

**NATIONAL BANKRUPTCY CONFERENCE**

*A Voluntary Organization Composed of Persons Interested in the  
Improvement of the Bankruptcy Code and Its Administration*

**OFFICERS**

*Chair*

DONALD S. BERNSTEIN

*Vice Chair*

RICHARD LEVIN

*Secretary*

MELISSA B. JACOBY

*Treasurer*

R. PATRICK VANCE

February 15, 2005

Hon. Arlen Specter, Chairman  
Committee on the Judiciary  
United States Senate  
Washington, DC 20510

Hon. Patrick Leahy, Ranking Member  
Committee on the Judiciary  
United States Senate  
Washington, DC 20510

**Re: S. 256 – Protection of Employees, Customers, and Trade  
Creditors**

Dear Chairman Specter and Senator Leahy:

I am transmitting on behalf of the National Bankruptcy Conference (“NBC”) a proposal to protect employees, customers, and trade creditors in the early stages of a chapter 11 case for your consideration in connection with your mark-up of S.256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The NBC is a voluntary organization composed of persons interested in the improvement of the Bankruptcy Code and its administration. A brief description of the NBC is attached.

The proposal and an explanation of its import and importance is set out below. We hope that the Committee will have the opportunity to give this issue serious consideration.

If we can be of any assistance in connection with this matter, please do not hesitate to contact me or any of the individuals listed below.

Sincerely,

*/s/ Donald S. Bernstein*

Donald S. Bernstein, Chair  
bernstn@dpw.com  
(212) 450-st4092

**CONFEREES**

PAUL H. ASOFSKY  
DOUGLAS G. BAIRD  
R. NEAL BATSON  
H. BRUCE BERNSTEIN  
RICHARD F. BROUDE  
STEPHEN H. CASE  
LEIF M. CLARK  
MICHAEL J. CRAMES  
DAVID G. EPSTEIN  
LEON S. FORMAN  
CHAIM J. FORTGANG  
S. ELIZABETH GIBSON  
DANIEL M. GLOSBAID  
MARCIA L. GOLDSTEIN  
ROBERT A. GREENFIELD  
NELL HENNESSY  
BARBARA J. HOUSER  
CARL M. JENKS  
HERBERT KATZ  
KENNETH N. KLEE  
DAVID A. LANDER  
JONATHAN M. LANDERS  
JOE LEE  
E. BRUCE LEONARD  
KEITH LUNDIN  
RALPH R. MABEY  
MORRIS W. MACEY  
BRUCE A. MARKELL  
ROBERT D. MARTIN  
HARVEY R. MILLER  
HERBERT P. MNKEL, JR.  
JEFFREY W. MORRIS  
GERALD F. MUNITZ  
PATRICK A. MURPHY  
SALLY SCHULITZ NEELY  
HAROLD S. NOVIKOFF  
ISAAC M. PACHULSKI  
RANDAL C. PICKER  
ALAN N. RESNICK  
LEONARD M. ROSEN  
MARY DAVIES SCOTT  
RAYMOND L. SHAPIRO  
MYRON M. SHEINFELD  
EDWIN E. SMITH  
GERALD K. SMITH  
HENRY J. SOMMER  
RICHARD S. TODER  
GEORGE M. TREISTER  
J. RONALD TROST  
ELIZABETH WARREN  
EUGENE R. WEDOFF  
JAY L. WESTBROOK  
ROBERT J. WHITE  
BRADY C. WILLIAMSON

**EMERITUS**

HERBERT H. ANDERSON  
JOHN A. BARRETT  
GEORGE BRODY  
DAVID COAR  
RONALD DEKOVEN  
MURRAY DRABKIN  
DEAN M. GANDY  
ROBERT E. GINSBERG  
GEROGE A. HAHN  
JOHN J. JEROME  
FRANK R. KENNEDY  
CHARLES P. NORMANDIN  
BERNARD SHAPIRO  
LAWRENCE K. SNIDER  
JOEL B. ZWEIBEL

ADMINISTRATIVE OFFICE  
SUZANNE ARMSTRONG BINGHAM  
ARMSTRONG & ASSOCIATES  
INTERNATIONAL, INC.

Hon. Arlen Specter, Chairman  
Hon. Patrick Leahy, Ranking Member  
February 15, 2005  
Page 2

Contact Information

Richard Levin, Vice Chair  
rlevin@skadden.com  
(213) 687-5940

Sally S. Neely, Co-Chair, Committee on Legislation  
sneely@sidley.com  
(213) 896-6024

Ralph R. Mabey, Co-Chair, Committee on Legislation  
mabey@llgm.com  
(801) 320-6720

cc. Members of the Senate Committee on the Judiciary

February 14, 2005

**National Bankruptcy Conference**

**PROPOSED LEGISLATION ON  
THE NECESSITY OF PAYMENT DOCTRINE  
IN REORGANIZATION CASES**

The National Bankruptcy Conference recommends addition of a new section to the Bankruptcy Code dealing with the necessity of payment doctrine and the payment of prepetition unsecured claims.

The "Doctrine of Necessity," which had its genesis in equity in railroad receiverships and reorganization cases dating back to the late 19th century, permits the payment of prepetition unsecured claims of certain creditors before a plan is confirmed. Because remaining creditors likely will not receive 100% recovery on their prepetition claims, the doctrine creates an exception to the Bankruptcy Code's underlying policy of equal distribution to creditors of the same class. The Bankruptcy Code lacks any statutory standards on this issue.

The doctrine has provided substantial protection to employees and to consumers, because it has permitted courts to authorize the payment of amounts owing to employees when a business files bankruptcy and the honoring of claims of customers, such as warranty claims, lay-away and other deposit claims, and pre-paid airline tickets and other purchases.

However, the doctrine has been overused in recent years. Motions for authorization to pay prepetition claims of "critical vendors" are now commonplace and are often presented to the court along with other "first day" motions, giving creditors little if any opportunity to object. Commercial creditors who don't get this special critical vendor treatment are hurt.

In part because of the overuse of the doctrine and the absence of any statutory standards for it, the Seventh Circuit recently cut way back on the use of the doctrine in the *Kmart* chapter 11 case. The Seventh Circuit's decision, while curing the problem of the doctrine's overuse for commercial creditors, could be read to jeopardize the court's ability to protect employees and consumers.

The proposed legislation creates clear standards for invoking the doctrine that protect employees and consumers and addresses the overuse problems that hurt commercial creditors.

**§ 1117. Payment of Prepetition Claims**

(a) After the order for relief, except as provided in sections 365, 1110, 1113, or 1114, subsections (b) or (c) of this section, a plan confirmed in the case, or the order confirming the plan, the trustee may not pay any unsecured claim that arose before the commencement of the case under this title.

(b) On request of the trustee and after notice and a hearing, the court may authorize the trustee to pay, or otherwise perform an obligation in connection with, an unsecured claim that arose before the commencement of the case, whether or not proof of the claim has been filed or deemed filed or the claim has been allowed, if such payment is in the best interest of the estate and—

(1) the claim is owed to an employee of the debtor and is of the kind and for the amount and time periods specified in section 507(a)(3) or 507(a)(4); or

(2) the claim arose from the purchase, before the commencement of the case under this title, of goods or services from the debtor in the ordinary course of business of the debtor, including a claim based on a warranty, right to a price discount, or right to receive delivery of goods or services.

(c) On request of the trustee and after notice and a hearing, the court may authorize the trustee to pay, or otherwise perform an obligation in connection with, an unsecured claim that arose before the commencement of the case, other than a claim of the kind specified in subsection (b) of this section, whether or not proof of the claim has been filed or deemed filed or the claim has been allowed, if—

(1) there is a compelling public interest in the continuation of the debtor's business and a material risk that the debtor's business will not continue without such payment or performance;

(2) such payment or performance is necessary to permit the reorganization of the debtor and the benefit to the estate of such payment or performance substantially outweighs the cost to the estate; or

(3) there is a compelling public interest in such payment or performance and the benefit to the estate of such payment or performance outweighs the cost to the estate.

Subsection by Subsection Analysis

Subsection (a) makes clear that payment of prepetition claims or the performance of prepetition performance prior to confirmation of a plan of reorganization can only be authorized under sections 365, 1110, 1113 and 1114 and subsections (b) and (c) of the newly proposed section 1115. Requests based on the court's general powers under section 105(a) or the broad terms of section 363 must be denied.

Subsection (b)(1) permits a court to authorize early payment of employee compensation related claims (including payments to benefit plans) up to the statutory maximum (see section 507(a)(3)) and only if it is in the best interest of the estate to do so. This will help insure that the debtor is able to retain employees after the filing, and because it is subject to the

statutory limit (\$4,650), it cannot be used to pay more substantial prepetition compensation claims of management. Subsection (b)(2) permits the court to authorize the debtor to honor prepetition customer claims, such as warranties, discounts and mileage programs so long as it is in the best interest of the estate to do so. There is a concern that if a debtor does not honor its commitments to customers, it may risk losing all or a portion of its customer base, thereby jeopardizing its chance to reorganize for the benefit of creditors and equity holders.

Subsection (c) deals with early payment of all other prepetition claims and the performance of other prepetition obligations. Subsection (c)(1) allows early payment of prepetition claims or performance of prepetition obligations if there is a compelling public interest in continuation of the debtor's business (e.g., a hospital or nursing home) and there is a material risk that the business will not be able to continue unless the claim is paid or the obligation is performed. Subsection (c)(2) permits early payment or performance if it is necessary for the reorganization of the debtor and the benefit to the estate from the payment or performance substantially outweighs the cost to the estate. Early payments to vendors would have to pass muster under this provision, which requires showings both that the payments are necessary for reorganization and that the benefits from payment substantially outweigh the cost to the estate. We believe that this will substantially limit the instances in which such payments are authorized by the courts. Finally, subsection (c)(3) authorizes early payment or performance if there is a compelling interest in such payment or performance and the benefit from the payment or performance outweighs the cost to the estate. This clause is intended to address situations like that present in the A.H. Robbins chapter 11 case, where some 30,000 women were injured from use of the Dalkon Shield contraceptive device. There, the debtor and the examiner sought to establish an emergency fund totaling \$15 million to provide surgery for a limited group of women under 40 years of age. Because the surgery had to be performed quickly if it was to be successful, payments could not await confirmation of a plan of reorganization. Further, any monies used would reduce the woman's claim under the plan. The district court approved creation of the fund, but the Fourth Circuit Court of Appeals reversed, holding that there was no statutory basis for early payment of prepetition claims. This subsection would authorize the creation of a fund under such circumstances.