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When the Bank Wants Its Borrower in Bankruptcy: Benefits of Bankruptcy for Lenders and Lender Liability Defendants

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WHEN THE BANK WANTS ITS BORROWER IN BANKRUPTCY: BENEFITS OF BANKRUPTCY FOR LENDERS AND LENDER LIABILITY DEFENDANTS

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I. INTRODUCTION

Bankruptcy features such as the automatic stay[1] and the avoidance powers[2] have traditionally caused lenders to look with disfavor upon the commencement by a borrower of a case under the Bankruptcy Code and have caused lenders to consider only as a last resort the alternative of exercising their right to commence an invol-

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1. 11 U.S.C. § 362 (1982). Section 362 imposes an automatic stay of virtually all actions of creditors to collect pre-filing debt or to exercise control over the debtor's property as of the date of the commencement of a bankruptcy case. *See id.* § 362(a). Creditors have traditionally viewed the automatic stay as a major obstacle to collecting debts and working out problem loans and as a reason to avoid a bankruptcy by or against their borrowers.

2. *Id.* §§ 544-548. Avoidance powers enable the trustee, or a debtor-in-possession in a case filed under Chapter 11 where no trustee has been appointed, to avoid certain pre-filing transfers from the debtor to or for the benefit of creditors. Two of the more common avoidance powers appear in sections 547 and 548. *Id.* §§ 547(b), 548(a). Section 547 governs preferences. A preference is (1) a transfer of an interest of the debtor in property, including a security interest such as a mortgage or lien on property, (2) to or for the benefit of a creditor, (3) for or on account of an antecedent debt, (4) made while the debtor was insolvent, (5) on or within 90 days before the date of filing or one year if the creditor was at the time of the transfer an insider, and (6) that enables the creditor to receive more than the creditor would have received under a Chapter 7 liquidation were the transfer never made. *Id.* § 547(b). Subject to certain defenses enumerated in 11 U.S.C. § 547(c) (1982), preferential transfers may be avoided and recovered by the debtor or trustee for the benefit of the bankruptcy estate. *Id.* §§ 547(b), 550.

Section 548 governs fraudulent conveyances. Fraudulent conveyances under the Bankruptcy Code may take one of two basic forms: conveyances made "with actual intent to defraud, hinder, or delay" creditors, *id.* § 548(a)(1); or conveyances made without actual fraudulent intent but while the debtor was insolvent or undercapitalized, or on account of which the debtor became insolvent, and where the debtor received less than reasonably equivalent value in exchange for the property transferred. *Id.* § 548(a)(2). Subject to certain defenses enumerated in 11 U.S.C. § 548(c) (1982), such transfers may be avoided. *Id.* § 548(a). Either the property or its value may be recovered from the initial transferee for the benefit of the bankruptcy estate, *id.* § 550(a), or from any immediate or mediate subsequent transferees except those who "take[] for value . . . in good faith, and without knowledge of the voidability of the transfer avoided." *Id.* § 550(b).

untary bankruptcy against a borrower.[3] Yet circumstances exist

3. Bankruptcy cases involving non-individual debtors are usually either Chapter 11 reorganizations or Chapter 7 liquidations. Any corporation or partnership, except a railroad, insurance company, or banking institution, may be a debtor under Chapter 7, 11 U.S.C. § 109(b) (1982), and any corporation or partnership, except a stockbroker, commodity broker, or railroad, may be a debtor under Chapter 11. *Id.* § 109(d) (Supp. IV 1986).

Chapter 7 or Chapter 11 cases, whether voluntary or involuntary, are commenced by the filing of a petition. *Id.* §§ 301, 303 (1982). A voluntary case is commenced by the debtor, *id.* § 301, and an involuntary case is commenced by creditors against the debtor. *Id.* § 303(b)(1)-(4). In order to commence an involuntary case against a debtor that has twelve or more creditors, excluding creditors that have an insider relationship with the debtor and creditors whose claims against the debtor are contingent as to liability or are the subject of a bona fide dispute, a petition must be filed by at least three eligible creditors whose claims against the debtor aggregate at least $5,000 more than the value of any liens on the property of the debtor securing such creditors' claims. *Id.* § 303(b)(1) (Supp. IV 1986). Where a debtor has fewer than twelve creditors, excluding insiders, recipients of certain avoidable transfers, and creditors whose claims against the debtor are contingent as to liability or are the subject of a bona fide dispute, a case may be commenced against the debtor by the filing of a petition by *one or more* eligible creditors, provided that the creditor[s]'s claim[s] against the debtor aggregate at least $5,000 more than the value of any liens on the property of the debtor securing such creditor[s]'s claim[s]. *Id.* § 303(b)(2) (1982). To be "eligible" to be a petitioning creditor, the creditor must hold a claim against the debtor that is neither contingent as to liability nor the subject of a bona fide dispute. *Id.* § 303(b)(1) (1982 & Supp. IV 1986).

If the debtor contests the commencement of an involuntary case against it, the case will be dismissed unless the petitioning creditors can establish one of the following:

> (1) the debtor is generally not paying . . . [its] debts as such debts become due unless such debts are the subject of a bona fide dispute; or
> (2) within 120 days before the date of the filing of the petition, a custodian, other than a trustee, receiver, or agent appointed or authorized to take charge of less than substantially all of the property of the debtor for the purpose of enforcing a lien against such property, was appointed or took possession.

Id. § 303(h)(1)-(2).

Upon the filing of a petition, an estate is created. *Id.* § 541 (Supp. IV 1986). The estate consists of virtually all interests of the debtor in property, whether legal or equitable, and whether contingent or fixed. *Id.* § 541(a) (1982 & Supp. IV 1986). Property interests of the debtor included in the estate are its claims and causes of action against third-parties, including lenders. *See infra* note 110 and accompanying text.

When the petition is filed, whether it is voluntary or involuntary, all creditors and other entities are automatically stayed from taking actions to collect their debts, enforce their liens, or exercise control over the debtor's property. 11 U.S.C. § 362(a) (1982 & Supp. IV 1986). This is commonly referred to as the automatic stay. The scope of the automatic stay is extremely broad, effectively prohibiting all collection efforts. The stay thus provides the debtor with a "breathing spell" in which to reorganize and, at the same time, protects creditors as a group by prohibiting individual creditors, unless they obtain court approval, from pursing payment of their claims, improving their collateral position, or obtaining control over property of the debtor. There are several exceptions to the automatic stay, *see id.* § 362(b), a discussion of which is beyond the scope of this Article.

On request of a party-in-interest, which includes a creditor in a Chapter 11 case, where lenders might obtain substantial benefits and advantages from dealing with a problem loan in the context of a borrower's bankruptcy case, particularly in light of the increasing number of lender liability lawsuits that have been initiated during the past few years. As a result of various provisions of the Bankruptcy Code and the nature and dynamics of the bankruptcy process itself, a lender can obtain significant control over its borrower's affairs; receive substantial protection for its collateral; eliminate interests of unreason-

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see id. § 1109(b) (1982), the court may terminate or modify the automatic stay. *Id.*§ 362(d) (1982 & Supp. IV 1986). A ground for relief for the secured lender is "cause," including but not limited to lack of adequate protection of the lender's interest in property of the debtor. *Id.* § 362(d)(1). A secured lender is also entitled to relief if it can establish that the debtor does not have any equity in its collateral and the collateral is not necessary to an effective reorganization. *Id.* § 362(d)(2).

Whether voluntary or involuntary, if the case is under Chapter 7 of the Code, a trustee is automatically appointed. *Id.*§ 701. Upon his appointment, the Chapter 7 trustee becomes the representative of the estate with the capacity to sue, *id.* § 323 (1982), and becomes the sole proper party to assert any and all claims and causes of action of the debtor. The trustee displaces management of the debtor, *see* Mixon v. Anderson (*In re* Ozark Restaurant Equip. Co.), 816 F.2d 1222, 1225 (8th Cir. 1987), and is charged with the duty to administer and to liquidate assets of the estate, including causes of action, thereby reducing them to money for distribution to creditors. 11 U.S.C. § 704 (1982 & Supp. IV 1986). *See, e.g.*, Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 352 (1985) (construing section 704).

In a Chapter 11 case, the debtor generally remains in possession of its property after the commencement of the case and management continues to operate the business and act as representative of the estate, 11 U.S.C. § 1107 (1982 & Supp. IV 1986), unless, on request of a party-in-interest and after notice and hearing, "cause" is established for the appointment of a Chapter 11 trustee. *Id.* § 1104(a).

The debtor-in-possession, or Chapter 11 trustee, may formulate, file, and seek confirmation of a Chapter 11 plan. *Id.* § 1121. The plan may propose a reorganization or a liquidation. Only the debtor or the trustee may file a plan within the first 120 days after the order for relief—the so-called "debtor's exclusivity period." The exclusivity period may, after notice and hearing, be reduced or enlarged "for cause" upon motion of a party-in-interest. *Id.* § 1121(d). Unless the exclusivity period is extended, any party-in-interest, including a lender, may file a plan 120 days after the order for relief. *Id.* § 1121(c)(2). An additional restriction on the debtor's exclusivity period applies where a plan has been filed by the debtor within 120 days after the order for relief but the plan has not been accepted, within 180 days after the order for relief, by each holder of a claim that is impaired thereunder; in such case, any party-in-interest may file a plan. *Id.* § 1121(c)(3).

Finally, a debtor may, as a matter of right, convert a Chapter 11 case to a case under Chapter 7 unless (1) a trustee has been appointed, (2) the case was commenced involuntarily, or (3) the case was previously converted to Chapter 11 from Chapters 7 or 13. *Id.* § 1112(a) (1982). Parties-in-interest, while not able to convert a case as a matter of right, may request conversion. *Id.* § 1112(b). Upon request of a party-in-interest and after notice and hearing, the court may convert a case to Chapter 7 "for cause." "Cause" includes: continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation; inability to effectuate a plan; unreasonable delay by the debtor that is prejudicial to creditors; denial of confirmation of a proposed plan; or a material default by the debtor with respect to a confirmed plan. *Id.*

able, uncooperative, or dissident third-parties; compromise claims of the borrower and the borrower's creditors; sell assets of the borrower; significantly increase its ability to collect its loans; and achieve other substantial benefits and advantages. Many of these benefits might enable a successful workout to occur whereas, outside bankruptcy, a workout would be impossible. And, in the context of a bankruptcy case, it is possible to obtain such benefits and advantages with significantly less risk that efforts to obtain control, protect its collateral, and collect the loan may result in a lender liability claim. Further, bankruptcy court provides perhaps the most favorable forum in which a lender might settle or litigate claims that the borrower or a third-party, such as a creditor of the borrower, has asserted or threatened to assert against it and perhaps the most favorable forum in which to resolve disputes between the borrower and its creditors. This Article discusses the ways that a bankruptcy by or against a borrower can benefit the lender seeking to collect, work out, or foreclose a troubled loan or resolve a lender liability claim.[4]

II. Benefits of Bankruptcy: Claims That May Be Avoided or Resolved By a Bankruptcy

When a loan becomes troubled, a lender must take steps to protect its collateral and work out or collect the loan. These steps may include asserting some control over the borrower's affairs, selling as-

4. While this Article refers to various theories upon which a borrower or borrower's creditors may base a lender liability claim, the Article is not intended to be an exhaustive presentation of the subject. Furthermore, the Authors do not intend the Article to educate the reader fully on the Bankruptcy Code. Rather the Article focuses on various benefits and advantages to a lender of a bankruptcy case by or against its borrower and ways in which a lender may use the bankruptcy process to avoid or enhance the defense of lender liability claims. The Article discusses various types of lender liability claims and various provisions of the Bankruptcy Code only where relevant.

It is also important to point out that the advantages and benefits to a lender of a borrower's bankruptcy are not derived at the borrower's expense. While the subject is beyond the scope of this Article, borrowers can obtain significant advantages and benefits from dealing with creditors, including their lenders, in the context of a bankruptcy case. And, in fact, many of the provisions in the Bankruptcy Code from which the lender might obtain benefits and protections are the same provisions from which debtors obtain benefits and protections. For example, outside bankruptcy unsecured creditors of the borrower often pose an obstacle to a successful workout or to the lender's efforts to collect its loan because the creditors pursue and obtain, for example, attachment and judgment liens on assets of the borrower. The automatic stay prohibits such actions. Furthermore, if a creditor has obtained a lien on assets of the borrower prior to the borrower's commencement of its bankruptcy case, the lien may be avoidable by the trustee or the debtor-in-possession, or the assets may be sold by the borrower free and clear of the lien under section 363. 11 U.S.C. § 363 (1982 & Supp. IV 1986). Both the lender and the borrower can benefit from the automatic stay and the ability of a debtor to sell assets free and clear of liens.

sets of the borrower, and negotiating resolutions of claims by and against the borrower and disputes involving the borrower. The very steps that a lender would consider the most effective and desirable in connection with a workout or collection of a loan, however, can give rise to claims of lender liability by the borrower or its creditors under a variety of theories that courts have recognized. For example, should a lender exert control over the business operations of its borrower so as to increase the likelihood of collecting on its loan in full, the lender might find itself subject to claims of liability for *all* the borrower's obligations incurred thereafter based on theories of alter ego/mere instrumentality[5] or agency.[6] Other theories of liability that

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5. *See, e.g.*, Fruehauf Corp v. T.E. Mercer Trucking Co. (*In re* T.E. Mercer Trucking Co.), 16 Bankr. 176, 189-90 (Bankr. N.D. Tex. 1981) (lender's extensive control, e.g., joint control over all borrower's bank accounts, merged the identity of borrower with lender and established alter ego relationship); *In re* Process-Manz Press, Inc., 236 F. Supp. 333, 348-49 (N.D. Ill. 1964) (debtor depended solely on lender for its financial needs and lender supplied funds to pay only a portion of the debtor's ongoing expenses even though it knew the trade debt was increasing, while its collateral and the debtor's inventory and accounts receivable were sold and collected in the ordinary course), *rev'd on other grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied sub nom.* Limperis v. A.J. Armstrong Co., 386 U.S. 957 (1967).

The alter ego/mere instrumentality theory requires that the lender exert almost total control over the debtor's business operations. For example, in Krivo Industry Supply Co. v. National Distillers & Chemical Corp., 483 F.2d 1098 (5th Cir. 1973), *modified in petition for reh'g denied*, 490 F.2d 916 (5th Cir. 1974), the court required "a strong showing that the creditor assumed actual, participatory, total control of the debtor. Merely taking an active part in the management of the debtor corporation does not automatically constitute control, as used in the 'instrumentality' doctrine, by the creditor corporation." *Id.* at 1105. The court characterized the requisite control as "total domination of the subservient corporation, to the extent that the subservient corporation manifests no separate corporate interests of its own and functions solely to achieve the purposes of the dominant corporation." *Id.* at 1106.

6. The *Restatement (Second) of Agency* recognizes the lender's extensive control over borrower's business activities as a basis for vicarious liability for acts or debts of the borrower based on agency principles: "A creditor who assumes control of his debtor's business for the mutual benefit of himself and his debtor, may become a principal, with liability for the acts and transactions of the debtor in connection with the business." RESTATEMENT (SECOND) OF AGENCY § 14(O) (1958), *cited in, e.g.*, A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285, 291 (Minn. 1981); Buck v. Nash-Finch Co., 78 S.D. 334, 343, 102 N.W.2d 84, 90 (1960). The only specific guidance is in the comment accompanying section 14(O), which states that the relation of principal and agent arises when the lender "directs what contracts may or may not be made." RESTATEMENT (SECOND) OF AGENCY § 14(O) comment a (1958), *quoted in, e.g.*, A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d at 291. Beyond this limited example, however, the comment actually does no more than beg the essential question by describing the point at which an agency relationship arises as "that at which he assumes de facto control over the conduct of his debtor." *Id.*

As they have demanded in applying the alter ego/mere instrumentality theory, discussed *supra* note 5 and accompanying text, some courts have demanded that a lender exert a very high degree of control over the borrower before finding an agency relationship. *See, e.g.*, Buck v. Nash-Finch Co., 78 S.D. at 335-43, 102 N.W.2d at 84-89 (quoting RESTATEMENT (SECOND) OF AGENCY 14(O) (1958)). In *Buck v. Nash-Finch* might stem from the lender's control over or involvement in its borrower's business operations include breach of fiduciary duty,[7] inter-

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Co., the lender's accountant visited the borrower twice weekly, made up the payroll, compiled weekly operating reports and financial statements, and co-signed all checks. *Id.* at 346-48, 102 N.W.2d at 90-91. In addition, the lender suggested that the borrower hire a particular person as store manager. *Id.* at 337-38, 102 N.W.2d at 86. The court had no difficulty finding that the lender controlled many facets of the buyer's business, but rejected liability for trade debt because the lender exerted no control specifically over the debtor's business operations. *Id.* at 346-49, 102 N.W.2d at 90-92. Apparently, the court did not focus on control over *payment* of the trade debt, a more significant type of control than determining what shall or shall not be purchased.

Again, courts have wrestled with the problem of describing exactly how much and what types of control will give rise to liability on the part of the lender under agency principles. *Compare* Buck v. Nash-Finch Co., 78 S.D. 334, 102 N.W.2d 84 (1960) *with* A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285 (Minn. 1981). *See also* Laurent v. Strites (*In re* Kentucky Wagon Mfg. Co.), 71 F.2d 802, 804 (6th Cir. 1934) (control establishing lender as principal, borrower as agent). It can be argued, however, that the degree of control required under agency principles is less than that required under the alter ego/mere instrumentality doctrine. For example, in *Jenson Farms*, the Minnesota Supreme Court considered eight factors in establishing the control requisite to finding an agency relationship: (1) lender's continual recommendation regarding the operations of debtor's business; (2) lender's right of first refusal to buy assets of debtor; (3) debtor's inability to mortgage property, such as stock, or pay dividends without lender's approval; (4) lender's right to inspect premises; (5) lender's criticisms of debtor's business practice; (6) lender's belief that debtor needed "strong paternal guidance"; (7) utilization of debtor's business forms containing lender's name; and (8) extensive financing of debtor's operations by lender and ability of lender to discontinue it. A. Gay Jensen Farms Co. v. Cargill, Inc., 309 N.W.2d at 291. Except for the use of business forms containing the lender's name, most of these indicia of control are common to most secured loans.

7. Whether formulated as an alter ego/mere instrumentality, agency, or simply a control relationship, some courts have recognized that the exercise of sufficient control creates fiduciary obligations on the part of the lender towards the borrower and, perhaps, the borrower's creditors. Again, the standards for imposing fiduciary responsibilities as well as the legal reasoning articulated by the courts are vague and somewhat inconsistent. For example, in Anaconda-Ericsson, Inc. v. Hessen (*In re* Teltronics Serv.), 29 Bankr. 139, 170-71 (Bankr. E.D.N.Y. 1983), the court stated that a noninsider lender may be held to occupy a fiduciary relationship towards its borrower, *but only* when the lender's ability to control was so overwhelming that the identity of the borrower had merged with that of the lender, thereby, arguably, confusing the level of control with that required under the alter ego/mere instrumentality theory. *See* Bank of New Richmond v. Production Credit Ass'n (*In re* Osborne), 42 Bankr. 988, 996-97 (W.D. Wisc. 1984) (court noted that creditors will be treated as fiduciaries, without requiring a finding of an alter ego/mere instrumentality relationship, if they exerted sufficient control over their debtor to the detriment of other creditors; sufficient control vaguely defined as *virtually* complete control, as opposed to the *total* control necessary for a finding of alter ego/mere instrumentality). *See also, e.g.*, *In re* Beverages Int'l Ltd., 50 Bankr. 273, 281-82 (Bankr. D. Mass. 1985) (creditor who takes control over debtor assumes fiduciary duties of management and duty to deal fairly with other creditors; court adopted an extremely flexible test that could create liability in situations where much less than total control is present—a court is to examine the sum of a creditor's conduct with respect to the debtor, total up all indicia of control, and determine whether the cumulative conduct has tipped the

ference with the debtor's business,[8] and fraudulent misrepresentation.[9] A lender may also lose any realistic opportunity for repayment by having its claim subordinated to all or a portion of the claims of other creditors of its borrower as a result of inequitable conduct, such as the misuse of the control it may have over its borrower.[10]

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scales, with the caveat that the creditor's duties are increased by the precise degree that the creditor has power and control over the debtor's affairs); *In re* W.T. Grant Co., 4 Bankr. 53, 75-77 (Bankr. S.D.N.Y. 1980) (extensive control creates fiduciary duty on the part of the lender towards borrower), *aff'd*, 69 F.2d 599 (2d Cir. 1983). Particularly troublesome for lenders is that if a fiduciary relationship is found to exist due to excessive control between a lender and its borrower, then the interplay between the lender and its borrower could mutate from an arm's length, adversarial relationship (in which the lender could act solely in its own interest) to one where the lender would owe its borrower an affirmative duty to act *in the borrower's* best interest.

8. *See, e.g.*, Melamed v. Lake Cty. Nat'l Bank, 727 F.2d 1399, 1403-1404 (6th Cir. 1984) (lender interfered with bankrupt's business relations by, inter alia, requiring a debtor's president to take a salary reduction, requiring a change of accountants, supervising all payments of the debtor, and by failing to notify the bankrupt of funds available for use); State Nat'l Bank v. Farrah Mfg. Co., 678 S.W.2d 661, 688-90 (Tex. Ct. App. 1984) (lender interfered with debtor's business relations by, inter alia, installing inexperienced management). *But see, e.g.*, Flintridge Station Assoc. v. American Fletcher Mortgage Co., 761 F.2d 434, 441-42 (7th Cir. 1985) (mortgage company's conditioning of construction loan increase on borrower disassociating itself from certain real estate developer justified under circumstances).

9. During a lender's workout or collection efforts concerning a troubled borrower, numerous opportunities for direct communications between the lender and its borrower, and between a lender and its borrower's creditors, will occur. No one would dispute that if a lender makes affirmative misrepresentations to its borrower or to the borrower's creditors, the lender should be liable for fraud. *See, e.g.*, Stirling v. Chemical Bank, 382 F. Supp. 1146, 1152-54 (S.D.N.Y. 1974) (court determined that a common law cause of action for fraud would exist if lender falsely represented to officers and shareholders of its borrower that if they resigned as officers and directors, and executed certain documents, the lender would not call existing loans and would extend new credit); State Nat'l Bank v. Farrah Mfg. Co., 678 S.W.2d at 680-82 (false threats to declare default and to throw borrower into bankruptcy if certain person was elected chief executive officer constituted fraud). More problematic for lenders in dealing with troubled loans, however, is the theory that if a lender has superior knowledge of and access to the financial affairs and financial information of its borrower arising out of its control over its borrower, the lender may be liable to third parties when it fails to disclose fully material information regarding the financial information of its borrower. *See, e.g.*, Central States Stamping Co. v. Terminal Equip. Co., 727 F.2d 1405, 1408-10 (6th Cir. 1984) (failure of lender, who provided some information, to disclose fully all material information to a prospective purchaser of an asset of its borrower is fraudulent); First Virginia Bankshares v. Benson, 559 F.2d 1307, 1321 (5th Cir. 1977) (where lender had superior knowledge and information regarding its borrower's financial affairs, court found that the lender had a duty to disclose certain material financial information to a creditor of the borrower to whom the lender had earlier made favorable report of creditworthiness).

10. As an alternative to holding the lender liable for the debtor's obligations incurred (or harm caused by the debtor or the creditor) after the lender's exercise of extensive control, a different remedy could be imposed by a court—the claim of the lender could be subordinated for purposes of payment to all or a portion of the other

Lenders may also be held liable for breach of an implied covenant of good faith, which has been held by some courts to govern various key aspects of a lender's actions in a problem loan situation, such as the granting of further advances, the termination of a loan, the declaration of a default, and the attempt to collect amounts due under a loan, even where the loan documents purport to vest absolute discretion in the lender.[11] In fact, a few courts have increased the risk

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claims against the debtor. *See generally* Chaitman, *The Equitable Subordination of Bank Claims*, 39 Bus. Law. 1561 (1984). This may occur when the lender has combined extensive control over the debtor with misuse of that control or other inequitable conduct resulting in injury to other creditors of the borrower or in the conferring of an unfair advantage or benefit to the lender. *See, e.g., In re* Simpson, 222 F. Supp. 904, 908 (M.D.N.C. 1963) (equitable subordination on grounds that lender, who controlled borrower sufficiently to establish a joint venture between them, extended credit despite inside knowledge that funds would not cover costs, including materialmen's liens); *In re* Beverages Int'l Ltd., 50 Bankr. 273, 283-85 (Bankr. D. Mass. 1985) (equitable subordination on grounds that lender manipulated borrower both to borrower's detriment and that of its creditor); Bergquist v. First Nat'l Bank (*In re* American Lumber Co.), 7 Bankr. 519, 529 (Bankr. D. Minn. 1979) (equitable subordination on grounds that lender, who controlled many of the key aspects of borrower's business, determined which of the debtor's creditors would be paid, and allowed payment only to those creditors who would interfere with collection of accounts receivable—which were the lender's collateral), *aff'd*, 5 Bankr. 470 (D. Minn. 1980).

11. Creditors have incurred liability for breach of the covenant of good faith, under section 1-203 of the Uniform Commercial Code, and/or the covenant of good faith and fair dealing articulated in section 205 of the *Restatement (Second) of Contracts*, as a result of various acts they performed when dealing with a troubled loan. *See* U.C.C. § 1-203 (1977); Restatement (Second) of Contracts § 205 (1981). For example, a banker's decision as to whether it will continue to make advances under a line of credit has been limited by some courts in that it has been held that the lender cannot refuse to continue advances unless the refusal is in good faith. *See, e.g.*, Reid v. Key Bank, 821 F.2d 9, 12-13 (1st Cir. 1987) (court upheld a jury finding that a bank had acted in bad faith in precipitously, and without warning, halting further advances, in failing to make a sufficient effort to negotiate alternative solutions, and in failing to give notice that it intended to terminate the lending relationship). *But see, e.g.*, Centerre Bank, N.A. v. Distributors, Inc., 705 S.W.2d 42, 46-48 (Mo. Ct. App. 1985) (under Missouri version of section 1-203 obligation of good faith does not condition lender's ability to demand payment of a demand note since section 1-203 would then add an inconsistent term to the freely negotiated agreement). An oral agreement, no less than a written one, carries an obligation of good faith performance. *See, e.g.*, Yankton Prod. Credit Ass'n v. Larsen, 219 Neb. 610, 616, 365 N.W.2d 430, 434 (1985) (notwithstanding security agreement that gave lender absolute discretion to advance credit, the purported existence of an oral agreement to make three separate loans would, if proved, state a claim under Nebraska's version of section 1-203).

Moreover, several courts have determined that a lender must observe good faith in exercising its rights and remedies under its loan documents even when that right or remedy is granted to the lender in specific and express loan covenants. *See, e.g.*, Reid v. Key Bank, 821 F.2d at 13-14 (ceasing loan advances, accelerating payment of a promissory note that purported to be a demand note, and taking steps to realize upon collateral without notice or warning and without making an effort to negotiate alternative solutions, even though neither notice, warning, nor workout negotiations were required by the loan documents, could constitute a violation of the covenant of good of liability for a lender in problem loan situations by imposing on it a duty of due care in its dealings with its borrower.[12]

Given the myriad of possible liability linchpins,[13] and the lack of

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faith, at least where it was customary for the lender to provide notice and an opportunity to work out the problem); K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 760 (6th Cir. 1985) (under New York version of section 1-203 duty to perform commercial contracts in good faith applies to creditor's demand of payment of demand note) (citing Brown v. AVEMCO Inv. Corp., 603 F.2d 1367, 1375-80 (9th Cir. 1979)). *But see, e.g.*, Flagship Nat'l Bank v. Gray Distrib. Sys., Inc., 485 So. 2d 1336, 1340 (Fla. Dist. Ct. App. 1986) (demand permissible under express terms of loan agreement without regard to good faith of lender); Pavco Indus., Inc. v. First Nat'l Bank, No. 86-910 (S.D. Ala. June 24, 1988) (court rejected borrower's claim that bank's demand for payment of a promissory note violated its obligation of good faith and fair dealing).

In essence, courts are expanding and modifying specific rights, remedies, and duties of contracting parties, which were negotiated and then embodied in a contract, beyond that expressly set forth and delineated in their contract by superimposing a good faith requirement. *See, e.g.*, Alaska State Bank v. Fairco, 674 P.2d 288, 291 (Alaska 1983) (even though loan documents permitted the lender to take possession without notice, failure to provide notice of intention to take possession of retail store violated obligation of good faith under Alaska's version of U.C.C. section 1-203 where parties' course of conduct and dealing required notice as a matter of fair dealing). *But see* Van Bibber v. Norris, 419 N.E.2d 115, 122-23 (Ind. 1981) (no violation of good faith where neither terms of the written security agreement nor parties' reasonable expectations required notice of intent to take possession of collateral).

By so doing, courts have caused workouts and foreclosures (these are often in the best interest of the borrower) to become matters posing significant risks to those lenders that choose to engage in them. The lender is often simply unable to determine whether it can enforce a term in its loan agreement (whether enforcement of the term would affect the borrower, creditors of the borrower, or other interested parties or lien holders) and, if it does, whether it will thereby subject itself to the potential for substantial liability. A principal advantage of dealing with a problem loan in the context of a bankruptcy case is that the Bankruptcy Code and the bankruptcy court can provide guidance to the lender as to what constitutes permissible conduct and it is usually possible for the lender to obtain court approval *prior* to taking action.

12. A lender may incur liability for the negligent administration of loan proceeds if the culpable loan officer acted, at least in part, within the scope of his employment. *See, e.g.*, Columbia Plaza Corp. v. Security Nat'l Bank, 676 F.2d 780, 788 (D.C. Cir. 1982) (plaintiff stated cause of action but jury found that loan officer acted solely in his own interests and so did not make the bank vicariously liable). Another court found that a lender may also be held liable for negligently overseeing the activity of a borrower who received its principal financing from the lender. *See, e.g.*, Connor v. Great W. Sav. & Loan Ass'n, 69 Cal. 2d 850, 864-66, 73 Cal. Rptr. 369, 376-77, 447 P.2d 609, 616-17 (1968) (bank liable to purchasers of defectively constructed homes whose builder received substantial financing from the bank). *See generally* Laudgren, *Liability of a Creditor in a Controlled Relationship with Its Debtor*, 67 MARQ. L. REV. 523, 549-52 (1984).

13. *See supra* notes 5-12. Other miscellaneous theories of lender liability which are related to control include the following:

Tax Liability. Under section 6672 of the Internal Revenue Code, I.R.C. § 6672 (1982), lenders have been held liable for uncollected and/or unpaid federal withholding taxes of their borrower due to control exercised over the borrowers. *See* Commonwealth Nat'l Bank v. United States, 665 F.2d 743, 754-57 (5th Cir. 1982). In *Commonwealth National Bank*, the bank had lent money to a corporation and in return obtained a lock box arrangement for receivables. The bank allowed the debtor to widely accepted bright lines between permissible and impermissible lender conduct,[14] this Article also argues that lenders should view

overdraw its checking account and honored all payroll checks but did not honor checks drawn to pay withholding taxes. Although the president of the debtor corporation directed the bank not to honor checks drawn to pay withholding taxes, the bank participated in decisions as to which creditors would be paid. *Id.* at 756. The court held the bank liable to the amount of unpaid withholding taxes, since the bank assumed control over the manner in which the employer's funds were to be spent and the decision as to which of the creditors were to be paid. *Id.* at 757. *But see* Goebert v. United States, 412 F. Supp. 356, 360 (E.D. Pa. 1976) (creditor's use of control over debtor to cause payment of its obligation to the creditor does not, without more, create liability on the part of the creditor for debtor's taxes).

Also, under section 3505(a) and (b) of the Internal Revenue Code, if a lender pays wages directly to employees or their agent, the lender is liable for all taxes required to be withheld by their employer plus interest. I.R.C. § 3505(a) (1982). Also, if a lender provides funds to an employer for the specific purpose of paying wages, with actual notice or knowledge that the employer does not intend to or will not be able to pay withheld taxes, the lender is liable for any of such unpaid taxes, plus interest in an amount not to exceed 25% of the funds lent for such purpose. *See id.* § 3505(b).

Preference Liability. While it does not impose substantive liability, section 547(b)(4)(B) of the Bankruptcy Code extends the time period during which payments to a creditor may be considered preferential transfers, and thus recovered, from 90 days to 1 year prior to the filing of a bankruptcy case if the creditor was an insider at the time of the transfer. 11 U.S.C. § 547(b)(4)(B) (1984). In the case of corporations, "insider" is defined as including, among others, directors, officers, affiliates, and persons *in control* of the corporation. For a collection of cases in which a creditor was deemed not to be in sufficient control of its debtor, thereby not extending the preference time period, see *In re* Jefferson Mortgage Co., 25 Bankr. 963 (Bankr. D. N.J. 1982).

For a case in which a creditor was held to be an insider, see Derosa v. Buildex, Inc. (*In re* F & S Cen. Mfg. Corp.) 53 Bankr. 842, (Bankr. E.D.N.Y. 1985). In *Derosa*, the court held that the control of the debtor did not have to be legal or absolute and that a creditor who does not deal at arm's length with the debtor, but who has a special relationship with the debtor through which it can compel payment of its debt, has sufficient control over the debtor to be deemed an insider.

Liability for Securities Law Violations. Section 15 of the Securities Act of 1933, 15 U.S.C. § 77o (1983), and section 20(a) of the Securities Exchange Act of 1934, *id.* § 78t, impose liability on persons who control others found to have violated the Acts, unless, in the case of section 15, the controlling person had no knowledge of or reasonable grounds to believe in the existence of a violation, or, in the case of section 20(a), the controlling person acted in good faith and did not directly or indirectly perform the act or acts constituting the violation. *See, e.g.*, Metge v. Baehler, 762 F.2d 621, 630-32 (8th Cir. 1985) (upheld two-part test for determining prima facie control under section 77o whereby plaintiff must show that lender (1) exercised actual control over general affairs of the violator and (2) exercised potential control over the particular transaction in question); Index Fund, Inc. v. Hagopian, 609 F. Supp. 499, 506-511 (S.D.N.Y. 1985) (applied three-part test for determining controlling person under section 78t of (1) primary violation, (2) scienter (reckless disregard), and (3) power to control the primary violator).

14. *Compare* Berquist v. First Nat'l Bank (*In re* American Lumber Co.), 7 Bankr. 519, 529 (Bankr. D. Minn. 1979), *aff'd* 5 Bankr. 47 (D. Minn. 1980) *with* Anaconda-Ericsson, Inc. v. Hessen (*In re* Teletronics Serv., Inc.), 29 Bankr. 139, 170-72 (E.D.N.Y. 1983). *See also* De Natale and Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 Bus. Law, 417, 444 (1985); Kun-

the bankruptcy case of its borrower as a safe haven for the collection or workout of its loans and as a forum that is compatible with the collection and workout of loans. The Bankruptcy Code and the bankruptcy court can provide the lender with guidance and assurances as to which conduct and actions are permissible and provide a forum within which the actions of the lender in connection with the workout or collection of its loans are supervised and approved by the court. The Bankruptcy Code provides the lender with the means to obtain significant control over its borrower's affairs, protect its collateral, increase its ability to collect its loans, eliminate the interests of unreasonable or dissident third-parties that have interfered with and posed an obstacle to a successful workout, and achieve other important benefits *and* do so with substantially less risk of lender liability. A borrower's bankruptcy thus provides lenders with the potential for the best of both worlds: increased protection and the ability to collect and work out its loans, and decreased potential for liability.

III. Benefits of Bankruptcy: Controls, Protections, and Powers Provided by Bankruptcy Law

While a debtor-in-possession in a Chapter 11 case may continue to operate its business without prior court approval,[15] the Bankruptcy Code provides substantial protection for a lender's interests by imposing definite restraints on the debtor-in-possession's ability to operate its business freely.[16] Such restraints can significantly enhance the lender's ability to protect its collateral and work out or collect its loans.

A. Use, Sale, or Lease of Property.

Under the Bankruptcy Code, the debtor-in-possession's ability to use, sell, or lease property is restricted. A debtor may use, sell, or lease property without prior court approval only in the "ordinary course of business."[17] While difficult to define,[18] transactions in the ordinary course of business generally have been limited to transactions that the debtor commonly entered into prior to the commence-

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kel, *The Fox Takes Over the Chicken House: Creditor Interference With Farm Management*, 60 N.D.L. Rev. 445, 451 (1984).

15. 11 U.S.C. §§ 1107-1108 (1982 & Supp. IV 1986). *See, e.g., In re* UNR Indus., Inc., 30 Bankr. 609, 612 (Bankr. N.D. Ill. 1983).

16. 11 U.S.C. § 363 (1982 & Supp. IV 1986).

17. 11 U.S.C. § 363(c)(1) (Supp. IV 1986). *See also* 2 Collier on Bankruptcy ¶ 363.03 (15th ed. 1987).

18. For a thorough analysis of the concept of "ordinary course of business," see Committee of Asbestos-Related Litigants and/or Creditors v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 60 Bankr. 612, 616 (Bankr. S.D.N.Y. 1986).

ment of its case under the Bankruptcy Code.[19] Despite the fact that a debtor has much leeway in operating its business in the ordinary course,[20] creditors are protected to some extent even then because, as representative of the bankruptcy estate, the debtor has a duty to creditors to protect and preserve the estate's assets.[21] Before the debtor may use, sell, or lease any property outside the ordinary course of business, it must first obtain court approval after notice and a hearing.[22] Courts have held that the debtor must present an "articulated business justification for such use."[23] Moreover, the bankruptcy court has the power to prohibit the debtor from performing any act or entering into any transaction without first obtaining court approval *whether or not* the act or transaction is within the ordinary course of the debtor's business.[24] As a result, if an interested party has shown the court sufficient cause to scrutinize the debtor's operations, the court may require that the debtor obtain a court order before it may conduct even ordinary business activities.[25]

A lender is further protected by the requirement of adequate protection.[26] If a lender has a mortgage on or security interest in property, the property cannot be used, sold, or leased unless the lender's interest is adequately protected against loss.[27] And some courts have held that, absent an emergency or other substantial business justification, a debtor may not sell substantially all of its assets or reorganize under Chapter 11 without following the procedures set forth in, and providing the protections to creditors afforded by, sections 1121 through 1129 of the Bankruptcy Code.[28]

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19. *See, e.g., In re* Lockwood Enter., 52 Bankr. 871, 874 (Bankr. E.D.N.Y. 1985) (post-petition loan held not to be in ordinary course of debtor's business).

20. *See, e.g.,* Committee of Asbestos-Related Litigants and/or Creditors v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 60 Bankr. at 615-16 (presumption of reasonableness attaches to a debtor's management decision); *In re* Simasico Prod. Co., 47 Bankr. 444, 449 (D. Colo. 1985) (authority to operate the business includes concomitant authority to exercise reasonable judgment in ordinary business matters).

21. *See In re* Russell, 60 Bankr. 42, 47 (Bankr. W.D. Ark. 1985); Green River Prod. Credit Ass'n v. Alvey (*In re* Alvey), 56 Bankr. 170, 172 (Bankr. W.D. Ky. 1985).

22. 11 U.S.C. § 363 (b)(1) (Supp. IV 1986). *See* Esposito v. Title Ins. Co. (*In re* Fernwood Mkts.), 73 Bankr. 616, 621 (Bankr. N.D. Ohio 1985) (sale out of ordinary course is void where creditor did not receive notice); 2 COLLIER ON BANKRUPTCY ¶ 303.03 (15th ed. 1987).

23. Committee of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1071 (2d Cir. 1983).

24. 11 U.S.C. § 363(c)(1) (Supp. IV 1986).

25. *See* B. WEINTRAUB & A. RESNICK, BANKRUPTCY LAW MANUAL ¶ 8.11[3][c] (1986).

26. For further discussion of adequate protection see *infra* notes 51-61 and accompanying text.

27. 11 U.S.C. § 363(e) (Supp. IV 1986). *See* B. WEINTRAUB & A. RESNICK, *supra* note 26, ¶ 8.11[3][a]-[d].

28. *See In re* Lionel Corp., 722 F.2d 1063, 1070 (2d Cir. 1983) (good business rea-

B. Cash Collateral.

A lender's *cash* collateral, in particular, receives substantial protection in a bankruptcy case. One of the greatest concerns of a lender dealing with a troubled loan is that the borrower will mismanage, transfer, hide, or otherwise dissipate collateral. This concern applies especially to cash collateral because it is highly volatile and subject to rapid dissipation.[29] The bankruptcy process offers the lender two effective means of protecting its cash collateral: the debtor must segregate and account for all cash collateral[30] and the debtor may not use the lender's cash collateral unless the lender consents to the proposed use or the court approves the proposed use after notice and a hearing.[31] The court will approve a proposed use of cash collateral only if the debtor can show that the lender's interest in the cash collateral is adequately protected.[32]

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son must exist before a sale of a substantial part of the estate will be permitted in the absence of a plan of reorganization); Pension Benefit Guar. Corp. v. Braniff Airways, (*In re* Braniff Airways), 700 F.2d 935 (attempts to determine plan issues in connection with a sale held to be improper), *reh'g denied*, 705 F.2d 450 (5th Cir. 1983); *In re* White Motor Credit Corp., 4 Collier Bankr. Cas. 2d (MB) 1562, 1570-71 (Bankr. N.D. Ohio 1981) (sale of substantially all assets, outside of a plan of reorganization, may be permitted only in an emergency). *But see* Hunt Energy Co. v. United States (*In re* Hunt Energy Co.), 48 Bankr. 472 (Bankr. N.D. Ohio 1985) (sale approved over creditors' objections because those creditors could be subject to cram-down).

Sections 1121 through 1129 of the Bankruptcy Code govern the process of filing and obtaining confirmation of a Chapter 11 plan. 11 U.S.C. §§ 1121-1129 (1982 & Supp. IV 1986). Where the claims of a creditor, or class of creditors, are impaired by a plan, those creditors have a right to vote to accept or reject the plan. *See id.* § 1126. In certain circumstances a creditor whose claim is impaired may be forced to accept the plan's treatment of the claim over the objection of the creditor under the debtor's "cram-down" power. *See id.* § 1129(b). The Bankruptcy Code provides, however, various procedural and substantive protections to creditors in connection with both the confirmation of a plan and a cram-down. *See id.*

29. "Cash collateral" is defined in section 363(a) of the Bankruptcy Code to mean "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest . . . ." 11 U.S.C. § 363(a) (Supp. IV 1986). Cash collateral includes the proceeds, products, offspring, rents, or profits of property subject to a security interest as provided in 11 U.S.C. § 552(b). *Id.* § 363(a).

30. *Id.* § 363(c)(4) (1982).

31. *Id.* § 363(c)(2). 2 COLLIER ON BANKRUPTCY ¶ 363.02 (15th ed. 1987). In fact, it has been held that where cash collateral has been used without a creditor's consent or without court order, the affected creditor may be entitled to a judgment of nondischargeability. *See* Green River Prod. Credit Ass'n v. Alvey (*In re* Alvey), 56 Bankr. 170, 173-74 (Bankr. W.D. Ky. 1985). *See also In re* Krisle, 54 Bankr. 330, 337-38 (Bankr. D. S.D. 1985) (court held debtor in contempt for unauthorized use of cash collateral and ordered him incarcerated until repaid).

32. 11 U.S.C. § 363(c)(2), (e) (1982 & Supp. IV 1986). *See In re* Markim, Inc., 15 Bankr. 56, 59-60 (Bankr. E.D. Pa. 1981). For a discussion of adequate protection, *see infra* notes 51-61 and accompanying text. Note also that the debtor bears the burden of proving that the lender is adequately protected. 11 U.S.C. § 363(o)(1) (Supp. IV 1986). *See generally* R. ROSENBERG, M. LUREY & M. FLICS, COLLIER LENDING INSTITU-

C. Obtaining Credit and Incurring Debt.

In addition to protections with respect to the debtor's use of cash collateral and the use, sale, or lease of other property, a lender is protected against harm that might be caused by the debtor's ability to obtain credit. For example, without prior court approval after notice and a hearing, a debtor may obtain financing and incur debt only on an unsecured basis *and* only in the ordinary course of business.[33] This restriction prevents the debtor from encumbering its assets in any way that would prejudice the prior lender's security interest.[34] Debtors-in-possession may obtain financing outside the ordinary course of business only with court approval after notice and a hearing.[35] Prior lenders may appear and contest any such proposed financing as, for example, an unnecessary burden on cash flow—cash flow that might otherwise be used to repay the prior lender's loan.

The leading commentator on bankruptcy has expressed serious doubt whether a traditional lending or financing arrangement is *ever* in the ordinary course of business as contemplated by the Bankruptcy Code.[36] Should this be the case, lenders considering new loans to a debtor have an interest in ensuring that the debtor obtains either the consent of all prior lenders or court approval before extending even unsecured credit in the ordinary course of business. Otherwise, a court may find that the extension of credit was unauthorized. While a lender's claim for payment of an authorized post-filing unsecured credit is entitled to an administrative expense priority, giving the claim priority over the claims of all pre-filing unsecured creditors,[37] a claim for payment of *un*authorized post-filing

TIONS AND THE BANKRUPTCY CODE ¶ 4.05 (1987) [hereinafter LENDING INSTITUTIONS]. Moreover, the standard of adequate protection for cash collateral is stricter than for other types of collateral in that an equity cushion may not, without more, suffice. *See* Sun Bank/Suncoast v. Earth Lite, Inc. (*In re* Earth Lite, Inc.), 9 Bankr. 440, 443 (Bankr. S.D. Fla. 1981) (adequate protection of cash collateral requires more than an equity cushion). *See also* 2 COLLIER ON BANKRUPTCY ¶ 363.02 (15th ed. 1987). The need for a stricter standard follows from the fact that, unlike other forms of collateral, cash collateral is very readily used and immediately consumed upon use.

33. A debt is unsecured where no property interest secures its payment.

34. 11 U.S.C. § 364(a) (Supp. IV 1986). Incurring unsecured debt does not seriously affect the secured creditor's interest (and arguably it benefits the secured creditor by preserving and maintaining the debtor's business) because a claim for payment of such debt is entitled, at best, to an administrative expense priority, *see id.* §§ 364(b) (1982), 503(b)(1)(A) (Supp. IV 1986), which is junior to the lender's secured claim. *See id.* § 507 (1982 & Supp. IV 1986). For a discussion of administrative expense priorities, see *infra* note 37.

35. 11 U.S.C. § 364(b) (1982). *See also* B. WEINTRAUB & A. RESNICK, *supra* note 25, ¶ 8.11[5]; 2 COLLIER ON BANKRUPTCY ¶ 364.03 (15th ed. 1987).

36. LENDING INSTITUTIONS, *supra* note 32, ¶ 4.04[1].

37. The Bankruptcy Code contains a scheme for payment of pre- and post-filing claims against the debtor. *See* 11 U.S.C. §§ 364, 507 (1982 & Supp. IV 1986). Section 507 contains a list of classes of pre-filing unsecured claims which receive priority in

extensions of unsecured credit may be relegated to general unsecured status, the lowest priority, or may result in the disallowance of the claim altogether.[38] The point is that whether the debtor seeks the prior lender's approval or the court holds a hearing at which the lender may appear and protect its interest, the bankruptcy process will usually prevent the debtor from obtaining new credit in a way that would prejudice the prior lender's interests.

Furthermore, a debtor in bankruptcy may not obtain secured financing except in a way that protects the prior pre-bankruptcy lender's interests. If the debtor is unable to obtain credit on an unsecured basis, a court may authorize a lien in favor of a new lender on any of the debtor's property not yet encumbered or a lien on encumbered property that is junior to that of any prior lender's lien.[39] If the debtor can obtain financing only if the new lender is granted a lien that is equal or superior in priority to any lien already encumbering an asset, the court may grant the lien only if the prior lender's interest is adequately protected.[40] Should protection be provided to the prior lender and it turns out that the protection was inadequate, the prior lender is entitled to at least a super priority administrative expense claim to the extent of the inadequacy.[41] Prior lenders are thus protected in that the trustee or debtor-in-possession must make specific showings and satisfy burdens of proof, and, in certain cases, provide protections to prior lenders before they can obtain any new secured credit. Such protections might often be the essential element in a successful workout. The

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payment over other pre-filing unsecured claims. *Id.* § 507. Claims that arise post-filing and which represent actual and necessary costs of preserving the bankruptcy estate, such as the fees of professionals, are classified as administrative expenses. *Id.* §§ 503(b)(4), 507(a)(1) (1982). These claims receive priority in payment over all pre-filing general unsecured claims. *See id.* § 507 (1982 & Supp. IV 1986). Generally, all administrative claims share equally on a pro rata basis. Under section 507(b), however, where adequate protection has been provided under sections 362, 363, or 364 to the holder of a lien on property of the debtor, such creditor's claims have priority over every other section 507(a)(1) administrative expense claim if the claim is allowable as an administrative expense under section 503(b) and the claim arises from (1) the enforcement of the automatic stay with respect to such property under section 362, (2) the use, sale, or lease of such property under section 363, or (3) the granting of a senior lien to another lender under section 364(d). *Id.* § 507(b) (1982). Further, the court may, if necessary for the purpose of enabling the trustee to obtain credit, grant a priority in payment "over any and all administrative expenses of the kind specified in section 503(b) or 507(b)." *Id.* § 364(c).

38. *See In re* Lockwood Enter., 52 Bankr. 871, 874 (Bankr. S.D.N.Y. 1985) (unauthorized post-filing loan not entitled to reimbursement from estate). *See generally* 2 COLLIER ON BANKRUPTCY ¶ 364.03 (15th ed. 1987).

39. 11 U.S.C. § 364(c)(2), (3) (1982).

40. *Id.* § 364(d)(1). *See also In re* Stanley Hotel, Inc., 15 Bankr. 660, 663 (Bankr. D. Colo. 1981); B. WEINTRAUB & A. RESNICK, *supra* note 25, at ¶ 8.11[5]; 2 COLLIER ON BANKRUPTCY ¶¶ 364.04, 364.05 (15th ed. 1987).

41. *See* 11 U.S.C. § 507(b) (1982).

Bankruptcy Code thus allows the lender to take affirmative control over the borrower's affairs and work out or collect a loan where it would not be possible to do so outside bankruptcy—and do so without subjecting the lender to claims by the borrower or the borrower's creditors.

D. Salaries.

Another major concern of a lender outside bankruptcy is the possibility that the debtor will drain assets by paying excessive salaries to its officers, who are often the principal shareholders of the debtor. Attempts by a lender to control salaries of a borrower's employees might, outside bankruptcy, subject a lender to liability.[42] A bankruptcy court is authorized to set the salaries of officers and other employees of the debtor.[43] Consistent with the power to limit or condition the rights, powers, and duties of the debtor-in-possession in the operation of its business,[44] the court may also remove and replace the persons operating the borrower's business.[45] In addition, the debtor may not employ professionals, such as accountants, lawyers, and business consultants, without first obtaining court approval both as to their employment and the specific terms governing it.[46]

E. Financial Information.

Still another concern of lenders facing a troubled loan is how to obtain reliable inside information as to the true state of the debtor's financial affairs so the lender might decide how best to protect its collateral and collect or workout its loan. The Bankruptcy Code allows the debtor to obtain substantial inside information concerning the debtor's operations. For example, a debtor-in-possession may be required to file written reports and other documents on a periodic basis concerning the financial affairs and condition of its business, its receipts and disbursements, its profits and losses, and other data pertaining to its ongoing operations.[47] The debtor may be required

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42. *See supra* notes 5-13.

43. *See In re* Hooper, Goode Realty, 60 Bankr. 328, 331 (Bankr. S.D. Cal. 1986) ("Clearly, this court is vested with the authority to review the propriety of salaries paid to the debtor in possession's [sic] officers under 11 U.S.C. § 105 and 11 U.S.C. § 1107(a).").

44. *See* 11 U.S.C. §§ 105, 1107(a), 1108 (1982).

45. *See* Gaslight Club, Inc. v. Official Creditor's Comm., 46 Bankr. 209, 212 (N.D. Ill. 1985).

46. *See* 11 U.S.C. §§ 327, 328 (1982); FED. R. BANKR. P. 2016-2019.

47. *See, e.g.*, 11 U.S.C. § 704(8) (Supp. IV 1986) (periodic reports); *id.* § 1106 (a)(1) (duties of trustee to make periodic reports). The following is often required: filing of proof of insurance; filing of proof of a new bank account; bi-weekly reports containing cash flow statements, tax statements and certifications, account receivable levels, and aged accounts payable statements; and monthly profit and loss

to file these reports with the court, the United States Trustee, and perhaps even particular creditors.[48] Moreover, in the context of cash collateral agreements, post-filing loans, sales of assets outside the ordinary course of business, and relief from stay actions, a lender should be able to obtain further detailed information more often.[49] To obtain equivalent information outside the bankruptcy context, the lender would have to insinuate itself into a position of control over the borrower that, again, might subject it to claims of lender liability.[50] Since such information is equally available to all creditors in a bankruptcy, the risk of lender liability is further decreased because, arguably, a lender would not be subject to a duty to disclose material information to a borrower's creditors.

F. Adequate Protection.

Bankruptcy courts have provided lenders, as elements of adequate protection,[51] many protections and elements of control that enable successful workouts and that if sought outside bankruptcy, might subject the lender to liability and many benefits that, if sought outside bankruptcy, might be vulnerable to avoidance under preference and fraudulent conveyance law. Adequate protection can often be obtained by a lender through its own initiative. For example, adequate protection of its interest in collateral can be obtained by a lender moving for relief from the automatic stay.[52] Furthermore, there are circumstances in which the debtor, as a condition to taking some action which might affect the lender's interest in collateral, must provide the lender with adequate protection.[53] Before a debtor can use cash collateral, for example, it must demonstrate to the court that the lender's interest in the cash collateral is adequately protected.[54]

Section 361 of the Code sets forth, by way of illustration, three types of adequate protection which may be provided in connection with relief from stay proceedings,[55] efforts by the debtor to use col-

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statements.

48. *See supra* note 47.

49. *See In re* Heatron, Inc., 6 Bankr. 493, 496-97 (Bankr. W.D. Mo. 1980) (debtor's use of cash collateral must be subject to the conditions that the debtor prepare various reports on regular basis).

50. *See supra* notes 5-13.

51. To discuss in great detail the developing law regarding adequate protection is beyond the scope of this Article. However, a brief discussion of adequate protection is necessary to demonstrate the advantages and benefits to a lender of a case under the Bankruptcy Code.

52. *See, e.g.*, 11 U.S.C. § 362(d) (1982 & Supp. IV 1986). For a discussion of the automatic stay, see *supra* notes 1 & 3.

53. *See, e.g.*, 11 U.S.C. § 363 (1982 & Supp. IV 1986) (use, sale or lease of property), *id.* § 364 (obtaining credit).

54. *Id.* § 363.

55. For a discussion of relief from stay, see *supra* note 3.

lateral,[56] and efforts by the debtor to obtain post-filing credit.[57] First, adequate protection may be provided by requiring a single payment or periodic cash payments to the extent that the automatic stay; the use, sale, or lease of collateral; or any lien granted to secure new credit results in a decrease in the value of the prior lender's interest in property.[58] Second, adequate protection may be provided by giving to the lender an additional or replacement lien, or additional or replacement collateral, to the extent that the automatic stay, the use, sale, lease of property, or a lien granted to secure new credit results in a decrease in the value of the prior lender's interest in property.[59] Third, adequate protection may be provided by granting such other relief, other than by merely providing an administrative expense claim, as will result in realization by the prior lender of the "indubitable equivalent" of the lender's interest in property of the debtor.[60] The three types of adequate protection set forth in section 361 are illustrative only.[61]

56. For a discussion of cash collateral, see *supra* text accompanying notes 29-32.

57. For a discussion of post-filing credit, see *supra* text accompanying notes 33-41.

58. 11 U.S.C. § 361(1) (Supp. IV 1986) *See, e.g.*, Moody v. American Restaurants Management Corp. (*In re* American Restaurants Management Corp.), 8 Bankr. 596, 598-99 (Bankr. S.D. Fla. 1981) (payments for insurance, interest and principal).

59. 11 U.S.C. § 361(2) (1982). Such additional or replacement collateral does not have to be the same type of collateral but merely equal in value to the collateral replaced. *See, e.g.*, First Nat'l Bank v. Shockley Forest Indus., 5 Bankr. 160, 163 (Bankr. N.D. Ga. 1980) (equipment, office furniture, and fixtures); *In re* Thompson, 5 Bankr. 667, 668 (Bankr. D. S.D. 1980) (bees, beehives, and subsequent honey crops).

60. 11 U.S.C. § 361(3) (1982). *See In re* Martin, 761 F.2d 472, 477 (8th Cir. 1985); *In re* Monnier Bros., 755 F.2d 1336, 1338-39 (8th Cir. 1985); *In re* Saypol, 31 Bankr. 796, 800 (Bankr. S.D.N.Y. 1983).

61. 11 U.S.C. § 361 (1982 & Supp. IV 1986). Other types of adequate protection include:

a. An "equity cushion." *In re* Jamaican House, Inc., 31 Bankr. 192, 194-95 (Bankr. D. Vt. 1983).

b. An equity cushion plus periodic and careful review of the facts present in the case. *In re* Don F. Pitts, 2 Bankr. 476, 478-79 (Bankr. C.D. Cal. 1979).

c. An equity cushion plus preparation of monthly financial reports, periodic payments of interest, payment of taxes, *and* limitation on salaries of officers. *In re* Heatron, Inc., 6 Bankr. 493, 496-97 (Bankr. W.D. Mo. 1980).

d. Periodic payments to the lender to meet cash flow problems of the *secured creditor. In re* Trombley, 34 Bankr. 141, 144 (Bankr. D. Vt. 1983).

e. Payments equal to interest plus a sum equal to depreciation of collateral. *In re* Five Leaf Clover Corp., 6 Bankr. 463, 467 (Bankr. S.D.W.V. 1980).

f. Personal guarantees in addition to other protections. *In re* Greenwood Building Supply, 23 Bankr. 720, 721-22 (Bankr. W.D. Mo. 1982).

g. Prohibiting debtor from replacing four salaried employees recently terminated and requiring the debtor to reduce the salaries; prohibiting the debtor from paying interest on the executives' loans to the debtor and allowing the debtor to reduce rental payments to the executives; and, finally, allowing the creditor to monitor the foregoing and make periodic inspections of debtor's books and records. *In re* Aurora Cord & Cable Co., 2 Bankr. 342, 347-48 (Bankr. N.D. Ill. 1980).

h. A continuance of the automatic stay conditioned upon a curing of all defaults.

G. *Post-Filing Financing.*

A lender can also obtain control, protections, and other benefits through the vehicle of a post-filing loan. Often, one of the most important elements to a successful workout is the lender's extension of further credit to the troubled borrower. A lender may make a loan for any one of a variety of reasons, some altruistic, some selfish. The new money might enable the borrower to revitalize its business and return to a more stable financial footing. The extension of credit might also be used to keep the business operating, enabling the borrower to sell inventory and collect receivables in the ordinary course of business and thereby maximize the lender's collateral. Furthermore, the loan proceeds could be used in whole or in part to preserve and maintain the business's assets[62] and/or going concern value while the business is marketed for sale as a going concern. Outside bankruptcy, however, efforts by a lender to obtain additional collateral for existing loans or other benefits, such as a change in management or releases as consideration for a new loan, might not be possible due to, for example, the claims of third-parties or the existence of liens on the lender's collateral and other assets of the borrower. Efforts by the lender to obtain additional collateral and other benefits outside bankruptcy might also subject the lender to liability, or benefits obtained might later be avoided under preference or fraudulent conveyance laws.[63]

Moreover, a lender can protect a new loan from later collateral attack, obtain other significant benefits and advantages for its new loan, and even improve its position in various ways with respect to its previous, existing loans. While many of the protections, benefits, and control devices obtained in connection with post-filing loans may also be obtained without lending new money,[64] the degree of control and level of benefits is usually greater if the lender is provid-

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See In re Shauckley Forest Indus., Inc., 5 Bankr. 160, 162-63 (Bankr. N.D. Ga. 1980).

i. A lien on all debtor's assets, a first priority administrative expense, and periodic payments on debts. *In re* Inforex, 10 Bankr. 497, 499 (Bankr. D. Ma. 1979); *see In re* Markin, Inc., 15 Bankr. 56, 59-60 (Bankr. E.D. Pa. 1987).

j. A court-ordered restriction on the use of cash collateral to a 90-day period within which debtor must file and have confirmed a plan of reorganization; if the plan is not filed within that time, the creditor may renew its request for periodic payments. *In re* Xinde Int'l, Inc., 13 Bankr. 212, 215-16 (Bankr. D. Ma. 1981).

k. Limiting use of cash collateral to the actual, necessary, and ordinary expenses directly connected to the debtor's use of the property generating cash collateral. *In re* Gaslight Village, Inc., 6 Bankr. 871, 875 (Bankr. Conn. 1980).

62. For example, the loan proceeds could be used to pay for heat, electricity, or insurance.

63. *See supra* note 2.

64. For example, many of the same protections can be obtained by a lender in connection with an agreement regarding the borrower's use of the lender's cash collateral. *See supra* text accompanying notes 29-32.

ing new money to the debtor.[65] In connection with post-filing financing pursuant to section 364 it is customary for the financing agreement between the lender and the debtor to contain the following terms and provisions:

> (1) covenants to maintain certain levels of inventory and receivables;
> (2) waivers of the debtor's right to surcharge the lender under Section 506(c);
> (3) provisions for enforcement of remedies on default, often including the self-executing right to seize collateral on default without further court approval;
> (4) restrictions against incurring further debt on a secured, unsecured, or super priority basis;
> (5) prohibitions against payment of pre-filing indebtedness to third parties;
> (6) restrictions on use of loan proceeds and the imposition of a variety of controls and limits upon a debtor's business, such as (i) requiring the debtor to adhere to a written budget regarding operating expenses and costs and use of cash collateral, (ii) setting employment levels and restricting the employment, or requiring the employment of particular professionals, (iii) setting minimum price levels for sales of inventory, e.g., no less than a certain percentage of costs, and requiring all sales to be for cash, thereby excluding credit sales, (iv) allowing an agent of the lender to enter the debtor's premises to monitor and observe collateral and operations, and (v) requiring that a bank officer co-sign checks issued by the debtor;
> (7) a clause requiring the debtor to provide additional or more frequent reports on financial conditions than those required by the U.S. Trustee and the court;
> (8) limitations on capital investments and limitations on the engagement of new or different business activities;
> (9) clauses establishing particular methods of preserving and maintaining collateral;
> (10) requirement that a plan of reorganization be filed and confirmed by a particular date, and often even requiring a particular treatment for the lender in the plan; and
> (11) a stipulation concerning a detailed business plan with respect to day-to-day operations.[66]

While there is little case law in this area, the ability of lenders to seek and obtain such protections, benefits, and control in post-filing

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65. *See In re* Greenwood Bldg. Supply, 23 Bankr. 720, 721-22 (Bankr. W.D. Mo. 1982) (a lender cannot use the concept of adequate protection to improve its secured position); LENDING INSTITUTIONS, *supra* note 32, ¶ 4.03.

66. *See generally* Bernstein, *Financing the Debtor-in-Possession: Some Practical Considerations* in 1986 ALI-ABA COURSE OF STUDY MATERIALS: BUSINESS REORGANIZATIONS UNDER THE BANKRUPTCY CODE 3; LENDING INSTITUTIONS, *supra* note 32, ¶¶ 4.04[8], 4.56- 4.62.

financing agreements has withstood attack, at least where notice was proper, a hearing was held or an opportunity for hearing was given, and creditors had an adequate opportunity to review the agreement and object to it.[67]

In connection with a post-filing loan, the lender can obtain complete protection for mortgages and liens granted to secure the new loan. Under the Bankruptcy Code, where a debtor is unable to obtain unsecured credit, the bankruptcy court may authorize security for a post-filing loan in the form of a lien on property that is not otherwise encumbered or, if property is encumbered, a junior lien on the property.[68] Furthermore, the bankruptcy court, unlike a state court, may, after notice and hearing, authorize security for a post-filing loan in the form of a lien on property which is *equal or even senior to an existing lien* on the property if an equal or senior lien is necessary in order for the debtor to obtain credit, provided the existing lienholder's interest in the property is adequately protected.[69] Therefore, it is possible to protect better a loan where it is made in the context of a bankruptcy case rather than outside it. And, because the bankruptcy court is authorized to grant "primary" liens, where there are junior liens, it is sometimes possible to make a loan that will enable a successful reorganization or workout *only* in the context of a bankruptcy case.

Also, through post-filing financing, a lender can obtain additional collateral to secure its pre-filing loans. One way to obtain additional collateral is through cross-collateralization, a process under which all pre- and post-filing loans are secured by all pre- and post-filing assets. Through this process, made possible in large part by the debtor's need for new financing, the lender may secure its pre-filing loans with a lien on assets on which it did not have a lien pre-filing. This, i.e., additional collateral, may be the only way the lender can make the post-filing loan and thus is a condition to a successful workout. The case law substantially supports cross-collateralization, provided there has been notice and an opportunity for hearing and a

67. *See In re* Becker Indus., 58 Bankr. 725 (Bankr. S.D.N.Y. 1986) (post-filing loans approved even though tied to business plan which was subject of arduous negotiations between lender and debtor, and even though loans would terminate if plan not confirmed by certain date); *In re* FCX, Inc., 54 Bankr. 833, 839-43 (Bankr. E.D.N.C. 1985).

68. 11 U.S.C. § 364(c)(2)-(3) (1982). *See In re* Garland Corp., 6 Bankr. 460-61, (Bankr. D. Mass. 1980) (court rejected creditor's committee objection to granting of lien on unencumbered assets to secure post-petition financing on theory that unsecured creditors are not entitled to adequate protection of their position with respect to unencumbered assets).

69. *See* 11 U.S.C. § 364(d) (1982). 2 COLLIER ON BANKRUPTCY ¶ 364.05 (15th ed. 1987). Where a new lien is given priority over an existing lien, the new lien is commonly referred to as a "priming" lien.

sufficient showing of need by the debtor for new financing.[70] Where a lender obtains additional collateral through cross-collateralization outside bankruptcy, the transfer of the additional collateral may constitute an avoidable transfer, either under state fraudulent conveyance law or, should the borrower commence a case under the Bankruptcy Code subsequent to the transfer, the transfer may constitute a preference or fraudulent conveyance under the bankruptcy law.[71]

Moreover, agreements concerning relief from stay, use of cash collateral, and post-filing loans almost always contain stipulations by the debtor that the pre-filing indebtedness owed to the lender is valid and confirmed, and that the mortgages, liens, and security interests securing the indebtedness are valid, perfected, and enforceable. It is also commonplace for the lender to obtain from the debtor a release of claims that the debtor may have against the lender. Such agreements have been held to be effective and binding against the debtor and, assuming notice and a reasonable opportunity to review and investigate, binding upon the debtor's creditors to the extent that the creditors later object to the indebtedness or the security or assert derivative-type claims against the lender arising out of its acts vis-a-vis the debtor.[72] Binding third-parties outside bankruptcy can be very difficult and, in many cases, may not be possible at all.

H. Pre-Filing Agreements to Extend Credit.

A lender is also protected from claims by the debtor against the lender where the lender refuses to extend credit or terminates an existing line of credit. Outside bankruptcy, a lender's ability to terminate a line of credit or to refuse to provide further advances under a line of credit has been limited by courts that have imposed

70. *See, e.g., In re* Roblin Indus., 52 Bankr. 241, 244-45 (Bankr. W.D.N.Y. 1985) (proposed financing through cross collateralization of pre-petition indebtedness appropriate). *See also* LENDING INSTITUTIONS, *supra* note 32, ¶ 4.03[2].

71. *See supra* note 2. The transfer by the borrower of a lien on property as additional security for an existing loan is a transfer of an interest of the debtor in property to a creditor on account of an antecedent debt and, assuming the borrower was insolvent and the lender was undersecured at the time of the transfer, the transfer would probably be avoidable as a preference. *See* 11 U.S.C. § 547(b) (1982 & Supp. IV 1986). Furthermore, again assuming the borrower was insolvent at the time of the transfer, if no new loan or other consideration, representing fair equivalent value in exchange for the new collateral, was made or given to the borrower at the time of the transfer, the transfer would probably be avoidable as a fraudulent conveyance. *See id.* § 548.

72. *See, e.g., In re* FCX, Inc., 54 Bankr. 833 (Bankr. E.D. N.C. 1985). *See also* LENDING INSTITUTIONS, *supra* note 32, ¶ 4.03[2][c] (discussing provisions in post-petition financing orders relating to pre-petition order liens and security, and their validity).

upon lenders in such situations a duty of good faith and fair dealing.[73] As a result of certain provisions in the Bankruptcy Code and case law construing it, however, the risk of liability for a lender that refuses to extend credit or terminates a credit line during the course of a case under the Bankruptcy Code should be virtually non-existent. Section 365(c)(2) of the Bankruptcy Code expressly provides that contracts to make loans, or extend other debt financing or financial accommodations are not assumable by a debtor.[74] And, under section 365(e), a contract that is not assumable under section 365(c)(2) may be terminated by the lender pursuant to a bankruptcy default clause in the contract between the lender and the borrower.[75] Thus a debtor cannot require a lender to make new advances on existing lines of credit or insist that a lender close a loan commitment.[76] In this way, because such loan obligations cannot be assumed without the consent of the lender, sections 365(c)(2) and 365(e)(2) should arguably serve to protect a lender from liability for refusing to make a new loan or for preventing a debtor from drawing down on existing lines of credit.

I. Management.

In addition to the variety of protections, remedies, benefits, and elements of control which a lender can take advantage of in bankruptcy *while the debtor remains in possession and basic control of its assets*, there are certain circumstances under which a lender may be able to obtain even more dramatic and significant protection by removing the control of the debtor's management over operations and assets or by removing management itself. For example, a lender may replace the management of its borrower with a Chapter 11 trustee, an independent fiduciary with duties to the lender and to all creditors.[77] Where management has shown itself to be incompetent or dishonest, the appointment of a trustee can provide substantial protection. Alternatively, this remedy may be achieved through appointment of an examiner;[78] or through the imposition of a Chapter

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73. *See supra* note 11.

74. 11 U.S.C. § 365(c)(2) (Supp. IV 1986); 2 COLLIER ON BANKRUPTCY ¶ 365.05[1] (15th ed. 1987).

75. 11 U.S.C. § 365(e)(2) (1982).

76. *See* Government Nat'l Mortgage Corp. v. Adana Mortgage Bankers, Inc. (*In re* Adana Mortgage Bankers, Inc.), 12 Bankr. 977, 983 (Bankr. N.D. Ga. 1980); 2 COLLIER ON BANKRUPTCY ¶ 365.05[1] (15th ed. 1987). However, a debtor may assume a financial accommodations contract if the lender consents. Government Nat'l Mortgage Corp. v. Adana Mortgage Bankers, Inc. (*In re* Adana Mortgage Bankers, Inc.), 12 Bankr. at 987.

77. *See* American Nat'l Bank v. MortgageAmerica Corp. (*In re* MortgageAmerica Corp.), 714 F.2d 1266, 1276 (5th Cir. 1983); *In re* O.P.M. Leasing Services, Inc., 28 Bankr. 740, 760 (Bankr. S.D.N.Y. 1983).

78. *See* 11 U.S.C. § 1104(b) (1982 & Supp. IV 1986). The appointment of an ex-

7 trustee, by filing an involuntary petition under Chapter 7[79] or converting the debtor's Chapter 11 case to a case under Chapter 7.[80] In some Chapter 11 cases, it may even be possible for a lender to obtain almost total control over the borrower's affairs and assets. This remedy is achieved through the confirmation of a plan of reorganization that has been drafted and filed by the lender under section

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aminer is an alternative remedy for a creditor. Section 1104(b) provides that after notice and a hearing, the court shall appoint an examiner to investigate the conduct of the debtor if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, *id.* § 1104(b)(1), or shall order such appointment if the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed five million dollars. *Id.* § 1104(b)(2). An examiner can be appointed to conduct an investigation of the current or former management of the debtor and perform any duties of a trustee that the court orders the debtor-in-possession not to perform. *See id.* § 1106(b). Appointment of an examiner may be warranted where there is a need for an investigation of certain matters, but appointment of a trustee would be either premature or unjustified. *See In re* 1243 20th Street, Inc., 6 Bankr. 683, 685 (Bankr. D.D.C. 1980) (appointment of an examiner less costly and disruptive to the debtor's business). An examiner may, however, be appointed and vested by the court with the duties of a trustee. *See In re* John Peterson Motors, Inc., 47 Bankr. 551, 553 (Bankr. D. Minn. 1985) (examiner appointed with almost identical powers and duties of a trustee).

The statutory duties of an examiner are set forth in section 1106(b) (1982 & Supp. IV 1986). However, it appears that the court, pursuant to its authority under section 105, may order that an examiner perform additional tasks. 11 U.S.C. § 105 (Supp. IV 1986). For example, in *In re* UNR Indus., Inc., 72 Bankr. 789, 795-96 (Bankr. N.D. Ill. 1987), the court, sua sponte, ordered that an examiner be appointed to: (1) determine whether negotiations toward a plan of reorganization had stalled; (2) inquire of the parties as to their positions in negotiations and to mediate differences in positions; (3) determine the strength of each party's position; and (4) file a report informing the court as to the status of the negotiations. Also in *In re* Armory Hotel Assoc., No. 87-20311 (Bankr. D. Me. Sept. 14, 1987), an examiner was appointed, with the duties and powers specified in 11 U.S.C. § 1106(b) (1982 & Supp. IV 1986), to conduct an investigation to determine whether there were grounds for the involuntary case and, if so, whether a trustee should be appointed. Specifically, the examiner was appointed to investigate: (1) whether the debtor was and/or had generally not been paying its debts as such debts became due, within the meaning of 11 U.S.C. § 303(h)(1) (1982 & Supp. IV 1986); (2) whether the appointment of a trustee was appropriate under 11 U.S.C. § 1104(a)(1) or (2); and (3) whether the debtor was complying in all respects with a temporary restraining order that had been entered by the court enjoining the debtor from transferring assets during the involuntary gap period and until a decision could be made with respect to the motion for appointment of a trustee. *In re* Armory Hotel Assoc., No. 87-20311, slip op. at 1-2.

It appears that the court could also order the appointment of an examiner to review the reasonableness of an offer of settlement made by a lender to the debtor-in-possession in connection with a claim asserted by the debtor against the lender. If the examiner's report concluded that, based on the likelihood of success on the merits, the costs of litigation, and the benefit to the estate of an immediate settlement, that the offer which the debtor refused to accept was reasonable and in the best interests of the estate, the court could find that the appointment of a trustee to settle the claim was justified and in the best interests of the bankruptcy estate.

79. *See* 11 U.S.C. § 303(g) (Supp. IV 1986).

80. *See id.* § 1112 (1982 & Supp. IV 1986). *See also supra* note 3.

1121(c).[81] Such a plan may provide for the partial or complete liquidation of the assets of the debtor.[82]

Those situations where a lender would most want to exercise control over a borrower's affairs and protect its collateral are also those situations where the Bankruptcy Code permits the appointment of a trustee in a Chapter 11 case.[83] Under section 1104(a), a trustee may be appointed "for cause."[84] "Cause" expressly includes "fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management."[85] A trustee may also be appointed

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81. *See id.* § 1121(c). *See also supra* note 3.

82. *See* 11 U.S.C. § 1123(a)(5)(D), (b)(4) (1982 & Supp. IV 1986).

83. *See id.* § 1104(a).

84. *Id.* § 1104(a)(1) (1982).

85. *Id.* Although section 1104(a)(1) does not specifically define "cause," the courts have found that the appointment of a trustee is justified under a variety of circumstances:

a. Where fraud by the debtor has been committed with respect to a single creditor. *In re* Bonded Mailings, Inc., 20 Bankr. 781, 786 (Bankr. E.D.N.Y. 1982).

b. Where the debtor engaged in pre-filing fraud. *In re* McCordi Corp., 6 Bankr. 172, 178 (Bankr. S.D.N.Y. 1980).

c. Where the debtor's conviction for mail fraud could adversely affect the value of the bankruptcy estate. *In re* New Haven Radio, Inc., 23 Bankr. 762, 767 (Bankr. S.D.N.Y. 1982).

d. Where the debtor engaged in dishonesty with respect to creditors. *In re* John Peterson Motors, Inc., 47 Bankr. 551, 553 (Bankr. D. Minn. 1985).

e. Where the debtor engaged in dishonesty with respect to the court. *In re* Ford, 36 Bankr. 501, 504 (Bankr. W.D. Ky. 1983); *In re* Deena Packaging Indus., Inc., 29 Bankr. 705, 708 (Bankr. S.D.N.Y. 1982).

f. Where the debtor has shown incompetence. *In re* Parker Grande Dev., Inc., 64 Bankr. 557, 562 (Bankr. S.D. Ind. 1986) (lack of skills and experience); *In re* Philadelphia Athletic Club, Inc., 15 Bankr. 60, 64 (Bankr. E.D. Pa. 1981) (poor record keeping); *In re* Anchorage Boat Sales, Inc., 4 Bankr. Rep. 635, 645 (Bankr. E.D.N.Y. 1980) (misapplication of proceeds and poor record keeping); *In re* Hotel Assoc., Inc., 3 Bankr. 343, 345 (Bankr. E.D. Pa. 1980) (poor record keeping). *Cf. In re* Harlow, 34 Bankr. 668, 670 (Bankr. E.D. Pa. 1983) (poor record keeping not enough to justify appointment of a trustee).

g. Where the debtor's current management exhibited gross mismanagement during the pre-filing period. *In re* JP Enters., Inc., 22 Bankr. 661, 662 (Bankr. E.D. Pa. 1982) (failure to pay rent for six months prior to filing constituted gross mismanagement); *In re* Great Northeastern Lumber & Millwork Corp., 20 Bankr. 610, 611 (Bankr. E.D. Pa. 1982); *In re* Main Line Motors, Inc., 9 Bankr. 782, 784 (Bankr. E.D. Pa. 1981). *Cf. In re* General Oil Distrib., Inc., 42 Bankr. 402, 410 (Bankr. E.D.N.Y. 1984) (court did not appoint a trustee, despite findings of numerous earlier instances of gross mismanagement due to late stage of bankruptcy proceeding, watchful eye of creditors, lack of any post-petition wrongdoing and profitability of corporate debtor under current management).

h. Where the debtor's current management exhibited gross mismanagement during the post-filing period. *In re* St. Louis Globe-Democrat, Inc., 63 Bankr. 131, 138 (Bankr. E.D. Mo. 1986); *In re* Denrose Diamond, 49 Bankr. 754, 759-60 (Bankr. S.D.N.Y. 1985); *In re* John Peterson Motors, Inc., 47 Bankr. 551, 553 (Bankr. D. Minn. 1985); *In re* Caroline Desert Disco, Inc., 5 Bankr. 536, 537 (Bankr. C.D. Ca. 1980); *In re* La Sherene, Inc., 3 Bankr. 169, 176 (Bankr. N.D. Ga. 1980). *Cf. In re* if it is in the interest of creditors, any equity security holders, and

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Coastal Dry Dock & Repair Corp., 62 Bankr. 879, 881 n.1 (Bankr. E.D.N.Y. 1986) (more than one creditor must be dissatisfied with current management); *In re* General Oil, 42 Bankr. 402, 410 (Bankr. E.D.N.Y. 1984); *In re* Crescent Beach Inn, Inc., 22 Bankr. 155, 156 (Bankr. D. Me. 1982) ("appointment of trustee would impose substantial financial burden on already hard-pressed debtor and . . . therefore appointment of trustee would not be in best interest of all creditors"); *In re* Sea Queen Kontaratos, 10 Bankr. 609, 610 (Bankr. D. Me. 1981).

i. Where the appointment of a trustee is in the best interest of creditors. *In re* Enserv Company, Inc., 64 Bankr. 519 (Bankr. 9th Cir. 1986); *In re* Parker Grande Development, Inc., 64 Bankr. 557, 563 (cost benefit analysis); *In re* Nigg, 63 Bankr. 630, 631 (Bankr. D.S.D. 1986); *Cf. In re* George E. Eichorn, 5 Bankr. 755, 757 (Bankr. D. Mass. 1980) (no trustee appointed where "no evidence of fraud, dishonesty or gross mismanagement by the debtor of his affairs was presented").

j. Where the appointment of a trustee is in the best interest of equity security holders. *In re* Philadelphia Athletic Club, Inc., 15 Bankr. at 62-63 (appointment of trustee in best interests of debtor's equity security holders where debtor was mismanaged and debtor's managing official's interest was adverse to that of such security holders); *In re* Antilles Yachting, Inc., 4 Bankr. 470, 474-75 (Bankr. D. St. Thomas & St. John, V.I. 1980) (trustee appointed where reorganization plan would impair secured creditor's claim by altering its legal, equitable and contractual rights).

k. Where the debtor commingled its affairs with the affairs of another corporation. *In re* Philadelphia Athletic Club, Inc., 15 Bankr. at 65 (commingling of debtor's assets with those of acquiring corporation contributed to decision to appoint trustee); *In re* La Sherene, Inc., 3 Bankr. 169, 175-76 (Bankr. N.D. Ga. 1980) (trustee appointed in part to perform independent review of commingling of debtor's affairs with those of sister corporation).

l. Where the debtor paid compensation to a relative of a director, the debtor or to a principal. *In re* La Sherene, Inc., 3 Bankr. at 175-76.

m. Where the principals of the debtor had prior involvement with bankruptcy cases under the Bankruptcy Code. *Id.*

n. Where the debtor was managed by controlling shareholders who had conflicts of interest with creditors. *In re* Antilles Yachting, 4 Bankr. at 474.

o. Where the debtor engaged in false financial reporting. *In re* Ford, 36 Bankr. 501, 504-505 (Bankr. W.D. Ky. 1983).

p. Where the debtor made unauthorized post-filing transfers. *In re* Lavender, 48 Bankr. 393, 396-97 (Bankr. E.D. Ark. 1984).

q. Where the debtor had a history of a failure to pay taxes. *In re* Ristagno, 27 Bankr. 104, 105 (Bankr. E.D. Pa. 1983); *In re* Great Northeastern Lumber, 20 Bankr. 610, 611 (Bankr. E.D. Pa. 1982).

r. Where the debtor had a history of failure to file tax returns. *In re* Evans, 48 Bankr. 46, 48-49 (Bankr. W.D. Tex. 1985).

s. Where the affairs of the debtor had been abandoned by management or the death of a key management figure. *In re* Smith, 6 Bankr. 641, 643 (Bankr. N.D. Ga. 1980).

t. Where the debtor fails to maintain records or file monthly operating reports or where there are unexplained operating losses. *In re* Horn & Hardart Baking Co., 22 Bankr. 668, 670-71 (Bankr. E.D. Pa. 1982).

u. Where it appears that an infusion of funds is necessary to pay operating expenses and it is unlikely that the debtor's current management will be able to obtain such funds. *In re* Concord Coal Corp., 11 Bankr. 552, 554-55 (Bankr. S.D.W.V. 1981).

v. Where the debtor has shown a regular practice of overdrafting bank accounts. *In re* Paolino, 60 Bankr. 828, 829 (Bankr. E.D. Pa. 1986); *In re* St. Louis Globe Democrat, 63 Bankr. 131, 139-140 (Bankr. E.D. Mo. 1985).

other interests of the estate.[86] Appointment of a trustee ousts the debtor's management from possession and operation of its business and terminates the debtor's authority or ability to use, sell, or lease assets or obtain credit.[87] A lender is protected by the appointment of a trustee, who has a fiduciary duty to the lender and others,[88] for several reasons,[89] not the least of which is that possession and con-

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w. Where the debtor has used funds withheld from employee wages for other than the withheld purpose. *In re* St. Louis Globe Democrat, 63 Bankr. at 138-39.

x. Where current management is unsuccessful due to a lack of skill. *In re* Parker Grande, 64 Bankr. 557, 562 (Bankr. S.D. Ind. 1986).

y. Where the debtor fails to comply with the United States Trustee's requirements regarding the filing of financial information. *In re* Cohoes Indus. Terminal, Inc., 65 Bankr. 918, 922-23 (Bankr. S.D.N.Y. 1986).

z. Where the Chapter 11 case consists of a liquidation and the debtor has failed to effectuate or administer said liquidation. *In re* Nigg, 63 Bankr. 630, 632 (Bankr. D.S.D. 1986).

aa. Where the management of the debtor has promoted the interest of the principals of the debtor rather than all interested parties. *In re* Cohoes Indus. Terminal, Inc., 65 Bankr. at 923.

The courts have made it clear that certain circumstances alone do not warrant the appointment of a trustee. For example, it has been stated that an appearance of impropriety by current management, whether with respect to a conflict of interest or otherwise, is not enough. *See In re* Evans Products Co., 62 Bankr. 173, 176 (Bankr. S.D. Fla. 1986); *In re* Allsun Juices, Inc., 34 Bankr. 162, 163-64 (Bankr. M.D. Fla. 1983); *In re* L.S. Good & Co., 8 Bankr. 312 (Bankr. N.D.W.V. 1980). Where the appointment of a trustee would hinder or delay confirmation of a plan, a trustee will not be appointed. *In re* Cooper Properties Liquidating Trust, Inc., 61 Bankr. 531, 537 (Bankr. W.D. Tenn. 1986); *In re* Macon Prestressed Concrete Co., 61 Bankr. 432, 438-39 (Bankr. M.D. Ga. 1986); *In re* Crescent Beach Inn, 22 Bankr. 155, 160 (Bankr. D. Me. 1982); *In re* Anchorage Boat Sales, Inc., 4 Bankr. 635, 644 (Bankr. E.D.N.Y. 1980).

For a complete discussion of circumstances warranting appointment of a Chapter 11 trustee, see 2 COLLIER BANKRUPTCY PRACTICE GUIDE ¶ 85.03 (1988).

86. *See* 11 U.S.C. § 1104(b)(1) (1982 & Supp. IV 1986).

87. *See* Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 352-53 (1985).

88. *See, e.g.*, American Nat'l Bank v. MortgageAmerica Corp. (*In re* MortgageAmerica Corp.), 714 F.2d 1266, 1276 (5th Cir. 1983) (trustee has a duty to *all* creditors).

89. Once appointed, a Chapter 11 trustee has certain mandatory statutory duties under section 1106(a). Among other duties, the trustee must account for all property received by the estate, *see* 11 U.S.C. §§ 704(2), 1106(a)(1) (1982 & Supp. IV 1986); examine proofs of claims and object where appropriate, *see id.* §§ 704(5), 1106(a)(1); and, if the debtor has not already done so, the trustee must file schedules of assets and liabilities, a statement of financial affairs, and a list of creditors pursuant to section 521(1). *See id.* § 1106(a)(2).

Except to the extent the court orders otherwise, the trustee must also investigate the conduct, assets, liabilities, and financial affairs of the debtor, the operation of the debtor's business, the ability of the debtor to continue to operate, and all other matters relative to the case or a plan of reorganization. *Id.* § 1106(a)(3) (1982). As soon as practicable after the investigation required by section 1106(a)(3), the trustee must also file a statement of the investigation. The statement must include any and all facts pertaining to causes of action available to the estate. *See id.* § 1106(a)(4). Furtrol of the lender's collateral is removed from the debtor and transferred to the trustee. Often, where past experience has caused a lender to lack confidence in its borrower's ability to work out of financial difficulties or to operate its business successfully, or where the lender simply distrusts its borrower's management, the lender may be willing to participate in a workout or reorganization of its borrower's financial affairs only if the borrower's management is replaced by a trustee. Under such circumstances, a workout or reorganization is made possible through a bankruptcy by the borrower.[90]

J. Court-Approved Settlements.

In a case under the Bankruptcy Code, there are many ways in which a lender can bind the debtor and creditors and parties-in-interest and thus prevent a later challenge to acts or conduct of the lender or agreements reached between the lender and the debtor. For example, the Bankruptcy Code allows a lender to obtain approval by the court of a disposition of collateral *prior to its disposition,*[91] thereby avoiding later claims relating to the disposition of the collateral. Pre-approval by a court of the manner in which the lender's collateral will be liquidated will insulate the lender from claims by the borrower that the collateral was not sold in a commercially reasonable manner. Negotiation of agreements concerning cash collateral, relief from stay, post-filing loans, and even plans of reorganization provide perfect opportunities for lenders to establish, by agreement, the time, manner, and methods of liquidation of collateral. Since all such agreements must be approved by the bankruptcy court, after notice and hearing, a lender should be able to insulate its disposition of collateral from later attack.[92]

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ther, the trustee must file a plan under section 1121, or he must file a report as to why a plan will not be filed or he must recommend conversion or dismissal of the case. *See id.* § 1106(a)(5) (1982 & Supp. IV 1986) (The debtor's exclusivity period with respect to the right to file a plan of reorganization terminates with the appointment of a trustee. After a plan has been confirmed, the trustee must file whatever reports or statements are necessary or required by court order.). *See id.* § 1106(a)(7) (1982).

In addition to the trustee's section 1106 duties, a Chapter 11 trustee has additional responsibilities including, but not limited to, the duty to represent the estate in connection with lawsuits. *See id.* § 323 (1982 & Supp. IV 1986); FED. R. BANKR. P. 6009. *See also In re* O.P.M. Leasing Serv., Inc., 13 Bankr. 54, 58 (Bankr. S.D.N.Y. 1981). The trustee must also investigate the existence of unscheduled executory contracts and unexpired leases, *see* Cheadle v. Appleatchee Riders Ass'n (*In re* Lovitt), 757 F.2d 1035, 1046 (9th Cir. 1985), and collect the property of the estate. *See, e.g.*, Stuart v. Pingree (*In re* Afco Dev. Corp.), 65 Bankr. 781, 787 (Bankr. D. Utah 1986) (failure to collect property may result in a charge against the trustee for the value of the asset).

90. *See* 11 U.S.C. § 1106 (1982 & Supp. IV 1986).

91. *See id.* § 363.

92. Section 9-507(2) of the Uniform Commercial Code provides, "A disposition

IV. Benefits of Bankruptcy: A Favorable Forum for Settling and Litigating Claims and Disputes.

In addition to minimizing the potential for future lender liability claims by a borrower or a creditor of its borrower, and providing controls and benefits that may enable a successful workout, a bankruptcy case provides perhaps the most favorable forum for a lender to settle or litigate lender liability claims and to achieve settlements and resolve disputes with third-parties, such as creditors or shareholders of the borrower. By eliminating biases of juries and presenting the issues before a bankruptcy judge who is experienced in financially troubled commercial matters, the bankruptcy forum can favor the lender for four principal reasons.

First, a borrower's bankruptcy case creates many opportunities for the lender to obtain permissible leverage over the borrower in order to negotiate reasonable settlements of claims by the borrower or its creditors against the lender or by the borrower's creditors against the borrower, and in order to negotiate a workout or reorganization. These opportunities, as discussed above, include negotiations of disputes concerning the use of cash collateral, the use or sale of property out of the ordinary course of business, relief from the automatic stay, post-filing extensions of credit, and negotiations concerning solicitation and confirmation of a plan of reorganization. In each of these situations, there is inherent pressure on the debtor to settle with its primary lender and on creditors to settle with the borrower and the lender. This pressure derives from, among other things, the debtor's need to use cash collateral, obtain credit, prevent relief from stay so assets can be utilized to reorganize, and the need to confirm a plan of reorganization. With respect to the debtor's creditors, the pressure derives from their needs, i.e., to use cash collateral, to obtain credit, and to confirm a plan of reorganization. Without such options, the debtor would be unable to reorganize and creditors would not receive any payments on their claims. In addition, a lender can increase its leverage by filing a motion to appoint

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which has been approved in any judicial proceeding or by any bona fide creditors' committee or representative of creditors shall conclusively be deemed to be commercially reasonable." U.C.C. § 9-507(2) (1981). Since judicial approval, after adequate notice and hearing, provides all interested parties with an opportunity to be heard, creditors should be estopped from later complaining that the sale was not commercially reasonable or from attacking it in some other fashion. *See* Bryant v. American Nat'l Bank & Trust Co., 407 F. Supp. 360, 363-64 (N.D. Ill. 1976) (secured creditor entitled to summary judgment because sale deemed commercially reasonable as it had already been approved at a hearing in the bankruptcy case of one co-borrower, where other co-borrowers voluntarily appeared). *See also* United States v. Kurtz, 525 F. Supp. 734, 742-43 (E.D. Pa. 1981) (guarantor prevented from asserting commercial reasonableness defense due to waivers in guaranty agreement *and* fact that sale had been judicially approved in bankruptcy case of principal debtor), *aff'd without op.*, 688 F.2d 827 (3d Cir. 1982), *cert. denied*, 459 U.S. 991 (1982).

a trustee,[93] a motion to appoint an examiner,[94] or a motion to convert the case from Chapter 11 to a case under Chapter 7.[95] Assuming, of course, that the lender can allege, in good faith, adequate grounds to support such actions. The lender can also file its own plan of reorganization.[96] Since each of these means of obtaining leverage is authorized by the Bankruptcy Code, the borrower cannot persuasively argue that the lender may not utilize the leverage to negotiate a reasonable settlement or workout, especially where, if such settlements or workouts are achieved, they are subject to court approval.[97]

Second, negotiating a settlement or a workout in the context of a bankruptcy case facilitates the parties' ability to reach a reasonable and fair settlement or workout by mitigating the influence of unreasonable or unrealistic parties. Outside bankruptcy a lender may be faced with a borrower, or in some instances a shareholder or creditor of the borrower, who, due to emotion and, on occasion, a lack of sophistication, is unrealistic about the strength of the claims it is asserting. The lender may also face a corporate borrower who is unwilling or unable to agree to reasonable terms because the settlement or workout would not provide a return to shareholders, who control the corporation and who have guaranteed the loan, or because the settlement or workout would leave the shareholders liable on their guaranties. Or the lender may face a situation where a reasonable settlement requires a creditor with an attachment lien to release its lien but the creditor is unwilling to do so. As a result, a reasonable out-of-court settlement or workout may be impossible or impracticable due to the objection of a minority of the parties involved, even though it would be in the best interests of the borrower, the majority of its creditors, and the lender.

A major advantage of settling a claim against a lender in bankruptcy is that the lender can have its proposed settlement evaluated under the reasonable and practical standard that a court applies in bankruptcy cases. The court will focus on several practical factors:

> (a) [t]he probability of success in the litigation; (b) the difficulties, if any, to be encountered in the matter of collection; (c) the complexity of the litigation involved, and the expense, inconvenience, and delay necessarily attending it; [and] (d) the paramount interest of the creditors and a proper deference to their reasonable views. . . .[98]

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93. *See supra* notes 77-90 and accompanying text.
94. *See supra* note 78.
95. *See supra* notes 3 & 80.
96. *See supra* notes 3 & 81-82.
97. *See* Lending Institutions, *supra* note 32, ¶ 4.03[2][b].
98. Martin v. Kane (*In re* A & C Properties), 784 F.2d 1377, 1381 (9th Cir. 1986) (quoting Lambert v. Flight Transp. Corp. (*In re* Flight Transp. Corp. Sec. Litig.), 730 F.2d 1128, 1135 (8th Cir. 1984), *cert. denied*, 105 S. Ct. 1169 (1984)), *cert. denied*, 107

While a bankruptcy court should not rubber stamp a settlement, the court need not conduct an exhaustive investigation into the merits of the underlying claims. The court need only canvass the issues to determine that the settlement does not " 'fall below the lowest point in the range of reasonableness.' "[99] If it does not, the court will approve the settlement. Furthermore, the primary purpose of a compromise settlement in bankruptcy "is to avoid the necessity of determining sharply contested and dubious issues."[100] Since the parties and the court apply essentially a cost/benefit analysis in evaluating the choice between pursuing or settling a lawsuit, the emphasis on objective considerations should preclude emotional or irrational factors from affecting the course of a lender liability lawsuit. Moreover, since the settlement standard requires consideration of the paramount interests of all *creditors*, the interests of shareholders and guarantors should not have an adverse impact on a reasonable settlement.[101]

In addition to the reasonable, practical, and flexible standard for approving settlements, the bankruptcy process also facilitates settlement and the workout of problem loans by enabling the debtor and the lender to implement and protect their settlement or workout over the objections of various dissident interested parties.[102] The debtor is authorized to settle all of its claims, including derivative claims which the debtor's shareholders have standing to assert.[103]

Conversely, if a proposed settlement or workout of a problem loan is in the best interests of the debtor's estate and its creditors, but management is unwilling to compromise because of undue pressure

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S. Ct. 189 (1986). *See also In re* Technology For Energy Corp., 56 Bankr. 307, 311 (Bankr. E.D. Tenn. 1985) (same factors).

99. Cosoff v. Rodman (*In re* W.T. Grant Co.), 699 F.2d 599, 608 (2d Cir. 1983) (quoting Newman v. Stein, 464 F.2d 689, 693 (2d Cir. 1972)), *cert. denied*, 464 U.S. 822 (1983). *See also* United States v. Alaska Nat'l Bank (*In re* Walsh Constr., Inc.), 669 F.2d 1325, 1328 (9th Cir. 1982) (bankruptcy court need not conduct exhaustive investigation into the validity of the asserted claim).

100. Wil-Rud Corp. v. Lynch (*In re* California Associated Prod. Co.), 183 F.2d 946, 949-50 (9th Cir. 1950).

101. *See* Cosoff v. Rodman (*In re* W.T. Grant Co.), 699 F.2d at 613-14.

102. *See In re* Technology For Energy Corp., 56 Bankr. at 319 (court approved settlement of lender liability suit over objection of shareholders and creditors). Lenders, guarantors, and other third parties commonly structure a plan that will ultimately release them from claims against them and/or their obligations to other parties.

103. *See* Griffin v. Bonapfel (*In re* All American, Inc.), 805 F.2d 1515 (11th Cir. 1986). In fact, in connection with the settlement reached with the trustee and approved by the court in *Griffin*, the lender obtained a permanent injunction restraining shareholders of the debtor corporation from suing the lender on all claims that were corporate causes of action covered by the settlement and release. The injunction was upheld against shareholders on the grounds that the corporate cause of action was property of the estate for which the trustee's settlement was conclusive and binding on all shareholders. *Id.* at 1517-18.

from shareholders or guarantors, the settlement or workout can still be achieved through the appointment of an objective, independent trustee, assuming appropriate "cause" exists.[104] Upon his appointment, a trustee becomes the representative of the estate with the capacity to sue[105] and becomes the sole and proper party to assert any and all claims and causes of action of the debtor.[106] It is the trustee's duty to act on behalf of the estate, the debtor, and its creditors as a whole, rather than the individual interests of the shareholders or guarantors.[107] A reasonable settlement or workout should thus be more likely because the trustee will evaluate the proposal on its overall merits rather than solely on its impact on the shareholders and guarantors.[108]

Third, if the parties do not settle and the lender must go to trial, the lender may find a bankruptcy court the most favorable forum in which to litigate a lender liability claim because the court may rule that the borrower is not entitled to a jury trial in the bankruptcy court. Given the potential prejudice of juries against large banking institutions, most lenders would prefer to have a lender liability lawsuit tried before a judge rather than a jury. While, to put it mildly,

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104. *See supra* notes 77-90 and accompanying text.

105. *See* 11 U.S.C. § 323(a) (1982).

106. *See id.* § 323(b). After a trustee has been appointed, a debtor may not prosecute a cause of action belonging to the estate unless that cause of action has been abandoned by the trustee. *See* Vreugdenhil v. Hoekstra, 773 F.2d 213, 215 (8th Cir. 1985). *See also, e.g.*, Mixon v. Anderson (*In re* Ozark Restaurant Equip. Co.), 816 F.2d 1222, 1225-26 (8th Cir. 1987) (discussing the various causes of action that a trustee may assert). For example, derivative suits are actions which may be commenced only by the trustee. *See id.* at 1225. A court also held that a debtor's cause of action for damages where a secured creditor sold collateral other than in a commercially reasonable manner is also an action which may be commenced only by the trustee as representative of the estate. *See* Lovett v. Shuster, 633 F.2d 98, 99 (8th Cir. 1980).

107. *See* Martin-Trigona v. Ferrari (*In re* WHET, Inc.), 750 F.2d 149, 150 (1st Cir. 1984). A principal limitation on the trustee's ability to compromise controversies is that a compromise may not simply be a disguised sale or disposition of assets of the estate, or a form of post-filing financing under sections 363 and 364, or an attempt to confirm a plan. Other sections of the Bankruptcy Code provide protections with respect to sales or other dispositions of property of the estate, post-filing financing, and plans. Accordingly, the parties must not attempt to accomplish those results through the medium of compromise. *See, e.g., In re* Abbotts, Inc., 788 F.2d 143, 147-48 (3rd Cir. 1986) (debtor and purchaser at auction may not collude on sale of debtor's assets to prejudice of creditors). *See also* Pension Benefit Guar. Corp. v. Braniff Airways (*In re* Braniff Airways), 700 F.2d 935, 939-40 (5th Cir. 1983) (order approving settlement reversed where it required secured creditors to vote in favor of a plan and provided for a release of claims against officers, directors, and lenders).

108. In connection with a compromise of a controversy, a lender should, of course, obtain a general release from the trustee of all claims the debtor could assert against the lender. Such a release should be enforceable. *See, e.g.*, Griffin v. Bonapfel (*In re* All American, Inc.), 805 F.2d 1515, 1517-18 (11th Cir. 1986) (trustee compromised shareholder derivative suit against lender, which compromise, inter alia, enjoined further derivative actions against the lender).

the case law in this area is unsettled,[109] there exists some authority to support the lender's argument that the jury trial right does not apply in the bankruptcy court.[110] In order for a lender to have a case tried without a jury, however, it must convince the bankruptcy court to rule that a lender liability lawsuit is a core proceeding[111] and that there is no right to a jury trial in a core proceeding.

There is some statutory and case law that supports the view that a lender liability claim is a core proceeding. Section 157 of title 28 of the United States Code defines core proceedings as including the following: matters concerning the administration of the estate;[112] matters concerning the allowance or disallowance of claims against the estate and matters concerning estimation of claims or interest for purposes of confirming a plan;[113] counterclaims by the estate

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109. *Compare, e.g.*, Zimmerman v. Cavanagh (*In re* Kenvale Mktg. Corp.), 65 Bankr. 548, 553-54 (Bankr. E.D. Pa. 1986) (there is a seventh amendment jury trial right in both a preference action and a core proceeding) *with, e.g.*, DuVoisin v. Anderson (*In re* Southern Indus. Banking Corp.), 66 Bankr. 370, 372-75 (Bankr. E.D. Tenn. 1986) (no seventh amendment jury trial right in a preference action).

110. *But see* (*In re* Leedy Mortgage Co.), 62 Bankr. 303 (Bankr. E.D. Pa. 1986) (court gave little weight to bankruptcy trustee's choice of forum and granted defendant's motion to withdraw case from bankruptcy court).

111. 28 U.S.C. § 157(b)(2) (Supp. IV 1986) defines "core proceedings":

> Core proceedings include, but are not limited to—
>
> (A) matters concerning the administration of the estate;
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> (B) allowance or disallowance of claims against the estate or exemptions from property of the estate, and estimation of claims or interest for the purposes of confirming a plan under chapter 11 or 13 of title 11 but not the liquidation or estimation of contingent or unliquidated personal injury tort or wrongful death claims against the estate for purposes of distribution in a case under title 11;
>
> (C) counterclaims by the estate against persons filing claims against the estate;
>
> (D) orders in respect to obtaining credit;
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> (E) orders to turn over property of the estate;
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> (F) proceedings to determine, avoid, or recover preferences;
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> (G) motions to terminate, annul, or modify the automatic stay;
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> (H) proceedings to determine, avoid, or recover fraudulent conveyances;
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> (I) determinations as to the dischargeability of particular debts;
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> (J) objections to discharges;
>
> (K) determinations of the validity, extent, or priority of liens;
>
> (L) confirmations of plans;
>
> (M) orders approving the use or lease of property, including the use of cash collateral;
>
> (N) orders approving the sale of property other than property resulting from claims brought by the estate against persons who have not filed claims against the estate; and
>
> (O) other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims.

112. *Id.* § 157(b)(2)(A).

113. *Id.* § 157(b)(2)(B).

against persons filing claims against the estate;[114] determinations of the validity, extent, or priority of liens;[115] and other proceedings affecting the liquidation of assets of the estate or adjustment of the debtor-creditor relationship.[116] Some recent case law supports the view that a lender liability lawsuit is a core proceeding especially if it is asserted as a counterclaim to the lender's proof of claim in the bankruptcy case.[117] As to the issue whether there is a right to a jury trial in a core proceeding, some courts have held that there is neither a statutory nor a constitutional right to a jury trial in the bankruptcy court in a core proceeding.[118]

Finally, while reasonable minds may differ on this point, it is arguable that a lender is generally better off litigating a lender liability lawsuit in the bankruptcy forum rather than in federal district court or a state court. First, the fundamental nature and purpose of bankruptcy law is to deal with financial and commercial transactions, the foreclosure or liquidation of collateral, and relationships between debtors and creditors.[119] As a result, hearings will be held before a judge who is experienced in workouts and debtor/creditor disputes. Second, because the bankruptcy court oversees many battles be-

114. *Id.* § 157(b)(2)(C).

115. *Id.* § 157(b)(2)(K).

116. *Id.* § 157(b)(2)(O).

117. *See, e.g.*, Judge v. Ridley & Schweigert (*In re* Leedy Mortgage Co.), 62 Bankr. 303, 306 (Bankr. E.D. Pa. 1986) (counterclaims for breach of contract and malpractice claims by debtor against former accountants were core matters; however, district court withdrew counterclaims on grounds that issues involved complex non-bankruptcy matters that were better guided by district court judge); Jefferson Nat'l Bank v. I.A. Durbin, Inc. (*In re* I.A. Durbin, Inc.), 62 Bankr. 135, 143-44 (Bankr. S.D. Fla. 1986) (a cause of action involving what otherwise would be a non-core matter becomes a core proceeding when asserted by way of counterclaim to a claim against the estate); Shell Materials v. First Bank (*In re* Shell Materials), 50 Bankr. 44, 46 (Bankr. M.D. Fla. 1985) (debtor's complaint seeking to have several mortgages and notes declared unenforceable under state law was core proceeding since it involved administration of the estate).

118. *See, e.g.*, Transpro Corp. v. NTW, Inc. (*In re* NTW, Inc.), 69 Bankr. 656, 659 (Bankr. E.D. Va. 1987) (no jury trial right with respect to a claim filed against the estate, whether the claim is legal or equitable in nature, nor with respect to a counterclaim asserted in response to the claim); Jefferson Nat'l Bank v. I.A. Durbin, Inc. (*In re* I.A. Durbin, Inc.) 62 Bankr. at 145 (no jury trial right in a core proceeding); Reda, Inc. v. Harris Trust & Sav. Bank (*In re* Reda, Inc.), 60 Bankr. 178, 179-80 (Bankr. N.D. Ill. 1986) (no statutory or constitutional right to a jury trial in the bankruptcy court in a core proceeding). *But see, e.g.*, Price-Watson Co. v. Amex Steel Corp. (*In re* Price-Watson Co.), 66 Bankr. 144, 159 (Bankr. S.D. Tex. 1986) (bankruptcy judges can try jury cases in non-core proceedings); Johnson v. State Farm Mut. Auto. Ins. Co. (*In re* Sara Ferita Fe Fowler Guenther), 65 Bankr. 650, 651 (Bankr. D. Colo. 1986) (defendant entitled to jury trial in non-core proceeding).

119. *See, e.g.*, 28 U.S.C. § 157(b)(2)(K) (Supp. IV 1986) (determinations of the validity, extent, or priority of liens are core matters); *id.* § 157(b)(2)(O) (proceedings affecting liquidation of the assets of the estate or the adjustment of the debtor-creditor relationship are core matters).

tween creditors and debtors over the use of cash collateral, post-filing financing, and sales of assets, the court is accustomed to efforts by lenders, and recognizes the necessity and practicality of such efforts, to utilize economic leverage to negotiate favorable results. Arguably, such experience on the part of the trier of fact, where the case is tried by the judge, should increase the likelihood of a favorable result for a lender.[120] Third, in a case under the Bankruptcy Code, the same judge presides over all aspects of the case as opposed to a state court proceeding where different judges may preside over different aspects of discovery, motions, or the trial. Thus to the extent that the borrower continually hinders or delays the discovery process, continually asserts frivolous arguments, or otherwise obstructs the litigation, the debtor may ultimately "poison the well" with the trier of fact. And fourth, it is the primary function of the bankruptcy process to rehabilitate debtors through a reorganization process while at the same time protecting the rights of creditors. Given the fact that the court and the process itself are geared towards looking at the reorganization or liquidation as a whole, rather than simply resolving one particular dispute, it is arguable that the process itself has a mitigating effect on the "all or nothing" lawsuit.[121]

V. Conclusion

In summary, the lender should not always look at the bankruptcy process as another obstacle to protecting its collateral and collecting its loans. Rather, the lender should view the bankruptcy process as a means of protecting its collateral, receiving adequate protection of its interests, and achieving a significant amount of control over a debtor's affairs. Moreover, it is possible to obtain such benefits, pro-

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120. *See, e.g.*, Anaconda-Ericsson, Inc. v. Hesson (*In re* Teltronics Serv. Inc.), 29 Bankr. 139, 169-74 (Bankr. E.D.N.Y. 1983) (nothing inherently wrong with a creditor carefully monitoring its debtor's financial situation nor with suggesting what course of action the debtor ought to follow). A creditor is not ordinarily a fiduciary of either his debtor or fellow creditors and owes them no special obligation of fidelity in the collection of his claim. *Id.* at 169. A creditor normally has the unqualified right to call a loan when due, to refuse to extend a loan for any cause or no cause at all, and to lawfully enforce collection. *See id. See also, e.g., In re* Technology For Energy Corp., 56 Bankr. 307, 316 (Bankr. E.D. Tenn. 1985) (financial power over a debtor does not necessarily impute insider status to a lender bank; while the bank exercised considerable economic leverage on the debtor to obtain a replacement of management, to require the debtor to give first priority to a sale of the business, and to hire consultants recommended by the bank, such conduct was not inequitable); Schick Oil & Gas v. Federal Deposit Ins. Corp. (*In re* Schick Oil & Gas), 35 Bankr. 282, 285 (Bankr. W.D. Okla. 1983) (even though the bank obtained some concessions from the debtor based on the loan transaction between them, such concessions were not sufficient to create "insider" status for bank nor did it demonstrate a control relationship beyond that normally incident to debtor-creditor relationship).

121. *See, e.g., In re* Technology For Energy Corp., 56 Bankr. at 317-19.

tections, and controls in the context of a borrower's bankruptcy case without fear of lender liability. In proper circumstances, the bankruptcy process can also be utilized to obtain benefits and advantages that are not available under state law in order to enable or facilitate the workout of a problem loan. Finally, if a lender liability claim has been or will be asserted, the bankruptcy forum may be the best place to achieve a reasonable settlement that is fair to the lender, the debtor, and all creditors of the debtor.