularly if bankruptcy is an act of default. Only in the exceptional case in which the debtor's liability is unclear will a basis exist for enjoining litigation against the guarantor.

135 Bankruptcy Code § 101(35) (West Supp. 1987).

136 Bankruptcy Code § 109(b),(d) (Supp. III 1985). Partnerships that fall within the definition of "family farmer" in section 101(17)(B) may file under Chapter 12. Bankruptcy Code § 109(f). In addition, creditors may file an involuntary petition against a partnership under Chapter 7 or 11. Bankruptcy Code § 303(a) (West Supp. 1987).

137 UNIF. PARTNERSHIP ACT § 15, 6 U.L.A. 174 (1914).

138 *Id.* §§ 18(a), 40(d), 6 U.L.A. 213, 469.

139 *Id. See generally* A. BROMBERG, CRANE AND BROMBERG ON PARTNERSHIP 335-36 (1968). In general, the partners are jointly liable for most obligations and jointly and severally liable for certain tort obligations. UNIF. PARTNERSHIP ACT § 15, 6 U.L.A. 174 (1914). In most jurisdictions, joint liability means that all partners subject to jurisdiction must be joined in an action on the debt. Nevertheless, each partner is liable for the entire obligation. A. BROMBERG, *supra*, at 335-36.

140 UNIF. PARTNERSHIP ACT § 18(a), 6 U.L.A. 213 (1914).

141 Bankruptcy Code § 541(a) (Supp. III 1985). *See* Rosenberg, *supra* note 55, at 1189.

In a liquidation case, section 723 of the Bankruptcy Code reiterates that the trustee of a debtor partnership has a claim against the general partners for any deficiency of partnership assets to pay claims against the partnership.[142] That claim has equal priority with claims of individual creditors of the partners.[143] Thus, the trustee has an interest in protecting the assets of general partners in order to assure their availability for the satisfaction of the partnership obligations.

Under the Bankruptcy Act of 1898, section 5 detailed procedural rules for enforcing the individual partners' liabilities for partnership obligations.[144] As under the Bankruptcy Code, the right to recover from individual partners derived from state partnership law and was, under section 70(a), property that passed to the trustee.[145] In construing section 5, the Supreme Court held that the trustee of a partnership could administer the property of nonbankrupt part-

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142 Bankruptcy Code § 723 (Supp. III 1985). The trustee must, to the extent practicable, first try to recover from general partners who are not debtors under title 11. Bankruptcy Code § 723(b) (Supp. III 1985). The court may, while it is determining the deficiency, require indemnity or an assurance of payment from any such partners, or it may order the partner not to dispose of property. *Id.* The trustee has a claim against the estate of any general partner who is in bankruptcy for the full amount of the claims of creditors allowed in the partnership case. However, the creditors of the bankrupt partnership do not themselves have claims against an individual partner in bankruptcy unless their claims are secured solely by property of the individual partner. Bankruptcy Code § 723(c) (Supp. III 1985). The legislative history explains the operation of section 723(c) as follows:

> Subsection (c) requires the partnership trustee to seek recovery of the full amount of the deficiency from the estate of each general partner that is a debtor in a bankruptcy case. The trustee will share equally with the partners' individual creditors in the assets of the partners' estates. Claims of partnership creditors who may have filed against the partner will be disallowed to avoid double counting.

H.R. REP. No. 595, *supra* note 6, at 381, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6337; S. REP. No. 989, *supra* note 6, at 95, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 5881. If the recovery from bankrupt general partners' estates is greater than the deficiency that the trustee sought to recover, "the court is required to determine an equitable redistribution of the surplus to the estate of the general partners." *Id.*

143 This overturns the so-called "jingle rule" of the prior Bankruptcy Act. That rule permitted creditors of individual partners to recover their claims from the partners' individual estates before partnership creditors could assert their claims against the individual partners. Bankruptcy Act of 1898, ch. 541, § 5(g), 30 Stat. 544, 548 (1898) (formerly codified at 11 U.S.C. § 23 (1976)), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 401(a), 92 Stat. 2549, 2682 (1978). *See generally* H.R. REP. No. 595, *supra* note 6, at 381, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6337; S. REP. No. 989, *supra* note 6, at 95, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 5881; 4 COLLIER ON BANKRUPTCY (15th ed.), *supra* note 15, ¶ 723.04[3].

144 Bankruptcy Act of 1898, ch. 541, § 5, 30 Stat. 544, 547-48 (1898) (formerly codified at 11 U.S.C. § 23 (1976)), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 401(a), 92 Stat. 2549, 2682 (1978).

145 *Id.* § 70(a), 30 Stat. 544, 565-66 (formerly codified at 11 U.S.C. § 110(a) (1976)), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 401(a), 92 Stat. 2549, 2682 (1978).

ners as part of the administration of the partnership estate.[146] Although the trustee did not have the benefit of the extraordinary bankruptcy avoidance powers,[147] the effect of this joint administration was to deprive a partner of control over his property without granting him the discharge that is normally the benefit that follows the deprivation.[148] A corollary of the joint administration of assets was that the bankruptcy court, pursuant to its general equitable powers, could aid the administration of the partners' estates by enjoining them from disposing of property and enjoining third parties from interfering with the partners' property.[149]

There are two classes of potential competing claimants for individual partners' property: creditors of the partnership enforcing the unlimited liability of general partners, and creditors of the individual partners. Under the prior Bankruptcy Act,[150] and under the Uniform Partnership Act,[151] when a court was administering the assets of the partnership and of individual partners, creditors of the partnership had priority to the partnership assets and creditors of the individual partners had priority to the partners' assets. Thus, if the court were to enforce these rules, the court needed the power to

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146 Francis v. McNeal, 228 U.S. 695 (1913). Bankruptcy rule 108(c) permitted the court to order partners to file schedules of assets and liabilities. FED. R. BANKR. P. 108(c), 11 U.S.C. app. 108(c) (1976). This was in part to enable the trustee to exercise this power to administer partners' assets. Bankruptcy rule 1007(g) now authorizes the court to order individual partners to file statements of personal assets and liabilities. FED. R. BANKR. P. 1007(g). Although the Bankruptcy Code no longer authorizes the trustee to administer the assets of individual partners, the schedules would enable the trustee to determine whether to exercise the partnership's right to pursue partners' assets. In a reorganization case, the schedules may be necessary to enable the court to determine whether a plan meets the "best interest of creditors" test. If the partners possess a sufficiently large excess of assets over liabilities, the partnership's plan may have to provide for 100% payment in order to assure that creditors receive at least the amount that they would have received upon liquidation of the partnership. *See generally* Rosenberg, *supra* note 55.

147 Liberty Nat'l Bank v. Bear, 276 U.S. 215, 224-26 (1928). Under the Bankruptcy Act, these powers included the power to avoid preferences (section 60), fraudulent conveyances (section 67(d)), certain statutory liens (section 67(c)), certain setoffs (section 68), transfers and transactions avoidable by actual creditors (section 70(e)), and transactions and transfers avoidable by a judicial lien creditor who extended credit and obtained a lien on the date of bankruptcy (section 70(c)).

148 Rosenberg, *supra* note 55, at 1180-81. Interestingly, because the partners would not be subject to the bankruptcy law, the jingle rule, which required using the partners' assets to satisfy their individual creditors first, would be inapplicable in the administration. By keeping the partners out of formal bankruptcy proceedings, the partnership creditors could receive prior right to the individual assets. *Id.* at 1183 n. 52.

149 *Id.* at 1184. *See, e.g.*, *In re* Jercyn Dress Shop, 516 F.2d 864 (2d Cir. 1975).

150 Bankruptcy Act of 1898, ch. 541, § 5, 30 Stat. 544, 547-48 (1898) (formerly codified at 11 U.S.C. § 23 (1976)), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 401(a), 92 Stat. 2549, 2682.

151 UNIF. PARTNERSHIP ACT § 40(h), 6 U.L.A. 469 (1914).

stay actions by partnership creditors against individual partners as well as actions against the partnership itself.

Under the Bankruptcy Code, neither the trustee of the partnership nor any of the partners' creditors has priority to the partners' assets.[152] Thus, no need exists for the trustee to assure that partnership creditors do not reach the assets of a partner before the individual creditors of that partner. This may suggest, therefore, that the trustee should have no power to interfere with partnership creditors' actions against partners if the partners themselves are not in bankruptcy and the trustee is not administering their estates.

However, section 723 of the current Code grants the court the extraordinary power to order any partner who is not a debtor under title 11 "to provide the estate with indemnity for, or assurance of payment of, any deficiency recoverable from such partner, or not to dispose of property."[153] Although the language does not directly say so, its spirit implies that the court can take those actions it deems necessary to protect a partner's property.[154] Coupled with section 105, this could permit an injunction barring partnership creditors from enforcing their claims against partners' property as well as an injunction barring the partner from voluntarily transferring the property.[155]

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152 "This section is a significant departure from present law. It repeals the jingle rule, which, for ease of administration, denied partnership creditors their rights against general partners by permitting general partners' individual creditors to share in their estates first to the exclusion of partnership creditors." H.R. REP. No. 595, *supra* note 6, at 381, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6337. It is unclear whether the jingle rule is repealed in a Chapter II case. Rosenberg, *supra* note 55, at 1199.

153 Bankruptcy Code § 723(b) (1982). Bankruptcy Rule 1007(g) (1987) authorizes the court to require general partners to file schedules of assets and liabilities to provide the trustee with information necessary to determine what action must be taken.

154 The House report stated that

> [u]nder 11 U.S.C. 723(b) the court is empowered to order any such partner to provide assurance that the partnership's estate will be paid.
>
> Thus the court may use 11 U.S.C. 105 to enjoin creditors of the partner from levying on the partners property or from obtaining liens thereon. This may need to be done because the judicial lien of the partnership's trustee under 11 U.S.C. 544(a) does not extend to property of the partners.

H.R. REP. No. 595, *supra* note 6, at 199-200, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6160.

155 Arguably, partnership creditors might be automatically stayed under section 362 from taking action against individual partners. The trustee of the partnership, as representative of the creditors, has a chose in action against the partners that is property of the estate. UNIF. PARTNERSHIP ACT §§ 18a, 40, 6 U.L.A. 469 (1914); Bankruptcy Code § 541(a). The Bankruptcy Code stays "any act to obtain possession of property of the estate." *Id.* § 362(a)(3). If the trustee's action encompasses the actions of partnership creditors, then actions directly by the creditors interfere with the trustee's control over property of the estate, i.e., the chose in action. *Cf. In re* S.I. Acquisition, Inc., 817 F.2d 1142 (5th Cir. 1987) ("alter ego" action by creditor stayed because under Texas law action belongs to debtor); Delgado Oil Co. v. Torres, 785 F.2d 857 (10th Cir. 1986)

On the other hand, the Bankruptcy Code eliminated the administration of a nonbankrupt partner's estate when the partnership is in bankruptcy.[156] Instead, the trustee of the partnership has, as under state law,[157] a chose in action against the partner to recover any deficiency in partnership assets.[158] By eliminating the administration of nonbankrupt partners' estates, it may seem that Congress intended to eliminate as well the power of the bankruptcy court to enjoin actions by third parties against property of the individual partners. Indeed, the explicit statutory grant of power to the court to order partners not to dispose of their property pending determination of any deficiency supports this.[159] After all, having codified part of the bankruptcy court's earlier power under the Act, if Congress intended the court to enjoin third party actions against partners' property it could have explicitly said so.

Nevertheless, when partnership creditors are seeking to enforce the unlimited liability of general partners, the trustee is often justified in asking a court to enjoin direct actions against individual partners until the partnership estate is settled. The partnership trustee represents all of the partnership creditors. The trustee has an action against the partners to recover the deficiency in partnership assets[160] and must distribute the recovery to creditors in accordance

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(shareholder's derivative action stayed because action is property of estate of corporate debtor). *But see In re* Ozark Restaurant Equip. Co., 816 F.2d 1222 (8th Cir.) ("alter ego" action not stayed when, under Arkansas law, action does not belong to debtor and instead is personal to creditors), *cert. denied sub nom.* Jacoway v. Anderson, 108 S. Ct. 147 (1987). Creditors might also be automatically stayed if their actions are considered so closely related to the trustee's action as to constitute property of the estate. *Cf.* A.H. Robins Co. v. Piccinin, 788 F.2d 994 (4th Cir.), *cert. denied,* 107 S. Ct. 251 (1986).

However, it appears that the trustee's chose in action is separate from partnership creditors' actions. The trustee's action is brought under sections 18(a) and 40 of the Uniform Partnership Act. Partners are jointly liable to the partnership for any deficiency in the partnership's assets, but if fewer than all of the partners are solvent and subject to jurisdiction, the available partners are liable for the full deficiency. Partners are liable to partnership creditors, as opposed to the partnership, under section 15 of the Uniform Partnership Act. Liability is joint and several with respect to many tort claims and joint with respect to other claims. Unlike "alter ego" actions or shareholder derivative suits, in which only one cause of action exists, the partners are liable under two separate causes of action. Thus, although creditors are stayed from asserting the partnership's claim, they are probably not stayed from asserting their own section 15 claims against individual partners.

156 Rosenberg, *supra* note 55, at 1189. *See also* 4 COLLIER ON BANKRUPTCY (15th ed.), *supra* note 15, ¶ 723.02.

157 UNIF. PARTNERSHIP ACT § 40, 6 U.L.A. 469 (1914).

158 Bankruptcy Code § 723(a) (Supp. III 1985).

159 Bankruptcy Code § 723(b) (1982) ("Pending determination of such deficiency, the court may order any such partner to provide the estate with indemnity for, or assurance of payment of, any deficiency recoverable from such partner, or not to dispose of property.").

160 Bankruptcy Code § 723(a) (Supp. III 1985).

with the priority rules of sections 507 and 726.[161] Unlike the voluntary contribution that a guarantor might make to a reorganization effort, which is not property of the estate until it is made, the trustee may enforce the partners' obligations as property of the estate.

If the general partner from whom the trustee seeks recovery is solvent (i.e., the value of his assets equals or exceeds his total partnership and individual liability), then an action by the partnership creditor against the partner is unobjectionable. By definition, the assets will suffice to satisfy both the partnership and the individual creditors.

If the partner is insolvent, however, courts should not allow partnership creditors to circumvent the Bankruptcy Code's priority scheme by racing to the general partners while the partnership is in bankruptcy.[162] By directly reaching the assets of individual partners before the trustee can recover them, partnership creditors could remove themselves from the bankruptcy distribution and "grab" assets that would otherwise have gone into the debtor partnership's estate for distribution to creditors generally.

Thus, a stay of actions against individual partners may at times be necessary to protect the trustee's rights while the trustee administers the partnership estate. In *In re Comark*[163] the court seems to have recognized some of these issues when it enjoined a partnership creditor from enforcing a judgment against two general partners of the bankrupt partnership. The court found that if it permitted the creditor to act prior to the partnership trustee's attempt to determine and collect the deficiency from the general partners, the creditor would receive preference over other partnership creditors and would precipitate a "race to the courthouse" by the other partnership creditors.[164] This would defeat the bankruptcy goal of equitably distributing a debtor's assets among its creditors.

On the other hand, in *In re Aboussie Bros. Construction Co.*[165] the court refused to enjoin actions against individual partners who had guaranteed partnership debts. Focusing on the entity theory of partnership law, the court held that there was no basis for disregarding the separate existence of the partners from the partnership, and,

161 Bankruptcy Code §§ 507, 726 (West 1979 & Supp. 1987).

162 Of course, the other creditors can protect themselves by instituting involuntary proceedings against the insolvent partner. *See*, Bankruptcy Code § 303 (West 1979 & Supp. 1987). Similarly, the partnership trustee may be a petitioning creditor. *See*, Kennedy, *Partnership and Partners Under the Bankruptcy Reform Act and the New (Proposed) Bankruptcy Rules*, 27 St. Louis U.L.J. 507, 534-35 (1983). Even if the trustee does file an involuntary petition, he will generally need two other petitioners. *Id.* Thus, an injunction may most effectively protect the estate.

163 53 Bankr. 945 (Bankr. C.D. Cal. 1985).

164 *Id.* at 947.

165 8 Bankr. 302 (E.D. Mo. 1981).

therefore, no basis for a co-debtor stay.[166] Unlike *Comark*, however, the partners in *Aboussie* failed to argue that a stay was necessary to protect their assets in order to enable them to cover any deficiency in partnership assets. Instead, the partners asserted grounds similar to those of guarantors seeking stays—that they might have to fund a reorganization of the partnership and that their undivided time and energy were necessary to further the reorganization effort. In effect, then, the *Aboussie* court may simply have decided that the partners' traditional guarantor arguments did not justify a co-debtor stay.

Another important difference between *Aboussie* and *Comark* is that while *Comark* was a Chapter 7 case, *Aboussie* involved a Chapter 11 debtor. In a Chapter 11 case, the issues concerning a stay of actions against individual partners differ from those in Chapter 7. First, section 723 does not apply in Chapter 11.[167] Thus, the express authorization to order individual partners to preserve their property does not apply in Chapter 11.

In addition, a Chapter 11 case normally envisions the continuation of the business with payment of debts out of the future income of the reorganized entity. Thus, problems of distributing scarce partnership assets upon liquidation should not normally arise.[168] Nevertheless, if the debtor proposes a liquidation plan in Chapter 11 a need may exist to preserve individual partners' assets for distribution under the plan. Moreover, because a court must determine prior to confirming a plan that the plan comports with the "best interest of creditors" test,[169] the court will in any event have to determine the amount that creditors could have recovered from general partners in a liquidation. The court must, therefore, have information about partners' assets and liabilities even if those assets are not to be used to satisfy the claims of partnership creditors.[170]

Yet even in a Chapter 11 partnership reorganization in which the business continues to operate, some co-debtor stay issues may arise. These are similar to the issues that arise in guarantor cases in Chapter 11. For example, the general partners may plan to finance a reorganized partnership. In that case, the same reasoning that may, in appropriate circumstances, justify co-debtor stays to protect guarantors and their assets for the benefit of all of the creditors applies to the partners. Indeed, the justification for a stay is greater here than in the guarantor cases, because none of the partnership

166 *Id.* at 303-04.
167 Bankruptcy Code § 103 (1982).
168 Rosenberg, *supra* note 55, at 1200. A debtor may propose a liquidation plan in Chapter 11, in which case similar distribution questions may arise.
169 Bankruptcy Code § 1129(a)(7) (West Supp. 1987).
170 *See* Bankruptcy Rule 1007(g) (1982).

creditors *ex ante* has any greater right to the individual partners' assets than the others. Thus the problem of depriving a creditor with foresight of the advantage he had obtained at the time of contracting does not arise.[171]

Similarly, the partners may constitute the key personnel operating the partnership and formulating a reorganization plan. As in the case of key-personnel guarantors, a court must consider this basis for a stay with care, but a limited stay may, in the long run, increase the recovery of partnership creditors generally.

In partnership cases, the bankruptcy policies a co-debtor stay may implicate include, as in guarantor cases, the need to support the reorganization effort. In addition, however, the policy of equitable distribution of a debtor's assets, including the partnership's claim against individual partners, becomes important as well.

In partnership cases, unlike the guarantor cases, the partners have, in effect, guaranteed all of the partnership obligations. There is no issue of enforcing the security obtained by one foresightful creditor to the possible detriment of other creditors. Instead, because all creditors are entitled to the benefit of the partners' liability, the issue becomes one of equitably distributing amounts that can be obtained from the partners.

The nonbankruptcy interest with which a stay would interfere is the expectation that partners will have unlimited liability for the debts of the partnership and that creditors of the partnership can reach the assets of an individual partner. In effect, partnership law renders the partners guarantors of the partnership obligations, and creditors presumably rely on that "guaranty" in extending credit to the partnership. If a court interferes with the enforcement of the partners' separate liability, then credit availability may decrease or credit may become more expensive to partnerships generally. In effect, the benefits of the partnership form of business entity—a separate entity functioning apart from the individual partners but which offers creditors the security of the partners' assets—may be lost.

In a liquidation case, any co-debtor stay will interfere minimally with these nonbankruptcy policies if the trustee, as representative of all of the partnership creditors, diligently pursues the partnership's claims against the individual partners for contributions to satisfy the partnership's obligations. In that case, the trustee may reach the partners' assets promptly, and the threat of dissipation or of com-

171 A partnership creditor may have had the foresight to have individual partners guarantee the partnership obligation. *See* UNIF. PARTNERSHIP ACT § 15(b), 6 U.L.A. 174 (1914); *In re* Comark, 53 Bankr. 945 (Bankr. C.D. Cal. 1985); A. BROMBERG, *supra* note 139, at 335. In that case, the issues will be considerably closer to those in the guarantor cases.

peting claims to those assets does not differ from the threat that partnership creditors would face if they pursued the partners themselves. Thus, as long as the trustee acts diligently, bankruptcy may be viewed as preventing the race by partnership creditors to both partnership and individual assets. In that event, the trustee's diligence should protect the creditors' interests; the only detriment to creditors will be the requirement that they share the fruits of the trustee's efforts with other partnership creditors.

In Chapter 11, however, diligent pursuit of the partnership's claims against partners is less likely than in Chapter 7.[172] In Chapter 11, the debtor normally remains in possession and serves as trustee.[173] In essence, the partners continue to run the partnership, and they presumably have little interest in pursuing themselves. If the partners can convincingly show that they are contributing assets to the reorganization effort, then a court should stay actions by partnership creditors against the partners to the extent that those actions would interfere with the contributions. This would further the bankruptcy policy of supporting the reorganization effort. Such a stay would only minimally interfere with nonbankruptcy policies because the assets that creditors would have reached are in fact going into the partnership where they will be available to the creditors.

If the partners contribute nothing to the reorganization effort, however, there is little reason to stay partnership creditors from pursuing individual partners. As in the guarantor cases, a court may sometimes appropriately grant a very brief stay to enable the partners to formulate a reorganization plan. Beyond that, however, because there is no one to pursue the partners on behalf of all of the creditors, and because enforcement of that nonbankruptcy right would not interfere with the bankruptcy case, a stay should not issue and creditors should freely pursue their nonbankruptcy remedies against partners who are not themselves in bankruptcy.

Even less justification exists for enjoining actions against partners by individual creditors of the partners. The partnership trustee has no greater rights than the individual partners' creditors to assets of the partners.[174] Moreover, the trustee does not represent those creditors, who have no connection to the partnership or its bank-

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172 One commentator has stated, "Research has uncovered no reported cases in which a debtor in possession or trustee in a rehabilitation case has . . . asserted a chose in action . . . to obtain partners' assets to contribute to a partnership reorganization plan." Rosenberg, *supra* note 55, at 1199.

173 Bankruptcy Code § 1107 (1982 & Supp. III 1985).

174 In fact, it is unclear whether the jingle rule has been repealed in Chapter 11 cases. *See supra* note 152. If it has not been repealed, there is even less reason to enjoin nonpartnership creditors from pursuing actions against partners. *See* Rosenberg, *supra* note 55, at 1199.

ruptcy. Thus, the bankruptcy of the partnership should not affect the rights of the partners' individual creditors to pursue their debtors. In effect, these rights, unrelated to the partnership, are similar to the unrelated actions against guarantors, actions a court should not usually stay in any event. Moreover, a refusal to stay actions unrelated to the partnership furthers the Bankruptcy Code's policy of not imposing bankruptcy administration of the estates of partners who are not in bankruptcy.

C. Tax Claims

The Internal Revenue Code requires employers to withhold from their employees' wages social security and income taxes[175] and to hold those taxes in trust for the government.[176] Because the government must credit the employee for withheld taxes even if the employer fails to remit these "trust fund" taxes to the government,[177] the Internal Revenue Code permits the government to collect the taxes from those persons responsible for an employer's failure to remit the withheld taxes.[178]

When a company suffers financial difficulty, it is not unusual for the company to defer its payments of these trust fund taxes in order to reserve cash for more pressing obligations.[179] Typically, management hopes that if it can survive its short term difficulties it can return to profitability. When management fails to realize its optimistic projections, however, the Internal Revenue Service will pursue "responsible officers and employees of the corporation" for the "trust fund" taxes the employer owes.[180]

If the employer is in a bankruptcy proceeding when the Interual Revenue Service seeks to collect from responsible individuals,[181] the individuals, typically principals of the employer, may seek to enjoin

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175 I.R.C. §§ 3102, 3402 (West 1979 & Supp. 1987).

176 I.R.C. § 7501(a) (1982).

177 *See, e.g.*, United States v. Huckabee Auto Co., 783 F.2d 1546, 1548 (11th Cir. 1986) (per curiam); Grasso v. Oehmann, 54 A.2d 570 (D.C. 1947).

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> Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

I.R.C. § 6672(a) (1982).

179 *E.g.*, Slodov v. United States, 436 U.S. 238, 243 (1978).

180 I.R.S. Policy Statement P-5-60 (May 30, 1984) (I.R. Manual MT 1218-157), *reprinted in* 8A Stand. Fed. Tax Rep. (CCH) ¶ 5569.01 (1986).

181 The Internal Revenue Service has indicated that it will seek to collect from responsible persons under I.R.C. § 6672(a) whenever it cannot immediately collect the taxes from the corporation. I.R.S. Policy Statement P-5-60, *supra* note 180, *reprinted in* 8A Stand. Fed. Tax Rep. (CCH) at ¶ 5569.01.

the collection effort. They may seek an injunction because their efforts are necessary for a successful reorganization, because they are providing funding to the debtor, or because the debtor's reorganization plan provides for payment of the "trust fund" taxes.

Enjoining the Internal Revenue Service from collecting "trust fund" taxes raises several issues, some similar to those in the guarantor cases and some unique. One initial question is whether the bankruptcy court has jurisdiction over a dispute between the Internal Revenue Service and a nondebtor principal, and another is whether the debtor has standing to seek an injunction to protect a nondebtor principal.

Courts are split on the question of the bankruptcy court's jurisdiction to hear the issue.[182] By statute, "[b]ankruptcy judges may hear and determine . . . all core proceedings arising under title 11, or arising in a case under title 11, . . . and may enter appropriate orders and judgments."[183] Core proceedings include "(A) matters concerning the administration of the estate; . . . (B) allowance or disallowance of claims against the estate; . . . [and] (O) other proceedings affecting . . . the adjustment of the debtor-creditor or the equity security holder relationship."[184]

Section 505 of the Bankruptcy Code directly authorizes the bankruptcy court to "determine the amount or legality of any tax, any fine or penalty relating to a tax."[185] Because the imposition of liability on responsible persons is a tax penalty,[186] some courts have based their jurisdiction to enjoin collection on section 505.[187] After all, these courts observe, the tax penalty derives from the operations of the debtor and the debtor's tax liability. Moreover, in many cases the debtor will have indemnified its responsible persons. Ulti-

182 *Compare In re* Campbell Enters., 66 Bankr. 200 (Bankr. D.N.J. 1986) (finding bankruptcy court jurisdiction); *and In re* J.K. Printing Servs., 49 Bankr. 798 (Bankr. W.D. Va. 1985) (same) *and In re* Original Wild West Foods, Inc., 45 Bankr. 202 (Bankr. W.D. Tex. 1984) (same) *and In re* Precision Colors, 36 Bankr. 429 (Bankr. S.D. Ohio 1984) (same) *and In re* Datair Sys. Corp., 37 Bankr. 690 (Bankr. N.D. Ill. 1983) (same) *and In re* Jon Co., 30 Bankr. 831 (D. Colo. 1983) (same) *and In re* H & R Ice Co., 24 Bankr. 28 (Bankr. W.D. Mo. 1982) (same) *with* United States v. Huckabee Auto Co., 783 F.2d 1546 (11th Cir. 1986) (per curiam) (finding that bankruptcy court lacks jurisdiction) *and In re* Pressimone, 39 Bankr. 240 (N.D.N.Y. 1984) (same) *and* United States v. Rayson Sports, 44 Bankr. 280 (N.D. Ill. 1984) (same). *See generally* Note, *Bankruptcy Court Jurisdiction and the Power to Enjoin the IRS*, 70 MINN. L. REV. 1279, 1281-94 (1986) (authored by Deborah Dyson).

183 28 U.S.C.A. § 157(b)(1) (West Supp. 1987).

184 *Id.* § 157(b)(2).

185 Bankruptcy Code § 505(a)(1) (1982).

186 I.R.C. § 6672 (1982). *But see* United States v. Sotelo, 436 U.S. 268 (1978) (although denominated a "penalty" under Internal Revenue Code, liability is in nature of a tax, at least for purposes of determining dischargeability).

187 *E.g., In re* H & R Ice Co., 24 Bankr. 28 (Bankr. W.D. Mo. 1982).

mately, therefore, the tax liability will fall on the debtor, even if it is initially imposed on the responsible persons.[188]

Other courts, however, have maintained that section 505 applies only to taxes the government imposes directly on the debtor.[189] These courts point out that unlike, for example, the guarantor's liability, which derives from the principal's liability, the liability of responsible persons under the Internal Revenue Code is separate from the employer's liability.[190] Therefore, unless the responsible persons choose to submit themselves to the jurisdiction of the bankruptcy court by filing their own bankruptcy petitions, they should not fall under the protection of section 505.

The Bankruptcy Code seeks to resolve claims against a debtor. The Code does not give the court jurisdiction to determine claims against third parties, even if those claims have some relationship to the debtor. Therefore, the section 505 authority to determine the amount or legality of a tax must encompass the debtor's tax liability rather than the liability of any third party. Indeed, the legislative history indicates that "[s]ubsections (a) and (b) . . . permit determination by the bankruptcy court of any unpaid tax liability *of the debtor*."[191] Thus, section 505 does not authorize the bankruptcy court to determine the liability of responsible persons or to enjoin collection of any tax penalty imposed on such persons.

Yet even if section 505 does not cover the liability of responsible persons, arguably the bankruptcy court still has jurisdiction to enjoin collection of any tax penalty imposed on such persons.[192] This jurisdiction arises from the section 105 authorization to "issue any order, process, or judgment that is necessary or appropriate to

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188 Even if an indemnity agreement exists, however, the bankruptcy court would have the power to determine whether indemnity is proper. Moreover, the section 362 automatic stay would prevent the responsible persons from enforcing the agreement during the pendency of the bankruptcy case. *But see In re* M. Frenville Co., 744 F.2d 332 (3d Cir. 1984) (indemnity claim may be post-petition obligation), *cert. denied sub nom.* Frenville Co. v. Avellino & Bienes, 469 U.S. 1160 (1985).

189 *See, e.g.*, United States v. Huckabee Auto Co., 783 F.2d 1546 (11th Cir. 1986) (per curiam); *In re* Success Tool and Mfg. Co., 62 Bankr. 221 (N.D. Ill. 1986); *In re* Pierce Coal and Constr., 49 Bankr. 779 (Bankr. N.D. W. Va. 1985).

190 *Huckabee Auto*, 783 F.2d 1546. Although the Internal Revenue Service has a policy of collecting the tax only once, technically it has the power to impose the penalty on the responsible persons and collect the tax from the debtor as well. *In re* Huckabee Auto Co., 46 Bankr. 741 (M.D. Ga. 1985), *aff'd sub nom.* United States v. Huckabee Auto Co., 783 F.2d 1546 (11th Cir. 1986) (per curiam).

191 H.R. REP. No. 595, *supra* note 6, at 356, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 6312 (emphasis added).

192 One commentator has argued that § 505 deserves a "nonliteral reading" in order to bring these suits within the jurisdiction of the bankruptcy court. Note, *supra* note 182, at 1305-07. While I agree with the result, I do not believe courts can ground jurisdiction on that section. Ample authority elsewhere in the Bankruptcy Code enables the bankruptcy court to protect the debtor's reorganization effort.

carry out the provisions of this title."[193] This situation does not differ significantly from other co-debtor stay cases in which creditors' actions against a principal of the debtor may interfere with the debtor's reorganization. Thus, the broadened jurisdiction of the bankruptcy court should suffice to enable it to consider the issue.[194]

Although the Internal Revenue Code views the liability of the responsible person as legally separate from that of the debtor, such a legal nicety cannot change the fact that the claim against the responsible person arose as a result of the activities of the debtor. Moreover, the Internal Revenue Service is a creditor of the debtor. Enforcement of the penalty has a direct impact on the estate because it may pressure the debtor to pay the IRS quickly in order to protect the principals.[195] Moreover, a significant drain on the principals' energies and assets may occur that could adversely affect the reorganization effort. Thus, because of the significant impact direct actions by the IRS will have, the bankruptcy court has jurisdiction to consider the controversy.

Resolving the question of standing in the tax context does not significantly differ from the general corporate guarantor context. The debtor will have standing if it "has ' "alleged such a personal stake in the outcome of the controversy' " as to warrant *his* invocation of federal court jurisdiction and to justify exercise of the court's remedial power on his behalf."[196] As in the guarantor cases, if the debtor shows that the collection effort will substantially and adversely affect it and jeopardize its reorganization, it will have standing to seek an injunction.[197]

As in the guarantor cases, however, the substantial and adverse impact must be on the debtor, not on the principal whom the debtor is seeking to protect. Thus, a more difficult standing issue arises if the debtor seeks a stay simply because the debtor's plan proposes payment of the tax obligation and the principal wants to avoid personal liability.[198] If that is all the harm the debtor can assert, then

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193 Bankruptcy Code § 105(a) (West Supp. 1987).

194 *See supra* notes 34-36 and accompanying text.

195 *Cf.* Note, *The Availability of Injunctions in Bankruptcy to Restrain Collection of I.R.C. § 6672(a) Penalties*, 7 CARDOZO L. REV. 613, 636-38 (1986) (authored by Beth Neelman) (discussing fiduciary obligation of officers).

196 *In re* Original Wild West Foods, Inc., 45 Bankr. 202, 205 (Bankr. W.D. Tex. 1984) (quoting Simon v. Kentucky Welfare Rights Org., 426 U.S. 26, 38 (1976) (quoting Warth v. Seldin, 422 U.S. 490 (1975))).

197 *Id.*

198 In order for a plan to be confirmed it must provide for full payment of priority tax claims, although payment may be in "deferred cash payments, over a period not exceeding six years after the date of assessment of such claim, of a value, as of the effective date of the plan, equal to the allowed amount of such claim." Bankruptcy Code § 1129(a)(9)(C) (West 1979). The Bankruptcy Code grants priority for "allowed unsecured claims of governmental units, only to the extent that such claims are for— . . .

the action against the principal will not adversely affect the debtor and the debtor may not have standing to challenge the assessment. Standing exists only when the action will in some meaningful way interfere with the reorganization.

Even if the bankruptcy court has jurisdiction and the debtor has standing to invoke that jurisdiction, the doctrine of sovereign immunity or the Anti-Injunction Act[199] could prevent the court from enjoining the collection effort. Section 106 of the Bankruptcy Code contains a limited waiver of sovereign immunity with respect to claims against a governmental unit that are property of the bankruptcy estate if the sovereign files a claim arising out of the same transaction or occurrence. Section 106 also provides that sections of the Code containing "creditor," "entity," or "governmental unit" apply to governmental units notwithstanding any assertion of sovereign immunity.[200]

If the bankruptcy court's power to enjoin actions against principals derives from section 105, then the government can perhaps assert sovereign immunity as a defense. Section 106(c) does not waive sovereign immunity because section 105 does not contain the words "creditor," "entity," or "governmental unit." If the stay request represented a claim that was property of the estate, then the government's filing of a tax claim in the bankruptcy case would waive immunity with respect to the stay request under section 106(a). However, the debtor has no legal or equitable interest in the principal's defense against the government that could be considered property of the estate. Moreover, when the estate seeks a stay it is not asserting a claim against the government. Thus, the government's sovereign immunity defense has some merit.[201]

(C) a tax required to be collected or withheld and for which the debtor is liable in whatever capacity." Bankruptcy Code § 507(a)(7)(C) (Supp. III 1985). The Senate Report states that

> [t]his category covers the so-called "trust fund" taxes, that is, income taxes which an employer is required to withhold from the pay of his employees, the employees' shares of social security and railroad retirement taxes, and also Federal unemployment insurance. This category also includes excise taxes which a seller of goods or services is required to collect from a buyer and pay over to a taxing authority.

S. REP. No. 989, *supra* note 6, at 71, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS at 5857.

199 "[N]o suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed." I.R.C. § 7421(a) (1982).

200 Bankruptcy Code § 106(c)(1) (1982).

201 In any event, if waiver of sovereign immunity with respect to the co-debtor stay request were based on whether the government filed a tax claim in the bankruptcy, the government would more likely forego filing a claim and instead proceed directly against responsible persons. This would increase, rather than limit, the exposure of responsible persons.

On the other hand, sovereign immunity would not protect the government from the bankruptcy court's injunctive power with respect to collections from the debtor which would interfere with the reorganization. Because the basis of enjoining collection from a principal of the debtor is to protect the debtor's reorganization, the court should find the same waiver of sovereign immunity notwithstanding that the debtor's involvement is less direct.[202]

The provision of the Internal Revenue Code commonly known as the Anti-Injunction Act[203] presents a more difficult obstacle to a co-debtor stay against the Internal Revenue Service. That Act prohibits suits to restrain the collection of taxes under the Internal Revenue Code. While several courts have found that the Anti-Injunction Act bars bankruptcy courts from enjoining tax collection,[204] the issue is not free from doubt.

Analysis of the effect of the Anti-Injunction Act properly begins with *Bostwick v. United States*.[205] In *Bostwick* the Internal Revenue Service failed to file proofs of claim in two bankruptcy proceedings. After receiving a discharge, the debtors sought a determination from the bankruptcy court of the dischargeability of certain tax debts, and an injunction against the collection of back taxes until the court determined their discharge.

The court held that the bankruptcy court had jurisdiction to determine the dischargeability question and had the power to enjoin the Internal Revenue Service from collecting the back taxes while the dischargeability issue was pending. Although the court agreed with the Internal Revenue Service that the statutory exceptions in the Anti-Injunction Act did not apply to the bankruptcy cases, it held that

> we do not believe that the 'anti-injunction statute' is relevant to the present case inasmuch as Congress has evidenced an intention to enact a complete scheme governing bankrnptcy which overrides the general policy represented by the 'anti-injunction' act . . . . We believe that the overriding policy of the Bankruptcy Act is the rehabilitation of the debtor and we are convinced that the Bankruptcy Court must have the power to enjoin the assessment and/or collection of taxes in order to protect its jurisdiction, administer the bankrupt's estate in an orderly and efficient manner,

202 *See, e.g., In re* Campbell Enters., 66 Bankr. 200 (D.N.J. 1986).

203 The Anti-Injunction Act was originally passed as part of the Revenue Act of 1866, ch. 184, § 19, 14 Stat. 78, 152 (codified as amended at 26 U.S.C. § 7421(a) (1982)).

204 *See, e.g., In re* LaSalle Rolling Mills, Inc., 832 F.2d 390 (7th Cir. 1987); A to Z Welding & Mfg. Co. v. United States, 803 F.2d 932 (8th Cir. 1986) (per curiam).

205 521 F.2d 741 (8th Cir. 1975).

and fulfill the ultimate policy of the Bankruptcy Act.[206]

Thus, the court found that because a complete statutory scheme governed discharge and granted the bankruptcy court the power to issue orders and injunctions necessary to effectuate discharge, the bankruptcy scheme took precedence over the Anti-Injunction Act.[207]

It is worth noting that *Bostwick*, which relied on the carefully drawn statutory scheme governing dischargeability, does not directly apply to a co-debtor stay request in which discharge of the debtor's liability is not at issue. Nevertheless, when the injunction is viewed as necessary to support the debtor's reorganization, the court can reach the same result because a carefully drawn statutory scheme also governs reorganizations.

In *A to Z Welding & Manufacturing Co. v. United States*,[208] however, the court seemed to reject this parallel by holding that the Anti-Injunction Act does bar an injunction against collection from responsible persons in the bankruptcy context. In a short per curiam opinion, the court limited the effect of *Bostwick* to Internal Revenue Service actions against a debtor which is itself in bankruptcy proceedings,[209] thus seriously eroding the value of *Bostwick* as support for the inapplicability of the Anti-Injunction Act.

Yet the *A to Z Welding* opinion does not analyze the problem nor does it discuss relevant case authority under the Anti-Injunction Act. Moreover, the court did not consider the possibility that Congress intended that the bankruptcy court's equitable power under section 105 should encompass the power to override the Anti-Injunction Act in order to foster successful reorganizations.

The Third Circuit considered the applicability of the Anti-Injunction Act to bankruptcy matters in *In re Becker's Motor Transportation, Inc.*[210] In *Becker's Motor* a debtor sought to enjoin the collection of penalties on pre-petition taxes because the Internal Revenue Service had not claimed the penalties in the bankruptcy proceeding and because the underlying taxes had been fully paid in the course of the Chapter 11 case. The court rejected the *Bostwick* exception to the Anti-Injunction Act and held that because bankruptcy court adjudications are not within the exceptions to that Act, a court cannot create such an exception.[211] It noted that Congress had ample

206 *Id.* at 744.

207 *See also In re* Campbell Enters., 66 Bankr. 200 (D.N.J. 1986); *In re* J.K. Printing Servs., 49 Bankr. 798 (Bankr. W.D. Va. 1985); *In re* Jon Co., 30 Bankr. 831 (D. Colo. 1983).

208 803 F.2d 932 (8th Cir. 1986) (per curiam).

209 *Id.* at 933.

210 632 F.2d 242 (3d Cir. 1980), *cert. denied*, 450 U.S. 916 (1981).

211 *Id.* at 246.

opportunities to create a statutory bankruptcy exception and that it had not done so. Thus, the court found the Anti-Injunction Act bars an injunction against tax collection in the bankruptcy context.[212]

The Third Circuit decided *Becker's Motor* after the passage of the Bankruptcy Code. Prior to enacting the Bankruptcy Code, the *Bostwick* court had held that the bankruptcy court could enjoin tax collection notwithstanding the Anti-Injunction Act.[213] Thus, at the time of passage of the Code, Congress may have omitted any reference to enjoining tax collection because it believed an injunction was already permissible. If Congress did not accept the *Bostwick* exception to the Anti-Injunction Act, it could have included in the Code a provision overruling *Bostwick*.

Congress substantially overhauled the Bankruptcy Code in 1984[214] and again in 1986,[215] and by the time of these amendments, both *Bostwick* and *Becker's Motor* had been decided. Nevertheless, Congress again failed to address this issue. The omission in these amendments of any reference to enjoining tax collections may indicate that Congress was content to let the courts fashion an appropriate exception, or, admittedly, it may simply indicate that Congress was unaware of the issue or unwilling to resolve it.[216]

Notwithstanding *Becker's Motor* and *A to Z Welding*, powerful support exists for finding judicial exceptions to the Anti-Injunction Act. In *Enochs v. Williams Packing & Navigation Co.*[217] a taxpayer sought to enjoin the district director of the Internal Revenue Service from collecting past-due taxes. The Court, recognizing a judicial exception to the Anti-Injunction Act, observed that the Act would not apply if the taxpayer (I) was certain to succeed on the merits and (2) could show that collection would cause him irreparable harm. By recognizing a judicial exception, the Court acknowledged that the Anti-Injunction Act does not bar all court interference with tax collection.

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212 *See also In re* LaSalle Rolling Mills, Inc., 832 F.2d 390 (7th Cir. 1987); Bowen Indus. v. United States, 61 Bankr. 61 (W.D. Tex. 1986); *In re* Steel Prods., 53 Bankr. 999 (W.D. Wash. 1985); *In re* Pressimone, 39 Bankr. 240 (N.D.N.Y. 1984).

213 *See In re* A & B Heating and Air Conditioning, 48 Bankr. 397 (Bankr. M.D. Fla. 1985) (congressional silence not persuasive).

214 Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1984).

215 Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No 99-554, 100 Stat. 3088 (1986).

216 *Cf. In re* Timbers of Inwood Forest Assocs., 808 F.2d 363, 369-70 (5th Cir. 1987) (en banc) (1986 amendments did not represent comprehensive overhaul of bankruptcy law but instead addressed a few specific problems), *aff'd sub nom.* United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 108 S. Ct. 626 (1988).

217 370 U.S. 1 (1962).

In *South Carolina v. Regan*,[218] the Court expanded the *Williams Packing* exception. In this case the state of South Carolina sought to enjoin as unconstitutional enforcement of certain provisions of the Tax Equity and Fiscal Responsibility Act of 1982.[219] These provisions denied tax exempt status to interest earned on obligations issued by states if states issued the obligations in bearer form.

In response to the Internal Revenue Service's argument that the Anti-Injunction Act barred the suit, the Court carved out another, even broader, judicial exception to the act. It held that the Act does not apply if there is no alternative remedy for the aggrieved party. In *Williams Packing*, the taxpayer could pay the tax and then seek a refund from the Internal Revenue Service. In *South Carolina v. Regan*, however, the state might issue bonds in bearer form and induce a taxpayer to pay the tax and seek a refund, but the state itself would have no means of contesting the statute unless a court found some exception for the action in the Anti-Injunction Act.

In the bankruptcy context, if the responsible person was himself seeking to contest the penalty, then at best the test in *Williams Packing* would apply. Because it is unlikely that the responsible person could show a certainty of success on the merits, he would have to pay the penalty and then sue for a refund if he believed that he was not liable.

When the debtor—as opposed to the responsible person—seeks to enjoin collection, however, the debtor is not claiming that the tax is not due. Instead, the debtor is claiming that the policies underlying the Chapter 11 proceeding argue in favor of temporarily enjoining collection from the responsible person. In other words, the debtor seeks an injunction to enable the debtor to successfully reorganize, for the benefit of the creditors generally as well as ultimately for the benefit of the public fisc. In that case, payment of the penalty and a suit for a refund constitutes an ineffective remedy for the debtor. The only effective remedy is a temporary injunction. Thus the action may fit within the *South Carolina v. Regan* exception to the Anti-Injunction Act, enabling the bankruptcy court to enjoin collection.[220]

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218 465 U.S. 367 (1984).

219 Pub. L. No. 97-248, 96 Stat. 324, 596 (1982).

220 This rationale meshes nicely with the preceding discussion of the court's jurisdiction. If the court were deciding the liability of the responsible person, as it seemingly is under section 505 of the Bankruptcy Code, then the person's remedy would be to pay the tax and seek a refund. If, as I have argued, the court is exercising its equitable power under section 105 in order to protect the debtor, then it is the debtor's remedy that is important. Payment of the penalty and the right to seek a refund is no remedy for the debtor because the debtor would simply cease doing business absent a stay.

This analysis, however, was generally considered and rejected by the Seventh Circuit Court of Appeals in *In re LaSalle Rolling Mills, Inc.*[221] In that case, the court held that the Anti-Injunction Act applies to bankruptcy court attempts to enjoin actions against responsible parties and that co-debtor stay actions do not fall within the exception created by *South Carolina v. Regan*. The debtor had argued that because the tax penalty would be assessed against its principals rather than against the debtor, the debtor itself would have no effective alternative remedy other than persuading the principal to raise defenses. In rejecting this argument, the court found that the alternative remedy to which the *South Carolina v. Regan* court referred was " 'to contest the legality of a particular tax.' "[222] Here, the legality of the tax penalty was not questioned; the debtor was seeking instead to postpone the assessment for reasons unrelated to whether the goverument was entitled to payment under the tax law.[223]

In focusing on the legality of the penalty, however, the court failed to appreciate the harm that the debtor was seeking to avoid. The facts, which were accepted by the court for purposes of the appeal, indicated that the principals were "indispensable to [the debtor's] successful reorganization,"[224] that the principal's time, energy, and funds needed for financing the reorganization would be diverted by the tax proceedings, and that such diversion would likely cause the reorganization effort to fail.[225] Thus, the harm was not payment of an improperly assessed penalty, but severe and significant interference with the bankruptcy proceeding of the debtor. It was with respect to preventing this interference that the debtor sought an injunction, and no alternative remedy would prevent this interference. When viewed from the perspective of the potential harm to the debtor, the lack of an alternative remedy becomes clear. Thus, the *LaSalle* court's focus on the legality of the tax may be misplaced.

Even if an action by a debtor to enjoin enforcement of the tax penalty against responsible persons does fit within the *South Carolina v. Regan* exception, courts should be wary about granting the relief sought. At the least, the Anti-Injunction Act represents a statutory statement expressing the extreme importance of the nonbankruptcy policy of enforcing tax liability.[226] Indeed, the Bankruptcy Code

221 832 F.2d 390 (7th Cir. 1987).

222 *Id.* at 393 (quoting South Carolina v. Regan, 465 U.S. at 373).

223 *Id.*

224 *Id.* at 391.

225 *Id.* at 391-92.

226 *See, e.g.*, Bob Jones Univ. v. Simon, 416 U.S. 725, 736-37 (1974) (suit to enjoin Internal Revenue Service from revoking private letter ruling that found university qualified for tax-exempt status).

recognizes the importance of tax collection, and defers to the tax collector in several important respects.[227] Thus, in balancing the gains to the bankruptcy system in enjoining the Internal Revenue Service with the effect on nonbankruptcy policies, the weight of the nonbankruptcy interests requires that a court find a particularly strong bankruptcy need before granting an injunction.

Recognizing that a court should not grant *any* injunction lightly, some courts have invoked the test for granting a preliminary injunction.[228] Under that test, as noted above, the court must find that failing to grant the injunction would irreparably harm the debtor or its estate, that there is a strong likelihood of success on the merits, that the party enjoined would suffer minimal harm, and that the injunction would not adversely affect the public interest.

The first part of the test requires a determination that collection from the responsible persons would substantially and adversely affect the reorganization effort. This focuses the inquiry on the effect on the debtor rather than the effect on the responsible person.

Some courts have interpreted the second part of the test to require a finding that the responsible person would not be liable to the IRS if liability were contested.[229] This, however, is nonsense. The problem in these cases is not that the responsible persons are claiming no liability, but rather that they are trying to delay collection while the reorganization proceeds, or at least while they develop a reorganization plan for the debtor. Thus, if the test is whether the responsible persons could legally avoid liability, then they will always fail. Instead, the court should inquire whether the debtor can show a likelihood of a successful reorganization.[230] In other words, the test of success on the merits is the debtor's success, not the responsible person's success. After all, it is the debtor, not the responsible person, that is seeking the relief.

The third part of the test addresses whether the Internal Revenue Service will suffer substantial detriment if a court delays its collection effort. The Internal Revenue Service might suffer substantial detriment if the delay enables the responsible person to dissipate his assets or enables other creditors of the responsible person to obtain his assets. However, a court can minimize the detriment if it takes proper steps to protect the interests of the

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227 *E.g.*, Bankruptcy Code §§ 507(a)(7) (priority for most taxes), 523(a)(1) (nondischargeability of most tax claims), 1129(a)(9)(C) (Chapter 11 plan must provide for full payment of priority tax claims), 1322(a)(2) (Chapter 13 plan must provide for full payment of priority tax claims) (West 1979 & Supp. 1987).

228 *See supra* note 124 and accompanying text.

229 *See, e.g.*, *In re* Campbell Enters., 66 Bankr. 200 (D.N.J. 1986); *cf. In re* LaSalle Rolling Mills, Inc., 832 F.2d 390, 393 (7th Cir. 1987).

230 *See supra* note 125 and accompanying text.

government.[231]

The potential adverse effect on the public interest is the interference with tax collections that would result from a co-debtor stay. Again, a court can minimize this adverse effect by limiting the availability of a stay to only the clearest cases and by providing adequate protection of the interest of the IRS.

Thus, even if the court has the bare power to enjoin the Internal Revenue Service from acting against nondebtor principals, it should exercise the power in only the most extreme cases. Generally, the government should not have to wait for payment over the life of a confirmed plan when it could collect more quickly from a responsible person. Section 6672 of the Internal Revenue Code imposes a penalty for failure to aid in the prompt collection of taxes, and in the normal case a bankruptcy court should not interfere with that important governmental interest. In the normal case, therefore, the responsible person should pay the claim immediately and, if entitled to it,[232] recover indemnity from the estate either in the context of the reorganization plan or when the stay of actions against the debtor expires.[233]

Some courts, however, have used their injunction power in seemingly inappropriate circumstances. For example, in *In re Original Wild West Foods, Inc.*[234] the court enjoined the Internal Revenue Service from foreclosing on the residence of an officer of the debtor or from otherwise assessing or collecting section 6672 liability from the officer. The officer had stated that if the court permitted the foreclosure he would " 'throw in the towel' " and end his efforts to rehabilitate the debtor.[235] Nothing indicated that the officer of the debtor was providing financing to the debtor and it was unclear from the court's opinion that his efforts were even necessary to the debtor's rehabilitation. In effect, the court simply succumbed to the officer's threat and on that basis alone enjoined the tax

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231 *See infra* notes 242-44 and accompanying text.

232 Normally the section 6672 penalty is separate from the debtor's tax liability. Because the responsible person is not a true surety, and technically the IRS could recover both from the debtor and from the responsible person, without an agreement between the responsible person and the debtor there may be no right to indemnification for amounts paid to the IRS. *See supra* note 190.

233 If the IRS is stayed from enforcing its claim against responsible parties, it will assert a seventh priority claim against the debtor. Bankruptcy Code § 507(a)(7) (1982). One commentator has pointed out that if the IRS is permitted to collect from responsible parties, the estate will benefit because even if the responsible parties are indemnified by the debtor, Bankruptcy Code section 507(d) denies them subrogation to the seventh priority to which the IRS is entitled. Thus, denial of a stay and payment by the responsible parties enables the debtor to, in essence, convert a priority claim to a general claim. *See* Note, *supra* note 195.

234 45 Bankr. 202 (Bankr. W.D. Tex. 1984).

235 *Id.* at 205 (quoting testimony given at trial).

collection.[236]

In fact, there should be little reason to succumb to such threats. If the reorganization is presently the officer's best employment opportunity, then he will continue in his position regardless of whether the Internal Revenue Service enforces a penalty against him. Similarly, a decision to seek or accept other employment will be unaffected by the penalty, which may be imposed regardless of where the officer is eventually employed. Thus, unless the officer irrationally intends to disregard his own self-interest in favor of destroying the debtor, courts should treat threats to "throw in the towel" as nothing more than empty threats.[237]

Other courts have gone too far in the other direction and refused to recognize the scope of their power when perhaps they should have applied it. For example, in *United States v. Huckabee Auto Co.*[238] the debtor corporation alleged that unless the court enjoined the IRS from collecting the tax penalty from the corporate principals, the corporation, pursuant to an indemnity agreement, would have to divert assets from its reorganization plan to the principals, and the plan would fail. Without addressing the validity of this assertion, the court rejected the injunction request, finding simply that the bankruptcy court lacked jurisdiction to enjoin collection from third parties.[239] It termed "irrelevant" the fact "that the penalty, if assessed, will adversely affect the corporate debtor's reorganization."[240] Yet, the court reached this conclusion because it considered only section 505. Had the court also considered section 105, it might have recognized that a temporary injunction, with appropriate protection for the IRS, could accomplish both the goal of assuring that tax claims are satisfied and protection of the reorganization effort.

Some courts seem more amenable to granting an injunction when the debtor's plan provides for full payment of the "trust fund" taxes and the debtor is current in making its payments. The danger here is that the court will enjoin collection from the principal because such collection offends the court's sense of fairness. A court might reason that if the debtor will eventually pay, the government

236 The court seemingly was influenced by the IRS's earlier representation that it would not assess the penalty against responsible persons as long as the debtor was timely in paying under the Chapter 11 plan. Nevertheless, even though the debtor was timely in paying, the IRS assessed the penalty. There may have been a basis for finding that the IRS was estopped from assessing the penalty, but that was not the basis of the court's holding.

237 *See* Note, *supra* note 195, at 631.

238 783 F.2d 1546 (11th Cir. 1986) (per curiam).

239 *Id.* at 1549.

240 *Id.*

does not need to collect from individuals liable only under a penalty provision. However, if the injunction is to issue under section 105, its justification must be the substantial need of the debtor, not its principals. The debtor requests the relief, and the debtor will have standing to do so only if an action against the principals will substantially and adversely affect its reorganization effort.

Although there is some basis for finding that courts should estop the Internal Revenue Service from collecting from responsible individuals when the IRS has accepted a confirmed reorganization plan calling for payment of the tax claim, careful analysis indicates that a court should not enjoin the action merely because the debtor has agreed to pay over time unless the IRS has also indicated that it would not take action against the responsible individuals.[241] The responsible person's liability is separate from the debtor's. The Internal Revenue Code is carefully crafted to assure that the government can collect the trust fund taxes as expeditiously as possible. If collection from a responsible person will not directly interfere with the debtor's reorganization, there is simply no basis for the bankruptcy court to interfere with this statutory scheme. The responsible person has not submitted himself to bankruptcy court protection, and if the reorganization can proceed notwithstanding the IRS's action, the government's collection efforts will not implicate the policies of the bankruptcy law.

Even if collection from a responsible person would interfere with the reorganization, the strong governmental interest in tax collection requires that a court be certain to protect the Internal Revenue Service, lest the responsible persons dissipate their assets and thereby defeat any future collection effort. For example, in *In re Campbell Enterprises, Inc.*[242] the corporate principals sought to enjoin IRS collection efforts because the imposition of tax liens on their residences would prevent them from mortgaging the residences to obtain funds which they would use to provide capital to the corporate debtor. The interference with the reorganization effort was potentially substantial—additional funds were essential to the success of the effort. Nevertheless, if the court prevented the IRS from acting against the principals, the principals would mortgage the residences and thereby put the funds to be contributed to the debtor beyond the reach of the IRS. If the reorganization were to fail, the government would be left without protection.

When a court enjoins the IRS from taking action against re-

241 *Cf. In re* Original Wild West Foods, Inc., 45 Bankr. 202 (Bankr. W.D. Tex. 1984)(U.S. attorney indicated at confirmation hearing no need to pursue personal jeopardy assessments as long as debtor kept payments under confirmed plan current).
242 66 Bankr. 200 (D.N.J. 1986).

sponsible persons to recover trust fund taxes, the IRS is entitled to adequate protection of its rights against the responsible persons.[243] Because Congress has repeatedly expressed its view of the importance of tax collections even in the bankruptcy context, an injunction against collection from responsible persons should not issue if it increases the risk that the taxes might remain unpaid. In *Campbell*, it appears from the court's discussion that there were no other available assets that the principals could use to satisfy the tax liability. Thus, unless the court could find some other means of adequately protecting the government's interest, the nonbankruptcy interest in tax collection should have overridden the bankruptcy policy of encouraging reorganization. The promise of payments over time in the context of a reorganization plan is not equivalent to payment immediately out of tangible assets.[244]

D. Suits Against Insurers

Finally, co-debtor stays arise in situations in which a debtor in bankruptcy has been insured against liability for pre-bankruptcy actions. Because the insurance policy belongs to the debtor, arguably it becomes property of the estate and the trustee may assert the debtor's rights under the policy.[245] Generally those rights will include indemnification against liability or, more likely, a right to have the insurance company pay any sums for which the debtor becomes liable (within the limits of the policy).[246] They will often also include a right to have the insurance company handle any litigation, including investigation, negotiation, posting of bond, and defense of the action.[247]

Outside of the bankruptcy context, most states either permit direct actions against insurance companies to recover for the insured's wrongful conduct or bar insurance companies from avoiding liability by conditioning their own liability on prior payment by its in-

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243 One type of protection always present is the nondischargeability of section 6672 liability. Bankruptcy Code § 523(a)(1) (1982). *See* United States v. Sotelo, 436 U.S. 268 (1978). This does not, however, assure that assets available when the injunction was sought will be available subsequently. Thus, a court should usually require some additional protection for the IRS.

244 *Cf. In re* Murel Holding Corp., 75 F.2d 941 (2d Cir. 1935).

245 Bankruptcy Code § 541 (1982).

There may be a distinction between the status of the policy and that of the proceeds of the policy. In *In re* Louisiana World Exposition, Inc., 832 F.2d 1391 (5th Cir. 1987), the court found that insurance policies purchased by the debtor to indemnify officers and directors were property of the estate but that the proceeds of the policies, which were payable on behalf of the officers and directors, were not property of the estate.

246 W. Keeton, D. Dobbs, R. Keeton & D. Owen, Prosser and Keeton on the Law of Torts 585 (5th ed. 1984). Payment differs from indemnification in that a direct pay situation does not require the debtor to lay out the funds and then seek indemnity.

247 *Id.*

sured.[248] This assures that the injured party will collect its judgment even if the insured has assets insufficient to satisfy the judgment. In effect, the insurance company becomes the debtor or, in a sense, holds the funds recoverable under the insurance policy in a "trust" for the injured party.[249]

If the insurance company is viewed as holding funds in trust for the injured party, then it should remain liable to the injured party even if the insured is in bankruptcy. No other creditor of the insured debtor has a better right to the funds involved than the injured party, and it is only through the injured party's action that the funds become available from the insurance company.[250] Moreover, the purpose of the state laws mandating insurance company liability is to assure that the injured party can recover from an insured defendant. In most cases there is no reason to permit the bankruptcy law to override that state policy.

The issues involved when the co-debtor is an insurer, however, differ from other co-debtor stay issues in two important respects. First, arguably the insurance policies are property of the estate under the section 541 definition.[251] Assuming that the policies are property of the estate, no reason exists to resort to section 105 to find a basis for staying actions against the insurer. Instead, section 362, which automatically stays any acts to obtain property of the estate, would stay an injured party from suing or recovering from the debtor's insurer.[252] Thus, if the policies are within the scope of section 541, the section 362 stay automatically applies.[253]

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248 *Id.* at 587.

249 *Cf.* 4 COLLIER ON BANKRUPTCY (15th ed.), *supra* note 15, ¶ 541.01, at 541-47 (debtor holds insurance proceeds in constructive trust for person to whom bill owed; therefore, proceeds not property of estate).

250 *See, e.g.*, Wedgeworth v. Fibreboard Corp., 706 F.2d 541, 547 (5th Cir. 1983) (vacated in part on reh'g, 706 F.2d 541, 548) ("[P]ayments by the insurer cannot inure to the debtor's pecuniary benefit. . . . A payment by the liability carrier will neither enhance nor decrease the bankruptcy estate.").

251 *See, e.g.*, *In re* Davis, 730 F.2d 176 (5th Cir. 1984); *In re* Johns-Manville Corp., 40 Bankr. 219 (Bankr. S.D.N.Y.), *rev'd in part on other grounds*, 41 Bankr. 926 (S.D.N.Y. 1984); *In re* Forty-Eight Insulations, Inc., 54 Bankr. 905 (Bankr. N.D. Ill. 1985).

252 *See, e.g.*, A.H. Robins Co. v. Piccinin, 788 F.2d 994 (4th Cir.), *cert. denied*, 107 S. Ct. 251 (1986); *In re* Johns-Manville Corp., 26 Bankr. 420, 436 (Bankr. S.D.N.Y. 1983), *aff'd*, 40 Bankr. 219 (S.D.N.Y.), *rev'd in part on other grounds*, 41 Bankr. 926 (S.D.N.Y 1984); *In re* Davis, 730 F.2d 176 (5th Cir. 1984); Wedgeworth v. Fibreboard Corp., 706 F.2d 541 (5th Cir. 1983) (vacated in part on reh'g, 706 F.2d 541, 548); *In re* Forty-Eight Insulations, Inc. 54 Bankr. 905 (Bankr. N.D. Ill. 1985).

253 Bankruptcy Code § 362(a)(3) (1982). Although an insurance policy is apparently property of the estate protected by the automatic stay, this need not inexorably lead to the conclusion that a direct action against the insurance company is barred. Under Bankruptcy Code § 541 (1982), only the debtor's legal or equitable interest in property becomes property of the estate. Thus, section 362 stays the direct action only to the extent that the direct action affects the debtor's interest. Because the debtor's interest is in indemnity for losses, in theory a direct action may proceed as long as it will impose no

Second, because insurance companies are usually solvent and liquid defendants, issues of protecting a claimant's ability to collect an eventual judgment need not normally arise. The concern is not with collection from the co-debtor, but with problems that may arise in equitably distributing the available insurance proceeds among claimants.

Most of the insurance cases in recent years have involved mass tort litigation in which thousands of claimants seek recovery from the debtor or the debtor's insurer.[254] In that situation, a finding that the policy is property of the estate and that tort claimants must seek their recoveries in the context of the bankruptcy proceeding makes sense. The limits on policy coverage will make it virtually certain that the funds will not satisfy all claims. The bankruptcy court may be the best available forum to distribute the insufficient assets equitably.[255] Moreover, because there is often litigation between the debtor and its insurers concerning the scope and coverage of the policies, determinations in the direct action might estop the debtor from litigating those issues.[256] Also, the debtor may have an obligation to aid the defense of the lawsuits, and performance of this obligation could adversely affect the debtor's estate.[257]

However, two problems arise if a court considers the insurance policies as property of the estate. First, as property of the estate the policy proceeds might then become available to all creditors rather than to the injured parties.[258] That approach would overturn an im-

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liability on the debtor. *See, e.g.*, *In re* Louisiana World Exposition, Inc., 832 F.2d 1391 (5th Cir. 1987).

254 *See, e.g.*, A.H. Robins Co. v. Piccinin, 788 F.2d 994 (4th Cir.), *cert. denied*, 107 S. Ct. 251 (1986); *In re* Johns-Manville Corp., 40 Bankr. 219 (Bankr. S.D.N.Y.), *rev'd in part on other grounds*, 41 Bankr. 926 (S.D.N.Y. 1984); Wedgeworth v. Fibreboard Corp., 706 F.2d 541, 548 (5th Cir. 1983) (vacated in part on reh'g, 706 F.2d 541, 548).

255 *Cf.* Roe, *Bankruptcy and Mass Tort*, 84 COLUM. L. REV. 846 (1984).

The problem of allocating insufficient insurance proceeds is not limited to mass tort situations. For example, in Tringali v. Hathaway Mach. Co., 796 F.2d 553 (1st Cir. 1986), two tort claimants sought recovery through an insurance policy with a limit lower than the aggregate of the claims. The court refused to authorize one of the claimants to proceed against the insurer because it found that the bankruptcy court was the appropriate forum for determining the proper distribution of the proceeds.

256 A.H. Robins Co. v. Piccinin, 788 F.2d 994 (4th Cir.), *cert. denied*, 107 S. Ct. 251 (1986); *In re* Johns-Manville Corp., 26 Bankr. 420, 435 (Bankr. S.D.N.Y. 1983), *aff'd*, 40 Bankr. 219 (S.D.N.Y.), *rev'd in part on other grounds*, 41 Bankr. 926 (S.D.N.Y. 1984).

257 *A. H. Robins*, 788 F.2d 994; *In re Johns-Manville*, 26 Bankr. 420. *See also In re* A.H. Robins Co., 828 F.2d 1023 (4th Cir. 1987), *cert. denied sub nom.* Oberg v. Aetna Casualty & Sur. Co., 56 U.S.L.W. 3648 (U.S. Mar. 22, 1988) (No. 87-1208).

258 *See supra* note 249.

In *In re* Soliz, 77 Bankr. 93 (Bankr. N.D. Tex. 1987), the court held that a cause of action against an insurer for breach of a duty to defend was property of the estate, and that the settlement proceeds were available to all creditors. The court distinguished this from the more typical liability insurance proceeds that are clearly for the benefit of the injured party.

portant nonbankruptcy policy of protecting injured parties but would yield no corresponding bankruptcy benefit. This approach would provide a windfall to commercial creditors who would never, outside of bankruptcy, benefit from the insurance (other than indirectly through the debtor's reduced liability to the tort claimants). Thus, if courts consider the insurance policies as property of the estate, then they should earmark them for the injured parties.[259]

Second, outside of the mass tort context, staying actions will unduly delay claimants from recovering their claims without any bankruptcy benefit from the delay. If the total of the claims involved falls within the policy limits and the insurance company admits the validity of the policy, a court has no reason to bar the injured party from recovering while the bankruptcy case progresses.[260] Tort cases proceed slowly enough without the added impediment of the tortfeasor's bankruptcy.

Even when the insurance covers all claims, however, the section 362 automatic stay should apply to direct actions. The stay would permit the bankruptcy court to make certain that in fact the available insurance suffices and that the direct action will not otherwise adversely affect the debtor. The injured party must seek relief from the stay at some cost, and at some delay,[261] yet the benefit of bankruptcy court oversight makes that delay worthwhile. Once the court ascertains the effectiveness and sufficiency of the insurance, however, it should grant relief from the stay.

Similarly, in a jurisdiction that does not permit a direct action, if the insurance coverage suffices to satisfy all of the claims against it, the court normally should be willing to lift the stay of actions against the debtor. Although the debtor would serve as the nominal defendant in the litigation, the insurance company would, under the terms of most policies, undertake the defense and obligate itself to satisfy any recovery. Thus, the only effect on the debtor would be the drain of resources as a result of its obligation to aid the insurance company in the defense. For example, employees of the debtor

259 One could argue that a court may reach this result by finding that the debtor has no legal or equitable interest in the policy proceeds, as opposed to the liability protection provided by the policy. *See, e.g.*, *In re* Louisiana World Exposition, Inc., 832 F.2d 1391 (5th Cir. 1987). However, in order to assure an equitable distribution of the proceeds among appropriate claimants, the court will normally want to assert jurisdiction over them through section 541 of the Bankruptcy Code. *See, e.g.*, Tringali v. Hathaway Mach. Co., 796 F.2d 553 (1st Cir. 1986).

260 *See, e.g.*, *In re* White Motor Credit, 761 F.2d 270 (6th Cir. 1985). *See also* 2 COLLIER ON BANKRUPTCY (15th ed.), *supra* note 15, ¶ 362.07[3], at 362-57 (court should normally permit action against debtor on claim covered by insurance to proceed because hardship to debtor likely outweighed by hardship to plaintiff).

261 *See* Bankruptcy Code § 362(e) (1982) (court must consider requests for relief from stay in expedited fashion).

might have to aid the insurer in responding to discovery requests or might have to testify at trial. While this itself could give the court a basis for continuing the stay in extremely complex litigation such as the mass tort cases,[262] individual nonmass tort claims do not normally involve that degree of complexity and may normally proceed without unduly interfering with the reorganization effort.

Not all insurance runs in favor of injured tort claimants. For example, a debtor who has borrowed on a secured basis using goods as collateral would normally be obligated to insure the goods, naming the secured party as loss payee. If the property suffers injury or destruction, the secured party may seek to recover directly from the insurance company.[263] Assuming the security interest is valid in bankruptcy, there is often no reason to deprive the secured party of its right of action.[264] Even here, however, a stay is appropriate to enable the bankruptcy court to assure that the security interest is valid in bankruptcy and that the debtor would have no equity in the

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262 *In re* A.H. Robins Co., 828 F.2d 1023 (4th Cir. 1987), *cert. denied sub nom.* Oberg v. Aetna Casualty & Sur. Co., 56 U.S.L.W. 3648 (U.S. Mar. 22, 1988) (No. 87-1208); A.H. Robins Co. v. Piccinin, 788 F.2d 994 (4th Cir.), *cert. denied,* 107 S. Ct. 251 (1986).

263 U.C.C. section 9-306(1) was amended in 1972 to clarify that the proceeds of insurance are proceeds of the collateral to which a security interest in the collateral may attach. U.C.C. § 9-306 official reasons for 1972 change, 3 U.L.A. 440 (1972) ("The new second sentence of subsection (1) is intended to overrule various cases to the effect that proceeds of insurance on collateral are not proceeds of the collateral."). *See also* PPG Indus. v. Hartford Fire Ins. Co., 531 F.2d 58 (2d Cir. 1976); *In re* Mewes, 56 Bankr. 108, 111-12 (Bankr. D.S.D. 1985).

264 Some dispute exists about whether an insurance contract is merely a personal contract between the insurer and the insured, the proceeds of which become property of the estate, or whether the contract is for the benefit of the secured party who would have a greater right to the proceeds. The better view recognizes that a secured party relies on the availability of insurance proceeds as a substitute for its collateral in the event that the collateral is damaged or destroyed and that the proceeds of the policy are held in constructive trust for the secured party. *See, e.g.*, Paskow v. Calvert Fire Ins. Co., 579 F.2d 949, 953 (5th Cir. 1978); Ettinger v. Cent. Penn Nat'l Bank, 2 Bankr. 385 (E.D. Pa. 1979), *rev'd on other grounds*, 634 F.2d 120 (3d Cir. 1980). *See also* U.C.C. § 9-306(1) (1972) (clarifying that insurance proceeds are proceeds of collateral to which security interest attaches); Henson, *Insurance Proceeds as "Proceeds" Under Article 9*, 18 CATH. U.L. REV. 453 (1969). *But see* Universal C.I.T. Credit Corp. v. Prudential Inv. Corp., 222 A.2d 571, 574 (R.I. 1966) ("An insurance contract or policy, so called, pertains to the persons to the contract and not to the item insured. It is a personal contract which does not attach to or run with the property insured."). COLLIER ON BANKRUPTCY also adopts the view that insurance proceeds become part of the estate, but recognizes that the debtor will often insure the property to protect the creditor:

> It is well established that money payable as the proceeds of a fire policy taken out before bankruptcy for the debtor's benefit does not arise from property, but from a personal contract between insurer and insured. Hence, such proceeds will become property of the estate rather than be awarded to a creditor holding a lien of [sic] the property, unless the debtor had covenanted to insure for the benefit of the person holding the lien, or an assignment has been made to the lienor.

4 COLLIER ON BANKRUPTCY (15th ed.), *supra* note 15, ¶ 541.12 (footnotes omitted).

insurance proceeds.[265] These will generally be relatively straightforward determinations and need not unduly delay the secured party in seeking its recovery. In addition, however, because the court may regard the insurance proceeds as property of the estate, the court may need to decide whether to turn the proceeds over to the debtor to be used to repair or replace the destroyed collateral or for the other purposes.[266]

As in the co-debtor stay cases involving principals, then, a careful analysis of the bankruptcy policies that litigation against insurers implicates, and of the nonbankruptcy policies with which a stay interferes, yields results that can reconcile conflicting interests. When interference with either the reorganization effort or the bankruptcy policy of equitable asset distribution is substantial, a stay is in order, provided that it is crafted in a manner that, under the circumstances, best protects the claimants as well as the debtor. When the litigation would have little effect on the reorganization effort, recognition of the nonbankruptcy policies suggests that the litigation be permitted to proceed.

Conclusion

Chapter 11 of the Bankruptcy Code fosters an atmosphere in which a debtor with a reasonable chance of successfully reorganizing can attempt to do so free of unjustified interference. When actions against co-debtors will interfere with that reorganization effort, a bankruptcy court may consider whether it should temporarily stay the actions in order to effectuate the bankruptcy policies.

In considering whether to stay actions, however, courts must recognize the extraordinary nature of such a remedy and use it sparingly. In addition, courts must give full weight to the nonbankruptcy policies underlying the action against the co-debtor, and weigh the benefit to the bankruptcy process against the interference with the nonbankruptcy policy. Only when there is a clear benefit to the bankruptcy process, and when that benefit outweighs the interference with nonbankruptcy interests, should a court consider staying an action against a party that has not itself chosen to seek bankruptcy protection.

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265 In Bradt v. Woodlawn Auto Workers, 757 F.2d 512, 515-16 (2d Cir. 1985), the court held that section 362 of the Bankruptcy Code stays a secured party from unilaterally seizing the proceeds of an insurance policy. The court found that the proceeds are property of the estate under Bankruptcy Code section 541(a)(6). The court noted that the secured party could seek relief from the stay and was entitled to adequate protection of its interest in the proceeds.

266 *See* United States v. Whiting Pools, Inc. 462 U.S. 198 (1983). Of course, if the security interest extends to the insurance proceeds, the secured party will be entitled to adequate protection of its interest. Bankruptcy Code §§ 362(d)(1), 363(e) (1982).

In balancing these interests, a court should consider limiting the stay and protecting the creditor so as to minimize the harm to the creditor and, consequently, the interference with nonbankruptcy policies. If bankruptcy courts recognize and carefully analyze the issues involved, co-debtor stays may, in appropriate cases, aid the reorganization effort and ultimately benefit the debtor, the stayed creditor, and creditors generally, thereby helping to realize the underlying bankruptcy goals of Chapter 11.