THE ANIMAL FARM OF ADMINISTRATIVE INSOLVENCY

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"All animals are equal."
The Seventh Commandment in Chapter II of ANIMAL FARM[1]

"ALL ANIMALS ARE EQUAL
BUT SOME ANIMALS ARE MORE EQUAL THAN OTHERS"
The sole Commandment in Chapter X of ANIMAL FARM[2]

INTRODUCTION

All administrative expenses are equal in priority.[3] But some are more equal than others. These expenses,[4] which are, principally, "the actual, necessary costs of preserving the estate,"[5] are now,[6] and have historically been,[7] afforded the first

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[1] GEORGE ORWELL, ANIMAL FARM 33 (Signet Classic ed., Penguin Books 1956) (1945) [hereinafter ORWELL].

[2] *Id*. at 123.

[3] *See* Hall v. Perry (*In re* Cochise Coll. Park, Inc.), 703 F.2d 1339, 1356 n.22 (9th Cir. 1983) ("All administrative expense creditors must be treated with 'absolute equality' unless, of course, some creditors, with full knowledge of the facts, have agreed to subordinate their claims."); *In re* MS Freight Distrib., Inc., 172 B.R. 976, 980 (Bankr. W.D. Wash. 1994) ("The general rule is that all administrative expenses must be treated with absolute equality unless a creditor agrees to subordinate its claims or unless the Code specifically provides otherwise."); *In re* IML Freight, Inc., 52 B.R. 124, 135 (Bankr. D. Utah 1985) ("[A]ll administrative expenses incurred under Chapter 11 are on a statutory parity with one another as to right to payment.").

[4] Administrative expenses are partially enumerated in and governed by section 503(b) of the Bankruptcy Code. 11 U.S.C. § 503(b) (2002); *see* Carpet Ctr. Leasing Co. v. Nalley Motor Trucks (*In re* Carpet Ctr. Leasing Co.), 991 F.2d 682, 685 (11th Cir. 1993) (noting "[a]dministrative expenses are governed by § 503(b) of the Bankruptcy Code"). *See generally* Trustees of the Amalgamated Ins. Fund v. McFarlin's, Inc., 789 F.2d 98, 100–01 (2d Cir. 1986) (discussing history and purpose of 11 U.S.C. § 503(b)).

[5] 11 U.S.C. § 503(b)(1)(A) ("After notice and a hearing, there shall be allowed, administrative expenses, other than claims allowed under section 502(f) of this title, including– the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case.").

[6] Administrative expenses share the first level of priority established in section 507(a)(1) of the Bankruptcy Code, with the fees and charges assessed against the bankruptcy estate under chapter 123 of the Judicial Code. *See* 11 U.S.C. § 507(a)(1) ("The following expenses and claims have priority in the following order: First, administrative expenses allowed under § 503(b) of this title and any fees and any fees and charges addressed under chapter 123 of title 28."); *see also* 28 U.S.C. §§ 1911–31 (comprising chapter 123 of Judicial Code). Bills passed separately by both Houses of Congress in 2001 and by the House of Representatives in 2003 would lower that priority by one rank and place domestic support obligations ahead of administrative expenses, but would not otherwise affect the issues discussed in this article. *See* H.R. 975, 108th Cong. § 212 (2003); H.R. 333, 107th Cong. § 212 (2001); S. 420, 107th Cong. § 212 (2001) (placing domestic support obligations as first priority under section 507 trumping administrative expenses).

priority in the distribution of the assets of an estate in bankruptcy.[8] In an administratively insolvent chapter 11 case, that is to say, a chapter 11 case in which there is an inability to pay allowed administrative expenses in full,[9] some administrative expenses are paid ahead of others,[10] some are paid in part,[11] and some, even though paid, are subject to disgorgement.[12] Finally, despite rules that seem to prohibit the creation of priorities within priorities,[13] some administrative

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[7] *See* 11 U.S.C. § 64(a)(1) (repealed 1978) (providing "costs and expenses of administration" are first priority under the Bankruptcy Act of 1898); *see also In re* Sierra Pac. Broadcasters, 185 B.R. 575, 578 n.8 (B.A.P. 9th Cir. 1995) (explaining 11 U.S.C. section 503(b) and section 64(a) of Bankruptcy Act of 1898 are "virtually identical"); *In re* Baths Int'l, 25 B.R. 538, 539 (Bankr. S.D.N.Y 1982) (stating section 64(a) of Bankruptcy Act of 1898 provided priority for administrative expenses).

[8] The importance of maintaining the first priority for administrative expenses – to assure the availability of services to administer the estate – has been noted by the House Report that accompanied the Bill that ultimately became the Bankruptcy Reform Act of 1978 and by the Commission on Bankruptcy Laws of the United States. *See* H.R. REP. NO. 95-595, at 186–87 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6146–48; REPORT OF THE COMM'N ON THE BANKRUPTCY LAWS OF THE U.S., H.R. DOC. NO. 93-137, at 214 (1973) (finding administrative expenses need to be paid first "to assure the availability of the services needed to administer a liquidation or reorganization case"); *see also* Mason v. Official Comm. of Unsecured Creditors (*In re* FBI Distrib. Corp.), 330 F.3d 36, 41 (1st Cir. 2003) (explaining administrative expenses are given first priority so businesses "otherwise wary of dealing with Chapter 11 businesses" will provide goods and services).

[9] *See In re* Microvideo Learning Sys., Inc., 232 B.R. 602, 603 (Bankr. S.D.N.Y. 1999), *aff'd*, 254 B.R. 90 (S.D.N.Y. 1999), *aff'd per curiam*, 227 F.3d 474 (2d Cir. 2000) (deciding issue of administratively insolvent debtor who had not paid all of its rent obligations); Joseph S. Athanas & Scott A. Semenek, *Pro-ration of Rent Dead in Third and Sixth Circuits – Landlords Won the Battle, but Will They Lose the War?*, 19 BANKR. DEV. J. 123, 127 (2002) (explaining administratively insolvent cases arise when debtor may not have enough unencumbered assets to pay administrative costs); Kimberly S. Winick, *Tenant Letters of Credit; Bankruptcy Issues for Landlords and Their Lenders*, 9 AM. BANKR. INST. L. REV. 733, 759–60 (2001) (stating "administratively insolvent" means debtor is "unable to pay in full all costs of administering the estate in bankruptcy").

[10] Notably, rent for nonresidential real property leases is paid ahead of other administrative expenses. *See In re* Pudgie's Dev. of N.Y., 223 B.R. 421, 426 (Bankr. S.D.N.Y. 1998), *aff'd sub nom*, Omni Partners v. Pudgie's Dev. of N.Y., Inc. (*In re* Pudgie's Dev. of N.Y., Inc.), 239 B.R. 688 (S.D.N.Y. 1999) (finding post-petition rent must be paid when due); *In re* Leisure Time Sports, Inc., 189 B.R. 511, 513 (Bankr. S.D. Cal. 1995) (concluding commercial lease payments have special priority amongst administrative expenses); *In re* Telesphere Comm., Inc., 148 B.R. 525, 531–32 (Bankr. N.D. Ill. 1992) (deciding operational payments have priority over other administrative expenses); *see also infra* notes 53–64 and accompanying text.

[11] *See In re* IML Freight, Inc., 52 B.R. 124, 139–40 (Bankr. D. Utah 1985) (concluding fees for professional services must be shared pro-rata); *In re* Jewish Mem'l Hosp., 13 B.R. 417, 419–21 (Bankr. S.D.N.Y. 1981) (explaining under section 64(a) of Bankruptcy Act, court has flexibility to find full payment may be inappropriate); s*ee also* G. Ray Warner, *Interim Compensation and the Routine Holdback: A Doctrine in Search of a Rationale*, 441 J. BANKR. L. & PRAC. 441, 442 (1992) (stating courts "employ [] routine holdback" based on theory of partial-payment rule).

[12] *See In re* Kearing, 170 B.R. 1, 7 (Bankr. D.D.C. 1994) (concluding professional fees are subject to disgorgement while ordinary course of business payments are not); *In re* Gherman, 114 B.R. 305, 307 (Bankr. S.D. Fla. 1990) (stating administrative expenses can be subject to disgorgement if creditor "had received a disproportionate administrative distribution in the light of the total administrative claims or the total distribution to creditors"); *see also In re Pudgie's Dev. of N.Y.*, 239 B.R. at 694–95 (finding rent for nonresidential real property is not subject to disgorgement).

[13] *See* United States v. Noland, 517 U.S. 535, 543 (1996) (disallowing priorities for sub-classes of claims); *In re* Columbia Ribbon Co., 117 F.2d 999, 1002 (3d Cir. 1941) (prohibiting priority status for sub-classification of claims within given class if contrary to Congressional mandate).

expenses will be paid ahead of others.[14] The Bankruptcy Code does not adequately deal with administrative insolvency; the courts have dealt with it inconsistently. The purpose of this article is to try to find principles that should govern the exercise of judicial discretion in confronting the problem of administrative insolvency.

I. JUST HOW EQUAL IS EQUALITY IN PRIORITY?

Equality of distribution is a central theme of the bankruptcy laws.[15] This theme manifests itself in numerous statutory provisions. The rights of secured creditors and priority creditors aside, the distribution mechanisms of the Bankruptcy Code provide that all general creditors receive pro rata distribution on their allowed claims. This is expressly stated in chapter 7 liquidations.[16]

In chapter 11 reorganizations, it is deduced from the requirements that plans classify claims, keeping claims that are substantially similar to each other in the same class, [17] provide the same treatment for each member of the class,[18] and either be accepted by each class,[19] or be fair and equitable to, and not discriminate unfairly

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[14] *See In re* Verco Indus., 20 B.R. 664, 665 (B.A.P. 9th Cir. 1982) ("The determination of when an administrative expense is to be paid is within the discretion of the trial [bankruptcy] court."); *In re* Va. Packaging Supply Co., 122 B.R. 491, 495 (Bankr. E.D. Va. 1990) ("In many bankruptcy cases, *when* a claim is paid makes the difference as to whether it will be paid at all.") (emphasis in original); *see also In re* Standard Furniture Co., 3 B.R. 527, 532 (Bankr. S.D. Cal. 1980) ("There being no specific direction in the Code . . . it was well established that the Court has wide discretion in allowing the payment of administrative expenses . . . .").

[15] *See* Beiger v. IRS, 496 U.S. 53, 58 (1990) (noting equality of distribution among creditors as central concern of Bankruptcy Code); Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 219–20 (1941) (describing power of bankruptcy court to adjudicate equities between creditors as complete). *See generally* REPORT OF THE COMM'N OF THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, at 75 (1973) (discussing development of bankruptcy policy and philosophy).

[16] *See* 11 U.S.C. § 726(b) (2002) (permitting pro rata distribution of property of state among claims); *see also Beiger*, 496 U.S. at 58 (stating creditors of equal priority should receive pro rata shares of debtor's property); Goldberg v. N.J. Lawyers' Fund for Client Prot., 932 F.2d 273, 280 (3d Cir. 1991) (discussing courts favoring pro rata distribution of funds when claimed by creditors of like status).

[17] *See* 11 U.S.C. § 1122(a) (allowing claim or interest to be placed in particular class if substantially similar to other claims or interests in class); Thomas C. Given & Linda J. Philipps, *Equality in the Eye of the Beholder-Classification of Claims and Interests in Chapter 11 Reorganization*, 43 OHIO ST. L.J. 735, 737 (1982) (discussing section 1122 of Bankruptcy Code relating to substantially similar claims). *But see In re* Sentry Co. of Tex., Inc., 264 B.R. 850, 860 (Bankr. S.D. Tex. 2001) (allowing substantially similar claims to be separately classified as well).

[18] 11 U.S.C. § 1123(a)(4) (requiring that plan "provide the same treatment for each claim or interest of a particular class unless the holder . . . agrees to less favorable treatment of such particular claim or interest."); *see In re* B & W Enters., Inc., 19 B.R. 421, 425 (Bankr. D. Idaho 1982) (applying language of section 1123 stating "[a] fundamental premise of bankruptcy is that all creditors of the same class shall be treated equally"); *In re* Huckabee Auto Co., 33 B.R. 132, 137–38 (Bankr. M.D. Ga. 1981) (asserting section 1123(a)(4) "restates the cardinal principle of bankruptcy practice that claims within a class should all be treated equally").

[19] 11 U.S.C. § 1129(a)(8) (requiring acceptance of plan by each class of claims or interests as prerequisite to its confirmation by court). Presumed acceptance, because a class is unimpaired, equivalently satisfies this requirement. *Id*.; *see* 11 U.S.C. § 1126(f) ("[A] class that is not impaired under a plan [is] conclusively presumed to have accepted the plan . . . ."); 11 U.S.C. § 1124 (defining impairment).

against, dissenting classes.[20] Indeed, the ability to avoid a preferential transfer[21] owes its existence to the notion that equality of distribution has been violated, and that the preferred creditor, who received a greater percentage distribution on its claim from an insolvent debtor than the Bankruptcy Code would allow, must return what it received and share ratably with other creditors.[22]

Nevertheless, by Congressional choice, some types of claims have a higher priority than others,[23] and the priority scheme is a hierarchy.[24] In a chapter 7 case, no distribution may be made to a lower priority claim until all claims with a higher priority have been satisfied,[25] and all claims in the same priority level that cannot be satisfied must receive the same percentage distribution.[26] Thus, equality of distribution within the same level of priority is preserved. In chapter 11 cases, the matter is not so simple because the competing principle of debtor rehabilitation[27]

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[20] 11 U.S.C. § 1129(b) (allowing confirmation of plan without acceptance by all classes under these circumstances); *see In re* Dow Corning Corp., 244 B.R. 705, 710 (Bankr. E.D. Mich. 1999) (defining unfair discrimination); *In re* Crosscreek Apartments, Ltd., 213 B.R. 521, 537 (Bankr. E.D. Tenn. 1997) (listing factors to consider when determining unfairness).

[21] 11 U.S.C. § 547(b) (permitting a trustee to avoid certain transfers of debtor's property).

[22] *See* Union Bank v. Wolas, 502 U.S. 151, 160–61 (1991) (citing legislative history of statute); Beiger v. IRS, 496 U.S. 53, 58 (1990) (noting section 547(b) furthers policy of equality of distribution among creditors); H.R. REP. NO. 95-595, at 177–78 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6137–38 (explaining purpose behind preference provisions).

[23] Section 507(a) lists nine levels of priority, some of which have dollar limitations. 11 U.S.C. § 507(a); *see* United States v. Noland, 517 U.S. 535, 536 (1996) (holding courts cannot equitably subordinate claims in derogation of Congress's scheme of priorities); Adventure Res., Inc. v. Holland, 137 F.3d 786, 796 (4th Cir. 1998) (noting priority list is fixed by Congress).

[24] *See* Granfinanciera, S.A. v. Nordberg, 492 U.S. 33, 56 (1989) (noting central to restructuring of debtor-creditor relations in bankruptcy is creditor's "hierarchically ordered claim to a pro rata share of a bankruptcy res.").

[25] *See* 11 U.S.C. § 726(a)(1) (requiring claim be paid in the order specified in section 507); *see also* U.S. Trustee v. Endy (*In re* Endy), 104 F.3d 1154, 1157–58 (9th Cir. 1997) (holding U.S. Trustee's fees and expenses pursuant to chapter 7 must be satisfied prior to chapter 11 expenses in case converted from chapter 11 to chapter 7).

[26] *See* 11 U.S.C. § 726(b). This provision does create two levels of "sub-priority" for administrative expenses in cases that are converted to chapter 7 from another chapter. The chapter 7 administrative expenses have priority over those incurred under another chapter. *Id*. *See generally In re* Ehrman, 184 B.R. 362, 364 (D. Ariz. 1995) (noting under section 726, "administrative expenses allowed under § 503(b) of Title 11 and fees and charges assessed pursuant to Chapter 123 of Title 28 are to be paid first on a pro rata basis.").

[27] *See* NLRB v. Bildisco, 465 U.S. 513, 528 (1984) (stating purpose of reorganization is to preserve asset values and jobs); Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 422–23 (1972) (noting rehabilitative purpose of reorganization is "in contradistinction" to goal of distribution of assets in liquidation). As explained in the House Report that accompanied the bill that ultimately became the Bankruptcy Reform Act of 1978:

> The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap . . . . It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.

puts pressure on the hierarchy.[28] The priority scheme must be honored at the time of plan confirmation because it is a requirement of confirmation that all administrative expenses and priority claims are paid in full.[29] But, prior to confirmation, the practical demands on a business reorganizing under chapter 11 sometimes require that payments be made without regard to whether the recipient has a claim that is entitled to priority and whether there are sufficient assets to pay all claims of equal or higher priority. Two examples will illustrate this point. First, pre-petition wages, which are entitled to the third level of priority,[30] are typically paid at the outset of a chapter 11 case to insure the continuation of the work force, even though there is no assurance that the debtor will ultimately have sufficient assets to pay administrative expenses in full.[31] Second and more controversially, critical vendors,[32] who furnish goods and services that the debtor cannot remain in business

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H.R. REP. NO. 95-595, at 220. This, of course, assumes that the reorganizing business does not continue to lose money, and becomes operationally profitable.

[28] *E.g., In re* Ionosphere Clubs, Inc., 98 B.R. 174, 178 (Bankr. S.D.N.Y. 1989) (approving payment of prior wage claims of active employees, and overruling objection of representative of inactive employees); *In re* Chateaugay Corp., 80 B.R. 279, 287 (Bankr. S.D.N.Y. 1987) (denying leave to appeal, but finding no error in bankruptcy court order authorizing payment of pre-petition worker's compensation claims in states chosen by debtors, and stating "[A] rigid application of the priorities of § 507 would be inconsistent with the fundamental purpose of reorganization"). *See generally* Jo Ann J. Brighton, *The Doctrine of Necessity: Is It Really Necessary?*, 10 J. BANKR. L. & PRAC. 107 (2000) (stating under necessity doctrine courts permit payments outside of statutory scheme); Charles Jordan Tabb, *Emergency Preferential Orders in Bankruptcy Reorganizations*, 65 AM. BANKR. L.J. 75 (1991) (stating under this scheme unsecured lender's claims can be elevated to secured status, ahead of all other unsecured claim).

[29] *See* 11 U.S.C. § 1129(a)(9).

[30] *Id.* (listing cash payments made with respect to section 507(a)(3)); 11 U.S.C. § 507(a)(3). These are subject to a maximum, currently $4,650 per individual, but adjusted every 3 years, based on the Consumer Price Index, and rounded to the nearest $25 dollars. The next adjustment is scheduled to occur on April 1, 2004. 11 U.S.C. § 104(b)(1).

[31] *See In re Ionosphere Clubs,* 98 B.R. at 178 (establishing pre-petition payment of wage, salary, and medical expenses required showing of necessity to pay); *accord In re* Gulf Air, Inc., 112 B.R. 152, 153–54 (Bankr. W.D. La. 1989) (holding chapter 11 debtor could immediately pay pre-petition employee wage and benefit obligations). The House Report for the bill that ultimately became the Bankruptcy Reform Act of 1978 notes the desirability of paying pre-petition priority wage claims early in the case. These reports identically provide:

> The priorities established in this section do not require that the claims listed be paid temporally in the order listed. For example, if it is clear that there are adequate assets in the estate to pay all priority creditors through the fourth or fifth priority, it would be appropriate to pay wage claims as soon as practicable, even before administrative expenses were determined, because most often the employees that worked for the failing enterprise will need the money to live on.

H.R. REP. NO. 95-595, at 358.

[32] *See In re* Fin. News Network, Inc., 134 B.R. 732, 735–36 (Bankr. S.D.N.Y. 1991) ("The 'doctrine of necessity' stands for the principle that a bankruptcy court may allow pre-plan payments of pre-petition obligations where such payments are critical to debtor's reorganization."). *Compare* Capital Factors, Inc. v. K Mart Corp., 291 B.R. 818, 823 (N.D. Ill. 2003) (prohibiting payments of pre-petition claims to critical vendors as unauthorized by Bankruptcy Code) *with In re* CoServ, L.L.C., 273 B.R. 487, 498–99 (Bankr. N.D. Tex. 2002) (basing authority to authorize payments of claims to critical vendors on debtor in possession's fiduciary duty to preserve and enhance estate; establishing 3-part test for authorizing payments of pre-petition claims to critical vendors: (i) debtor must deal with vendor/creditor; (ii) failure to deal with

without – such as manufacturers of brand name footwear to footwear retailers,[33] and distributors of motion pictures to cinema chains[34] – often receive payment of pre-petition debts, which are not entitled to any priority, simply because the critical vendor will exercise its right not to do business with debtor, unless its pre-petition debt is paid in full.[35] When these payments are authorized,[36] courts employ a rationale alternatively called the "necessity of payment doctrine"[37] or the "doctrine of necessity,"[38] which is sometimes justified by the courts in holding that the priority scheme is not strictly applicable in a chapter 11 case prior to confirmation.[39]

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vendor/creditor risks probable harm or eliminates economic advantage disproportionate to amount of claim; and (iii) there is no practical or legal alternative to payment of claim).

[33] *See In re* Just for Feet, Inc., 242 B.R. 821, 823–24 (Bankr. D. Del. 1999) (authorizing payment under necessity of payment doctrine where payment of pre-petition claims of athletic footwear and apparel vendors was critical to reorganization of chapter 11 debtor-corporation which operated retail stores specializing in brand-name athletic footwear).

[34] *See In re* Loews Cineplex Entm't Corp., No. 01-40346 (ALG) (Bankr. S.D.N.Y. May 7, 2001); *In re* Weststar Cinemas, Inc., No. 99-3375 (JJF) (D. Del. 1999).

[35] *See In re CoServ*, 273 B.R. at 498–99 (explaining how doctrine of necessity is rule of payment, not priority, allowing trustees to pay pre-petition debts in order to obtain continued supplies or services essential to debtor's reorganization); *In re Just for Feet*, 242 B.R. at 824 (authorizing payment of pre-petition claims to trade vendors when such payment is deemed necessary to survival of debtor in chapter 11 reorganization); *see also In re* James A. Phillips, Inc., 29 B.R. 391, 394–95 (Bankr. S.D.N.Y. 1983) (suggesting critical suppliers who have right to file mechanics' liens may be paid on pre-petition claims in ordinary course of business without notice or hearing or court authorization to prevent creation of liens).

[36] *See In re* Penn. Cent. Transp. Co., 467 F.2d 100, 102 n.1 (3d Cir. 1972) (granting preferential treatment to those creditors supplying goods and services critical to debtor's ongoing operations); *In re Fin. News Network*, 134 B.R. at 735–36 (authorizing pre-petition payments essential to debtor's survival in chapter 11). *But see K Mart*, 291 B.R. at 823 (prohibiting pre-petition payments to critical vendors); *In re* Timberhouse Post & Beam, Ltd., 196 B.R. 547, 550–51 (Bankr. D. Mont. 1996) (finding pre-petition payments to alter priority scheme, as set forth in Bankruptcy Code, by redistributing creditors' rights).

[37] *See e.g., In re CoServ*, 273 B.R. at 498–99 (formulating precise test to determine "necessity"); *In re Just for Feet*, 242 B.R. at 824–25 (explaining "necessity of payment doctrine" was first recognized by Supreme Court "over a century ago in a railroad bankruptcy"); *see also In re* Lehigh & N.E.R. Co., 657 F.2d 570, 581 (3d Cir. 1981) (employing necessity of payment doctrine in reorganization framework in order to pay claimants vital to continuing debtor's business).

[38] *See In re* C.A.F. Bindery, Inc., 199 B.R. 828, 835 (Bankr. S.D.N.Y. 1996) (describing doctrine, but declining to apply it); *In re* NVR, L.P., 147 B.R. 126, 128 (Bankr. E.D. Va. 1992) (stating same); *In re* Eagle-Picher Indus., Inc., 124 B.R. 1021, 1023 (Bankr. S.D. Ohio 1988) (applying doctrine to authorize payments to toolmakers for debtors' automotive tool manufacturing operations). One court has collected the grounds for payments of pre-petition debts to be authorized under the "doctrine of necessity" as: (i) critical to the reorganization, (ii) indispensably necessary to continuing business operations or to avoid a serious threat to the chapter 11 process, (iii) in the best interest of the debtor and its creditors, (iv) for compelling business justifications, and (v) not merely to appease a major creditor. *In re NVR*, 147 B.R. at 128. Some of these are obviously duplicative. Another court has held that the doctrine is applicable when payment of pre-petition claims "will help to 'stabilize [the] debtor's business relationships without significantly hurting any party.'" *In re* UNR Indus., Inc., 143 B.R. 506, 520 (Bankr. N.D. Ill. 1992) (quoting Russell A. Eisenberg & Frances F. Gecker, *The Doctrine of Necessity and its Parameters*, 73 MARQ. L. REV. 1, 2 (1989)).

[39] *See In re* Ionosphere Clubs, Inc., 98 B.R. 174, 178 (Bankr. S.D.N.Y. 1989) (noting authority indicating strict application of priorities may sometimes contravene purposes of reorganization); *In re* Chateaugay, Corp., 80 B.R. 279, 287 (Bankr. S.D.N.Y. 1987) ("A rigid application of the priorities of § 507 would be inconsistent with the fundamental purpose of reorganization and the Act's grant of equity powers to bankruptcy courts . . . ."); *see also In re* Structurlite Plastics Corp., 86 B.R. 922, 930–33 (Bankr. S.D. Ohio 1988) (noting argument, but declining to rule on it).

Needless to say, not all chapter 11 cases are successful. Those businesses that continue to lose money during their sojourn in chapter 11 will likely become administratively insolvent at some point. Continuing loss to or diminution of the estate without a reasonable likelihood of rehabilitation is a ground for conversion of the case to a chapter 7 liquidation or the case's outright dismissal.[40] Nevertheless, it is not always easy to ascertain the point at which there is no longer any reasonable likelihood of rehabilitation. Creditors facing the prospect of substantially diminished recovery, and especially, eternally optimistic debtors, have reason to put off recognition of the inevitable. Moreover, once rehabilitation is acknowledged as unlikely, an effort is frequently made to sell the business as a going concern, to preserve asset values and jobs, rather than see the business liquidated.[41] In these circumstances, administratively insolvent estates continue in chapter 11, and continue to run up administrative expenses that may never be satisfied in full.

The Bankruptcy Code offers no direct guidance on when and whom to pay during administrative insolvency in a chapter 11 case. Indeed, the Bankruptcy Code offers no guidance at all on the timing of payment of administrative expenses prior to confirmation.[42] As a result, the courts enjoy enormous discretion in determining who gets paid and when.[43] The struggle over the limited funds of an administratively insolvent estate leads claimants to seek ways to promote the relative priority of their own claims or demote the relative priority of competing claims. The Bankruptcy Code does furnish concepts of relative promotion and

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[40] 11 U.S.C. § 1112(b)(1) (2002); *see, e.g., In re* Greene, 57 B.R. 272, 276 (Bankr. S.D.N.Y. 1986) (applying section 1112(b)(1)'s twofold test where creditor sought to convert or dismiss).

[41] The sale would be of substantially all the assets of the debtor outside of a plan, free and clear of claims and liens, pursuant to sections 363(b) and 363(f) of the Bankruptcy Code. 11 U.S.C. §§ 363(b), 363(f). These sales outside of a plan are generally permissible for sound business reasons. *E.g.*, Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1071 (2d Cir. 1983). *See generally* REGINALD W. JACKSON, BUSINESS BANKRUPTCY ACQUISITIONS: SALE OF SUBSTANTIALLY ALL ASSETS OUTSIDE OF PLAN, §§ 5.01–5.05 (Richard N. Tilton ed. 1998). The purchaser may acquire the assets free and clear of any liens, if the criteria for such sales are satisfied, namely (1) applicable nonbankruptcy law permits such a free and clear sale; (2) the lien holder consents; (3) the price is greater than the aggregate value of all liens; (4) the lien is in bona fide dispute; or (5) the lien holder could be compelled to accept a money satisfaction. 11 U.S.C. § 363(f) (1978). *See generally* DANIELLA SALTZ, BUSINESS BANKRUPTCY ACQUISITIONS: SALE FREE AND CLEAR OF LIENS UNDER § 363(F), §§ 4.01–4.08 (Richard N. Tilton ed. 1998).

[42] Requests for payment of administrative expenses are authorized, 11 U.S.C. § 503(a) (1978), but there is no regulation about timing of payment. Unsecured trade credit is also authorized for operating business in 11 U.S.C. § 364(b), but, once again, the statute does not determine when payment is required, especially during administrative insolvency. Moreover, interim compensation of professionals is authorized in 11 U.S.C. § 331, but without any direction as to timing of payments. *See In re* Standard Furniture Co., 3 B.R. 527, 532 (Bankr. S.D. Cal. 1980) (finding 11 U.S.C. § 503(a) does not address timing of administrative expense payments).

[43] *See In re* Colortex Indus., Inc. 19 F.3d 1371, 1384 (11th Cir. 1994) (holding determination of timing of payment of administrative expenses is matter within discretion of bankruptcy court); *In re* Transp. Natural Gas Corp. 978 F.2d 1409, 1418 (5th Cir. 1992) (noting payment of administrative claim is matter of court's discretion); Sapir v. CPQ Colorchrome Corp. (*In re* Photo Promotion Assocs., Inc.), 881 F.2d 6, 8 (2d Cir. 1992) (asserting bankruptcy judge has broad discretion in applying 11 U.S.C. §§ 549(a) and 503(b)); s*ee also supra* notes 11–14 and accompanying text.

demotion of priority. The former is colloquially called "superpriority";[44] the latter is named "equitable subordination."[45]

II. PRIORITY SHIFTING DOCTRINES

A. Priority Upgrade: Superpriority

Administrative expenses are allowable under section 503(b), which contains a nonexclusive list of these expenses.[46] The Bankruptcy Code expressly provides in

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[44] Section 364(c)(1) of the Bankruptcy Code empowers the court to permit the obtaining of credit or the incurring of debt "with a priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b)" of the Bankruptcy Code. 11 U.S.C. § 364(c)(1). Section 507(b) of the Bankruptcy Code provides that if the trustee (or debtor in possession) furnishes adequate protection to a secured creditor to prevent the lifting of the automatic stay, to enable the use of property, or to permit the granting of a senior lien in such property, and the secured creditor's interest in the collateral nevertheless declines in value, giving the secured creditor an allowable administrative expense claim under subsection (a)(1) of section 507, then that claim has "priority over every other claim allowable under such subsection." 11 U.S.C. § 507(b). Since these provisions offer "priority over" administrative expense claims, these "priorities over" have come to be known as "superpriorities." *See In re* LNC Inv., Inc. v. First Fid. Bank, 247 B.R. 38, 41 (S.D.N.Y. 2000) (discussing origin and requirements of "superpriority").

[45] Section 510(c) of the Bankruptcy Code permits the court, "under principles of equitable subordination" to "subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim." 11 U.S.C. § 510(c); *see* United States v. Reorganized CF&I Fabricators of Utah, Inc. (*In re* CF&I Fabricators of Utah, Inc.), 53 F.3d 1155, 1158 (10th Cir. 1995) (determining when equitable subordination is imposed); U. S. Abatement Corp. v. Mobil Exploration & Producing U.S., Inc. (*In re* United States Abatement Corp.), 39 F.3d 556, 561 (5th Cir. 1994) (establishing three-prong test to identify when equitable subordination is permitted).

[46] Section 503(b) of the Bankruptcy Code provides:

> (b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including –
>
> (1)
>
> (A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case;
>
> (B) any tax –
>
> (i) incurred by the estate, except a tax of a kind specified in section 507(a)(8) of this title; or
>
> (ii) attributable to an excessive allowance of a tentative carryback adjustment that the estate received, whether the taxable year to which such adjustment relates ended before of after the commencement of the case; and
>
> (C) any fine, penalty, or reduction in credit relating to a tax of a kind specified in subparagraph (B) of this paragraph;
>
> (2) compensation and reimbursement awarded under section 330(a) of this title;
>
> (3) the actual, necessary expenses, other than compensation and reimbursement specified in paragraph (4) of this subsection, incurred by –
>
> (A) a creditor that files a petition under section 303 of this title;
>
> (B) a creditor that recovers, after the court's approval, for the benefit of the estate any property transferred or concealed by the debtor;

three places that some administrative expenses are entitled to priority over other administrative expenses. First, in section 726(b), the administrative expenses incurred in a case after its conversion to chapter 7 are given priority over those that had been incurred in another chapter.[47] Second, in section 507(b), administrative expenses incurred by a secured creditor, who had been furnished adequate protection that turned out to be inadequate, are entitled to priority over all other administrative expenses.[48] Third, in section 364(c)(1), the trustee or debtor in possession may be authorized to incur debt with a priority over ordinary

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> (C) a creditor in connection with the prosecution of a criminal offense relating to the case or to the business or property of the debtor;
> (D) a creditor, an indenture trustee, an equity security holder, or a committee representing creditors or equity security holders other than a committee appointed under section 1102 of this title, in making a substantial contribution in a case under chapter 9 or 11 of this title;
> (E) a custodian superseded under section 543 of this title, and compensation for the services of such custodian;
> (F) a member of a committee appointed under section 1102 of this title, if such expenses are incurred in the performance of the duties of such committee;
>
> (4) reasonable compensation for professional services rendered by an attorney or an accountant of an entity whose expense is allowable under paragraph (3) of this subsection, based on the time, the nature, the extent, and the value of such services other than in a case under this title, and reimbursement for actual and necessary expenses incurred by such attorney or accountant;
> (5) reasonable compensation for services rendered by an indenture trustee in making a substantial contribution in a case under chapter 9 or 11 of this title, based on the time, the nature, the extent, and the value of such services other than in a case under this title; and
> (6) the fees and mileage payable under chapter 119 of title 28.

11 U.S.C. § 503(b)(1). Because the list is preceded by the term "including," the list is not exclusive. 11 U.S.C. § 102(3). *See* Einstein/Noah Bagel Corp. v. Smith (*In re* BCE W., L.P.), 319 F.3d 1166, 1172 (9th Cir. 2003) ("Section 503(b)(1)(A) of the Code defines administrative expenses and provides a nonexclusive list of allowable expenses."); *In re* Williams, 246 B.R. 591, 594 (B.A.P. 8th Cir. 1999) (noting although section 503(b) lists administrative expenses, the term "including" in the statute indicates that the list is nonexclusive); *In re* Adams, 275 B.R. 274, 281 (Bankr. N.D. Ill. 2002) ("Section 503(b) is a nonexclusive list of six categories of administrative claims.").

[47] 11 U.S.C. § 726(b). *See In re* Metro. Elec. Supply Corp., 185 B.R. 505, 509 (Bankr. E.D. Va. 1995) ("When a Chapter 11 case is converted to one under Chapter 7, the Chapter 7 administrative expenses have a priority of payment over the Chapter 11 administrative expenses."); *In re* Kearing, 170 B.R. 1, 8 (Bankr. D.D.C. 1994) (explaining chapter 7 administrative claims receive first priority under section 726(b)).

[48] 11 U.S.C. § 507(b); *see, e.g.,* Carpet Cent. Leasing Co. v. Nalley Motor Trucks (*In re* Carpet Cent. Leasing Co.), 991 F.2d 682, 685 (11th Cir. 1993) ("[Section 507(b)] provides that when adequate protection has been given to a secured creditor and later proves to be inadequate, the creditor becomes entitled to a superpriority administrative expense claim to the extent that the proffered adequate protection was insufficient."); *In re* Cal. Devices, Inc., 126 B.R. 82, 86 (Bankr. N.D. Cal. 1991) (concluding secured creditor's administrative expenses are entitled to section 507(b) superpriority); *In re* Summit Ventures, Inc., 135 B.R. 478, 481 (Bankr. D. Vt. 1991) ("Section 507(b) grants a . . . where a secured creditor has been provided adequate protection . . . but only to the extent protection proves inadequate").

administrative expenses under section 503(b) and over what may be labeled "inadequate adequate protection" administrative expenses under section 507(b).[49]

B. Quasi-Superpriority

Nevertheless, other provisions of the Code, especially those added after 1978, contain provisions for payment with language such as "notwithstanding section 503(b)(1)"[50] or "[n]otwithstanding any other provision of this title."[51] Claimants under these provisions have contended, sometimes successfully, that such language, in effect, grants them an implied additional superpriority.[52] These claimants include workers covered by collective bargaining agreements[53] and retirees for covered benefits.[54] The United States Trustee has been generally successful at the appellate

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[49] 11 U.S.C. § 364(c)(1). *See* Adventure Res. Inc., v. Holland, 137 F.3d 786, 797 (4th Cir. 1998) ("364(c)(1)'s authorization for the bankruptcy court to accord 'priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title' to credit obtained or debt incurred for the purpose of operating the debtor's business.") (quoting *In re* Roth Am., Inc., 975 F.2d 949, 956 (3d Cir.1992)); *In re* Five Star Partners, L.P., 193 B.R. 603, 612 n.3 (Bankr. N.D. Ga. 1996) (stating courts may authorize trustee to obtain credit or incur debt with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b)).

[50] *See* 11 U.S.C. § 365(d)(3) (establishing rule relating to timely performance of obligations under an unexpired lease for nonresidential real property); 11 U.S.C. § 365(d)(10) (establishing rule relating timely performance of obligations under an unexpired lease of personal property other than a lease to an individual for personal, family or household purposes).

[51] *See* 11 U.S.C. § 1114(e) (timely payment of retiree benefits); *cf.* 11 U.S.C. § 1113(f) ("No provision of this title shall be construed to permit a trustee to unilaterally terminate or alter any provisions of a collective bargaining agreement . . . .").

[52] *E.g., In re* Telesphere, 148 B.R. 525, 529 (Bankr. N.D. Ill. 1992) (implying superpriority by direction for timely performance of obligations, notwithstanding section 503(b)(1)). *Contra, e.g.*, Temecula v. LPM Corp. (*In re* LPM Corp.), 300 F.3d 1134, 1138 (9th Cir. 2002) (holding no superpriority); Calet, Hirsch & Ferrell v. Microvideo Learning Sys., Inc. (*In re* Microvideo Learning Sys., Inc.), 227 F.3d 474, 474 (2d Cir. 2000) (per curiam) (adopting opinion of bankruptcy court holding of no superpriority). Two leading bankruptcy treatises take opposite views on whether the section confers superpriority status. *Compare* 3 COLLIER ON BANKRUPTCY ¶ 365.04[3][f] (Lawrence P. King et al. eds., 15th ed. Rev. 2000) ("The better approach is to reject any superpriority for the lessor's claim.") *with* 2 WILLIAM L. NORTON, JR., NORTON BANKR. L. & PRAC. 2D § 39:42 (1999) ("The better view is that the 'shall timely perform' language in Code § 365(d)(3) means what it says . . . . Thus, the command to "timely perform" must be obeyed even though to do so grants a [super]priority as a practical matter.").

[53] *Compare* United Steelworkers of Am. v. Unimet Corp. (*In re* Unimet Corp.), 842 F.2d 879, 884 (6th Cir. 1988) (stating failure of payments under collective bargaining agreement to qualify as administrative expenses is no reason not to enforce payment command of section 1113, which supercedes Bankruptcy Code's priority provisions), *cert. denied*, 488 U.S. 828 (1988) *and* Eagle, Inc. v. Local No. 537, United Ass'n of Journeymen, 198 B.R. 637, 638–39 (Bankr. D. Mass. 1996) (finding superpriority under section 1113) *with* Adventure Res., Inc. v. Holland, 137 F.3d 786, 796–97 (4th Cir. 1998) (holding no superpriority) *and* Air Line Pilots Ass'n v. Shugrue (*In re* Ionosphere Clubs, Inc.), 22 F.3d 403, 407–08 (2d Cir. 1994) (holding same).

[54] *See In re* GF Corp., 115 B.R. 579, 586 (Bankr. N.D. Ohio 1990) (directing payment of retiree benefits under section 1114(e)(1) immediately upon unencumbered funds becoming available, and recognizing the creation of "a super-priority without the authority of an explicit provision of the Bankruptcy Code"), *vacated*, 120 B.R. 421, 424–25 (Bankr. N.D. Ohio 1990) (on approval of a settlement, stating "not the purpose of enacting § 1114 to force debtors-in-possession into Chapter 7"), *appeal dismissed*, 140 B.R. 884 (N.D. Ohio 1992), *appeal dismissed*, 996 F.2d 1215 (6th Cir. 1993). For more examples of debtor retirees,

level in asserting priority for its unpaid fees, which are due only while the case is in chapter 11, over unpaid chapter 11 administrative expenses in cases converted to chapter 7.[55]

Chief among these quasi-superpriority provisions is section 365(d)(3), which commands that trustees (and debtors in possession) "timely perform all the obligations of the debtor . . . under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title."[56] The case law on whether this provision gives landlords better rights than other unpaid administrative claimants is a virtual cacophony of judicial decision-making. For example, between June 1996 and September 1998, three bankruptcy judges from the District of Massachusetts construed the section 365(d)(3)'s timely payment requirement in four different ways, holding, in turn, that: there is a superpriority effect;[57] whether there is a superpriority effect or not, payment, as directed by prior orders, continues to be required, irrespective of conversion to chapter 7 and probable administrative insolvency;[58] there is an exception to the superpriority effect for funds collected by a chapter 7 trustee after conversion to chapter 7;[59] and there is no superpriority effect.[60]

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see United Mine Workers of Am. 1992 Benefit Plan v. Rushton (*In re* Sunnyside Coal Co.), 146 F.3d 1273, 1274 (10th Cir. 1998); *In re* Cedar Rapids Meats, Inc. 117 B.R. 448, 451 (Bankr. N.D. Iowa 1990).

[55] *See* United States Tr. v. Endy (*In re* Endy), 104 F.3d 1154, 1157–58 (9th Cir. 1997) ("[M]ajority approach under which United States Trustee's fees and the chapter 7 expenses are first satisfied ratably, followed by chapter 11 expenses, is more consistent with the statutory scheme and its underlying purposes."); Huisinga v. Carter (*In re* Juhl Enters.), 921 F.2d 800, 803 (8th Cir. 1990) (stating trustee's fees have priority over chapter 11 expenses); *In re* Jonick Deli Corp., 263 B.R. 196, 199–200 (Bankr. S.D.N.Y. 2001) (following majority view that trustee's fees not be subordinated to chapter 7 expenses based upon analysis of statutory language). United States trustee fees are imposed by 28 U.S.C. § 1930(a)(6), which is in chapter 123 of title 28. The Bankruptcy Code's priority section, 11 U.S.C. § 507, places in the first priority administrative expenses under section 503 and fees under chapter 123 of title 28. 11 U.S.C. § 507(a)(1). *See* 11 U.S.C. § 726(a) (stating in cases converted to chapter 7, distribution of the estate is first to first priority, namely administrative expenses and chapter 123 fees); 11 U.S.C. § 726(b) (asserting although chapter 7 administrative expenses have priority over chapter 11 administrative expenses, statute does not give chapter 7 administrative expenses priority over chapter 123 fees). Consequently, these appellate courts reason that United States trustee fees, like chapter 7 administrative expenses, share priority over chapter 11 administrative expenses. *Contra In re* Wetmore, 117 B.R. 201, 201–02 (Bankr. W.D. Pa. 1990) (asserting chapter 11 expenses accrued by United States Trustee must be subordinated to chapter 7 expenses in order to realize goals of liquidation).

[56] 11 U.S.C. § 365(d)(3).

[57] *See In re* McCabe, 212 B.R. 21, 22 (Bankr. D. Mass. 1996) (holding section 365(d)(3) demands immediate payment "even where the estate is administratively insolvent"); *see also In re* Brennick, 178 B.R. 305, 307–08 (Bankr. D. Mass. 1995) (stating trustee must pay debtor's rent "even though to do so grants a priority . . ."); *In re* Telesphere Communications, Inc., 148 B.R. 525, 531 (Bankr. N.D. Ill. 1992) (believing there is implict superpriority for rent payments).

[58] *See In re* Rich's Dep't Stores, Inc., 209 B.R. 810, 816–18 (Bankr. D. Mass. 1997) (following *Peaberry's Ltd.* holding prior court order to pay rent "compel[s] the immediate payment of lease obligations").

[59] *See In re* MJ 500, Inc., 217 B.R. 93, 94–95 (Bankr. D. Mass. 1998) (distinguishing present case from *In re McCabe*, 212 B.R. at 22 and holding landlords are not entitled priority to funds collected in chapter 7 period after conversion from chapter 11); *see also* Temecula v. LPM Corp. (*In re* LPM Corp.), 300 F.3d 1134, 1138 (9th Cir. 2002) (stating no superpriority effect is given when chapter 11 case is converted to chapter 7 case).

Although proponents of each view on implied superpriority appeal to the plain language of the statute,[61] both sides note that there is a failure to supply a statutory remedy for noncompliance with the timely performance requirement,[62] and the arguments presented for both views are essentially based on policy. In favor of quasi-superpriority are the notions that lessors cannot use self-help to terminate their relationships with debtors,[63] and the failure to grant such status encourages disobedience of intentional statutory directives, and sometimes express court orders.[64] The contrary view stresses the inequity to other administrative creditors,[65] who are also presumably entitled to be timely paid for their post-petition goods and services, despite the lack of special legislation so mandating.[66] The bankruptcy laws are intended to address the situation when a debtor has insufficient resources to meet the legitimate demands of creditors. Outside the world of administrative expenses, priorities are clearly established, and thereafter, equality of distribution is the governing principle.[67] During administrative insolvency, the same clarity is absent. Nevertheless, this author contends the rule ought to be that in the absence

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[60] *See In re* J.T. Rapps, Inc., 225 B.R. 257, 264 (Bankr. D. Mass. 1998) (holding section 365(d)(3) "does not afford automatic superpriority status to . . . nonresidential real property rent claims"); *see also In re* Orvco, Inc., 95 B.R. 724, 727 (B.A.P. 9th Cir. 1989) (stating no superpriority status for commercial rent claims); *In re* Nutri/System of Fla. Assocs., 178 B.R. 645, 655 (E.D. Pa. 1995) (deciding when estate does not have enough money to pay all administrative claims, rent claims do not receive superpriority status).

[61] *See, e.g., In re* Microvideo Learning Sys., Inc., 232 B.R. 602, 606 (Bankr. S.D.N.Y. 1999) ("The majority [rejecting implied superpriority] and the minority [adopting implied superpriority] each contend that they are embracing the 'plain meaning' of the statute.").

[62] *See, e.g., In re Rich's Dep't Stores*, 209 B.R. at 815 ("Although courts are split on whether immediate payment of lease obligations is mandated by the statute, there is agreement that the statute itself does not contain an explicit remedy for the debtors' failure to timely perform their obligations until assumption or rejection."); *see also In re* Dieckhaus Stationers of King of Prussia, Inc., 73 B.R. 969, 973 (Bankr. E.D. Pa. 1987) ("[T]he Code provides no express remedy for a trustee's failure to comply with his obligations under section 365(d)(3).").

[63] *See In re Telesphere Communications*, 148 B.R. at 529 (stating lessors unlike utilities, trade creditors or post-petition employees cannot use self-help remedy of ending relationship with debtor).

[64] *See* 11 U.S.C. § 365(d)(3) (providing trustee shall timely perform obligations of debtor any unexpired lease of nonresidential real property); *In re Rich's Dep't Stores*, 209 B.R. at 815–16 (stating Congress differentiated between nonresidential real estate lessors and other creditors; expressing views of commentator that purpose of these provisions is to provide lessors of nonresidential real property timely rent payment); C. Alan Gauldin, *The Commercial Real Estate Landlord's Rights to Receive Post-Petition Rental Payments Under Section 365(d)(3) of the Bankruptcy Code*, 14 U. ARK. LITTLE ROCK L.J. 491, 506 (1992) (stating Congress intended to grant lessors of nonresidential real property some level of priority status over administrative claimants).

[65] *See In re Microvideo Learning Sys.*, 232 B.R. at 607–10 (asserting superpriority reading of § 365(d)(3) ignores fundamental principles of bankruptcy). *See generally In re* Food Etc., 281 B.R. 82, 88 (Bankr. S.D. Ala. 2001) (noting immediate payment order would raise lessor's claim above other administrative claims which is not explicitly provided in Code's applicable provisions); *In re* Caldor, 240 B.R. 180, 189 (Bankr. S.D.N.Y. 1999) (stating court cannot accord claims priority treatment not provided in Code).

[66] *See* 11 U.S.C. § 1108 (granting trustee authority to operate debtor's business); 11 U.S.C. § 364(a) (granting trustee operating business authority to incur unsecured debt in ordinary course of such business); 11 U.S.C. § 503(b)(1) (allowing trustee operating business authority to incur unsecured debt in ordinary course of such business as administrative expense).

[67] *See supra* notes 15–22 and accompanying text.

of a clear statement of priority, the requirement for timely payment should not supercede the principle of equality of distribution.

C. Priority Downgrade: Equitable Subordination

Equitable subordination is a statutory license to do equity. Congress has authorized the courts to apply "principles of equitable subordination"[68] and demote the priority of certain claims without specifying the substance of those principles. The legislative history makes clear that Congress deferred to the courts to develop such principles.[69] The original equitable subordination cases depict inequitable conduct by creditors who are also fiduciaries of the debtor – directors, officers and controlling shareholders[70] – who abuse their position of control over the debtor to favor themselves at the expense of other creditors.[71] The doctrine has been extended to non-fiduciary insider creditors,[72] and then to non-insider creditors,[73] so long as their inequitable conduct caused injury to other creditors or conferred an unfair advantage upon themselves.[74] These extensions of the original doctrine have as a

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[68] 11 U.S.C. § 510(c) (promulgating rule allowing bankruptcy courts to use equitable principles to ensure fairness in prioritizing claims). *See* Citicorp Venture Capital v. Comm. of Creditors Holding Unsecured Claims, 323 F 3d. 228, 233 (3d Cir. 2003) (announcing court may use equitable principles to subordinate claims); *cf*. United States v. Noland, 517 U.S. 535, 543 (1996) (holding court may not make policy decisions which infringe on congressional authority in subordination of claims).

[69] The statements of the floor leaders in both Houses in lieu of a conference committee report on the Bankruptcy Reform Act of 1978, identically provide: "It is intended that the term 'principles of equitable subordination' follow existing case law and leave to the courts development of this principle." 124 CONG. REC. 32398 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards); *id*. at 33998 (daily ed. Oct 5, 1978) (statement of Sen. DeConcini). *But see* United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213, 229 (1996) (stating claim went beyond subordination authority and transgressed onto Congressional policy making).

[70] *See* Pepper v. Litton, 308 U.S. 295, 306–07 (1939) (announcing new role of courts with respect to different fiduciaries and court's equitable authority over them); Giorgio v. Boyajain (*In re* Giorgio)**,** 862 F.2d 933, 939 (1st Cir. 1988) (discussing subordination of fiduciaries who use unfair tactics against fellow creditors).

[71] *See Pepper*, 308 U.S. at 306–07 ("The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain."); Taylor v. Standard Gas & Elec. Co., 306 U.S. 307, 322–23 (1939) (emphasizing importance of arm's length dealing to avoid inequitable conduct); *see also* A. Mechele Dickerson, *A Behavioral Approach to Analyzing Corporate Failures*, 38 WAKE FOREST L. REV. 1, 50 n.181 (2003) (stating section 510(c) is used to increase fairness when creditors engage in misconduct).

[72] *See* Wilson v. Huffman (*In re* Missionary Baptist Found. of Amer., Inc.), 818 F.2d 1135, 1144 (5th Cir. 1987) (noting cases have suggested an insider need not be a fiduciary); Markus Stadler, *Treatment of Shareholder Loans to Undercapitalized Corporations in Bankruptcy Proceedings*, 17 J.L. & COM. 1, 15 (1997) (stating equitable subordination applies to both insider and non-insider non-fiduciaries).

[73] *See In re* Toy King Dist., 256 B.R. 1, 195–96 (Bankr. M.D. Fla. 2000) (stating non-insider creditor suits bear high standard of proof); *In re* 80 Nassau Assocs., 169 B.R. 832, 838 (Bankr. S.D.N.Y. 1994) (noting same). *See generally* Andrew DeNatale & Prudence B. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 BUS. LAW. 417, 421–29 (1985) (discussing discretionary nature of equitable subordination doctrine).

[74] The generally-agreed upon criteria for equitable subordination are: (i) inequitable conduct by the claimant; (ii) causing injury to creditors or unfair advantage to the claimant; and (iii) a result consistent with bankruptcy law. *See* Benjamin v. Diamond (*In re* Mobile Steel Co.), 563 F.2d 692, 700 (5th Cir. 1977);

common characteristic inequitable conduct by the creditor whose claim is subordinated.[75]

The next extension of the doctrine was to eliminate the requirement of inequitable conduct, and subordinate based on some other appeal to equity or general fairness. If inequitable conduct by the claimant is not an absolute requirement, then equitable subordination could be applied to administration expenses, especially to those that, absent their post-petition administrative status, namely non-compensatory damages, would be automatically subordinated under chapter 7.[76] Equitable subordination of penalties causing an administrative insolvency is particularly appealing when one focuses on the penalties' effect. In an administrative insolvency, even though the penalties are imposed because of some wrongdoing by the debtor, the effect is felt, not by the debtor, whose shareholders have no stake in the distribution of the debtor's assets, but rather by the innocent creditors, whose distribution is necessarily diluted. What rational principle of equitable distribution of the assets of an insolvent estate provides for the automatic subordination of penalties in a chapter 7 case, but prevents such subordination in a chapter 11 case? Such inquiries have led courts in cases involving liquidating chapter 11 plans, or conversions to chapter 7, to subordinate penalties in administratively insolvent chapter 11 cases under "principles of equitable subordination," without finding any inequitable conduct on the part of the creditor to whom the penalty is owed.[77]

The Supreme Court, however, has decisively rejected such subordination.[78] Although the Court did not rule out the possibility of equitable subordination

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accord United States v. Noland, 517 U.S. 535, 538–39 (1996); Machinery Rental, Inc. v. Herpel (*In re* Multiponics, Inc.), 622 F.2d 709, 713 (1980).

[75] Three types of inequitable conduct that support equitable subordination have been recognized: (i) fraud, illegality, or breach of fiduciary duty; (ii) undercapitalization; and (iii) the claimant's use of the debtor as a mere instrumentality or alter ego. *See* Smith v. Assocs. Commercial Corp. (*In re* Clark Pipe & Supply Co.), 893 F.2d 693, 699 (5th Cir. 1990); *Wilson*, 818 F.2d at 1142–43.

[76] Section 726(a)(4) subordinates any claim for "fine, penalty, or forfeiture, or for multiple, exemplary or punitive damages . . . to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim." 11 U.S.C. § 726(a)(4) (2002). Indeed, the same passage from the legislative history that allows the courts to develop the "principles of equitable subordination," goes on to state: "To date, under existing law, a claim is generally subordinated only if the holder of such claim is guilty of inequitable conduct, or the claim itself is of a status susceptible to subordination, such as a penalty . . . ." 124 CONG. REC. 32398 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards); *id*. at 33998 (daily ed. Oct. 5, 1978) (statement of Sen. DeConcini); *see also supra* note 69.

[77] *E.g.*, Schultz Broadway Inn v. United States, 912 F.2d 230, 234 (8th Cir. 1990) (stating bankruptcy court may determine whether penalty claim should be subordinated under chapter 11); *In re* Virtual Network Servs. Corp., 902 F.2d 1246, 1248 (7th Cir. 1990) (indicating courts follow "principles of equitable subordination" in determining subordination of claims); *In re* Import & Mini Car Parts, Ltd., 136 B.R. 178, 181–82 (Bankr. N.D. Ind. 1991) (presenting chapter 7 converted from chapter 11 case where trustee was permitted to subordinate administrative claims).

[78] *See* United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213, 228–29 (1996) (holding, unanimously, equitable subordination under section 510(c) relying upon "categorical reordering of priorities that takes place at the legislative level of consideration is beyond the scope of judicial authority . . . ."); *Noland*, 517 U.S. at 540–41 (deciding unanimously Congress expressly distinguished between compensatory and noncompensatory tax penalties in the Bankruptcy Code's priority provisions); *see also* Jo

without inequitable conduct,[79] the Court refused to sanction a subordination of a claim just because of its status.[80] The Court determined that kind of priority judgment is for Congress, not the courts.[81] Consequently, equitable subordination has become a tool of limited utility in dealing with administrative insolvency.

Inability to deprive governmental units of their *pro rata* participation for their penalty claims presents a greater impetus to deprive another disfavored group from its ration of the estate's meager assets. This disfavored group is the estate's professionals, especially the lawyers.

III. PROFESSIONAL COMPENSATION AND ADMINISTRATIVE INSOLVENCY

> *One Sunday morning, when the animals assembled to receive their orders, Napoleon announced that he had decided on a new policy. From now onwards Animal Farm would engage in trade with the neighbouring farms: not, of course, for any commercial purpose, but simply in order to obtain certain materials which were urgently necessary . . . .*
> *. . . . There would be no need for the animals to come in contact with human beings, which would clearly be most undesirable . . . . A Mr. Whymper, a solicitor . . . , had agreed to act as an intermediary between Animal Farm and the outside world. . . .*
> *Every Monday Mr. Whymper visited the farm . . . . He was a sly-looking little man with side whiskers, a solicitor in a very small way of business, but sharp enough to have realised earlier than anyone else that Animal Farm would need a broker and that the commissions would be worth having. The animals watched his coming and going with a kind of dread, and avoided him as much as possible.*[82]

Professional compensation in bankruptcy cases is highly regulated. Unlike other suppliers of post-petition goods and services, who may simply render invoices at the agreed-upon or customary price, professional persons must have their

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Ann J. Brighton, *Capital Contribution or a Loan? A Practical Guide to Analyzing Recharacterization Claims* (*or, when is Equitable Subordination the Appropriate Analysis?*), 21 AM. BANKR. INST. J. 1, 45 (June 2002) (stating *Noland* and *Reorganized CF&I Fabricators* eliminated subordination without inequitable conduct, save for cases dealing with stock redemption claims).

[79] *Noland*, 517 U.S. at 543 (limiting holding by avoiding question of "whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated").

[80] *Id*. at 540–41 (reversing lower court's categorical approach to tax penalty subordination, which would, in the Court's view, sweep away "the distinction between legislative and trial court functions").

[81] *Id*. at 543 (ruling "bankruptcy courts may not take it upon themselves to make that categorical determination [between administrative expenses and post-petition tax penalties which rightly belongs to Congress] under the guise of equitable subordination").

[82] ORWELL, *supra* note 1, at 66–68.

employment approved by the court,[83] submit applications for allowance of compensation and reimbursement of disbursements on notice to creditors, parties in interest, and the United States Trustee,[84] respond to any objections of creditors,[85] and await an allowance of reasonable compensation by the court, which employs statutory criteria to determine such allowance.[86] Significantly, professional compensation prior to the conclusion of a bankruptcy case, and in particular, in chapter 11 cases, prior to confirmation of the plan, is also regulated by section 331 of the Bankruptcy Code, entitled "Interim compensation."[87] This provision authorizes payments to professional persons "not more than once every 120 days, or

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[83] 11 U.S.C. § 327(a) (2002) (stating court's approval is required for trustee's employment of professionals); 11 U.S.C. § 1103(a) (2002) (requiring court to approve committee's employment of professionals); FED. R. BANKR. P. 2014(a) (narrating necessary procedure to obtain court's order approving employment of professionals).

[84] 11 U.S.C. § 330(a)(1) (stating after notice to parties in interest and United States Trustee, court may award reasonable compensation and reimbursement of expenses to professional); 11 U.S.C. § 331 (stating professional may apply for compensation order, which will be granted by court after notice and hearing); FED. R. BANKR. P. 2002(a)(6) (directing court to give notice of hearing to trustee, creditors, parties in interest regarding any request for compensation or reimbursement that exceeds $1000); FED. R. BANKR. P. 2016(a) (requiring an entity seeking compensation or reimbursement to file application with court and give copy of application to United States Trustee).

[85] *See* 11 U.S.C. § 307 (providing that United States Trustee may raise and be heard on any issue arising in chapter 11 proceeding); 11 U.S.C. § 330(a)(2) (allowing court to award lower than requested compensation upon motion from United States Trustee or any other party in interest); 11 U.S.C. § 1109(b) (stating party in interest may raise and be heard on any issue arising in chapter 11 proceeding); 28 U.S.C. § 586(a)(3)(A) (requiring United States Trustee to file with court its comments and objections, if any, with respect to applications for compensation and reimbursement under section 330 of title 11).

[86] 11 U.S.C. § 330(a)(3)-(4)(A) provides:

> (3)(A) In determining the amount of reasonable compensation to be awarded, the court shall consider the nature, the extent, and the value of such services, taking into account all relevant factors, including --
>
> (A) the time spent on such charges;
>
> (B) the rates charged for such services;
>
> (C) whether the services were necessary to the administration of, or beneficial at the time which the service was rendered toward the completion of, a case under this title;
>
> (D) whether the services were performed within a reasonable amount of time, commensurate with the complexity, importance, and nature of the problem, issue or task addressed; and
>
> (E) whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.
>
> (4)(A) Except as provided in subparagraph (B), the court shall not allow compensation for --
>
> (i) unnecessary duplication of services; or
>
> (ii) services that were not --
>
> (I) reasonably likely to benefit the debtor's estate; or
>
> (II) necessary to the administration of the case.

[87] 11 U.S.C. § 331; *see In re* Knudson, 84 B.R. 668, 670 (B.A.P. 9th Cir. 1988) (stating section 331 of Bankruptcy Code regulates *inter alia* compensation of professionals); *In re* Mariner Post-Acute Network, Inc., 257 B.R. 723, 727 (Bankr. D. Del. 2000) (asserting section 331 provides rules for interim fee applications).

more often if the court permits," subject to the same standards that govern final compensation.[88] The provision was new to the Bankruptcy Reform Act of 1978. Its purpose was to make clear what had been controversial under the Bankruptcy Act of 1898; that bankruptcy courts had the ability to pay professional compensation before the case was over.[89]

IV. HOLDBACKS

The implementation of interim compensation has raised the question whether, in the absence of any serious objection to the compensation requested, the entire amount sought by the professional in its application ought to be paid, or whether some percentage ought to be held back. Indeed, it has long been the view that the value of the professional's services often could not be appraised until the case concluded, for only then can one be certain whether the professional's efforts were worthwhile.[90] Even though interim compensation is interlocutory,[91] and subject to reconsideration at the end of the case,[92] there nevertheless remains a general

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[88] 11 U.S.C. § 331. Some courts have established procedures in appropriate cases for monthly payment of fees. *See In re Knudson*, 84 B.R. at 672–73 (holding that a fee retainer procedure may be authorized where court finds that extremely large fees accrue each month, the extended payment period will cause undue hardship on counsel, the counsel is responsive to any reassessment and a notice hearing takes place prior to any payment under the fee retainer procedure); *In re Mariner Post-Acute Network*, 257 B.R. at 730–31 (concluding professional may receive only percentage of monthly compensation unless bond covering any possible disgorgement is posted or funds are placed into trust account until an interim fee allowance is granted by court); *see also* General Order M-219 (Bankr. S.D.N.Y. 2000), *available at* http://www.nysb.uscourts.gov/orders/m219.pdf, (adopting procedure for obtaining an order authorizing monthly payment of professional fees).

[89] *See* S. REP. NO. 95-989, at 41 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5827 ("Section 331 permits trustees and professional persons to apply to the court not more than once every 120 days for interim compensation . . . . The court may permit more frequent applications if the circumstances warrant."); H.R. REP. NO. 95-595, at 330 (1977), *reprinted in* U.S.C.C.A.N. 5963, 6286–87. *See generally* COLLIER COMPENSATION, EMPLOYMENT & APPOINTMENT OF TRUSTEES & PROFESSIONALS IN BANKRUPTCY CASES ¶ 5.02[1] (Stan Bernstein et al. eds., 2002) [hereinafter COLLIER] ("As an equitable remedy, some courts allowed interim fees . . . when the court would be in a position to measure the full benefit to the estate of the services performed by the professionals.").

[90] *See In re* Mansfield Tire & Rubber Co., 19 B.R. 125, 127 (Bankr. N.D. Ohio 1981) ("[T]he court has rather consistently held that the interim compensation process will be used to relieve the economic burden on counsel only and leave to the conclusion of the proceeding a determination of a final award when all factors may be considered in their proper perspective."); *In re* Paramount-Publix Corp., 10 F. Supp. 504, 510 (S.D.N.Y. 1934) (noting calculation of value of legal services "more wisely done" at termination proceedings).

[91] *See, e.g.*, Stable Mews Assocs. v. Togut (*In re* Stable Mews Assocs.), 778 F.2d 121, 124 (2d Cir. 1985) (citing Richardson-Merrell Inc. v. Koller, 472 U.S. 424 (1985)). *But see, e.g.,* Four Seas Ctr., Ltd. v. Davres, Inc. (*In re* Four Seas Ctr., Ltd.), 754 F.2d 1416, 1419 (9th Cir. 1985) (lacking jurisdiction to hear appeal of such non-final order).

[92] *See, e.g., In re* Taxman Clothing Co., 49 F.3d 310, 316 (7th Cir. 1995) (vacating compensation order at termination of proceedings); Leighton Holdings Ltd. v. Belofsky & Assocs. (*In re* Kids Creek Partners, L.P.), No. 97-C3949, 1997 U.S. Dist. LEXIS 15715, at *21 (N.D. Ill. Oct. 2, 1997) (permitting trustees and creditors to seek reimbursement at end of proceedings from professionals paid); Matz v. Hoseman, 197 B.R. 635, 639 (N.D. Ill. 1996) ("An award of interim fees by the bankruptcy court under § 331 is not final . . . and is subject to later review by the court . . . .") (citations omitted).

reluctance to pay the full amount requested by a professional in its application for interim compensation. Besides questions of value, these amounts held back from interim compensation payments to professionals, colloquially, "holdbacks," have developed a myriad of additional rationales to support their use. These include permitting the court to defer ruling on objections to the amount of compensation requested, to express displeasure with the lack of progress or degree of contentiousness of a case, or to goad professionals into concluding a case.[93] Significantly, holdbacks are also justified as a means of preventing or ameliorating administrative insolvency. Courts have used their discretion in awarding interim compensation to reduce payments to professionals to preserve the estate for other administrative claimants.[94] This, of course, is unequal treatment of claims of equal priority.

V. DISGORGEMENT

Upon the discovery of administrative insolvency, the question is raised whether those claimants who have already received payment should be required to disgorge or give back some or all of what they received, so that the administrative claimants may share *pro rata*.[95] This notion is indeed similar to the concept of an avoidable preference.[96] If some creditors are paid, when others of equal rank are not, the payment should be returned, so that the estate can be distributed evenhandedly.[97] Significantly, most of the discussion of disgorgement focuses on professionals, and

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[93] *See generally* COLLIER, *supra* note 89, ¶ 5.02[1] (permitting holdbacks unless fees withheld were "'life-threatening' to law or accounting firms" (quoting *In re* Investors Funding Corp., 422 F. Supp. 461 (S.D.N.Y. 1976))); Warner, *supra* note 11, at 411 (posing various justifications for compensation holdbacks).

[94] *See In re* Alberto, 121 B.R. 531, 538 (Bankr. N.D. Ill. 1990) (delaying allowance of interim compensation until outcome of appeal, so court can use discretion wisely); *In re* Gherman, 114 B.R. 305, 307 (Bankr. S.D. Fla. 1990) (stating court's discretion in allowing interim compensation is not prohibited by Bankruptcy Code, and certain compensation is subject to the court's discretion); *In re* Robin Indus., Inc., 16 B.R. 695, 697 (Bankr. N.D. Ga. 1982) (concluding Congress intended for court to use discretion in granting interim compensation).

[95] In chapter 7 cases, including those converted from chapter 11, administrative claims are to be paid *pro rata*, if there are insufficient assets to pay them in full. 11 U.S.C. § 726(b) (2002). *See In re* Chute, 235 B.R. 700, 701–02 (Bankr. D. Mass. 1999) (discussing disgorgement of professional fees so claimants may be reimbursed pro rata); *In re* Kaiser Steel Corp., 74 B.R. 885, 891 (Bankr. D. Colo. 1987) (stating all claims share pro rata on same basis except for super-priority claims); *In re* Interstate Motor Freight Sys. IMFS, Inc., 71 B.R. 741, 744 (Bankr. W.D. Mich. 1987) (stating all claimants should be reimbursed pro rata).

[96] A preference is a transfer of an interest of the debtor in property, to or for the benefit of a creditor, on account of antecedent debt, made while the debtor is insolvent, within 90 days of the bankruptcy petition (or within a year, if the creditor is an insider), that enables the creditor to receive a greater distribution on its debt than in a chapter 7 case. 11 U.S.C. § 547(b) (2002). *See generally* 5 COLLIER ON BANKRUPTCY ¶ 547.01 at 7–12 (Lawrence P. King et al. eds., 15th ed. Rev. 2000) (summarizing preferences under 11 U.S.C. § 547); Timothy M. Lupinacci, *Analyzing Industry Standards in Defending Preference Actions: Equitable Purpose in Search of Statutory Clarity*, 5 J. BANKR. L. & PRAC. 129, 129–32 (1995) (discussing preference under 11 U.S.C. § 547(b)).

[97] *See* Union Bank v. Wolas, 502 U.S. 151, 160–61 (1991) (quoting H. R. REP. NO. 95-595, at 179 (1977)); *In re* CHG Intern., Inc., 897 F.2d 1479, 1482 (9th Cir. 1990) ("The foremost purpose behind the voidable-preference provision is to assure fair or equal treatment of all creditors within the same class.").

whether disgorgement of interim compensation is mandatory or discretionary.[98] Requiring disgorgement from workers is unthinkable. Courts have held that payments to ordinary suppliers of goods and services are not subject to disgorgement.[99] One court has granted a similar immunity to landlords.[100]

Why professionals in particular? The answer may be that disgorgement of professional fees is expressly or impliedly sanctioned in two entirely different circumstances. First, those who violate the requirements for employment as a professional person, such as disinterestedness,[101] absence of an adverse interest,[102] and full disclosure of connections,[103] may be compelled to disgorge compensation.[104] Second, those who receive interim compensation, which on final

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[98] The most extreme position is that disgorgement of interim compensation is mandatory in cases of administrative insolvency. *See In re* Specker Motor Sales Co., 289 B.R. 870, 872 (Bankr. W.D. Mich. 2003) (holding 11 U.S.C. § 726(b) requires disgorgement of interim compensation in every case of administrative insolvency); *In re* Kingston Turf Farms, Inc., 176 B.R. 308, 310 (Bankr. D. R.I. 1995) (concluding disgorgement is required as a matter of law in order for all claimants to be paid pro rata); *In re* Kearing, 170 B.R. 1, 7–8 (Bankr. D.C. 1994) (holding disgorgement is mandatory). Other courts conclude that disgorgement is discretionary. *See In re* Unitcast, Inc., 219 B.R. 741, 753 (B.A.P. 9th Cir. 1998) ("[D]isgorgement is a remedy within the discretion of the bankruptcy judges as the final arbiters of professional fees . . . ."); *In re* Anolik, 207 B.R. 34, 39–40 (Bankr. D. Mass. 1997) (stating disgorgement of claims must be decided on a case-by-case basis); *see also In re Chute*, 235 B.R. at 702 (holding mandatory disgorgement of contingency fees inappropriate).

[99] *See In re* Telesphere Communications, Inc., 148 B.R. 525, 530–31 (Bankr. N.D. Ill. 1992) ("[O]perational payments, by their nature, enjoy a de facto priority over other administrative expenses, without any express provision for superpriority."); *In re* Pac. Forest Indus. Inc., 95 B.R. 740, 743 (Bankr. C.D. Cal. 1989) (discussing differences in the Bankruptcy Code between payment of professionals and other people who provide services to debtor); *In re* Vernon Sand & Gravel, Inc., 109 B.R. 255, 257 (Bankr. N.D. Ohio 1989) (explaining rationale behind immediate payment of expenses resulting from ordinary course of business).

[100] *See In re* Rich's Dep't Stores, Inc., 209 B.R. 810, 817 (Bankr. D. Mass. 1997) (holding landlord was not subject to disgorgement).

[101] *See* 11 U.S.C. § 101(14) (defining disinterested person as one whom has no connection with debtor or creditor's situation and does not represent any adverse interest); 11 U.S.C. § 327(a) (1993) (requiring trustee to only employ disinterested professional); *see also, e.g., In re* Granite Sheet Metal Works, Inc., 159 B.R. 840, 845 (Bankr. S.D. Ill. 1993) (emphasizing court can deny compensation and require reimbursement of expenses if professional is not disinterested person thus has adverse interest to that of estate).

[102] *See* 11 U.S.C. § 327(a) (stating trustee may employ disinterested professional without interest adverse to estate); *see also, e.g., In re Granite Sheet Metal Work,*, 159 B.R. at 845 (maintaining debtor's choice of counsel limited to disinterested persons without adverse interest otherwise court may deny compensation or require reimbursement of expenses).

[103] *See* FED. R. BANKR. P. 2014(a) (mentioning application for employment of professional persons must state person's connectedness with debtor, creditor or any other party in interest); *see also In re Granite Sheet Metal Works*, 159 B.R. at 845 (discussing disinterested person has no connection with debtor and if such relationship does exist and is not disclosed, court is authorized to deny compensation for services or reimbursement of expenses); *In re* Lee, 94 B.R. 172, 176–77 (Bankr. C.D. Cal. 1988) (reiterating professional's obligation to disclose connectedness with debtor, creditor or any other parties in interest in employment application).

[104] *See* 11 U.S.C. § 328(c) (stating court may deny allowance of compensation for services and require reimbursement of expenses by professional person if such person is not disinterested or holds interest adverse to any party in interest); *see also* Futuronics Corp. v. Arutt, Nachamie & Benjamin (*In re* Futuronics Corp.), 655 F.2d 463, 468–69 (2d Cir. 1981) (denying compensation to professional who failed to disclose connectedness with parties in interest); *In re* Arlan's Dep't Stores, Inc., 615 F.2d 925, 931–34 (2d Cir. 1979) (holding compensation severely limited due to breach of fiduciary obligation by professional in failing to

examination, is determined to be excessive based on the statutory factors for determining reasonable compensation are required to refund what is essentially an overpayment.[105] Because professionals are subject to disgorgement in these two situations, it may be viewed as a limited extension of existing law to add a third. But these circumstances have little in common with a professional who has violated no ethical duties, and has earned his interim fee, but is confronted with unpaid administrative expenses of equal or higher priority.

Disgorgement of professional compensation based solely on administrative insolvency is not expressly authorized by the Bankruptcy Code.[106] It is therefore an equitable doctrine, imported from non-bankruptcy law. Disgorgement or restitution in other contexts require either wrongdoing or unjust enrichment.[107] The first of these may be easily ruled out. The second is inapplicable as well. It is hardly unjust enrichment for a professional to receive appropriate compensation for services rendered. The professional has not inadvertently or mistakenly received an unearned benefit. The problem arises when other claimants have not been paid.

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disclose connectedness with all parties in interest); *In re* Granite Partners, L.P., 219 B.R. 22, 35 (Bankr. S.D.N.Y. 1998) (concluding professional had adverse interest warranting total denial of compensation for services); *In re* Angelika Films 57th, Inc., 227 B.R. 29, 38 (Bankr. S.D.N.Y. 1998) (defining adverse interest as one creating bias against estate or possessing economic interest potentially in rivalry with estate and stating in such circumstances denial of compensation justified); *In re* Leslie Fay Cos., Inc., 175 B.R. 525, 537 (Bankr. S.D.N.Y. 1994) (warranting monetary sanction where full disclosure of connectedness is not made).

[105] *See* Taxman Clothing Co., 49 F.3d 310, 314–16 (7th Cir. 1995) (expressing interim compensation fees are reviewable by court which has discretion to require disgorgement of excessive fees); Arens v. Boughton (*In re* Prudhomme), 43 F.3d 1000, 1003 (5th Cir. 1995) (noting bankruptcy rule authorizes disgorgement of excessive fees); *In re* Wilde Horse Enters., Inc., 136 B.R. 830, 845–46 (Bankr. C.D. Cal. 1991) (noting forfeiture of compensation to professional representing debtor is within discretion of court).

[106] The reconsideration of claims provision concludes: "[t]his subsection does not alter or modify the trustee's right to recover from a creditor any excess payment or transfer made to such creditor." 11 U.S.C. § 502(j). Even if this section created, by negative implication, a right of recovery, it is applicable only against a "creditor." A "creditor" is defined in 11 U.S.C. § 101(10) as having a claim that arose, or is deemed to have arisen, "at the time of or before the order for relief." So, a "creditor" holds a pre-petition claim, not one for an administrative expense, such as professional compensation. Moreover, the avoidance of post-petition transfers provision applies to transfers that neither authorized by the Bankruptcy Code nor by the court. *See* 11 U.S.C. § 549(a). Payment of an interim compensation award, however, is authorized by both the Bankruptcy Code and the court. Such authorization could presumably be withdrawn if the order is vacated. Administrative insolvency, however, is not one of the usual grounds for vacating an order, which are: (1) mistake, inadvertence, surprise or excusable neglect; (2) newly discovered evidence which by due diligence could not have been discovered in time to move for a new trial; (3) fraud, misrepresentation or other misconduct; (4) the judgment is void; (5) the judgment has been satisfied, released or discharged, or a prior judgment upon which it is based has been reversed or vacated; or (6) any other reason justifying relief from the operation of the judgment. FED. R. CIV. P. 60(b) (applicable to bankruptcy cases by FED. R. BANKR. P. 9024).

[107] *See* Atl. Coast Line R.R. v. Florida, 295 U.S. 301, 309–10 (1935) (restitution); Mohamed v. Kerr, 91 F.3d 1124, 1126 (8th Cir. 1996) (restitution); SEC v. Huffman, 996 F.2d 800, 802–03 (5th Cir. 1993) (disgorgement); *In re* Cross, 218 B.R. 76, 78 n.2 (B.A.P. 9th Cir. 1998) (disgorgement); *In re* Bonham, 224 B.R. 435, 437 (Bankr. D. Ala. 1998) (disgorgement).

This is the notion of preference, which is unknown at common law.[108] But disgorgement based on administrative insolvency creates a preference without its usual defenses, such as an ordinary course transaction,[109] or the provision of subsequent new value to the debtor.[110]

Disgorgement based solely on administrative insolvency, then, is a doctrine employed to promote fairness, but is itself unfairly employed. Many similarly situated are exempt from attack. Indeed, those pre-petition creditors, who, for good reason, were paid at the outset of the case, such as employees and critical vendors, are seldom thought of as candidates for disgorgement, even though their claims have a lower priority.[111] And, those who are subjected to disgorgement are not guilty of wrongdoing or unjust enrichment. Finally, if a pre-petition recipient of a preference has defenses, there is no justification for the failure to provide those defenses to a post-petition recipient.[112] That professionals may be subjected to disgorgement based on ethical violations or reappraisals of the value of their services is no reason to single them out for disgorgement based administrative insolvency.

VI. EXAMPLES OF CREATIVE SOLUTIONS

Chapter 11 cases end in one of three ways: confirmation,[113] conversion[114] or dismissal.[115] Administratively insolvent chapter 11 cases ordinarily[116] cannot

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[108] *See* 3 COLLIER ON BANKRUPTCY ¶ 60.02 at 755 (James W. Moore, eds., 14th ed. 1978) (noting at common law debtor may prefer any one of his creditors). *See generally* Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy,* 38 VAND. L. REV. 713 (1985).

[109] *See* 11 U.S.C. § 547(c)(2).

[110] 11 U.S.C. § 547(c)(4); *see In re* Maxwell Newspapers, Inc., 192 B.R. 633, 637 (Bankr. S.D.N.Y. 1996) (denying disgorgement).

[111] *See supra* notes 30–39 and accompanying text.

[112] At a minimum, disgorgement based on administrative insolvency should be subject to the two-year statute of limitations on avoidance of post-petition transfers. *See* 11 U.S.C. § 549(d) (2003) (stating there is two year statute of limitations for avoidance of post-petition transfers); *In re* Home Am. T.V.-Appliance Audio, Inc., 232 F.3d 1046, 1050 (D. Ariz. 2000) (stating there is two year statute of limitations for avoidance of post-petition transfers); *In re* Shape, Inc., 138 B.R. 334, 337 (Bankr. D. Me. 1992) (stating section 549 operates as a statute of limitations).

[113] *See* 11 U.S.C. § 1129 (stating requirements for confirmation of plan); 11 U.S.C. § 1141 (stating effects of confirmation of plan). Strictly speaking, this should be substantial consummation of a confirmed plan, which is defined as the occurrence of three things:

(A) transfer of all or substantially all of the property proposed by the plan to be transferred; (B) assumption by the debtor or the successor to the debtor under the plan of the business or of the management of all or substantially all of the property dealt with by the plan; and (C) commencement of distribution under the plan.

11 U.S.C. § 1101(2). After substantial consummation the plan may not be modified, 11 U.S.C. § 1127(b) (2003); and the case may be closed. 11 U.SC. § 350(a) (2003); FED. R. BANKR. P. 3022.

[114] 11 U.S.C. § 1112 (stating requirements for conversion). Usually the conversion is to chapter 7, §§ 1112(a)–(b), but may be to chapter 12 or 13, if the debtor is eligible for relief under such chapter. *See* 11 U.S.C. §§ 109(e)–(f) (stating requirements for debtors under chapters 12 and 13); 11 U.S.C. § 1112(d) (requirements for conversion to chapter 12 or 13); 11 U.S.C. § 1112(f) (limiting conversions to other chapters to debtors who qualify under those chapters).

achieve confirmation, because one of the requirements of confirmation is full payment of priority claims, including administrative expenses.[117] The usual options are therefore conversion to chapter 7 or dismissal.[118] Each alternative often presents problems. Dismissal normally requires the reinstatement of avoided transfers and liens, and the revesting of the estate's property in the entity that held it prior to bankruptcy.[119] Such undoing of the bankruptcy case may substantially diminish the estate available for distribution. Conversion to chapter 7, of course, mandates the cessation of business,[120] and the concomitant loss of going concern values. It is true that chapter 7 trustees may be authorized to operate the debtor's business for a limited period.[121] Nevertheless, interim trustees are selected from a panel maintained by United States Trustees and are required to be disinterested.[122] Such a

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[115] *See* 11 U.S.C. § 305(a)(1) (stating when court can dismiss case); § 1112(b) (stating for what causes court can dismiss case); FED. R. BANKR. P. 1017 (stating procedure for dismissal of bankruptcy case).

[116] *See In re* Escobedo, 28 F.3d 34, 35 (7th Cir. 1994) (reiterating mandatory requirement that all plans provide for full payment of priority claims); *In re* Southwestern Water Corp., 227 B.R. 262, 263 (Bankr. W.D. Tex. 1998) (discussing Congressional decision to allow courts to confirm plans only after full payment of priority claims). *But see In re* Teligent, Inc., 282 B.R. 765 (Bankr. S.D.N.Y. 2002), discussed *infra* notes 133–46 and accompanying text.

[117] 11 U.S.C. § 1129(a)(9). The pragmatic notion that a liquidating plan can be confirmed, even if it does not provide for full payment of priority claims, because it provides a better distribution to creditors than conversion to chapter 7, is one that nevertheless contradicts the statute. The bankruptcy courts do not have authority to override the statute, even to pursue a more equitable result. *See* Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988) (court's equitable power "must and can only be exercised within the confines of the Bankruptcy Code"); Sandy Ridge Dev. Corp. v. La. Nat'l Bank (*In re* Sandy Ridge Dev. Corp.), 881 F.2d 1346, 1352 (5th Cir. 1989) (stating any bankruptcy plan must meet all statutory requirements in order to be approved); *In re* Hill, 95 B.R. 293, 297 (Bankr. N.D.N.Y. 1988) (noting court's equitable relief extends only to extent defined in statute).

[118] In practice, where the estate consists of burdensome assets to be abandoned, *see* 11 U.S.C. § 554(a), and some cash, a dismissal order may be accompanied by an approved schedule of distribution. *See In re* Purco, 76 B.R. 523, 532 (Bankr. W.D. Pa. 1987) (discussing trustee's authority to abandon property held to be burdensome); *In re* Mowbray Eng'g Co., Inc., 67 B.R 34, 35 (Bankr. M.D. Ala. 1986) (expanding on situations where court may permit trustee to abandon burdensome assets).

[119] 11 U.S.C. § 349(b). The court, for cause, may order otherwise. *Id*. That power, however, is to be used to protect rights acquired in reliance on the case, such as the rights of good faith purchasers of estate assets. The principal statutory purpose of dictating the effects of dismissal is to restore pre-bankruptcy property rights, as if the bankruptcy case had never occurred. S. REP. NO. 95-989, at 49 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5834; H.R. REP. NO. 95-595, at 338 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6294.

[120] A chapter 7 trustee is statutorily commanded to liquidate, 11 U.S.C. § 704(1), and has no automatic authority to operate the debtor's business. *See* 11 U.S.C. § 721; *cf*. 11 U.S.C. § 1108 (granting chapter 11 trustee authority to operate debtor's business).

[121] 11 U.S.C. § 721; *see also In re* Gen. Teamsters, Warehousemen, and Helpers Local 890, 225 B.R. 719, 734 (Bankr. N.D. Cal. 1998) (noting business of chapter 7 debtors can only be done by trustee); *In re* Greater Miami Trading, Inc., 177 B.R. 1022, 1023 (Bankr. S.D. Fla. 1995) (allowing trustee to operate debtor's business for only limited period after conversion to chapter 7).

[122] *See* 11 U.S.C. § 701(a)(1) ("[T]he United States trustee shall appoint one disinterested person that is a member of the panel of private trustees established under section 586(a)(1) of title 28 . . . ."); 28 U.S.C. § 586(a)(1) (requiring United States Trustee to keep panel of private trustees); 11 U.S.C. § 101(14)(E) (defining disinterested person as one who "does not have an interest materially adverse to the interest of the estate"). A trustee serving in the case immediately prior to conversion to chapter 7 may also be named interim trustee. *See* 11 U.S.C. § 701(a)(1).

trustee would likely be at a substantial disadvantage to chapter 11 management in temporarily operating a complex business with either the hope of finding a buyer or an eye toward an orderly liquidation.

Faced with an administratively insolvent chapter 11 case and undesirable alternatives of conversion or dismissal, courts have occasionally adopted creative solutions. Two of these solutions are discussed below.

A. Caldor

The Caldor Corporation and its affiliates once constituted one of the largest discount retailers in the Northeast and Mid-Atlantic states. In January 1999, after more than three years of operating losses in chapter 11, the debtors reached the stage when they became administratively insolvent and had no realistic prospect for reversal of their fortune. Having consulted with its holders of secured debt, Caldor determined that the best way to maximize value was to implement a wind-down program that consisted of reducing employees and overhead, conducting going-out-of-business sales, and selling real estate and assigning real property leases. This wind-down program required continued operations despite the administrative insolvency. Cognizant of the financial situation, suppliers of goods and services necessary for the wind-down were understandably reluctant to proceed without assurance of full payment.[123]

In response to Caldor's application, the bankruptcy court entered an order, pursuant to section 364(c)(1) of the Bankruptcy Code,[124] granting administrative expenses incurred during the so-called "Wind-Down Period" priority over those incurred during the so-called "Operating Period."[125] Although this "Wind-Down Order" was entered *ex parte*, it provided for service a notice of its terms on all known holders of administrative expenses and for publication of such notice in one major national newspaper and one trade periodical, and afforded anyone the

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[123] Application for Order (i) Authorizing Debtors to Wind-Down Their Business Operations and Affairs, and Implement Necessary Procedures with Respect Thereto, (ii) Enjoining Collection Efforts by Operating Period Creditors, (iii) Establishing a Bar Date for Filing Operating Period Claims, (iv) Scheduling Hearing on Debtors' Application for Entry of Order, *inter alia*, (a) Approving Agreement with Secured Term Debt Holders, and (b) Enjoining Pending Litigations and Proceedings with Respect to Certain Pre-Petition Claims, and (v) Granting Other Relief Pending Such Hearing at 1–8, *In re* Caldor, Inc., (Bankr. S.D.N.Y. Jan. 22, 1999) (No. 95-44080).

[124] 11 U.S.C. § 364(c)(1).

[125] Order (i) Authorizing Debtors to Wind-Down Their Business Operations and Affairs, and Implement Necessary Procedures with Respect Thereto, (ii) Enjoining Collection Efforts by Operating Period Creditors, (iii) Establishing a Bar Date for Filing Operating Period Claims, (iv) Scheduling Hearing on Debtors' Application for Entry of Order, *inter alia*, (a) Approving Agreement with Secured Term Debt Holders, and (b) Enjoining Pending Litigations and Proceedings with Respect to Certain Pre-Petition Claims, and (v) Granting Other Relief Pending Such Hearing, at 5-6, *In re* Caldor, Inc. (Bankr. S.D.N.Y. Jan. 22, 1999) (No. 95-44080) [hereinafter Caldor Wind-Down Order]. The court subsequently determined that such procedure afforded due process to administrative expense claimants. *See In re* Caldor, Inc., 240 B.R. 180, 187–89 (Bankr. S.D.N.Y. 1999), *aff'd sub nom*. Pearl-Phil GMT (Far East) Ltd. v. Caldor Corp., 266 B.R. 575 (S.D.N.Y. 2001).

opportunity to object to any of its provisions at a subsequent hearing.[126] The *Caldor* court thus creatively employed a superpriority provision, customarily used in debtor in possession financing, to facilitate the orderly liquidation of an administratively insolvent case.

In overruling a challenge to the order, the *Caldor* court rejected the argument that it was engaged in "judicial law making," and found that section 364(c)(1) supplied express authority for the order.[127] The court reasoned that had the case been converted to chapter 7, the objecting Operating Period claimant would have been in the same priority position, sharing *pro rata* with administrative expense claims in the aborted chapter 11 case, and subject to the administrative expense claims of the chapter 7 trustee.[128] Instead of converting the case, the court determined that the time and expense of replacing management and its professionals with a chapter 7 trustee and his professionals would "further diminish these already administratively insolvent estates."[129] Furthermore, no credit would be extended to Caldor during the Wind-Down Period without a priority over administrative expenses incurred during the Operation Period, a superpriority that afforded reasonable assurance of full payment.[130] The Wind-Down Order and its superpriority were factually and legally justified.[131] The district court upheld this reasoning on appeal.[132]

B. Teligent

A different administrative insolvency problem confronted the bankruptcy court in *In re* Teligent,[133] Telegent and its affiliates provided retail and wholesale telecommunications services. The debtors, financed by the use of cash collateral and post-petition borrowings, operated at a loss in chapter 11. To retire secured debt, the debtors sold off operating subsidiaries, but could not sell their core assets. The remaining assets, which served as collateral for pre- and post-petition loans, were insufficient to satisfy the secured lenders. A substantial amount of administrative expenses were unpaid. Rather than foreclose, the lenders agreed to pay for a plan that would grant the lenders ownership of the reorganized debtor, which would operate a downsized business. The plan would set up a small fund for unsecured creditors, and a larger one for administrative and priority creditors. The plan had the support of the debtor and the creditors' committee, and was accepted by the unsecured creditors.[134]

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[126] Caldor Wind-Down Order, *supra* note 123, at 9–12.
[127] *In re Caldor, Inc.*, 240 B.R. at 188–89.
[128] *Id*.
[129] *Id*.
[130] *Id*. at 189.
[131] *Id*. at 190.
[132] Pearl-Phil GMT (Far East) Ltd. v. Caldor Corp., 266 B.R. 575, 584–85 (S.D.N.Y. 2001).
[133] 282 B.R. 765 (Bankr. S.D.N.Y. 2002).
[134] *Id*. at 766–68.

The difficulty in confirming the plan was the need to obtain the consent of all administrative and priority claimants to receive less than their statutory right to full payment of their claims.[135] Although there were 2,006 administrative and priority claimants, most of these claims were under $3,000, and the plan provided that any administrative or priority claim of $3,000 or less, or reduced to $3,000, would be paid in full.[136] Consequently, 454 administrative and priority claimants had to be solicited to consent to the treatment proposed by the plan.[137] The debtors sent each such claimant a court-approved consent form. The form explained that in the absence of universal consent of these claimants, the plan would fail, and the case would be converted or dismissed. Although the claimants were to receive a small percentage payment of their claim, under either conversion or dismissal the claimants would receive nothing. Most of the claimants returned the form and indicated their consent to the plan, many opting to reduce their claims to $3,000 to receive full payment of such sum. Ultimately, no claimant refused to consent. No response was received from 107 claimants, and the issue arose as to how best to construe the silence.[138]

The court construed the silence as consent and confirmed the plan.[139] The court first held that the consent required by the Bankruptcy Code need not be express, but could be implied.[140] The court then conceded that under standard contract law principles, silence or inaction does not ordinarily result in the acceptance of an offer.[141] The exceptions are when there is a duty to speak,[142] and when the parties understand that "the offeree in remaining silent and inactive intends to accept the

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[135] 11 U.S.C. § 1129(a)(9) (2002) (stating in Historical and Statutory Notes that court will confirm under (a)(9)(A) absent consent of all claimants where there is fair and equitable value for dissenting class); *see id*. at 768 ("Because so little was available for distribution, almost any one of the 454 could prevent confirmation merely by insisting on his right to full payment."). If there is a dissenting class, a court may nevertheless confirm the plan under section 1129(a)(9) if the negotiated plan provides to the dissenting class value equal to what would have been provided under a plan that is fair and equitable. *See* 11 U.S.C. § 1129(a)(9) (Historical and Statutory Notes).

[136] *In re Teligent*, 282 B.R. at 768; *cf.* 11 U.S.C. § 1122(b) (allowing separate classification of claims for purpose of creating administrative convenience class).

[137] *In re Teligent*, *Inc.,* 282 B.R. at 768. Pre-petition creditor claims must be classified and their acceptance is determined through class voting. *See* 11 U.S.C. §§ 1122(a), 1123(a)(1), 1126(c), 1129(a)(8). Administrative and tax priority creditors claims, however, need not be classified. *See* 11 U.S.C § 1123(a)(1). Whether or not they are classified, administrative and tax priority creditors claims must each receive payment in full, unless each claim holder agrees to a less favorable treatment. *See* 11 U.S.C. § 1129(a)(9).

[138] *In re Teligent*, 282 B.R. at 770.

[139] *Id.* at 773.

[140] *Id*. at 771. The statute provides for full payment, "[e]xcept to the extent that the holder of a particular claim has agreed to a different treatment . . ." 11 U.S.C. § 1129(a)(9). The court reasoned that the statute required the claimants to "agree" to a less favorable treatment, but did not require an "express agreement." In ordinary usage, an agreement may be implied, and the Supreme Court has instructed that words in statutes be given "their ordinary, contemporary, common meaning." *In re Teligent*, 282 B.R. at 771 (quoting Pioneer Inv. Servs. Co. v. Brunswick Assocs. Ltd., 507 U.S. 380, 388 (1993)).

[141] *In re Teligent*, 282 B.R. at 771 (citing RESTATEMENT (SECOND) OF CONTRACTS § 69(1) (1981)).

[142] *Id*. (citing JOHN D. CALAMARI & JOSEPH M. PERILLO, THE LAW OF CONTRACTS § 2–18, (3d ed. 1987)).

offer."[143] Both were held applicable.[144] The administrative claimants had a "duty to speak" in these circumstances because the fate of all interested in the outcome of the case – administrative expense holders, creditors, employees – depended on these claimants' responses to the consent form, and the claimants knew this. If one claimant refused to consent, the plan would fail, the remaining employees would be terminated, and no one other than the secured lenders would receive any distribution at all.[145] In addition, the court determined that the claimants who did not return the consent forms intended their silence to be construed as an acceptance. Many of the claimants informed representatives of the debtors that this was their intention, while others responded with disgust at the mention of the case, and no one communicated an objection to the proposal. In the end, a refusal to consent was contrary to each claimant's economic self-interest because it meant rejecting something in favor of nothing.[146]

Not only does *Teligent* provide a method to confirm a particular kind of administratively insolvent chapter 11 case, it also supports the concept that creative solutions to administrative insolvency can be superior to the standard ones of conversion or dismissal. As with the *Caldor* superpriority, going-concern values and jobs were preserved, and distributions to claimants were enhanced. Most significantly, in both cases, the courts established rules that preserved the principle of equality of distribution, subject to statutorily authorized priorities, rather than making *ad hoc* determinations of which claim to pay or prioritize.

CONCLUSION

> *Meanwhile life was hard. The winter was as cold as the last one had been, and food was even shorter. Once again all rations were reduced, except those of the pigs and the dogs. A too rigid equality of rations, Squealer explained, would have been contrary to the principles of Animalism.*[147]

The current rules governing administrative insolvency have the clarity of a pig sty. The courts certainly have discretion to determine the timing of payment of administrative expenses. During administrative insolvency this discretion is tantamount to determining who gets paid and who does not. The Bankruptcy Code has express priority and superpriority provisions. It also has infelicitously worded provisions, which depending on which court you are bound or persuaded by, may or may not grant additional claimants superpriority status. Attempts to subordinate post-petition, noncompensatory penalty claims and treat them similarly to their pre-

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[143] *In re Teligent*, 282 B.R. at 771 (quoting RESTATEMENT (SECOND) OF CONTRACTS § 69(1) (1981)).
[144] *Id*.
[145] *Id*. at 772–73.
[146] *Id.* at 773.
[147] ORWELL, *supra* note 1, at 104–05.

petition counterparts, which are automatically subordinated, have been categorically rejected by the Supreme Court. Professionals are subjected to holdbacks of their compensation to forestall administrative insolvency, and disgorgement of such compensation in the advent of administrative insolvency. The principle of equality of distribution seems to have gotten lost amid the scuffle for what little money is left.

Ideally, there would be legislation to address the problem. But since comprehensive bankruptcy reform has been stalled for several years in Congress, and such reform has not addressed this problem, a legislative solution cannot be depended upon in the near future.[148] It is therefore for the courts and the rulemaking bodies to consider adopting procedures that will let all who enter this terrain of administrative insolvency know where they stand. If some claimants are to be more equal than others, this should be known in advance. Outside of administrative insolvency, there are established priority rules, then equality, then established subordination criteria. The same hierarchy should be imposed on administrative insolvency.

If the case is not converted to chapter 7, and continuation in chapter 11 is necessary to preserve going concern values and maximize recovery for the benefit of those interested in the estate, then that decision should have the court's approval. When administrative insolvency is thus declared, the other purpose of chapter 11, namely preserving jobs, should also be honored. . 364(c) should be expressly employed to provide explicit priority to workers and to those, including professionals, whose services are necessary to preserve such values. Implied or quasi-superpriorities should be banned. Disgorgement should be employed, if at all, to provide for true equality of distribution for administrative claimants, not a false one in which only the professionals are the targets. In this way, an administratively insolvent chapter 11 case does not become an Orwellian nightmare, in which a system created to remedy distress transforms into a tyranny that leaves everyone, except the pigs and the dogs, worse off than when they started.

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[148] Comprehensive bankruptcy revision has come close to enactment in each of the last three Congresses. It failed for different reasons in the 106th and 107th Congress. At the time of this writing, the bill passed by the House of Representatives in March 2003 remains unconsidered by the Senate. None of the bills has addressed administrative insolvency.