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Elizabeth Warner
University of Michigan Law School

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CONSUMER WARRANTY CLAIMS AGAINST COMPANIES IN CHAPTER 11 REORGANIZATIONS

The financial peril of the American auto industry in recent years is a disturbing and persistent reminder that the United States economy is in poor health. Chrysler Corporation, currently the leading example of the auto industry's ills, is struggling to stay afloat on a raft of federally-loaned dollars — a raft which may require more government dollars before it is seaworthy. A recurring fear is that Chrysler, and companies like Chrysler throughout American industry, will ultimately have to file for reorganization under Chapter 11 of the Bankruptcy Code.¹

When a company offering goods or services for sale to the public goes bankrupt, a somewhat atypical group of creditors may have a stake in the proceedings — holders of warranty rights.² Warranty holders are unlikely to think of themselves as creditors by virtue of their warranty rights. They are more likely to perceive themselves as consumers, more often on the debtor than the creditor side of a financial transaction. Unlike their more sophisticated co-creditors, they have not extended “credit” to the debtor in any traditional sense.³ They may in fact never

¹ 11 U.S.C. §§ 1101-1174 (Supp. III 1979).

² Many kinds of warranties are contemplated here. Some warranties are expressly made by the seller, and the buyer usually receives a document to this effect. In addition, there are many warranties implied by law, particularly U.C.C. §§ 2-312, 2-313, 2-314, 2-315 (1978 Official Text), although these warranties may be excluded or modified between the parties, U.C.C. § 2-316. Most warranties arising by operation of law are due to the U.C.C. § 2-714(2) (measure of damages for breach of warranty), and § 2-715 (buyer's incidental damages from seller's breach [of warranty]). Specific promises made in warranties thus vary. This article includes in its definition of warranty rights the right arising under U.C.C. § 2-714 and surrounding sections, specifying buyer's remedies upon breach of warranty. Note, however, that while these remedies too may be modified or excluded by the parties, U.C.C. § 2-719, the seller is the only party with the power to fix terms in the typical consumer contract.

³ Outside of bankruptcy law, it serves no purpose to characterize the holder of warranty rights as a creditor of the party who made the warranty. But the purchase of a good also includes the purchase of warranty rights, whether express or implied by law. It is the warranty right, enforceable against the debtor but for bankruptcy, which gives rise to the creditor status of the buyer. See notes 23-26 and accompanying text *infra*.

become aware that litigation relative to their rights as creditors is taking place.⁴

But bankruptcy law regards the warranty claims of consumer creditors⁵ in much the same way it does the unsecured claims of a debtor's bank, supplier, or contractor. The warranty holder is subject to the same requirements and is offered the same safeguards as are the others.⁶ The problem, then, is to fit the warranty creditor's claim into a complex federal bankruptcy law designed with solvent, knowledgeable commercial creditors in mind.⁷

This article examines the rights of individuals who have purchased warranted goods from a business that subsequently undergoes reorganization under Chapter 11 of the Bankruptcy Reform Act of 1978.⁸ Part I establishes that warranty rights are

⁴ Although the bankruptcy court is obliged to give creditors notice that a bankruptcy case has commenced, the court gets its list of creditors from the debtor, who in turn is not likely to have the names of all warranty creditors, if indeed the debtor has any list at all. See note 83 and accompanying text *infra*.

⁵ The term "consumer creditors" refers herein to consumers who are creditors of the debtor manufacturer/seller. See note 3 *supra*.

⁶ Unsecured creditors who are sellers of goods may be in a better position than the warranty creditor. U.C.C. § 2-702(2) (1978 Official Text) grants reclamation rights to the seller of goods on account if exercised within a certain period of time. The warranty holder, however, has not extended "credit" in any traditional sense and has nothing to reclaim from the debtor.

⁷ 11 U.S.C. § 507(a)(5) (Supp. III 1979), was designed in part to protect certain consumer creditors, but warranty holders do not qualify under this section.

⁸ Pub. L. No. 95-598, tit. I, § 101, 92 Stat. 2549 (codified primarily at 11 U.S.C. §§ 101-151326 (Supp. III 1979)). New title 11 is commonly referred to as the Bankruptcy Code and the previous law as the Bankruptcy Act, although the terms are rapidly becoming interchangeable. Liquidation cases, covered in 11 U.S.C. §§ 701-766 (Supp. III 1979), though far greater in number to reorganizations, traditionally offer nothing to a warranty holder in payment on his or her claim, and will not be discussed in the text.

Because, however, of the historical likelihood that cases under Chapter 11 will have to be converted to or will eventually end as Chapter 7 cases, a warranty creditor should also examine his or her rights in Chapter 7. See Kennedy, *The Impact of a Chapter 11 Bankruptcy Proceeding on Chrysler Corporation*, reprinted in SUBCOMM. ON ECON. STABILIZATION OF THE HOUSE COMM. ON BANKING, FINANCE AND URBAN AFFAIRS, 96TH CONG., 1ST SESS., FINDINGS OF THE CHRYSLER LOAN GUARANTEE BOARD 87 (Comm. Print 1980). The primary difference between proceedings in these chapters is that Chapter 7 entails liquidation of the debtor's assets to pay claims, while Chapter 11 supposes a reorganization and continuance of the debtor's business. The overwhelming majority of cases are liquidation cases. See D. EPSTEIN & J. LANDERS, *DEBTORS AND CREDITORS: CASES AND MATERIALS* 608 (1978).

In Chapter 7 all unsecured creditors, including warranty creditors, receive a pro rata distribution after all priority claims have been paid, 11 U.S.C. § 726 (Supp. III 1979). Since the assets are sold at liquidation value, the pro rata amount received is traditionally small; in many cases, unsecured creditors receive nothing at all. D. EPSTEIN & J. LANDERS, *supra*, at 632. Furthermore, creditors do not have any say as to the treatment of their claims under Chapter 7 — unlike Chapter 11, where creditors can vote to reject a plan which impairs their claims. The only advantage for unsecured creditors of Chapter

claims in bankruptcy and outlines the procedure that must be followed by a creditor for distribution from the debtor's estate.⁹ Part II focuses on how warranty claims are treated in Chapter 11. Part III discusses ways to alleviate the warranty creditor's representational burden, particularly through the intervention and aid of public interest groups. This article concludes that warranty creditors will receive favorable treatment in a reorganization plan, but recommends that claims arising after bankruptcy proceedings commence be treated as administrative expenses or as claims arising in the ordinary course of business. Finally, to assure adequate representation of warranty creditors, a public interest group should be allowed to participate in the creditor's committee if it can meet the standards for intervention under the Federal Rules of Civil Procedure.

I. CHAPTER 11 OF THE BANKRUPTCY REFORM ACT OF 1978

A. *Filing for Bankruptcy and Its Consequences for the Warranty Creditor*

The long-awaited Bankruptcy Reform Act became effective on October 1, 1979.¹⁰ The Act completely rewrote title 11 of the United States Code, repealing the old Bankruptcy Act of 1898, as amended.¹¹ Chapter 11 of the Act is one of the major changes

7 is that they will get claims settled more quickly. The advantage of expedience, however, is negated if the amount received on a claim is significantly smaller than it might have been in a Chapter 11 reorganization. See note 13 *infra*.

⁹ The warranty creditor's remedies under the bankruptcy procedure are separate from any additional relief he or she may obtain through common law actions against third parties. See generally W. PROSSER, *LAW OF TORTS* 654-56 (4th ed. 1971), for a discussion of these common law actions.

¹⁰ Pub. L. No. 95-598, tit. IV, § 402(a), 92 Stat. 2682 (1978). For an introduction to the Act and its legislative history, see Klein, *H.R. 8200: The Bankruptcy Act Comes of Age*, 84 *COM. L.J.* 8 (1979).

¹¹ Pub. L. No. 95-598, tit. IV, § 401(a), 92 Stat. 2682 (1978).

The old Rules of Bankruptcy Procedure, codified in 11 U.S.C. (1976), will continue to govern all bankruptcy cases commenced under the Act to the extent not inconsistent with the new law, until new rules are promulgated by the Supreme Court. Pub. L. No. 95-598, tit. IV, § 405(d), 92 Stat. 2685 (1978). As of 1981, only interim rules have been drafted, which are merely advisory and not binding. Interim Bankruptcy Rules, tit. 11 U.S.C.A. 1-2 (West Pamphlet 1979) (statement of the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States). Permanent new rules of procedure are not expected to be promulgated until 1983 or 1984. See generally Kennedy, *Some Comments About the Rules of Bankruptcy Procedure Under the Bankruptcy Reform Act*, 85 *COM. L.J.* 125 (1980).

All bankruptcy cases, including those cases "arising in or related to" the bankruptcy

from prior law and consolidates several previous chapters in bankruptcy law.¹²

Unlike the straight liquidation form of bankruptcy, Chapter 11 allows a debtor who wishes to stay in business to file a reorganization plan with the court providing for repayment of debt over a period of time long enough to enable the debtor to get back on its feet.¹³ The plan specifies how and to what extent claims will be paid and how the debtor is going to reorganize its business (through sale of assets, merger, issuance of securities, etc.) to carry out the terms of the plan.¹⁴ The debtor has 120 days after the bankruptcy court issues the order for relief in which to file a plan.¹⁵ After this time, any party in interest may file a plan.¹⁶ In complex cases, it will take several years to form and file a plan.¹⁷

Until a plan is filed and confirmed by the court,¹⁸ an automatic stay relieves the debtor from satisfying any warranty claims in goods sold before filing in bankruptcy.¹⁹ The stay ap-

case, are tried in federal court. 28 U.S.C. § 1471 (Supp. III 1979). The Bankruptcy Reform Act established a separate federal court system for the treatment of bankruptcy cases. Pub. L. No. 95-598, tit. IV, § 405, 92 Stat. 2685 (1978) (transition rule); § 409, 92 Stat. 2687 (1978) (establishment of new court system effective April 1, 1984). See generally McNutt, *The New Bankruptcy Court under the Bankruptcy Reform Act of 1978: The District Court's Little Brother Grows Up*, 39 FED. BAR J. 62 (1980).

¹² Chapter 11 combines elements of Chapters X, XI, and XII of the Bankruptcy Act of 1898, as amended. See H.R. REP. NO. 595, 95th Cong., 1st Sess. 223-24 (1977), reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6183 [hereinafter cited as HOUSE REPORT]. Chapter 11 of the Act also incorporates § 77 of the old Act (railroad reorganizations).

¹³ Congress recognized the value of reorganization over liquidation in certain cases: "If the business can extend or reduce its debts, it often can be returned to a viable state. It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets." HOUSE REPORT, *supra* note 12, at 220.

Typically, creditors will receive more in a Chapter 11 proceeding than in a Chapter 7 liquidation, on the theory that a business is worth more as a going concern than if liquidated.

¹⁴ 11 U.S.C. § 1123(a)(5) (Supp. III 1979).

¹⁵ *Id.* § 1121(a)-(b).

¹⁶ *Id.* § 1121(c). "Party in interest" is left undefined by the Act and will be determined by the Rules of Bankruptcy Procedure and case law. A party in interest must have an interest in the debtor's estate to be administered, *Gregg Grain Co. v. Walker Grain Co.*, 285 F. 156 (5th Cir. 1922). According to § 1121(c), this includes "the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee."

¹⁷ In the reorganization of a large, complex debtor, such as Chrysler Corporation, an acceptable plan may take years to form. As one commentator has noted, "The 120 days allowed by the statute to the debtor for the filing of a plan bears no close relationship to the time required for the preparation of a plan involving the complexities of Chrysler's debt and stock structure." Kennedy, *supra* note 8, at 85.

¹⁸ 11 U.S.C. § 362(c)(2) (Supp. III 1979).

¹⁹ *Id.* § 362(a)(1). Filing itself stays the accrual of interest on ripe claims, *id.* § 502(b)(2).

plies to both claims which ripen before and after filing, so long as the warranty contract is dated before filing. The stay may sometimes be lifted or modified, but the procedure is available more to traditional creditors than to warranty holders.²⁰ Otherwise, satisfaction of the warranty claim often lies in the business discretion of the trustee or debtor-in-possession²¹ who operates the debtor's business after filing. Although warranty creditors may request particular treatment, the trustee is answerable only to the court.²²

B. *The Warranty as a Claim in Bankruptcy*

Any entity having a claim against the debtor which arose before the filing of the petition in bankruptcy court is a creditor.²³ The term "claim" has been defined in the broadest possible way:²⁴ it encompasses "a right to payment, whether or not

²⁰ 11 U.S.C. § 362(d)(1) (Supp. III 1979) allows relief from the stay "for cause, including the lack of adequate protection of an interest in property of [the party seeking relief from the stay]." Adequate protection includes making periodic cash payments to the creditor and/or providing additional or replacement liens to the creditor. *See id.* § 361. While a secured creditor is entitled to adequate protection or relief whenever requested, *id.* § 362(d), it is generally accepted that an unsecured creditor has no special interest in the debtor's assets, and is therefore not entitled to protection. *In re Garland Corp.*, CCH B.L.R. ¶ 67,643 (App. Panel 1st Cir. 1980). Consequently, a warranty holder, as an unsecured creditor, *see note 46 infra*, is not likely to get relief from the automatic stay on grounds of lack of adequate protection.

²¹ The court shall order the appointment of a trustee in Chapter 11 cases: 1) "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management," 11 U.S.C. § 1104(a)(1) (Supp. III 1979); or 2) "if such appointment is in the best interests of creditors," *id.* § 1104(a)(2). When neither is the case, the debtor will remain in possession and assume most of the trustee's duties, *id.* § 1107.

If a trustee is requested but not appointed, the court shall instead order the appointment of an examiner "to conduct such an investigation of the debtor as is appropriate." *Id.* § 1104(b). If a trustee is not appointed, the debtor-in-possession remains in control of the business, and has all the duties of a trustee. 11 U.S.C. § 1107(a) (Supp. III 1979).

These sections reflect a specific congressional intent to avoid the appointment of a trustee unless "the protection afforded by a trustee is needed and the costs and expenses of a trustee would not be disproportionately higher than the protection afforded." HOUSE REPORT, *supra* note 12, at 234.

²² For example, the trustee may use the debtor's property other than in the ordinary course of business only after notice and a hearing, 11 U.S.C. § 363(b) (Supp. III 1979), which gives creditors a chance to object to the proposed use. Creditors cannot object, however, to the treatment of executory contracts by a trustee, *id.* § 365; such action is subject only to the court's approval, *id.* § 365(a). See Section II B 1 *infra* for a more detailed look at executory contracts.

²³ 11 U.S.C. § 101(9) (Supp. III 1979).

²⁴ This is a departure from prior law, which relied on a concept of provability of claims. *See note 38 and accompanying text infra. See also HOUSE REPORT, supra note 12, at 309.*

such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.”²⁵ Even without the broad definition of “claim” under the new Act, warranty holders would still be creditors. Whether express or implied, a warranty is a contract. Warranty holders own contract rights and hence are creditors under traditional bankruptcy law.²⁶

The debtor’s liability under a warranty may be fixed or contingent.²⁷ Consequently, two kinds of claims will exist at the time of filing: the ripe claim, where liability was triggered before the filing, and the contingent claim, where the warranty has not yet expired and liability may be triggered in the future. When and if the claim ripens may determine how favorably a warranty claim will be treated in bankruptcy.

1. *Ripe prepetition claims*— Warranty claims which ripen before filing are not significantly different from other claims based on contract disputes. The warranty holder will have acquired an injury that is or can be liquidated into costs of repair or replacement. The automatic stay, however, will prevent a suit against the debtor for the disputed amount.²⁸ Due to the intrusion of the stay, warranty creditors with ripe claims have an incentive to be aware and interested in the progress of the case. The number of creditors in this category is not likely to be large, however. Many debtor businesses such as auto companies, appliance franchisees, and jewelry stores provide service on warranties as a part of daily business. A debtor intending to file for reorganization will not usually halt normal business operations long before filing, if at all. This substantially lessens the chance that grounds for a ripe claim will arise.

2. *Claims contingent at filing*— While the warranty creditor with a ripe claim has an out-of-pocket interest in insuring that his claim is paid in bankruptcy, the holder of an untriggered warranty may not realize the importance of protecting his or her interest. Warranty creditors must be listed by the debtor or file a proof of claim²⁹ with the court in order to have their claims

²⁵ 11 U.S.C. § 101(4) (Supp. III 1979).

²⁶ See, e.g., *In re Godwin Bevers Co., Inc.*, 575 F.2d 805 (10th Cir. 1978).

²⁷ Contingent obligations include all debts that depend on some event uncertain in terms of occurrence or time of occurrence. See *Edwards Co. v. Long Island Trust Co.*, 75 Misc.2d 739, 347 N.Y.S.2d 898 (1973). By contrast, an unliquidated claim is one that is ripe, but not evaluated, e.g., a tort claim which has not been reduced to judgment.

²⁸ 11 U.S.C. § 362(a)(1) (Supp. III 1979).

²⁹ One of the debtor’s first duties after commencement of a case is to file with the court a schedule of creditors and their claims. 11 U.S.C. § 521 (Supp. III 1979). Claims listed in the debtor’s schedule which are not disputed, unliquidated, or contingent (e.g.,

considered in the plan.³⁰ If unlisted, the debt is nondischargeable unless the creditor had notice or actual knowledge of the proceedings.³¹ Hence, the contingent claimholder who knows about the reorganization but fails to file a claim cannot get satisfaction of a liability which arises during the proceeding because of the automatic stay,³² and may find that he cannot bring suit *after* the case closes because of the discharge. If the warranty creditor does not know of the reorganization, his claim is still valid. Unfortunately, since many reorganizations convert to Chapter 7 liquidations,³³ there may be no assets left to pay the warranty creditor after the case.

Even if the warranty creditor's contingent claim is listed to be treated in the reorganization plan, he has an interest in policing the progress of the case. Although some statutory safeguards protect against grossly unequal treatment in the plan,³⁴ the warranty creditor should be concerned with the valuation of his claim and delay in payment.

Warranty creditors whose rights are contingent will have to

ripe claims) are deemed filed and allowed by the court. *Id.* § 1111(a). Only holders of allowed claims are entitled to vote to accept or reject a plan. *Id.* § 1126(a).

It is not likely that the debtor will list all of its warranty creditors with contingent claims. Some businesses require a purchaser to fill out and mail a warranty card containing name and address before a warranty becomes effective. But many other warranties automatically become part of the sales contract or are implied by law, *see note 2 supra*. In such a case, the seller does not have a record of the buyer's name and address, and the warranty creditor must file a proof of claim under 11 U.S.C. § 501 (Supp. III 1979). The Rules of Bankruptcy Procedure govern the characteristics of a proof of claim. HOUSE REPORT, *supra* note 12, at 293, 296.

³⁰ A creditor must file a proof of claim within six months after the first date set for the first meeting of creditors, although later filing is allowed upon a showing of cause. FED. R. BANKR. PROC. 302(e) *in* 11 U.S.C. Appendix (1976). The court requires strict adherence to the provisions relating to the debtor's scheduling of debts, *Wyser v. Estrin*, 285 A.D. 827, 136 N.Y.S.2d 744 (1955), but amendments to the schedules are liberally allowed so long as the creditor is notified in time to enable him or her to file a proof of claim, *In re Seeley Tube & Box Co.*, 219 F.2d 389 (3rd Cir.), *cert. denied*, 350 U.S. 821 (1955).

³¹ 11 U.S.C. § 523(a)(3) (Supp. III 1979). Thus, the debtor has an incentive to list as many creditors as possible on its schedules.

³² The automatic stay forces the same result as if the warranty did not exist. If the goods develop a warranted defect or failure, the warranty creditor must either live with the defect or pay someone else to cure it, while waiting for payment on his or her claim.

Some warranties specifically prohibit the buyer from making such arrangements with a third party, but this should be of no consequence once the debtor is prevented in bankruptcy from honoring the warranty. Such prohibitions are made on the supposition that the entity liable under the warranty will be able to honor its agreement. If the debtor-in-possession continues to honor warranties and a trustee is later appointed, 11 U.S.C. § 549(a) (Supp. III 1979) permits the trustee to reclaim any post-petition transfer of property of the estate that was not authorized by the Act explicitly or by the court.

³³ *See Kennedy, supra* note 8, at 87.

³⁴ *See notes 49-55 and accompanying text infra.*

estimate the value of their warranty claim and file a proof of claim to this effect in order to participate in the reorganization.³⁵ The court may have to determine whether this estimation is correct.³⁶ The Rules of Bankruptcy Procedure will specify how contingent claims are to be estimated;³⁷ formerly, contingent claims were often incapable of valuation and not allowed.³⁸

When a contingent claim becomes ripe after having been evaluated by the creditor in a proof of claim and allowed by the court, the creditor will have a new basis for estimating the value of his or her claim. This cost-of-cure value will probably be different from the former estimated value of the claim. The Bankruptcy Act provides for revaluation of claims for "cause" or where equity demands.³⁹

³⁵ 11 U.S.C. § 502(c) (Supp. III 1979) requires the creditor to estimate a contingent claim "the fixing or liquidation of which . . . would unduly delay the closing of the case" See note 27 *supra*. Because estimation of contingent claims is difficult, and there are no guidelines for such estimation, a warranty creditor may wish to avoid estimation, claiming that the warranty claim will be liquidated long before the reorganization is completed. Section 502(c), however, also reflects the necessity of knowing the total value of claims against the estate for the very purpose of drafting a plan. Furthermore, warranties which last for more than one or two years will almost certainly require estimation while contingent. The chances are good, therefore, that contingent warranty claims will have to be estimated when the creditor files a proof of claim.

³⁶ Where many contingent warranty holders independently file proofs of claim it is inevitable that identical claims will be given different values, especially as there are no guidelines for estimating contingent claims. A party in interest may object to the disparity in values given to the claims, whereupon the court must make the determination as follows: "if . . . objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim as of the date of the filing of the petition . . ." 11 U.S.C. § 502(b) (Supp. III 1979). See also *In re DeCordier*, 4 B.C.D. 129 (E.D.N.Y. 1978).

³⁷ There are several ways to evaluate a contingent claim. What is being valued is the right not to current payment, but the right to receive payment if the contingency occurs—a right, in short, in peace of mind until the warranty expires. The warranty can be viewed as having been purchased when the product was purchased, and thus can be valued as a percentage of the purchase price. Where a warranty approaches the character of a maintenance contract (*e.g.*, a six-month "check-up" on a car), it might be possible to approximate a fair market value for the warranty as the cost of purchasing identical coverage in the marketplace.

³⁸ HOUSE REPORT, *supra* note 12, at 352. For a discussion of the former law of the provability of contingent and unliquidated claims, see Note, *Tort Claims Under the Present and Proposed Bankruptcy Acts*, 11 U. MICH. J.L. REF. 417 (1978).

³⁹ 11 U.S.C. § 502(j) (Supp. III 1979) provides: "Before a case is closed, a claim that has been allowed may be reconsidered for cause, and reallowed or disallowed according to the equities of the case." The right to revaluation is not automatic; a petition for revaluation of a previously allowed claim rests in the sound discretion of the court, *McLeod v. Boone*, 91 F.2d 71, 73-74 (9th Cir. 1937).

The provision for revaluation cuts two ways. A warranty holder who was forced to estimate the value of a contingent claim can use § 502(j) to revalue the claim upward if liability is triggered and the claim becomes ripe. Similarly, however, a creditor whose contingent warranty later expires without liability ever having been triggered may find his or her claim revalued by the court to zero. Revaluation downward is not likely, however. First, the court will probably value contingent claims quite low from the start.

Even where a warranty creditor has a liquidated prepetition claim, he or she will also have a contingent claim for as long as the warranty is in effect. A warranty holder may accumulate several liquidated claims, before and after filing. Finally, the warranty creditor with an untriggered claim should file his or her claim in order to participate in the interim daily conduct of the debtor's business. The certain delay of plan confirmation⁴⁰ encourages warranty creditors to seek pre-confirmation treatment of their claims.⁴¹ Participation as claimholders in the reorganization process gives warranty creditors direct access to the court and trustee.

Deciding to participate in the reorganization proceeding is only the beginning of the warranty creditor's headaches. Whether ripe or contingent, a warranty claim is unsecured, and as such has a very low priority,⁴² or right to payment, compared with other claims. Fortunately for the warranty creditor, Chapter 11 is flexible enough to provide some favorable treatment of warranty claims.

II. TREATMENT OF A WARRANTY CREDITOR IN A CHAPTER 11 REORGANIZATION PLAN

A. *Relief for Warranty Creditors in the Plan*

Assuming that warranty creditors have had notice and, where required to do so, filed proofs of claim toward protecting their rights, the next stage in a Chapter 11 case is initiated when the debtor files a plan of reorganization with the court.⁴³ The plan is the heart of the operative provisions of Chapter 11. It enables

Moreover, even an untriggered warranty had some value while in existence, representing at least a part of the purchase price.

⁴⁰ Professor Frank Kennedy has estimated that "[a] review of the record of big cases suggests that a reorganization case involving a debtor the size of Chrysler and its affiliates will require five years or more between the opening and the closing of the case." Kennedy, *supra* note 8, at 85. Aside from the railroad reorganizations, which lasted 20 to 30 years, recent reorganizations of large corporations include: Dolly Madison Industries (seven years, five months), King Resources (seven years), Equity Funding (four years, eight months), United States Financial (four years, four months), and Interstate Sales (three years, 11 months). *Id.*

⁴¹ See Part II C *infra*.

⁴² See generally 11 U.S.C. § 726 (Supp. III 1979). This section assigns payoff priority in liquidation cases and must be used by the reorganization court. See note 46 *infra*.

⁴³ 11 U.S.C. § 1121 (Supp. III 1979). The debtor gets the first opportunity at plan-drafting. See notes 13-17 and accompanying text *supra*.

the debtor to avoid liquidation of its business while receiving a discharge on its obligations as formerly bargained for.⁴⁴ The plan may provide for virtually any treatment of claims, from complete repayment to no repayment. Even secured creditors' claims might be impaired in a plan. What makes or breaks a plan is its acceptance by creditors and its confirmation by the court.

A debtor chooses to reorganize under Chapter 11 because it wants to remain in business. Presumably it will continue to offer for sale products similar to those offered before bankruptcy, perhaps containing identical warranties. A debtor may thus be very concerned with providing well for warranty holders in a plan, anticipating how future sales will suffer if potential buyers were to find out old warranties were not being honored in bankruptcy.⁴⁵ Despite the fact that few claims are entitled to less priority than warranty claims,⁴⁶ a debtor can provide favorably for warranty claims in its plan because it is not obliged to honor the strict rules of priority. In other words, the debtor can provide for its warranty holders at the expense of other unsecured creditors. It might also be possible to persuade classes of creditors with a

⁴⁴ HOUSE REPORT, *supra* note 12, at 220-21.

⁴⁵ A dramatic illustration of this is the recent plight of Chrysler Corporation. Chrysler dealership owners in Detroit report loss of sales because people are worried about the treatment of their warranty rights if the company files in Chapter 11. Detroit Free Press, Jan. 18, 1981, at 3A, col. 2. See also Kennedy, *supra* note 8, at 79: "If Chrysler should be unable to honor its warranty obligations respecting automobiles sold before the filing of the petition, the effect on post-petition acceptability of Chrysler products would be devastating."

⁴⁶ The validity and size of a creditor's claim in bankruptcy against the debtor frequently are minor issues beside the question of which creditor is paid first—the question of *priority*. Since a debtor usually undergoes bankruptcy only when it does not have the assets to meet the claims of all its creditors, some creditors in bankruptcy will not receive the full value of their claims. Yet the debtor's assets might be enough to fully pay any one claim. Hence, a creditor will want to establish a priority over other creditors, enabling it to satisfy its claim completely before others are entitled to receive anything from the debtor's estate.

Although it is intimately connected with bankruptcy, priority among creditors is governed largely by local law. Most conspicuous among the nonfederal law is Article 9 of the Uniform Commercial Code. See generally Schmitt & Johnson, *A Poker Player's Guide to Uniform Commercial Code Secured Transactions*, 84 Com. L.J. 142 (1979).

Claims are divided into three major types: secured, unsecured, and administrative. Warranty claims are not secured claims, which are defined at 11 U.S.C. § 506(a) (Supp. III 1979), and hence are unsecured claims. Administrative claims are otherwise undistinguished claims which are entitled to first priority by virtue of 11 U.S.C. §§ 503, 507 (Supp. III 1979).

Generally speaking, the only claims which share in the distribution after unsecured claims are those of equity security holders. 11 U.S.C. § 726(a) (Supp. III 1979) specifies the order in which claims are to be paid; the debtor is at the bottom of this list. *Id.* § 726(a)(6). If the debtor is a corporation, as is contemplated in this article, its shareholders occupy the lowest rung. Although § 726(a) is expressly reserved for liquidation cases, *id.* § 103(b), the section is incorporated into Chapter 11 by reference, see *id.* § 1129(a)(7).

higher priority to give up value to the class containing warranty holders. Even high priority creditors have a large stake in seeing the reorganization succeed. This flexibility is limited by the risk of losing creditor acceptance if the plan deviates greatly from priority rules.

The parties to a reorganization necessarily have an incentive to provide well for warranty holders.⁴⁷ Factors may exist, however, which militate against warranty holders being well-treated in a plan. First, the plan drafters may think the debtor too weak financially to fully honor some claims and consequently draft a reorganization plan that offers little to the warranty and other low priority creditors. Second, many if not most creditors have a priority over warranty creditors and can exercise great influence in drafting a plan to their own benefit. Finally, warranty claims may be undervalued by the court, especially when they are contingent, because the debtor may think it economically advantageous to pay contingent claimholders off in cash rather than honor ripe claims that might later arise.

The warranty holder can do little about the possible undervaluation of claims. However, if the plan impairs⁴⁸ their claims providing less than full payment due to one of the reasons mentioned above (*i.e.*, debtor's financial weakness or influence of high-priority creditors) warranty holders may vote to reject the plan.⁴⁹ The bankruptcy court may not confirm a plan over the objections of a dissenting *class* of claimholders whose rights are impaired unless the plan "does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan."⁵⁰

A plan can be "fair and equitable" despite dissent, and the

⁴⁷ Creditors' committees can exercise considerable influence in the drafting of a plan and attendant matters such as investigation of the debtor's assets, 11 U.S.C. § 1103(c)(2)-(3) (Supp. III 1979). The appointment of committees and their members (who are usually entities holding the largest claims against the debtor of the type represented by such committee, *id.* § 1102(b)(2)), is in the discretion of the court. *Id.* § 1102(a)(2). It is possible that the court can be persuaded to appoint a committee of warranty holders. Recently, bankruptcy courts have been more flexible in appointing parties to the committee who do not fit the traditional mold. *Cf. In re Schatz Fed. Bearings Co., Inc.*, 6 B.C.D. 6932 (S.D.N.Y. 1980) (union appointed to creditors' committee).

⁴⁸ 11 U.S.C. § 1129(a)(8) (Supp III 1979). Impairment of a claim is defined in § 1124. Essentially, a claim is impaired under a plan if the plan provides for less than full payment of the face amount.

⁴⁹ *Id.* § 1126(a). A class of creditors has accepted the plan when it votes to do so by a simple majority in number and a two-thirds majority in amount of allowed claims. *Id.* § 1126(c), (f).

⁵⁰ *Id.* § 1129(b)(1).

dissenting class⁵¹ will then be forced to accept the plan. Before the court can overrule the dissent of a class of unsecured creditors, however, the provisions of "cram-down" must be met.⁵² Cram-down mandates either that the creditor receive "property of a value, as of the effective date of the plan, equal to the allowed amount of such claim," or that no junior creditor receive *any* payment under the plan.⁵³ Although cram-down disregards the voluntary nature of plan acceptance and class participation, the provision does require a plan to contain certain minimum standards of fairness, and thus safeguards creditors' priority rights to an extent.

Procedurally, the cram-down provisions are not much of a hurdle, since warranty holders have such low priority in distribution. But in at least one situation, cram-down provides limited protection to warranty creditors. When reorganization debtors want to provide for their stockholders, the cram-down provision acts as a shield for the warranty creditors: since shareholders have less priority, the debtor must give warranty holders the full value of their claims in order to give *anything* to the shareholders.⁵⁴

Warranty creditors have at least one additional tool for obtaining leverage over senior creditors. The legislative history makes clear that a further requirement of "fair and equitable" is that no *senior* creditor receive more than 100 percent of its claim if a junior creditor's rights are impaired.⁵⁵ Thus, in a situation where intermediate creditors above warranty creditors are

⁵¹ For reorganization purposes, creditors are divided into classes according to claims or interests which are "substantially similar," *id.* § 1122(a). Whoever files the plan makes the initial determination. What constitutes substantially similar claims, however, is left to case law. See 5 COLLIER ON BANKRUPTCY ¶ 1122.03 (15th ed. 1980).

Subject to court approval, all unsecured claims under a set amount may be placed in a single class for ease of administration, 11 U.S.C. § 1122(b) (Supp. III 1979). It is likely that most warranty claims will be placed in the same class; general unsecured claims are frequently classified together. See 5 COLLIER ON BANKRUPTCY, *supra*, ¶ 1122.03[4]. Warranty claims may also share a class with other claims.

A plan must treat all members of a class identically, unless the holder of a claim agrees to less favorable treatment, 11 U.S.C. § 1123(a)(4) (Supp. III 1979). Treatment among *different* classes, on the other hand, can vary widely.

⁵² *Id.* § 1129(b)(2). See HOUSE REPORT, *supra* note 12, at 413. See generally Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979).

⁵³ 11 U.S.C. § 1129(b)(2)(B) (Supp. III 1979).

⁵⁴ Cram-down gives no protection to a dissenting class with respect to a class of equal priority. Accordingly, a debtor's plan may provide for warranty creditors at the expense of other unsecured creditors. The creditors must be in different classes, however. See *id.* § 1123(a)(4).

⁵⁵ 124 CONG. REC. H11104 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards).

to be paid with stock of the debtor (a common practice), the value of that stock will have to be ascertained in order to insure that these creditors are not receiving more than 100 percent of their allowed claims. Because business valuations are costly and undesirable,⁵⁶ warranty creditors can insist that their claims be fully paid, lest they demand a stock valuation.

B. *Relief for Warranty Creditors Before Confirmation of a Plan*

Warranty creditors have a certain degree of leverage over the drafters of a reorganization plan, because the continued goodwill of customers is so vital to the company's continued success. Thus, the chances are good that the plan will treat warranty creditors well. Reorganizations, however, can last for years.⁵⁷ Since the filing of a petition in bankruptcy operates as an automatic stay of virtually any attempt to enforce a claim, even where that claim has been reduced to judgment,⁵⁸ creditors must often wait for years before getting satisfaction of their claims. Moreover, reorganizations often fail, ending up as Chapter 7 liquidations⁵⁹ in which unsecured creditors often receive next to nothing.⁶⁰ This section therefore explores possible interpretations of the law which allow satisfaction of warranty claims *before* the plan is confirmed.

1. *Executory contracts*— Liability on a warranty may be triggered while the consumer creditor, having bought the goods on credit, is still paying for them. If the creditor has been extended credit by the *debtor*,⁶¹ the relationship between the parties can be viewed as an executory contract. Performance remains "due to some extent on both sides,"⁶² since the holder of the warranty claim owes the balance of payments, and the debtor owes the fulfillment of the warranty. The warranty creditor may be entitled to special pre-plan treatment if his purchase

⁵⁶ See Klee, *supra* note 52, at 145.

⁵⁷ See note 40 *supra*.

⁵⁸ See notes 19-20 and accompanying text *supra*.

⁵⁹ See note 33 *supra*.

⁶⁰ See note 8 *supra*.

⁶¹ The case of a third party loan (*e.g.*, from a bank) to the buyer that finances the purchase of the warranted goods must be distinguished. If the warranty creditor has paid for the goods with the proceeds of a *third party* loan, then from the debtor's standpoint the goods have been fully paid for and there remains only the debtor's liability on the warranty. The relationship between the warranty creditor and the debtor is unchanged, although the creditor has now incurred a debt to pay for the goods.

⁶² HOUSE REPORT, *supra* note 12, at 347.

contract is still executory.

a. *Assumption of executory contracts.* The trustee may elect to honor a contract which is executory as of filing.⁶³ The trustee may also reject any executory contract, subject to the court's approval.⁶⁴ Generally, a trustee will reject unfavorable contracts and accept favorable ones. A warranty contract seems unfavorable, because the trustee has the financially advantageous side of the bargain. The warranty holder probably must continue payments to the debtor whether the trustee accepts or rejects the contract;⁶⁵ hence, acceptance means only that the trustee agrees to pay claims otherwise barred by the automatic stay. The warranty contract is also a favorable contract, for the treatment of warranty claims will influence sales. Poor or delayed treatment will surely injure the acceptability of the debtor's goods in the marketplace. Similarly, although acceptance requires the payment of ripe claims, it also should result in an increase in the value of inventory, and an increase in cash flow. Consequently, the trustee should be encouraged to accept executory warranty contracts as vital to the success of interim and future business.

If the trustee assumes the contract, the warranty creditor is as well off as if bankruptcy had not occurred.⁶⁶ In view of the length of time it can take to confirm a plan, it is better for a warranty creditor to have present satisfaction than to have favorable plan treatment in the future. Rejection of an executory contract is treated as a breach by the debtor as of the day imme-

⁶³ 11 U.S.C. § 365(a) (Supp. III 1979).

The trustee can affirm an executory contract at any time before a plan is confirmed, although the other party may petition the court to direct the trustee to accept or reject within a certain period of time. *Id.* § 365(d)(2).

⁶⁴ *Id.* § 365(a). If there has previously been a default by the debtor not due to bankruptcy, the trustee cannot assume the contract without first curing the default and providing adequate assurance of future performance to the creditor. *Id.* § 365(b)(1).

⁶⁵ Although there is authority both in the U.C.C. and the Bankruptcy Reform Act which permits the buyer to offset amounts owed to the seller against damages due to breach, the automatic stay generally prevents such setoff, *id.*, § 362(a)(7). See notes 69-71 and accompanying text *infra*.

When the sale is covered by Article 2 of the U.C.C., the buyer is allowed to deduct his or her damages due to seller's breach from the price, §§ 2-717, 2-714 (1978 Official Text) (authorizing damages for breach of warranty). The Code appears to be referring only to ripe claims, however. Section 2-714(1) requires that the buyer give notice to the seller of any nonconformity in the goods. If the trustee rejected only contingent liability on the warranty, then by hypothesis the goods have not yet developed any nonconformity and these sections of the U.C.C. would not seem to apply, even though from the standpoint of the Bankruptcy Reform Act there is a breach.

⁶⁶ See *Vilas & Sommer, Inc. v. Mahony (In re Steelship Corp.)*, 576 F.2d 128, 132 (8th Cir. 1978). But see note 64 *supra*. See generally Fogel, *Executory Contracts and Unexpired Leases in the Bankruptcy Code*, 64 MINN. L. REV. 341 (1980).

diately preceding the filing of the petition.⁶⁷ Thus, rejected contract claims become claims for damages for prepetition breach. The warranty creditor whose executory contract has been rejected is in the same position as the warranty creditor whose contract is not executory.⁶⁸

b. *Setoff*. Even if the executory contract is not assumed, the Bankruptcy Reform Act preserves the common law right of a creditor to offset the amount of his or her claim against the balance of the contract price.⁶⁹ Courts should find setoff suitable for ripe claims for several reasons. These claims are liquidated and setoff will probably not impair the reorganization. Indeed, permitting setoff, like honoring a warranty as part of an executory contract, will enhance the value and saleability of the debtor's goods. Allowing an offset also avoids publication of news that the debtor is not paying warranty claims. Potential customers who hear that other warranty claims are not being paid might otherwise be scared away, even though the trustee has the power to honor warranties on postpetition sales.⁷⁰

The court may be less receptive to lifting the stay and allowing setoff where the claim is contingent. Setoff of a contingent claim is an unusual commercial practice outside of bankruptcy, for contingent claims are not normally given a dollar value. Neither the buyer nor the seller regards the warranty as creating a right to payment until a claim ripens. Further, disallowing setoff of contingent claims carries none of the risk to future sales as does refusing to permit setoff of ripe claims; and permitting setoff of contingent claims depletes the estate of funds which it would not otherwise be paying, which may impede the progress of the reorganization.⁷¹ Finally, retailers who

⁶⁷ 11 U.S.C. § 365(g) (Supp. III 1979).

⁶⁸ Both claims are valued as of the same day (the date of filing), and the valuation method is the same regardless of whether the claim arose ordinarily as a result of bankruptcy or arose as a rejected executory contract. Rejected contract status may in fact entitle the claim holder to greater damages in view of the extensive common law on damages for breach of contract.

⁶⁹ 11 U.S.C. § 553 (Supp. III 1979). This provision parallels the right of a buyer to deduct damages from the purchase price under U.C.C. § 2-717. See note 65 *supra*. Although the automatic stay bars setoff after the filing of the petition, *id.* § 362(a)(7), a claim which is subject to setoff is a secured claim under § 506(a) "to the extent of the amount subject to setoff." *Id.* § 506(a). The creditor can therefore petition the court for the automatic stay to be lifted or in the alternative for adequate protection. See note 20 *supra*.

⁷⁰ The trustee has the power to honor warranties arising out of postpetition sales (but not postpetition claims) as part of his or her general power to "enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing." 11 U.S.C. § 363(c)(1) (Supp. III 1979).

⁷¹ Congress was concerned with the disruptive effect of setoff on reorganizations. See

sell durable goods on installment plans depend on the regular payment of installments on past sales for their cash flow and inventory financing. A drought in this expected source of funds beyond the level caused by setoff of ripe claims could be fatal to reorganization of this type of enterprise.⁷²

2. *Administrative expense priority*— Executory contract treatment and the right to setoff both depend on the creditor owing some performance or debt to the debtor. Many warranty holders will be unable to take advantage of these provisions because they owe no such performance or debt. Furthermore, because of the automatic stay, setoff requires court permission after a hearing and is of little immediate value. Warranty holders whose claims cannot be called part of an executory contract must thus look elsewhere in the law for favorable treatment outside of the plan.

Warranty creditors may get immediate relief if the warranty claim is treated as an administrative expense.⁷³ Administrative expense claims can be paid in full before a plan is confirmed.⁷⁴ The holder of an administrative expense claim, like the holder of a secured claim, can therefore sidestep most of the Chapter 11 process. Furthermore, administrative treatment is not dependent upon the existence of a mutual duty of performance between debtor and creditor, and hence is of greater use to more warranty creditors.

Warranty claims arguably fall under one category of administrative expenses in the Reform Act: "the actual, necessary costs and expenses of *preserving the estate*."⁷⁵ The definition of "estate" includes "all interests [of the debtor], such as interests in real or personal property, tangible and intangible property . . . whether or not transferable,"⁷⁶ and includes the goodwill of the

generally HOUSE REPORT, *supra* note 12, at 183-86.

⁷² See, e.g., *Diversa-Graphics, Inc. v. Management & Technical Services Co.*, 561 F.2d 725 (8th Cir. 1977) (cash flow considerations prohibited use of setoff).

⁷³ Administrative expense claims are paid by a distribution off the top of the debtor's estate, 11 U.S.C. §§ 507(a)(1), 726 (Supp. III 1979). Included in this category are professional fees for services rendered in the administration of the case, *id.* § 503(b)(4), certain tax claims, *id.* § 503(b)(1)(B), expenses incurred by a creditor in recovering property that belongs to the estate, *id.* § 503(b)(3)(B), and other actual expenses necessary to preserve the estate, *id.* § 503(b)(1)(A).

⁷⁴ *Id.* § 503(a), (b), § 507(a)(1). The preferred status of these claims conditions payment on prior notice and hearing.

⁷⁵ *Id.* § 503(b)(1)(A) (emphasis added).

⁷⁶ HOUSE REPORT, *supra* note 12, at 175-76 (emphasis added). See also 11 U.S.C. § 541 (Supp. III 1979).

business.⁷⁷ As discussed above, honoring warranty claims can be critical to the success of the reorganization; conversely, failing to honor them quickly and in full can be fatal.⁷⁸

Warranty creditors are more than just creditors; they are also the debtor's customers. While preferential treatment of any creditor's claim has a beneficial effect on the goodwill of the business, it is *customer* goodwill which determines how successfully a business competes for consumers' attention and money on a day-to-day basis. Accordingly, the court should consider the payment of warranty claims as administrative expenses, particularly where the case is likely to be complex and time consuming.

This advantage may be limited to claims which ripen after filing of the Chapter 11 petition. Claims which ripen before the filing of the petition are not likely to be considered as administrative expense claims; it is more difficult to argue that prepetition claims are expenses of administering a case that had not yet commenced. Fortunately, claims that ripen prepetition are the type of liquidated claims that are traditionally suited for plan treatment. Moreover, the trustee's power to honor warranties as postpetition *sales* may be enough to preserve goodwill. This position may underestimate consumer reaction to knowledge that *some* warranty claims are not being paid—a reaction which may not be overcome by promises from the trustee that postpetition sales warranties will be honored. On balance, however, treating only claims which ripen postpetition as administrative expenses seems more in line with the traditional function of administrative expenses.⁷⁹ Since warranty creditors with claims which ripened prepetition are not left remediless, the position advocated here seems a good compromise.

3. *Claims in the ordinary course of business*— The trustee has a large amount of responsibility in handling the debtor's estate. The trustee not only collects the property of the estate and recovers preferential and fraudulent transfers, but also runs the debtor's business.⁸⁰ Because of this responsibility, the trustee in a reorganization is given special authority to "enter into transac-

⁷⁷ Goodwill is clearly part of the debtor's property:

It is unquestioned that business goodwill, in connection with the business to which it relates, constitutes property in the hands of the debtor-owner. Consequently, such goodwill passes to the estate and thereupon may be conveyed by the trustee to another when the business is sold intact.

⁷⁸ 4 COLLIER ON BANKRUPTCY ¶ 541.09[5] (15th ed. 1980) (citing *inter alia* Mutual Life Insurance Co. v. Menin, 115 F.2d 975 (2d Cir.), cert. denied, 313 U.S. 578 (1940)).

⁷⁹ See note 45 *supra*.

⁷⁹ See notes 73-74 and accompanying text *supra*.

⁸⁰ See 11 U.S.C. § 1108 (Supp. III 1979).

tions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing."⁸¹ Thus, while creditors are given an opportunity to object to the payment of administrative expense claims, payment of claims in the ordinary course of business rests in the discretion of the trustee, and prior notice and hearing is not required. Consequently, the trustee may decide to satisfy warranty claims as a part of the costs of daily business.

The terms of the warranty determine the amenability of warranty claims under this clause. The fulfillment of some warranties may be considered more in the "ordinary" course of a particular business than others in the discretion of the trustee. A warranty promising service may be more likely to be honored by the trustee than a warranty arising by operation of law, where the creditor has only a right to damages. The trustee must get court approval before he can pay out so-called "cash collateral" as damages.⁸² Cash collateral does not include inventory, equipment, or labor, however. Thus, a parts-and-labor service warranty is more easily honored by the trustee in his daily business than a warranty right implied by law which may give rise to only a claim for damages.

Whether honoring a warranty can be considered part of the ordinary course of the debtor's business may further depend on how important the warranty was to the sale. The warranty on a new car will be more important than the warranty on a less expensive product with few moving parts. Where the promises in a warranty are a significant part of the sales contract, the debtor's ordinary course of business consists of warranty service as well as sales. Certainly this will be the view of the debtor's customers, who may have considered the promises in the warranty a critical factor in the decision to buy. Thus, customer attitude should be an important factor in determining whether a warranty is honored in the ordinary course of business.

Where service is an important element of consumer sales, courts should treat warranty claims as claims "in the ordinary course of business." Since ripened claims will be satisfied as they arise, this treatment obviates the need to value contingent claims at all. A problem remains as to the treatment of claims

⁸¹ *Id.* § 363(c)(1).

⁸² Cash collateral means "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents in which the estate and an entity other than the estate have an interest." *Id.* § 363(a). The trustee may use cash collateral only after consent of the secured party or authorization by the court, *id.* § 363(c)(2).

which ripened before filing of the petition, and the treatment of damages-only warranty claims. As these claims are liquidated, however, they are more suited to traditional treatment under the reorganization plan.

III. PUBLIC INTEREST GROUP REPRESENTATION OF WARRANTY HOLDER RIGHTS

Warranty holders are forced into the unaccustomed position of creditor by the law of financial catastrophe. The vast majority of warranty creditors have little commercial law expertise. Not all warranty creditors will receive notice of bankruptcy proceedings relative to their interests, especially where their claims are contingent.⁸³ To many, if not most, warranty creditors, the time and expense involved in going to court and filing a proof of claim will outweigh the prospect of eventual plan payment, even if their claims are fully paid. This is especially unfortunate where those administering a reorganization have a powerful incentive to honor warranty claims as fully as possible, and where avenues to favorable treatment exist. Warranty creditors should be encouraged to participate in bankruptcy proceedings and ideally should band together to exercise their rights efficiently and forcefully.

A public interest group may be the most effective and efficient party to intervene on behalf of warranty creditors. Warranty creditors will have difficulty organizing themselves due to lack of notice, incomplete debtor schedules, and insufficient time and resources. A strong outside voice advocating their interests as a group may overcome these difficulties. An organization dedicated to the public interest or consumer causes will generally have resources and expertise not available to the individual. Furthermore, public interest groups may be willing to represent

⁸³ 11 U.S.C. § 342 (Supp. III 1979) states that the bankruptcy court "shall [give] such notice as is appropriate of an order for relief in a case under this title." Further, Interim Rule 2002 requires the court to give notice to all creditors of certain significant events such as hearings. INTERIM BANKR. RULE 2002(b) in 11 U.S.C.A. (West Pamphlet 1979). The court is to give notice by mail unless impractical, in which case notice is to be given by publication.

The court will get its list of creditors from the debtor's schedule. See Interim Rule 1007 (West Pamphlet 1979). This list cannot be expected to be complete, nor is it likely that a warranty creditor/consumer has sufficient knowledge of his position to stay abreast of the debtor's financial situation in all cases. See also FED. R. BANKR. PROC. 203, in 11 U.S.C. Appendix (1976).

consumer creditors for little or no fee.⁸⁴

In the bankruptcy process, the court acts mostly as a witness. Except for certain disputes arising between parties, it is not an adversarial proceeding in the traditional sense.⁸⁵ In order to best represent the rights of warranty creditors, however, an intervenor will need to participate in many areas of the bankruptcy proceeding, many of which are non-adversarial. The intervenor will want a voice in the valuation of warranty creditors' claims, the assumption or rejection of warranty claims which are executory contracts, the treatment of warranty claims as administrative expenses, and the treatment of superior and competing claims.

A seat on the creditors' committee would give the public interest group the broadest possible access to these non-adversarial matters.⁸⁶ While the creditors' committee mandated by statute usually includes only the largest unsecured claimholders, the court also has the power to create additional creditors' committees "to assure adequate representation of creditors."⁸⁷ Consequently, the court may appoint a committee to represent the interests of warranty creditors alone, on which a representative from the public interest group could sit, to represent creditors with claims too small to participate individually. While appointment of a representative rather than an actual creditor stretches the meaning of "creditors' committee," public interest representation of consumer creditors in bankruptcy cases is a congressional concern. The House has expressed its confidence that the

⁸⁴ The Consumers Union of U.S., Inc., a national consumer group that publishes *Consumer Reports*, has expressed concern with warranty creditors' rights in bankruptcy and has considered representing warranty creditors in court (internal memo, Washington Office, Dec. 1980).

⁸⁵ See FED. R. BANKR. PROC. 701, in 11 U.S.C. Appendix (1976), which identifies only certain proceedings in the bankruptcy case as adversarial:

[A]ny proceeding instituted by a party before a bankruptcy judge to (1) recover money or property [e.g., setoff] . . . (2) determine the validity, priority or extent of a lien or other interest in property, (3) sell property free of a lien or other interest for which the holder can be compelled to take a money satisfaction, (4) object to or revoke a discharge, (5) obtain an injunction, (6) obtain relief from a stay as provided in Rule 401 [for unsecured claims] or 601 [secured claims], (7) determine the dischargeability of a debt.

⁸⁶ See note 47 *supra*. Courts have been extremely flexible in defining a "creditor" for the purpose of sitting on a creditor's committee. See, e.g., *In re Schatz Federal Bearings Co.*, 6 B.C.D. 692 (S.D.N.Y. 1980). In *Schatz*, the court said the debtor's pension plan obligations, which were incorporated by reference in the collective bargaining agreement with employees' union, constituted a claim enforceable by the union against the debtor. Hence, the court held the union to be a creditor, despite debtor's position that the creditor entitled to enforce the pension plan was the administering board of the plan.

⁸⁷ 11 U.S.C. § 1102(a)(2) (Supp. III 1979).

Rules and case law "will make appropriate provision for notice and intervention in order that the rights of widely dispersed and ill-represented consumer creditors will be protected."⁸⁸ To date, no rules specific to the protection of consumer creditors have appeared, making action of this type essential to further the congressional intent.

Even should the court not allow public interest groups to participate on the creditors' committee, the group may be able to intervene in certain adversarial proceedings which occur throughout the progress of the case. Federal Rule of Civil Procedure 24 governs intervention in adversary proceedings.⁸⁹ Intervention may be as of right or permissive. Intervention as of right under Rule 24 exists when the applicant has an interest relating to the subject matter of the case which may be harmed by the disposition of the case.⁹⁰ If, however, the applicant's interest is adequately represented by existing parties, intervention as of right will be denied.⁹¹

No clear rule exists for determining a sufficient interest relating to the litigation.⁹² The category is broad, however, and includes more than just legal interests.⁹³ It remains unclear whether the public interest in protecting consumer creditors is sufficiently related to the subject matter of bankruptcy litigation to justify intervention. Bankruptcy judges "attentive to the public interest in bankruptcy cases,"⁹⁴ however, have been liberal in allowing state Attorneys General to intervene on this ground. A second issue, of course, is whether a particular consumer or public interest group would effectively represent the rights of warranty creditors. As with the "sufficient interest" test, the court would have to assess this factor on a case-by-case basis.

⁸⁸ HOUSE REPORT, *supra* note 12, at 189. The House considered a proposal by the National Association of Attorneys General which would give a state Attorney General the power to "intervene as a matter of right [in bankruptcy cases] whenever, in his unreviewable discretion, he determines that intervention is in the public interest." *Id.* An Attorney General would also be entitled to notice under the proposal when a bankruptcy case involved consumer creditors, and would be able to file an involuntary petition against a business that had harmed or was likely to harm consumer creditors. Because it thought these matters were properly the domain of the Rules of Bankruptcy Procedure, the House did not adopt the proposal in its version of what became the Bankruptcy Reform Act. See H.R. 8200, 95th Cong., 1st Sess. (1977). See also HOUSE REPORT, *supra*, at 1-3.

⁸⁹ FED. R. BANKR. PROC. 724, in 11 U.S.C. Appendix (1976).

⁹⁰ FED. R. CIV. P. 24(a).

⁹¹ *Id.*

⁹² See 7A C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1908 (1972) [hereinafter cited as WRIGHT & MILLER].

⁹³ See *Textile Workers Union of America v. Allendale Co.*, 226 F.2d 765 (D.C. Cir. 1955).

⁹⁴ HOUSE REPORT, *supra* note 12, at 189.

Where some warranty creditors are participating in the litigation, the bankruptcy court may be inclined to conclude that the consumer creditor interest is being adequately represented by existing parties. Generally, however, the courts tend to favor intervention.⁹⁵ As long as the applicant's interest is not *identical* with that of an existing party, the rule is satisfied at least if there is a "significant possibility" that the applicant's interest is not already adequately represented.⁹⁶ A party seeking to intervene on behalf of warranty creditors, then, should stress the importance of representing those creditors *not* already present in the litigation, and thus distinguish its interest in the case from the interest of a warranty creditor who is participating but only in fact representing his or her own claim. A motion for intervention as of right usually contains a motion for permissive intervention as an alternative. Permissive intervention rests in the discretion of the court if the applicant's claim and the main case have a common question of law or fact.⁹⁷ Courts normally will grant the motion unless intervention would unduly delay or prejudice the course of the litigation.⁹⁸ Finally, a court which does deny an applicant leave to intervene frequently allows the applicant to file an *amicus curiae* brief.⁹⁹

There is little reason to believe that a concerned organization cannot offer at least some input in a bankruptcy proceeding affecting consumer creditors. Although at present there exist standards only for intervention in an adversary proceeding in bankruptcy, public interest groups wishing to represent warranty creditors may qualify under this standard. Furthermore, since the legislative history of the Bankruptcy Reform Act reflects a congressional concern for consumer creditors,¹⁰⁰ bankruptcy courts should allow public interest intervention in all aspects of bankruptcy. If a group qualifies under Rule 24 to intervene in an adversarial proceeding, it should also be allowed to participate on the creditors' committees. Meeting the standards of Rule 24 for formal adversary proceedings ought to be sufficient for participation in a more informal advisory committee. In any event, public interest lawyers may become counsel of record for warranty creditors or may distribute information apprising con-

⁹⁵ WRIGHT & MILLER, *supra* note 92, § 1909.

⁹⁶ See *Nuesse v. Camp*, 385 F.2d 694, 704 (D.C. Cir. 1967).

⁹⁷ FED. R. CIV. P. 24(b).

⁹⁸ *Id.*

⁹⁹ See, e.g., *Peterson v. United States*, 41 F.R.D. 131 (D. Minn. 1966).

¹⁰⁰ See note 88 *supra*.

sumer creditors of their rights in a reorganization.¹⁰¹

CONCLUSION

Though warranty holders are unsecured creditors ostensibly not entitled to any priority, their claims in Chapter 11 cases will be a matter of great concern to the trustee and the court. Warranty creditors are the debtor's customers, and their support of the debtor's products is vital to continued debtor goodwill. Consequently, the chances are good that these creditors will be well provided for in a Chapter 11 plan. Where the creditor is still paying for the warranted goods, the right of setoff exists, thus giving the warranty creditor a secured claim to the extent of set-off. The trustee may also choose to treat such a situation as an executory contract and assume it, thus honoring the warranty as if bankruptcy had not occurred. There are also grounds in the Bankruptcy Reform Act for treating warranty claims as administrative expenses or claims in the ordinary course of business. All of these avenues lead to payment before a Chapter 11 plan is confirmed.

In drafting the Bankruptcy Reform Act, Congress was concerned with the vulnerability of consumer creditors in bankruptcy cases, and indicated its desire to see appropriate provision for consumer creditor protection in the Rules of Bankruptcy Procedure. Although no definite rules on the subject have yet been promulgated, courts have been liberal in allowing intervention for this reason. A public interest group can hope to intervene either directly in the proceedings, or indirectly, through amicus briefs, printed material available to warranty creditors, or as counsel of record to individual warranty creditors. Courts should permit these groups to participate in the creditors' committees, at least if they meet the standards for intervention under the Federal Rules of Civil Procedure. Intervention, as well as favorable treatment through interpretation of pertinent provisions of the Bankruptcy Act, are consonant with the goal of fair protection for warranty creditors.

— *Elizabeth Warner*

¹⁰¹ See *Can You Depend on Either Car?*, CONSUMER REPORTS 12, 13 (1981) (information on how warranties are likely to fare in bankruptcy).

