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CHANGES IN ATTITUDES, CHANGES IN PLATITUDES: A SHORT EXAMINATION OF NON−UNIFORM APPROACHES TO BUSINESS INSOLVENCY

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Imagine a world in which a government bureaucracy monitors businesses for financial miscues, and stands ready to take over and sell the business if insolvency is even plausible. Imagine further that all entities engaged in the business sector cooperate and get advance notice of the sale—even before the entity that is about to be closed finds out it will be closed.

We have it.

Now imagine a world in which private lenders monitor businesses for financial miscues, and stand ready to take over and sell a business if insolvency or default is possible. Imagine further that key supplies to the business stand ready to assist this takeover, and that entities engaged in this business sector cooperate with the lender and the third party to effectuate smooth sales and ensure continuity of business.

We have that, too.

Finally, imagine a world in which companies such as Federal Express or United Parcel Service are the major financiers of industry, and in which manufacturer's receivables are bought and sold on securities exchanges. Imagine further a world in which these shippers also monitor manufacturers' and retailers' sales performance, and cut off non−performing players before bankruptcy is even an option.

That's coming.

In this article, I want to examine each of the three worlds above. They are, respectively, the worlds of American banking, fast−food franchising and the newly−emerging field of logistics. Along the way, I want to examine their different (and almost diffident) approaches to bankruptcy as contemplated by title 11 of the United States Code. I then want to see if these approaches have any impact on viewing bankruptcy as a national solution to financial insolvency.[1] In my conclusion, I offer some thoughts about the implications of this recharacterization for bankruptcy reform.

I. DIFFERENCES IN ATTITUDES: THE THREE MODELS

It is not uncommon to view bankruptcy as mandatory.[2] Many have objected to non−waivable restrictions because private parties involved may develop more efficient plans than those presented by statute.[3] In many respects, this view of a mandatory system is not inaccurate; some courts have indicated that waivers of ability to file bankruptcy are unenforceable.[4] Bankruptcy, however, traditionally has looked at substance over form.[5] Therefore, my examination is of substantive changes from the bankruptcy baseline as a result of practices that exist, and in many cases, may come to be.

A. The Government Regulation Model

We all know that banks, as well as many other financial institutions, are exempt from the provisions of title 11.[6] But what happens if they experience financial trouble, as did the savings and loan industry in the late 1980s?[7] The basic response is that government takes over the financial institution, and has broad powers to sell or liquidate.[8]

Not only does it have the power to sell, it has the power to sell without notice.[9] The Supreme Court has accepted that a "John Doe" lawsuit may be filed against the bank to be closed, hearings may be conducted, and a receiver may be appointed, all before notice is given to the bank's management .[10]

The reason for this broad power is that banking is so critical to the economy and requires suspension of the normal rules of notice and a hearing before seizure.[11] In addition, the rules regarding suspension and closure are well known, and even customary, and thus the minimal hearings given (after the closure) are sufficient to meet any expectations of due process.[12]

The same process more or less applies as well to insurance companies,[13] and securities brokers.[14] However, state regulation of insurance companies has not proceeded with the efficiency shown by federal regulators.[15] Hampered by the Contract Clause,[16] insurance company regulation fails to achieve the national uniformity brought about by the Bankruptcy Code.

B. The Fast Food Franchise Shuffle

The key in governmentally−supervised financial restructuring, however, is fast action once the problem is identified. Can that action proceed without government intervention under private contract law? The initial answer may be no, but in certain industries the alchemy brought about by the combination of non−bankruptcy liens and trademark law may achieve the same substantive result.

One sees this combination in national franchise operations, such as Pizza Hut, Kentucky Fried Chicken and other similar chains. These national franchisors are in competition with other franchisors. [17] Keeping a constant and distinctive presence in a market is critical to long−term profitability.[18] The long−term damage done by a franchisee who does not adhere to the national standards is thought to severely and adversely affect the chain's reputation and profits.[19]

So what to do when a franchisee has financial difficulties? Throw them out. How is this done? By revoking the license to use the trademark that is critical to the franchise, and then threatening to enjoin non−conforming use of items containing the trademark.[20] In short, there are many reasons why the napkins and swizzle sticks at McDonald's contain the representations of its trademarked arches: continued use after revocation of the trademark license would constitute trademark infringement, and trademark infringement is remedied by something other than monetary damages. [21]

What about the need for continuous presence? This is where banks and financial companies use their negotiating skill. When a bank lends to a fast food franchise, it will (unless the franchisee has significant financial clout) take a security interest in most everything the franchisee has. However, this typically does not include a security interest in what makes the franchise run–the license to use the franchisor's trademark. Instead, the practice in the fast food industry is for the lender to enter into an agreement with the franchisor under which the franchisor will agree to take over operations from the franchisee if the franchisee is in default to the lender.[22] This implies that the lender will monitor the franchisee closely, since most of any recovery will have to come from operations occurring when the franchisee is in possession.

Regardless of the exact structure, however, the private sector here has replicated the substantive outcome in the bank regulatory scheme. The financial operations of a debtor are closely monitored, and when they do not adhere to a narrow tolerance, the debtor is dispossessed and the lender assumes full control. [23]

C. The Coming Change in Logistics—Supply Chain Financing

The fast food franchise scheme outlined above rests on the use of injunctions available under federal trademark law. [24] In the regular scheme of things, injunctions are not generally available, rather damages (and long trials to determine their amount) are the rule. [25] A simplistic analysis might thus conclude that such summary actions to dispossess the debtor are not generally possible.

Changes in the field of logistics cast doubt on this conclusion. Logistics concerns the movement of goods from place to place, such as inventory from supplier to manufacturer or manufacturer to retailer. Managing logistics operations, such as many freight companies or couriers do every day, has become increasingly sophisticated in recent years. Managerial techniques such as "just in time" inventory control have spurned the development of an increased use of computerized tracking, and other technical innovations.[26]

What do these developments have to do with bankruptcy? Potentially a great deal. Several investment banks are suggesting to their clients a concept called "Supply Chain Financing," which introduces some potentially revolutionary techniques to the field of inventory financing. [27]

To illustrate this, let me construct a simplified model of current inventory financing. Imagine a parts supplier, a manufacturer, and a retailer. Under current practices, the parts supplier finances its inventory with its own bank. It uses logistics shippers to transport the goods to a manufacturer. The supplier's bank (or at least another lender with a relationship with the supplier) also typically finances the receivable created when the sale is made to the manufacturer.

Similar arrangements are made at the manufacturer upon receipt and assembly of the parts (which then become its inventory), and at the retailer upon sale and shipment of the finished goods. [28] In all, there are three sets of financiers in this model, one each for the supplier, the manufacturer and the retailer. [29]

Supply chain financing eliminates this model. The key concept is that the logistics industry knows where everything is, all the time, because they either put it there, or picked it up. Thus, they can thus monitor the sales of all parts in the system with precision, or at least all sales by entities who use their services, or those they serve.

While knowledge is power, more is needed. At least in America, the system has as a necessary component in the extension of unsecured credit. Can logistics companies supply this credit? With the rise in the securitization market for receivables, logistics companies (when allied with financial intermediaries such as investment banks) can supply this financing.

In supply chain financing, the logistics company not only "picks up" the part to be shipped, it "buys" it from the supplier. When it delivers the part to the manufacturer, it is more than a delivery, it is a "sale." The logistics company obtains financing to do this by aggregating all the receivables from the manufacturers it "sells" to, repackaging them, and then selling undivided interests in them to the public; in short, it securitizes them. [30] By focusing on one industry sector (e.g., computer manufacturers), the logistics company can obtain relevant credit ratings for its receivable securities. If it desires, the logistics company can also finance the other side; that is, it will then "buy" the finished product, and "sell" it to a retailer. It then creates a second pool of undivided interests in the receivables owed it by retailers, again appropriately priced, and lays off that payment risk on the broader market. [31]

Along the way, however, it also collects, and through the use of computers, manages impressive amounts of information about which suppliers are providing timely deliveries, and which retailers have the quickest sales turnaround. [32] Why? Because the representatives of the logistics companies are providing most, if not all, of the businesses' basic shipping and delivery needs, and keeping track of them. [33] They will know, for example, from their delivery records which retailer sells products the fastest, and with just a little change in questions asked, which manufacturer produces the most error−free products, and so on.

What can it do with this information? For one, it can prevent the build up of unsecured credit by under−performing players. By simply refusing to buy or sell from such companies, they can effectively put them out of business. [34] And since they control the inventory flow and sales of such companies, being cut off from this source effectively puts them out of business–with little or no assets. Their inventory is subject to a lien in favor of the logistics company, and their debts are owed to a conglomerate pool.

The result could be the asset−less manufacturer, who only "orders" (that is, "buys" from the logistics company) such inventory as it needs to meet current demand. Thus, at any one time, the only goods that the manufacturer will "own" will be designated for a product already ordered. It is conceivable to run a manufacturing concern from the space it takes to house a computer, and to assemble the product as it is delivered (and even this function may be leased or "outsourced"). Warehousing of inventory and completed goods will be squeezed from the system, or its cost borne by logistics companies (and their investment banks). [35]

The result is not unlike the fast food consequence. Players in the chain who are sub−par performers are discovered early, and their credit is immediately cut off. Since there is a concentration of credit in the logistics company, there is relatively little unsecured debt (perhaps utilities, wages, etc.). Moreover, since the logistics company bought the receivables and has a lien on the inventory, there are not many assets available for those creditors. [36] The end result may be why there are not many restaurant or supermarket bankruptcies; economic forces simply don't let the debtors accumulate enough assets or debt for their to be any significant fight.

II. CHANGES IN PLATITUDES: A LINK BETWEEN NON−BANKRUPTCY LAW, ADROIT LAWYERING AND BANKRUPTCY

If supply chain financing, or something like it, is the future, what implications does this have for bankruptcy? One result might be the reduction of bankruptcies related to manufacturers or retailers, since they will not have any real assets to reorganize around. The focus will be on the logistics companies, but so long as the public markets continue to show an appetite for receivables, they will have funding at relatively low rates.

This trend will shift the focus away from bankruptcy as the primary, if not sole, vehicle for the relief of financial distress. There may simply no longer be any financial incentive to play the bankruptcy game. With traditional creditors gone or severely reduced in importance, there may be a resurgence in the interests in non−traditional creditors, such as employees, tort claimants, and tax authorities.

If these non−traditional creditors become the primary creditors in a bankruptcy, we may then need to revisit many of the basic assumptions in bankruptcy. Priorities for wages and taxes may mean little if there are no assets from which they are to be paid. More importantly, for those who view chapter 11 bankruptcy as a cauldron for the negotiation of a business' problems, a shift to supply chain financing may deprive the process of its traditional players, with unknown results. Alternate forms of compensation will have to be found. [37] There may be a resurgence in successor liability claims, as a potential way to pay creditors short of taxing non−participants. In short, supply chain financing has the potential to hasten the death of liability as we know it. [38]

At a different level, a possible inference of these creative non−bankruptcy alternatives to insolvency may be that bankruptcy does not presently yield the certainty modern business needs to be competitive. Supply chain financing has the potential to eliminate many of the objections to chapter 11−−the delays, the cost, and the waste.

It also has the potential to eliminate the collective benefits of preserving jobs and communities, and of the public interest in how the consequences of failure are spread throughout society. [39] With a drift from bankruptcy as the one forum for dispute resolution, there may be a reduction of opportunities to address public interest concerns that are sometimes incidentally raised and decided in the modern chapter 11 case. This raises a point worth pondering (and a point worth ending on): what should society's attitude be toward private financial failure, and if the platitudes of current bankruptcy law do not provide any answers, should we reform the system, or let adroit lawyers create structures that make it essentially irrelevant? Discussion of that topic, however, is for another day.

FOOTNOTES:

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[1]I use the term insolvency to refer to all manner of financial distress. As a consequence, I include what is sometimes referred to as "equitable insolvency"—the inability to pay debts as they become due—as well as legal insolvency—the status of having more debts than assets. *See* U.C.C. § 1−201(23) (1977) (combining both senses of insolvency).Back To Text

[2]The recent National Bankruptcy Review Commission report noted that in many respects the efficacy of bankruptcy requires bankruptcy to be the required method of non−consensual insolvency regulation. *See* National Bankr. Rev. Comm'n, Bankruptcy: The Next Twenty Years, Final Report 478−87 (1997) [hereinafter Commission Report]; *see also* 124 Cong. Rec. 32, 401 (1978) (stating "[t]he explicit reference in title 11 forbidding the waiver of certain rights is not intended to imply that other rights, such as the right to file a voluntary bankruptcy case under section 301, may be waived"). Back To Text

[3]*See* Commission Report, *supra* note 2, at 486 (stating freedom of contract should permit parties "to specify their own remedies in advance rather than using remedies provided by statute"); *see also* Alan Schwartz, *Contracting Around Bankruptcy*, 13 J.L. Econ. & Org. 127 (1997); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 Tex. L. Rev. 51 (1992).Back To Text

[4]*See, e.g., In re* Weitzen, 3 F. Supp. 698, 698 (S.D.N.Y. 1933) (stating contract waiving benefit of bankruptcy is unenforceable); *see also In re* Madison, 184 B.R. 686, 690 (Bankr. E.D. Pa. 1995) (finding agreement not to file bankruptcy for set period of time violative of public policy and unenforceable); Fallick v. Kehr (*In re* Fallick), 369 F.2d 899, 904 (2d Cir. 1966) (finding advance agreement waiving benefits of former Bankruptcy Act void); *cf.* Federal Nat'l Bank v. Koppel, 148 N.E. 379, 380 (Mass. 1925) (distinguishing agreement to pay debt after discharge from agreement to pay in event of discharge).Back To Text

[5]*See, e.g.,* Consumer News and Bus. Channel Partnership v. Financial News Network Inc. (*In re* Financial News Network Inc.), 980 F.2d 165, 169 (2d Cir. 1992) (noting that "in bankruptcy proceedings substance should not give way to form").Go Back

[6]*See* 11 U.S.C. § 109(b)(2) (1994) (stating that banks and other financial institutions may not be debtors under chapter 7 of Bankruptcy Code); *id.* § 109(d) (conditioning eligibility to file under chapter 11 on eligibility to file under chapter 7).Back To Text

[7]*See, e.g.,* Transohio Sav. Bank v. Office of Thrift Supervision, 967 F.2d 598, 601−03 (D.C. Cir. 1992) (providing detailed account of savings and loan industry crisis of 1980).Back To Text

[8]*See* 12 U.S.C. § 192 (1994) (giving comptroller of currency power to control banking association in default).Back To Text

[9]*See, e.g.,* FDIC v. Bank One, Waukesha, 881 F.2d 390, 394 (7th Cir. 1989) ("Often the first that depositors know of the failed bank's trouble is the announcement of the [purchase and assumption] and the erection of the new owner's sign over the door.").Back To Text

[10]*See, e.g.,* Fuentes v. Shevin, 407 U.S. 67, 92 n.26 (1972) (noting summary seizure of property is permitted "to protect against the economic disaster of a bank failure") (citing Fahey v. Mallonee, 332 U.S. 245 (1947)).Back To Text

[11]*See* Fahey v. Mallonee, 332 U.S. 245, 253−54 (recognizing that suspension of usual procedure is not unconstitutional given "history and customs of banking").Back To Text

[12]*See id.*Back To Text

[13]*See* 11 U.S.C. § 109(b)(2) (1994) (stating that domestic insurance companies may not be debtors under chapter 7 of Bankruptcy Code); *id.* § 109(d) (allowing only those eligible under chapter 7 to file under chapter 11) .Back To Text

[14]*See id.* § 109(d). For an early comment on this point, see Nicholas Wolfson & Egon Guttman, *The Net Capital Rules for Brokers and Dealers*, 24 Stan. L. Rev. 603, 603 (1972) (examining "purpose, scope and interpretation" of rules that govern brokerage industry).Back To Text

[15]In 1996, there were eight insurance company failures, rising to 23 in 1997. *See 23 Insurance Companies Failed in 1997, Up from Eight in 1996, Ratings Firm Says,* BNA Bankr. L. Daily, Jan. 20, 1998, at D2.Back To Text

[16]*See* U.S. Const., art. I, § 10. Because of this clause, state governments cannot alter the contractual rights of non−citizens, and arguably cannot alter rights under contracts governed by the law of another state. *See id.*Back To Text

[17]*See* Deutchland Enters. v. Burger King Corp., 957 F.2d 449, 450 (7th Cir. 1992) (involving franchisor's suit to terminate franchise agreement because franchisee was operating under other franchise agreement with competing franchisor); Burger King Corp. v. Pilgrim's Pride Corp., 705 F. Supp. 1522, 1523 (S.D. Fla. 1988) (involving defendant's use of Burger King's trademark as unfair competition and deliberate "copying" of Burger King's product); McDonald's Corp. v. Moore, 243 F. Supp. 255, 257−58 (S.D. Ala. 1965) (involving unfair competition in that Moore copied McDonald's operative manual and breached agreement not to begin construction or operation of additional outlets until suit was heard).Back To Text

[18]*Cf., e.g.,* Frisch's Restaurant, Inc. v. Shoney's Inc., 759 F.2d 1261, 1262−63 (6th Cir. 1985) (involving franchisee who owned exclusive trademark for twenty−five years suing for injunction). The protection of this presence in a market is demonstrated in the numerous attempts for injunctions. *See, e.g.,* McDonald's Corp. v. Druck & Gerner, DDS., P.C., 814 F. Supp. 1127, 1139 (N.D.N.Y. 1993) (involving McDonald's suit to enjoin defendant's use of "McDental" as business name); Burger King Corp. v. Hall, 770 F. Supp. 633, 634 (S.D. Fla. 1991) (involving franchisor's suit to enjoin former franchisee from continuing to use franchisor's trademark and to hold herself out as authorized franchisee); *see also* Dawn Donut Co. v. Hart's Food Stores, Inc., 267 F.2d 358, 366−367 (2d Cir. 1959) (noting franchisor must strictly control nature and quality of goods and services associated with mark or risk loosing mark by abandonment). Back To Text

[19]*See Dawn Donut,* 267 F.2d at 366−67 (2d Cir. 1959) (noting franchisor must strictly control nature and quality of goods and services associated with mark or risk loosing mark by abandonment). Back To Text

[20]Should the franchisee continue to operate under the trademarked name, or use products bearing the mark, after any legitimate termination of the franchisee's license, the franchisor may be able to obtain an injunction against further operation. *See, e.g.,* Burger King Corp. v. Mason, 710 F.2d 1480, 1492−93 (11th Cir. 1983) (finding franchisee had infringed on franchisor's trademark through continued use of mark after franchise agreement had been terminated and finding such use would result in confusion among consumers). *See also* 15 U.S.C. § 1114(a)(2)(A) (1994) (providing injunction for non−consensual use of registered work).Back To Text

[21]*See Mason,* 710 F.2d at 1492−93 (noting that injunction is remedy for trademark infringement).Back To Text

[22]*See* S & R Corp. v. Jiffy Lube Int'l, Inc., 968 F.2d 371, 375 (3d Cir. 1992) ("The franchisor has the power to terminate the relationship [with the franchisee] where the terms of the franchise agreement are violated.").
Back To Text

[23]*See generally* Robert E. Scott, *A Relational Theory of Secured Financing*, 86 Colum. L. Rev. 901, 946 (1986) (discussing monitoring in private sector); *cf.* Roslyn Tom, Note, *Interpreting the Meaning of Lender Management Participation Under Section 101(20)(A) of CERCLA*, 98 Yale L.J. 925, 931 (1989) (explaining need for monitoring banks in relation to CERCLA).Back To Text

[24]*See* David Gurnick, *Intellectual Property in Franchising: A Survey of Today's Domestic Issues*, 20 Okla. City U. L. Rev. 347, 356 (1995) (explaining injunctions are sought to stop continued use of trademark after agreement is terminated); *see also* Little Caesar Enters. v. R−J−L Foods, Inc. 796 F. Supp. 1026, 1036 (E.D. Mich. 1992) (granting franchisor's motion for preliminary injunction in franchisor's trademark infringement suit against recently terminated franchisees); Burger King Corp. v. Lee, 766 F. Supp. 1149, 1157−58 (S.D. Fla. 1991) (granting franchisor's motion for preliminary injunction prohibiting former franchisee from continued use of franchisor's trademark and service marks). *But see* Andre R. Jaglom, *The Broad Scope of Franchise Laws: Traps for the Distribution Contract Drafter*, C888 ALI− ABA 251, 259−61 (March 17, 1994) (noting terminating franchisee's right to use trademark under state laws is very difficult and often results in prolonged litigation and possible damages for wrongful termination).Back To Text

[25]*See* Restatement (Second) of Contracts § 359(1) (1981) (stating "an injunction will not be ordered if damages would be adequate to protect the expectation interest of the injured party").Back To Text

[26]*See generally* Jonathan B. Baker, *Fringe Firms and Incentives to Innovate*, 63 Antitrust L.J. 621, 630 (1995) ("Under this system, earlier work is not authorized until it is demanded by a later production step, work in process is not created or improved without a guarantee that it is needed, and components from suppliers are delivered just before they are needed.")Back To Text

[27]The description of supply chain financing in this article draws heavily upon an address by Richard P. Palmieri at University of Vienna. *See* Richard P. Palmieri, Forum für Internationales Wirtschaftsrecht, *Rationalizing the Financial Side of Supply Chain Strategies* (Oct. 21, 1997). Mr. Palmieri is the Managing Director of Logistics and Supply Chain Financing for Deutsche Morgan Grenfell.Back To Text

[28]*See generally* John P. Esser, *Institutionalizing Industry: The Changing Forms of Contract*, 21 L. & Soc. Inquiry 593, 620−625 (1996) (describing development of contract law as responding to developments in production techniques).Back To Text

[29]*See id.* at 603.Back To Text

[30]*See generally* Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 Tul. L. Rev. 101, 109−116 (1997) (describing asset securitization). Back To Text

[31]*See id*. at 105 (opining popularity of asset securitization to risk allocation attributes both to creditors and debtors).Back To Text

[32]*See* Baker, *supra* note 26, at 631 (noting "just in time" system seeks to identify process innovations by "investing in information").Back To Text

[33]*See id*.Back To Text

[34]*See* Daniel L. Sullivan, *General Considerations Involving Logistics Management Companies*, 63 J. Trans. Law, Logistics & Pol. 408, 420 (1996) (noting advantages of using logistics management companies).Back To Text

[35]*See id*. Back To Text

[36]*See id*. Back To Text

[37]I do not exclude from the realm of alternate sources the possibility that governments may pass different lien laws, giving, for example, wage creditors priority over consensual security interests. *See, e.g.,* Ind. Code § 32−8−24−1(a):

> Except as provided in subsection (b), the employees of any corporation doing business in Indiana, whether organized under the laws of this state or otherwise, are entitled to have and hold a first and prior lien upon: (1) the corporate property of the corporation; and (2) the earnings of the corporation; for all work and labor done and performed by the employees for the corporation, from the date of the employees' employment by the corporation. A lien under this section shall lie prior to any and all liens created or acquired subsequent to the date of the employment of the employees by the corporation, except as otherwise provided in this chapter.

Id

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[38]*See* Lynn M. LoPucki, *The Death of Liability*, 106 Yale L.J. 1, 89−92 (1996) (arguing introduction of computer technology has made judgment proofing easier; consequently, more firms are seeking to make themselves judgment proof).Back To Text

[39]*See generally* Karen Gross, Failure and Forgiveness: Rebalancing the Bankruptcy System (1997); Julie A. Veach, Note, *On Considering the Public Interest in Bankruptcy: Looking to the Railroads for Answers*, 72 Ind. L.J. 1211, 1214−26 (1997) (discussing public interest of bankruptcies).Back To Text