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Re-reading Reading: "Fairness to All Persons" in the Context of Administrative Expense Priority for Postpetition Punitive Fines in Bankruptcy

Stephen D. Hurd

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Re-reading *Reading*: “Fairness to All Persons” in the Context of Administrative Expense Priority for Postpetition Punitive Fines in Bankruptcy

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I. INTRODUCTION

Who gets the money when there isn't enough to go around? This is the practical question that the bankruptcy system seeks to answer every day.¹ In answering this question, the Bankruptcy Code draws a particularly bright line at the filing of a bankruptcy petition.² The filing of a petition creates the bankruptcy estate, which is a dis-

1. Reducing the bankruptcy system to this generalization may seem trite. Professor Jackson has argued forcefully, however, that the core functions of bankruptcy law are to limit what creditors can take from the debtor (addressed by the automatic stay provision) and to "decide rights among creditors when there are not enough assets to go around." THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 4 (1986); see also Elizabeth Warren, *Bankruptcy Policy*, U. CHI. L. REV. 775, 777, 789-90 (1987) (noting bankruptcy's role in allocating losses when such losses are inevitable).

In the context of postpetition punitive fines, this central idea—that bankruptcy principally serves to define who gets paid when there are insufficient assets—must be kept in the forefront for two reasons. First, the idea highlights the general dichotomy between *whether* a right exists against the debtor and the *priority* such a right receives. Whether a right exists is generally within the province of non-bankruptcy law. See JACKSON, *supra*, at 33. But the existence of a right against the debtor says nothing about who gets paid out of the insufficient assets; this is purely a question of each claim's priority, which is defined by bankruptcy law as a debt-collection matter. See Kathryn R. Heidt, *The Automatic Stay in Environmental Bankruptcies*, 67 AM. BANKR. L.J. 69, 118 (1993) [hereinafter Heidt, *Automatic Stay*]; David M. Hyman, *Troubled Waters: When Environmental Enforcement Meets Bankruptcy*, 18 VT. B.J. & L. DIG. 26, 36 (April 1992).

Second, in cases ending with a Chapter 7 liquidation, the question of who gets paid helps to frame the interests at stake. In a Chapter 7 liquidation, non-bankruptcy disputes between the government and the debtor are transformed into a dispute between creditors. The debtor will either cease to exist or will emerge as an empty corporate shell; thus the only question is which creditors will be paid. See Kathryn R. Heidt, *Undermining Bankruptcy Law and Policy: Torwico Electronics, Inc. v. New Jersey Department of Environmental Protection*, 56 U. PITT. L. REV. 627, 628-29 (1995) [hereinafter Heidt, *Undermining Bankruptcy*] (arguing that the *Torwico* court misunderstood bankruptcy as a battle between debtor and creditor as opposed to a dispute between creditors); Heidt, *Automatic Stay*, *supra*, at 118 ("The contest is not between the debtor and government [creditor], it is between one group of creditors and another."); Scott P. Hilsen, *Enforcing Criminal Money Judgments in Bankruptcy: Is the Government Out of Line?*, 8 GA. ST. U. L. REV. 259, 284 (1992) (arguing that in bankruptcy, government interests are weighed against those of other creditors).

2. Bankruptcy proceedings are initiated by the filing of a petition by the debtor, a joint petition by the debtor and spouse, or an involuntary petition filed by creditors of the debtor. See 11 U.S.C. §§ 301-303 (1994). In voluntary bankruptcy cases, the petition under section 301 or 302 constitutes the order for relief, and all events relating to the debtor or bankruptcy proceeding are classified as either prepetition or postpetition. See 11 U.S.C. §§ 301-302. In involuntary cases filed under section 303, the order for relief does not coincide with the petition, but instead arises after the bankruptcy court determines either that the debtor has not timely controverted the petition, or that if the petition is challenged, certain statutory criteria have been satisfied such that the involuntary bankruptcy case should proceed. See 11 U.S.C. § 303(h). In an involuntary case, the definition of prepetition remains the same, but postpetition events are further subdivided into two categories: claims arising in the ordinary course of the debtor's business during the time between the involuntary filing and the order for relief are treated as if they arose prepetition, see 11 U.S.C. § 502(f) (1994), while all other events arising after the filing of the petition are classified as postpetition.

tinct legal entity from the debtor.³ Creditors with claims against the debtor arising before filing (“prepetition”)⁴ receive payment of their claim, if at all, through bankruptcy’s collective distribution scheme. In contrast, persons whose claims arose after filing (“postpetition”), but before completion of the bankruptcy proceeding, cannot receive payment of their claims through the general bankruptcy distribution⁵ because their claims are against the *estate*, rather than against the *debtor*.⁶

The ability of a postpetition creditor to recover from the estate depends on whether the postpetition claim qualifies as an administrative expense under 11 U.S.C. § 503(b). Postpetition claims granted priority will be paid in their entirety—even if this exhausts the estate—prior to payment of any prepetition claims.⁷ Postpetition claims denied administrative expense priority are either discharged⁸ in a Chapter 11 reorganization⁹ or individual Chapter 7 liquidation,¹⁰ or they survive against the worthless shell of the debtor remaining after a corporate Chapter 7 liquidation. Thus payment of postpetition

3. See 11 U.S.C. § 541(a)(1) (1994).

4. This Note is concerned exclusively with the priority relationship between prepetition claims and postpetition punitive claims. Because of this focus, all analysis in this Note assumes that the issue of when a claim arose has been correctly determined as either pre- or postpetition.

Determining when a claim “arose,” however, is by no means an easy issue, particularly with claims for latent tort injuries (e.g., asbestos or DES exposure), where the negligence may occur prepetition but the harm may manifest itself after the bankruptcy has been filed or even resolved. See *United States v. LTV Corp. (In re Chateaugay)*, 944 F.2d 997, 1005 (2d Cir. 1991) (considering timing issues in the definition of a claim); DOUGLAS G. BAIRD, *THE ELEMENTS OF BANKRUPTCY* 90 (rev. ed. 1993); KATHRYN R. HEIDT, *ENVIRONMENTAL OBLIGATIONS IN BANKRUPTCY* ¶ 3.04, at 3-37 (1993); Kathryn R. Heidt, *Environmental Obligations in Bankruptcy: A Fundamental Framework*, 44 FLA. L. REV. 153, 175-86 (1992) [hereinafter Heidt, *Fundamental Framework*]; Richard P. Krasnow & Debra Dardeneau, *The Treatment of Environmental Matters in Bankruptcy Cases*, in AMERICAN LAW INSTITUTE & AMERICAN BAR ASSOCIATION, *ALI-ABA COURSES OF STUDY: CHAPTER 11 BUSINESS REORGANIZATIONS* 127, 140-43 (1997); Jeffrey S. Theuer, *Aligning Environmental Policy and Bankruptcy Protection: Who Pays for Environmental Claims under the Bankruptcy Code?*, 13 T.M. COOLEY L. REV. 465, 509-16 (1996).

5. As with almost any bankruptcy generalization, an exception exists. See 11 U.S.C. § 348(d) (1994) (treating certain postpetition obligations as prepetition if the case is converted from one Chapter to another).

6. See JACKSON, *supra* note 1, at 34.

7. See 11 U.S.C. §§ 507(a)(1), 726(a)(1), 1129(a)(9)(A) (1994).

8. “Discharge” in bankruptcy is defined by 11 U.S.C. § 524. In practical terms, once a debt has been discharged, the creditor can only recover sums beyond those awarded in the bankruptcy proceeding if the debtor makes additional payments voluntarily.

9. See 11 U.S.C. § 1141(d)(1)(A) (1994).

10. See 11 U.S.C. § 726(a)(1) (1994) (discharge not available if the debtor is not an individual).

claims is generally an all-or-nothing proposition contingent upon the claim being granted administrative expense priority.¹¹

Congress defined administrative expenses to include those expenses necessary to the bankruptcy proceeding, such as compensation for trustees, creditor costs in filing an involuntary bankruptcy petition, and reasonable attorney and accountant fees.¹² Congress also defined administrative expenses to include the "actual, necessary costs and expenses of preserving the estate,"¹³ thus leaving courts with the task of interpreting and defining the outer boundaries of administrative expense priority. While it is clear that postpetition costs that actually benefit the estate—including costs concerned with the continuing operation of the business—fall within this category and should receive administrative expense priority, it is less clear whether postpetition costs that do not benefit the estate should qualify as "actual and necessary" administrative expenses.¹⁴

The Supreme Court addressed this issue in the 1968 case of *Reading Co. v. Brown*.¹⁵ *Reading* concerned a compensatory damages claim for the negligence of the receiver in a Chapter XI arrangement.¹⁶ The Court granted administrative expense priority for this claim and held that it was more "natural and just" that "those injured by the operation of the business during an arrangement should . . . recover ahead of those for whose benefit the business is carried on."¹⁷ *Reading* thus established compensatory fairness as a central interpretive principle in determining what costs would receive administrative expense priority.

Postpetition *punitive* fines, which by definition are non-compensatory, add a new wrinkle to the question. Some courts considering these punitive fines have granted administrative expense priority based solely upon *Reading* and its discussion of costs ordinarily

11. *C.f.* James K. McBain, *Environmental Impediments to Bankruptcy Reorganizations*, 68 IND. L.J. 233, 243 (1992) (recognizing in the context of claims for environmental cleanup that determination of administrative expense priority is an "all or nothing decision").

12. *See* 11 U.S.C. § 503(b) (1994).

13. *Id.*

14. *See infra* Part II.A.

15. 391 U.S. 471 (1968).

16. An arrangement with creditors is "[a] plan of a debtor for the settlement, satisfaction, or extension of the time of payment of his debts." BLACK'S LAW DICTIONARY 109 (6th ed. 1990). Chapter XI proceedings under the superseded Bankruptcy Act were called arrangements, and Chapter 11 reorganizations under the current Bankruptcy Code are likewise a form of arrangement. This Note adopts the terminology of "arrangements" for Bankruptcy Act Chapter XI proceedings but "reorganizations" for Bankruptcy Code Chapter 11 proceedings.

17. *Reading*, 391 U.S. at 477, 482.

incident to the operation of a business.¹⁸ Such decisions, however, clearly violate the *Reading* Court's concern for compensatory fairness, because they leave injured claimants uncompensated in order to fully compensate uninjured claimants.¹⁹

Other courts considering postpetition punitive fines have acknowledged that *Reading* alone cannot provide the basis for administrative expense priority.²⁰ These courts instead have granted priority based upon 28 U.S.C. § 959, which requires that bankruptcy estates be operated in accordance with all valid state laws.²¹ These courts have reasoned that denying administrative expense priority for postpetition punitive fines provides an advantage to bankrupt businesses over their nonbankrupt competitors, thus violating the principle of "competitive neutrality."²² Granting administrative expense priority for postpetition punitive fines based upon section 959's competitive

18. See, e.g., *Cumberland Farms, Inc. v. Florida Dep't of Env'tl. Protection*, 116 F.3d 16, 20 (1st Cir. 1997); *In re Bill's Coal Co.*, 124 B.R. 827, 830 (D. Kan. 1991).

19. In the context of prepetition punitive fines, Congress has expressed a clear fairness judgment that when there is not enough money to go around, parties should be fully compensated for actual losses before punitive fines are paid. See 11 U.S.C. § 726(a)(4) (1994). This section distinguishes (and reduces the priority of) certain claims based solely upon the fact that they are punitive and "not compensation for actual pecuniary loss suffered by the holder of such claim." *Id.* Thus, for example, a timely-filed claim based upon a judgment for \$100,000 compensatory damages and \$500,000 punitive damages would fall into two different priorities: \$100,000 would be second priority, and \$500,000 would be fourth priority (and would thus be paid only after all higher-priority claims had been paid in full).

While this prepetition policy does not apply to postpetition punitive fines, see *Alabama Surface Mining Comm'n v. N.P. Mining Co. (In re N.P. Mining)*, 963 F.2d 1449, 1460 (11th Cir. 1992), it demonstrates congressional understanding that *compensatory fairness* cannot be used as the basis for preferring punitive fines over compensatory claims. For an extensive review of the treatment of prepetition fines under the Bankruptcy Act, and the scope of obligations classified as fines, see J.F. Ghent, Annotation, *Bankruptcy: Disallowance of Claims for "Penalties" under 11 U.S.C. § 93(j)*, 1 A.L.R. FED. 657 (1969).

20. See, e.g., *N.P. Mining*, 963 F.2d at 1456 (holding the *Reading* compensatory fairness concern inapplicable to punitive fines).

21. 28 U.S.C. § 959(b) provides:

[e]xcept as provided in section 1166 of title 11, a trustee, receiver or manager appointed in any cause pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.

22. See *N.P. Mining*, 963 F.2d at 1458; *Kentucky v. Karst Robbins Coal Co.*, No. 94-335, 1995 U.S. Dist. LEXIS 6296 (E.D. Ky. Mar. 29, 1995); *In re Double B Distribs., Inc.*, 176 B.R. 271 (Bankr. M.D. Fla. 1994); *In re Motel Investments, Inc.*, 172 B.R. 105 (Bankr. M.D. Fla. 1994). "Competitive neutrality" is the idea that bankruptcy should not become a haven from which debtors can gain advantage over non-bankrupt competitors by not complying with onerous regulatory requirements. See *In re White Crane Trading Co.*, 170 B.R. 694, 702 (Bankr. E.D. Cal. 1994); David A. Brenningmeyer, *The Limited Power of Federal Bankruptcy Courts to Stay Enforcement of State Environmental Regulations*, 44 ME. L. REV. 485, 509 (1992); Heidt, *Automatic Stay*, *supra* note 1, at 126. See also *infra* Part II.C.

neutrality rationale, however, interferes with the compensatory fairness principle that was so important to the *Reading* Court.

In reality, compensatory fairness and competitive neutrality simply conflict with one another. Uniformly granting administrative expense priority for postpetition punitive fines violates compensatory fairness; uniform denial of priority violates competitive neutrality. This Note develops an administratively feasible interpretation of priority expenses that falls within the courts' broad interpretive power and recognizes the importance of both compensatory fairness and competitive neutrality.

Part II of this Note looks at judicial interpretation and development of actual and necessary costs entitled to administrative expense priority. Part III then examines in detail the two rationales courts have used to grant administrative expense priority for postpetition punitive fines. Finally, Part IV proposes an alternative, suggesting that granting administrative expense priority for these fines in successful Chapter 11 reorganizations, but denying priority in Chapter 7 liquidations, properly interprets the scope of the *Reading* fairness principle and best effectuates the objectives of the Bankruptcy Code. This interpretation of actual and necessary costs is within the courts' power and is administratively feasible under current bankruptcy rules. Based upon these advantages, this Note concludes that courts should interpret *Reading* as a narrow fairness-driven category of actual and necessary costs, and should only grant priority for postpetition punitive fines in successful Chapter 11 reorganizations where the debtor would receive an unfair competitive advantage if the fines were denied priority.

II. ADMINISTRATIVE EXPENSE PRIORITY IN BANKRUPTCY

Administrative expenses are postpetition obligations that are accorded priority for policy reasons.²³ To encourage estates and

23. To receive priority, administrative expenses must be incurred postpetition. See DAVID G. EPSTEIN ET AL., *BANKRUPTCY* § 7-11, at 464 (1993) (discussing denial of administrative expense priority to claim from a creditor who delivered goods to the debtor just hours before the debtor filed for bankruptcy). Section 64(a)(1) of the now-repealed Bankruptcy Act expressed this requirement directly, and it is logically required by the reference to the "estate" in section 503(1)(A) of the present Bankruptcy Code, 11 U.S.C. § 503(1)(A). The sole exception is 11 U.S.C. § 503(b)(3)(A), granting priority for the costs of an involuntary bankruptcy petition.

Most denials of administrative expense priority have turned on this issue, and this statutory requirement has been construed quite strictly so as to limit administrative expenses. See *Otte v. United States*, 419 U.S. 43, 53 (1974); WILLIAM L. NORTON, JR., 2 *BANKRUPTCY LAW AND PRACTICE* § 42:13 (2d ed. 1997); Theuer, *supra* note 4, at 506. Strict interpretation of the

creditors to undertake certain costs, Congress sought to ensure repayment by granting these costs administrative expense priority.²⁴ Congress enumerated a number of administrative expenses that result from the bankruptcy proceeding itself.²⁵ In addition, however, Congress recognized that the estate will incur many costs that do not fall within these enumerated categories, and such expenses may also receive administrative expense priority as "actual, necessary costs and expenses of preserving the estate."²⁶

Actual and necessary expenses include expenses which are not necessitated by the bankruptcy proceeding itself, but which arise from the continued operation of the estate during the proceeding. The estate will usually continue to operate during a Chapter 11 reorganization²⁷ and it will sometimes continue to operate during a Chapter 7 liquidation.²⁸ The estate will incur costs arising from these continued

postpetition requirement maximizes the amount of the estate ultimately available to prepetition creditors.

Priority for administrative expenses has a long pedigree, first appearing in the Bankruptcy Act of 1800. See David M. Reeder, *The Administrative Expense Priority in Bankruptcy—A Survey*, 36 *DRAKE L. REV.* 135, 136 (1986/87).

24. Administrative expense priority is generally effective protection for a person undertaking these costs. But in extreme cases, administrative expenses can total more than the value of the estate, in which case all allowed administrative expense priority claims will share pro-rata in the estate distribution. See WILLIAM M. COLLIER, 4 *COLLIER ON BANKRUPTCY* § 503.03[5][b] (Lawrence P. King ed., 15th ed. rev. 1997). A classic example comes from *Reading Co. v. Brown*, 391 U.S. 471 (1968). In *Reading*, the principle asset had been destroyed by fire, and the \$3,500,000 in negligence claims was "substantially more than the total assets of the [estate]." *Id.* at 473. Thus the successful petitioners in *Reading* were assured of at most a partial pro-rata recovery on their claims.

25. See 11 U.S.C. § 503(b) (1994).

26. *Id.*

27. Chapter 11 contemplates the rehabilitation of the debtor's business rather than its liquidation. To this end, the Chapter 11 estate will usually continue to operate, in most circumstances under the same management as before the proceeding began. See generally Harvey R. Miller & Erica M. Ryland, *The Role of Mega Cases in the Development of Bankruptcy Law, in THE DEVELOPMENT OF BANKRUPTCY AND REORGANIZATION LAW IN THE COURTS OF THE SECOND CIRCUIT OF THE UNITED STATES* 189, 209 (1995); IRVING SULMEYER ET AL., *COLLIER HANDBOOK FOR TRUSTEES AND DEBTORS IN POSSESSION* § 20.02-03 (Lawrence P. King ed., 1997). But occasionally—particularly where the debtor has been forced into an involuntary Chapter 11—the estate may cease operations. See, e.g., *Kentucky v. Karst Robbins Coal Co.*, No. 94-335, 1995 U.S. Dist. LEXIS 6296, at *5 (E.D. Ky. Mar. 29, 1995) (relating to an involuntary Chapter 11 debtor in possession that ceased operations while seeking to convert to a Chapter 7).

28. An economic assumption underlying Chapter 7 is that orderly liquidation is likely to produce more value than piecemeal liquidation. See Elizabeth Warren, *Evaluate the Present and Shape the Future, in THE DEVELOPMENT OF BANKRUPTCY AND REORGANIZATION LAW IN THE COURTS OF THE SECOND CIRCUIT OF THE UNITED STATES* 255, 268 (1995). While it is presumed that a business worth operating would file under Chapter 11, there are certain circumstances under which continuing operations benefit orderly liquidation and ultimately increase the return to the creditors. See SULMEYER ET AL., *supra* note 27, § 10.10[1]. In such situations, the bankruptcy court may authorize continued operations by the Chapter 7 estate. See 11 U.S.C. § 721.

operations (the most obvious example is a reorganizing debtor continuing to buy inventory for sale). Under these circumstances, society benefits from third parties' continued business dealings with the estate. These dealings help to rehabilitate the debtor's estate in a Chapter 11 reorganization and to preserve the assets of the estate in a Chapter 7 liquidation.²⁹ To encourage third parties to do business with the estate, courts have interpreted "actual, necessary costs and expenses of preserving the estate" to include obligations incurred in the continuing operation of the debtor's business in bankruptcy.³⁰

Thus administrative expenses are not static, congressionally defined categories of costs. Instead, Congress chose to define a number of specific costs as administrative expenses, but also to include a broad inclusive category of actual and necessary costs which could be flexibly interpreted and developed by the courts. Postpetition punitive fines (other than tax fines³¹) are not expressly included as administrative expenses. Therefore, if they are to be granted priority, it must be through judicial recognition as actual and necessary costs.

This section summarizes three different judicial interpretations of actual and necessary administrative expenses: the traditional "benefit to the estate" requirement; the Supreme Court's compensatory fairness exception to the benefit requirement from *Reading Co. v. Brown*; and the section 959 competitive neutrality exception to the benefit requirement.

A. Actual and Necessary Expenses Under the Bankruptcy Act: The Benefit Requirement

Under the Bankruptcy Act, a postpetition obligation had to have benefited the estate to receive administrative expense priority as an "actual and necessary [cost] of preserving the estate."³² This bene-

29. See *Cramer v. Mammoth Mart, Inc. (In re Mammoth Mart)*, 536 F.2d 950, 954 (1st Cir. 1976).

30. See *Reading Co. v. Brown*, 391 U.S. 471, 475 (1968); COLLIER, *supra* note 24, § 503.06[1].

31. See 11 U.S.C. § 503(b)(1)(C).

32. See, e.g., *In re Mammoth Mart, Inc.*, 536 F.2d at 954 ("[E]ven when there has technically been performance by the contract creditor during the reorganization period, he will not be entitled to section 64(a)(1) priority if the bankrupt estate was not benefited in fact therefrom."); *American Anthracite and Bituminous Coal Corp. v. Arrivabene, S.A.*, 280 F.2d 119, 124 (2d Cir. 1960) ("Where no benefits are received by the bankrupt estate or its representative under the contract, and the contract is not assumed, the creditor's claim is not entitled to priority."); *Chase Bag Co. v. Schouman*, 129 F.2d 247, 248 (6th Cir. 1942) ("The real question to be determined is whether the credit was one which preserved or benefited the estate."); *First Nat'l Bank v. Robinson*, 107 F.2d 50, 54 (10th Cir. 1939) ("the bank was entitled to priority only to the extent that the funds which it advanced benefited the estate"); *In re Cohen*, 64 F.2d 103,

fit requirement kept fees and administrative expenses at a minimum so as to preserve as much of the estate as possible for the creditors.³³

*American Anthracite & Bituminous Coal Corp. v. Arrivabene*³⁴ demonstrates how courts interpreted “benefit to the estate” narrowly in bankruptcy to preserve the estate as much as possible for the prepetition creditors. In *Arrivabene*, the debtor chartered two freighters, and the creditors provided the freighters for the debtor’s exclusive use pursuant to the contracts. The debtor failed to obtain cargo for either freighter, and later filed for an arrangement.³⁵ The arrangement trustee had the power to affirm or reject these prepetition contracts; but until the trustee reached his decision, the freighters were contractually required to remain at the loading ports and could not be reassigned or used for any other purpose.³⁶ The trustee ultimately rejected the contracts, and the creditors sought administrative expense priority for losses during the two months that the freighters were required to remain on call for the trustee.³⁷

The district court and court of appeals both rejected administrative expense priority.³⁸ Because the trustee never used the freighters and received no other tangible benefits from the executory contracts, the creditors’ losses did not benefit the estate and thus were not entitled to administrative expense priority.³⁹ The only “benefit” received by the estate was the option to retain the services of the boats, and this benefit was not sufficient to support administrative expense priority for the creditors’ losses.⁴⁰

The reasoning in *Arrivabene* suggests that, in the interest of limiting administrative expenses and preserving the estate, courts should construe benefit to the estate narrowly inside bankruptcy. If analogous facts occurred outside of bankruptcy—parties entered into

104 (2d Cir. 1933) (“we hold that beneficial services performed after petition filed may be compensated”).

33. See *Otte v. United States*, 419 U.S. 43, 53 (1974); NORTON, *supra* note 23, § 42:13; Theuer, *supra* note 4, at 506.

34. 280 F.2d 119 (2d Cir. 1960).

35. For the definition of “arrangement,” see *supra* note 16.

36. See *Arrivabene*, 280 F.2d at 119.

37. See *id.*

38. See *id.*

39. See *id.* at 125-26.

40. See *id.* at 126. The court reached this result using a very narrow definition of benefit to the estate: “Here the only benefit conferred upon the debtor in possession . . . was the value of the option either to accept or reject the charter.” *Id.*; cf. *Dayton Hydraulic Co. v. Felsenthal*, 116 F. 961 (6th Cir. 1902) (granting administrative expense priority for payments on an unoccupied leasehold because exclusion of competitors from the leasehold actually benefitted the estate).

a technically defective charter contract, the freighter was provided to the shipper, it sat empty and unused for two months, and then the shipper refused to perform based upon the contract defect—courts could formulate some remedy to protect the shipowner, and would likely find that the shipper received considerable enrichment by having the freighter available.⁴¹ In the context of bankruptcy, however, the *Arrivabene* court required a more tangible benefit to the estate, thus limiting the scope of administrative expenses.

Courts applied the strict benefit requirement frequently under the superseded Bankruptcy Act to insure that administrative expenses were minimized.⁴² Under the Bankruptcy Code, this close judicial scrutiny of actual benefit to the estate has been weakened by the *Reading* compensatory fairness exception to the benefit requirement, discussed immediately below. Nonetheless, a few present-day courts continue to adhere to the *Arrivabene* “heightened standard” or “tangible benefit requirement” by requiring that the estate receive “substantial” and “direct” benefits.⁴³

B. *Reading Co. v. Brown and the Compensatory Fairness Exception to the Benefit Requirement*

The 1968 Supreme Court decision in *Reading Co. v. Brown*⁴⁴ effected a revolutionary change in the scope of actual and necessary administrative expenses. *Reading* addressed the issue of whether damages for injury to third parties resulting from the negligence of a receiver administering an estate under a Chapter XI arrangement constituted actual and necessary costs entitled to administrative expense priority under section 64 of the Bankruptcy Act.⁴⁵ The

41. Outside of bankruptcy, courts could have and likely would have found the debtor liable to the creditors for supplying the ships, either for the contract amount under a promissory estoppel theory, or for the amount of the creditors' losses under a quantum meruit theory.

42. See, e.g., *Chase Bag Co. v. Schouman*, 129 F.2d 247 (6th Cir. 1942); *First Nat'l Bank v. Robinson*, 107 F.2d 50 (10th Cir. 1939). These cases illustrate that under the Bankruptcy Act, benefit to the state was a fact-intensive inquiry.

43. See *Gull Indus., Inc. v. John Mitchell, Inc. (In re Hanna)*, 168 B.R. 386, 388 (B.A.P. 9th Cir. 1994) (noting that “[a]dministrative status is allowed when a claim . . . directly and substantially benefits the estate,” but deciding the case on other grounds); COLLIER, *supra* note 24, § 503.06[3][b] n.15 (citing *In re White Motor Corp.*, 831 F.2d 106 (6th Cir. 1987)).

44. 391 U.S. 471 (1968).

45. See *id.* at 476. In *Reading*, a realty corporation filed a petition for a Chapter XI arrangement, and a receiver was appointed to conduct the debtor's business. During the arrangement, a fire originating in the debtor's building destroyed the building and damaged adjacent real and personal property. Fire loss claimants filed 147 claims, each styled as a claim for “administrative expenses” under the arrangement, and each asserting that the receiver's negligence in operating the debtor's estate caused the fire. See *id.* at 473. A short time later the debtor was voluntarily adjudicated bankrupt, and a Chapter VII liquidation proceeding was

Court's decision to grant administrative expense priority to such tort claims provided a fundamental reinterpretation of actual and necessary costs.

Although the tort claims at issue did not benefit the estate in the conventional sense,⁴⁶ the Supreme Court granted administrative expense priority.⁴⁷ The Court identified compensatory fairness to all claimants as the decisive factor in granting administrative expense priority for non-beneficial tort damages,⁴⁸ adopting the position that struck the majority as "just."⁴⁹

The Court in *Reading* concluded that it seemed "more natural and just" for "those injured by the operation of the business during an arrangement [to] recover ahead of those for whose benefit the business is carried on."⁵⁰ This holding—and the facts on which it is based—clearly implicates a concern with compensating injured parties, and a careful reading suggests that compensation for injuries lies at the heart of the Court's fairness concerns in *Reading*.

The Court identified two specific fairness concerns, each of which is only relevant in the context of a party seeking compensation for postpetition injuries. First, the Court worried about imposing the costs of the arrangement on innocent parties.⁵¹ The Court recognized that absent a governmentally sanctioned arrangement, the debtor likely would have already lost the real estate to a solvent claimant through state debt-collection law, and thus a fire such as this one could be compensated for by insurance and the new owner's assets.⁵² The concern was not that the arrangement in any way made the debtor more dangerous, but that it represented a governmental

commenced. *See id.* at 473-74. The importance of the administrative expense priority for the tort claimants was simple: if the tort claimants were granted administrative expense priority, they would completely exhaust the very limited resources of the estate to the detriment of prepetition unsecured creditors and the United States government which held a tax claim; but if the claimants were denied administrative expense priority, then the liquidated estate would be distributed entirely to the United States and to the unsecured creditors. For purposes of this litigation, both sides stipulated that the receiver's negligence caused the fire damages to the tort claimants. *See id.* at 474.

46. In developing its fairness-based rationale for granting administrative expense priority for the tort claims, the Court noted that while the estate clearly did not benefit from the tort claims, it was seeking to benefit from the continued operations that led to the stipulated tort. *See id.* at 478-79. But under prior case law, courts had used the more conventional meaning of benefit, under which a tort claim would not qualify. *See supra* Part II.A.

47. *See Reading*, 391 U.S. at 485.

48. "In our view the trustee has overlooked one important, and here decisive, statutory objective: fairness to all persons having claims against an insolvent." *Id.* at 477.

49. *Id.* at 482.

50. *Id.*

51. *See id.* at 478.

52. *See id.* at 482.

decision to allow continued operations with full knowledge that those injured in these operations would have zero recovery.⁵³ This fairness concern disappears if no party is injured by the estate; in such circumstances, by definition no costs of the bankruptcy proceeding are imposed on innocent creditors.

The Court's second specific fairness concern regarded the balancing of interests between prepetition and postpetition creditors. The Court realized that postpetition tort claimants, if denied administrative expense priority in a liquidation, would be entirely foreclosed from recovery for their injuries.⁵⁴ To avoid such a result, the Court reasoned that prepetition creditors hope that continued operation during the arrangement will eventually return the debtor to solvency and lead to full payment of the debtor's obligations.⁵⁵ Based upon this concept of relative control and benefit, without regard for the creditors' actual level of control, the Court concluded that it was more just for prepetition creditors to bear the cost of postpetition torts.⁵⁶

This second fairness concern loses its force if there are no injured postpetition parties. It is easy to see the fairness of making the parties who stood to gain from continued operations pay for injuries suffered as a result of those operations. It is much less clear, however, why an uninjured postpetition creditor should recover ahead of—and potentially to the exclusion of—all prepetition creditors, regardless of the prepetition creditors' injuries or their lack of control over the estate's conduct.

Thus *Reading's* facts, its holding, and the Court's analysis of specific fairness concerns all point to compensatory fairness as the driving principle in the case. Where a party has been injured by the estate, it is more just to prioritize that party's claims over the claims of prepetition creditors who would benefit from continued operations. But applying or extending the holding from *Reading* to circumstances where the postpetition creditor has suffered no injury could lead to results manifestly at odds with the very fairness concerns that motivated the Court to grant priority in *Reading*.⁵⁷

53. See *id.* at 478.

54. See *id.* at 481 ("a tort claim arising during an arrangement, like a tort claim arising during a bankruptcy proceeding proper, is not provable as a general claim in the bankruptcy"). Even the receiver recognized that a tort claimant "ought to have some means of asserting its claim against the business whose operation resulted in the fire," but the Court rejected the receiver's alternative suggestions as unsatisfactory and without statutory support. *Id.* at 479.

55. See *id.*

56. See *id.* at 479. The key to understanding the majority's concern is to grasp that either the prepetition or postpetition creditors will exhaust the estate assets, while the other group will be burdened with the entire loss.

57. See *infra* notes 85-86 and accompanying text.

C. 28 U.S.C. § 959 and the Competitive Neutrality
Exception to the Benefit Requirement

After *Reading*, the definition of actual and necessary costs entitled to administrative expense priority included costs that benefit the estate and costs which should receive administrative expense priority under the compensatory fairness principle enunciated in *Reading*. The Court thus indicated a willingness, under appropriate circumstances, to exercise the judiciary's interpretive powers to define actual and necessary costs based upon the policy considerations underlying bankruptcy law. The Eleventh Circuit has developed another exception arising out of the fairness concerns underlying 28 U.S.C. § 959.⁵⁸

Section 959(b) requires that trustees and debtors in possession "manage and operate the property [of the estate] according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof."⁵⁹ This section simply confirms that bankruptcy does not shield trustees or debtors in possession from the operation of valid⁶⁰ state laws.⁶¹ In addition, section

58. See *Alabama Surface Mining Comm'n v. N.P. Mining Co. (In re N.P. Mining)*, 963 F.2d 1449 (11th Cir. 1992). *N.P. Mining* is a postpetition punitive fine case, and as such will be discussed in greater detail *infra* Part III.B. Here, however, the case is important in describing the second court-developed exception to the benefit requirement for actual and necessary costs entitled to administrative expense priority.

59. 28 U.S.C. § 959(b) (1994).

60. The phrase "valid state laws" merely points out the fact that section 959(b) is not a blanket enforcer of all state laws. Under the Supremacy Clause of the U.S. Constitution, any state law that conflicts with a Bankruptcy Code provision (or other federal law) is preempted. See *Perez v. Campbell*, 402 U.S. 637, 656 (1971) (invalidating a state law that required payment of discharged tert obligations prior to reinstatement of a driver's license; holding codified at 11 U.S.C. § 525(a) (1994)); Brenningmeyer, *supra* note 22, at 512 ("[U]nder preemption analysis the Code must prevail over contradictory state legislation."); Ellen E. Sward, *Resolving Conflicts Between Bankruptcy Law and the State Police Power*, 1987 WIS. L. REV. 403, 407 n.16 (1987) ("The supremacy clause of the United States Constitution, Article VI, cl.2, requires that bankruptcy law preempt any state laws that are in conflict with it.").

61. The Supreme Court has expressed this same policy in *Ohio v. Kovacs*, 469 U.S. 274 (1985): "[W]e do not question that anyone in possession of the site . . . must comply with the environmental laws of the State of Ohio. Plainly, that person or firm may not maintain a nuisance, pollute the waters of the State, or refuse to remove the source of such conditions." *Id.* at 285. Because noncompliance with state environmental laws can lead to the imposition of punitive fines, this passage has been cited as support for granting administrative expense priority for postpetition punitive fines. See *In re Bill's Coal Co.*, 124 B.R. 827, 830 (D. Kan. 1991).

As will be discussed in great detail below with regard to section 959, the passage above—and the policy of requiring compliance with all valid state laws—does not speak to the issue of administrative expense priority for postpetition punitive fines. See *infra* Part III.B. The existence and priority of an obligation are separate questions—the obligation to comply is a

959 seeks to insure that bankruptcy does not provide a competitively advantageous haven from which the debtor can continue to operate while avoiding costly and onerous regulatory requirements that its competitors must observe. This principle is referred to in this Note as competitive neutrality.⁶²

In *In re N.P. Mining*, the Eleventh Circuit relied upon the competitive neutrality principle to craft another category of actual and necessary costs entitled to administrative expense priority.⁶³ *N.P. Mining* involved a request by the State of Alabama for administrative expense priority for postpetition punitive fines imposed for violations of Alabama strip mining statutes.⁶⁴ These fines were not beneficial to the estate, and so did not qualify for administrative expense priority under the traditional benefit requirement. Nor, as the court recognized, did the compensatory fairness principle of *Reading* apply to such punitive fines.⁶⁵ The court therefore considered whether some other judicially recognized bankruptcy policy mandated priority for these fines. The court found this policy consideration in the section 959 competitive neutrality principle: because a nonbankrupt party would have to abide by the law and pay the fines, and because denying administrative expense priority would give the debtor a competitive advantage, the court granted administrative expense priority for the fines.⁶⁶

The court in *N.P. Mining* cited liberally to *Reading*, and ultimately couched its holding in language from the *Reading* decision. The court also noted, however, that the central holding of *Reading*—"a policy of fairness to persons injured by the estate"—did not apply to noncompensatory postpetition claims.⁶⁷ The *N.P. Mining* approach to administrative expense priority, based upon the section 959 competitive neutrality principle, represents a second separate

product of non-bankruptcy law, while the bankruptcy priority assigned to punitive fines arising from noncompliance is a question for bankruptcy law. See *supra* note 1. As discussed *infra* Part III.B.2, the state and federal governments have numerous other tools to insure compliance with state laws.

62. See *In re White Crane Trading Co.*, 170 B.R. 694, 702 (Bankr. E.D. Cal. 1994) ("The purpose of bankruptcy is not to permit debtors or non-debtors to wrest competitive advantage by exempting themselves from the myriad of laws that regulate business."); Brenningmeyer, *supra* note 22, at 509 ("[T]he Code was not intended . . . to give debtors a competitive advantage in the marketplace.").

63. 963 F.2d at 1450.

64. See *id.*

65. See *id.* at 1456.

66. See *id.* at 1458.

67. *Id.* at 1456 (quoting *Reading Co. v. Brown*, 391 U.S. 471, 484 (1968)) (citation omitted).

exception to the benefit requirement for actual and necessary costs.⁶⁸ Three courts subsequently addressing this same issue have declared that *N.P. Mining* controls, and have therefore granted administrative expense priority for postpetition noncompensatory claims based on the section 959 competitive neutrality principle.⁶⁹ These decisions have not discussed the compensatory fairness principle of *Reading*, and thus continue the distinction between the compensatory fairness and competitive neutrality principles as separate bases for administrative expense priority.

Thus after *N.P. Mining*, three judicially developed categories of postpetition costs fall within the definition of actual and necessary expenses: (1) obligations that benefit the estate; (2) compensatory claims of those injured by the continued operations of the estate; and (3) claims that should receive priority in order to insure competitive neutrality in bankruptcy.

III. CURRENT PRIORITY TREATMENT OF POSTPETITION PUNITIVE FINES IN BANKRUPTCY

Although *Reading* concerned only compensatory claims, later courts have drawn on *Reading* in addressing priority for punitive fines. Courts that have directly considered this issue⁷⁰ have granted priority for postpetition punitive fines,⁷¹ basing their decisions on one

68. Note that *Reading* and its compensatory fairness progeny would be decided the same way under the competitive neutrality principle. Judge-made tort law is as much valid state law as are statutes. See *Erie v. Tompkins*, 304 U.S. 64, 78 (1938). Thus the presumptively negligent receiver in *Reading* violated valid state law—and hence section 959—to the same degree as did the mine operator in *N.P. Mining*.

Competitive neutrality is a separate exception to the benefit requirement only in the sense that there are postpetition claims that would fail the *Reading* test but nonetheless could be granted administrative expense priority based upon competitive neutrality (e.g., postpetition punitive fines, the subject of this Note).

69. See *Kentucky v. Karst Robbins Coal Co.*, No. 94-335, 1995 U.S. Dist. LEXIS 6296, at *6 (E.D. Ky. Mar. 29, 1995) (“The controlling case is *In re N.P. Mining Co.*”); *In re Double B Distribs., Inc.*, 176 B.R. 271, 273 (Bankr. M.D. Fla. 1994) (“This case is controlled by *In re N.P. Mining Co.*”); *In re Motel Investments, Inc.*, 172 B.R. 105, 107 (Bankr. M.D. Fla. 1994) (“The Court agrees that *N.P. [Mining]* is controlling in this case.”).

70. Several courts have declared rules regarding administrative expense priority for postpetition punitive fines in cases where such fines were not at issue. See, e.g., *Leavell v. Karnes*, 143 B.R. 212, 219 (S.D. Ill. 1990) (declaring without analysis, in a case that did not directly concern priority for postpetition punitive fines, that “[i]t follows that any fines, penalties or cleanup costs caused by a trustee’s violation of environmental laws during the operation of a business should also be considered administrative expenses.”).

71. Despite these decisions, the issue is not entirely settled. Only three Courts of Appeals have addressed the issue directly, and each court has used a different rationale for granting administrative expense priority for postpetition punitive fines. See *Cumberland Farms, Inc. v.*

of two rationales. Two courts have based their decisions directly on *Reading*, extending its holding to noncompensatory claims.⁷² The remaining courts have recognized that *Reading* is inapplicable in the punitive context, but instead have granted priority based upon the competitive neutrality principle underlying 28 U.S.C. § 959.⁷³

This section explores and critiques the two rationales that have been used to grant administrative expense priority for postpetition punitive fines. While the pure *Reading* rationale is difficult to accept in the absence of the compensatory concerns fundamental to

Florida Dep't of Envtl. Protection, 116 F.3d 16, 21 (1st Cir. 1997) (giving fine administrative status because "it would be fundamentally unfair to allow [appellant] to flout [the state's] environmental protection laws and escape paying a penalty for such behavior."); *In re N.P. Mining*, 963 F.2d 1449 (discussed *infra* Part III.B); *United States v. Elliott (In re Elkins Energy)*, 761 F.2d 168, 171-72 (4th Cir. 1985) ("Subjecting the estate to postpetition penalty claims will encourage the creditors to ensure that the debtor is complying with the law while at the same time ensuring that violations of law do not go unpunished."). In other words, the circuits that have considered the issue have not developed any consensus on the meaning of *Reading* in the context of postpetition punitive fines.

Finally, while the Ninth Circuit has not addressed this issue directly, courts there have generated rumblings of discontent with the expansive reading of administrative expenses. *See Gull Indus., Inc. v. John Mitchell, Inc. (In re Hama)*, 168 B.R. 386, 388 (B.A.P. 9th Cir. 1994) (declaring that administrative expenses must "directly and substantially benefit the estate" but expressly declining to address this heightened benefit requirement because the case could clearly be decided on the separate timing issue); *In re Lazar*, 207 B.R. 668, 685 (Bankr. C.D. Cal. 1997) ("[b]enefit to the estate must be measurable in assets distributable to creditors, or the elimination of claims which would otherwise require creditors to share the assets with others").

72. *See Cumberland Farms*, 116 F.3d at 20; *In re Bill's Coal Co.*, 124 B.R. 827, 830 (D. Kan. 1991).

73. *See N.P. Mining*, 963 F.2d at 1458; *Karst Robbins*, 1995 U.S. Dist. LEXIS 6296 at *6; *In re Double B Distribs.*, 176 B.R. at 273; *In re Motel Investments*, 172 B.R. at 107. *United States v. Elliott (In re Elkins Energy)*, 761 F.2d 168 (4th Cir. 1985)—which was actually the first case decided on the issue—likewise granted administrative expense priority for postpetition punitive fines, but "offer[ed] no explanation" for its decision to grant priority. *See N.P. Mining*, 963 F.2d at 1459. Close examination suggests that the *Elliott* court used an argument that later developed into both of the distinct rationales employed by courts in considering administrative expense priority for postpetition punitive fines.

The primary issue in *Elliott* was whether postpetition punitive fines were disallowed under section 57(j) of the Bankruptcy Act. Section 57(j) arguably disallowed both prepetition and postpetition punitive fines. Based upon the Supreme Court's prior jurisprudence allowing claims for postpetition tax penalties, however, the court concluded that section 57(j) only applied to prepetition penalties, and that postpetition penalties were allowed. *See Elliott*, 761 F.2d at 171.

The court went on to grant administrative expense priority for these allowed fines. *See id.* at 172. The court's arguments for allowing the claims, though, suggest that the principles behind both *Reading* and section 959 may have informed the decision to grant administrative expense priority. On one hand, the court was concerned that, as in *Reading*, the estate was acting wrongly while being operated for the benefit of the creditors. *See id.* at 171. On the other hand, the court was also concerned with the ability of the debtor to enhance the profitability of its operations by failing to comply with regulatory statutes. *See id.* This concern clearly foreshadowed the section 959 competitive neutrality argument advanced by later courts to justify administrative expense priority for postpetition punitive fines. *See id.* Both of these concerns likely influenced the court's decision to grant administrative expense priority. Each rationale is discussed in detail in the following sections.

the *Reading* decision, the section 959 rationale raises a compelling point. The critique of this rationale sets the stage for the discussion of an alternative approach that reconciles *Reading's* notion of compensatory fairness with section 959's principle of competitive neutrality.

A. *Reading and Postpetition Punitive Fines*

Two courts have extended *Reading* to postpetition punitive fines. In *In re Bill's Coal Co.*, the district court summarized *Reading* as "suggest[ing] that 'actual and necessary costs' should include costs ordinarily incident to operation of a business."⁷⁴ The court reasoned that punitive fines are ordinarily incident to regulated mining operations and should therefore receive administrative expense priority.⁷⁵ In *Cumberland Farms, Inc. v. Florida Department of Environmental Protection*, the court likewise granted administrative expense priority for postpetition punitive fines based on the "costs ordinarily incident" language from *Reading*, noting in passing but not relying on the *Reading* Court's compensatory fairness concerns.⁷⁶

Remarkably, the courts in these cases adopted the *Reading* "costs ordinarily incident" language without regard for the compensatory fairness issues that form the factual and policy basis of *Reading*. The court in *In re Bill's Coal* did not mention fairness concerns when discussing *Reading* or in deciding the case at hand.⁷⁷ The court did not even consider the fairness implications of prioritizing punitive fines above compensatory claims⁷⁸—an issue that other courts granting administrative expense priority have acknowledged is a fundamental fairness concern.⁷⁹

74. 124 B.R. 827, 830 (D. Kan. 1991) (quoting *Reading*, 391 U.S. at 483).

75. *See id.*

76. 116 F.3d 16, 20 (1st Cir. 1997) ("[T]he payment of a fine for failing, during bankruptcy, to meet the requirements of Florida environmental protection laws is a cost 'ordinarily incident to operation of a business' in light of today's extensive environmental regulations").

77. 124 B.R. at 829-30.

78. As discussed *supra* note 1, administrative expense priority for postpetition punitive fines in a case where the estate is ultimately liquidated punishes the prepetition creditors (regardless of whether they were culpable or not), rather than the culpable debtor in possession. The court in *In re Bill's Coal* lost sight of the core debt-collection function of "decid[ing] rights among creditors when there are not enough assets to go around," JACKSON, *supra* note 1, at 4, and confused the government versus debtor regulatory relationship with the Chapter 7 government-as-creditor versus non-governmental creditor relationship. *See* JACKSON, *supra* at 1, at 8; Heidt, *Undermining Bankruptcy*, *supra* note 1, at 628-29; Hilsen, *supra* note 1, at 284.

79. *See, e.g., N.P. Mining*, 963 F.2d at 1456 ("A policy of fairness to persons injured by the estate, therefore, does not dictate that the postpetition penalties levied [here] receive first priority.").

In *Cumberland Farms*, the court twice noted the importance of compensatory fairness in *Reading*. In discussing *Reading*, the court acknowledged the “decisive statutory objective [of] fairness to all persons having claims against the insolvent,” and also recognized the “grave financial injury” suffered by the *Reading* petitioners.⁸⁰ In considering the First Circuit’s subsequent application of *Reading*, the court noted that “[w]e have recognized a special category of expenses entitled to administrative priority status, based on considerations of fundamental fairness, see *Reading*, consisting of amounts due entities ‘injured by the debtor-in-possession’s operation of the business’”⁸¹ But the court then proceeded to decide the case without regard for and with no discussion of the deviation from both the facts and policy of *Reading*.⁸² The court closed the opinion by invoking fairness: “It would be fundamentally unfair to allow [debtor] to flout Florida’s environmental protection laws and escape paying a penalty for such behavior.”⁸³ This type of fairness, however, was not at issue in *Reading*, and the court never explains why postpetition punitive claimants should have priority over prepetition compensatory claimants.⁸⁴

Granting administrative expense priority for postpetition punitive fines based upon *Reading* has one glaring problem: In a world where bankruptcy debtors rarely pay all obligations in full, every dollar allocated to pay a punitive fine as an administrative expense takes a dollar away from prepetition creditors (including parties who have suffered compensable tort injuries). A grievously injured prepetition creditor⁸⁵ could find the entire estate—and her

80. *Cumberland Farms*, 116 F.3d at 20.

81. *Id.* at 21 (quoting *Cramer v. Mammoth Mart, Inc.*, (*In re Mammoth Mart*), 536 F.2d 950, 954 (1st Cir. 1976)).

82. *Id.* (“We hold that the present case does come within the ambit of *Reading* and *Charlesbank*.”).

83. *Id.* This concern with fairness to competitors of the debtor is certainly important, at least in the context of a successful Chapter 11 reorganization. See *infra* Part III.B.3. But this fairness concern was not at issue in *Reading*. Judicial recognition of this competitive neutrality fairness principle represents a distinct and new category of administrative expense priority from what was developed in *Reading*.

84. See *id.*

85. The quintessential “injured creditor” is of course a tort victim. When comparing compensatory and punitive claims, however, a contract creditor can be “injured” just as much as a tort creditor. If debtor fails to deliver the automobile that creditor has purchased and paid for, creditor has a consensual contract claim for \$10,000; if debtor instead delivers the car but the next day negligently collides with the car, totaling it, creditor has a non-consensual tort claim for \$10,000 (assuming no depreciation). Creditor is equally injured under either scenario. Compensatory damages become a legally recognized common denominator, and for purposes of comparing priorities between compensatory and punitive claims, consensual contract creditors and non-consensual tort creditors are similarly situated.

entire recovery—exhausted by state punitive fines for violations that did not harm anyone.⁸⁶ This result is not far-fetched or theoretical: in *Elliott, Cumberland Farms*, and *N.P. Mining*, parties who suffered compensable prepetition injuries walked away with a lessened recovery because postpetition punitive fines were granted administrative expense priority. While there is a need for administrative expense priority for expenses that actually benefit the estate or in situations where the reorganizing estate harms someone,

86. This problem can be particularly prominent in the context of punitive environmental fines. Because of the technical complexity and continuing nature of environmental violations, see, e.g., FLA. STAT. ANN. §§ 403.161, 403.141 (West 1997), fines and penalties completely unrelated to compensation can overwhelm an estate. See *Alabama Surface Mining Comm'n v. N.P. Mining Co.* (*In re N.P. Mining*), 963 F.2d 1449, 1450 (11th Cir. 1992) (recognizing that because of the continuing nature of environmental fines, "initially small fines for minor infractions can balloon into large fines."); David P. Currie, *State Pollution Statutes*, 48 U. CHI. L. REV. 27, 64 (1981) ("[E]ven a small sum, compounded daily, may mount up significantly over time."). In one recent case, the postpetition punitive fines totaled \$193,914,000, see *In re Lazar*, 207 B.R. 668, 672 (Bankr. C.D. Cal. 1997); in *Cumberland Farms*, 116 F.3d at 20, penalties could have been set as high as \$647,000,000.

Administrative expense priority for such large sums raises the very real possibility of governmental units absorbing the entirety of a bankrupt estate to the detriment of general creditors, including individuals actually harmed by the debtor's wrongdoing. Cf. *United States v. Johns-Manville*, 18 Env't. Rep. Cas. (BNA) 1177, 1181 (D.N.H. 1982) (recognizing in the context of the automatic stay the conflict between compensatory claims from injured parties and remedial claims from governmental units). At the extreme, administrative expense priority for punitive fines could lead to such inequities as a prepetition creditor dying of cancer from groundwater contamination receiving nothing while the state receives the entire estate for harmless prepetition violations of, for example, an insurance filing requirement.

States would respond that such punitive fines prevent future violations that may lead to actual injury. Thus a state would argue that calling an insurance filing violation "harmless" misses the entire benefit of having such a regulation. This argument is entirely true in a successful Chapter 11 reorganization—we do not want these debtors to "roll the dice" in bankruptcy, knowing that if they lose the estate's resources will be wholly inadequate to compensate for the harms they produce, but that if they win the fines will be discharged. See *infra* Part III.B.3. But in the case of Chapter 7 liquidations or failed Chapter 11 reorganizations converted to liquidations, this answer fails; the only question in these cases is who gets the money—the parties actually harmed, or the government as an unharmed claimant.

Administrative expense priority for postpetition noncompensatory fines also raises the possibility of strategic revenue-raising behavior by state environmental authorities. Presently, many state environmental compliance oversight programs rely on noncompensatory fines and penalties for funding. See, e.g., TENN. CODE ANN. § 68-201-101 and 102 (1997) (establishing the Environmental Protection Fund into which all environmental civil penalties are deposited, and specifying that "[t]he fund shall be available to the department of environment and conservation to help defray the costs of administering [environmental] regulatory programs [such as] permitting, monitoring, investigation, enforcement, and administration of the department's functions . . . including the payment of salaries and benefits to employees administering the regulatory programs"). The opportunity to move compliance fines to the top of the priority list creates an incentive for state agencies to target bankrupt debtors for extraordinary compliance oversight (far beyond what is required for the immediate protection of human health and the environment). While such strategic behavior would be legal, it is detrimental to innocent general creditors, and it also distorts normal compliance oversight priorities. Cf. Sward, *supra* note 60, at 434 (noting strategic disincentives to the state to undertake cleanup efforts).

fairness and justice suggest that administrative expense priority should not be granted when the expense did not benefit the estate or compensate anyone for a loss.

B. Section 959 and Postpetition Punitive Fines

The court in *N.P. Mining* understood that punitive fines do not raise a *Reading* compensatory fairness issue. The court noted that *Reading* sought the “natural and just” result in the context of the “statutory objective of ‘fairness to all persons having claims against the insolvent.’”⁸⁷ The court explained that this fairness concern did not apply in the instant case, however, because punitive fines did not represent compensation for any injury. A policy of fairness to persons injured by the estate, therefore, did not dictate that the postpetition penalties receive first priority. In fact, the court noted, punitive penalties historically have been disfavored by the Code for fairness reasons.⁸⁸

Instead, the *N.P. Mining* court granted the punitive fines administrative expense priority based on Section 959.⁸⁹ Because a nonbankrupt party would have to pay the fines,⁹⁰ and because denying administrative expense priority would give the debtor a competitive advantage, the court concluded that priority was appropriate to ensure the trustee’s compliance with state law.⁹¹

87. *N.P. Mining*, 963 F.2d at 1456 (quoting *Reading Co. v. Brown*, 391 U.S. 471, 477, 482 (1968)).

88. *See id.*

89. *Id.* at 1458 (“Appellant raises another federal policy [section 959], one that we hold does justify giving first priority to punitive penalties . . .”).

90. This narrow version of the section 959 argument is by itself difficult to support in light of the many ways in which bankruptcy alters the debtor’s relationships with different parties. *See United States v. LTV Corp. (In re Chateaugay)*, 944 F.2d 997, 1002 (2d Cir. 1991) (“Here we encounter a bankruptcy statute that is intended to override many provisions of law that would apply in the absence of bankruptcy—especially laws otherwise providing creditors suing promptly with full payment of their claims.”). Bankruptcy is replete with circumstances where the bankruptcy debtor is treated differently than it would be in the exact same circumstances outside of bankruptcy; this different treatment is the point of petitioning for bankruptcy. For example, a nonbankrupt entity cannot receive protection from an act to create, perfect, or enforce a lien; nor can it avoid the consequences of an executory lease or collective bargaining agreement; nor can it force a payment plan on an unwilling individual creditor. *See* 11 U.S.C. §§ 362(a)(4), 365, 1113, 1129(b)(1). Bankruptcy fundamentally alters, at least in the immediate term, the estate’s dealings with its general and secured creditors, its employees, its contractual partners, and its tort victims. *See Warren, supra* note 1, at 786.

91. *See N.P. Mining*, 963 F.2d at 1458. The *N.P. Mining* court recognized one important limitation on these administrative expenses arising from section 959: because section 959 requires that the estate be *operated and managed* in compliance with valid state law, the court only granted administrative expense priority for punitive fines incurred for actions taken while the bankrupt business was actually being operated or managed. *Id.* at 1460-61. The mere existence of a noncompliant estate is not sufficient grounds for liability under section 959, and

Three courts subsequently addressing this same issue have declared that *N.P. Mining* controls, and have therefore granted administrative expense priority for postpetition punitive fines based on the section 959 competitive neutrality principle.⁹² These cases have refined the *N.P. Mining* "operation" limit to administrative expense priority, but have otherwise not broken any new ground on the scope of actual and necessary costs entitled to administrative expense priority.

1. Priority Violates the Compensatory Fairness Principle of *Reading*

While *N.P. Mining* and its progeny may not rely directly on *Reading* to support their holdings, the granting of administrative expense priority for postpetition punitive fines in these cases violates the compensatory fairness principle of *Reading*. As discussed above in the context of *In re Bill's Coal* and *Cumberland Farms*, every dollar paid in full to postpetition punitive fines decreases the amount available for distribution to prepetition claimants, including those actually injured or otherwise owed compensation by the debtor.⁹³ Thus the competitive neutrality principle used in *N.P. Mining* conflicts with the *Reading* Court's fairness principle. For this reason, the competitive neutrality rationale is questionable unless it provides some significant advantage in terms of effectuating some other important bankruptcy policy.

2. Priority is Not Required to Ensure Compliance with State Laws

The facially obvious policy behind section 959 is the requirement that bankruptcy estates comply with valid state laws. Technically, administrative expense priority for postpetition punitive fines is required to insure that bankruptcy estates are operated in compliance with all state laws.⁹⁴ But as discussed above,⁹⁵ this is a

therefore is not sufficient to accord administrative expense priority to punitive fines levied for this noncompliance. See *Vass v. Conron Bros. Co.*, 59 F.2d 969, 971 (2d Cir. 1932).

92. See *Kentucky v. Karst Robbins Coal Co.*, No. 94-335, 1995 U.S. Dist. LEXIS 6296, at *6 (E.D. Ky. Mar. 29, 1995) ("The controlling case is *In re N.P. Mining Co.*"); *In re Double B Distribs., Inc.*, 176 B.R. 271, 275 (Bankr. M.D. Fla. 1994) ("This case is controlled by *In re N.P. Mining Co.*"); *In re Motel Investments, Inc.*, 172 B.R. 105, 107 (Bankr. M.D. Fla. 1994) ("The Court agrees that *N.P. [Mining]* is controlling in this case.").

93. See *supra* notes 85-86 and accompanying text.

94. See *N.P. Mining*, 963 F.2d at 1458.

hopelessly narrow way of asking the question; it ignores the many ways in which estates in bankruptcy operate differently than entities outside bankruptcy. The more appropriate question is whether states can enforce their laws absent administrative expense priority for these fines. In other words, if administrative expense priority is denied for postpetition punitive fines, will debtors in possession "flout" state laws,⁹⁶ "cut[ting] costs by ignoring safety and environmental violations"?⁹⁷

Section 959 merely recognizes that a debtor may not shirk the responsibilities of valid state laws while in bankruptcy. Section 959 does not substantively favor all state laws over bankruptcy law, and in fact, bankruptcy law preempts state law if they conflict. Therefore the question is really about the degree to which the state would be able to enforce its laws without administrative expense priority for postpetition punitive fines. If courts deny administrative expense priority for postpetition punitive fines, states will still have several tools available to compel compliance with their laws, and these tools are just as capable of insuring compliance and of proactively deterring noncompliance by debtors in possession.⁹⁸

First, nothing in the Bankruptcy Code, nor anything inherent in the denial of administrative expense priority for punitive fines, stops the state from seeking injunctive relief against the debtor in possession or trustee for noncompliance with state law.⁹⁹ Section

95. See *supra* note 90.

96. *Cumberland Farms, Inc. v. Florida Dep't of Envtl. Protection*, 116 F.3d 16, 21 (1st Cir. 1997).

97. *N.P. Mining*, 963 F.2d at 1458.

98. This Note is not suggesting that debtors in possession currently comply with all applicable laws, nor that state enforcement tools are sufficient to insure such compliance. The point is that debtors in possession will be no less likely to comply if administrative expense priority for postpetition punitive fines were taken out of the state's enforcement quiver. Removing this tool creates no new incentives for either the debtor or the creditors to favor noncompliance; nor would the state be any less capable of detecting, stepping, and deterring such noncompliance. The primary benefit to the state of priority for punitive fines is fiscal rather than substantive. In light of this fact, the wisdom of a law that gives the state a weapon that punishes prepetition creditors regardless of their culpability, and yet has only marginal benefit in terms of actual deterrence or enforcement, is questionable.

99. Further, denying administrative expense priority for punitive fines in Chapter 7 liquidations does not reduce the efficacy of these fines in deterring noncompliance by the Chapter 11 debtor in possession or trustee. As will be discussed further below, if the Chapter 11 reorganization succeeds, postpetition punitive fines should be granted administrative expense priority based upon the competitive neutrality principle. For the reorganization plan to be confirmed, all administrative expenses must be paid in full in cash by the effective date of the plan unless otherwise agreed. See 11 U.S.C. § 1129(a)(9)(A) (1994). Thus as postpetition punitive fines mount during the Chapter 11 proceeding, the possibility of successfully reemerging becomes vanishingly small. See *McBain*, *supra* note 11, at 242. The debtor in pos-

959(a) expressly authorizes suit, without leave of the appointing court, against trustees and debtors in possession for actions undertaken in carrying on the business.¹⁰⁰ Further, nothing in the automatic stay provision limits or stays any suit against the trustee or debtor in possession for injunctive relief relating to the operation of the estate.¹⁰¹ Once the state has obtained injunctive relief against the debtor in possession or trustee, continued violation of the state laws—and thus violation of the injunction—can be remedied by way of a contempt of court proceeding against the debtor in possession or the trustee.¹⁰² Because such a contempt proceeding can result in both fines and jail time for the recalcitrant party, this technique is a powerful weapon for the enforcement of obligations within bankruptcy.¹⁰³

Second, the Bankruptcy Code provides for removal of the debtor in possession for cause. Section 1104(a)(1) grants the court the discretionary power to remove the debtor in possession and appoint a trustee for cause.¹⁰⁴ Thus if the debtor in possession fails to comply with state laws, the state as a party in interest can petition the court for appointment of a trustee. Because trustees displace current management and thus generally provide less probability of successful Chapter 11 reorganization,¹⁰⁵ the threat to appoint a trustee provides additional incentive to the debtor in possession to comply with state law.

session, to the extent that it opted for Chapter 11 in hopes of reorganizing, has no incentive to let postpetition punitive fines mount, because this makes successful reorganization impossible.

100. 28 U.S.C. § 959(a) (1994).

101. See 11 U.S.C. § 362(a) (1994). For that matter, nothing in section 362 stays an action to impose monetary liability on the estate for postpetition actions. Section 362(a) stays eight categories of action by all entities. Five of these, paragraphs (1), (2), (5), (6), and (7), are by their terms expressly limited to claims, actions, proceedings, or judgments arising before the commencement of the bankruptcy case (and in paragraph (1), that could have been commenced before the bankruptcy petition). Paragraph (3) stays any act to obtain possession or control of property of or from the estate; paragraph (4) stays any act to create, perfect, or enforce any lien against property of the estate; and paragraph (8) stays all proceedings concerning the debtor before the United States Tax Court.

Thus when postpetition conduct by the debtor in possession or trustee violates state law, the state is not stayed from actions seeking either monetary or injunctive relief. If both monetary and injunctive relief are obtained, the state can proceed to enforce the injunctive relief during the pendency of the bankruptcy; but enforcement of a monetary judgment will be stayed during the bankruptcy proceeding under section 362(a)(3) and (4).

102. See CHARLES ALAN WRIGHT ET AL., 11A FEDERAL PRACTICE AND PROCEDURE § 2960 (2d ed. 1995).

103. One writer has compared injunctive relief to a criminal statute drafted and enforced on behalf of and to the specific requirements of a civil litigant. See OWEN FISS, *THE CIVIL RIGHTS INJUNCTION* 35 (1978).

104. See 11 U.S.C. § 1104(a) (1994).

105. See Miller & Ryland, *supra* note 27, at 209.

Finally, in many industries the state has the straightforward power to seek either a court or administrative order shutting down the operations of any entity operating within the state in violation of health and safety laws.¹⁰⁶ This power is the ultimate incentive for debtors in possession to comply with state health and safety laws. Although an extreme response, it is particularly appropriate in the context of bankruptcy estates, where the debtor in possession may have additional incentives for noncompliance in a last-ditch attempt to save the business from liquidation.

These tools together provide the state with ample machinery to enforce compliance with state laws even in the absence of administrative expense priority for postpetition punitive fines. The "importance" to compliance efforts of granting priority to punitive fines is really twofold: (1) they are admittedly the easiest way for the state to pressure a business to comply;¹⁰⁷ and (2) many state regulatory organizations rely upon the funds generated by these fines for ongoing operations, including the funding of salaries and benefits, creating an incentive for state agencies to favor fines regardless of whether they are strictly necessary to enforce compliance.¹⁰⁸ While there is nothing wrong with this tendency, it bears noticing that such fines are not necessary for compliance—they are merely expeditious and advantageous to the state.¹⁰⁹ Administrative expense priority for

106. See, e.g., *Alabama Surface Mining Comm'n v. N.P. Mining Co. (In re N.P. Mining)*, 963 F.2d 1449, 1459 (11th Cir. 1992) ("The ASMC has as one of its remedies the right to secure an administrative or court order mandating cessation of the operation of a mine by an operator who violates any of the provisions of the mining act and regulations.").

107. See, e.g., *Nicholas v. United States*, 384 U.S. 678, 692 (1966) (quoting *Boteler v. Ingels*, 308 U.S. 57, 61 (1939)) ("[I]f the trustee were exempt from the [tax] penalty, a 'State . . . would be denied the traditional and almost universal method of enforcing prompt payment.'").

108. See *supra* note 86.

109. This expeditiousness and advantage may be sufficient to support administrative expense priority for these fines. In the context of tax fines, the Supreme Court has granted administrative expense priority based partially on the benefits to the state of having this tool available. See *Nicholas*, 384 U.S. at 692; *Boteler*, 308 U.S. at 61.

On the other hand, these tax decisions may rest on unique provisions not applicable in non-tax contexts. See 28 U.S.C. § 960 (1994). Section 960 subjects the business in bankruptcy to applicable taxes "to the same extent" as solvent businesses, and section 6659(a)(1) of the Internal Revenue Code in effect at the time of *Nicholas* and *Boteler* provided that penalties on taxes "shall be assessed, collected, and paid in the same manner as taxes." I.R.C. § 6659(a)(1) (1964) (repealed 1989). Reading the statutes together, a tax penalty becomes in operation part of the tax liability, and the use of "extent" in section 960 indicates that overall quantitative tax liability may not be reduced by virtue of presence in bankruptcy. These particular wordings are not present in the context of environmental and other punitive fines. Further, this holding may simply be part of the general judicial deference to tax penalties (rather than to all penalties). See, e.g., Warren, *supra* note 28, at 255, 277 (recognizing that the Bankruptcy Code intentionally and systematically prefers government taxing authorities over other creditors in order to "minimize[] losses to the public fisc" and to internalize costs of business failures to parties dealing with the debtor). But see *United States v. Elliott (In re Elkins Energy)*, 761 F.2d

postpetition punitive fines should be evaluated for its effects on the purposes and results of the bankruptcy process, rather than uniformly favored simply because it is a fiscally beneficial compliance tool.

3. Priority is Required in the Chapter 11 Context to Ensure No Competitive Advantage

In adopting section 959, Congress sought to insure that bankruptcy did not become a haven in which debtors could gain advantage over competitors by shirking onerous regulatory requirements.¹¹⁰ If a Chapter 11 reorganization is dismissed or converted to a Chapter 7 liquidation, there will be no violation of the competitive neutrality principle: dismissal will not discharge the punitive fines,¹¹¹ and in a conversion to Chapter 7, postpetition expenses that are not granted administrative expense priority become claims against the Chapter 7 estate.¹¹²

If the Chapter 11 debtor successfully emerges from bankruptcy, however, postpetition punitive fines are discharged without receiving any payment under the reorganization plan. A holder of a postpetition claim against the estate is not a statutory creditor¹¹³ and thus cannot file a claim and participate in the Chapter 11 reorganization plan; but at the same time, "the confirmation of a plan discharges the debtor from any debt that arose before the date of such confirmation."¹¹⁴

168, 170-71 (4th Cir. 1985) (rejecting any distinction among tax and non-tax penalties based upon being tax-related or not).

110. See *In re White Crane Trading Co.*, 170 B.R. 694, 702 (Bankr. E.D. Cal. 1994); Brenningmeyer, *supra* note 22, at 509.

111. Upon dismissal, estate property re-vests in the debtor, and the state can enforce and collect the fines against the debtor. See 11 U.S.C. §§ 349, 362(c) (1994).

112. See 11 U.S.C. § 348(d) (1994). Note that if the Chapter 11 reorganization is converted to a Chapter 7 liquidation, there is no competitive advantage concern associated with fines during either the Chapter 11 or 7 proceedings, because the debtor will not emerge as an operative entity.

113. 11 U.S.C. § 101(10) defines "creditor" as used in the statute (as opposed to common usage). With certain exceptions discussed above, this definition excludes postpetition creditors from status as "creditors" under the Bankruptcy Code, thus denying them the right to partake in the bankruptcy distribution.

114. 11 U.S.C. § 1141(d) (1994). Thus under the plain language of section 1141(d)(1), a postpetition, pre-confirmation claim not accorded administrative expense priority is wiped clean unless preserved in the plan or order confirming the plan. While Chapter 11 creditors are free to vote for a plan that pays postpetition punitive fines, it is difficult to imagine why they would lower their own distributions by doing so. In the absence of such a voluntary move, postpetition but pre-confirmation fines will not receive a distribution under the plan but will nonetheless be discharged under section 1141(d) upon confirmation of the Chapter 11 reorganization plan.

Under this statutory regime, a Chapter 11 debtor in possession could actually benefit from its failure to comply with onerous regulatory burdens so long as noncompliance does not harm another party. If the debtor emerges from bankruptcy, all punitive fines incurred during the reorganization and not accorded administrative expense priority will be wiped clean, giving the debtor in possession a significant short-term advantage. Section 959 was fashioned to counteract this circumstance. Further, where the punitive fines are designed to punish wrongful conduct and deter similar behavior in the future,¹¹⁵ it makes sense to grant priority to such punitive fines in a successful Chapter 11 reorganization because these fines punish the correct party.

The effect of section 1141(d)(1)(A)—discharging postpetition expenses that do not receive administrative expense priority—stands as a major policy impediment to simply denying administrative expense priority outright for postpetition punitive fines. Instead, the courts must consider alternatives to outright administrative expense priority for postpetition punitive fines, measuring these alternatives by their fidelity to section 503(b) and the Bankruptcy Code as a whole, and by their practical effects in effectuating the objectives of bankruptcy law.

IV. ALTERNATIVE TO ADMINISTRATIVE EXPENSE PRIORITY FOR POSTPETITION PUNITIVE FINES

A reinterpretation of the meaning and scope of the Supreme Court's decision in *Reading* suggests an alternative that would allow courts to satisfy both the compensatory fairness concern of *Reading* and the competitive neutrality concern underlying section 959.

A. *An Outcome-Sensitive Priority Model*

Reading suggested that actual and necessary costs consist of costs tangibly benefitting the estate, and also non-beneficial costs when for fairness reasons it would simply be inequitable not to grant administrative expense priority. Fairness and justice were the central landmarks of *Reading*; while these concepts may have been

115. See, e.g., *International Bhd. of Elec. Workers v. Foust*, 442 U.S. 42, 48 (1979) (quoting *Gertz v. Robert Welch, Inc.*, 418 U.S. 323, 350 (1974)) ("Punitive damages 'are not compensation for injury. Instead, they are private fines levied by civil juries to punish reprehensible conduct and to deter its future occurrence.'").

left ill-defined, they are exactly the concepts that courts must grapple with to determine what claims are entitled to administrative expense priority.

Reading and its progeny reveal two fairness principles to consider when determining which claims will receive administrative expense priority as actual and necessary costs: compensatory fairness and competitive neutrality. Having identified the two primary fairness principles, application of *Reading* becomes straightforward. If a postpetition cost benefits the estate, grant administrative expense priority as an actual and necessary expense. But if the postpetition cost does not benefit the estate, grant administrative expense priority only if denying priority would violate either compensatory fairness or competitive neutrality.

If a Chapter 11 debtor in possession incurs a postpetition punitive fine, this fine does not benefit the debtor in possession, the estate, or the other creditors. But if the debtor successfully reorganizes and emerges from Chapter 11, then these punitive fines will be discharged under section 1141(d) unless granted administrative expense priority. This discharge would be a manifestly unfair result because it would directly advantage the debtor over its competitors. Because of this element of unfairness, it is within the spirit of *Reading* to grant these punitive fines administrative expense priority.

On the other hand, if the Chapter 11 debtor in possession who has incurred a postpetition punitive fine subsequently converts to Chapter 7, then the fairness rationale for granting the fine administrative expense priority disappears. Denying these fines administrative expense priority does not disadvantage competitors because the debtor will not emerge from bankruptcy. Thus, because these punitive fines never benefitted the estate, and because priority for these fines is not required in the interest of fairness, administrative expense priority should be denied.¹¹⁶

This alternative grants or denies administrative expense priority for postpetition punitive fines incurred during a Chapter 11 proceeding based upon the ultimate disposition of the case as either a Chapter 11 reorganization or a Chapter 7 liquidation. At first glance, this idea appears to conflict with the all-or-nothing nature of an administrative expense. But if actual and necessary administrative expenses are defined as those costs for which fairness to all interested

116. Note that *compensatory* fines such as in *Spunt v. Charlesbank Laundry, Inc. (In re Charlesbank Laundry, Inc.)*, 755 F.2d 200 (1st Cir. 1985), would still receive administrative expense priority because of the *Reading* fairness rationale.

parties requires priority—a definition fully supported by *Reading*—then an argument for granting or denying administrative expense priority based on the end result of the proceeding is simply another way of distinguishing those cases where fairness dictates that certain costs receive administrative expense priority.¹¹⁷

Even if this alternative is substantively superior to outright allowance of administrative expense priority for postpetition punitive fines, two questions remain: first, whether this alternative better effectuates the policies underlying bankruptcy; and second, whether the bankruptcy courts have the authority and practical ability to implement a system that grants or denies administrative expense priority based on the outcome of the Chapter 11 proceeding.

B. Effectuation of Bankruptcy Policies

This proposed alternative to a bright line rule of granting administrative expense priority for postpetition punitive fines effectuates several policies that bankruptcy seeks to accommodate. This interpretation ensures compliance with valid state laws, guarantees no competitive advantage to the debtor from noncompliance, and produces equitable results for prepetition creditors with compensatory claims by insuring that noncompensatory claims intended solely to punish the debtor do not overwhelm or reduce compensatory distributions.

117. An analogous approach may be developing in the context of the trustee's abandonment power under 11 U.S.C. § 554(a) (1994). In *Midlantic National Bank v. New Jersey Department of Environmental Protection*, 474 U.S. 494, 507 (1986), the Supreme Court held that a trustee may not abandon property in contravention of a state statute or regulation that is reasonably designed to protect the public health or safety from identified hazards. But the court then severely limited the scope of this extraordinarily broad holding:

This exception to the abandonment power . . . is a narrow one. It does not encompass a speculative or indeterminate future violation of such laws that may stem from abandonment. The abandonment power is not to be fettered by laws or regulations not reasonably calculated to protect the public health or safety from imminent and identifiable harm.

Id. at 507 n.9.

Faced with this discord between broad holding and narrow limitation, some bankruptcy courts have limited the broad *Midlantic* holding where no imminent threat of harm exists and where no unencumbered assets are available. See John W. Ames et al., *Midlantic's Footnote Followed: Abandonment Allowed Where No Imminent Harm is Perceived*, AM. BANKR. INST. J., June 1983, at 8. This "equitable" approach recognizes that what is really at stake is a balancing of risk of harm to the public—clearly a valid concern of nonbankruptcy law—and the core bankruptcy concern of maximizing the assets of the estate for the benefit of prepetition creditors.

This equitable balancing of interests, as opposed to a bright-line declaration that abandonment cannot occur in violation of any state law, is analogous to the balancing of interests suggested in this Note.

Under this interpretation, a Chapter 11 debtor in possession wishing to emerge from bankruptcy has every incentive to comply with state laws, because postpetition punitive fines will have to be paid in full before the debtor can emerge.¹¹⁸ Further, to the extent that *Reading* is correct in assuming that prepetition creditors actively monitor and control the actions of the debtor in possession, these creditors have full incentive to force appointment of a trustee or conversion to Chapter 7 if the debtor in possession fails to comply with state laws. The creditors know that every dollar of punitive fines assessed reduces the amount available to the prepetition creditors in the reorganization plan.¹¹⁹ Thus the incentive structure of this interpretation does not disfavor compliance with state laws.

Allowing administrative expense priority in successful reorganizations also ensures that the bankruptcy debtor receives no competitive advantage from being in bankruptcy.¹²⁰ If the debtor emerges, it can do so only after paying all postpetition punitive fines in full as administrative expenses. Thus the reorganized bankruptcy debtor must pay exactly the same fines as if it were not in bankruptcy. But if the case is finally converted to Chapter 7, then the issue of competitive neutrality between the bankruptcy debtor and its competitors disappears. The key is recognizing that this is true for punitive fines imposed during both the Chapter 11 and the subsequent Chapter 7 proceeding. If a \$1,000,000 punitive fine is denied administrative expense priority (and subsequently discharged under section 1141(d) upon confirmation of the reorganization plan), then the debtor will emerge from bankruptcy with a spare \$1,000,000 not available to its competitors who violated the same laws outside of bankruptcy. But if the debtor never emerges from bankruptcy, no competitive advantage arises from the denial of administrative expense priority for a Chapter 11 postpetition punitive fine.¹²¹

In the case of a conversion to Chapter 7, the competitive neutrality fairness concern is replaced by the other fairness concern: the *Reading* concern for reaching a "natural and just" distribution which ensures "fairness to all persons having claims against an insolvent."¹²² As the court in *N.P. Mining* correctly observed, *Reading* did not create a per se postpetition-beats-prepetition fairness rule.

118. See *supra* note 99.

119. See *supra* text accompanying notes 85-86.

120. See *supra* Part III.B.3.

121. See *supra* text accompanying notes 111-12.

122. *Reading Co. v. Brown*, 391 U.S. 471, 477, 482 (1968).

Instead, *Reading* created a compensation-based fairness rule that compensated parties injured by the estate before prepetition creditors.¹²³ Denial of administrative expense priority for postpetition punitive fines comports with this compensatory fairness principle, and in general supports the norm that compensation for actual harm should take precedence over punitive fines, especially when resources are scarce.¹²⁴

Denying administrative expense priority for postpetition punitive fines in cases that are converted to Chapter 7 would prioritize these claims in a "natural and just" position. When a case is converted to Chapter 7, postpetition punitive fines denied administrative expense priority under this interpretation are converted into prepetition claims accorded the same priority as if they had actually arisen prepetition.¹²⁵ Section 726(a)(4) assigns fourth priority to "any fine, penalty or forfeiture . . . or punitive damages . . . to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim."¹²⁶ This fourth priority is below the second priority accorded to compensatory claims but above the sixth priority held by the debtor.¹²⁷ Thus in a Chapter 7 distribution, claims for punitive fines receive nothing until all compensatory unsecured claims have been paid, and the debtor

123. *Id.*; see also *Cramer v. Mammoth Mart, Inc. (In re Mammoth Mart)*, 536 F.2d 950, 954 (1st Cir. 1976) ("Section 64(a)(1), in addition, has been interpreted as providing general protection to claimants that are injured by the debtor-in-possession's operation of the business even though their claims did not arise from transactions that were necessary to preserve or rehabilitate the estate.")

124. This policy judgment underlies the reduced priority of prepetition punitive claims under 11 U.S.C. § 726(a)(4) (1994). While postpetition matters are treated differently from prepetition and the limitation of section 726(a) is on its face not applicable to postpetition fines, the Supreme Court has only allowed administrative expense priority for postpetition punitive fines in the tax context. This allowance can be justified on the historically different treatment the Court has given to governmental taxing entities compared with other creditors, and it is now expressly embodied in section 503(b)(1)(C): "There shall be allowed administrative expenses . . . including any fine, penalty, or reduction in credit relating to a tax of a kind specified [above]." 11 U.S.C. § 503(b)(1)(C) (1994).

Thus while *Nicholas v. United States*, 384 U.S. 678 (1966), and *Boteler v. Ingels*, 308 U.S. 57 (1939), can be read as demonstrating a broad intent to grant administrative expense priority for any postpetition punitive fine, these cases can also be read as tax cases that are not controlling outside the tax context. This latter interpretation is supported by the express inclusion of tax penalties (but no other penalties) in the text of section 503(b).

125. See 11 U.S.C. § 348(d) (1994). Under section 348(d), a claim arising "after the order for relief but before conversion in a case that is converted [to Chapter 7], other than a claim specified in section 503(b) of this title, shall be treated for all purposes as if such claim had arisen immediately before the date of the filing of the petition."

126. 11 U.S.C. § 726(a)(4).

127. 11 U.S.C. § 726(a)(2) does not expressly include compensatory fines, but this category of priority is a catch-all that by exclusion from section 726(a)(4) includes compensatory fines up to the amount of actual pecuniary loss.

(who, unless a trustee had been appointed, is the culpable lawbreaker who caused the punitive fine to be assessed) receives nothing until all punitive fines have been paid.

Further, the bankruptcy court's powers of equitable subordination under section 510(c)¹²⁸ allow it to deal with situations where a particularly strong prepetition creditor had or should have had the power and knowledge to stop the debtor in possession's violations which caused the punitive fines to be imposed.¹²⁹ If the court determines that a prepetition creditor had this power and knowledge but let the violations continue in hopes of receiving a higher return, then this inequitable conduct would be sufficient grounds for the court to subordinate that individual claim.¹³⁰ This use of section 510(c) equitable subordination is much more realistic and fair than the de facto universal subordination of prepetition creditors under cases like *United States v. Elliott*.¹³¹ *Elliott* held that "once the petition is filed the [prepetition] creditors lose their 'innocent' status."¹³² This rule seems both unduly formalistic and unfair. It would be far more realistic and fair to equitably subordinate only those claimants who truly had the power and ability to enforce debtor compliance, but chose not to do so.

In summary, granting administrative expense priority for postpetition punitive fines upon successful reorganization, but denying this priority if the case is converted to Chapter 7, solves both dilemmas presented by these fines. This alternative ensures competitive neutrality and compliance with valid state laws, and it provides fairness to all claimants against the estate. It is superior on policy grounds to both outright allowance and outright denial of administrative expense priority. The only remaining questions are whether this solution is within judicial power and can be practically implemented.

128. 11 U.S.C. § 510(c) (1994) (granting courts equitable subordination powers).

129. This fiction that creditors control the debtor in great detail is likely true for at least some creditors in some cases, but most certainly is not true of all or even most creditors.

130. See, e.g., *In re Mobil Steel Co.*, 563 F.2d 692, 700 (5th Cir. 1977) (recognizing that equitable subordination is triggered by "some type of inequitable conduct" by a creditor to the detriment of other creditors or unfair benefit of the party acting inequitably).

131. 761 F.2d 168 (4th Cir. 1985).

132. *Id.* at 171.

C. Fidelity to Congress's Interpretive Grant

The text of the Bankruptcy Code suggests that Congress approved of a role for the courts in interpreting and developing the concept of actual and necessary costs entitled to administrative expense priority. In completely overhauling federal bankruptcy law, Congress could have overruled *Reading*. Instead it adopted almost the same language in section 503(b)(1)(A) as it had used in section 64(a)(1) of the Bankruptcy Act.¹³³ The legislative history for section 503 indicates no concern with judicial interpretations of actual and necessary costs. Only the treatment of taxes and related interest and penalties under section 503(b) appeared to have engendered any real congressional scrutiny.¹³⁴

Where Congress did diverge from the text of section 64(a)(1), it used expansive language evidencing an intent that the courts play a continuing role in interpreting and developing the concept of actual and necessary costs. For instance, Congress inserted the word "including" into its description of actual and necessary costs,¹³⁵ and section 102(3) defines as a rule of construction that "'includes' and 'including' are not limiting."¹³⁶

D. Feasibility of Judicial Implementation

The final question to be addressed is whether the suggested interpretation of actual and necessary costs entitled to administrative expense priority could be implemented. Congress vested exceptionally broad discretion in the bankruptcy courts as to the mechanics of

133. See *Al Copeland Enters., Inc. v. Texas (In re Copeland)*, 991 F.2d 233, 239 (5th Cir. 1993). In *In re Execuair Corp.*, 125 B.R. 600 (Bankr. C.D. Cal. 1991), the court noted that:

After the *Reading* decision, the Bankruptcy Code was completely revised and Congress made no substantial changes in the definition of administrative claim. Had they chosen to do so, Congress could have defined administrative expense so as to overrule the *Reading* case. . . . In fact, it appears that they broadened the concept of administrative expense claim by using the word "including" to demonstrate that the sub-parts of § 503(b)(1) are examples and not limitations of what can be determined to be an administrative claim.

Id. at 602-03.

134. See S. REP. NO. 95-989, at 66 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5852; H.R. REP. NO. 95-595, at 355 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6311. The Senate and House Reports have identical (and equally uninformative) language defining administrative expenses under section 503. In fact, these Reports use identical language to describe section 503 of the Bankruptcy Code except for the tax provisions, where the two Reports diverge. See S. REP. NO. 95-989, at 66; H.R. REP. NO. 95-595, at 355. The Reports suggest that Congress did not closely consider section 503 except for the tax-related language.

135. See 11 U.S.C. § 503(b) (1994).

136. 11 U.S.C. § 102(3) (1994).

administrative expense priority. The courts have almost unfettered discretion in how and when to handle allowance and payment of a claim for administrative expense priority.¹³⁷ Section 503(b) only requires that “[a]fter notice and a hearing, there shall be allowed administrative expenses.”¹³⁸ The Bankruptcy Rules likewise provide no significant limitations on the court’s discretion regarding the mechanics of administrative expenses.¹³⁹ The absence of any guidance on administrative expenses leaves the bankruptcy courts with broad discretion on mechanics.

The most direct technique for implementing the suggested alternative involves the court’s claim reconsideration power under Bankruptcy Rule 3008. Rule 3008 provides that “[a] party in interest may move for reconsideration of an order allowing or disallowing a claim against the estate. The court after a hearing on notice shall enter an appropriate order.”¹⁴⁰ Although the Rule speaks only of allowing or disallowing a claim, the Committee Note indicates that this Rule would apply to a motion for reconsideration of allowance of administrative expense priority under section 503(b): “After reconsideration, the court may . . . accord the claim a priority different from that originally assigned it, or enter any other appropriate order.”¹⁴¹

Thus upon the original motion during Chapter 11, the court can grant administrative expense priority for postpetition punitive fines, based on the fact that such fines are actual and necessary costs because of the fairness concern of competitive neutrality. The court need not allow disbursement of the fine amount until the effective date of the plan. But if instead of a successful reorganization the Chapter 11 proceeding is converted to a Chapter 7 proceeding, then subsequent to this conversion the court can reconsider the order

137. See COLLIER, *supra* note 24, § 503.02[1] (“[C]ourts exercise their discretion in setting bar dates according to the circumstances of each case.”); *id.* § 503.03 (“The appropriate time for making payments from the estate for allowed administrative expenses is not directly specified in the Bankruptcy Code or Rules.”); *id.* § 503.03[3] (“[T]he timing for payment of administrative claims is a matter to be determined within the discretion of the bankruptcy court.”).

138. 11 U.S.C. § 503(b).

139. FED. R. BANKR. PROC. 3009 is the only Bankruptcy Rule having any impact on the mechanics of administrative expenses. Rule 3009 requires that “[i]n a chapter 7 case, dividends to creditors shall be paid as promptly as practicable.” This rule supports the allowance of interim distributions to creditors in large chapter 7 cases. COLLIER, *supra* note 24, § 503.03. Neither this Rule nor any other statutory provision or Rule, though, mandates that administrative expense claims be administered or paid before final distribution in Chapter 7 or the plan’s effective date in Chapter 11.

140. FED. R. BANKR. PROC. 3008.

141. FED. R. BANKR. PROC. 3008 advisory committee note; see *In re Zeig*, 194 B.R. 469 (Bankr. D. Neb. 1996).

allowing administrative expense priority. Based upon the elimination of the competitive neutrality fairness concern because of the conversion to Chapter 7, and on the absence of any benefit to the estate, the court can, upon reconsideration, deny priority for the postpetition punitive fines. Upon this denial, these postpetition, pre-conversion claims are treated by operation of section 348(d) as prepetition claims entitled to fourth distribution priority under section 726(a)(4).

While the reconsideration of administrative expense priority based upon the outcome of the Chapter 11 proceeding may seem problematic at first blush, it is substantively appropriate once the role of fairness concerns in determining actual and necessary costs is appreciated. It is procedurally appropriate because reconsideration of a prior order is an "ancient and elementary power" of a court.¹⁴²

V. CONCLUSION

Thirty years after being decided, *Reading Co. v. Brown* remains the key to understanding the impact of fairness considerations on administrative expense priority. Punitive fines, however, are a marked departure from the issue presented in *Reading*, so the effect of the compensatory fairness principle from *Reading* in the punitive context will only become evident if the Court takes a case addressing this issue. The Court has not done so, and in the interim, lower courts must muddle through with reference to the principles of *Reading* and Section 959.

Reading establishes that where Congress has given the courts interpretive latitude in bankruptcy, fairness provides a significant non-textual interpretive tool: the "decisive statutory objective [of bankruptcy is] fairness to all persons having claims against the insolvent."¹⁴³ *Reading* identifies one clear fairness principle: it is "more natural and just" that "those injured by the operation of the business during an arrangement should . . . recover ahead of those for whose benefit the business is carried on."¹⁴⁴ A second critical fairness principle emerges from the underlying competitive neutrality purpose of Section 959. This section seeks to insure that bankruptcy does not provide a competitively advantageous haven from which the debtor

142. *Central Ill. Co. v. Irving Trust Co. (In re Pottasch Bros. Co.)*, 79 F.2d 613, 616 (2d Cir. 1935).

143. *Reading Co. v. Brown*, 391 U.S. 471, 477 (1968).

144. *Id.* at 482.

can continue to operate while avoiding costly and onerous regulatory requirements that must be observed by its competitors. Fairness to competitors and an understanding of the perverse incentives that an opposite ruling would create require that a debtor who successfully reorganizes and emerges from Chapter 11 must pay punitive fines fully, just as would a competitor outside of bankruptcy.

Compensatory fairness and competitive neutrality cannot be reconciled with one another under the current judicial preference for granting outright administrative expense priority for postpetition punitive fines. But both of these principles can be given full effect under a more flexible outcome-sensitive application of administrative expense priority. In a Chapter 11 reorganization, competitive neutrality requires that punitive fines be granted administrative expense priority as actual and necessary costs. If the Chapter 11 reorganization is converted to a Chapter 7 liquidation, however, then upon motion by the Chapter 7 trustee the court can reconsider the order allowing administrative expense priority. If the court believes that a dominant prepetition creditor had the power and knowledge to force the debtor to comply with state laws but failed to do so, the court can equitably subordinate this individual creditor's claims under section 510(c).

This suggested interpretation is within the courts' broad interpretive grant from Congress, is procedurally achievable, and has a number of beneficial results relative to the current judicial response to this issue. This interpretation views *Reading* for what it is: a revolutionary case that established a fairness-driven exception to the benefit requirement for actual and necessary costs. Recognizing *Reading* as a specific and limited exception to the benefit requirement reinvigorates a common sense understanding of actual and necessary costs.¹⁴⁵ This interpretation is refreshingly simple compared with the 'costs ordinarily incident' rationale employed by some courts,¹⁴⁶ which has the practical effect of rendering all postpetition costs actual and

145. See *McBain*, *supra* note 11, at 243 (noting that at present the determination of actual and necessary costs of preserving the estate "has become an elusive, fact-specific determination that provides little guidance for potential litigants").

146. See, e.g., *Cumberland Farms, Inc. v. Florida Dept. of Env'tl. Protection*, 116 F.3d 16, 20 (1st Cir. 1997).

necessary. Most importantly, however, this reading of *Reading* best effectuates the Court's decisive bankruptcy concern: fairness to all persons having claims against the debtor.

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