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Offensive Uses of the Bankruptcy Stay

*Daniel Keating**

I. INTRODUCTION

One of the most significant features of the 1978 Bankruptcy Reform Act[1] was markedly broadened versions of the automatic and

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1. Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101-1330 (1988).

postdischarge stays.[2] If bankruptcy is the refuge for the honest but unfortunate debtor,[3] then the stay is the specific tool that makes the refuge meaningful. Indeed, more than one court has characterized the stay as a shield that gives the corporate debtor an opportunity to reorganize[4] and affords the individual debtor a chance for the proverbial fresh start.[5]

Even courts mindful of the debtor-protection function of the stay, however, are careful to note that the debtor should use the stay only as a shield, and not as a sword. Virtually every judge would agree in principle that offensive uses of the stay are impermissible.[6] Unfortunately, the judicial consensus against debtors wielding the stay as a weapon has not been matched by a similar consensus on where to draw the line

2. 11 U.S.C. §§ 362, 524 (1988); *see also infra* part II.A.

3. *See* Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934) (stating that one of bankruptcy law's central policies is to give "the honest but unfortunate debtor . . . a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preëxisting [sic] debt").

4. *See, e.g., In re* Briggs Trans. Co., 780 F.2d 1339, 1343 (8tb Cir. 1985) (stating that the automatic stay in corporate reorganization proceedings "shields creditors from each other and is intended to aid in equitably distributing the debtor's assets in a way that maximizes the interests of all parties").

5. *See, e.g.,* Stringer v. Huet (*In re* Stringer), 847 F.2d 549, 551 (9th Cir. 1988) (explaining that in the case of individual bankruptcy the automatic stay "was designed to shield the debtor from financial pressure during the pendency of the hankruptcy proceeding").

The notion of bankruptcy as a "fresh start" for the individual debtor is hardly a recent concept. *See, e.g.,* Wetmore v. Markoe, 196 U.S. 68, 77 (1904) (stating that "[s]ystcms of bankruptcy are designed to relieve the honest debtor from the weight of indebtedness which has become oppressive and to permit him to have a fresh start in business or commercial life, freed from the obligation and responsibilities which may have resulted from business misfortunes").

6. *See, e.g.,* Oberg v. AETNA Casualty & Sur. Co. (*In re* A.H. Robins Co., Inc.), 828 F.2d 1023, 1026 (4th Cir. 1987) (stating that "[o]ur system of law universally frowns on a party who would use the stay as both a sword and a shield"); Bohack Corp. v. Borden, Inc. (*In re* The Bohack Corp.), 599 F.2d 1160, 1168 (2d Cir. 1979) (noting that courts "must be cautious to avoid a decision which could convert Rule 11-44 [pre-Code stay] from a shield into a weapon"); Bernstein v. IDT Corp., 76 B.R. 275, 281 (S.D.N.Y. 1987) (decrying use of stay "as a sword instead of a shield"); Boone v. Beacon Bldg. Corp., 613 F. Supp. 1151, 1155 (D.N.J. 1985) (stating that the automatic stay provisions of the Bankruptcy Act only operate "in actions where the petitioner is in a *defensive* posture") (emphasis in original); Turner Broadcasting Sys., Inc. v. Sanyo Elec., Inc., 33 B.R. 996, 1000 (N.D. Ga. 1983) (noting that "the stay is not designed to be an offensive weapon—a sword"); Drubner v. Gaslight Village (*In re* Gaslight Village, Inc.), 8 B.R. 866, 870 (D. Conn. 1981) (stating that "[t]he automatic stay under Code § 362 was not intended to be used as a weapon or club to reduce secured creditors into submission"); Central Fidelity Bank v. Cooper (*In re* Cooper), 116 B.R. 469, 472 (Bankr. E.D. Va. 1990) (asserting that codebtor stay of Code § 1301 "is to be used as a shield and not as a sword"); Jandous Elec. Constr. Corp. v. City of New York (*In re* Jandous Elec. Constr. Corp.), 106 B.R. 48, 50 (Bankr. S.D.N.Y. 1989) (holding that debtor "may not use the automatic stay as a sword when the debtor is the plaintiff in a pending nonbankruptcy suit"); Walter E. Heller & Co. v. Food Mktg. Assoc., Ltd. (*In re* Fasano/Harris Pie Co.), 43 B.R. 864, 870 n.14 (Bankr. W.D. Mich. 1984) (decrying use of stay "as a sword . . . rather than as a shield to preserve the status quo"). *But see* Pettibone Corp. v. Baker (*In re* Pettibone Corp.), 110 B.R. 848, 855 (Bankr. N.D. Ill. 1990) (stating that the debtor's alleged offensive use of the stay "is precisely what the law allows a debtor to do").

between offensive and defensive uses of the well-known bankruptcy device.

In a number of important and recurring cases courts regularly are allowing both individual and corporate debtors to use the stay offensively as a means of extracting a future benefit from a nondebtor party to whom the debtor owes a prepetition debt. The dangers of this trend are subtle but significant. With an increase in use of the stay as a weapon will come a decrease in the willingness of nondebtor parties to extend credit to financially troubled corporations and individuals.[7] Furthermore, offensive uses of the stay will compromise the equality of treatment and value-preservation goals of corporate bankruptcy,[8] while exacerbating the moral hazard problem inherent in an individual debtor's discharge right.[9]

Part II of this Article proposes a simple and functional test to distinguish offensive from defensive uses of the stay that is consistent with the historical underpinnings of the Bankruptcy Code's automatic and postdischarge stays.[10] The proposed test defines as an offensive use of the stay any situation in which the court compels the nondebtor party to grant the debtor future benefits when the debtor has not first assumed preexisting burdens owed to the nondebtor party. The foundations of the test are then justified by reference to a general linkage of burdens with benefits that pervades both the Code and well-established bankruptcy case law.[11]

Part III sets out five categories of cases in which courts have allowed debtors to use the stay as a sword: conditional refusals to deal;[12] license renewals;[13] college transcript withholdings;[14] banks' administrative freezes on debtor accounts;[15] and consumer secured installment loans.[16] Part III explores the manner in which courts run afoul of the proposed test for distinguishing offensive from defensive uses of the stay in each of the five situations. Further, Part III shows how these cases are inconsistent with the burden/benefit theme that is found both in the Code and in the case law. Part III also examines how the antidis-

7. *See infra* notes 59-61, 119-20 and accompanying text; part IV.B.

8. *See infra* part IV.A.

9. *See infra* part IV.B.

10. *See infra* part II.A. All further references in the text and footnotes will refer to the Bankruptcy Code simply as "the Code."

11. *See infra* part II.B.

12. *See infra* part III.A.

13. *See infra* part III.B.

14. *See infra* part III.C.

15. *See infra* part III.D.

16. *See infra* part III.E.

crimination provision of the Code[17] should affect the outcomes in the categories of cases explored.

Finally, Part IV considers in greater detail the costs of continued judicial misuse of bankruptcy's stays, in both cases involving corporate debtors and those involving individual debtors.

II. Defining Offensive Uses of the Stay

A. *A Brief History of the Stay*

Any discussion of the stay in bankruptcy must begin by distinguishing the so-called "automatic stay" from the postdischarge stay. The automatic stay of Section 362 of the Bankruptcy Code takes effect the moment a debtor files a bankruptcy petition with the bankruptcy court and generally lasts until the case ends or a discharge is granted.[18] There are several categories of enumerated acts against debtors that Section 362 prohibits, but the broadest of these prohibitions is found in Section 362(a)(6), which bars "any act to collect, assess or recover a [prepetition] claim" against the debtor.[19]

The postdischarge stay, in contrast, generally picks up where the automatic stay leaves off.[20] In its broadest form the postdischarge stay of Section 524 purports to enjoin any act to collect, recover, or offset a discharged debt.[21] Unlike the automatic stay, the postdischarge stay theoretically has no point of expiration.[22]

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17. 11 U.S.C. § 525 (1988).

18. Section 362 begins by stating that "a petition filed under section 301, 302, or 303 of this title . . . operates as a stay, applicable to all entities, of [various enumerated acts]." *Id.* § 362(a). Section 362(c) provides that, absent a lift of stay, the automatic stay of acts against property of the estate "continues until such property is no longer property of the estate." *Id.* § 362(c)(1). Section 362(c) states that the stay will continue until the earliest of three events: (1) the closing of the case; (2) dismissal of the case; or (3) the time when a discharge is granted or denied. *Id.* § 362(c)(2).

Section 362(d) also provides that the court may lift the stay on request of a party in interest. *Id.* § 362(d). Section 362(d)(1) provides that the court shall lift the stay "for cause, including the lack of adequate protection of an interest in property" of the party petitioning for relief from stay. *Id.* § 362(d)(1). Section 362(d)(2) provides that with respect to a stay of acts against property of the estate, the court shall lift the stay if the debtor lacks equity in the property and the property is not necessary for an effective reorganization. *Id.* § 362(d)(2).

19. *Id.* § 362(a)(6).

20. This will be true when, as is typical, the court grants the debtor's discharge. Under § 362(c)(2)(C), the grant of discharge will end the automatic stay, but the postdischarge stay of § 524 takes effect immediately upon discharge. *Id.* § 362(c)(2)(C); *see* § 524 (beginning with statement that "[a] discharge in a case under this title" has enumerated injunctive effects).

21. Section 524(a)(2) provides that a discharge in bankruptcy "operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such debt as a personal liability of the debtor, whether or not discharge of such debt is waived." *Id.* § 524(a)(2).

22. A creditor may avoid the effects of a debtor's discharge by entering into a formal reaffirmation agreement with the debtor. Such an agreement must be made prior to the court granting

The Bankruptcy Reform Act significantly enhanced the power and scope of both the automatic and postdischarge stays.[23] Prior to the Reform Act, the United States Supreme Court had promulgated the Rules of Bankruptcy Procedure, which created several stays that collectively were comparable to the automatic stay.[24] Many courts, however, interpreted those stays to cover only formal judicial actions by creditors to collect debts.[25] In contrast, both the broader language of Section 362 and its legislative history indicate that the Code's automatic stay provision should prohibit all attempts, legal or otherwise, by creditors to collect prepetition debts from the debtor.[26] Therefore, under the current automatic stay, even informal collection activities such as making harassing telephone calls or posting deadbeat signs on the debtor's premises are violations of the stay.[27]

Similarly, the postdischarge stay has been strengthened over time. Originally, the debtor's discharge in bankruptcy was meaningful only as

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discharge to the debtor. *Id.* § 524(c)(1). Nothing in the Code, however, prevents a debtor from voluntarily repaying a debt that has been discharged. *See id.* § 524(f).

The Code also provides that certain categories of debts are nondischargeable. *See id.* § 523(a). Such categories include certain debts that stem from taxes, fraud, willful injuries, alimony, student loans, and injuries resulting from a debtor driving while intoxicated. In addition, the Code lists certain conditions under which a court may deny a discharge entirely, for example, a debtor's commission of fraud connected to administration of the case. *See id.* § 727(a).

23. *See id.* §§ 362, 524.

24. In 1973 the Supreme Court adopted Rule 401, which provided that the filing of a petition operated as an automatic stay of certain actions on unsecured debts. Rules of Bankruptcy Procedure, 411 U.S. 995, 1048 (1973). The Court also adopted Rule 601, a stay against lien enforcement, and Rule 13-401, a stay barring actions against the debtor or lien enforcer in cases filed under Chapter 13. *Id.* at 1062, 1177. In 1974 the Court adopted an automatic stay available in Chapter 11 cases, Rules of Bankruptcy Procedure, 415 U.S. 1007, 1033 (1974), and in 1975 it adopted the stays that applied to Chapter 10 and Chapter 12 cases. Rules of Bankruptcy Procedure, 421 U.S. 1023, 1069, 1116 (1975).

Prior to the promulgation of the Bankruptcy Rules of Procedure, there were a number of stays in bankruptcy, each fairly limited in scope. *See* Frank R. Kennedy, *The Automatic Stay in Bankruptcy*, 11 U. MICH. J.L. REF. 177, 179-86 (1978).

25. *See* Frank R. Kennedy, *Automatic Stays Under the New Bankruptcy Law*, 12 U. MICH. J.L. REF. 1, 22 (1978) (asserting that § 362(a)(6) of the Code "overrules the numerous cases that decline to interfere with nonjudicial efforts to collect debts").

26. Section 362(a)(6) stays "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case nnder this title." 11 U.S.C. § 362(a)(6). The legislative history of § 362 specifically notes that the stay "stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy." HOUSE COMM. ON THE JUDICIARY, BANKRUPTCY LAW REVISION, H.R. REP. No. 595, 95th Cong., 1st Sess. 340 (1977).

27. *See, e.g.*, Sechuan City, Inc. v. North Am. Motor Inns, Inc. (*In re* Sechuan City, Inc.), 96 B.R. 37 (Bankr. E.D. Pa. 1989) (holding that a creditor's signs in hotel lobby indicating that the debtor restaurant owner was not paying its bills violated § 362(a)(6)). The legislative history of § 362 indicates that Congress intended § 362(a)(6) to prevent creditors from even phoning debtors to encourage repayment. H.R. REP. No. 595 at 342 (1977); *cf. In re* Reed, 11 B.R. 258 (Bankr. D. Utah 1981) (holding that dumping garbage on a debtor's lawn violates stay).

an affirmative defense to state court collection actions brought by creditors whose debts had been discharged.[28] The problem with this version of discharge was that many ill-informed debtors either failed to recognize the necessity of pleading the affirmative defense or simply did not appear in court at all, enabling the creditor to continue collection efforts unimpeded by the discharge.[29] Thus, the discharge provided little postbankruptcy protection to an uninformed debtor.

In 1970 Congress passed legislation amending the discharge provisions of the Bankruptcy Act.[30] These amendments expanded the power of the bankruptcy court by permitting it to enjoin any formal collection actions brought by creditors on discharged debts.[31] That new injunctive power, however, did not encompass creditors' nonjudicial attempts to collect discharged debts, as does the Code in Section 524.[32]

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28. *See* Doug Rendleman, *The Bankruptcy Discharge: Toward a Fresher Start*, 58 N.C. L. Rev. 723, 727-32 (1980).

29. *Id.* at 729-30.

30. Act of Oct. 19, 1970, 84 Stat. 990, *repealed by* Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101-1330 (1988); *see also* Kennedy, *supra* note 24, at 186-87.

31. Kennedy, *supra* note 24, at 186.

32. *See* Rendleman, *supra* note 28, at 734 (noting that the legislative history of dischargeability amendments of 1970 supports the view that Congress did not intend to forbid "the informal, nonjudicial tactics like threatening collection letters that creditors used to secure reaffirmation"); *see also* H.R. Rep. No. 595, at 365-66 (noting that § 524 "has been expanded over a comparable provision in Bankruptcy Act § 14f to cover any act to collect, such as dunning by telephone or letter, or indirectly through friends, relatives, or employers, harassment, threats of repossession, and the like").

Also significant in the development of both stays has been the increase in sanctions available to the bankruptcy court against those who transgress the stay. After the Bankruptcy Rules gave bankruptcy judges formal injunction ability, the bankruptcy court gained the power to hold creditors in contempt in order to enforce the postdischarge stay. Prior to the enactment of the Code, however, that contempt power was rarely exercised against recalcitrant creditors. *But see* Fidelity Mortgage Investors v. Camelia Builders, Inc. (*In Re* Fidelity Mortgage Investors), 550 F.2d 47 (2d Cir. 1976) (holding general contractors in contempt for initiating state court action against a Chapter 11 debtor without first securing permission of the bankruptcy court). Rule 920 of the Bankruptcy Rules of Procedure allowed courts to impose sanctions for violation of the discharge injunction. *See* Rendleman, *supra* note 28, at 733. Professor Rendleman noted that "[t]he bankruptcy judges wielded the contempt rule as hesitantly as the Advisory Committee and the Supreme Court that had promulgated it." *Id.* at 734. Prior to the Bankruptcy Rules of 1970, bankruptcy judges apparently never used the contempt power they had to enforce the automatic stay. *See* Kennedy, *supra* note 24, at 259. Professor Kennedy pointed out that although he could find no case imposing or considering the contempt sanction against a violator of the statutory stays that predated the Bankruptcy Rules, there are cases in which courts imposed monetary sanctions for violation of the Bankruptcy Rule stays. *Id.*

Once the Code was in place, bankruptcy courts did not hesitato to use their contempt power to remedy violations of both stays. *See, e.g.*, Mountain Am. Credit Union v. Skinner (*In re* Skinner), 917 F.2d 444 (10th Cir. 1990) (upholding a bankruptcy court's contempt power for a § 362 violation); *In re* Simonetti, 117 B.R. 708 (Bankr. M.D. Fla. 1990) (using contempt power to remedy a violation of a § 524 postdischarge injunction). In 1984 Congress codified a power that courts already had by amending § 362 to give the bankruptcy court the right to assess actual damages, including attorney's fees, against willful stay violators. Act of July 10, 1984, Pub. L. No. 98-353, Although the Code significantly increased the breadth of the bankruptcy stay, nowhere in the new stay provisions or in their legislative history did Congress suggest that debtors could use the stay as a tool to coerce nondebtor parties to provide them with future benefits.[33] This Article proposes a test for distinguishing permissible defensive uses of the stay from inappropriate offensive uses. An impermissible offensive use is defined as any situation in which the debtor invokes the stay to obtain future benefits from a nondebtor party. For example, under this test, a debtor could not compel a supplier to whom the debtor owed prepetition debts to provide further goods or services to the debtor, even on a cash basis, if the debtor did not first satisfy the prepetition claims in full. This proposed test challenges many current judicial interpretations defining the stay's appropriate scope.[34]

Although the test is at odds with many case holdings, it is consistent with the 1978 Reform Act's expansion of the stay from a prohibition of only formal court actions on prepetition debts to a prohibition of all acts to collect prepetition debts.[35] The standard proposed herein would continue to construe the stay as barring both formal and informal actions on the part of creditors to collect prepetition debts.

The proposed test would, however, allow a nondebtor party to condition its grant of future benefits to the debtor on the debtor's repayment of prepetition debts to the nondebtor party. Some courts have construed such a conditional refusal to deal as a veiled act to collect a prepetition debt which therefore violates the stay.[36] These courts fail to recognize that bankruptcy law routinely allows creditors to condition future benefits to a debtor on the debtor's cure of prepetition defaults owed to that creditor. This linkage of burdens with benefits is specifically sanctioned by various provisions of the Code and by case law

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Title III, §§ 304, 363(b), 392, 441, 98 Stat. 352, 363, 365, 371 (codified as amended at 11 U.S.C. § 362(h) (1988)). That provision also enables bankruptcy courts to award debtors punitive damages "in appropriate circumstances." 11 U.S.C. § 362(h).

33. *See generally* H.R. Rep. No. 595, at 340-44, 365-66 (legislative history of §§ 362 and 524).

Professor Rendleman, commenting on the Code's broadened versions of the stay, asserts that the new broadened stays should prevent nonjudicial harassment such as letters, phone calls, and certain refusals to deal, including credit unions refusing future service and colleges refusing to provide transcripts. Rendleman, *supra* note 28, at 751-52. Professor Rendleman fails to appreciate, however, the distinction between bare attempts to collect through letters and phone calls, and the mere withholding of future benefits pending payment. The legislative history speaks only in terms of expanding the stay to prevent both informal and legal attempts to collect. There is no indication in the legislative history that Congress intended the stays to enable debtors to insist on future benefits from creditors without first assuming prepetition burdens.

34. *See infra* part III.

35. *See supra* part II.A.

36. *See infra* note 55.

outside of the stay area.[37]

B. *Bankruptcy's Burden/Benefit Linkage*

1. In the Code

A general theme throughout various Code provisions is that a debtor wishing to gain benefits from a nondebtor party must assume burdens owed to that party. A classic example of this burden/benefit linkage is the Code's rule concerning a debtor's ability to assume executory contracts. Section 365 provides that "if there has been a default in an executory contract" of a debtor, the trustee must not only give adequate assurance of its future performance, but also cure any prepetition defaults on the contract.[38]

Although the mechanism in Section 365 is typically used by corporate debtors,[39] there is an analogue in the Code for individual debtors. Section 524, the Code's reaffirmation provision, is a formal means for the individual debtor to assume prepetition burdens that would otherwise be dischargeable.[40] Congress, by providing this formal reaffirmation section, was acknowledging that in certain situations it makes sense for the debtor to effect a selective waiver of her discharge right.[41] More significantly, the reaffirmation provision reflects the view that if the debtor wishes to gain a postdischarge benefit from a particular party, the nondebtor party has the right to insist that the debtor assume prepetition burdens owed to that party.

Another prominent example of the burden/benefit theme pervading the Code is the setoff provision in Section 553. Section 553 permits a prepetition creditor to set off claims to the debtor's estate against any obligations the creditor owes to the debtor.[42] In effect, Section 553 prohibits the debtor from demanding the benefit of full repayment from a

37. *See infra* part II.B.

38. 11 U.S.C. § 365(b)(1) (1988).

39. Section 365 is typically used by corporate debtors because in a Chapter 7 liquidation case a trustee is automatically appointed and has the power to assume or reject executory contracts of the debtor. *See id.* §§ 701-04 (providing for the selection and duties of Chapter 7 trustee); *id.* § 365(a) (permitting the trustee to assume or reject executory contracts of the debtor). The individual debtor who files a Chapter 13 case has the power, pursuant to § 1322(b)(7), to assume or reject executory contracts as part of the bankruptcy plan. *Id.* § 1322(b)(7) (incorporating the rules of § 365). The most common user of § 365 is a corporate Chapter 11 debtor-in-possession. Debtors-in-possession generally remain in control of a company and have all of the powers that a trustee normally has, including the power to assume or reject executory contracts. *Id.* § 1107(a) (giving a debtor-in-possession most of the rights of a trustee).

40. *Id.* § 524(c) (outlining the prerequisites of a valid reaffirmation agreement).

41. *See id.* § 524(c)(3), (c)(6) (permitting reaffirmation only if debtor's attorney determines that agreement imposes no undue hardship on debtor or, when the debtor is not represented, if the court determines that a reaffirmation agreement is in debtor's best interest).

42. *See id.* § 553(a).

creditor while at the same time relegating the creditor to an incomplete recovery of the debtor's obligation. Thus, the debtor is not allowed the benefit of repayment without assuming the burden of comparable satisfaction.

2. In the Case Law

Some of the most significant manifestations of bankruptcy's burden/benefit linkage are found not in the Code itself, but in well-established bankruptcy case law. For example, the fundamental concept of lien pass-through is never specifically mentioned in the Code, although the legislative history of Section 522 affirms the continued viability of that common-law provision.[43] Under the lien pass-through doctrine, if a creditor has a valid lien on property of the debtor that is not avoided in the bankruptcy case, the lien survives the debtor's discharge.[44] Thus, if the debtor wants the benefit of retaining a secured creditor's collateral, she must somehow assume the burden of paying that creditor for its lien interest.[45]

Another example of the burden/benefit theme in bankruptcy case law is the general recognition of valid transfer restrictions on property of the estate. If, for example, the debtor owns a seat on the Board of Trade that cannot be transferred without first satisfying all of the debtor's Board creditors, then the bankruptcy estate must also contend with that transfer restriction.[46] Thus, the estate may enjoy the benefit of selling the property only at the cost of assuming the burden of first satisfying the debtor's Board of Trade creditors.

Two other common-law doctrines further demonstrate the tendency of courts to condition a debtor's ability to secure future benefits on the debtor's willingness to assume past burdens. The doctrine of cross-collateralization enables a postpetition lender to gain collateral not only for its new loans, but also for unsecured loans that were not

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43. *See* H.R. REP. No. 595, at 361.

44. *See* Long v. Bullard, 117 U.S. 617 (1886); *see also In re* Pence, 905 F.2d 1107, 1109 (7th Cir. 1990) (stating that "Congress' recent amendment of section 506(d) could only be viewed as codifying, *or recodifying,* the long-established rule of the *Long* line of cases that a secured creditor need not participate in a bankruptcy proceeding to preserve his lien" (citation omitted & emphasis in original)); *In re* Tarnow, 749 F.2d 464, 465 (7th Cir. 1984) (explaining that the *Long* doctrine "allows a creditor with a loan secured by a lien on the assets of a debtor who becomes bankrupt before the loan is repaid to ignore the bankruptcy proceeding and look to the lien for the satisfaction of the debt").

45. Two vehicles a debtor may use to assume the burden of paying the creditor for its lien interest are reaffirmation, 11 U.S.C. § 524(c) (1988), and redemption, *id.* § 722.

46. Board of Trade v. Johnson, 264 U.S. 1 (1924). Even after the enactment of the Code, courts continue to cite with approval the holding in *Board of Trade. See, e.g.,* Chicago Mercantile Exch. v. United States, 840 F.2d 1352, 1355 (7th Cir. 1988).

repaid by the debtor prior to its bankruptcy filing.[47] Cross-collateralization thereby allows the postpetition lender to condition future credit on the debtor's agreement to assume, through the granting of collateral, unsatisfied burdens owed to that lender.

Similarly, the common-law doctrine of necessity enables a supplier of goods or services to condition future dealings with a debtor on the debtor's payment of prepetition unsecured claims to the supplier.[48] The doctrine of necessity, like the other case law and Code doctrines discussed above, recognizes that a nondebtor party may condition its willingness to offer special benefits to the debtor on the debtor's fulfillment of existing obligations owed to the nondebtor.

III. Offensive Uses of the Stay: Recurring Cases

A. *Refusals to Deal*

1. Corporate Debtors

Imagine for a moment that Debtor is a retail shoe seller and Creditor is a supplier that manufactures shoes.[49] Debtor and Creditor have a one-year requirements contract in which Creditor agrees to sell to Debtor at the beginning of each month the dress shoes Debtor needs for that month.[50] Debtor is obligated to pay Creditor for the shoes, at Creditor's then-prevailing rate, within ten days following receipt of the shoes.

Midway through the fourth month of the contract, Debtor files a Chapter 11 petition. Debtor wishes to continue purchasing shoes from Creditor while Debtor is reorganizing in bankruptcy.[51] Debtor likes the price and quality of Creditor's shoes, and Creditor is conveniently located for Debtor's business. In addition, Creditor sells a couple of popular shoe lines that Debtor is unable to obtain easily from another manufacturer.

For all of these reasons, Debtor wants to enforce its prepetition contract with Creditor. Debtor, however, does not make this decision

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47. *See infra* text accompanying notes 99-103.

48. *See infra* text accompanying notes 75-77.

49. This hypothetical is based loosely on the facts of Ike Kempner & Bros., Inc. v. U.S. Shoe Corp. (*In re* Ike Kempner & Bros., Inc.), 4 B.R. 31 (Bankr. E.D. Ark. 1980).

50. The Uniform Commercial Code specifically sanctions the enforceability of output and requirements contracts. *See* U.C.C. § 2-306 (1990).

51. When a company files a Chapter 11 petition, it thereby assumes an identity that is technically distinct from the prepetition entity. The debtor company is then known formally as a "debtor-in-possession." 11 U.S.C. § 1101(1) (1988). Although it is cloaked with a new name, the debtor-in-possession may continue to operate the business. *See id.* § 1107(a) (stating that the debtor-in-possession shall have the rights and powers of a trustee); *id.* § 1108 (providing that a trustee's powers include operation of the debtor's business).

until two weeks into the case, and by that time, Debtor is officially in breach of its contract with Creditor, since Debtor has failed to pay Creditor for its most recent shipment of shoes. Debtor wonders whether, notwithstanding its breach, it may enforce Creditor's contractual obligation to continue supplying shoes.

In this scenario, the Code is quite clear on two points. First, Debtor may indeed continue to enforce the contract notwithstanding the existing breach.[52] Second, Debtor may insist on contractual performance from Creditor only if Debtor first pays Creditor for the shoes Creditor delivered prepetition.[53]

Now consider a slight change in the facts. Imagine that Debtor and Creditor conduct the same monthly transactions, but without a specific contract. That is, Debtor and Creditor engage in a regular series of monthly shoe transactions, but do not commit in advance to any specific duration of the arrangement. Once again, the payment term is ten days subsequent to Debtor's receipt of the shoes. Furthermore, as in the first example, Debtor files Chapter 11 bankruptcy when its payment for the last shipment of shoes is overdue.

Although it is in bankruptcy, Debtor would like to continue buying shoes from Creditor. Shortly after the bankruptcy filing, Debtor approaches Creditor and offers to do business on a cash-in-advance basis

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52. Section 365 permits the debtor-in-possession, with the court's approval, to assume or reject any executory contract or unexpired lease of the debtor. *Id.* § 365(a). Section 365 also specifically allows the debtor-in-possession to assume an executory contract or lease notwithstanding the existence of a default. *Id.* § 365(b)(1).

The drafters of the Code did not specifically define an executory contract, but one widely cited definition is that proposed by Professor Vern Countryman. Professor Countryman defines an executory contract as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973). Michael Andrew has proposed a slightly different definition of an executory contract. Andrew defines an executory contract as consisting of two necessary components: "(a) debtor and non-debtor each have unperformed obligations, and (b) the debtor, if it ceased further performance, would have no right to the other party's continued performance." Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. COLO. L. REV. 845, 893 (1988).

53. Section 365(b)(1) requires the debtor-in-possession to do three things in order to assume an executory contract that is in default: cure the default, or provide adequate assurance that the trustee will promptly cure such default; compensate the nondebtor party for damages suffered pursuant to the default, or provide adequate assurance that the trustee will provide such prompt compensation; and provide adequate assurance of future performance under the contract or lease.

Professor Jay Westbrook describes the debtor's obligation to cure before assuming as part of the "cost of sale" of the executory contract to the bankruptcy estate. He notes that if the estate's expense of performing the contract exceeds the proceeds obtained under the contract, the debtor-in-possession will suffer a net loss by assuming the contract. *See* Jay L. Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 247 (1989). Courts have made it clear that a debtor-in-possession must assume or reject a contract in total, and thus may not assume only beneficial parts. *See, e.g.*, NLRB v. Bildisco & Bildisco, 465 U.S. 513, 531-32 (1984).

so that Creditor will incur no future credit risk. Creditor agrees to continue doing business, but only on one condition: Debtor must first pay Creditor in full for the prepetition shipment of shoes.

Initially, Creditor's position in the second hypothetical may appear stronger than its position in the first. In the first situation, Creditor had a specific legal obligation to supply shoes for the rest of the contract, although the obligation was contingent on Debtor's return performance. In the second situation, Creditor had no such legal obligation. Thus, because Creditor has no legal obligation to do business with Debtor, it seems that Creditor should be able to condition its continued dealings with Debtor on Debtor's payment in full for the prepetition shoe delivery.

Many courts, unfortunately, fail to appreciate the analogy between the second situation and the standard executory contract scenario. These courts would contend that in the second hypothetical Creditor's condition that Debtor cure prepetition obligations owed to Creditor before it will engage in future business with Debtor violates the automatic stay.[54] Such courts characterize the conditional refusal to deal as "any act to collect" a prepetition debt.[55] This interpretation of the stay gives Debtor a weapon, thus enabling it to gain benefits from Creditor that Debtor could not have required absent its bankruptcy filing.

Furthermore, these "offensive stay" decisions create an anomalous situation in which Debtor acquires leverage against parties who owe it no legal duties yet lacks such leverage against parties who do owe Debtor specific contractual obligations.[56] Under these holdings, a bankruptcy court can force a creditor with no contractual duty to the debtor to do further business without insisting on a cure of the debtor's prepetition defaults. On the other hand, a court cannot force a creditor who

54. *See infra* text accompanying notes 65-73.

55. *See, e.g.*, *In re* Guinn, 102 B.R. 838, 842-43 (Bankr. N.D. Ala. 1989); Karsh Travel, Inc. v. Airlines Reporting Corp. (*In re* Karsh Travel, Inc.), 87 B.R. 110, 111-12 (Bankr. N.D. Cal. 1988), *aff'd*, 102 B.R. 778 (N.D. Cal. 1989); Sportfame of Ohio, Inc. v. Wilson Sporting Goods Co. (*In re* Sportfame of Ohio, Inc.), 40 B.R. 47, 50 (Bankr. N.D. Ohio 1984); *In re* Haffner, 25 B.R. 882, 886-87 (Bankr. N.D. Ind. 1982).

56. Other commentators have noted this anomaly in other situations. *See* DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 669-72 (2d ed. 1990) (noting the argument that a refusal-to-deal case "is no different in principle" than the one that arises in a situation in which a nondebtor party who has an executory contract wishes to condition its future dealings with the debtor on the debtor's payment of prepetition debts); Russell A. Eisenberg & Frances F. Gecker, *The Doctrine of Necessity and its Parameters*, 73 MARQ. L. REV. 1, 7-8 (1989) (using § 365(b), on assumption of executory contracts, among other statutory provisions, to justify the doctrine of necessity); Richard L. Epling, *Preconfirmation or Preclosing Payment of Prepetition Claims in Bankruptcy*, 91 CONN. L.J. 187, 193-94 (1989) (noting the unfairness of allowing a prepetition creditor whose contract is assumed to receive a preference while a similarly situated prepetition creditor whose contract is rejected becomes an unsecured creditor).

does have an executory contract with the debtor to render future benefits to the debtor until the debtor cures its prepetition defaults to that creditor.[57]

In creating the executory contracts section of the Code, why did the drafters decide to condition the debtor's ability to assume existing

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57. However, the creditor who has an executory contract will not necessarily be in a better position than a similarly situated creditor who lacks such a contract. The creditor with an executory contract may be worse off, for example, when the contract contains a set price for future deliveries and that price has become favorable to the debtor by the time of the bankruptcy filing. When a market shift occurs, the creditor without an executory contract is not bound to sell at the earlier lower price. Absent such a price fluctuation, however, an offensive use of the stay may put a supplier who owes specific obligations to the debtor in a better position than a similarly situated third party who owes no such obligations. The pricing question in these situations raises several issues. First, a creditor without an executory contract could potentially avoid the effects of an offensive stay by raising its postpetition price to the debtor to reflect the unpaid prepetition debts. This probably would not work because such a back door attempt to recover the prepetition debt would likely be apparent to the court. In the *Sportfame* case, for example, the court forced a supplier to continue doing bnsiness with the debtor, emphasizing that "[a]s far as possible, the parties shall operate on a normal business relationship consistent with their previous course of dealing over the past ten years." 40 B.R. at 53. *See also* Charles J. Tabb, *Emergency Preferential Orders in Bankruptcy Reorganizations*, 65 AM. BANKR. L.J. 75, 98 (1991) (noting that "bankruptcy judges are not fools, and can see through transparent schemes to do by indirection what is not permitted directly").

A second pricing issue that arises is why a supplier that has such monopoly-like leverage with the debtor does not charge a higher price to tbe debtor prior to bankruptcy than it charges to customers with whom it lacks such leverage. The answer may be that customers of the supplier prefer uniform pricing, so that any benefits to the supplier of segmenting its market are outweighed by costs in general customer confidence. For example, other customers of the supplier may become worried if they sense that the supplier will quickly take advantage of any firm-specific leverage that it can develop. These other customers would probably not, however, be concerned if the supplier is simply insisting that the debtor pay for old shipments before the supplier delivers new ones.

A final issue arises in these supplier cases when the supplier, who is owed money for prepetition deliveries, simply refuses to deal with the debtor whether or not the debtor agrees to make payments for the unpaid goods. Rarely will a prepetition creditor's refusal to deal not constitute an attempt, either explicit or implicit, to get paid for prepetition deliveries. If the debtor is willing to pay cash for postpetition deliveries, that cash is as good as any other customer's cash. Thus, the supplier would seem to have no reason to refuse to sell to the debtor other than to exercise leverage with respect to unpaid prepetition shipments.

It is conceivable, however, that a supplier who refuses to sell to the debtor is motivated by something other than a desire for payment of prepetition debts. First, the supplier may wish to refuse delivery to the debtor, even on a cash basis, because the supplier simply dislikes customers that file bankruptcy. Second, if the supplier's supply of goods or services is limited, it may wish to allocate them to customers who the supplier believes are likely to be aroumd for future dealings. In either of these situations, the court should not force the recalcitrant supplier to continue dealing with the debtor. Since the supplier is not attempting to collect a prepetition debt, the automatic stay is not implicated at all, and thus there can be no offensive use of the stay. Additionally, courts have not interpreted § 525's antidiscrimination provisions to apply to private parties, and thus that section does not provide a basis for forcing the supplier to continue dealing with the debtor, even on a cash basis. *See infra* note 152. *But see* Blackwelder Furniture Co. v. Drexel Heritage Furnishings (*In Re* Blackwelder Furniture), 7 B.R. 328, 338-39 (Bankr. W.D.N.C. 1980) (noting that a substantial question existed as to whether a private supplier's refusal to deal was unlawful discrimination contrary to "the letter or the policy" of the Code).

contracts on the cure of prepetition defaults? It could be argued that as long as a debtor gives adequate assurance of postpetition performance, the debtor ought to be able to insist on reciprocal postpetition performance from the nondebtor party. Any obligation that a debtor owed under the prepetition contract would simply be treated as an unsecured claim against the debtor's estate. An advantage of this approach is that the debtor's assumption of an executory contract would not create an apparent preference to the other contracting party for the debtor's unsecured prepetition obligations.[58]

In rejecting such a "non-cure" system of contract assumption, the Code drafters may have wished to avoid the effect such a regime would have on the willingness of nondebtor parties to make contracts with financially struggling entities. If a debtor could file bankruptcy, assume an existing contract, and cure any existing defaults with the proverbial ten cents on the dollar, parties would be less likely to enter into contractual relationships with potential bankruptcy candidates.[59]

Alternatively, rather than refusing to deal with debtors on the brink, nondebtor parties might charge financially unstable companies a significant premium that reflects the risk inherent in performing the bargain in full while the debtor offers something much less in return.[60] Even under the Code's current system, debtors in bankruptcy can choose to breach prepetition executory contracts and pay damages in bankruptcy dollar rates, a risk that by itself creates a disincentive for nondebtor parties to contract with potential bankrupts.[61] Had the Code drafters created the additional rule that a debtor choosing to assume the benefits of a contract could simultaneously ignore some of its burdens, the disincentive effects may have crippled troubled companies.

Yet the Code's current rule on contract assumptions leaves an uneasy sense that the nondebtor party to the contract is receiving a preference. Preferences are anathema in bankruptcy. Even a novice student of the Code knows that one of bankruptcy's chief goals is equality of treatment among creditors.[62] But that simple policy statement ignores

58. *See* Epling, *supra* note 56, at 193-94 (noting the apparent anomaly of allowing a prepetition creditor whose contract is assumed by the debtor-in-possession to receive preferred treatment while a similarly situated prepetition creditor whose contract is rejected becomes a general unsecured creditor).

59. *See* Raymond T. Nimmer, *Executory Contracts in Bankruptcy: Protecting the Fundamental Terms of the Bargain*, 54 U. COLO. L. REV. 507, 512-13 (1983).

60. *See id.* at 513.

61. The power of a debtor-in-possession to "reject" an executory contract has heen analogized to the ability of any party, whether in bankruptcy or not, to breach a contract and pay damages for the hreach. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 108 (1986).

62. *See, e.g.*, Research-Planning, Inc. v. Segal (*In re* First Capital Mortgage Loan Corp.), 917 F.2d 424, 428 (10th Cir. 1990) (noting "the prime bankruptcy policy of *equality of distribution*

an important point: upon the debtor's bankruptcy not all creditors are on an equal footing. At the point of the debtor's bankruptcy, the creditor who possesses an ability to confer some special future benefit on the debtor is not in the same position as the creditor who has nothing to offer the debtor.

The Code's drafters recognized this difference in positions among creditors in the Code's provisions on assumption of executory contracts.[63] Perhaps, too, the drafters sensed that a fundamental unfairness would result if a Chapter 11 debtor were able to insist on further benefits from another party while at the same time failing to honor its own obligations to that party.[64] A similar inequity results, however, in cases that have enabled the debtor to use the stay offensively. Offensive use of the stay compels performance from the other party while not guaranteeing return performance on obligations owed to that party when the bankruptcy petition was filed.

2. Refusals to Deal and the Necessity Doctrine

The classic refusal-to-deal scenario occurs quite frequently in Chapter 11 reorganization cases. There are typically three classes of nondebtor parties whose threats not to deal with the debtor carry some weight. The first class consists of suppliers similar to Creditor in the above hypothetical.[65] A supplier is likely to be in such a situation for two reasons: it is often owed money by the debtor for prepetition deliveries on credit, and its products or services may offer the debtor firm-specific advantages that the debtor could not easily obtain through other sources.

The debtor's own employees comprise the second class of nondebtor parties who may be in a position to condition future benefits to the debtor on cure of prepetition defaults.[66] Like suppliers, employ-

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among creditors of the debtor" (citation omitted & emphasis in original)).

63. *See supra* notes 49-53 and accompanying text.

64. *See* Nimmer, *supra* note 59, at 512 (noting that a system in which debtors could assume executory contracts without curing prepetition defaults would raise "questions of inequity").

65. *See supra* text accompanying notes 49-53; see, e.g., B&W Enters. v. Goodman Oil Co. (*In re* B&W Enters., Inc.), 713 F.2d 534 (9th Cir. 1983) (rejecting a supplier's attempt to condition continued business on a Chapter 11 debtor's payment of prepetition claims by holding that the court has no power to authorize such payments). *See generally* Eisenberg & Gecker, *supra* note 56, at 15-16 (discussing cases in which a debtor made prepetition payments to postpetition suppliers).

66. *See, e.g.*, Michigan Bureau of Workers' Disability Compensation v. Chateaugay Corp. (*In re* Chateaugay Corp.), 80 B.R. 279 (S.D.N.Y. 1987) (allowing the preconfirmation payment of certain prepetition employee claims); *In re* Gulf Air, Inc., 112 B.R. 152 (Bankr. W.D. La. 1989) (authorizing the payment of prepetition wages and benefits to employees). *But see In re* FCX, Inc., 60 B.R. 405 (E.D.N.C. 1986) (denying a Chapter 11 debtor's request to pay its employees for prepetition wages owed); *In re* Structurlite Plastics Corp., 86 B.R. 922 (Bankr. S.D. Ohio 1988) (holding the payment of certain prepetition employee medical claims to be an illegal subordination of re-

ees of a firm in Chapter 11 will often have the two ingredients that give rise to an effective refusal to deal: leverage against the debtor in the form of firm-specific skills not readily available on the open market, and prepetition wages that were unpaid at the point of filing. Although an employee already receives a Code-created priority for unpaid prepetition wages, the size of the priority will sometimes be smaller than the amount of unpaid salary owed to the worker.[67] Furthermore, the Code's grant of the employee priority does not assure immediate payment.[68]

Consumer customers are the final group of nondebtor parties sometimes involved in a refusal to deal.[69] Imagine, for example, a major commercial airline filing for relief under Chapter 11. It is almost certain that many customers of the airline will have purchased tickets for future flights prior to the bankruptcy filing.[70] Technically, customers holding tickets at the point of filing are prepetition unsecured creditors.[71] Although the customer group may not speak with a single voice, most customers probably would choose not to fly again with the debtor airline until the airline honors existing tickets.[72]

Of the nondebtor parties in these three classes, only suppliers have

maining unsecured creditors); Eisenberg & Gecker, *supra* note 56, at 12-15 (discussing various cases in which debtors made prepetition payments to employees).

67. Section 507(a)(3) of the Code gives a third priority to prepetition employee wages earned within 90 days prior to the debtor's bankruptcy filing, but only to the extent of $2000 for each individual employee. 11 U.S.C. § 507(a)(3) (1988).

68. *See Structurlite*, 91 B.R. at 816 (stating tbat "§ 507 of the Code provides no independent source of authority for a bankruptcy court to order payment of a pre-petition, unsecured claim: it merely establishes a system of priority for unsecured claims").

69. *See* Eisenberg & Gecker, *supra* note 56, at 15-16 (discussing cases allowing payments te customers).

70. That was the case, for example, when Eastern Airlines filed for bankruptcy. *See id.* at 15.

71. The Code's expansive definition of "claim" would encompass the right of a customer who had purchased a ticket prepetition to fly on a flight scheduled postpetition. *See* 11 U.S.C. § 101(4)(B) (1988) (defining "claim" to include a "right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured").

72. Recognizing this reality, the court in Eastern Airlines allowed the Cbapter 11 debtor to permit consumers holding tickets purcbased prepetition to use those tickets for postpetition fligbts on tbe airline. *See* Eisenberg & Gecker, *supra* note 56, at 15. Arguably, a rational customer should write off the past and choose to fly in tbe future with the airline offering the cheapest flight, even if it happens to be the airline that is now the customer's debtor. Thus, if customers acted rationally, it would not make sense for the airline to honor tickets purchased by customers prepetition. This argument ignores at least two realities. First, many customers may not be able to simply ignore past dealings with the airline. A revenge motive may cause these customers to fly with another airline even when the airline that stiffed them in tbe past offers the lowest rate. Second, customers who have been disappointed in the past by a particular airline may have legitimate fears about whether the airline will treat them similarly in the future. Thus, choosing to honor these customers' prepetition tickets may inject a feeling of customer confidence that would otherwise be lacking.

been direct victims of a debtor's offensive use of the stay. This is hardly surprising. It is one thing for a bankruptcy court to compel a supplier to continue doing business with a debtor. It is quite another to force employees to work or to mandate that consumers fly a particular airline. Nevertheless, even with employees and consumers, questions have arisen as to whether the debtor's selective payment of prepetition claims amounts to a violation of the automatic stay by the debtor itself.[73] The automatic stay aside, some courts have concluded that bankruptcy courts simply lack the power to allow a debtor to make selective payments of prepetition claims.[74]

Fortunately, a number of courts have wisely allowed the debtor's judicious use of selective payments to certain unsecured creditors under a theory known as the "doctrine of necessity."[75] The doctrine of necessity evolved from a related doctrine, the necessity of payment rule, which originated in railroad reorganization cases.[76] The necessity of payment rule, which is still recognized today, allows a reorganizing railroad to pay any unsecured prepetition creditors that it determines it must pay to ensure postpetition survival.[77]

Courts that permit offensive uses of the stay are, by implication, refusing to recognize the doctrine of necessity. Nor are all commenta-

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73. *See, e.g.*, Crowe & Assocs., Inc. v. Bricklayers and Masons Union Local No. 2, 20 B.R. 225, 227 (E.D. Mich. 1982), *aff'd*, 713 F.2d 211 (6th Cir. 1983) (an employer believed that acceding to its employees' demand to pay prepetition debts to the employees would violate the stay).

74. *See, e.g.*, Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299, 302 (4th Cir. 1987), *cert. denied*, 485 U.S. 962 (1988) (holding that the bankruptcy court lacked the discretion to permit A.H. Robins to establish a fund to make interim payments to prepetition Dalkon Shield victims); Crowe & Assocs., Inc. v. Bricklayers and Masons Union Local No. 2 (*In re* Crowe & Assocs., Inc.), 713 F.2d 211, 216 (6th Cir. 1983) (noting that even if the debtor wished to pay prepetition employee claims, "the bankruptcy court may not permit it to do so"). *See generally* Tabb, *supra* note 57, at 92-98 (reviewing cases that reject the authority of the court to permit such prepetition payments).

Section 549 is sometimes cited as authority for the invalidity of such payments. *See, e.g.*, B&W Enters., Inc. v. Goodman Oil Co. (*In re* B&W Enters., Inc.), 713 F.2d 534, 535 (9th Cir. 1983). In effect, § 549 provides that the trustee may avoid postpetition transfers of property of the estate unless those transfers are authorized either by the Code or by the court. 11 U.S.C. § 549 (1988). The use of § 549 to invalidate such payments, however, avoids the harder question of whether the court possesses equitable powers under § 105 to allow such payments to advance the reorganization.

75. *See generally* Eisenberg & Gecker, *supra* note 56. Courts have used several Code provisions and theories to justify the doctrine of necessity, although the Code does not explicitly authorize use of the doctrine. Some of the mechanisms proposed by courts and commentators to justify the doctrine of necessity are the following: § 105(a) of the Code allowing the bankruptcy court to issue "any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title," 11 U.S.C. § 105(a) (1988); an analogy to § 365(b)'s rules on assumption of executory contracts; and the notion that those prepetition creditors getting paid have a "lien-like" claim which entitles them to payment. Eisenberg & Gecker, *supra* note 56, at 5-10.

76. Eisenberg & Gecker, *supra* note 56, at 2-5.

77. *Id.* at 3.

tors enamored with the necessity concept. Professor Charles Tabb, the leading expert on the subject of what he terms "emergency preferential orders," contends that courts, if they recognize the necessity doctrine at all, should narrowly construe it to cover only those cases in which the public interest is truly at stake.[78]

Professor Tabb does not suggest that the stay should force nondebtor parties to deal with the debtor. Rather, he argues that the debtor-in-possession should not be allowed to pay certain prepetition unsecured creditors in full in order to gain some benefit in the future.[79] The problem, according to Professor Tabb, is that very early in the case, prepetition creditors with leverage over the debtor will attempt to exert pressure by withholding future dealings unless the debtor makes immediate payment on outstanding prepetition claims.[80]

The debtor's existing management will decide whether to succumb to the leverage of those creditors, since the Chapter 11 rules allow the current managers to remain in place unless a trustee is appointed because of fraud or mismanagement.[81] Professor Tabb contends that the managers of a Chapter 11 firm have a perverse incentive to accede to the demands of unsecured creditors with leverage.[82] The reason, he says, is that the managers, who are often stockholders, will lose all hope of future gain if the company liquidates.[83] Only a successful reorganization will allow those managers to retain their jobs and realize any value from their stock.[84]

Professor Tabb notes that if the Chapter 11 company is insolvent, the true owners of the company are the unsecured creditors. Since the unsecured creditors are the claimants at the margin, they are the "owners in equity" of the firm. Thus, they should be the ones deciding whether the burden to the firm of paying these particular unsecured creditors in full is worth the benefit of conducting continued business with them. According to Professor Tabb, the problem is that these selective payments to prepetition creditors often take place so soon after the case begins that the unsecured creditors do not have a meaningful

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78. Tabb, *supra* note 57, at 100. In addition to his *Emergency Preferential Orders* article, Professor Tabb has written articles discussing both the substantive and procedural issues surrounding cross-collateralization, which is one category of emergency preferential orders. *See* Charles J. Tabb, *Lender Preference Clauses and the Destruction of Appealability and Finality: Resolving a Chapter 11 Dilemma*, 50 OHIO ST. L.J. 109 (1989); Charles J. Tabb, *A Critical Reappraisal of Cross-Collateralization in Bankruptcy*, 60 S. CAL. L. REV. 109 (1986).

79. *See* Tabb, *supra* note 57, at 75.

80. *Id.* at 76.

81. 11 U.S.C. § 1104(a) (1988).

82. Tabb, *supra* note 57, at 79.

83. *Id.*

84. *Id.*

opportunity to participate in the decision.[85]

Professor Tabb's argument has some merit, but in one sense it goes too far. The debtor-in-possession will have to make countless decisions about the postpetition operation of the business.[86] In all of these decisions, the management's discretion will arguably be tainted by incentives that are skewed toward preserving the business at all costs. Nevertheless, the Code's drafters believed that the detrimental effects of the current managers' perverse incentives are, in the aggregate, outweighed by some countervailing benefit.[87] That benefit includes the avoidance of inevitable transition costs that would result from a sudden change in management, as well as the retention of firm-specific skills and knowledge that the existing management embodies.[88]

As Professor Tabb acknowledges, unsecured creditors have some protection against the possibility of self-interested decisionmaking by the managers.[89] First, the debtor-in-possession has a fiduciary duty to protect the interests of the unsecured creditors.[90] Second, to the extent that existing managers make decisions that are ultimately deemed harmful to the firm, those managers risk ouster through the appointment of a Chapter 11 trustee.[91] Finally, unsecured creditors are given a formal voice in significant decisions of the debtor-in-possession through the creditors' committee,[92] as well as through the general right of a

85. *Id.* at 76-78.

86. Unless the court orders otherwise, the debtor-in-possession continues to operate the business following the filing of a petition in bankruptcy. 11 U.S.C. §§ 1107, 1108 (1988).

87. The legislative history of the Code specifically mentions that one key reason for leaving the debtor-in-possession in control is that continuation of experienced management will benefit both debtors and creditors by leading to a greater likelihood of successful reorganization. HOUSE COMM. ON THE JUDICIARY, BANKRUPTCY LAW REVISION, H.R. REP. No. 595, 95th Cong., 1st Sess. 233 (1977).

88. The legislative history notes that another advantage of leaving the current management in place is avoidance of the expense of a trustee. *Id.*

89. Tabb, *supra* note 57, at 77-78.

90. *See, e.g.*, Fulton Stato Bank v. Schipper (*In re* Schipper), 933 F.2d 513, 515 (7th Cir. 1991) (holding that a debtor-in-possession owes fiduciary duty to unsecured creditors).

91. Section 1104 of the Code provides that a Chapter 11 trustee shall be appointed by the court, on request of a party in interest, "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case," or "if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate. . . ." 11 U.S.C. § 1104(a)(1)-(2) (1988). It is unlikely that a trustee would be appointed quickly enough to avoid the effects of a self-interested decision by management in the emergency order context. Nevertheless, the threat of a trustee appointment may help serve as a check on the existing management's perverse incentives with respect to these early decisions.

92. Section 1102 of the Code provides that the United States trustee shall appoint a committee of unsecured creditors, which shall ordinarily consist of the persons that hold the seven largest unsecured claims against the debtor. *Id.* § 1102(a)(1), (b)(1). The United States trustee may appoint additional creditors' committees if the trustee deems it appropriate or, on request of a party in interest, if such additional committees are necessary to assure adequate representation of credi-

party in interest to be heard on any issue in a Chapter 11 case.[93]

Professor Tabb's complaint that emergency orders allow the selective payment of prepetition creditors certainly is valid with respect to the third form of protection that unsecured creditors have against the danger of existing management's perverse incentives. If unsecured creditors do not receive adequate notice, they will hardly have a meaningful opportunity to be heard. The objection to lack of notice, however, is more appropriately met by requiring the most effective notice possible under the circumstances rather than by instituting a blanket ban on such payments.[94]

Furthermore, emergency preferential orders will, at a minimum, have the sanction of the bankruptcy judge, who presumably has some sense about whether the cost of payments to certain prepetition unsecured creditors yields a corresponding benefit for the entire group of creditors.[95] In refusal-to-deal cases, the decision faced by the debtor-in-possession is similar to other choices that will routinely confront Chapter 11 managers. In deciding whether to assume or reject an executory contract, for example, the debtor-in-possession is forced to consider cost-benefit factors that are analogous to those involved in a refusal-to-deal case.[96]

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tors or of equity security holders. *Id.* § 1102(a)(1)-(2). Section 1103 enumerates the powers and duties of these committees, which include the employment of professionals, consultation with the debtor-in-possession concerning the administration of the case, investigation of the operation of the debtor-in-possession's business, participation in the formulation of a plan, and the requesting of appointment of a Chapter 11 trustee. *Id.* § 1103(a)-(c).

93. *Id.* § 1109(b).

94. This is not to suggest that Professor Tabb opposes requiring the most effective notice possible to unsecured creditors in these situations. Professor Tabb's stated first choice would be a blanket ban on emergency preferential orders. If such orders are to be made, however, he advocates that the procedural rights of unsecured creditors be strictly protected. Tabb, *supra* note 57, at 75.

95. Professor Tabb acknowledges the role of the bankruptcy court itself, as a court of equity, in protecting the interests of creditors. *Id.* at 77. He argues, however, that the attempt in the 1978 Reform Act to restrict bankruptcy judges to a judicial, rather than administrative, role "is not and realistically cannot be honored in practice." *Id.* at 78.

96. *See* Andrew, *supra* noto 52, at 890 (emphasizing that the estate's ability to assume the benefit of executory contract comes only at the cost of the estate's reciprocal performance). Timing is one distinction between the decision management faces with respect to emergency orders and the decision it faces with respect to executory contracts. Whereas management must often decide whether to accept a lender's or supplier's terms within a matter of days or hours in the emergency order context, § 365(d)(2) gives the debtor-in-possession until the time of confirmation to decide whether to accept or reject an executory contract. 11 U.S.C. § 365(d)(2). Thus, creditors of the debtor would almost always have an opportunity to object to what they consider an ill-advised assumption of an executory contract by the debtor-in-possession. Nevertheless, courts give great deference to the debtor-in-possession's discretion on the assumption or rejection decision, notwithstanding the perverse incentives faced by existing management. *See* Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303, 1309-10 (5th Cir. 1985) (holding that the test for court approval of a debtor-in-possession's decision regarding the assumption or rejection of an executory contract is

First, management must determine how much it will cost to cure prepetition defaults on the contract. This is akin, in a refusal-to-deal situation, to the burden of paying the nondebtor party for prepetition goods or services for which the debtor never paid.[97] Second, the Chapter 11 debtor with an executory contract will consider the benefits of assuming the contract. Perhaps there is a set future price in the contract that, relative to the current market, is now favorable to the debtor.[98] Moreover, the nondebtor party to the contract may offer something that the debtor could not easily find elsewhere. The debtor in a refusal-to-deal case must similarly assess the relative advantage of pursuing future dealings with the recalcitrant prepetition creditor.

Another situation in which Chapter 11 debtors regularly must make difficult cost-benefit analyses occurs when a lender insists on cross-collateralization. The stage is set for cross-collateralization when an unpaid prepetition lender grants postpetition credit to the debtor. The lender insists that the debtor's postpetition collateral attach not only to the new loan, but also to the lender's prepetition unsecured claims.[99] Some courts purport to ban cross-collateralization under any circumstance,[100] but most courts will allow it provided that the parties adhere to strict notice requirements.[101]

When a lender offers to lend on the basis of cross-collateralization, the Chapter 11 debtor faces a choice similar to that confronting it in refusal-to-deal and executory contract situations. The debtor-in-possession must determine whether the postpetition credit terms offered by this prepetition lender are the most cost-effective terms available. This determination will be a function of the availability of other postpetition credit, the nature of other lenders' terms, and the amount of prepetition indebtedness that the original lender is insisting be cross-collateralized.[102]

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merely the business judgment test).

97. *Cf.* Andrew, *supra* note 52, at 891 (suggesting that in some cases it might make sense for the debtor to pay certain prepetition claimants on the theory that the estate would thereby capture some greater benefit from that claimant).

98. *See* Westbrook, *supra* note 53, at 247-49 (proposing an example of this type of contract).

99. *See* Tabb, *supra* note 57, at 81.

100. *See, e.g., In re* Monach Circuit Indus., Inc., 41 B.R. 859, 861-62 (Bankr. E.D. Pa. 1984).

101. *See, e.g.,* Burchinal v. Central Washington Bank (*In re* Adams Apple, Inc.), 829 F.2d 1484, 1490 (9th Cir. 1987) (dicta); *In re* Ames Dep't Stores, Inc., 115 B.R. 34, 39 (Bankr. S.D.N.Y. 1990).

102. On the surface, it might seem that the debtor-in-possession has no incentive to avoid giving whatever collateral the postpetition lender demands since the encumbrance of collateral would appear to hurt only the debtor's other creditors and not the debtor's shareholders or management. This view, however, ignores the fact that both management and shareholders have a valid desire to keep the company's collateral unencumbered to the extent possible because the com-

The cross-collateralization situation is distinct from the refusal-to-deal case in that even courts that ban cross-collateralization will not force the lender to extend credit on other terms. Bankruptcy seems to have a sacrosanct tenet that courts should never force creditors to extend new credit to a bankrupt. Courts will not enforce specific prepetition contractual promises to lend, even if the debtor-in-possession has cured all prepetition obligations owed to that lender.[103]

Some courts are less reluctant to force nondebtor parties to continue supplying goods or services to the debtor at normal cost.[104] Such nondebtor parties arguably suffer less harm than a lender forced to extend new credit.[105] Yet being stripped of legitimate leverage is a form of injury, as the Code's provision on executory contracts implicitly recognizes. Indeed, as noted earlier, these decisions create the odd result that the creditor with a contractual duty to deal further with the debtor may end up in a better position than the creditor who lacks such a duty.

3. Individual Debtors

On the surface at least, the typical refusal-to-deal case involving an individual debtor seems analytically similar to the cases involving Chapter 11 corporations. Imagine, for example, that Jane Debtor receives medical services from a private health clinic. She receives the services on credit, files a Chapter 7 bankruptcy, and has the clinic's debt discharged along with those debts owed to several other prepetition creditors.[106]

A few months later, Jane goes back to the clinic and seeks medical treatment. The clinic advises Jane that it will not treat her until she satisfies the clinic's discharged debt. Jane protests and offers cash in advance for the treatment she seeks, but the clinic credit manager will not relent. Jane goes to court and, alleging violation of the stay, gets an injunction forcing the clinic to do business with her on a cash basis.

One distinction between this case and those involving Chapter 11

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pany's ability to obtain additional credit may depend on the existence of property to pledge as collateral.

103. Section 365 of the Code provides that the debtor-in-possession may not assume or assign any executory contract of the debtor if the contract is one "to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor." 11 U.S.C. § 365(c)(2) (1988).

104. *See, e.g.*, Sportfame of Ohio, Inc. v. Wilson Sporting Goods Co. (*In re* Sportfame of Ohio, Inc.), 40 B.R. 47 (Bankr. N.D. Ohio 1984); Ike Kempner & Bros., Inc. v. U.S. Shoe Corp. (*In re* Ike Kempner & Bros.), 4 B.R. 31 (Bankr. E.D. Ark. 1980).

105. *See, e.g.*, *Sportfame*, 40 B.R. at 53 (finding that the nondebtor party "has made no showing and made no arguments that it would suffer any harm by being required to accept cash for selling goods to plaintiff and turning a profit").

106. The facts in this example are based loosely on those involved in the case of Olson v. McFarland Clinic, P.C. (*In re* Olson), 38 B.R. 515 (Bankr. N.D. Iowa 1984).

corporations is that here the stay that is allegedly violated is the postdischarge stay rather than the automatic stay.[107] Analytically, a more significant difference is that the executory contract assumption model, which is useful in the corporate setting, does not really fit the individual case.

Suppose that Jane had an executory contract with the medical clinic requiring it to provide her with medical services for some period of time, with payment due shortly after each visit. If Jane had the power to assume that executory contract, she would first have to cure her prepetition defaults by paying the clinic in full for the prior services.[108] If allowed to use the stay offensively, Jane would thereby have a greater right to force continued service from a clinic that did not owe her a contractual obligation than from a clinic that did. Thus, if Jane had the power to assume executory contracts, her offensive use of the stay against the clinic would be inconsistent with the burden/benefit linkage set down in the Code's executory contracts section.

Unlike a corporate debtor-in-possession in a Chapter 11 case, however, Jane as an individual does not have the ability to assume her own executory contracts in a Chapter 7 bankruptcy.[109] The rule prohibiting individuals from assuming executory contracts stems from the fundamental difference between individual and corporate bankruptcies. When a corporation files for bankruptcy, the bankruptcy estate *is* the corporation. There is no entity other than the estate itself. When an individual files for bankruptcy, on the other hand, the bankruptcy estate is separate and distinct from the living, breathing human being that filed the petition.[110]

In a Chapter 7 case a trustee is appointed to administer the estate.[111] The trustee's chief task is to convert the assets of the estate to cash and then distribute the cash to the debtor's creditors.[112] Pursuant to this aim, the Chapter 7 trustee in an individual case may choose to

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107. As noted earlier, the automatic stay ends when the court grants a discharge, and is replaced by tbe postdischarge stay. *See supra* text accompanying notes 18-22.

108. 11 U.S.C. § 365(b)(1)(A) (1988) (providing that a trustee must cure defaults in order to assume an executory contract).

109. *See infra* text accompanying notes 110-13.

110. *See* JACKSON, *supra* note 61, at 90 (noting this distinction between individuals and corporations in the context of what constitutes property of the estate); *cf.* 11 U.S.C. § 541(a)(6) (1988) (providing that property of the estate includes proceeds or profits "from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case").

111. 11 U.S.C. § 704 (1988); *see also* § 705(b) (allowing the creditor's committee to consult witb the trustee in the administration of the estate).

112. Section 704 of the Code provides that the Chapter 7 trustee shall "collect and reduce to money the property of the estate for which such trustee serves, and close such estate as expeditiously as is compatible with the best interests of parties in interest." *Id.* § 704(1).

assume executory contracts to which the bankrupt was a party at the point of filing.[113]

Thus, in Jane's case, the fact that she would receive a net benefit from the trustee's assumption of her medical services contract would not influence the trustee's decision about whether to assume the contract. A Chapter 7 trustee will assume an executory contract only when the contract offers some benefit that the debtor's creditor group can enjoy. The trustee can realize that benefit for the estate by assuming the contract and then assigning it to a third party for cash, thus allowing easy distribution to Jane's claimants.[114] Given the limited role of contract assumption in individual Chapter 7 cases, Jane's trustee would have no interest in assuming a medical services contract when the assumption would benefit only Jane.

If the executory contract model is not useful in consumer cases, are offensive uses of the stay by individual debtors like Jane therefore analytically unobjectionable? To answer that question in the negative, one need look no further than the Code's reaffirmation section. That section, which applies to situations in which the debtor agrees to make an otherwise dischargeable debt contractually enforceable, is the conceptual home for the burden/benefit linkage in consumer cases.[115]

The role of reaffirmation in consumer bankruptcies has been a controversial issue. The pendulum has swung variously from enforcing reaffirmations with no consideration and no requirement of court approval, to allowing reaffirmations only with the bankruptcy court's approval, to the current middle position embraced by the Code allowing a reaffirmation as long as either the bankruptcy judge or the debtor's attorney deems it in the debtor's best interest.[116]

At first glance, it seems doubtful that a reaffirmation would ever make sense for an individual debtor. But the desirability of reaffirmation by an individual debtor can be understood by recalling the burden/benefit choice that faces a Chapter 11 corporation seeking to assume an executory contract. Like their corporate analogues, individual debtors will reaffirm debts whenever the benefits that the debtor will gain from reaffirmation exceed the costs of reaffirmation. The quintessential reaf-

113. *See id.* § 365(a) (permitting the trustee to assume or reject any executory contract or unexpired lease of the debtor); *id.* § 103(a) (providing that the rules of Chapters 1, 3, and 5 of the Code apply to cases under Chapters 7, 11, 12, or 13).

114. Section 365(f) of the Code gives the trustee the general power to assign assumed contracts as long as the contract assignee provides adequate assurance of future performance. *Id.* § 365(f).

115. *See id.* § 524(c) (containing requirements for the enforceability of reaffirmation agreements).

116. *See* Margaret Howard, *A Theory of Discharge in Consumer Bankruptcy*, 48 OHIO ST. L.J. 1047, 1073-75 (1987).

firmation case involves a debtor who owes a debt secured by collateral that the debtor would like to keep.[117]

Courts and legislators have long been suspicious of reaffirmations, mainly because so many ill-advised debtors have succumbed to pressure to sign agreements offering no discernible benefit to the debtor.[118] Nevertheless, Congress recognized that occasionally the consumer debtor might sensibly choose to revive an obligation that the debtor could have had discharged.[119]

Let us return to the case of Jane Debtor and the medical clinic. Whether or not Jane has an executory contract with the clinic ultimately will not matter. In either case, Jane could seek a reaffirmation of her debt to the clinic as a means of ensuring postdischarge service from the clinic. The real question raised in the offensive stay arena, however, is whether Jane should have to resort to reaffirmation in order to secure whatever unique benefits the clinic can offer her following discharge.

As noted above, the Code allows reaffirmations because of an underlying recognition that it occasionally makes sense for a debtor to purchase products or services from a creditor at the cost of selectively waiving its discharge. Given this reality, it would seem anomalous to deny the medical clinic the ability to use whatever leverage it had through its unique appeal to Jane, while at the same time condoning the ability of other creditors to use their leverage to effect reaffirmations of prepetition debts. An interpretation of the stay that would enable Jane to force the clinic to do business with her, however, would be a strong disincentive for such clinics to extend credit to the financially struggling Janes of the world. Moreover, those on the brink of bankruptcy are arguably the most in need of the discretionary credit that providers of consumer goods and services can offer.

The offensive use of the stay is especially pervasive in the reaffir-

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117. *See, e.g., In re* McGrann, 6 B.R. 612 (Bankr. E.D. Pa. 1980) (approving the reaffirmation of a debt secured by motor vehicles since the vehicles were necessary for transportation to work).

118. *See* Rendleman, *supra* note 28, at 729-30 (explaining that reaffirmations were a common form by which debtors waived discharge prior to the enactment of the Code); *cf. In re* Long, 3 B.R. 656 (Bankr. E.D. Va. 1980) (refusing to allow the debtor to reaffirm a $1300 dischargeable debt to her employer on the grounds that there would be no benefit to debtor in reaffirming).

119. Professor Rendleman suggests that the reaffirmation compromise in the Code reflects the theory that a bankrupt's moral obligation to repay a creditor remains even after discharge. It would have been a better choice, he says, for Congress to ban reaffirmations completely. Rendleman, *supra* note 28, at 752-53. That view, however, ignores the many reasons unrelated to moral obligation that a debtor may have for wanting to reaffirm. Professor Howard, for example, lists five reasons why a debtor might wish to reaffirm a discharged debt, only the last of which is morally based: to avoid repossession of collateral; to protect a codebtor who is not in bankruptcy; to secure postpetition credit from the creditor to whom the reaffirmation is made; to avoid criminal prosecution or incarceration for a previous conviction, typically on a bad-check charge; and, finally, for reasons of moral satisfaction. *See* Howard, *supra* note 116, at 1072-73.

mation area. Some courts have denied creditors the ability to even propose reaffirmation arrangements for the debtor in which future benefits are offered.[120] For example, imagine that a credit-card issuer to whom Jane Debtor owed prepetition debts wrote Jane's attorney a letter, with a copy to Jane. The letter, in nonthreatening language, advised that if Jane wished to retain her credit card she would have to reaffirm those prepetition debts on the card that would otherwise be dischargeable. Some courts facing this type of situation have held that the creditor's proposal of such a reaffirmation offer is an act to collect a prepetition debt and therefore violates the stay.[121] This approach may be appropriate if the creditor proposing the reaffirmation agreement has nothing to offer the debtor in the future other than the moral satisfaction of paying off creditors. But it is less defensible when the creditor has a deal for the debtor that might be worth taking.

A rule that permits only debtor-initiated reaffirmations would bring potential disadvantages to consumer debtors and little discernible benefit.[122] Yet such a rule would result from an interpretation of the stay that forbids creditors from conditioning future benefits to debtors on assumption of past burdens. This interpretation of the stay would leave the task of discovering positive reaffirmation arrangements either to the debtor, who may be ignorant of the reaffirmation option, or to the debtor's attorney, who may do little more for the debtor than file the appropriate court papers. Thus, the debtor will never discover some advantageous deals because of the effective gag rule that an offensive view of the stay imposes on creditors who have future benefits to give.

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120. *See* Olson v. McFarland Clinic, P.C. (*In re* Olson), 38 B.R. 515 (Bankr. N.D. Iowa 1984) (prohibiting a medical clinic from offering future medical services on the condition that the debtor pay for prepetition services); Green v. National Cash Register Co. CI Corp. Sys. (*In re* Green), 15 B.R. 75 (Bankr. S.D. Ohio 1981) (refusing to allow a creditor to offer the debtor postpetition credit on the condition that the debtor reaffirm prepetition debts owed to the same creditor); *In re* Stephens, 2 B.R. 365 (Bankr. N.D. Ohio 1980) (same).

121. *See* Olson, 38 B.R. at 516-18; Green, 15 B.R. at 78; Stephens, 2 B.R. at 366. *But see* Brown v. Pennsylvania State Employees Credit Union, 851 F.2d 81, 84-86 (3d Cir. 1988) (finding no stay violation when a credit union sent a letter to a Chapter 7 debtor advising her that if she wished future services from the credit union, she must reaffirm the prepetition debt).

122. Professor Howard suggests that § 362(a)(6) should not prohibit creditors from acceding to debtor-initiated requests for reaffirmation, but should prevent creditors from approaching a debtor for possible reaffirmation. Howard, *supra* note 116, at 1073 n.174. This view has support in a Senate committee report on the 1984 Bankruptcy Code Amendments: "Creditors can no longer independently contact debtors to encourage them to reaffirm debts because such contact is prohibited by the Code. . . . Reaffirmations obtained presently that are subsequently denied by a bankruptcy court are, in fact, only voluntary reaffirmations." SENATE COMM. ON THE JUDICIARY, OMNIBUS BANKRUPTCY IMPROVEMENTS ACT OF 1983, S. REP. No. 65, 98th Cong., 1st Sess. 11 (1983). Through empirical work, Professors Teresa Sullivan, Elizabeth Warren, and Jay Westbrook found that in practice creditors regularly seek out debtors to initiate possible reaffirmations. TERESA A. SULLIVAN ET AL., AS WE FORGIVE OUR DEBTORS 281 n.12 (1989) (stating that "[m]ost creditors who get reaffirmations ask for them when the debtor shows up for the section 341 hearing").

The apparent attraction of restricting reaffirmation agreements to those initiated by the debtor is that the debtor would be less likely to fall prey to reaffirmations that are not in the debtor's best interest. That concern, however, rings hollow given the detailed substantive and procedural Code requirements that any reaffirmation agreement must currently meet. Under the existing reaffirmation rules, either the debtor's attorney or the judge is responsible for any enforceable reaffirmation agreement that is not truly in the debtor's best interest.[123]

A refusal to permit consumer debtors to use the automatic stay offensively would not necessarily lead to a rash of letters from creditors seeking reaffirmation agreements. If the creditor cannot demonstrate to the court that the proposed reaffirmation offer has a potential benefit to the debtor that might justify the debtor's cost of reaffirmation, then a finding of stay violation would be appropriate.

Few creditors, however, could meet this standard. Obviously the secured creditor would qualify as a party that can offer the debtor a worthwhile deal if the value of the collateral relative to the unpaid debt is high enough.[124] But so might a credit-card issuer whose consideration for the reaffirmation is a new credit card, a device whose value in today's market goes well beyond its mere credit limit.[125] Furthermore, the terms under which a recently discharged debtor could obtain a new card on the open market might make the old card issuer's reaffirmation deal worth taking.

4. Utility Cases

One additional analytical wrinkle must be dealt with in refusal-to-deal cases. As discussed previously, the executory contract and reaffir-

123. Section 524(c) contains detailed prerequisites to the enforceability of a reaffirmation agreement. First, the agreement must be made prior to the grant of discharge. 11 U.S.C. § 524(c)(1). Second, the agreement must contain a clear and conspicuous statement advising the debtor that she may rescind the agreement at any time prior to discharge or 60 days after the agreement is filed with the court, whichever is later. *Id.* § 524(c)(2). Third, the agreement must be filed with the court and, if the debtor is represented by an attorney, the attorney must file an affidavit stating that the reaffirmation "represents a fully informed and voluntary agreement by the debtor" and "does not impose an undue hardship on the debtor or a dependent of the debtor." *Id.* § 524(c)(3)(A)-(B). If the debtor is not represented by an attorney, then the court itself must determine that the reaffirmation does not impose an undue hardship and is in the best interest of the debtor. *Id.* § 524(c)(6).

124. It may occasionally make sense for a debtor to reaffirm a secured debt to an undersecured creditor. For example, an individual may attach idiosyncratic value to a car used for collateral that would not be reflected in the car's market value. Furthermore, a debtor who reaffirms a secured debt and keeps the car avoids the transaction cost and uncertainty of entering the market to purchase a different car following the bankruptcy.

125. For example, credit cards are often necessary for ordering goods or services over the phone, for renting automobiles, or for securing hotel reservations.

mation provisions of the Code implicitly sanction creditors' ability to exercise leverage that stems from the debtor's desire for future benefits.[126] In contrast, the Code denies utilities the ability to use the powerful leverage they possess to ensure payment of otherwise dischargeable prepetition debts.[127]

Under Section 366 of the Code, no utility is allowed to discontinue or refuse service on the basis of a debtor's prepetition defaults to the utility.[128] The utility is entitled to adequate assurance of the debtor's future performance, but the utility will become just another unsecured creditor with respect to any prepetition services for which the debtor never paid.[129] This rule is a departure from pre-Code case law, which regularly allowed utilities to withhold postpetition service from the debtor until the debtor satisfied prepetition debts to the utility that had been discharged as part of the debtor's bankruptcy.[130]

It is perhaps too easy to justify this exception to the Code's general philosophy of burden/benefit linkage. An obvious distinction is that utilities are monopolies, and as such give debtors little choice but to accede to their demands.[131] The problem with this distinction is that many nonutilities, or even nonformal monopolies, have monopoly-like leverage over a particular debtor.[132]

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126. *See supra* parts III.A.1-3.

127. *See In re* Monroe Well Serv., Inc., 83 B.R. 317 (Bankr. E.D. Pa. 1988) (holding that if the debtor assumed a three-year service agreement with the utility, it would have to cure prepetition defaults; if it rejected, the utility would have to continue service anyway on terms comparable to those given a new customer); Kiriluk v. Chester Water Auth. (*In re* Kiriluk), 76 B.R. 979, 982 (Bankr. E.D. Pa. 1987) (noting a striking difference between §§ 365(b) and 366, since the former requires the debtor's cure as a prerequisite for the assumption of future benefits, whereas the latter does not); *In re* Gehrke, 57 B.R. 97, 97-98 (Bankr. D. Or. 1985) (applying § 366 rather than § 365 when the electric co-op association had a practical monopoly on electrical service in the region and deeming § 366 an exception to § 365).

128. 11 U.S.C. § 366(a). At least one federal court of appeals has held that § 366 requires a utility to restore service terminated prepetition if the debtor so requests. Whittaker v. Philadelphia Electric Co. (*In re* Whittaker), 882 F.2d 791 (3rd Cir. 1989).

129. Section 366(b) gives the trustee or the debtor 20 days from the filing of the petition to furnish adequate assurance of future performance to the utility. 11 U.S.C. § 366(b) (1988).

130. *See, e.g.*, Ryan v. Ohio Edison Co., 611 F.2d 1170 (6th Cir. 1979) (holding that the pre-Code postdischarge stay only prevents creditors from pursuing discharged claims through formal court proceedings and does not prevent utilities from exercising their leverage in order to collect by threatening to shut off power or actually shutting it off); Slenderella Sys., Inc. v. Pacific Tel. & Tel. Co., 286 F.2d 488 (2d Cir. 1961). *But see* South Cent. Bell Tel. Co. v. Simon (*In re* Fountainebleau Hotel Corp.), 508 F.2d 1056 (5th Cir. 1975) (rejecting a utility's use of state law leverage to compel the payment of prepetition claims).

131. The legislative history of § 366 says that it is intended to apply to "utilities that have some special position with respect to the debtor, such as an electric company, gas supplier, or telephone company that is a monopoly in the area so that the debtor cannot easily obtain comparable service from another utility." HOUSE COMM. ON THE JUDICIARY, BANKRUPTCY LAW REVISION, H.R. REP. No. 595, 95th Cong., 1st Sess. 350 (1977).

132. For example, in Jane Debtor's case, perhaps the medical clinic in question is the only

If offensive uses of the stay are permissible in cases involving either monopolies or creditors with monopoly-like leverage over the debtor, then a rather illogical line must be drawn. Under this model, only a creditor whose leverage is not powerful is allowed to use it. Thus, creditors face an odd balancing act when debtors attempt to use the stay offensively. On the one hand, creditors hope that the unique future benefits they offer the debtor will be significant enough to give them meaningful leverage. On the other hand, the creditors have to contend in court that their leverage against the debtor was not so powerful as to offer the debtor no real choice but to accede to their insistence that the debtor assume prepetition burdens owed to that creditor.[133]

There is a second, more subtle, way to distinguish utilities from other nondebtor parties who offer the debtor desirable future benefits. As mentioned above, one cost of allowing offensive use of the stay is that nondebtors will be less likely to extend credit to financially struggling parties who are not yet in bankruptcy.[134] Thus, an offensive stay creates a disincentive effect that arguably would not occur with utilities because the regulatory environment in which utilities operate severely limits their discretion to choose customers.[135]

Thus, whereas a private party who senses that a customer is heading for imminent insolvency could either refuse credit altogether or grant credit only on stricter terms, a utility typically cannot engage in this type of differential customer treatment.[136] The utility can respond to its differential bankruptcy treatment, however, by simply giving less credit flexibility to all customers.[137] This would enable the utility to

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one within 100 miles of Jane's residence. *Cf.* Sportfame of Ohio, Inc. v. Wilson Sporting Goods Co. (*In re* Sportfame of Ohio, Inc.), 40 B.R. 47, 50 (Bankr. N.D. Ohio 1984) (noting that the supplier's products, "due to advertising and name brand identification, were hoth in demand and often irreplaceable in the minds of debtor's customers"). It is not uncommon in refusal-to-deal cases for the nondebtor party to exercise something approaching monopoly-like leverage over the debtor.

133. The illogical nature of this sort of line-drawing was apparently lost on the Third Circuit in *Brown v. Pennsylvania State Employees Credit Union.* In that case, the court noted that the credit union's conditional refusal to deal with the debtor did not violate the stay because "[t]he conveniences which the credit union supplies the debtor—direct deposit and automatic payment of life insurance premiums—do not rise to such a level that the threat of their withdrawal is necessarily coercive." Brown v. Pennsylvania State Employees Credit Union, 851 F.2d 81, 85 (3d Cir. 1988).

134. *See supra* text accompanying notes 59-61, 119-20.

135. *See generally* Roger D. Colton, *Heightening the Burden of Proof in Utility Shutoff Cases Involving Allegations of Fraud*, 33 HOWARD L.J. 137, 138-143 (1990) (describing the contours of a public utility's "common law duty to serve," which includes the "obligation to provide service to all who pay for it").

136. *Id.*

137. *See* Veryl V. Miles, *Adequate Assurance of Payment Under Section 366 of the Bankruptcy Code: A Term for Interpretive Flexibility or Judicial Confusion?*, 20 AKRON L. REV. 715, 738-39 (1987) (noting that the amount of a utility's state-approved security deposit will typically reflect "the maximum risk of loss that the utility would incur if they had to terminate service to a

limit the size of any unsecured claim in bankruptcy.

For analytical purposes, perhaps the most honest way to handle the Code's section on utilities is not to attempt justifiable distinctions of the provision that make it fit neatly within a Code that generally honors creditor leverage existing outside of bankruptcy. Rather, a better approach might simply limit the section to its terms and consider it for what it is—a fairly narrow and, in the end, fairly insignificant exception to the Code's usual adherence to a burden/benefit linkage.[138]

B. License Cases

1. The Classic Fact Scenarios

Government license cases have generated an increasing amount of controversy in the corporate area.[139] The typical situation involves a debtor business that has a liquor license.[140] Under state law, either renewal or transfer of the license is statutorily conditioned on the debtor's payment of state taxes. The debtor is delinquent on its state taxes and files for bankruptcy. Once in bankruptcy, either the debtor wishes to have its license renewed notwithstanding the delinquent state taxes,[141] or the estate's representative wishes to transfer the license to some third party without first paying the taxes.[142]

Offensive use of the stay comes into play in the license cases when the court characterizes as a stay violation the state licensor's refusal to renew the license or allow the transfer pending payment of prepetition taxes.[143] Once again, the debtor or the trustee is attempting to secure

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customer pursuant to the state rules").

138. Arguably, the existence of § 366 implies that offensive nses of the stay in other contexts must be impermissible. If Congress intended § 362(a) to prohibit conditional refusals to deal, then the specific rule in § 366 prohibiting such refusals by utilities would be unnecessary.

139. *See, e.g.*, Bavely v. United States Internal Revenue Serv. (*In re* Terwilliger's Catering Plus, Inc.), 911 F.2d 1168 (6th Cir. 1990) (permitting a Chapter 7 debtor to transfer a liquor license free of state law restrictions that condition transfer on the payment of state taxes), *cert. denied*, 111 S. Ct. 2815 (1991); California v. Farmers Markets, Inc. (*In re* Farmers Markets, Inc.), 792 F.2d 1400 (9th Cir. 1986) (allowing a state liquor board to condition the transfer of the debtor's liquor license on the debtor's payment of delinquent prepetition state taxes); *In re* Feature Homes, Inc., 116 B.R. 731 (Bankr. E.D. Cal. 1990) (allowing a state to refuse the revival of a corporate license to the debtor until payment of delinquent prepetition state taxes); Elsinore Shore Assocs. v. Casino Control Comm'n (*In re* Elsinore Shore Assocs.), 66 B.R. 723 (Bankr. D.N.J. 1986) (refusing to allow the state casino control commission to condition the renewal of the debtor's casino license on the payment of prepetition license fees and taxes).

140. *See, e.g.*, Aegean Fare, Inc. v. Licensing Bd. (*In re* Aegean Fare, Inc.), 35 B.R. 923 (Bankr. D. Mass 1983); Anderson v. Mississippi State Tax Comm'n (*In re* Anderson), 15 B.R. 399 (Bankr. S.D. Miss. 1981).

141. *See, e.g.*, *Aegean Fare*, 35 B.R. at 924-25; *Anderson*, 15 B.R. at 400.

142. *See, e.g.*, *In re* Hoffman, 65 B.R. 985 (D.R.I. 1986); Nu-Process Brake Engineers, Inc. v. Benton (*In re* Nu-Process Brake Engineers, Inc.), 119 B.R. 700 (Bankr. E.D. Mo. 1990).

143. *See, e.g.*, *In re* Nejberger, 120 B.R. 21, 23 (E.D. Pa. 1990) (holding that the refusal of a

further benefits from a nondebtor party without first assuming prepetition burdens owed to that same party. An approach consistent with the burden/benefit linkage running throughout the Code would allow the licensor to condition the renewal or transferability of the license on the debtor's payment of delinquent prepetition taxes.

For individual debtors, the most common fact patterns involve driver's licenses. In the typical situation, the state has some sort of financial responsibility act under which an individual's retention of a driver's license following an accident is conditioned on the driver either paying any tort judgment arising from the accident or posting proof of financial responsibility.[144] In the problematic situation, a driver files for bankruptcy, then attempts to regain the license despite having discharged the tort judgment that led to the license suspension. License cases involving individuals differ from corporate license cases in that the party from whom the debtor wants future benefits (the state) is not the party to whom the past burden is owed (the tort victim). As the next subpart demonstrates, this distinction may prove significant for purposes of defining a reasonable scope for the Code's antidiscrimination section.[145]

2. The Role of Section 525

It is not surprising that the fact patterns that give rise to offensive uses of the Code's stay provisions also provoke improper uses of the Code's antidiscrimination section.[146] Section 525 of the Code provides that a governmental unit may not deny a license or discriminate against a person with respect to a grant solely because the person has become a debtor or had a debt discharged under the bankruptcy laws.[147] The legislative history of Section 525 indicates that Congress intended it to

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state liquor board to renew a liquor license until the debtor paid delinquent taxes violated § 362); *Hoffman*, 65 B.R. at 989 (same); *Nu-Process Brake Engineers*, 119 B.R. at 702-03 (same); *Aegean Fare*, 35 B.R. at 927-28 (holding that the refusal to renew a liquor license pending payment of prepetition taxes violates § 362).

144. *See, e.g.*, Norton v. Tennessee Dep't of Safety (*In re* Norton), 867 F.2d 313 (6th Cir. 1989) (involving a state statute providing that every driver found financially irresponsible was required to pay a $65 fee, maintain insurance, and pass a new driver's test); Duffey v. Dollison, 734 F.2d 265 (6th Cir. 1984) (relying on a state statute providing that anyone failing to satisfy an auto-related tort judgment within 30 days must post proof of financial responsibility).

145. *See infra* part III.B.2.

146. *See, e.g.*, Elsinore Shore Assocs., 66 B.R. at 733, 741 (holding that a state casino control commission's insistence on payment of prepetition license fees and taxes as a condition for a casino license renewal violated both § 362 and § 525); Anderson, 15 B.R. at 400 (holding that the refusal to renew a liquor license for the failure to pay prepetition taxes violated § 525).

147. *See* 11 U.S.C. § 525(a) (1988). In 1984 Congress amended § 525 to add subsection (b), which prohibits discrimination by private employers against an employee "solely because" of the employee's bankruptcy or failure to pay a debt that was discharged in bankruptcy. *Id.* § 525(b).

codify the result in *Perez v. Campbell.*[148]

In *Perez*, a pre-Code decision, the Supreme Court held that a state could not refuse to renew a driver's license for nonpayment of an auto-related tort judgment that had been discharged in bankruptcy.[149] Courts have struggled to define the appropriate scope of Section 525.[150] One reason for this struggle is that formulating a workable definition of Section 525 forces courts to determine the precise functional significance to a debtor of having a debt discharged in bankruptcy.

What does it mean for a debtor to have a debt discharged in bankruptcy? Section 524 and its legislative history indicate that the discharge means, at a minimum, that creditors of discharged debts cannot take actions, judicial or informal, to collect those debts.[151] Section 525's antidiscrimination provision apparently goes further, but it is unclear how much Congress intended it to reduce other collateral consequences of discharging debts in bankruptcy.

A very broad interpretation of Section 525 would give additional content to the notion of discharge: having a debt discharged would be equivalent, for all purposes enumerated in Section 525(a), to the debtor paying the debt in full.[152]

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148. 402 U.S. 637 (1971). The legislative history of § 525 provides that the section "codifies the result of Perez v. Campbell, which held that a State would frustrate the Congressional policy of a fresh start for a debtor if it were permitted to refuse to renew a drivers license because a tort judgment resulting from an automobile accident had been unpaid as a result of a discharge in bankruptcy" (citation omitted). HOUSE COMM. ON THE JUDICIARY, BANKRUPTCY LAW REVISION, H.R. REP. No. 595, 95th Cong., 1st Sess. 366-67 (1977).

149. 402 U.S. at 656.

150. *Compare* Spruce Ltd. Partnership v. Lutz (*In re* Lutz), 82 B.R. 699, 705 (Bankr. M.D. Pa. 1988) (holding that § 525 does not mean that a debtor can assume an executory contract without curing the prepetition default under § 365) *with* Sudler v. Chester Hous. Auth. (*In re* Sudler), 71 B.R. 780, 787 (Bankr. E.D. Pa. 1987) (holding that § 525 "overrides" § 365 so as to allow a debtor to assume benefits in executory contracts without curing prepetition defaults).

151. *See supra* notes 28-32 and accompanying text.

152. Pre-Code cases held that discharge of a debt in bankruptcy was not equivalent to payment of the discharged debt. *See, e.g.*, McClendon v. Kenin, 385 P.2d 615, 616 (Or. 1963) (stating that "discharge is not a payment or extinguishment of the debt; it is simply a bar to all future legal proceedings for the enforcement of the discharged debt" (citation omitted)). The legislative history of § 524 says that, "[i]n effect, the discharge extinguishes the debt, and creditors may not attempt to avoid that." H.R. REP. No. 595 at 366. That statement, however, does not imply that discharge is equivalent to "paid for all purposes." If the § 524 discharge amounted to payment of the debt for all purposes, § 525's antidiscrimination rules would be unnecessary. An even broader interpretation of § 525 would extend the same payment-in-full concept to prohibit discrimination by private parties. Some commentators have advocated this extension, see Douglass G. Boshkoff, *Private Parties and Bankruptcy-Based Discrimination*, 62 IND. L.J. 159, 175-79 (1987); *see also* Rendleman, *supra* note 28, at 741-45. Supporting the argument for extending § 525 to private parties is language in that section's legislative history which says that "[t]he enumeration of various forms of discrimination against former bankrupts is not intended to permit other forms of discrimination." H.R. REP. No. 595 at 367. The legislative history also notes that § 525 as enacted is not as broad as an earlier version of the provision that would have prohibited discrimination by private parties. *Id.*

However, even a narrower interpretation of Section 525 that makes discharge equivalent to payment in full only for government creditors in license cases would represent a large and significant exception to the burden/benefit theme that pervades the Code. Such an interpretation would also create a conflict between the executory contracts section of the Code and the antidiscrimination section in cases in which a governmental unit has a specific executory contract to provide the debtor with a license or grant.

The conflict arises because Section 365(b), standing alone, would require the debtor party to cure prepetition defaults in order to assume an executory contract with the government. Because a broad reading of Section 525 would make the debtor's discharge of prepetition obligations owed to the government equivalent to actual payment of those debts, the debtor's need to cure as a condition of contract assumption under Section 365(b) would be obviated.

Courts confronted with this tension between the Code's executory contracts section and its antidiscrimination provision have gone both ways on the issue. In *Sudler v. Chester Housing Authority* (In re *Sudler*)[153] the debtor was a public housing tenant who was behind in her rent when she filed for Chapter 7 bankruptcy. The city housing authority, which operated the public housing project, argued that, under Section 365, if the debtor wished to assume her lease, she first had to cure prepetition defaults. The court rejected this argument and held that Section 525 is an exception to the general rule in Section 365.[154]

Apparently one factor leading to rejection of the earlier version was that the credit industry feared it would he unable to consider a prospective customer's past bankruptcy in deciding whether to extend credit. *See* Boshkoff, *supra*, at 165. But very few courts have been willing to read § 525(a) to cover situations other than those enumeratcd. *See, e.g., In re* Draughon Training Institute, Inc., 119 B.R. 927, 933 (Bankr. W.D. La. 1990) (holding that privatc discriminatory conduct was not prohibited by § 525); Barbee v. First Va. Bank-Colonial (*In re* Barbee), 14 B.R. 733, 735-36 (Bankr. E.D. Va. 1981) (same); *In re* Coachlight Dinner Theatres of Nanuet, Inc., 8 B.R. 657, 658-59 (Bankr. S.D.N.Y. 1981) (same); *cf.* Wilson v. Harris Trust & Sav. Bank, 777 F.2d 1246, 1249 (7th Cir. 1985) (stating that "Congress would not have added section 525(b) if it thought private employers were already barred from discriminating against debtors under § 525"). *But see* Olson v. McFarland Clinic, P.C. (*In re* Olson), 38 B.R. 515, 519 (Bankr. N.D. Iowa 1984) (stating in dicta tbat "recent decisions have strongly suggested that § 525 should be construed to apply to private entities"); Blackwelder Furniture Co. v. Drexel-Heritage Furnishings, Inc. (*In re* Blackwelder Furniture Co.), 7 B.R. 328, 338-39 (Bankr. W.D.N.C. 1980) (holding that a substantial question existed as to whether a private supplier's refusal to deal was unlawful discrimination contrary to "the letter or the policy" of the Code); Boshkoff, *supra*, at 168 (criticizing the Seventh Circuit's statutory reasoning as "quite unsatisfactory").

153. 71 B.R. 780 (Bankr. E.D. Pa. 1987).

154. *Id.* at 787. The court's assumption that an individual in a Chapter 7 case had the ability to assume a lease was interesting. Section 365 gives a trustce the power to assume executory contracts or unexpired leases, and a trustee is always appointed in a Chapter 7 case. If the individual debtor in *Sudler* wanted to assume the lease for her own personal benefit, the appropriate vehicle to do so probably would have been § 524's provision on reaffirmation. *See supra* text accompany-

Thus, the court said that the public housing authority could not prevent the debtor from continuing to rent her unit on the basis of a prior rent obligation discharged in bankruptcy.[155]

The court in *Spruce Limited Partnership v. Lutz* (In re *Lutz*)[156] reached the opposite conclusion. In *Lutz* a landlord sought to evict a tenant because of the tenant's failure to pay prepetition rent. The court assumed arguendo that this landlord was a governmental unit, and noted that Section 525 did not make discharge equivalent to payment in full.[157] The court stated that "[a] debtor's right to require another party to continue to perform its obligations under an executory contract is governed by the terms of that contract."[158] Thus, explained the court, when a landlord elects to terminate a lease because of prepetition defaults, that act is not, by itself, discriminatory.[159]

Whereas many bankruptcy courts have read Section 525(a) to mean that discharge equals payment in the circumstances enumerated by the subsection,[160] most federal courts of appeals have seemed uncomfortable with such an expansive interpretation of Section 525(a)'s effect. In *Goldrich v. New York State Higher Educucation Services Corp.* (In re *Goldrich*)[161] the Second Circuit determined that Section 525 did not prevent the state from refusing to extend new student loans to applicants who had discharged previous student loans. The court emphasized that the statute in question did not discriminate against bankrupts because it applied to anyone who failed to repay previous student loans, not just those who had previous loans discharged in bankruptcy.[162] In so holding, the Second Circuit was refusing to treat dis-

ing notes 108-19.

155. *Sudler*, 71 B.R. at 786-87; *see also* Hiser v. Blue Cross (*In re* St. Mary Hosp.), 89 B.R. 503, 505 (Bankr. E.D. Pa. 1988) (stating that "the strong public policy of 11 U.S.C. § 525(a) overrides the potential requirement of 11 U.S.C. § 365(b)(1)" (citation omitted)), *aff'd*, 931 F.2d 51 (3d Cir. 1991).

156. 82 B.R. 699 (Bankr. M.D. Pa. 1988).

157. *Id.* at 704 (stating that although discharge relieves debtors of personal liability on missed payments, nothing in the Code or legislative history "indicate[s] that the discharge was intended to cure defaults in leases or other executory contracts and thereby reinstate them").

158. *Id.*

159. *Id.* at 705.

160. Section 525(a) makes it unlawful for a governmental unit to deny, revoke, suspend, or refuse to renew a license, permit, charter, franchise, or other similar grant to, condition such a grant to, discriminate with respect to such a grant against, deny employment to, terminate the employment of, or discriminate with respect to employment against a debtor. 11 U.S.C. § 525(a) (1988).

161. 771 F.2d 28 (2d Cir. 1985).

162. *Id.* at 31 (explaining that "the language of [the New York state law] indicates that it applies uniformly to all students who fail to repay student loans, whether they declare bankruptcy or not"). The *Goldrich* court also noted that the legislative history of § 525 indicates that the section does not prohibit consideration of other factors, such as future financial responsibility, "as long as that consideration was done in a nondiscriminatory fashion." *Id.* at 31; *see also* Elter v.

charge in a Section 525 case as full repayment of the discharged debt.

In the Sixth Circuit case of *Duffey v. Dollison*,[163] an Ohio statute required a driver who failed to pay an automobile-related tort judgment within thirty days to post proof of financial responsibility in order to get a driver's license back. The debtor in *Duffey* incurred such a judgment, failed to pay it, and then had it discharged in bankruptcy. When the state insisted that the debtor post proof of financial responsibility notwithstanding the discharge, the debtor complained that such a requirement violated Section 525.[164] The debtor wanted the court to treat the discharge of his tort judgment as if it were payment of the debt for purposes of the license statute. The court found no discrimination in the application of the Ohio statute to this debtor because the statute applied to all drivers with unpaid debts, not just those who had discharged them.[165]

The Sixth Circuit used the same logic five years later in *Norton v. Tennessee Department of Safety (In re Norton)*,[166] which involved a Tennessee statute requiring a reissuance fee to be paid by drivers whose licenses had been suspended for failure to pay tort judgments. The debtor in *Norton* complained that the debt that prompted the suspension of his license was now discharged. The court, however, found no discrimination because all drivers failing to pay tort judgments, not just bankrupts, had to pay a reinstatement fee.[167]

While these narrow constructions of Section 525 are consistent with the Code's general linkage of burdens with benefits, the distinctions drawn by both the Second Circuit and the Sixth Circuit are hard to reconcile with the result in *Perez*. Using the logic of the Second and Sixth Circuits, the state rule struck down in *Perez*, that drivers had to pay auto-related tort judgments in order to regain their licenses, certainly applied to anyone who failed to pay a judgment, not just to bankrupts. Yet the apparent even-handedness of the rule in *Perez* was not enough to save it from being struck down as inconsistent with bankruptcy's fresh start principles.

Great Lakes Higher Educ. Corp. (*In re* Elter), 95 B.R. 618 (Bankr. E.D. Wis. 1989) (permitting a state agency to deny new educational loans to students who had prior educational loans discharged in bankruptcy).

163. 734 F.2d 265 (6th Cir. 1984).

164. *Id.* at 267.

165. *Id.* at 273.

166. 867 F.2d 313 (6th Cir. 1989).

167. *Id.* at 317; *see also In re* Callendar, 99 B.R. 378, 380 (Bankr. S.D. Ohio 1989) (upholding a state credit union's policy of refusing services to members who have had a credit union loan discharged in bankruptcy because "it is not only those employees of the Postal Service who cause loss to the Credit Union by filing bankruptcy who are deprived of the services of the Credit Union, but employees who cause loss by any means . . .").

Given Section 525's explicit reliance on the *Perez* holding, perhaps it is artificial to attempt an interpretation of that section other than "discharge equals full payment" for the cases enumerated. The Second and Sixth Circuits attempted to find an interpretation of Section 525 that lay somewhere between the specific holding of *Perez* and an equating of discharge with full payment in all government license or grant cases. Unfortunately, this attempt to draw a meaningful line ultimately created distinctions analytically devoid of meaning. Noted bankruptcy scholar Dean Thomas Jackson could find no narrow construction of Section 525 that was consistent with *Perez* and concluded that Section 525's codification of *Perez* is, as a normative matter, simply wrong.[168]

Dean Jackson analogizes the rights of an automobile tort creditor under these state statutes to those of a lien holder. He suggests that because ordinary liens pass through bankruptcy unless specifically avoided, the lien-like leverage that an automobile tort creditor enjoys in these states should similarly pass through bankruptcy unaffected by the discharge.[169]

Theoretically, Dean Jackson is probably right. *Perez* stripped away the leverage in bankruptcy that state law had given tort creditors, leverage that should have been effective both inside and outside of bankruptcy. As Dean Jackson and his frequent coauthor, Professor Douglas Baird, have explained in great detail, there are inherent dangers in using bankruptcy as a place to change relative creditor entitlements that exist outside of bankruptcy.[170]

Perhaps there is a way to define a role for Section 525 that is consistent with *Perez*, but nevertheless does not equate discharge with payment in full in all government license or grant cases. Ideally, debtors would not lose out on government grants or other government benefits solely because of the stigma attached to filing bankruptcy. This type of discrimination occurred in In re *Son-Shine Grading, Inc.*,[171] for example, when the state of North Carolina refused to deal with a Chapter 11 debtor solely because the debtor was in bankruptcy. Similarly, in *Marine Electric Railway Products Division v. New York City Transit Authority* (In re *Marine Electric Railway Products Division*)[172] the court held that the New York City Transit Authority could not reject a

168. JACKSON, *supra* note 61, at 266-69.

169. *Id.* at 267.

170. *See* BAIRD & JACKSON, *supra* note 56, at 42; Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 121 (1984) (concluding that bankruptcy's concern ought to be with increasing the overall size of the pie, not with changing the size of the pieces).

171. 27 B.R. 693 (Bankr. E.D.N.C. 1983).

172. 17 B.R. 845 (Bankr. E.D.N.Y. 1982).

debtor's bid on a public contract solely because the debtor was a Chapter 11 debtor in possession.

In these pure discrimination cases, the party charged with discrimination was not owed a prepetition claim by the debtor.[173] On the other hand, it seems much more defensible when the government conditions future benefits to a debtor on payment of an obligation owed to it by the debtor.

There is a meaningful way to distinguish the *Perez* scenario from the situation in which the government is asking for payment before providing or renewing a debtor's liquor license. In *Perez* the state statute serves as a collection device for third-party automobile tort victims. In the typical liquor license case there is no such third-party beneficiary. The government's insistence on payment of taxes means only that the party to whom the debtor looks for further benefit is not forced to give such benefit while foregoing collection of past obligations.

Thus, a preferable interpretation of Section 525 would forbid the following two categories of conduct by a governmental unit: pure discrimination by the government based solely on the debtor's bankruptcy filing without regard to any particular discharged debt; and a conditioning of benefits that has the effect of creating a collection device for a third party. Interpreted this way, Section 525 would have independent significance in combatting true bankruptcy discrimination. Further, it would codify the holding in *Perez* without making discharge by the debtor tantamount to full payment for all purposes when a government licensor or grantor is also a creditor.

The proposed reading of Section 525 would lead to the result that the Sixth Circuit sought in the *Duffey* and *Norton* cases without having to rely on reasoning that would essentially overrule *Perez*. Under the state statutes in *Duffey* and *Norton*, any driver who failed to pay a discharged auto-related tort judgment would have to either pay the discharged judgment or purchase insurance as proof of financial responsibility in order to keep a license. In almost every case the discharged

173. *See* Exquisito Servs., Inc. v. United States (*In re* Exquisito Servs., Inc.), 823 F.2d 151 (5th Cir. 1987) (prohibiting discrimination based solely on a government contract bidder's filing of Chapter 11; no prepetition debt of the government was involved). The dissent in *Exquisito* claimed that the majority read § 525 too liberally in prohibiting the Air Force from refusing to renew its food service contract with the debtor in possession. *Id.* at 155 (Jolly, J., dissenting). The dissent said that § 525 should apply only when the government is acting as sovereign in license and grant cases, and not when the government is acting like a private party conditioning its grant of a benefit on the receipt of a mutual benefit. *Id.* (Jolly, J., dissenting). The problem with this distinction is that in many license cases, the government conditions the grant of a benefit, such as a liquor license, on the receipt of a mutual benefit, such as the payment of state taxes. Thus, in license or grant cases and cases in which the government acts like a private party, the government has a benefit to give that is linked with a specific burden owed to the government.

debtor will choose to purchase the insurance rather than pay the discharged debt to the third party.[174]

In *Perez* the state statute required a debtor to pay the third party's discharged debt. Thus, the statute provided the third-party creditor with an effective collection device. In contrast, application of the state statute in *Duffey* and *Norton* would rarely result in a collection device for third-party tort creditors.

Similarly, the *Goldrich* court could have reached the result it wanted without using a rationale inconsistent with *Perez*.[175] To distinguish its facts from those in *Perez*, the Second Circuit could have noted that whereas the statute in *Perez* created a collection device for third parties, the New York statute merely gave leverage to the very governmental unit from whom the debtor sought future benefits.

3. A Property of the Estate View of Corporate License Cases

The license renewal and transfer cases can be analyzed from another perspective, one that involves neither the automatic stay nor the antidiscrimination provisions of the Code. In the typical liquor license case, a different way to justify the state's ability to condition the license's transfer on payment of prepetition taxes is to argue, as some courts and commentators have done,[176] that the property right represented by the liquor license comes into bankruptcy subject to any valid conditions on its enjoyment that existed outside of bankruptcy.

This particular analysis has significant support in case law,[177] al-

174. There are a number of reasons for this. First, the cost of paying the discharged tort judgment is typically large, given that the tort judgment often prompted the debtor to file bankruptcy in the first place. Second, the tort judgment would have to be paid in a lump sum, whereas the cost of insurance typically is amortized over the course of the year. Third, if the debtor chooses to purchase insurance, at least the debtor is getting some future benefit for her money—namely, the benefit of having insurance. Paying the discharged tort judgment, however, fails to give the debtor any independent benefit beyond requalifying for her driver's license.

175. In addition to justifying the New York statute by saying it applied to all applicants who had defaulted on previous student loans, the *Goldrich* court noted another distinction between the case before it and those covered by § 525. According to the court, the legislative history of § 525 indicates that even parties covered by the section could take a prior bankruptcy into account in deciding whether to extend credit. Goldrich v. New York State Higher Educ. Servs. Corp. (*In re* Goldrich), 771 F.2d 28, 31 (2d Cir. 1985). This credit versus no credit dichotomy seems to distinguish *Goldrich* from *Perez*, but it does not distinguish *Duffey* or *Norton* from *Perez*, since neither of the Sixth Circuit cases involved the government in the position of lender.

176. *See, e.g.*, California v. Farmers Markets, Inc. (*In re* Farmers Markets), 792 F.2d 1400, 1403 (9th Cir. 1986); JACKSON, *supra* note 61, at 97.

177. *See* Calvert v. Bongards Creameries (*In re* Schauer), 835 F.2d 1222, 1225 (8th Cir. 1987) (recognizing the validity in bankruptcy of state law transfer restrictions on margin certificates issued by a farm cooperative to the debtor); Artus v. Alaska Dep't of Labor (*In re* Anchorage Int'l Inn), 718 F.2d 1446, 1451-52 (9th Cir. 1983); United States v. Professional Sales Corp. (*In re* Professional Sales Corp.), 56 B.R. 753, 764 (N.D. Ill. 1985) (noting, when a Chapter 11 debtor attempted to enjoin the revocation of an interim status permit of the Environmental Protection

though its conclusions are far from universally accepted.[178] Arguably, the "conditional property" doctrine is just another manifestation of the general bankruptcy theme that a debtor's right to insist on future benefits ought to be conditioned on the debtor's assumption of preexisting burdens owed to the party from whom future benefits are sought.[179]

The classic pre-Code Supreme Court case that formulated this doctrine is *Board of Trade v. Johnson*.[180] In *Johnson* the debtor owned a seat on the Chicago Board of Trade. The debtor's contract with the Board provided that the debtor could transfer the seat to a third party only after paying in full any creditors on the Board of Trade.

The trustee of the debtor's estate argued that the conditional restriction on transfer of the seat should not prevent the seat from being classified as property of the estate.[181] The Supreme Court's holding enabled the trustee to win the battle but lose the war: the Court said that the seat did indeed become property of the estate, but was subject to the restrictions on transfer that existed outside of bankruptcy.[182] In this case the debt owed to the debtor's Board of Trade creditors exceeded the amount for which the seat could be sold on the open market. Thus, although the seat became property of the estate, it ultimately had no value to the estate.[183]

The conditional property analysis applies only to cases involving corporate licenses and not to cases involving individual driver's licenses. Although a corporate license qualifies as property of the estate, an individual driver's license is excluded from the estate as a nontransferable, purely personal right of the individual.[184] In liquor license cases, courts have applied various combinations of the stay, antidiscrimination, and property approaches to justify the state's ability to condition transfer of

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Agency, that "the interim status is encumbered with statutory conditions that limit its value and are therefore an incident of any property right enjoyed with such status").

178. *See* Bavely v. United States Internal Revenue Serv. (*In re* Terwilliger's Catering Plus, Inc.), 911 F.2d 1168, 1177 (6th Cir. 1990) (declining to follow the Ninth Circuit in *Farmers Market* "to the extent they reach a contrary result"); *see also In re* Kick-Off, Inc., 82 B.R. 648, 650 (Bankr. D. Mass. 1987) (describing the Ninth Circuit's reasoning as "an interesting exercise in metaphysics that has a superficial appeal," but "[w]e are not persuaded").

179. Dean Jackson makes this point eloquently when he analogizes the treatment of executory contracts in bankruptcy to the conditional property analysis set down by the Supreme Court in the *Board of Trade* case. *See* JACKSON, *supra* note 61, at 107-08.

180. 264 U.S. 1 (1924).

181. *Id.* at 3-4.

182. *Id.* at 15.

183. The debtor in this case owed more than $60,000 to members of the Board of Trade. The seat itself, however, was worth only $10,500 at the time he filed for bankruptcy. *Id.* at 7-8.

184. *See* ELIZABETH WARREN & JAY L. WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 204 (2d ed. 1991) (reasoning that a driver's license "represents a very valuable legal right that is of no value to anyone but the debtor," and thus "cannot be property of the estate").

the license on payment of prepetition taxes.[185] Thus, it is not surprising that courts have failed to reach a consensus in resolving this recurring issue.

C. Transcript Cases

Transcript cases merit separate treatment in a discussion of offensive uses of the stay for at least two reasons: first, there are many of these cases; and second, these cases demonstrate the arbitrary distinctions that courts must draw when they broadly interpret the Code's antidiscrimination provisions. Transcript cases frequently arose prior to the enactment of the Code,[186] and they continue to arise today in large numbers.[187]

In transcript cases the basic facts are almost always the same. An ex-student from a college or university still owes money on loans that the student took out while in school. The ex-student files bankruptcy, and then needs a copy of his transcript from the school to which he owes the student loans. The school, however, has a policy of refusing to release transcripts to students whose student loans are in default, so it refuses to give the student the transcript.

The many cases in this area can be classified along two dimensions: state versus private schools, and dischargeable versus nondischargeable student loans. Thus, there are four possible combinations of these two variables: state school makes dischargeable loan,[188] private school makes dischargeable loan,[189] state school makes nondischargeable loan,[190] and private school makes nondischargeable loan.[191]

Debtors seeking transcripts have used both the theory that the school violated the stay[192] and the theory that the school violated the

185. *See Bavely*, 911 F.2d at 1171-72 (stating that a license transfer was allowed through § 541 analysis only); Elsinore Shore Assocs. v. Casino Control Comm'n (*In re* Elsinore Shore Assocs.), 66 B.R. 723 (Bankr. D.N.J. 1986) (holding that the refusal to renew a casino license violated both §§ 362 and 525); Aegean Fare, Inc. v. Licensing Bd. (*In re* Aegean Fare), 35 B.R. 923 (Bankr. D. Mass. 1983) (finding a violation of § 362 only); Anderson v. Mississippi State Tax Comm'n (*In re* Anderson), 15 B.R. 399 (Bankr. S.D. Miss. 1981) (finding a violation of § 525 only).

186. *See, e.g.*, Girardier v. Webster College, 563 F.2d 1267 (8th Cir. 1977); Handsome v. Rutgers Univ., 445 F. Supp. 1362 (D.N.J. 1978).

187. *See, e.g.*, Johnson v. Edinboro State College, 728 F.2d 163 (3d Cir. 1984); California State Univ., Fresno v. Gustafson (*In re* Gustafson), 111 B.R. 282 (Bankr. 9th Cir. 1990).

188. *See, e.g.*, *In re* Reese, 38 B.R. 681 (Bankr. N.D. Ga. 1984).

189. *See, e.g.*, Parraway v. Andrews Univ. (*In re* Parraway), 50 B.R. 316 (W.D. Mich. 1984).

190. *See, e.g.*, *Johnson*, 728 F.2d 163.

191. *Cf. In re* Ware, 9 B.R. 24 (Bankr. W.D. Mo. 1981) (refusing to allow a private college to withhold a transcript to induce payment of a loan that was not yet discharged in the Chapter 13 plan proposing a 20% payment to unsecured creditors).

192. *See, e.g.*, Lanford v. Macalester College (*In re* Lanford), 10 B.R. 132 (Bankr. D. Minn. 1981).

Code's antidiscrimination section.[193] Courts have tended to be more sympathetic to a school's policy of withholding transcripts when the debtor's student loan is nondischargeable, presumably because the nondischargeable character of the loan removes any possible argument that discharge equals payment.[194]

The inconsistency between the result courts reach in cases involving state schools and the result courts reach in cases involving private schools highlights one of the problems with interpreting Section 525 to mean that discharge equals full payment to governmental units in license cases. Because Section 525 applies only to governmental units, courts are generally unwilling to extend its protection to the debtor's dealings with private parties.[195] Thus, a court reading Section 525 to equate discharge with payment by the debtor would find no discrimination when a private school withholds a transcript but would find a Section 525 violation when a public school is the withholding institution.

Such a distinction between the treatment of a state school and that of a private school has little justification in principle. However, this arbitrary distinction could be avoided completely with the narrower read-

193. *See, e.g., In re* Heath, 3 B.R. 351 (Bankr. N.D. Ill. 1980) (holding that a state college's refusal to release a transcript to a student who had a dischargeable student loan violated both § 525 and § 362).

194. *See, e.g., Johnson*, 728 F.2d at 164-65 (holding that a state college's refusal to release a transcript to a student who had a nondischargeable loan debt did not violate § 525). *But see Gustafson*, 111 B.R. at 288 (Bankr. 9th Cir. 1990) (holding that a state college's refusal to release a transcript prior to the determination of dischargeability violated both § 362 and § 525). The dissent in *Gustafson* analogized the college's position in the transcript case to the position of a bank in the freeze cases. *Id.* at 290 (Russell, J., dissenting); *see infra* part III.D. (discussing administrative freeze cases). The dissent noted that if the university is forced to turn over the transcripts prior to a determination of dischargeability, it has lost its leverage even if the student loan debt turns out to be nondischargeable. 111 B.R. at 290 (Russell, J., dissenting). On the other hand, if the university refuses to turn over the transcript prior to a determination of the student loan's dischargeability, it has violated the automatic stay. *Id.* The dissent argued that the university "must not be put to such a Hobson's choice until the court has actually determined the dischargeability of the debt." *Id.*

Similarly, in Howren v. Board of Trustees of the Univ. of Ala. (*In re* Howren), 10 B.R. 303 (Bankr. D. Kan. 1980), the court held that a university violated the stay by withholding a transcript from a former student prior to a determination of the dischargeability of the student's educational loan debt. *Id.* at 305-06. The university unsuccessfully argued that it had a lien on the transcript to secure repayment of the student loan debt. *Id.* at 305. One commentator noted that the transcript in *Howren* could not have been collateral, since the university had failed to take the proper steps under Article 9 of the U.C.C. Anthony P. Lawthier, Comment, *Student Loans and the Withholding of Transcripts Under the Bankruptcy Reform Act of 1978*, 30 U. KAN. L. REV. 265, 273-75 (1982). That argument, however, misses the larger point that, notwithstanding any Article 9 interest the university has in the transcript under state law, the university possesses a special form of leverage that it could use under state law to insure repayment of the student loan. The commentator fails to explain why such leverage, which is valid outside of bankruptcy, should not similarly be valid inside of bankruptcy.

195. *See supra* note 152.

ing of Section 525 proposed earlier.[196] The proposed interpretation would ban only government actions that amounted to pure discrimination on the basis of bankruptcy or that created, as did *Perez*, a collection device for third parties. When a state school withholds a transcript because of an unpaid student loan, it is not discriminating against ex-students simply because they filed bankruptcy. Nor is the state school creating a collection device for a private third party. Rather, the purpose of the refusal is to cause the student to repay the student loan, for which the ultimate guarantor is the same government that conferred the benefit in the first place.

Of course, if a court perceives the school's transcript withholding as a violation of the stay, any state-private distinction under Section 525 is moot. A 1990 amendment to the Code makes it likely that fewer courts will allow debtors to use the stay offensively to obtain the benefit of transcripts without assuming corresponding burdens owed to the school.[197] The Code has never permitted Chapter 7 debtors to discharge student loans,[198] and a 1990 amendment now makes such loans nondischargeable in Chapter 13 cases as well.[199] Thus, only those courts that allow a debtor to use the stay offensively for nondischargeable debts will continue to give the debtor a potent weapon against a former school.

One of the most insightful opinions in the student transcript area was written in the Eighth Circuit case of *Girardier v. Webster College*.[200] Ironically, most courts discount the holding in *Girardier* because it was a pre-Code case governed by a postdischarge stay that prohibited only formal court actions to collect discharged debts.[201] Thus, the majority's holding that a college's refusal to release a transcript did not violate the stay was premised in part on the narrower scope of the pre-Code postdischarge stay.[202]

In a thoughtful concurrence, Judge Bright[203] agreed with the majority's holding, but not with its rationale. The majority had noted that if Webster College were a public school, the result would have to be

196. Conversely, this arbitrary distinction could be avoided by interpreting § 525 very broadly to provide that discharge equals payment in full for both public and private parties.

197. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 3007(b), 104 Stat. 1416 (1990).

198. *See* Howard, *supra* note 116, at 1086-87.

199. 11 U.S.C.A. § 1328(a)(2) (West Supp. 1991) (making educational loans as defined by § 523(a)(8) a new exception to the Chapter 13 discharge).

200. 563 F.2d 1267 (8th Cir. 1977).

201. *See, e.g.*, Virginia Union Univ. v. Parham (*In re* Parham), 56 B.R. 531, 532-33 (Bankr. E.D. Va. 1986) (stating that the *Girardier* holding "has been legislatively overruled" by the Code's broadened stay).

202. *Girardier*, 563 F.2d at 1272.

203. *Id.* at 1277 (Bright, J., concurring).

different in order to comport with *Perez*. Judge Bright began by pointing out the anomaly created by the majority's holding: that "a state school is obligated to furnish transcripts to a bankrupt former student but, until he or she pays the discharged educational loan, a private school is not."[204]

Judge Bright then explained why a college, public or private, should be able to withhold a transcript without violating the postdischarge stay. First, he said, Webster College in no way coerced the debtors to pay discharged debts. Rather, "Webster College merely declined to confer any additional benefits upon the debtors by furnishing transcripts of their grades for the unpaid educational courses."[205] Then, echoing the theme of burden/benefit linkage that underlies bankruptcy law, Judge Bright said that no college, public or private, should have to enhance educational benefits that it has already given by issuing a transcript when it has not been paid for its services.[206]

Judge Bright's point that no party should be forced to enhance benefits it has already given until the debtor first assumes prepetition burdens is an argument that continues to have force even subsequent to the enactment of the Code. The Code's broadened postdischarge stay in no way mandates that nondebtor parties such as Webster College must give continuing benefits to a debtor who has yet to pay its prepetition obligations.[207] As Judge Bright simply stated toward the end of his concurrence, "[t]he equities here lie with the college."[208]

D. *Administrative Freeze Cases*

The administrative freeze cases provide a fruitful area of offensive stay use by debtors.[209] These cases have resulted from some imprecise

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204. *Id.* (Bright, J., concurring).

205. *Id.* at 1278 (Bright, J., concurring).

206. *Id. But see* Rendleman, *supra* note 28, at 746-50. Professor Rendleman argues that a transcript is like a driver's license in that both issuing entities are monopolies, and in that creditors should not be allowed te hold either as ransom to pay discharged debts. According to Professor Rendleman, state bar associations denying law licenses on the basis of bankruptcy present an analogous problem. *Id.* Both the law license and driver's license situations, however, can be distinguished from the transcript case. The law license case is clearly distinguishable because the state bar associations that would seek to deny admission to applicants who have filed bankruptcy are not prepetition creditors. As explained earlier, the driver's license case is also distinguishable from the transcript case because while the driver's license statutes create collection devices for third parties, in the transcript case the creditor is merely attempting to link the grant of its own future benefit to the debtor's assumption of a preexisting burden owed to the creditor.

207. *See supra* notes 20-37 and accompanying text.

208. *Girardier*, 563 F.2d at 1278 (Bright, J., concurring).

209. *See, e.g.*, First Conn. Small Business Inv. Co. v. Bank of Boston Conn. (*In re* First Conn. Small Business Inv. Co.), 118 B.R. 179 (Bankr. D. Conn. 1990); Homan v. Kemba Cincinnati Credit Union (*In re* Homan), 116 B.R. 595 (Bankr. S.D. Ohio 1990).

Code drafting, as well as from the tendency of some judges to read Code provisions in isolation.

The basic facts in the administrative freeze scenario are straightforward. The debtor, either consumer or corporate, will typically have a demand account with a bank. The bank, in turn, will have a loan to the debtor that is currently outstanding. Shortly after the debtor files bankruptcy, the debtor comes into the bank and demands that the bank return all of the money in the demand account. The bank, realizing that the debtor owes money to it, refuses to release the funds to the debtor, a right that the bank will almost invariably enjoy under relevant state law.[210]

Many courts have held that such a refusal by the bank violates the stay.[211] These holdings provide an egregious example of courts allowing debtors to use the stay offensively. In the refusal-to-deal cases, courts at least make debtors pay in full for any benefits that the nondebtor party confers upon them postpetition.[212] In the typical freeze case, however, the bank is effectively told that it must give up money in which it has an interest without receiving adequate protection of its interest in the unpaid loan.

Full appreciation of the freeze cases requires examination of a number of Code provisions that are difficult to reconcile. First, there is Section 553, which generally sanctions a creditor's exercise of any state-law setoff right that it may have against the debtor at the point of filing.[213] Section 553 is consistent with the burden/benefit linkage found elsewhere in the Code: it prohibits the debtor from insisting on payment in one-hundred-cent dollars from a nondebtor party while relegating the nondebtor party to collection of ten-cent "bankruptcy dollars" on the loan that the debtor owes to it. If the debtor wants a benefit—payment in full of the nondebtor's obligation to it—the debtor must first satisfy burdens that it owes to the nondebtor party.

In apparent contrast to Section 553's corroboration of the Code's general benefit/burden linkage stands Section 362(a)(7), which says

210. *See* BAIRD & JACKSON, *supra* note 56, at 512 (noting that "[w]hen Debtor fails to repay its loan to Bank, Bank is generally entitled, under State law, to 'set-off' the monies 'in' the checking account against the obligation that Debtor owes Bank").

211. *See, e.g.*, First Conn. Small Business Inv. Co. v. Bank of Boston Conn. (*In re* First Conn. Small Business Inv. Co.), 118 B.R. 179 (Bankr. D. Conn. 1990); Homan v. Kemba Cincinnati Credit Union (*In re* Homan), 116 B.R. 595 (Bankr. S.D. Ohio 1990).

212. *See, e.g.*, Sportfame of Ohio, Inc. v. Wilson Sporting Goods Co. (*In re* Sportfame of Ohio, Inc.), 40 B.R. 47, 53 (Bankr. N.D. Ohio 1984) (requiring the debtor to pay cash in advance or upon receipt of goods delivered postpetition).

213. 11 U.S.C. § 553(a) (1988). The exceptions listed in § 553(a) to the general right of setoff include situations in which the creditor party purchases a claim against the debtor within 90 days of the bankruptcy in order to enhance its setoff right, *id.* § 553(a)(2), and situations in which a creditor bank compels the debtor to deposit money in the debtor's bank account, *id.* § 553(a)(3).

that the bankruptcy filing stays any act of nondebtor parties to set off prepetition debts that the debtor owes the nondebtor party.[214] There is a sensible way to construe Section 362(a)(7) so that it will not conflict with Section 553, but most courts have failed to consider it. This nonconflicting approach would view Section 362(a)(7) as a formal check on efforts by nondebtor parties to effect setoffs when the state-law setoff requirements are not met. Most states, for example, require true mutuality of parties for a valid setoff, so that, for example, a bank could not set off from the debtor's account a debt owed to the bank by a subsidiary corporation of the debtor.[215] Section 362(a)(7) may simply be a mechanism, then, to ensure that the bankruptcy court has an opportunity to examine the validity of a bank's setoff rights before those rights are finally effected.[216]

Two other Code provisions support a limited view of the role of Section 362(a)(7) in freeze cases. Section 363 states that debtors may not use "cash collateral" unless either the party with an interest in it consents or the court, after notice and a hearing, authorizes such use.[217] If the court authorizes the debtor's use of cash collateral, it must, upon request, give adequate protection to the nondebtor party with an interest in the cash collateral.[218] In the freeze cases, the money in the debtor's account would qualify as cash collateral under the definition given in Section 363.[219] As noted above, that section permits debtors to

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214. *Id.* § 362(a)(7); *see also id.* § 362(a)(3) (barring any act "to exercise control over property of the estate"). Courts have not construed § 362(a)(7) to stay a creditor's exercise of recoupment, which is related to a setoff. While both setoffs and recoupments involve the cancelling of debts between a debtor and a creditor, setoffs may involve claims arising out of separate transactions whereas recoupments involve only claims arising out of the same transaction. *See* United States v. Midwest Serv. and Supply Co. (*In re* Midwest Serv. and Supply Co.), 44 B.R. 262, 265-66 (D. Utah 1983); *In re* Yonkers Hamilton Sanitarium Inc., 22 B.R. 427, 432 (Bankr. S.D.N.Y. 1982); *cf.* California Canners and Growers v. Military Distribs. of Va., Inc. (*In re* Cal. Canners and Growers), 62 B.R. 18, 21 (Bankr. 9th Cir. 1986) (specifically rejecting recoupment theory when one transaction occurs prepetition and the other occurs postpetition).

215. *See, e.g.,* Davidovich v. Welton (*In re* Davidovich), 901 F.2d 1533, 1537 (10th Cir. 1990) (holding that the mutuality requirement for setoff mandates that debts involved be between the same parties standing in the same capacity).

216. Many jurisdictions hold that for a setoff to be definitively affected, at least three steps are required of the creditor: the decision to exercise setoff; some affirmative action to accomplish the seteff; and some record evidencing that the creditor has exercised the right of setoff. *See* United States v. Citizens & Southern Nat'l Bank, 538 F.2d 1101 (5th Cir. 1976); Baker v. National City Bank of Cleveland, 511 F.2d 1016 (6th Cir. 1975); Clarkson Co. v. Shaheen, 533 F. Supp. 905, 925 (S.D.N.Y. 1982). The requirement of an overt act for setoff implies that the mere withholding of funds in these jurisdictions does not by itself amount to a setoff.

217. 11 U.S.C. § 363(c)(2)(A)-(B) (1988). It is also noteworthy that § 506(a) of the Code specifically characterizes a secured claim as any valid right to setoff that a creditor has at the point of the debtor's filing. *Id.* § 506(a).

218. *Id.* § 363(e).

219. *Id.* § 363(a) (defining cash collateral as cash or cash equivalents in which "the estate and an entity other than the estate have an interest").

use that money only to the extent that a court gives the bank appropriate protection for its interest in the money.

The other Code provision that supports a more limited view of Section 362(a)(7) is Section 542(b).[220] That provision requires an entity that owes a debt to the debtor to pay the debt over to the trustee "except to the extent that such debt may be offset under [S]ection 553."[221] Any type of account that the debtor has at a bank would simply be a debt that the bank owes to the debtor.[222] Under Section 542(b), then, a bank with a right of setoff need not turn over to the trustee any of the debtor's funds in its possession. The language in that Section also suggests that the drafters of the Code recoguized a difference between the mere withholding of funds and the act of setoff.[223]

In addition to the statutory provisions, there is a powerful common-sense argument against permitting offensive use of the stay in freeze cases. Consider a situation in which a dispute arises between two parties as to whether the bank has a valid right of setoff when the debtor demands funds from the bank. Suppose there is a rule that forces the bank to give up the money, but it later becomes evident that the bank was correct in asserting a right to setoff. At that point, there is a reasonable likelihood that the bank will be unable to realize its setoff rights because the debtor has already spent the money.[224]

On the other hand, imagine a rule that prohibits the debtor's offensive use of the stay. That is, suppose that the bank is permitted to freeze the account and take the issue to court within a reasonable time period to determine the parties' relative rights to the funds.[225] Under this rule, if the bank's claim of setoff rights proved invalid, the estate would have a solvent party from whom to collect not only the funds in the account, but also any damages caused by the bank's invalid claim of setoff rights.

220. *Id.* § 542(b).

221. *Id.*

222. *See, e.g.*, Walter v. National City Bank of Cleveland, 330 N.E.2d 425, 427 (Ohio 1975) (explaining that in setoff cases "a bank stands in the relationship of debtor to its depositor").

223. *See* Kenney's Franchise Corp. v. Central Fidelity Bank, NA, 22 B.R. 747, 748 (W.D. Va. 1982) (reasoning that use of the phrase "may be offset" in § 542(b) "clearly contemplates that the setoff right has not been exercised" and that "Congress has recognized a significant distinction between the withholding of payment and the exercise of the setoff right" (citation omitted)).

224. *Cf.* Bank of Am. Nat'l Trust and Sav. Ass'n v. Edgins (*In re* Edgins), 36 B.R. 480, 484 (Bankr. 9th Cir. 1984) (criticizing cases that consider administrative freezes to be a stay violation, noting that a bank's attempt to regain the money later "will, all too often, be an attempt to lock the barn door after the horse has been stolen").

225. The court in Crispell v. Landmark Bank (*In re* Crispell), 73 B.R. 375 (Bankr. E.D. Mo. 1987), for example, gave the creditor seven days from the point at which it froze debtor's account either to turn the funds over to the trustee or to request the court to allow it to exercise its right of setoff under § 553. *Id.* at 379-80.

In some jurisdictions, the bank's risk in acceding to the debtor's request for the account money may be even greater than the usual danger that the debtor may dissipate the funds. Some courts go so far as to hold that a bank's postpetition release of funds in the debtor's account amounts to a waiver of the bank's right to setoff.[226] Thus, a rule allowing an offensive use of the stay in these jurisdictions would create an impossible dilemma for the bank. It may refuse to release the funds and risk violation of the stay, or it may release the funds and risk waiver of its setoff right.

The Code's specific mandate that courts honor a bank's state-law setoff right is a clear direction that the debtor's burden/benefit linkage must not be uncoupled in administrative freeze cases. Courts permitting debtors to use the stay offensively by forcing the bank to release funds on which it has a setoff right do violence to these specific Code provisions. More significantly, these courts ignore one of the fundamental precepts underlying bankruptcy law: that a court should not force a nondebtor party to provide additional benefits to a debtor unless the debtor honors existing burdens to the nondebtor party.

E. Consumer Installment Cases

The last recurring category of cases in which courts allow debtors to use the stay offensively does not fit neatly within the burden/benefit paradigm that characterizes the others. In consumer installment cases it almost appears that the creditor, not the debtor, is attempting to use the rules of bankruptcy to improve its position.

The typical consumer installment case[227] involves the following facts: A consumer has purchased a car on credit through a secured loan from a bank. Up to the time the consumer files Chapter 7 bankruptcy, the consumer has been current on the car's installment loan. At the time of bankruptcy filing, the value of the car is less than the current outstanding balance on the loan. The loan agreement may or may not have a clause providing that the consumer's filing of bankruptcy constitutes a default under the loan agreement and accelerates all remaining principal amounts under the loan.

Once in bankruptcy, the consumer wishes to keep making payments under the loan agreement and to retain possession of the car.

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226. *See, e.g.*, Holder v. Wilson (*In re* Wilson), 49 B.R. 19, 21 (Bankr. N.D. Tex. 1985); National Bank of Boaz v. Royal Crown Bottling Co. of Boaz, Inc. (*In re* Royal Crown Bottling Co. of Boaz, Inc.), 29 B.R. 52, 54 (Bankr. N.D. Ala. 1981).

227. *See, e.g.*, Lowry Fed. Credit Union v. West, 882 F.2d 1543 (10th Cir. 1989); Berenguer v. Bank South, N.A. (*In re* Berenguer), 77 B.R. 959 (Bankr. S.D. Fla. 1987); *In re* Cassell, 41 B.R. 737 (Bankr. E.D. Va. 1984); First and Merchants Nat'l Bank v. Ballance (*In re* Ballance), 33 B.R. 89 (Bankr. E.D. Va. 1983).

The bank, on the other hand, wants to repossess the car and sell it unless the consumer chooses one of two options: reaffirm the car loan, or exercise the right to redeem the car. Neither option is particularly attractive to the consumer. If he reaffirms, he is reaffirming not only the portion of the loan that is currently secured, but the unsecured portion as well. Thus, the consumer who reaffirms is in effect waiving the discharge that would otherwise be applicable to the unsecured balance of the bank's claim.[228] In order to redeem the car, the consumer must come up with sufficient cash to make a lump-sum payment equal to the current fair market value of the car.[229]

Many courts have concluded that the debtor need not make this choice, and may keep the car by merely continuing to make payments pursuant to the original loan agreement.[230] These courts point out that the bank is protected by its right of repossession. If the consumer defaults on the loan after the bankruptcy case, the bank may repossess

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228. *See* 11 U.S.C. § 524(c) (1988).

229. Section 722 of the Code governs the debtor's right to redeem. Under § 722, a debtor may redeem personal property that is either exempted by the debtor or abandoned by the trustee by paying the party bolding the lien on the property the amount of that lienholder's secured claim. *Id.* § 722. Although a few courts have held that a debtor may exercise the right to redemption through installment payments, see, *e.g.*, Clark v. Ford Motor Credit Co. (*In re* Clark), 10 B.R. 605, 607 (Bankr. C.D. Ill. 1981), a majority of courts considering the issue have held that tbe redemption right must be exercised through a lump sum payment. *See* General Motors Acceptance Corp. v. Bell (*In re* Bell), 700 F.2d 1053, 1058 (6th Cir. 1983); Chrysler Credit Corp. v. Schweitzer (*In re* Schweitzer), 19 B.R. 860, 864 (Bankr. E.D.N.Y. 1982).

230. *See West*, 882 F.2d at 1546 (holding that the debtor is not forced to choose between redemption and reaffirmation); *In re* Belanger, 118 B.R. 368, 372 (Bankr. E.D.N.C. 1990) (same); *Ballance*, 33 B.R. at 91. *But see In re* Edwards, 901 F.2d 1383, 1387 (7th Cir. 1990) (holding that debtors must choose among redemption, reaffirmation, and surrender of the collateral); *Bell*, 700 F.2d at 1057 (same).

The debate about whether a consumer debtor who is current on installment payments may retain the collateral by simply continuing to make payments has existed since the enactment of the Code in 1979. The controversy took on a new dimension, however, with the Consumer Finance Amendments to tbe Code in 1984. As part of the 1984 Amendments, Congress added § 521(2) to the Code. Section 521(2)(A) requires every Chapter 7 debtor to file a statement of intention indicating whether the debtor intends to retain or surrender liened property and, "if applicable," whether the debtor intends to redeem or reaffirm. 11 U.S.C. § 521(2)(A). Some courts have concluded that the enactment of § 521(2) provides additional support for the conclusion that debtors must choose between redemption and reaffirmation even if they are not in default at the time of bankruptcy filing. *See, e.g., Edwards*, 901 F.2d at 1386-87. Other courts have held that the choices outlined in § 521(2) are not exclusive, and that debtors may keep their collateral merely by continuing to make installment payments as originally agreed. *See, e.g., In re* Hunter, 121 B.R. 609, 617 (Bankr. N.D. Ala. 1990). An analogous controversy involving consumer debtors, known as "lien-stripping," is being heard before the Supreme Court. Dewsnup v. Timm (*In re* Dewsnup), 908 F.2d 588 (10th Cir. 1990), *cert. granted*, 111 S. Ct. 949 (1991). In a lien-stripping case, a consumer is allowed to use the lien avoidance language of § 506(d) to strip down an undersecured creditor's lien on collateral to the value of the collateral. The consumer then is allowed to keep the collateral by making installment payments on the new reduced principal balance of tbe secured creditor's loan. *See generally* Margaret Howard, *Stripping Down Liens: Section 506(d) and the Theory of Bankruptcy*, 65 AM. BANKR. L.J. 373 (1991).

the car and sell it.[231] The bank, however, is not allowed to pursue the debtor for any deficiency remaining after such a foreclosure sale.[232]

The debtor's offensive use of the stay in these situations is not immediately obvious. However, the automatic stay enables the debtor to enjoy the continuing benefit of using the car on which the bank has a lien without assuming all of the burdens that attach to that benefit.[233] A true assumption of the contract by the debtor would be a reaffirmation, in which a later default by the debtor would enable the bank not only to foreclose on its collateral but also to sue the debtor for the deficiency. Reaffirmation by the debtor might be ill-advised, however, because the car's value in these cases is typically less than the debtor's remaining obligation.[234] That eventuality, however, does not justify shielding the debtor from having to face the hard choice between redemption and reaffirmation.[235]

Courts permitting debtors to use the stay offensively in these cases have stumbled in various ways. The red herring to which these courts most commonly fall prey is the default-on-bankruptcy clauses contained in some contracts.[236] Many courts have jumped to the conclusion

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231. *See, e.g.*, *Hunter*, 121 B.R. at 616; *In re* Hughes, 95 B.R. 20, 22 (Bankr. E.D.N.Y. 1989).

232. *See, e.g.*, *Hunter*, 121 B.R. at 612; *Hughes*, 95 B.R. at 22-23.

233. Secured creditors in these cases have often sought a lift of the stay under § 362(d)(1) on the basis either that cause existed or that the creditor would lack adequate protection if the debtor failed to redeem or reaffirm. Courts have generally held that a debtor's continued payments on an installment contract adequately protect a creditor during the pendency of the automatic stay. *See, e.g.*, Riggs Nat'l Bank of Washington, D.C. v. Perry (*In re* Perry), 729 F.2d 982, 984-85 (4th Cir. 1984); Wilson v. Colonial Am. Nat'l Bank (*In re* Wilson), 97 B.R. 285 (Bankr. W.D. Va. 1989). Perhaps more creditors should attempt to get a lift of the stay under § 362(d)(2). As long as the creditor is undersecured, § 362(d)(2)(A) will be met, since the debtor by definition will have no equity in the property. Furthermore, if the debtor has filed a Chapter 7 case, then § 362(d)(2)(B) necessarily will be met since the property will not be necessary for an effective reorganization. This approach was used successfully by the secured creditor in Gaglia v. First Federal Savings & Loan (*In re* Gaglia), 76 B.R. 82 (Bankr. W.D. Pa. 1987).

234. The debtor may, however, attach greater value to the car than would the market. *See supra* note 124.

235. As the court in *Edwards* points out, "the alternative of reaffirmation is not necessarily onerous." *Edwards*, 901 F.2d at 1386 n.9. The *Edwards* court notes that even if the creditor refuses to negotiate a reaffirmation, a lump-sum redemption need not be the debtor's only other option, because "there is always the possibility of refinancing with a different lender." *Id.* Furthermore, other courts have noted that many debtors also have the option of filing a Chapter 13 bankruptcy, which would enable them to keep their collateral and pay only the value of the creditor's secured claim in installments through the Chapter 13 plan. *See, e.g.*, *In re* Whatley, 16 B.R. 394, 397 (Bankr. N.D. Ohio 1982). To be eligible to file a Chapter 13 bankruptcy, an individual must have a regular income, unsecured debts of less than $100,000, and secured debts of less than $350,000. 11 U.S.C. § 109(e).

236. *See, e.g.*, Century Bank at Broadway v. Peacock (*In re* Peacock), 87 B.R. 657, 659 (Bankr. D. Colo. 1988) (relying on the existence of an ipso facto clause to deny relief to a secured creditor); Brock v. American Sec. Bank (*In re* Brock), 23 B.R. 998, 1003-04 (Bankr. D.D.C. 1982) (deeming ipso facto clauses contrary to bankruptcy's fresh start policy).

that these clauses must be invalid because the Code generally eschews "ipso facto" clauses—clauses whose operation is triggered by the filing of bankruptcy.[237] Thus, the courts conclude, once the ipso facto clause is stricken, there is no default.[238] With no default, there is no acceleration of the remaining balance, and the bank is effectively left with no claim cognizable in bankruptcy.[239]

This reliance on the invalidity of ipso facto clauses is flawed on two fronts. First, the banks in these cases do not need ipso facto clauses in order to cause the debtor's claim to accelerate upon the bankruptcy filing. The Code itself causes that result.[240] One of the key purposes of bankruptcy is to dispose of all claims against the debtor, whether matured or not, in a single forum at a distinct point in time. Accordingly, through both its broad definition of "claim"[241] and through specific legislative history in the section on allowance of claims,[242] the Code mandates that all unmatured claims are immediately due when a debtor files bankruptcy.[243]

Second, the two sections of the Code that invalidate ipso facto clauses do so for reasons that do not apply to installment loans. Section 365 will not allow an ipso facto clause to avoid the assumption of a contract by the estate,[244] and Section 541 will not allow an ipso facto clause to prevent a debtor's property from coming into the estate.[245] These clauses are not honored in bankruptcy because the debtor lacks

237. *See, e.g., In re* Winters, 69 B.R. 145, 147 (Bankr. D. Or. 1986) (finding an ipso facto clause unenforceable).

238. *See, e.g., West*, 882 F.2d at 1546.

239. *See, e.g., Ballance*, 33 B.R. at 91. Although virtually none of these courts discuss the claim question directly, courts that allow continued installment payments would never permit the installment creditor to participate in any distribution that may occur. If the installment creditor received a distribution on its claim and then continued to receive all of its remaining installment payments following discharge, it would in effect be paid twice.

240. *See infra* notes 241-43 and accompanying text.

241. In § 101(4), the definition of "claim" includes a right to payment, "whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(4)(A) (1988).

242. The legislative history of § 502 specifies that § 502(b) contains the principle that "bankruptcy operates as the acceleration of the principal amount of all claims against the debtor." HOUSE COMM. ON THE JUDICIARY, BANKRUPTCY LAW REVISION, H.R. REP. No. 595, 95th Cong., 1st Sess. 353 (1977).

243. Section 502(b)(1) itself reinforces the notion that unmatured claims are allowable in bankruptcy. 11 U.S.C. § 502(b)(1) (providing that the court shall allow claims except when a claim is unenforceable "for a reason other than because such claim is contingent or unmatured").

244. *Id.* § 365(e)(1)(A) (providing that executory contracts may not be terminated in bankruptcy solely because of a provision that is conditioned on "the insolvency or financial condition of the debtor").

245. *Id.* § 541(c)(1)(B) (providing that an interest of debtor in property becomes property of the estate notwithstanding any provision "that is conditioned on the insolvency or financial condition of the debtor").

the proper incentives to avoid inclusion of the clauses in prepetition contracts.[246]

Suppose, for example, that a corporate debtor who is not in bankruptcy is negotiating a contract with another party. Imagine that the other party wishes to include a clause that would cause the contract to be cancelled immediately if the debtor files bankruptcy. The debtor has little reason to object to such a clause since the resulting costs ultimately would be felt not by the debtor, but by the debtor's unsecured creditors. When a debtor files bankruptcy, the claimants at the margin will typically be the unsecured creditors of the debtor. Thus, if the contract has value to the estate, its loss will be felt most directly not by the shareholders or managers of the debtor, but by the parties whose claims are then at the margin—the debtor's unsecured creditors.[247]

This danger is not present when the ipso facto clause purports to make bankruptcy a default that will accelerate the outstanding principal balance of the loan. These clauses are common in the consumer installment cases. At worst, the ipso facto clauses in these cases are merely superfluous because the Code itself accelerates all outstanding claims against the debtor.[248]

The truly astounding aspect of the consumer installment cases is that the creditor is left with no claim in the bankruptcy, but nevertheless suffers a discharge of the unsecured portion of the debtor's obligation to it. Basic fairness as well as the Code itself dictate that a creditor who incurs the cost of discharge should, at a minimum, be entitled to participate in whatever distribution the debtor's estate affords.[249] Yet some courts allowing offensive uses of the stay in consumer installment cases would give the bank the worst of all worlds: the court would refuse to lift the stay to allow a foreclosure, discharge the unsecured portion of the bank's debt, and then refuse to allow the bank to participate

246. Nimmer, *supra* note 59, at 540-41.

247. *Id.*

248. *See supra* notes 241-43 and accompanying text.

249. *See* 11 U.S.C. § 727(b) (providing that a discharge in Chapter 7 discharges the debtor from all prepetition debts and any liability on a claim under § 502); *id.* § 726(a)(2) (providing for the distribution of property of the estate in payment of any allowed unsecured claim following payment of § 507 priority claims). The reality in most of these consumer installment cases is that the unsecured crediters will receive nothing. *See* Rendleman, *supra* note 28, at 724 (noting that "few consumer bankrupts own enough assets to administer"); *see also* Charles S. Hallinan, *The "Fresh Start" Policy in Consumer Bankruptcy: A Historical Inventory and an Interpretive Theory*, 21 U. RICH. L. REV. 49, 50 n.2 (1986) (observing that prior to enactment of the Code, 85% of all "straight" bankruptcy filings by individuals were no-asset cases, and experience under the Code "suggest[s] that the situation has not materially improved"). Nevertheless, the notion that a creditor of the debtor is not a claimant and yet should have her unsecured liability discharged is fundamentally inconsistent.

in the case as a claimant.[250]

IV. The Costs of Offensive Stay Use

A. Corporate Cases

There is an inherent tension in the role of corporate bankruptcy. As one commentator points out, bankruptcy should not be a place where companies can painlessly void commercial contracts.[251] Alternatively, an overly strict adherence to the debtor's state-law obligations may "cripple bankruptcy's legitimate functions."[252]

Corporate bankruptcy's legitimate functions include the equal treatment of equally situated creditors and the preservation of existing going-concern values.[253] When courts allow debtors to use the stay offensively, they unwittingly do violence to both of these fundamental principles of bankruptcy.

As mentioned earlier, many courts use the phrase "equality of treatment" without the key qualification: "equal treatment of *equally situated* creditors."[254] As the Supreme Court has recognized on more than one occasion, property rights in bankruptcy are defined by reference to state law.[255] Thus, an unsecured creditor with leverage effective under state law is clearly in a different position than a creditor who lacks such leverage.

This notion of leverage recognition in bankruptcy pervades such

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250. These decisions also create perverse incentives for debtors to maintain the collateral adequately. If a creditor's only recourse following discharge is to await default and then foreclose on the collateral, the debtor will not suffer fully the effects of the collateral's depreciation. *See In re* Whittaker, 85 B.R. 788, 793 (Bankr. E.D. Tenn. 1988) (noting these incentive problems and stating that it would be "wholly inequitable" to permit debtors to retain the collateral by continuing their payments without personal liability).

251. Westbrook, *supra* note 53, at 229.

252. *Id.*

253. *See, e.g.*, House Comm. on the Judiciary, Bankruptcy Law Revision, H.R. Rep. No. 595, 95th Cong., 1st Sess. 220 (1977) (stating that the premise of business reorganization is that a company's assets are worth more in a going concern than they are if sold for scrap); *see also* NLRB v. Martin Arsham Sewing Co., 873 F.2d 884, 887 (6th Cir. 1989) (asserting that the theme of bankruptcy is equality of distribution).

254. *See* Simonson v. Granquist, 369 U.S. 38, 42-43 (1962) (noting Congress's policy in the Bankruptcy Act of "equitable distribution of assets among creditors" and citing lien holders as an exception thereto); Union Pac. R.R. Co. v. Moritz (*In re* Iowa R.R. Co.), 840 F.2d 535, 538 (7th Cir. 1988) (citing the doctrine of "equal treatment of all creditors under Title 11" (citations omitted)); *see also* Citicorp Acceptance Co. v. Robinson (*In re* Sweetwater), 884 F.2d 1323, 1328 (10th Cir. 1989) (noting the "basic bankruptcy purpose of treating all similarly situated creditors alike").

255. *See, e.g.*, Ohio v. Kovacs, 469 U.S. 274, 285-86 (1985) (O'Connor, J., concurring) (stating that absent federal policy to the contrary, property rights in bankruptcy are defined by state law) (*citing* Butner v. United States, 440 U.S. 48, 54 (1979)).

Code concepts as executory contract assumption,[256] reaffirmation,[257] and set-off.[258] The benefit/burden linkage is also inherent in such well-established bankruptcy case law doctrines as lien pass-through,[259] the general validity of nonbankruptcy transfer restrictions,[260] cross-collateralization,[261] and the doctrine of necessity.[262] In almost every offensive stay case, the court violates the equality of treatment principle by attempting to put the creditor with leverage on a par with a creditor who lacks such an advantageous position.[263]

Bankruptcy's unique contribution to the goal of preserving a corporation's going-concern value is that it halts the potentially destructive race among creditors to liquidate a debtor in piecemeal fashion.[264] The automatic stay is the procedural device that accomplishes this end.[265] When the debtor can use the stay as a weapon to insist on future benefits from certain creditors without honoring prepetition burdens, the effects of the stay dramatically change.

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256. *See* 11 U.S.C. § 365(b)(1) (1988); *see also supra* text accompanying note 38 (discussing § 365).

257. *See* 11 U.S.C. § 524(c); *see also supra* notes 39-41 and accompanying text (discussing § 524).

258. *See* 11 U.S.C. § 553; *see also supra* text accompanying note 42.

259. *See, e.g.*, Long v. Bullard, 117 U.S. 617 (1886) (allowing secured creditors whose claims are not satisfied in full to pursue collateral in hands of the debtor following bankruptcy, notwithstanding discharge). This doctrine has arguably been codified by 11 U.S.C. § 524(a)(2), which says that a discharge enjoins any creditor's actions to recover on such debts with respect to the "personal liability of the debtor." *See* H.R. REP. No. 595, at 361 (stating that "[t]he bankruptcy discharge will not prevent enforcement of valid liens"); *see also supra* text accompanying notes 43-45 (discussing § 522).

260. *See, e.g.*, California v. Farmers Markets, Inc. (*In re* Farmers Markets, Inc.), 792 F.2d 1400 (9th Cir. 1986); *see also supra* note 46 and accompanying text.

261. *See, e.g.*, *In re* Ames Dep't Stores, Inc., 115 B.R. 34, 39 (Bankr. S.D.N.Y. 1990); *see also supra* text accompanying note 47.

262. *See, e.g.*, United States v. Midwest Serv. and Supply Co. (*In re* Midwest Serv. and Supply Co.), 44 B.R. 262, 265-66 (D. Utah 1983); *see also supra* text accompanying note 48.

263. There is one species of state law leverage that bankruptcy law correctly ignores: the leverage obtained by creditors who have attempted to opt out of bankruptcy's collective proceeding at the last minute. This is the underlying rationale behind bankruptcy's preference provisions, which strip away state law leverage that creditors have obtained in the 90 days prior to bankruptcy or, in the case of insiders, within one year prior to the filing. *See* 11 U.S.C. § 547 (discussing preferences); *see also* JACKSON, *supra* note 61, at 125 (explaining that preference law "is essentially a transitional rule designed to prevent individual creditors from opting out of the collective proceeding once that event becomes likely").

264. *See* BAIRD & JACKSON, *supra* note 56, at 39-42; *see also* Tringali v. Hathaway Machinery Co., 796 F.2d 553, 562 (1st Cir. 1986) (pointing out that the stay enables creditors to replace the race and other systems of debt collection with a more orderly distribution of assets).

265. *See* Kennedy, *supra* note 25 at 61-62 (asserting that the stay is necessary to prevent creditors from improving their positions by resorting to means not under control of bankruptcy court); *see also* Murray Tabb, *Competing Policies in Bankruptcy: The Governmental Exception to the Automatic Stay*, 21 TULSA L.J. 183, 184 (1985) (suggesting that the purposes of the stay are to give the debtor a respite and to prevent creditors from having to engage in a race to the debtor's assets).

The stay becomes a device by which the debtor, as well as creditors who lack leverage, may strip away the leverage held by other creditors. Bankruptcy becomes a means by which the relative positions among parties are transformed rather than a costly last resort to avoid the effects of a possible state law race to the debtor's assets.[266] Once courts allow the stay to be used offensively, forum-shopping will inevitably result.

Imagine, for example, a furniture business that is struggling financially, but is nevertheless worth more as a going concern than it would be if it were liquidated in piecemeal fashion.[267] Suppose further that a particular supplier of the furniture store offers the debtor a type of furniture that the debtor both needs and cannot readily obtain elsewhere. The supplier delivers a large shipment of furniture to the debtor on credit. The debtor has not yet paid the supplier for the shipment, and the debtor sells the furniture and uses the cash for other operating expenses.

The debtor then wants additional furniture from the supplier. Moreover, the debtor is willing to pay cash in advance. The supplier refuses to sell any more furniture, even on a cash basis, until the debtor pays for the most recent shipment on credit. The debtor would probably take the deal on the supplier's terms, because its managers believe that this supplier's furniture is crucial to the continued operation of the business.

Suppose that there are a half-dozen other unsecured creditors of the debtor who lack the leverage enjoyed by this particular supplier. These other creditors are irked that the furniture store is planning to extinguish its debt to the supplier, but not its debt to them. In a world in which courts allow offensive use of the automatic stay, these other creditors will have a perverse incentive to see the furniture store in bankruptcy, even when the store's going-concern value could be less expensively preserved outside of bankruptcy.[268]

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266. *See* Theodore Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. REV. 953, 957-58 (noting that whenever bankruptcy changes the relative nonbankruptcy entitlements among unsecured creditors, secured creditors and the debtor, "a new and costly level of planning becomes inevitable"). In addition to the stratcgic costs incurred as a result of such a change in relative entitlements, the bankruptcy process itself is anything but inexpensive for the creditor group. The administrative costs of a typical Chapter 11 reorganization in which a creditors' committee is appointed have been estimated at $100,000. Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 135 n.13 (1986).

267. It may often be the case that an insolvent company is worth more as a going concern than if it is liquidatcd piecemeal. A simple example is the case of Johns-Manville, which had a significant going-concern surplus even though it would have been unable to pay in full all of the asbestos-related tort claims against it. *See In re* Johns-Manville Corp., 36 B.R. 727 (Bankr. S.D.N.Y. 1984).

268. *See* BAIRD & JACKSON, *supra* note 56, at 41 (noting that often corporations are more

The basis of the other creditors' perverse incentive is that if the debtor is in bankruptcy, the supplier's state law leverage will be stripped away by the debtor's offensive use of the automatic stay. Thus, bankruptcy will enable the other creditors to improve their positions relative to the supplier with leverage. When bankruptcy becomes a place where the relative rights of parties are altered vis-à-vis state law, those whose rights will improve in bankruptcy will tend to shop for the bankruptcy forum whether or not bankruptcy is in the best interests of creditors as a group. It is this sort of forum-shopping problem that the Supreme Court decried when it held in *Butner v. United States* that, absent some specific federal policy to the contrary, property rights in bankruptcy ought to be defined by state law.[269]

B. Individual Cases

The function of bankruptcy for individual debtors must also strike a balance between competing concerns. To say that the goal of personal bankruptcy is to give the debtor a "fresh start" does not adequately define the precise effects of discharge on an individual.

On the one hand, most commentators would agree that discharge should not be completely costless to debtors.[270] If it were, there would be a tremendous disincentive for individuals to honor contractual obligations.[271] Furthermore, in a world in which discharge held no collateral consequences for debtors, the market for credit would be severely limited.[272]

On the other hand, if an individual's discharge could be achieved only at the cost of complete satisfaction of all claims, many debt-laden individuals would lack the incentive to become productive members of society. A debtor's desire to work and earn an income would be significantly reduced if a large portion of her effort would benefit her credi-

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cheaply reorganized outside of a compulsory workout process such as bankruptcy).

The ability of creditors to force an involuntary bankruptcy is governed by § 303. If a debtor has fewer than 12 creditors, it takes one or more creditors holding in the aggregato at least $5000 in noncontingent, undisputcd, unsecured claims to force the debtor into bankruptcy. For a debtor with 12 or more creditors, an involuntary bankruptcy petition requires three or more creditors holding a total of at least $5000 in unsecured claims that are neither contingent nor disputed. 11 U.S.C. § 303(b).

269. 440 U.S. 48, 55 (1979) (asserting that an important reason for the uniform treatment of property interests inside and outside of bankruptcy is to discourage forum shopping).

270. *See, e.g.*, Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1427 (1985) (asserting "[t]hat the exercise of the right of discharge should come at *some* cost, however, is not—or at least should not be—an open question" (emphasis in original)).

271. *See* Eisenberg, *supra* note 266, at 976-77 (explaining that allowing a bankruptcy discharge "merely upon request" would create "obvious disincentives to perform contracts").

272. *See* Jackson, *supra* note 270, at 1427 (stating that "[b]ecause of the nature of credit, free access to discharge would be disastrous for a credit-based economy").

tors rather than herself.[273]

The Code strikes a balance between these competing objectives by allowing the debtor a discharge, but not without a cost. One cost of discharge is that the debtor must submit all of his nonexempt property to the court for distribution.[274] Furthermore, the Code's reaffirmation provisions require a debtor wishing to receive specific future benefits from a creditor to waive the potential discharge with respect to that creditor.[275]

The perverse incentives that the bankruptcy discharge offers debtors will be exacerbated to the extent that offensive uses of the stay reduce the collateral consequences to the debtor of filing bankruptcy. Many debtors file bankruptcy for reasons beyond their control.[276] But some consumer filings result from circumstances that the debtor could have avoided.[277]

If the bankruptcy discharge is a form of insurance for the individual debtor's financial disasters, then attaching some collateral consequences to the discharge will make it less likely to occur. The notion of discharge as insurance highlights the reality that discharge presents a moral hazard for debtors.[278]

In the insurance field, insurers use a copayment mechanism to re-

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273. *See* Rendleman, *supra* note 28, at 726 (noting that when a debtor is doomed to spend his life working for his creditors, his motive to work may be destroyed); Local Loan Co. v. Hunt, 292 U.S. 234, 245 (1934) (observing that "[f]rom the viewpoint of tbe wage-earner there is little difference between not earning at all and earning wholly for a creditor"); *see also* Steven L. Harris, *A Reply to Theodore Eisenberg's* Bankruptcy Law in Perspective, 30 UCLA L. REV. 327, 341 (1982) (suggesting that fresh start promotes the debtor's rehabilitation by giving him sufficient freedom from the demands of his creditors and sufficient assets to enable him to become an economically productive member of society).

274. *See* Jackson, *supra* note 270, at 1426-27. The reality, of course, is that this cost is negligible for most individual debtors who file bankruptcy. *See supra* note 249. Dean Jackson identifies as an additional cost of the bankruptcy discharge a consequence that is not specified in the Code: the individual "puts others on notice that he migbt resort to [bankruptcy] again," tbus "decreas[ing] his access to credit in the future." Jackson, *supra* note 270, at 1427.

275. 11 U.S.C. § 524(c) (1988).

276. *See* Rendleman, *supra* noto 28, at 766 (contending that increasing liberalization of bankruptcy law suggests that society "assumed tbat poor debtors were not responsible for their troubles").

277. *See* Eisenberg, *supra* note 266, at 980 (suggesting that some individual bankruptcies are "negligent"); William H. Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, LAW & CONTEMP. PROBS., Autumn 1977, at 13, 16 (asserting that the more costly default is to the debtor, the less likely that the debtor will default); *cf.* Hallinan, *supra* note 249, at 89 (noting that the increased number of consumer filings following the enactment of the Code prompted some to wonder whether the Code had caused some individuals who did not "need" bankruptcy to file nevertbeless to obtain its protection).

278. *See* Jackson, *supra* note 270, at 1428 n.114. Insurance generally creates a moral hazard for the insured party because those who are insured against certain risks have an incentive to use less than optinal care to avoid those risks. *See* CAROL A. HEIMER, REACTIVE RISK AND RATIONAL ACTION 28-32 (1985).

duce the moral hazard problem even when the insured's control over the insurable event is arguably minimal.[279] Prohibiting an individual debtor from using the stay offensively is akin to forcing the debtor to make copayments for his discharge insurance. The result is that the debtor has additional incentive to avoid filing bankruptcy, to the extent that the event is within the debtor's control.

One commentator has suggested that a way to limit "negligent bankruptcies" by consumers is to insist that, as a condition of discharge, the debtor contribute some portion of future earnings to the payment of prepetition claims.[280] That proposal has been criticized on the ground that Congress gave debtors the right to choose whether and to what extent they will surrender postpetition earnings to prepetition creditors.[281] On the other hand, a simple refusal to allow offensive uses of the stay will provide many of the advantages of both positions.

Because it forces debtors to assume prepetition burdens in order to receive postpetition benefits, the debtor's discharge has collateral consequences. Those consequences will serve as a check on the debtor's moral hazard and will help to avoid bankruptcies that the debtor is able to prevent. At the same time, the debtor alone will decide which prepetition burdens are worth assuming and what portion of future income to allocate to prepetition claims.

There is an additional benefit to be gained from the collateral consequences that attach to a debtor's discharge when offensive uses of the stay are prohibited. The beneficiaries of the increased cost of the debtor's discharge will be more willing to extend credit to those financially struggling individuals who need it the most. This will not result from an altruistic desire on the part of goods and service providers to give a break to a financially struggling customer. Rather, to the extent that a prospective customer's future discharge becomes less costly to a merchant creditor, the merchant's ultimate prospects of making a net

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279. As Heimer notes, depending on the particular risk the insurance covers, the policyholder can exercise anything between no control and complete control over losses. HEIMER, *supra* note 278, at 9. Even when the insured has little control over the insured risk—storm-weather damage, for example—the insured may be responsible for a deductible and copayments. This makes sense, however, because the amount of damage incurred by a homeowner, even in a storm, may be a function of precautions that the homeowner takes.

280. Eisenberg, *supra* note 266, at 980 (suggesting that linking discharge to some effort to repay out of future earnings would help create a self-regulating mechanism by which debtors would avoid negligent bankruptcies).

281. *See* Harris, *supra* note 273, at 350-51; *cf.* Douglas G. Boshkoff, *Limited, Conditional, and Suspended Discharges in Anglo-American Bankruptcy Proceedings*, 131 U. PA. L. REV. 69, 118 (1982) (noting problems that arise when courts condition discharge on something other than a fixed level of payment by the debtor: the judge "inevitably . . . become[s] an arbiter of the debtor's lifestyle").

profit on such a marginal customer will necessarily increase.[282]

V. Conclusion

The automatic and postdiscbarge stays are fundamental bankruptcy devices used both to give corporate debtors the chance to preserve going-concern values and to afford individual debtors the opportunity for a financial fresh start. The historical development of the two stays implies, however, that Congress never intended them to enable the debtor to insist on future benefits from nondebtor parties without assuming corresponding burdens to that same party.

Such offensive uses of the stay are contrary to the corporate bankruptcy goals of value preservation and equality of treatment among creditors. Furthermore, in individual cases, the reduction in collateral consequences of bankruptcy that result from offensive uses of the stay exacerbates the moral hazard that the discharge necessarily creates for individual debtors. Such costs in both corporate and individual bankruptcies can be avoided if courts truly adhere to the maxim that the stay ought to be used as a shield and not as a sword.

282. *See* Meckling, *supra* note 277, at 16 ("The borrower knows that the more confident the lender is that he will be repaid, the more willing be will be to extend a loan, and the lower the interest rate will be."); *id.* at 21 (stating that if bankruptcy law increases lending costs, tbose costs will in tbe long run be passed on to the borrower).