Lender Preference Clauses and the Destruction of Appealability and Finality: Resolving a Chapter 11 Dilemma

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I. Introduction

The Friday before Christmas week of 1984 the bankruptcy judge presiding over the Chapter 11 reorganization[1] involving Ellingsen MacLean Oil Company faced a dilemma.[2] Ellingsen, a supplier of home heating oil in Michigan, had no money to buy heating oil to supply to its residential customers for Christmas. If it failed to provide that oil its business probably would collapse. Yet, Ellingsen's lender would extend further credit only if the court preferred the lender's prepetition unsecured claim[3] over all other unsecured claims and immunized its secured claim[4] from an existing fraudulent conveyance attack. Not surprisingly, the unsecured creditors who learned of this proposal opposed giving such concessions to the lender, because those concessions potentially took millions of dollars away from them. Furthermore, only a few of the creditors had even received notice of the lender's proposal, even though Ellingsen had been in Chapter 11 for nine months. Faced with this emergency, however, the bankruptcy court, like most,[5] capitulated to the lender and granted the "lender preference clauses."[6] The creditors who knew of this order immediately

1. 11 U.S.C. §§ 1101–1146 (1982 & Supp. IV 1986) are the generally applicable provisions of "Chapter 11," the single reorganization chapter of the current federal bankruptcy law, promulgated in the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978), and amended in the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, Titles I and III, 98 Stat. 333 (1984), and in the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3088 (1986). This law is known as and will be referred to as the "Bankruptcy Code" or "Code."

2. The facts are discussed in the district court and Sixth Circuit opinions in Unsecured Creditors' Comm. v. First Nat'l Bank & Trust (*In re* Ellingsen MacLean Oil Co.), 65 Bankr. 358, 359–60 (W.D. Mich. 1986), *aff'd*, 834 F.2d 599, 600–01 (6th Cir. 1987), *cert. denied*, 109 S. Ct. 55 (1988).

3. See 11 U.S.C. §§ 101(4), 506(a) (1982) for definitions of "claim" and "unsecured claim," respectively.

4. See id. § 506(a) for definition of "secured claim."

5. For a discussion of the reluctant trend toward granting preferences to bankruptcy lenders, see Tabb, *A Critical Reappraisal of Cross-Collateralization in Bankruptcy*, 60 S. Calif. L. Rev. 109, 116–19 (1986). In that article, I argued that cross-collateralization clauses, a form of "lender preference clause," *see infra* note 6, should not be allowed under any circumstances. *See* Tabb, *supra*, at 110.

6. "Lender preference clauses," a term I have coined to describe the general type of clause which prefers the lender's prepetition claims over those of other similarly situated creditors, may come in a variety of forms. The best known clause is "cross-collateralization," pursuant to which *postpetition* assets of the bankruptcy estate are used to *secure* the *prepetition* unsecured portion of the lender's claim. Many courts have approved these clauses. *See, e.g., In re* Beker Indus., 58 Bankr. 725, 741–42 (Bankr. S.D.N.Y. 1986); *In re* FCX, Inc., 54 Bankr. 833, 837, 840 (Bankr. E.D.N.C. 1985); *In re* Roblin Indus., 52 Bankr. 241, 244–45 (Bankr. W.D.N.Y. 1985); *In re* Vanguard Diversified, Inc., 31 Bankr. 364, 366 (Bankr. E.D.N.Y. 1983); *In re* General Oil Distrib., 20 Bankr. 873, 876 (Bankr. E.D.N.Y. 1982); McCain Foods, Inc. v. Flagstaff Foodservice Co. (*In re* Flagstaff Foodservice Corp.), 14 Bankr. 462, 468–69 (Bankr. S.D.N.Y. 1981); Borne Chem. Co. v. Lincoln First Commercial Corp. (*In re* Borne Chem. Co.), 9 Bankr. 263, 269 (Bankr. D.N.J. 1981). Others have not. *See* Otte v. Manufacturers Hanover Commercial Corp. (*In re* Texlon Corp.), 596 F.2d 1092, 1098–99 (2d Cir. 1979); *In re* Monach Circuit Indus., 41 Bankr. 859, 861 (Bankr. E.D. Pa. 1984). *Texlon* is discussed in Tabb, *supra* note 5, at 113–16, with regard to its discussion of the merits of cross-collateralization and in Part IV of this Article with regard to its discussion of the finality issue. Another clause is "cross-superprioritization," in which the lender's prepetition unsecured claim is given *priority* over all other claims in the bankruptcy case. *See, e.g., FCX*, 54 Bankr. at 841 (court in dictum stated it might not approve such a clause, but construed loan agreement as not providing for such a priority); *Roblin*, 52 Bankr. at 244; *Vanguard*, 31 Bankr. at 366; *General Oil*, 20 Bankr. at 874–75; *Borne Chem.*, 9 Bankr. at 266, 268, 270. Sometimes outright payment of the prepetition claims is called for, although this practice is extremely disfavored by the courts. *See* B & W Enter. v. Goodman Oil Co. (*In re* B & W Enter.), 713 F.2d 534, 535–37 (9th Cir. 1983).

A final type of clause does not in a technical sense prefer the lender's prepetition claim; instead, the clause effects a *waiver* of objections to the validity of prepetition collateral positions. This was the clause that most disturbed the unsecured creditors and the dissent in *In re* Ellingsen MacLean Oil Co., 834 F.2d 599, 607 (6th Cir. 1987) (Merritt, J., dissenting). *See also FCX*, 54 Bankr. at 837, 841–42; *Roblin*, 52 Bankr. at 243–44 (court that approved cross-collateralization refused to approve such a waiver clause); *Flagstaff*, 16 Bankr. at 134–35; *Borne*, 9 Bankr. at 266.

appealed, but the appeal could not be heard before the lender advanced the money to meet the emergency. The appellate court held that the creditors' appeals were moot under Bankruptcy Code section 364(e).[7] The lender had won. Not only had it manipulated an emergency to extract highly controversial benefits, but it also had insulated those benefits from appellate review. When one considers the very forceful legal objections that can be made to such preferential arrangements,[8] this was truly a startling and troubling result. Unfortunately, it was not unusual, as will be discussed below.[9]

In another reorganization case, involving Texlon Corporation,[10] the debtor's lender similarly had extracted lender preference clauses, this time in an *ex parte* financing order entered without notice on the day the petition was filed. This financing order never was appealed. Several months later, after substantial further loans were made by the lender pursuant to the financing order, the case was converted to a straight liquidation bankruptcy. The bankruptcy trustee then asked the bankruptcy court to modify its earlier order to take away the lender's preferences. The bankruptcy judge, although sympathetic with the trustee's arguments against the propriety of granting such preferential benefits in the first place, felt constrained by notions of finality and refused to alter his final order.[11] On appeal, the Second Circuit surprisingly held that the finality of the order did not preclude its modification by the bankruptcy judge, as long as no rights of the lender had vested in reliance on the order.[12] In that case, the lender lost, despite the apparent finality of the order.

These leading cases graphically highlight, in the financing order context, how courts are misapplying principles of appealability[13] and finality[14] in Chapter 11 reorganization cases. These errors stem in part from confusion generated by the unusual procedural nature of a Chapter 11 reorganization case,[15] in part from the

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7. *In re* Ellingsen MacLean Oil Co., 65 Bankr. 358, 364–65 (W.D. Mich. 1986). The text of § 364(e) is set forth *infra* text accompanying note 47. Section 364(e) protects a good faith § 364 lender against an appellate modification or reversal of the authorizing financing order if no stay of the order was obtained. *See infra* subparts III.A. and III.C.

8. These arguments, discussed in detail in Tabb, *supra* note 5, at 119–74, are: (1) the Bankruptcy Code's principle of equality of distribution to similarly situated creditors (here, unsecured creditors) is being violated; (2) the inducement rationale supporting postpetition priorities does not apply; and (3) § 364 states the exclusive list for permissible postpetition financing incentives.

9. *See infra* subpart III.A., and particularly the cases discussed *infra* note 44.

10. *In re* Texlon Corp., 596 F.2d 1092, 1094–95 (2d Cir. 1979).

11. *In re* Texlon Corp., 3 Bankr. Ct. Dec. (CRR) 1013, 1016–17 (Bankr. S.D.N.Y. 1977), *rev'd*, 596 F.2d 1092 (2d Cir. 1979).

12. *Texlon*, 596 F.2d at 1099–1101. *See infra* Part IV for further discussion of the finality issue.

13. Most of the discussion in the cases with regard to appealability has focused on the mootness issue, particularly under 11 U.S.C. § 364(e), discussed *infra* subparts III.A. and III.C. The broader term "appealability" is used here because some appellate courts have also stated that appellants may be estopped to prosecute the appeal. Estoppel is discussed *infra* subpart III.B.2.

14. "Finality" in this Article refers to the policy of repose applicable to noninterlocutory orders that have not been appealed in the time indicated by applicable procedural rules. This Article does not examine the difficult question of what bankruptcy orders are sufficiently "final" to be appealed. *See, e.g.*, Grundy Nat'l Bank v. Looney (*In re* Looney), 823 F.2d 788, 790 (4th Cir.), *cert. denied*, 108 S. Ct. 488 (1987); A.H. Robins Co. v. Piccinin, 788 F.2d 994, 1009 (4th Cir.), *cert. denied*, 479 U.S. 876 (1986). Unless expressly stated to be interlocutory by the bankruptcy judge, *see, e.g.*, *In re* FCX, Inc., 54 Bankr. 833, 839 (Bankr. E.D.N.C. 1985), financing orders are considered "final" in the sense that they may be appealed.

15. The "case," not separately defined in the Code (although identified by inference in many statutory provisions, *see, e.g.*, 11 U.S.C. § 101(12) (1982), defining "debtor" as the "person or municipality concerning which a *case* under

tendency of bankruptcy courts to try to save a reorganization at all costs,[16] despite the fact that most reorganizations fail,[17] and in part from the dynamics of the reorganization case.[18] The failure of courts to apply properly these principles of appealability and finality poses serious concerns for the bankruptcy system. Reorganizations are threatened. Substantive rights may be gained or lost because of this procedural dysfunction. Using bankruptcy financing orders as a context, this Article explores these problems of appealability and finality and suggests appropriate resolutions that will facilitate reorganizations, treat all parties fairly, and further the policies of the Bankruptcy Code.

The interests of the debtor, the debtor's lender, and the unsecured creditors often diverge.[19] As seen in *Ellingsen* and *Texlon*, and as will be explained in Part II, the

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this title has been commenced" (emphasis added)), is the overall judicial action concerning the debtor. It may last several years in large, complex cases such as *Manville*. The "case" is comprised of many separate "proceedings," which are the multitude of separate matters undertaken during the case. An analogy may be drawn to the administration of a decedent's estate. Some but not all of the proceedings in a case are adversarial. For example, a suit by the trustee to recover money is an "adversary proceeding," FED. R. BANKR. P. 7001(1), and is almost identical to a traditional civil lawsuit. Other matters not classified as "adversary proceedings" still may be contested, and are referred to as "contested matters." *Id.* R. 9014. A motion by a creditor for relief from the automatic stay of 11 U.S.C. § 362 (1982 & SUPP. IV 1986) is an example. Many of the procedural rules governing civil lawsuits apply to contested matters. Finally, many administrative matters, such as the appointment of a trustee, may not be contested at all. Many of these administrative functions have been delegated to the United States trustee in the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3088 (1986). *See infra* notes 211–14 and accompanying text. A further complication in attempting to make sense of the procedural morass of a Chapter 11 case is that the notice given of the various proceedings in a case varies widely and sometimes is dispensed with entirely. *See infra* Part V for further discussion.

16. In *Ellingsen*, for example, the creditors believed that the Chapter 11 case was doomed to failure and that the bankruptcy judge was just prolonging the agony at their expense. *See* Petitioner's Brief for Certiorari at 5–6 n.4, Unsecured Creditors' Comm. v. First Nat'l Bank & Trust (*In re* Ellingsen MacLean Oil Co.), 56 U.S.L.W. 3739 (U.S. Apr. 14, 1988) (No. 87-1718), *cert. denied*, 109 S. Ct. 55 (1988).

17. *See* United Sav. Ass'n v. Timbers of Inwood Forest Assocs. (*In re* Timbers of Inwood Forest Assocs.), 808 F.2d 363, 382 (5th Cir. 1987) (en banc) (Jones, J., dissenting), *aff'd*, 108 S. Ct. 626 (1988) (over 90% of Chapter 11 cases filed in the last five years have failed).

18. *See infra* Part II; *see also* Tabb, *supra* note 5, at 111, 163–67.

19. The debtor, having just filed a Chapter 11 petition, typically is not in a strong bargaining position to obtain postpetition financing, and thus in most cases is willing to accede to whatever demands the lender makes. *See In re* Texlon Corp., 596 F.2d 1092, 1098 (2d Cir. 1979) ("The debtor in possession is hardly neutral. Its interest in its own survival, even at the expense of equal treatment of creditors, and close relations with a lending institution tend to prevent the exploration of other available courses."). *See* Tabb, *supra* note 5, at 165–66; Comment, *Initial Financing Restrictions in Chapter XI Bankruptcy Proceedings*, 78 COLUM. L. REV. 1683, 1685 n.26 (1978) [hereinafter *Initial Financing Restrictions*]. The acquiescent debtor effectively is binding the unsecured creditors by agreeing to the financing, especially if the mootness holdings discussed in subpart III.A. below are followed. This problem of a consenting party giving away the rights of others is also prevalent in the area of consent decrees. *See generally* Laycock, *Consent Decrees Without Consent: The Rights of Nonconsenting Third Parties*, 1987 U. CHI. LEGIS. FORUM 103. The debtor's lender usually is most interested in maximizing its return on its prepetition claim. *See* Tabb, *supra* note 5, at 111, 144; *Initial Financing Restrictions*, *supra*, at 1694. This often means keeping the debtor afloat long enough to realize higher going concern values on its prepetition collateral, instead of lower liquidation values. If the lender has a significant prepetition unsecured claim, the lender may try to enhance its position vis-à-vis other unsecured creditors by means of lender preference clauses.

The unsecured creditors want the reorganization to succeed so that the dividend on their unsecured claims will be increased. Financing made without lender preference clauses typically would meet with their approval, since the new money is of course crucial to the success of the debtor's business rehabilitation. Even in that instance, however, if the debtor were liquidated immediately, unsecured creditors who would receive a significant dividend might be hesitant about continuing a questionable Chapter 11 case, because their dividend might be eroded by the accrual of administrative expenses during the pendency of the case. If the Chapter 11 financing is made on a preferential basis, the likelihood of opposition by the unsecured creditors increases dramatically, since the direct effect of the preferences is to pay the lender before the general body of unsecured creditors. The more indirect and distant hope of an ultimately increased dividend that might result from a successful reorganization now theoretically made possible by the new loan often is insufficient

debtor's lender has been able to use its willingness to extend further financing essential to the reorganization as a lever to obtain preferred treatment for its prepetition claims. This practice is highly controversial,[20] and the validity of granting such preferences is very much open to question. To complicate matters further, the financing order containing these lender preference clauses typically is entered on an emergency basis with little or no notice to the very creditors whose interests potentially are being prejudiced.[21] Yet bankruptcy judges, presented with an emergency threatening the reorganization, often feel they have little choice but to acquiesce.

The affected unsecured creditors have attacked the prejudicial lender preference clauses in the financing order either by appealing, as in *Ellingsen*,[22] or by asking the bankruptcy court to reconsider its order, as in *Texlon*.[23] Although most of the attention in the debate over the validity of lender preference clauses has focused on substantive issues,[24] cases such as *Ellingsen* and *Texlon* indicate that procedural issues of mootness, estoppel, and finality instead have been determinative. Unfortunately, the courts have gotten the results exactly wrong. In the case of appeals, courts protect the lender when they should not; in the case of motions to reconsider, courts do not protect the lender when they should.

Where the objecting creditors appeal, the lender's preferences have been protected by the courts' improper interpretation of the mootness provisions of Bankruptcy Code section 364(e).[25] As set forth in Part III, neither section 364(e) nor general principles of mootness or estoppel should prevent the appellate court from reviewing the lender preference clauses. The lender preference clauses are severable from the rest of the financing order. Promoting appellate review would further the development of the substantive law as to the validity of lender preference clauses. The bankruptcy lender still would have the certainty of knowing within the time for filing an appeal[26] whether the lender preference clauses were being contested.

Part IV addresses the propriety of the bankruptcy court itself modifying or vacating its earlier order pursuant to a motion filed after the time for filing an appeal

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to assuage the unsecured creditors' concerns about the preferences granted to the lender. *Ellingsen* is a typical example of this unsecured creditor opposition.

20. *See* cases cited *supra* note 6. *Compare* Tabb, *supra* note 5, at 110 (should not be allowed) *and Initial Financing Restrictions*, *supra* note 19, at 1693–95 (should not be allowed), *with* Bohm, *The Legal Justification for the Proper Use of Cross-Collateralization Clauses in Chapter 11 Bankruptcy Cases*, 59 AM. BANKR. L.J. 289, 296–97 (1985) (should be allowed); Weintraub & Resnick, *Cross-Collateralization of Prepetition Indebtedness as an Inducement for Postpetition Financing: A Euphemism Comes of Age*, 14 U.C.C. L.J. 86, 89–90 (1981) (should be allowed), *and* Ordin, In re *Texlon Corporation: Finality of Order of Bankruptcy Court*, 54 AM. BANKR. L.J. 173, 177–78 (1980) (should be allowed).

21. The lender preference cases almost always involve abbreviated notice, with the financing order entered at or near the commencement of the case. *See, e.g.*, Butler Paper Co. v. Graphic Arts Lithographers (*In re* Graphic Arts Lithographers), 71 Bankr. 774, 775–76 (Bankr. 9th Cir. 1987) (three hours notice, entered day after case filed); *In re* Texlon, 596 F.2d at 1094 (no notice, entered day case filed). *See also* M. BIENENSTOCK, BANKRUPTCY REORGANIZATION 225 (1987); *Initial Financing Restrictions*, *supra* note 19, at 1699. This topic is explored in depth in Part V.

22. *See supra* notes 1–7 and accompanying text and *infra* subpart III.A.

23. *See supra* notes 10–12 and accompanying text and *infra* subpart IV.A.

24. *See* cases and articles cited *supra* note 20.

25. *See infra* text accompanying note 47 and subpart III.A.

26. FED. R. BANKR. P. 8002 specifies the time for filing an appeal. The standard period is 10 days after the date of entry of the judgment, *id.* R. 8002(a), although the period may be extended for up to another 20 days. *Id.* R. 8002(c).

has expired. Traditional concepts of finality suggest that such an attack should be rejected except in very limited circumstances. Surprisingly, however, a few prominent cases, such as *Texlon*,[27] relax the normal requirements on the basis of a dated vision of bankruptcy proceedings. Those courts state that bankruptcy orders may be modified freely as long as no intervening rights have vested in reliance on the order.[28] This Article concludes that bankruptcy courts should limit relief to situations encompassed within rule 60(b)[29] of the Federal Rules of Civil Procedure. In the financing order context, relief would be granted only when there has been insufficient notice[30] or some fraud by the lender.[31]

Part V of this Article analyzes the notice problem separately, because notice issues are important both in appellate attacks and in motions to the bankruptcy court for relief. Although the courts typically are lenient to the lender and allow minimal notice,[32] considerable confusion exists, and inconsistent results are reached, given the exigent circumstances under which financing orders are usually entered.[33] Part V recommends a framework for resolving notice issues in bankruptcy generally and in financing cases specifically. This framework would provide sufficient protection for all parties involved and would enhance certainty as to the sufficiency of the notice given. At the same time, application of this framework by the courts would take away some of the unfair protection enjoyed by lenders in many recent cases.

II. The Setting in Which Lender Preference Clauses Are Granted

A Chapter 11 debtor usually has an urgent need for new money to keep its business operating.[34] The debtor's prebankruptcy lender in many cases is able to take advantage of this need and its own willingness to extend the new money to extract lender preference clauses. Lender preference clauses prefer the prepetition claims of the debtor's lender over all unsecured claims.[35] Typically, the lender's unsecured claims are given priority. Another type of clause makes the lender's secured claims immune from avoidance. For example, assume that prior to bankruptcy the debtor's lender had a total claim of five million dollars, with collateral securing the loan valued at only four million dollars. For bankruptcy purposes, the lender would have a secured claim of four million dollars and an unsecured claim of one million

27. *See supra* notes 10–12 and *infra* notes 177–210 and accompanying text.

28. *See infra* subpart IV.A.

29. See *infra* note 176 for the applicable provisions of FED. R. CIV. P. 60(b), specifying the grounds for relief from a final judgment. FED. R. BANKR. P. 9024 incorporates rule 60(b) into bankruptcy practice.

30. *See infra* notes 172 and 258–62 and accompanying text and subpart V.D.

31. *See infra* notes 164–71 and 251–57 and accompanying text.

32. *See, e.g., In re* Graphic Arts Lithographers, 71 Bankr. 774, 775–76 (Bankr. 9th Cir. 1987) (three hours notice sufficient).

33. *See, e.g., In re* Sullivan Ford Sales, 2 Bankr. 350, 355 (Bankr. D. Me. 1980); J. ANDERSON, CHAPTER 11 REORGANIZATIONS § 9.12, at 9–45 (1984). Most of the contested lender preference cases involve extremely short notice. *See* cases cited *infra* note 318.

34. *See In re* Ellingsen MacLean Oil Co., 834 F.2d 599, 603 (6th Cir. 1987); Burchinal v. Central Washington Bank (*In re* Adams Apple, Inc.), 829 F.2d 1484, 1489–90 (9th Cir. 1987); *In re* FCX, Inc., 54 Bankr. 833, 835 (Bankr. E.D.N.C. 1985); M. BIENENSTOCK, *supra* note 21, at 225; Tabb, *supra* note 5, at 111.

35. *See supra* note 6 for a more detailed discussion of the types of lender preference clauses.

dollars.[36] A lender preference clause might require the lender's one million dollar prepetition unsecured claim to be paid prior to all other unsecured claims, or it might bar any scrutiny of the validity of the four million dollar secured claim. These results violate established bankruptcy policies.[37] Accordingly, it seems odd that the bankruptcy court would approve a lender preference clause. The more sensible route seemingly would be for the debtor in possession to borrow from another lender who does not make such extortionate demands.[38]

The problem is that the debtor in possession in many cases does not have the freedom to borrow from another lender, but instead is "locked in" to its prebankruptcy lender.[39] Thus does the old lender use its willingness to extend new money to coerce the bankruptcy court into granting preferential treatment for its prepetition claim.

The "lock in" effect occurs for several reasons. The first is time. The debtor often needs the money immediately and does not have time to find a new lender.[40] Second, the prebankruptcy lender may insist on being the bankruptcy lender so that it can enhance its position.[41] The lender may threaten to take a hostile approach in the bankruptcy case if it is not allowed to be the bankruptcy lender on preferential terms.[42] Finally, the old lender may be the only lender willing to extend new money to the debtor. That lender has a vested interest in seeing the reorganization succeed so that it can realize more on its prepetition secured and unsecured claims.[43] Other potential lenders who do not have prepetition claims against the debtor lack the same incentive. Thus, the dynamics of reorganization financing are such that the debtor's prebankruptcy lender is able to obtain lender preference clauses in a significant number of cases.

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36. *See* 11 U.S.C. § 506(a) (1982).

37. *See supra* note 8 and accompanying text.

38. As pointed out in Tabb, *supra* note 5, at 113, unsecured creditors are not prejudiced if the financing is done by a new lender who does not have a prepetition unsecured claim to prefer.

39. *See id.* at 164–65 for a discussion of the "lock in" effect.

40. *See supra* note 33 and accompanying text.

41. In *In re* Adams Apple, Inc., 829 F.2d 1484, 1486 (9th Cir. 1987), the debtor before filing Chapter 11 had negotiated possible borrowing arrangements with willing new lenders. The prebankruptcy lender, however, apparently insisted on being the bankruptcy lender and "required the debtors to file Chapter 11 proceedings to clarify [the bank's] rights." *Id.* This certainly represents a novel use of Chapter 11, which most people previously had thought existed for the benefit of debtors, not lenders.

The converse of the situation under consideration is not true. The prebankruptcy lender cannot be compelled to loan money to the debtor in possession. Any prepetition commitment to lend cannot be enforced in bankruptcy against the lender. 11 U.S.C. § 365(c)(2) (1982).

42. For example, the lender may threaten to move for relief from the automatic stay under 11 U.S.C. § 362 (1982 & Supp. IV 1986); may oppose the use of cash collateral under 11 U.S.C. § 363; may demand adequate protection under 11 U.S.C. § 361; and, most damaging of all, may vote against the proposed plan of reorganization, requiring the debtor to attempt to invoke the "cram down" powers of 11 U.S.C. § 1129(b) to confirm the plan over the lender's dissent. As a practical matter it is extremely difficult for a debtor to successfully reorganize in the face of opposition from its major secured creditor.

43. *See supra* note 19. Thus, in a sense, the "lock in" effect works both ways.

III. DESTROYING APPEALABILITY: MOOTNESS AND ESTOPPEL AS A CATCH-22 FOR THE VICTIMIZED CREDITOR

The most significant recent development regarding the issues of the finality and appealability of financing orders containing lender preference clauses has been in those cases, beginning with *Ellingsen*,[44] holding the appeal of the entire financing order moot under Bankruptcy Code section 364(e).[45] These holdings have insulated lender preference clauses from appellate scrutiny. This Part will explain why those cases are wrong and why substantive appellate review of the validity of lender preference clauses is proper, even though the lender has advanced new money.

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44. This line of cases began in 1986 with the district court decision in *In re* Ellingsen MacLean Oil Co., 65 Bankr. 358 (W.D. Mich. 1986), which is discussed *infra* this note. That decision was followed in *In re* Graphic Arts Lithographics, 71 Bankr. 774 (Bankr. 9th Cir. 1987). In *Graphic Arts* the financing order, which contained a cross-collateralization clause, was entered *ex parte* on three hours telephonic notice the day after the Chapter 11 petition was filed. Four creditors of the debtor appealed, but since no stay of the financing order was obtained, the lender's § 364(e) motion to dismiss for mootness was granted. *Id.* at 775–76. The appellate court assumed without discussion that § 364(e) applied to the cross-collateralization clause and determined that the lender had not acted in bad faith, since the funds were advanced for a proper purpose, to allow the debtor to operate postpetition, and since the lender did not know that cross-collateralization was illegal, but only that it was a disputed concept. *Id.* at 776–77. The court erroneously concluded that its mootness holding made it unnecessary to consider the notice question. *Id.*

The next important case was *In re* Adams Apple, 829 F.2d 1484 (9th Cir. 1987). Although several major unsecured creditors objected to the cross-collateralization clause, the bankruptcy court approved the financing arrangement tentatively the day after the cases were filed, and funds were advanced. Final authorization later was given. One unsecured creditor immediately filed a motion requesting a stay pending appeal, but the bankruptcy court denied that motion, as well as a motion to reconsider its order. *Id.* at 1486. Thus, the objecting creditors could have done nothing more to stop the implementation of the order. After the district court affirmed the financing order on the merits, *id.* at 1486–87, the Ninth Circuit dismissed the appeal as moot under § 364(e). *Id.* at 1487–91. The court first held that § 364(e) applied to cross-collateralization clauses. *Id.* at 1488–89. The court's analysis of the applicability issue is considered in detail *infra* subpart III.A. Having decided that § 364(e) applied to cross-collateralization clauses, the Ninth Circuit had no trouble finding that the lender had acted in good faith, following the reasoning of the district court in *Ellingsen* and the bankruptcy appellate panel in *Graphic Arts*. *Id.* at 1489–91.

Shortly after the Ninth Circuit decision in *Adams Apple*, the Sixth Circuit affirmed the district court's holding of mootness in *In re* Ellingsen MacLean Oil Co., 834 F.2d 599 (6th Cir. 1987). Many of the pertinent facts in *Ellingsen* are discussed at the beginning of this Article. *See supra* notes 1–7 and accompanying text. After entry of a financing order containing several lender preference clauses on one day telephonic notice to a few creditors, the creditors' committee and an individual large creditor appealed to the district court, but did not obtain a stay of the order. *Ellingsen*, 834 F.2d at 600–01; *Ellingsen*, 65 Bankr. at 360, 362–63. The district court granted the lenders' motion to dismiss the appeal as moot under § 364(e). *Ellingsen*, 65 Bankr. at 363–65. The court first held that sufficient notice was given and rejected the allegation that the debtors and the banks had contrived the emergency. *Id.* at 361–63. The court next held that the lenders had acted in good faith, for the reasons outlined above in the discussion of *Graphic Arts*. *Id.* at 363–65.

A sharply divided Sixth Circuit affirmed the district court's decision to dismiss the appeal as moot under § 364(e). *Ellingsen*, 834 F.2d at 605. Judge Wellford for the majority largely followed the district court's analysis, holding first that § 364(e) applied to lender preference clauses. *Id.* at 601–05. He then held that the lenders had acted in good faith. *Id.* at 605.

Judge Nelson concurred "to emphasize the limited precedential effect of our holding." *Id.* at 605–06 (Nelson, J., concurring). Unlike the majority, *id.* at 602–04, Judge Nelson expressed reservations about the substantive validity of cross-collateralization, but concurred based on an estoppel theory. According to Judge Nelson, the appellants were on notice that the order itself stated that the § 364(e) safe harbor provision would apply; the banks relied on this statement; and the appellants' failure to get the order stayed estopped them. *Id.* at 606. *See infra* note 100 and subpart III.B.2. for further discussion of the estoppel argument.

Judge Merritt in a short dissent vehemently disagreed with the court's holding. *Ellingsen*, 834 F.2d at 607 (Merritt, J., dissenting). He objected particularly to the clause waiving all objections to the prepetition liens of the banks and would have reversed and permitted the pursuit of the fraudulent conveyance claim. *Id.* He concluded that § 364(e) does not apply at all to lender preference clauses, which deal only with *prepetition* matters, but instead would limit the reach of § 364(e) to "authorized postpetition loans and liens to secure such loans." *Id.* Judge Merritt, unlike the majority, assumed that the order was severable. Finally, he argued that it was bad policy to allow prepetition lenders "to use their leverage in making emergency loans in order to insulate their prepetition claims from attack." *Id.*

45. *See infra* text accompanying note 47 for the text of 11 U.S.C. § 364(e) (1982).

Subpart III.A. analyzes the difficult question of whether section 364(e) applies at all to lender preference clauses. The resolution of the applicability issue is of paramount importance. If section 364(e) does not apply, the lender is relegated to general mootness and estoppel arguments, which, as discussed in subpart III.B., should not preclude a substantive appellate review. On the other hand, if section 364(e) does apply, the lender will be protected except in the case of inadequate notice or fraud. Subpart III.C. explains why the utilization of lender preference clauses standing alone has not been enough to prove bad faith sufficient to deprive a lender of section 364(e)'s protections.

A. *The Dubious Applicability of Section 364(e) to the Appeal of Lender Preference Clauses*

Section 364(e) of the Bankruptcy Code provides a safe harbor for good faith bankruptcy lenders. Those lenders are protected from the effects of an appellate reversal or modification of a section 364 financing order when the order was not stayed pending the appeal.[46] Section 364(e) provides:

> The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.[47]

The crucial first issue in determining whether a lender is protected by section 364(e) as to lender preference clauses in a financing order is whether section 364(e) applies at all to such clauses. The two circuit cases addressing this question, *Ellingsen* and *Adams Apple*, each concluded that section 364(e) did apply to lender preference clauses.[48] This Article asserts that those cases should not be followed and that section 364(e) should not prevent appellate review of the merits of lender preference clauses.

Section 364(e)'s principal purpose is the salutary one of facilitating reorganizations by inducing lending to Chapter 11 debtors.[49] The operative idea is that the

46. *See Ellingsen*, 834 F.2d at 603; *Adams Apple*, 829 F.2d at 1487–88; *In re* EDC Holding Co., 676 F.2d 945, 947 (7th Cir. 1982); *Graphic Arts*, 71 Bankr. at 776; Credit Alliance Corp. v. Dunning-Ray Ins. Agency (*In re* Blumer), 66 Bankr. 109, 113 (Bankr. 9th Cir. 1986), *aff'd*, 826 F.2d 1069 (9th Cir. 1987) (describing § 364(e) as "[t]he strongest statutory protection possible"); H.R. REP. No. 595, 95th Cong., 1st Sess. 347 (1977), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6303; S. REP. No. 989, 95th Cong., 2d Sess. 58 (1978), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5844.

"Section 364 financing order" means an order granting those priorities and liens expressly authorized in § 364. Lender preference clauses are not expressly authorized by § 364. *See infra* note 58 and accompanying text.

47. 11 U.S.C. § 364(e) (1982).

48. *See Ellingsen*, 834 F.2d at 601–05; *Adams Apple*, 829 F.2d at 1488–89. *See supra* note 44 for a more detailed discussion of these cases.

49. *Ellingsen*, 834 F.2d at 604; *Adams Apple*, 829 F.2d at 1488; Tabb, *supra* note 5, at 138. As the Seventh Circuit stated in *EDC Holding*, 676 F.2d at 947, the leading case on § 364(e):

> These provisions seek to overcome people's natural reluctance to deal with a bankrupt firm whether as purchaser or lender by assuring them that so long as they are relying in good faith on a bankruptcy judge's approval of

bankruptcy lender will never be at risk with regard to the validity of the transaction in advancing funds to the debtor in possession. If a stay of the order is obtained, no funds will be advanced; if no stay is obtained and the money is lent, then any appeal will be dismissed as moot.[50]

Several competing arguments are made as to whether section 364(e)'s safe harbor extends to lender preference clauses. The principal argument against applying section 364(e) to lender preference clauses is based on the plain meaning of the statute and reinforced by the statute's essential purpose to induce lending.[51] The counter-arguments for applying section 364(e) are: a different application of the inducement policy;[52] the "package" theory;[53] the need to further finality;[54] and estoppel.[55]

The primary argument made that lender preference clauses are not protected by

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the transaction they need not worry about their priority merely because some creditor is objecting to the transaction and is trying to get the district court or the court of appeals to reverse the bankruptcy judge.

Section 364(e) does not represent any new policy decision under the Code. Along with rule 8005, it is derived from former FED. R. BANKR. P. 805 (as amended 1976) (repealed 1983) and, before that, FED. R. BANKR. P. 11-62(2) (1973) (amended 1976) (repealed 1983). *See* Tabb, *supra* note 5, at 138 n.151. Those predecessor rules, which protected a good faith purchaser of a "certificate of indebtedness" from an appellate reversal, were characterized by the Advisory Committee Note as being "declaratory of existing case law." FED. R. BANKR. P. 805 (Adv. Comm. Note 1976). The same inducement rationale that underlies § 364(e) and R. 8005 supported the predecessor rules as well. *See* 14 COLLIER ON BANKRUPTCY ¶ 11-62.03, at 11-62-11 to -12 (14th ed. 1976).

"Certificates of indebtedness" were used under the Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (1898), *amended by* Chandler Act, ch. 575, 52 Stat. 840 (1938) (repealed 1978), when a special priority or lien was granted to the bankruptcy lender, but typically were not used in more routine credit extensions supported only by administrative expense status. *See* Tabb, *supra* note 5, at 140. Thus, the certificate of indebtedness is the direct ancestor of 11 U.S.C. § 364(c) (1982) (providing for superpriority status, liens on unencumbered property, and junior liens on encumbered property) and *id.* § 364(d) (providing for senior liens on already encumbered property). *See* Tabb, *supra* note 5, at 125. For a general discussion of the use of certificates of indebtedness under the former Act, *see* Baker, *Certificates of Indebtedness in Reorganization Proceedings: Analysis and Legislative Proposals*, 50 AM. BANKR. L.J. 1 (1976), and Tondel & Scott, *Trustee Certificates in Reorganization Proceedings Under the Bankruptcy Act*, 27 BUS. LAW. 21 (1971). Certificates of indebtedness are not used under the Code. *See* 2 COLLIER ON BANKRUPTCY ¶ 364.04[1], at 364-11 (15th ed. 1987).

No express lender protection rule covered noncertificate administrative priority lending in Act cases. The difference in the rules governing the finality of certificate and noncertificate lending was based on the necessity to protect the integrity of the more formal certificate process. *See* Tabb, *supra* note 5, at 140–41. Section 364 does not differentiate between types of lending for purposes of lender protection, but instead applies the safe harbor of § 364(e) to all credit extensions under § 364. 11 U.S.C. § 364(e) (1982). The significance of the limiting words "under this section" in § 364(e) is discussed *infra* notes 56–63 and accompanying text.

50. A party appealing a financing order entered under the authority of § 364 thus must obtain a stay of the order to prevent the appeal from being dismissed as moot. *See Ellingsen*, 834 F.2d at 604–05; *In re* Graphic Arts Lithographers, 71 Bankr. at 774, 776 (Bankr. 9th Cir. 1987). Bankruptcy rules 8005 and 7062 specify the stay procedure in bankruptcy cases and must be read together. *See In re* Baldwin United Corp., 45 Bankr. 385, 386 (Bankr. S.D. Ohio 1984); 9 COLLIER ON BANKRUPTCY, *supra* note 49, ¶¶ 7062.07, 8005.03, at 7062-8, 8005–04. The Advisory Committee Note to rule 8005 makes clear that rule 8005 is intended to implement § 364(e), referring specifically to the operative principle of § 364(e). *See* FED. R. BANKR. P. 8005 (Adv. Comm. Note 1987). Rule 8005 gives the particulars for obtaining a discretionary stay pending appeal, and rule 7062 (which largely incorporates FED. R. CIV. P. 62) deals with the stay of proceedings to enforce a judgment. Obtaining a stay of a § 364 financing order is not a matter of right, but is subject to the discretion of the bankruptcy judge. *See In re* First South Sav. Ass'n., 820 F.2d 700, 709 (5th Cir. 1987); 9 COLLIER ON BANKRUPTCY, *supra* note 49, ¶¶ 7062.07, 7062.09, 8005.03, at 7062-7, 7062-9, 8005-4. Rule 7062 expressly adds § 364 financing orders to the list of exceptions to the automatic stay of FED. R. CIV. P. 62(a). As will be discussed in more detail later in the Article, the showing required to obtain a discretionary stay is a very high one, a point of importance for the discussion following about whether the stay requirement should apply to lender preference clauses. *See infra* notes 130–39 and accompanying text.

51. *See infra* notes 56–62 and accompanying text.

52. *See infra* notes 63–81 and accompanying text.

53. *See infra* notes 82–92 and accompanying text.

54. *See infra* notes 93–96 and accompanying text.

55. *See infra* note 100 and subpart III.B.2.

section 364(e) is that section 364(e), on its face[56] only applies to authorizations to incur debt or to obtain credit "under this section," and to the granting of a priority or lien "under this section," meaning, of course, section 364.[57] It is undisputed that lender preference clauses are not provided for expressly anywhere in section 364 (or anywhere else in the Code, for that matter).[58] The apparently straightforward conclusion is that section 364(e), being limited by its own terms to section 364 financing orders, does not extend to nonsection 364 financing clauses such as lender preference clauses.[59]

This plain meaning argument is consistent with the underlying purposes of section 364(e). As noted, that section attempts to induce lenders to do business postpetition with the debtor in possession by permitting those lenders to rely on the finality of the authorizing financing order.[60] The priority of and security for funds actually advanced *postpetition* thus cannot and should not be disturbed once the funds are advanced.[61] By definition, however, the lender preference clauses are designed to enhance in different ways the status of and the likelihood of repayment of funds already advanced *prior* to the filing of the Chapter 11 petition.[62] Striking such a lender preference clause does not affect the security for or priority of the postpetition loan made pursuant to the financing order.

The Sixth and Ninth Circuits, however, did not accept the plain meaning argument. The Sixth Circuit in *Ellingsen* asserted without elaboration that it was not aware of any case authority for such a proposition.[63] The Ninth Circuit in *Adams Apple* declined to interpret the language of section 364(e) as limiting the automatic safe harbor of that section to those financing techniques expressly listed in section 364. Instead, the *Adams Apple* court, based on section 364(e)'s underlying policy of inducing lending, read section 364 as *impliedly* authorizing lender preference clauses, thus bringing those clauses within section 364(e)'s ambit.[64] According to the Ninth Circuit, then, lender preference clauses do fall within section 364(e)'s inducement policy because some lenders may choose to invest in the Chapter 11 debtor only because of the possible extra profit to be realized from preferring their prepetition

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56. *See supra* text accompanying note 47.

57. *See In re* Ellingsen MacLean Oil Co., 834 F.2d 399, 601 (6th Cir. 1987); *In re* Adams Apple, Inc., 829 F.2d 1484, 1488 (9th Cir. 1987).

58. *See* Tabb, *supra* note 5, at 119–21, 133, 137–40. 11 U.S.C. § 105(a) (1982 & Supp. IV 1986) states in relevant part that "[t]he bankruptcy court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." The propriety of invoking § 105(a) as the basis for the court's authority to approve cross-collateralization clauses is debated by Tabb, *supra* note 5, at 153–74 (not proper), and Bohm, *supra* note 20, at 295–97 (proper).

59. *See Ellingsen*, 834 F.2d at 607 (Merritt, J., dissenting).

60. *See supra* notes 49–50 and accompanying text.

61. For example, under 11 U.S.C. § 364(c) (1982), the court may authorize the postpetition credit extension to have "priority over any or all administrative expenses." Known as a "superpriority," this guarantees that the Chapter 11 lender will be first in line amongst Chapter 11 claimants for payment out of the residue of the estate. *See* Tabb, *supra* note 5, at 126–28, for a discussion of superpriority financing. Liens on specific property may be granted to secure the postpetition loan pursuant to 11 U.S.C. §§ 364(c)(2), 364(c)(3), and 364(d) (1982).

62. *See supra* note 6 for a discussion of the operation of lender preference clauses.

63. *In re* Ellingsen MacLean Oil Co., 834 F.2d 599, 602 (6th Cir. 1987).

64. *In re* Adams Apple, Inc., 829 F.2d 1484, 1488–89 (9th Cir. 1987). The lender preference clauses under consideration were cross-collateralization clauses. *Id.* at 1486. *See supra* note 6 for an explanation of cross-collateralization clauses.

claim.[65] Such an investment choice allegedly must be protected in order to encourage bankruptcy lending.[66]

The argument of the Ninth Circuit proves too much. While "slippery slope" arguments sometimes may be unfairly made in rebuttal,[67] such a rebuttal argument is merited here. The logical conclusion of the *Adams Apple* position is that *any* clause in a financing order, no matter how egregious or how violative of the bankruptcy laws, cannot be stricken on appeal if a stay were not obtained.[68] Surely it is not good bankruptcy jurisprudence to exalt one policy—here, the inducing of postpetition loans—over all other bankruptcy policies without even the possibility of appellate review. So interpreted, section 364(e) becomes an invitation to bankruptcy judges to disregard the law. Given the dynamics surrounding the entry of financing orders, in which the lender has the judge at its mercy,[69] this invitation is unwise.

If it is conceded that some clauses are too outrageous to be upheld even under the *Adams Apple* theory, then the question of whether there can be appellate review turns on the extent of the substantive unfairness of the clause.[70] Indeed, a careful reading of the opinions shows that the mootness holdings in *Adams Apple* and in *Ellingsen* were based in part on those courts' view that the contested clauses were not too offensive on the merits.[71] That approach undermines their procedural argument, however. If a merit review can be undertaken, then the lender cannot rely with certainty on the protection of its favored clause.[72]

The foregoing criticisms of the Ninth Circuit's rejection of the plain meaning

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65. *Id.* at 1488–89 n.9.

66. *See also Ellingsen*, 834 F.2d at 602. The Ninth Circuit also gave some weight to the finality policy, stating that appellate review of financing orders that had not been stayed and under which funds had been lent "would intrude on a reorganization process already underway and would interfere with the lender's ability to plan for its outlay of funds." *Adams Apple*, 829 F.2d at 1489. As discussed in subpart III.B, *infra*, the *Adams Apple* court is suggesting, based partly on finality concepts, that it might find an appeal moot on general mootness principles, irrespective of § 364(e). *See infra* notes 118–22 and accompanying text. This approach overstates the intended scope of the mootness doctrine. The issue must be clearly focused as to whether finality itself, separate and distinct from questions of remedial effectiveness that underlie mootness, requires dismissing the appeal. I conclude below that finality should not be given such pre-emptive weight here. *See infra* notes 93–96 and 123–24 and accompanying text.

67. *See* Schauer, *Slippery Slopes*, 99 HARV. L. REV. 361 (1985).

68. A creditor probably could not obtain a stay. *See infra* notes 130–39 and accompanying text.

69. *See supra* Part II.

70. The good faith of the lender cannot serve as an adequate check, because the lender's self-interest dictates that it should try to obtain all possible benefits in return for financing. While Adam Smith's "invisible hand" may work in a free enterprise situation, so that the maximum economic result is obtained by every entity's unfettered pursuit of its own self-interest, the rationale breaks down when one party has a position of dominance or control, as the prebankruptcy lender often does in a Chapter 11 case. *See supra* Part II.

71. *In re* Ellingsen MacLean Oil Co., 834 F.2d 599, 602–03 (6th Cir. 1987); *In re* Adams Apple, Inc., 829 F.2d 1484, 1488 (9th Cir. 1987). The Sixth and Ninth Circuits may be utilizing an "abuse of discretion" standard, pursuant to which the merits of the trial court's action are reviewed, but on the very deferential basis of whether that court abused its discretion in approving the lender preference clauses. The Fifth Circuit in *In re* First South Sav. Ass'n, 820 F.2d 700, 705 (5th Cir. 1987), used this standard in granting a petition for mandamus directing the issuance of a stay of a standard § 364 financing order. In the lender preference context an abuse of discretion standard will not work well, because the bankruptcy court has little choice but to approve the clause requested, as seen in Part II, and thus in a real sense is not exercising its discretion at all.

72. The appellate court should acknowledge straightforwardly that it is undertaking a merit review and not hide behind some procedural legerdemain. Doing so would sharpen the decision-making process on the merits by the appellate court. In addition, precedential confusion stems from a merit-driven decision disguised as a procedural decision. Other courts, which might entertain more serious doubts about the substantive validity of lender preference clauses, may be influenced on the separate procedural question by the holdings in *Ellingsen* and *Adams Apple*.

argument in favor of a strained application of section 364(e)'s inducement policy assumes that lenders really do rely on lender protection clauses and that such reliance deserves protection. These assumptions may be unwarranted. In an earlier article attacking the substantive validity of cross-collateralization clauses, I questioned whether lenders in fact rely on the presence or absence of a cross-collateralization clause in deciding whether or not to lend to the debtor in possession.[73] Other factors, such as enhancing the recovery on prepetition collateral and increasing the dividend on prepetition unsecured claims, may instead be determinative.[74] If cross-collateralization clauses are available, however, lenders will take advantage of them, whether actually necessary to induce lending or not.[75]

Furthermore, even if the lender did rely on the lender preference clause in making the loan, that reliance may not deserve protection. The real issue is whether lender preference clauses are so contrary to the Bankruptcy Code that they should not be enforced; saying that those clauses must be given effect because the lender expected such a result simply begs the essential question. The critical reliance of the lender is protected even if the lender preference clauses are not, as the lender's security for and priority of the monies advanced *post*petition will not be affected.[76] The only complaint the lender then can make is that it did not receive the full reward promised for the postpetition loan.[77] As stated, however, the question is the legitimacy of promising that reward.[78]

Furthermore, it is not clear why the lender should be entitled to rely on all of the provisions in the order. Cases like *Ellingsen* and *Adams Apple* permit the lender to bootstrap questionable provisions into a status of legality by insulating them within the cocoon of an otherwise allowable order and then "relying" on the integrity of that order. In many areas of the law a party operating close to the line where legality crosses over into illegality assumes the risk of an erroneous assessment of on which side of the line its behavior falls. So too the bankruptcy lender utilizing a questionable clause should have to assume the risk that it guessed wrong as to the legality of that clause.

In addition, the lender who obtains a lender preference clause is a monopolist. Indeed, the requirements for approving such clauses dictate that the lender must in

73. *See* Tabb, *supra* note 5, at 144–45, 167–68.

74. The timing of the financing in *Adams Apple* is instructive with regard to the question of the actual reliance of the lender on the order. The lender advanced $48,000 even before the first temporary hearing, and $200,000 more before the final authorization. *Adams Apple*, 829 F.2d at 1486.

75. *See* Tabb, *supra* note 5, at 166–68.

76. *In re* Texlon Corp., 596 F.2d 1092, 1101 (2d Cir. 1979).

77. *See Adams Apple*, 829 F.2d 1484, 1488 (9th Cir. 1987). The same argument is made in a slightly different way pursuant to the "package theory," by suggesting that the lender effectively is trading alternative forms of compensation for the lender preference clauses. *See infra* notes 82–92 and accompanying text. *See also* Tabb, *supra* note 5, at 169–70.

78. Furthermore, the lender did not characterize the lender preference clause as compensation for the postpetition loan, but as repayment of the prepetition loan, and should not be able later to recharacterize the provision for its own benefit. Forcing the lender to characterize the clauses properly as compensation would allow the bankruptcy court to make a more accurate assessment of the true recovery the lender is seeking, decreasing the likelihood that the court will approve a financing order which carries the possibility of exorbitant returns for the lender. *See* Tabb, *supra* note 5, at 144–45, 169–70. For example, if the court had not vacated the cross-collateralization clause in *Texlon*, the lender would have realized a return of approximately 240% per year based on the clause.

fact occupy a monopoly position.[79] The lender's monopoly profit, which can be exorbitant,[80] should not be enforced. This profit could not be obtained elsewhere. The operative assumption of the *Adams Apple* court that the lending climate in Chapter 11 must be improved in order to compete with non-Chapter 11 lending opportunities[81] mischaracterizes the situation. The Chapter 11 monopoly lender has an inherently superior status compared to having to lend in a competitive market. Restoration of competitive balance in lending markets does not require increasing the available compensation to lenders in the form of lender protection clauses.

The applicability of section 364(e) to lender preference clauses has also been supported by the so-called "package" theory.[82] This theory is a close relative of the Ninth Circuit's inducement argument[83] and adds little of substance to that argument. Courts, however, give the package theory independent weight.[84] This theory extends section 364(e) protection to nonsection 364 lender preference clauses because those clauses are included in the same financing order—the same "package"—as legitimate section 364 clauses, which are without dispute entitled to the safe harbor of section 364(e). All clauses of the order assertedly deserve equivalent protection because the lender theoretically negotiated the financing order as a unitary, integrated package and may have given up some other potential benefits in exchange for the lender preference clauses.[85] Because the lender has done so, it would be both unfair[86] and a perversion of the intent and meaning of the financing order for a court to sever out and deny protection to the lender preference clauses. Thus, although the lender preference clauses standing alone in an order might not qualify for section 364(e) protection,[87] they are saved by their association in an order with qualified section 364 provisions.

The package theory should be rejected as a basis for bringing nonsection 364 lender preference clauses within the scope of section 364(e)'s protection. Just like the

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79. *See supra* Part II. *See also* Tabb, *supra* note 5, at 145, 163. *In re* Vanguard Diversified, Inc., 31 Bankr. 364 (Bankr. E.D.N.Y. 1983), sets out the required elements for approving a cross-collateralization clause. These elements illustrate the monopoly position the bankruptcy lender must have: "(1) Absent the proposed financing, its [debtor's] business operations will not survive . . . ; (2) It is unable to obtain alternative financing on acceptable terms . . . ; (3) The proposed lender will not accede to less preferential terms . . . ; and (4) The proposed financing is in the best interests of the general creditor body." *Id.* at 366.

80. *See supra* note 78 for a discussion of the profit that would have been realized in *Texlon.*

81. *Adams Apple*, 829 F.2d at 1488.

82. This theory also could be termed "salvation by association," because the otherwise unprotected lender preference clauses gain protection by their association in an order with protected clauses.

83. *See supra* notes 64–81 and accompanying text for a discussion of the Ninth Circuit's arguments.

84. *See, e.g., In re* Ellingsen MacLean Oil Co., 834 F.2d 599, 602 (6th Cir. 1987) ("This aspect of the order [referring to the waiver of objections clause], however, was part of the whole 'package' authorized under § 364(c).")

85. *See* Tabb, *supra* note 5, at 138–39, 169–70; *see also* D. BAIRD & T. JACKSON, CASES, PROBLEMS & MATERIALS ON BANKRUPTCY 530 (1985). The courts have not fully fleshed out this argument, although the district court came close in *In re* Ellingsen MacLean Oil Co., 65 Bankr. 358, 365 n.7 (W.D. Mich. 1986). In that case, the Sixth Circuit relied implicitly on the package concept. *See Ellingsen*, 834 F.2d at 602, 603.

86. See Evans v. Jeff D., 475 U.S. 717, 726–27 (1986), in which the Supreme Court ruled that a court may only approve or disapprove a settlement agreement, but may not modify that agreement and force the parties to accept the modified agreement. The contention that the waiver of attorneys' fees in the class action settlement was "forced," *id.* at 723, was not accepted by the Court. *Id.* at 728.

87. The *Ellingsen* and *Adams Apple* courts, however, probably would apply § 364(e) protection to lender preference clauses standing alone, based on the reliance or inducement theory. *See Ellingsen*, 834 F.2d at 602–04; *In re* Adams Apple, Inc., 829 F.2d 1484, 1488 (9th Cir. 1987).

Sixth and Ninth Circuits' inducement theory, the package theory proves too much. Its logic suggests that *any* provision included in a financing order also containing legitimate section 364 clauses is not subject to appellate review unless a discretionary stay is granted. This approach obviously carries with it serious potential for abuse, a potential realized in cases like *Adams Apple* and *Ellingsen.*[88] The bankruptcy court, as discussed earlier,[89] functionally provides little or no check on the lender.

The underlying justifications for the package theory cannot withstand close scrutiny. The strongest justification is that the lender may have traded away other beneficial clauses[90] for the lender preference clauses. The dynamics of the typical situation in which such orders are generated, however, suggest that the lender has not given away anything, but instead has taken everything it thinks it can get.[91] Even if negotiation did occur, it does not logically follow that possibly illegal clauses can be justified because they were taken in trade for legal clauses.[92]

Courts holding that section 364(e) extends to nonsection 364 lender preference clauses also have given weight to the idea that the lender is entitled to and the bankruptcy system needs finality and repose for orders.[93] Indeed, in Part IV of this Article, I conclude that courts considering motions for relief from the judgment have given insufficient weight to the concept of finality. Finality is not, however, controlling and pre-emptive, but instead must be balanced with competing policies.

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88. Probably the most important lender preference clause for the banks in *Ellingsen* was not the cross-collateralization clause, but instead the clause that waived all objections to the validity of the banks' four million dollar prepetition security position. *Ellingsen*, 834 F.2d at 600–01. An independent order accomplishing the same settlement would have been subject to the very strict scrutiny dictated by the Supreme Court in Protective Comm. for Indep. Stockholders v. Anderson, 390 U.S. 414 (1968). Despite this, in *Ellingsen* the Sixth Circuit permitted the banks to avoid *Anderson* scrutiny by characterizing the waiver clause not as a "settlement" but as a condition of the postpetition financing order. *Ellingsen*, 834 F.2d at 604. The dissent protested that "[t]he banks here should not be permitted to make several million dollars in prepetition loans secured and uncontestable at the expense of the other creditors by the simple expedient of making a § 364 postpetition loan." *Id.* at 607 (Merritt, J., dissenting). The district court's attitude highlights the danger of abuse even more clearly: it refused *Anderson* scrutiny because it did not characterize the financing order "as *purely* the settlement of a controversy." *Ellingsen*, 65 Bankr. at 365.

Similarly, potential for abuse exists with regard to cross-collateralization and cross-superprioritization clauses, which directly violate the fundamental bankruptcy norm of equality between similarly situated creditors by preferring the lender's prepetition unsecured claim over all other unsecured claims. *See supra* notes 6, 8. Whether countervailing policies necessitate subordinating the equality norm is a difficult question to resolve on the merits. The package theory, however, forecloses the possibility of appellate review of the merits of controversial provisions.

89. *See supra* Part II.

90. In particular, the argument is made that a lower interest rate might have been accepted in return for the lender preference clauses. *See* D. BAIRD & T. JACKSON, *supra* note 85, at 530; Tabb, *supra* note 5, at 170; *Initial Financing Restrictions*, *supra* note 19, at 1686.

91. Indeed, the substantive elements for approving a cross-collateralization clause require that the lender be in a monopoly position able to dictate the terms of the financing order without negotiation. *See supra* note 79 and accompanying text. Experience suggests that lenders in such a situation present financing orders on a take-it-or-leave-it basis and that lender preference clauses are becoming standard parts of the lender's financing order forms. If such a scenario is accurate, then much of the rationale for protecting the lender disappears.

92. In my earlier article on cross-collateralization I suggested the possibility that the proper conclusion to be drawn from an application of the reliance and package theories in combination with the plain meaning of § 364(e) is not either (1) that a bifurcated system exists with cross-collateralization clauses permissible but not protected by § 364(e), which would be contrary to the package and reliance theories but consistent with the plain meaning of the section, or (2) that cross-collateralization clauses are permissible and protected, which would be consistent with the package and reliance theories but not with the plain meaning of § 364(e), but instead that cross-collateralization clauses are illegal per se, which would give full effect to the package and reliance theories *and* to the plain meaning of § 364(e). *See* Tabb, *supra* note 5, at 137–39.

93. *See In re* Adams Apple, Inc., 829 F.2d 1484, 1489 (9th Cir. 1987).

The countervailing policy to that of finality is the desire to implement correctly the substantive aims of the bankruptcy laws in a fair and equitable way after thoughtful consideration.[94] The task is to reach an appropriate accommodation.

The balance is properly struck by requiring a timely appeal of the financing order, but allowing review of the questionable lender preference clauses pursuant to the appeal. Under this approach, the lender would know within ten days of the entry of the financing order whether or not the lender preference clauses were under attack.[95] If an appeal were filed within that time, the lender would have to live with the uncertainty that the order might be overturned, an uncertainty inherent in the concept of appeal. Finality cannot be given so much weight that normal appellate practice is abandoned.

The courts' confusion as to the role of finality in the case of appeals results from a failure to separate concepts. In the appellate context all that finality dictates is that the appeal be filed within the required time limits. Finality also dictates that no attack on the judgment should be allowed after the time for filing an appeal except under the strict requirements of rule 60(b) of the Federal Rules of Civil Procedure.[96] Finality does not, however, require dismissing an appeal that is timely filed. Dismissing a timely filed appeal should be based on something other than finality: mootness,[97] the need to induce lending to Chapter 11 debtors,[98] a lack of equitable behavior on the part of the appellants,[99] or the like.[100]

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94. *See, e.g.*, *In re* Whitney-Forbes, Inc., 770 F.2d 692, 697 (7th Cir. 1985); Taylor v. Lake (*In re* Cada Investments), 664 F.2d 1158, 1162 (9th Cir. 1981); Bill Roderick Distrib. v. A.J. Mackay Co. (*In re* A.J. Mackay Co.), 50 Bankr. 756, 760 (Bankr. D. Utah 1985); *see infra* note 219 and accompanying text.

95. FED. R. BANKR. P. 8002(a).

96. *See infra* Part IV.

97. *See infra* subpart III.B.1.

98. *See supra* notes 49–50 and 60–81 and accompanying text.

99. *See infra* subpart III.B.2.

100. A final theory advanced by the courts in granting § 364(e) protection to lenders for lender preference clauses is a variation of an estoppel argument. Subpart III.B.2. below explains why a true estoppel argument should not be accepted as a basis for dismissing an appeal of the lender preference clauses in a financing order. The cases raising an estoppel under § 364(e) reason as follows. The estoppel is based on a statement in the financing order that the mootness provisions of § 364(e) will apply to all the provisions of the order, including the lender preference clauses. The lender supposedly is entitled to rely on that statement in advancing funds. The objecting creditors who fail to obtain a stay, knowing of the statement in the order and of the probable reliance of the lender on that statement, are estopped to assert that the statement of § 364(e)'s applicability is in error. *See In re* Ellingsen MacLean Oil Co., 834 F.2d 558, 606 (6th Cir. 1987) (Nelson, J., concurring); *In re* Adams Apple, Inc., 829 F.2d 1484, 1488–89 n.6 (9th Cir. 1987).

This § 364(e) estoppel theory is absurd. A lower court cannot create procedural requisites for the appeal of its own decisions. Such a court has no jurisdiction to dictate appellate requirements, and therefore any reliance by the lender is unjustified. In a similar vein, the appealing creditors are free to ignore any such supposed requirements. To paraphrase an old maxim, saying so just does not make it so. The mootness holding in a true § 364 case stems from the statute, not from anything the bankruptcy court does or does not say. The very issue this Part has been considering is whether the *statutory* provisions extend to situations not expressly covered therein. It is no answer to say that the lower court thinks the statute does apply to those cases. The statute either does or does not apply; what the lower court thinks is irrelevant.

In fact, the courts invoking this theory are concerned about the failure of the appealing creditors to obtain a stay of the financing order. *See Ellingsen*, 834 F.2d at 603, 606 (Nelson, J., concurring). These creditors are perceived as having acted inequitably, to the lender's potential detriment. This concern, however, has nothing to do with § 364(e), but instead raises questions about the propriety in general of dismissing an appeal because of inequitable conduct by the appellant, an issue that will be examined in subpart III.B.2.

B. *The Inapplicability of General Principles of Mootness and Estoppel to the Appeal of Lender Preference Clauses*

Assuming that section 364(e) should not prevent an appellate court from passing on the validity of lender preference clauses, it is still possible that the appeal could be dismissed based on general principles of mootness or estoppel, which apply to all appellate cases irrespective of the provisions of any particular statute or rule.[101] In the present context, the general argument is that the appellants should get a stay to preserve the status quo while the appeal is decided. This subpart of the Article concludes that appeals of lender preference clauses should not be dismissed based either on mootness or estoppel.

1. *Mootness*

The mootness doctrine goes to the basic question of the function of the court. Indeed, on its most fundamental level, mootness is based on the case or controversy requirement of article III of the Constitution.[102] Mootness decisions do not turn solely on constitutional grounds, but are predicated just as much on jurisprudential considerations having to do with remedial effectiveness and wise judicial administration.[103] Courts eschew rigid, formalistic rules in this area and instead attempt to ascertain the feasibility or futility of potential appellate relief on a case by case basis.[104]

In the lender preference context, the mootness argument emphasizes the fact that the lender has advanced money to the debtor pursuant to the appealed order, supposedly making it impossible for the appellate court to grant effective relief, since it cannot restore the status quo ante.[105] Bankruptcy appeals in other contexts have been dismissed as moot based on the rationale that circumstances have changed during the pendency of the appeal that make it impossible for the appellate court

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101. *See* Algeran, Inc. v. Advance Ross Corp., 759 F.2d 1421, 1423 (9th Cir. 1985); King Resources Stockholders' Protective Comm. v. Baer (*In re* King Resources Co.), 651 F.2d 1326, 1331 (10th Cir. 1980); Casady v. Bucher (*In re* Royal Properties, Inc.), 621 F.2d 984, 986–87 (9th Cir. 1980); Bennett v. Gemmill (*In re* Combined Metals Reduction Co.), 557 F.2d 179, 188–89 (9th Cir. 1977).

102. *See In re* AOV Indus., 792 F.2d 1140, 1147 (D.C. Cir. 1987); 13A C. WRIGHT, A. MILLER & E. COOPER, FEDERAL PRACTICE AND PROCEDURE § 3533.1, at 215 (2d ed. 1984); Note, *The Mootness Doctrine in the Supreme Court*, 88 HARV. L. REV. 373, 374–76 (1974) [hereinafter *Mootness Doctrine*].

103. *See* 13 C. WRIGHT, A. MILLER & E. COOPER, *supra* note 102, § 3533.1, at 222.

104. *See AOV Indus.*, 792 F.2d at 1147–48. The court must consider as well the importance of the parties' respective interests. *See* 13 C. WRIGHT, A. MILLER & E. COOPER, *supra* note 102, § 3533.3, at 300. The party claiming mootness has the burden of proof. *See id.* § 3533.1, at 56 (Supp. 1988).

105. The general principle that mootness must follow from an inability to give effective relief was stated by the Supreme Court in a seminal mootness case:

> The duty of this court, as of every other judicial tribunal, is to decide actual controversies by a judgment which can be carried into effect, and not to give opinions upon moot questions or abstract propositions, or to declare principles or rules of law which cannot affect the matter in issue in the case before it. It necessarily follows that when, pending an appeal from the judgment of a lower court, and without any fault of the defendant, an event occurs which renders it impossible for this court, if it should decide the case in favor of the plaintiff, to grant him any effectual relief whatever, the court will not proceed to a formal judgment, but will dismiss the appeal.

Mills v. Green, 159 U.S. 651, 653 (1895). The function of the stay pending appeal, then, is to preserve the status quo, thereby preventing mootness. *See, e.g.*, *Combined Metals*, 557 F.2d at 194; *In re* Lewis Jones, Inc., 369 F. Supp. 111, 116 (E.D. Pa. 1973).

to give effective relief. Most of the cases have involved a bankruptcy court order authorizing a sale of property, with the sale then being closed before the merits of the appeal can be heard.[106] A few cases have involved an order confirming a reorganization plan, with the plan then being implemented in large part before the appeal can be heard.[107] Even in that situation, however, other cases have held that at least that part of the plan not yet implemented could be reviewed on appeal.[108]

Of course, obtaining a stay of the financing order would eliminate the potential mootness problem, but the failure to obtain a stay pending appeal leads to mootness only if it is *impossible* for the appellate court to give meaningful, effective relief because of changed circumstances.[109] Courts call for "remedial inventiveness."[110] Furthermore, appellate courts have not hesitated to find bankruptcy court orders only partially moot.[111] In other words, the part of the order that can be dealt with effectively will not be found moot. This partial mootness approach has been invoked most often in the case of confirmed reorganization plans that have been partially implemented.[112] Other bankruptcy appeals not found moot usually involve the payment of money to a party, typically an attorney seeking compensation.[113] Even if the compensation has already been paid, the courts have found the compensation order not moot. Relief can be granted by ordering the return of the money paid.

These mootness principles suggest that an appeal of a financing order containing lender preference clauses should at most be only partially mooted if no stay is

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106. *See, e.g., In re* Andy Frain Servs., 798 F.2d 1113, 1125 (7th Cir. 1986); *In re* Abbotts Dairies, 788 F.2d 143, 146–47 (3d Cir. 1986); Willemain v. Kurtz (*In re* Willemain), 764 F.2d 1019, 1023 (4th Cir. 1985); Hoese Corp. v. Vetter Corp. (*In re* Vetter Corp.), 724 F.2d 52, 55–56 (7th Cir. 1983); Bleaufontaine, Inc. v. Roland Int'l (*In re* Bleaufontaine, Inc.), 634 F.2d 1383, 1389–90 (5th Cir. 1981). In these cases the appellate courts routinely concluded that they were without power to unwind the completed sale and thus could not give the appellants attacking the sale authorization any relief. The result was particularly obvious to the courts when the affected purchasers were not even parties to the appeal, *see, e.g.*, Casady v. Bucher, 621 F.2d 984, 986 (9th Cir. 1980), although the result did not change when the purchasers were parties to the appeal. *See, e.g.*, Algeran, Inc. v. Advance Ross Corp., 759 F.2d 1421, 1424 (9th Cir. 1985); Greylock Glen Corp. v. Community Sav. Bank, 656 F.2d 1, 3–4 (1st Cir. 1981). Most of those holdings are based on the current bankruptcy statute, 11 U.S.C. § 363(m) (1982), *see, e.g.*, Sulmeyer v. Karbach Enter. (*In re* Exennium, Inc.), 715 F.2d 1401, 1403–04 (9th Cir. 1983), or the bankruptcy rule, FED. R. BANKR. P. 805 (1973) (repealed 1983), that preceded § 363(m), *see, e.g.*, Schupak v. Dutch Inn, 614 F.2d 504, 506 (5th Cir. 1980), that specifically provide for mootness when no stay of the sale authorization order is obtained. The opinions, however, make clear that the rule or statute merely declares the existing mootness law. *See, e.g.*, A & H Holding Corp. v. O'Donnell (*In re* Abingdon Realty), 530 F.2d 588, 590 (4th Cir. 1976).

107. *See In re* AOV Indus., 792 F.2d 1140, 1146–50 (D.C. Cir. 1987); Trone v. Roberts Farms (*In re* Roberts Farms), 652 F.2d 793, 797 (9th Cir. 1981).

108. *See AOV Indus.*, 792 F.2d at 1148–50; *In re* King Resources, Co., 651 F.2d 1326, 1331–32 (10th Cir. 1980).

109. *See* Rosner v. Worcester (*In re* Worcester), 811 F.2d 1224, 1228 (9th Cir. 1987) (court not "powerless" to set aside a foreclosure sale under applicable state law); Dahlquist v. First Nat'l Bank (*In re* Dahlquist), 751 F.2d 295, 298–99 (8th Cir. 1985) (not "impossible" to order return of money paid pursuant to interim compensation order). Indeed, in one important bankruptcy case involving an appeal from an order confirming a reorganization plan, the Tenth Circuit held that part of the order was not moot even though the court was unsure exactly what remedies could have been given if it had reversed. *King Resources*, 651 F.2d at 1332 & n.4.

110. *See* 13 C. WRIGHT, A. MILLER & E. COOPER, *supra* note 102, § 3533.3, at 300.

111. *See AOV Indus.*, 792 F.2d at 1148–50; *King Resources*, 651 F.2d at 1332; *In re* Combined Metals Reduction Co., 557 F.2d 179, 194–95 (9th Cir. 1977).

112. *See* cases cited *supra* note 111. In those cases, the appellate courts have found moot only those parts of the confirmation order that have been implemented. The parts still to be performed can be affected by an appellate reversal. The courts talk in terms of the "continuing impact" of the plan. *Combined Metals*, 557 F.2d at 194–95. *See also* 13 C. WRIGHT, A. MILLER & E. COOPER, *supra* note 102, § 3533.2, at 249–51.

113. *In re* AOV Indus., 792 F.2d 1140, 1149 (D.C. Cir. 1987); *Dahlquist*, 751 F.2d at 297–99; Salomon v. Logan (*In re* International Envtl. Dynamics, Inc.), 718 F.2d 322, 325–26 (9th Cir. 1983).

obtained and the lender advances funds based on the financing order. The only change in circumstances flowing from the order is the making of the loan. Assuming, as is almost certainly the case, that the debtor has spent the money, no effective relief can be given with regard to the part of the financing order relating to the extension of funds *post*petition[114] without unfairly prejudicing the lender. Effective relief can be given by the appellate court with regard to the lender preference clauses, however, by striking those clauses.[115] The lender preference clauses do not affect in any way the money advanced postpetition, but only direct that the lender's *pre*petition claim, which by definition was fixed and established before the bankruptcy financing order was entered, be accorded some preferential treatment.[116] No changes have occurred with regard to that prepetition claim, other than a declaration of a change in rights. That declaration can be withdrawn.[117]

The lender's response will be that a change in circumstances has taken place—the postpetition funds were advanced.[118] The lender will argue that the postpetition loan would not have been made but for the possibility of an additional benefit on the lender's prepetition claim.[119] In short, the lender will argue that it relied upon the financing order,[120] that the financing order was a package deal,[121] and that part of the package relied upon cannot be taken away.[122] These arguments, which were discussed and rejected in the preceding Part of this Article, are not mootness arguments because, as suggested above, effective relief *can* be given with regard to

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114. Thus, those provisions in the financing order authorizing the postpetition loan, granting security for those extensions, and establishing the priority for the funds advanced cannot effectively be reversed to the extent funds have been advanced. The appellate court can give effective relief as to that part of the loan authorization which has not yet been acted upon, because there will not yet have been a change in circumstances with regard to that part of the loan authorization. *See* Bohm, *supra* note 20, at 309–10 n.70.

115. The lender will be a party to the appeal and, thus, be before the appellate court, a necessary predicate to the granting of relief against the lender. *See, e.g., In re* Royal Properties, Inc., 621 F.2d 984, 986 (9th Cir. 1980).

116. *See supra* note 6 for discussion of lender preference clauses.

117. The case against mootness gets a bit more difficult in the unusual case in which payments are made to the lender on its prepetition claim pursuant to the lender preference clauses before the appellate action occurs. This is not common because the lender will be repaid first for the postpetition advances and then for the prepetition claim. Even if payment is made to the lender, however, relief, for mootness purposes, could be effected by ordering the lender to return that payment, as illustrated by the attorneys' compensation cases. *See supra* note 113. This approach is consistent with the general rule that payment of a money judgment does not moot an appeal of that judgment. *See, e.g.,* United States *ex. rel.* Morgan & Son Earth Moving v. Timberland Paving & Constr., 745 F.2d 595, 598 (9th Cir. 1984). One financing order case held that the appeal was not moot even though the bankruptcy lender, after the debtor's postpetition default, had been paid the proceeds of the sold collateral, since the lender could be ordered to repay the money. Credit Alliance Corp. v. Dunning-Ray Ins. Agency (*In re* Blumer), 66 Bankr. 109, 113 (Bankr. 9th Cir. 1986). That case goes further than is needed in our hypothetical case, since the payment was on funds actually advanced *post*petition and the lender had relied on the authorization to extend the loan. The *Blumer* court emphasized that normally § 364(e) would apply, even though general mootness principles did not apply, *id.*, thus making clear that § 364(e) goes beyond the dictates of traditional mootness doctrine.

If the lender's prepetition claim has not been repaid in full, the appellate court should always review the validity of the lender preference clauses, since those clauses will have a "continuing impact," *see supra* note 112, with regard to future assets generated by the bankruptcy estate.

118. This argument is discussed *supra* notes 65–66 and 76–78 and accompanying text in connection with the question of whether § 364(e) applies to lender preference clauses.

119. *See, e.g., In re* Adams Apple, Inc., 829 F.2d 1484, 1488 (9th Cir. 1987).

120. *See supra* notes 64–81 and accompanying text.

121. *See supra* notes 82–92 and accompanying text.

122. The Ninth Circuit in dicta in *Adams Apple* took this view, suggesting that mootness, apart even from § 364(e), exists as soon as the postpetition loan is made. *Adams Apple*, 829 F.2d at 1489.

the lender preference clauses simply by striking them.[123] The money loaned postpetition by the lender either will or will not be repaid based on facts that have nothing to do with the existence or nonexistence of the lender preference clauses.[124]

2. *Estoppel*

A second general basis for dismissing appeals of possible relevance to the lender preference context is estoppel. Estoppel has been recognized as separate from mootness as a basis for dismissing a bankruptcy appeal.[125] The linchpin of the estoppel theory is the idea that the objecting creditors are at fault for not obtaining a stay[126] and that their inequitable conduct led to a prejudicial change in

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123. Effective relief also can be given in the unusual case where payment is already made to the lender by ordering the return of money paid out pursuant to the lender preference clauses. *See supra* note 117.

124. A final mootness concept deserves mention. That is the idea that some questions should be decided by the appellate court even if no effective relief can be given to the appellant in this case, if the case falls within the narrow exception for cases "capable of repetition, yet evading review." *See generally* 13 C. WRIGHT, A. MILLER & E. COOPER, *supra* note 102, § 3533.8, at 370–91; *Mootness Doctrine, supra* note 102, at 386–88. This doctrine requires a showing that this type of dispute is likely to recur, that the dispute is again likely to evade review, and that this appellant will be affected. *See* 13 C. WRIGHT, A. MILLER & E. COOPER, *supra* note 102, § 3533.8, at 378–80; *Mootness Doctrine, supra* note 102, at 386–88. The creditors appealing an order authorizing lender preference clauses would argue that: (1) this type of dispute is likely to recur, since lender preference clauses are being commonly used in bankruptcy cases; (2) the dispute is likely to evade review, since the requirements for granting a discretionary stay of the financing order are in all cases inherently inconsistent with the emergency-based requirements for granting lender preference clauses, *see infra* notes 130–39 and accompanying text, and absent a stay nothing is to stop future lenders from going forward with financing once the order is entered; and (3) either they specifically or the group of bankruptcy unsecured creditors will be adversely affected by the future financing orders containing lender preference clauses. While extension of the affected class to "unsecured creditors" stretches standard doctrine, which requires this appellant to show he will be affected; *see* 13 C. WRIGHT, A. MILLER & E. COOPER, *supra* note 102, § 3533.8, at 382–83, such an extension is necessary, or review will be avoided for the whole group. *See Mootness Doctrine, supra* note 102, at 386–87.

One appellate court rejected the application of the "capable of repetition, yet evading review" doctrine in the context of mootness arising from a failure to get stays in bankruptcy cases. Bennett v. Gemmill (*In re* Combined Metals Reduction Co.), 557 F.2d 179, 190–91 (9th Cir. 1977). The court's principal rationale was that the only reason that the issue would evade review was because of a failure by the appellants to obtain a stay, which is not a sufficient reason. The court seemed to be suggesting that the failure to obtain a stay was attributable to the appellants and could be rectified by more diligent pursuit of their rights. This suggestion would not be true in financing cases, when the appellants would find it almost impossible to obtain a stay. *See infra* notes 130–39 and accompanying text. Furthermore, what then should be the result in cases like *Adams Apple*, in which the appellants did ask for a stay, but had their request denied? *In re* Adams Apple, Inc., 829 F.2d 1484, 1486–87 (9th Cir. 1987); *see supra* note 44 and *infra* notes 140–41 and accompanying text. The *Combined Metals* court also stated that the dispute could not recur with regard to the specific asset sold, *Combined Metals*, 557 F.2d at 190–91, but this is too literal of an interpretation of the "capable of repetition, yet evading review" doctrine, which refers only to this *type* of dispute.

Regardless of the theoretical applicability of the doctrine in the financing context, however, it is likely that the attitude reflected in *Combined Metals* in the sale context would prevail in the financing context as well, and the appellants therefore would have only a minimal chance of successfully invoking the doctrine. *But see* United States v. Marine Power & Equip. Co. (*In re* Marine Power & Equip. Co.), 71 Bankr. 925, 927 (W.D. Wash. 1987) (order entered extending automatic stay despite expiration of 30-day period of § 362(e) within which relief supposedly must be ordered, on theory that procedures followed are defective and likely to be repeated, requiring relief to be given to protect affected parties).

125. The leading case establishing that estoppel is a basis independent from mootness for dismissing a bankruptcy appeal is Trone v. Roberts Farms (*In re* Roberts Farms), 652 F.2d 793, 798 (9th Cir. 1981) ("An entirely separate and independent ground for dismissal has also been established because Appellants have failed and neglected diligently to pursue their available remedies to obtain a stay of the objectionable orders of the Bankruptcy Court and have permitted such a comprehensive change of circumstances to occur as to render it inequitable for this court to consider the merits of the appeal.") (plan of arrangement).

126. For example, the swing vote in *Ellingsen* was Judge Nelson, who concurred with the holding that the appeal should be dismissed, based on a vague estoppel notion. *In re* Ellingsen MacLean Oil Co., 834 F.2d 599, 606 (6th Cir. 1987) (Nelson, J., concurring) ("The unsecured creditors having been made aware of the bankruptcy court's position that

circumstances.[127] Two reasons exist for not applying the estoppel ground for dismissal here. First, the nature of the change in circumstances is not the type requiring dismissal. The only change in circumstances that occurs if no stay is obtained is that the lender advances funds postpetition to the debtor in possession. As discussed earlier,[128] those aspects of the financing integrally connected to this postpetition loan should be, and are, protected. The lender preference clauses, however, are severable from the postpetition loan, because they relate to the prepetition claim, and no change in circumstances has occurred with regard to the prepetition claim.[129] For this reason alone, the lack of equity ground should not lead to dismissal, even if the appellants really were negligent in not requesting a stay.

Second, and more significantly, it is nonsense to say that the appellants are "at fault" for failing to obtain a stay. Indeed, in the context of emergency financing orders, it would be virtually impossible for them to obtain a stay, for granting one would be inherently inconsistent with the emergency predicate for these financing orders.[130] More generally, a discretionary stay is considered "extraordinary relief,"[131] allowed only when the four requirements[132] for a preliminary injunction[133] are "clearly established":[134]

(1) whether the movant is likely to succeed on the merits;
(2) whether the movant will suffer irreparable injury if the stay is not granted;
(3) whether the granting of the stay would substantially harm the other parties; and
(4) whether the granting of the stay would serve the public interest.[135]

The third requirement, whether the granting of the stay would substantially harm the other parties, and the fourth requirement, whether granting the stay is in the public interest, are inherently inconsistent with the substantive requirements for granting

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under Section 364(e) the validity of the replacement liens would not be affected by reversal on appeal unless the amended order were stayed, it seems to me that the unsecured creditors *acted at their peril in failing to obtain such a stay.*") (emphasis added). This position is absurd. *See supra* note 100.

127. Some cases addressing the question of whether an appeal of an order directing the payment of attorneys' fees should be dismissed when no stay of the order was obtained and the fees were paid have refused to extend the *Roberts Farms* principle and have permitted the appeals to proceed. *See* Dahlquist v. First Nat'l Bank (*In re* Dahlquist), 751 F.2d 295, 298–99 (8th Cir. 1985); Salomon v. Logan (*In re* International Envtl. Dynamics, Inc.), 718 F.2d 322, 326 (9th Cir. 1983). Each of those cases relied upon the fact that the attorney who had been paid the money knew that the order was being contested. In our situation the lender would know of the contest within the 10-day time period for filing an appeal under FED. R. BANKR. P. 8002(a).

128. *See supra* notes 61–62 and 76 and accompanying text.

129. *See supra* notes 61–62, 76, and accompanying text.

130. *See supra* note 79.

131. *In re* Great Barrington Fair and Amusement, Inc., 53 Bankr. 237, 239 (Bankr. D. Mass. 1985).

132. Usually all four elements must be satisfied, *In re* Charter Co., 72 Bankr. 70, 72 (Bankr. M.D. Fla. 1987); *In re* Smoldt, 68 Bankr. 533, 535 (Bankr. N.D. Iowa 1986); *In re* Sung Hi Lim, 7 Bankr. 319, 321 (Bankr. D. Haw. 1980), although the weight given to each may vary depending on the strength of the others and the exact circumstances involved. *See In re* First South Sav. Ass'n, 820 F.2d 700, 709 & n.10 (5th Cir. 1987); *Charter Co.*, 72 Bankr. at 72; *Great Barrington*, 53 Bankr. at 239.

133. The standards for issuance of a discretionary stay pending appeal are the same as those for issuance of a preliminary injunction under FED. R. CIV. P. 65. *See, e.g.*, *In re* Baldwin United Corp., 45 Bankr. 385, 386 (Bankr. S.D. Ohio 1984); Commonwealth Nat'l Bank v. Dobslaw (*In re* Dobslaw), 20 Bankr. 922, 924 (Bankr. E.D. Pa. 1982), *aff'd*, 712 F.2d 864 (3d Cir. 1983), *cert. denied*, 465 U.S. 1024 (1984); *In re* Tolco Properties, Inc., 6 Bankr. 490, 491 (Bankr. E.D. Va. 1980).

134. *Baldwin United*, 45 Bankr. at 386.

135. *First South*, 820 F.2d at 709.

lender preference clauses, and accordingly it is extremely unlikely that a stay would ever be granted in such a case. A primary justification for having Chapter 11 reorganizations is the public interest in saving a business, with the attendant economic benefits to society.[136] The harm that would occur both to the "other parties" and to the "public interest" if the stay is granted is that the loan would not be made immediately, and the debtor's reorganization then would likely fail because of a lack of needed operating capital.[137] Yet, a prerequisite for a court to approve a requested lender preference clause is that the debtor prove that "absent the proposed financing, its business operations will not survive."[138] It is difficult to see how a court could make a finding of fact that the financing must be made immediately to save the reorganization and then turn around and stay that financing.[139]

The Catch-22 situation facing the objecting creditors is clearly shown by the *Adams Apple* case. In that case, the creditors did request a stay from the bankruptcy court, but the request was denied.[140] The financing was made, and the appeal then was declared moot.[141] The wisdom of a system that permits such a result must be carefully scrutinized.[142] The tenor of the appellate opinions does not, however, indicate that the courts grasp the very real conundrum created in this situation.[143]

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136. *See* H.R. REP. No. 595, 95th Cong., 1st Sess. 220 (1977), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6179.

137. *See supra* note 34 and accompanying text for a discussion of the critical need for financing that most Chapter 11 debtors have.

138. *In re* Vanguard Diversified, Inc., 31 Bankr. 364, 366 (Bankr. E.D.N.Y. 1983). For a discussion of the application of this requirement, see Tabb, *supra* note 5, at 163.

139. The facts in *Ellingsen, see supra* notes 1–7 and accompanying text, illustrate this dilemma. The application for financing was made on Thursday, December 20, with the stated purpose of the requested financing being to enable the debtor to purchase home heating oil for delivery beginning the next Monday, December 24. The hearing and entry of the order occurred on Friday, December 21. If the court had stayed its order, the financing would not have been forthcoming by the next Monday, the debtor could not have purchased home heating oil, the customers for whom the heating oil was intended allegedly then would be lost to another home heating oil supplier, and the reorganization then would fail. Under those circumstances it is inconceivable that the bankruptcy court would have stayed the financing order. *See* Petitioner's Brief for Certiorari at 17 n.15, Unsecured Creditors' Comm. v. First Nat'l Bank & Trust (*In re* Ellingsen MacLean Oil Co.), 56 U.S.L.W. 3739 (U.S. Apr. 14, 1988) (No. 87-1718), *cert. denied*, 109 S. Ct. 55 (1988).

140. *In re* Adams Apple, Inc., 829 F.2d 1484, 1486–87 (9th Cir. 1987).

141. *Id.* at 1488–89.

142. The mere fact that a stay is denied does not, however, preclude an appellate court from finding mootness. *See, e.g.*, Van Iperen v. Production Credit Ass'n (*In re* Van Iperen), 819 F.2d 189, 190 (8th Cir. 1987); Greylock Glen Corp. v. Community Sav. Bank, 656 F.2d 1, 3 (1st Cir. 1981).

143. Research has not revealed a single case where an emergency financing order granting lender preference clauses was stayed. In *In re First South Sav. Ass'n*, the Fifth Circuit issued a limited writ of mandamus directing the district court to issue a stay. *In re* First South Sav. Ass'n, 820 F.2d 700, 716 (5th Cir. 1987). The issuance of the stay did not threaten the reorganization in that case, however, since the requested financing was not urgent. *Id.* at 705. As discussed above, a lender preference clause may *only* be granted in the case of an emergency. *See supra* notes 79 and 130 and accompanying text.

The other two elements for the granting of a stay also present serious difficulties for the appellants. The first is that the appellant show a likelihood of success on the merits. *See supra* note 135 and accompanying text. Since the application for a stay must be made to the bankruptcy court in the first instance, FED. R. BANKR. P. 8005, which court has just granted the lender preference clause, this requirement obviously is a difficult one for the appellant to satisfy. In effect the appellant must convince the court that it might have been wrong in granting the order. *In re* Great Barrington Fair & Amusement, Inc., 53 Bankr. 237, 239–40 (Bankr. D. Mass. 1985). Given the potential mootness consequence resulting from the denial of a stay, however, appellate courts in analogous situations have stated that courts should give very thorough consideration to the merits of the appellant's stay application. *In re* Roberts Farms, 652 F.2d 793, 798 (9th Cir. 1981); *In re* Combined Metals Reduction Co., 557 F.2d 179, 192 (9th Cir. 1977). Furthermore, under rule 8005 the stay may be granted by the bankruptcy appellate panel or the district court if a showing is made as to why relief cannot be obtained by the bankruptcy court, and mandamus is always a fallback option, as in *First South*. Such intervention by the appellate

C. *The Implementation of Section 364(e): Assessing the Lender's Good Faith*

Even if section 364(e) is held to apply to a nonsection 364 lender preference clause, contrary to the conclusion in subpart III.A. above, the court still must decide whether the requirements of section 364(e) are satisfied in the particular case. If they are, the appeal will be dismissed.[144] The requirements are, first, that no stay was obtained and, second, that the lender acted in good faith. Given the standards for issuance of a stay, it is fair to assume that no stay will ever be obtained.[145] The sole issue under section 364(e) would therefore be whether the lender extended the credit in good faith.[146]

Two different types of arguments have been made by appealing creditors to allege bad faith on the part of the lender. One focuses on the substance of the order itself; the other focuses on alleged procedural abuses by the lender acting in concert with the debtor in possession. Neither holds much promise for the objecting creditors.

1. *Substantive Impropriety*

The first type of bad faith argument is based on the substantive provisions of the order, contending that the lender evinces bad faith by demanding improper concessions.[147] Thus, in the leading section 364(e) case, *In re EDC Holding*

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courts will be forthcoming, however, only in the most extreme cases, given the normal deference to lower courts on matters entrusted to their discretion. *See* Wymer v. Wymer (*In re* Wymer), 5 Bankr. 802, 807–08 (Bankr. 9th Cir. 1980); *id.* at 808–12 (George, J., concurring). In *First South*, the Fifth Circuit found the facts and the law on the merits to be overwhelming so as to establish a clear abuse of discretion. *First South*, 820 F.2d at 709–15.

The second element for the granting of a stay is whether the movant has made a showing of irreparable injury if the stay is not granted. In *First South*, the movant argued that the mootness that would result from an application of § 364(e) constituted such irreparable injury. Although the Fifth Circuit did not decide directly the merits of this contention, they apparently did give it some credence, noting "the significance of the fact that . . . an appeal . . . would likely be rendered moot." *Id.* at 709 n.11. Some courts, on the other hand, have suggested that the irreparable injury requirement must contemplate something more than the fact that the appeal would be mooted. Otherwise, those courts argue, the exception would swallow up the mootness rule, and the discretionary stay in essence would be converted into a stay as of right. *Great Barrington*, 53 Bankr. at 240; *In re* Baldwin United Corp., 45 Bankr. 385, 386 (Bankr. S.D. Ohio 1984). The view taken by these cases is unduly narrow. Recognizing the potential harm of mootness to objecting creditors as a sufficient injury for the second element of the stay test does not mean that a stay always must be granted. The court still must weigh all of the requisite elements. Recognizing mootness as a sufficient injury instead prevents the objecting creditor from automatically losing the application for a stay.

144. *See In re* Ellingsen MacLean Oil Co., 834 F.2d 599, 604 (6th Cir. 1987); *In re* Adams Apple, Inc., 829 F.2d 1484, 1488–91 (9th Cir. 1987); 11 U.S.C. § 364(e) (1982).

145. *See supra* notes 130–39 and accompanying text.

146. *See Ellingsen*, 834 F.2d at 605; *Adams Apple*, 829 F.2d at 1489; *In re* Graphic Arts Lithographers, 71 Bankr. 774, 776 (Bankr. 9th Cir. 1987).

147. *See, e.g.*, *Ellingsen*, 834 F.2d at 605; *Adams Apple*, 829 F.2d at 1490; *In re* EDC Holding Co., 676 F.2d 945, 948 (7th Cir. 1982); *Graphic Arts*, 71 Bankr. at 777.

The courts disagree as to the proper appellate standard of review for addressing the good faith issue in the context of lender preference clauses. The Sixth Circuit in *Ellingsen* stated that good faith is a question of fact, limiting review of a trial court finding of good faith to the very deferential "clearly erroneous" standard of FED. R. CIV. P. 52(a). While this approach might be proper with regard to a good faith issue involving possible notice deficiencies, the better approach in the context of a bad faith attack predicated on the alleged improper substance of the order is that of the Ninth Circuit in *Adams Apple*. That court recognized that the issue was primarily one of law—whether the lender preference clauses were illegal per se—and accordingly the appellate court had much more discretion to review the merits of the good faith finding. *Ellingsen*, 829 F.2d at 1490 n.10. Under the *Adams Apple* approach, pursuant to the theory of *EDC Holding*, *see infra* note 151, a court convinced that lender preference clauses are illegal per se might be able to find bad faith.

As the courts have noted, good faith is not defined in the Bankruptcy Code. *Ellingsen*, 834 F.2d at 605; *Adams Apple*, 829 F.2d at 1489; *Graphic Arts*, 71 Bankr. at 776. Courts have borrowed the "honesty in fact" standard from the

Company,[148] the portion of the priority loan by the bank alleged by the creditors' committee to be in bad faith was, by the terms of the loan agreement itself, ultimately to be paid to the attorneys of the debtor's union for attorneys' fees incurred in litigation against the bankruptcy estate. The appealing creditors' committee had not obtained a stay of the order pending appeal, and the district court had held the appeal to be moot under section 364(e).[149] The Seventh Circuit reversed, holding that the lender acted in bad faith, that the appeal was not moot, and that the objectionable portion of the order should be stricken.[150]

The key point for the Seventh Circuit was that the lender knew the money was to be used for a clearly illegal purpose.[151] Judge Posner for the court stated, "If the lender *knows* his priority is invalid but proceeds anyway in the hope that a stay will not be sought or if sought will not be granted, we cannot see how he can be thought to be acting in good faith."[152] The court further elaborated that a lender will not be protected "[w]here it is evident from the loan agreement itself that the transaction has an intended effect that is improper under the Bankruptcy Code."[153] In contrast, the court said that section 364(e) would protect a lender who believed that the priority sought would be valid but who could not be sure given the likelihood of appellate objections.[154] The crucial distinction, then, appears to be the certainty the lender has as to the illegality of the transaction.

The lender preference cases have distinguished *EDC Holding* on two bases. The first has to do with the purpose for which the funds will be used, the second with the state of mind of the lender. The focus should remain on the latter to ensure that the proper questions are being asked and answered.

In *EDC Holding*, the funds advanced were to be used for the improper purpose of paying a union's attorneys' fees.[155] In lender preference cases, on the other hand, courts have given considerable weight to the fact that the funds are being advanced for the unquestionably proper purpose of providing operating capital for the reorganizing debtor.[156] The relevant issue in deciding whether an appeal should be dismissed under section 364(e) is not the propriety of the intended use of the money, however, but whether the lender extended the credit in good faith. The appellate court

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Uniform Commercial Code to define good faith. *Ellingsen*, 834 F.2d at 605. However, whatever the supposed standard is probably will not make much difference, because any formulation necessarily must be vague and conclusory, adding little to the general concept of good faith.

148. 676 F.2d 945 (7th Cir. 1982).

149. See *id.* at 946–47 for a discussion of the facts.

150. *Id.* at 948–49.

151. *Id.* at 947–48. *EDC Holding*'s rationale arguably could be applied to lender preference clauses, since the illegality in that case involved giving a priority payment to parties not entitled to such priority under the terms of the Code. Such a rearranging of priorities, of course, is the essence of lender preference clauses. *See supra* note 6.

152. *In re* EDC Holding Co., 676 F.2d 945, 947 (7th Cir. 1982) (emphasis in original).

153. *Id.* at 948.

154. *Id.* at 947.

155. *Id.* at 946–48. The contested part of the loan was to be used to pay the legal fees of the debtor's union which had been incurred by the union in litigation against the estate. Such a payment is impermissible under the bankruptcy laws. *Id.* at 946, 948.

156. *In re* Graphic Arts Lithographers, 71 Bankr. 774, 777 (9th Cir. 1987); *In re* Ellingsen MacLean Oil Co., 65 Bankr. 358, 364 (W.D. Mich. 1986).

considering a section 364(e) question is not deciding whether to approve financing,[157] but whether to protect the lender. This depends on the lender's purposes, activities, and state of mind. It should be possible for a lender to lend funds for a proper purpose but still be in bad faith. A failure to recognize this possibility skews the appellate court's decision as to the lender's good faith.

The proper question is whether a lender who lends postpetition with the avowed purpose of potentially enhancing its prepetition secured or unsecured position at the expense of general unsecured creditors via lender preference clauses is lending in good faith. *EDC Holding* suggests that the answer to this question depends upon whether the lender *knows* with certainty that the lender preference clauses are improper. Using this analysis, the lender preference cases uniformly have held that the lender is not acting in bad faith.[158] The reasoning followed is that since some prior lower court cases have approved lender preference clauses, a subsequent lender seeking to include such clauses in its financing order cannot know with certainty that the clauses are illegal, and thus is not acting in bad faith.[159]

The foregoing analysis applies even if the reviewing court itself believes that the clauses are improper. For the purposes of the case before it, the court has no choice but to say that the lender is not acting in bad faith by asking for a benefit other courts have granted. This means that the mootness holdings will continue to snowball based on even a single earlier case allowing any particular lender preference clause. The only way to stop the snowball effect is for an appellate court, while holding the appeal in the particular case moot under the foregoing analysis, to go on to state in dictum that it believes lender preference clauses are illegal per se.[160] Then, any lender in that court's jurisdiction lending money *after* that opinion would not be able to sustain a good faith showing with regard to a lender preference clause under the *EDC Holding* approach because it would know that the clauses were illegal in that jurisdiction.[161]

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157. In deciding whether to approve financing orders courts traditionally have considered the propriety of the debtor's intended use of the money lent. *See* Baker, *supra* note 49, at 35; Tondel & Scott, *supra* note 49, at 22.

158. *See In re* Ellingsen MacLean Oil Co., 834 F.2d 599, 605 (6th Cir. 1987); *In re* Adams Apple, Inc., 829 F.2d 1484, 1490 (9th Cir. 1987); *Graphic Arts*, 71 Bankr. at 777.

159. This argument originally was made by the district court in *Ellingsen*, 65 Bankr. at 364, and that reasoning then was followed in the subsequent opinions in *Graphic Arts*, 71 Bankr. at 777, and *Adams Apple*, 829 F.2d at 1490, and by the Sixth Circuit in *Ellingsen*, 834 F.2d at 605. *See supra* note 44.

160. Bankruptcy Judge Babitt in *Texlon* held that he had to sustain the order, but gave notice that he would not approve such clauses in the future. *In re* Texlon Corp., 3 Bankr. Ct. Dec. (CRR) 1013, 1017 (Bankr. S.D.N.Y. 1977), *rev'd on other grounds*, 596 F.2d 1092 (2d Cir. 1979). An appellate court may be reluctant to issue such an advisory opinion.

161. The lender would respond that the court's prior statement was just dictum and that regardless there was a good faith hope of overturning the opinion in an appellate court. Once the law had been clearly stated to the contrary in that jurisdiction, however, the lender seeking disapproved benefits should have to take the chance of a merit review on appeal and should not be entitled to have the appeal dismissed under § 364(e).

Of course, the contrary is also true. If an appellate court in a jurisdiction holds or states in dictum that lender preference clauses are permissible, then any lender in that jurisdiction should be entitled to rely on that opinion conclusively to establish the lender's good faith as against substantive attacks. Procedural attacks on the lender's good faith, discussed in subpart III.C.2., still would be possible.

2. *Procedural Irregularities*

Establishing that seeking a lender preference clause does not in and of itself constitute bad faith, as discussed in the preceding subpart, should not conclude the good faith inquiry. Unfortunately, some courts have stopped at this juncture.[162] The courts should instead be receptive to arguments that a lender who has participated with the debtor in procedural irregularities in obtaining the financing order has acted in bad faith.[163] Two types of procedural abuse arguments may be made.

First, the lender's misrepresentation to the court of the existence of the substantive prerequisites to the granting of a particular type of security or priority to the lender might establish bad faith. Bankruptcy courts do not like lender preference clauses,[164] even though sometimes effectively forced to grant them.[165] Those clauses are only granted, however, if the court believes it has no choice if the reorganization is to be salvaged.[166] If the lender knows that alternatives to financing on a preferential basis do exist, but seeks the lender preference clause without disclosing that fact to the court, the lender probably should be considered to have acted in bad faith.[167] The protections of section 364(e) then would not be available to such a lender.[168] The courts have not policed against this type of potential misconduct in the lender preference context, however.[169]

Lenders, of course, will be concerned about allowing inquiry on hindsight into such subjective matters. The only alternative, however, is an absolute rule of protection. Misrepresentation has long been a basis for giving relief from a judgment,[170] and no reason exists for having a more protective rule in the appellate context under section 364(e).[171] Furthermore, the difficulty of proving such knowl-

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162. *See, e.g., In re* Graphic Arts Lithographers, 71 Bankr. 774, 777 (Bankr. 9th Cir. 1987).

163. An attempt to avoid the mootness provisions of § 364(e) by proving procedural abuse arguments is not limited to lender preference clauses. Any financing order, even one clearly within the letter and spirit of § 364, is subject to attack on the ground of procedural deficiencies. Procedural abuse arguments also may be made in the context of motions for relief from the judgment, discussed in Part IV *infra.*

164. The prominent *Vanguard* case, which established the generally accepted guidelines for approving cross-collateralization clauses, *see supra* note 79, stated that "cross-collateralization is a disfavored means of financing." *In re* Vanguard Diversified, Inc., 31 Bankr. 364, 366 (Bankr. E.D.N.Y. 1983).

165. *See supra* Part II and notes 69 and 89 and accompanying text.

166. See *supra* note 79 for the requirements for granting cross-collateralization clauses established by *Vanguard.*

167. *See* Bohm, *supra* note 20, at 311–12 n.76. *See infra* notes 251–57 and accompanying text. For example, a cross-collateralization clause should be granted only if, among other things, the debtor proves that no alternative financing could be obtained on acceptable terms and that the lender would not accede to less preferential terms. *Vanguard,* 31 Bankr. at 366. Suppose the lender in fact would have lent the money even without the cross-collateralization clause, but testified in court that it would not lend without such a clause. Alternatively, assume that the lender knew that the debtor could obtain financing from a new lender, but insisted, as a condition to its cooperation in the Chapter 11 case, that it be allowed to do the Chapter 11 lending, with the hope of improving the status of its unsecured prepetition claims via a lender preference clause. In these hypothetical cases the lender could be held to have acted in bad faith.

168. In addition, such activity constitutes misrepresentation or fraud sufficient to warrant relief from the judgment under FED. R. CIV. P. 60(b)(3). *See infra* notes 251–57 and accompanying text; Bohm, *supra* note 20, at 311–12 n.76.

169. As discussed earlier, *see supra* note 41 and accompanying text, the lender in *Adams Apple* apparently insisted on the Chapter 11 filing and then obtained a cross-collateralization clause even though other potential lenders might have been available. *In re* Adams Apple, Inc., 829 F.2d 1484, 1486 (9th Cir. 1987). The Ninth Circuit did not even raise the question of whether the lender had participated in a misrepresentation of the necessary requisites of cross-collateralization to the bankruptcy court so as to forfeit § 364(e) protection.

170. FED. R. CIV. P. 60(b)(3).

171. Indeed, to the extent the concern is with undermining the finality of the financing order, one should be more concerned about attacks on the judgment under FED. R. CIV. P. 60(b), which may come as late as a year or more after

edge on the part of the lender would insulate all but the most flagrant cases of abuse. A per se rule of protection does not seem necessary to further any legitimate aim of the lender or the bankruptcy system. The appellate courts in deciding the good faith issue thus should at least be open to allegations of what essentially amounts to a lender-debtor conspiracy to circumvent the substantive requirements for approval of lender preference clauses.

The second procedural argument made in an attempt to establish the lender's bad faith is that the lender participated with the debtor in obtaining the financing order without giving sufficient notice to creditors.[172] The notice problem pervades the financing context and accordingly will be discussed in detail in Part V below. That Part will argue that lenders should be subjected to greater scrutiny than is exercised at present with regard to notice inadequacies.

IV. DESTROYING FINALITY: BANKRUPTCY COURT REVISION OF FINAL ORDERS

A. *The Inexplicable Resurrection of the Administrative Order Doctrine*

Part III examined how appellate courts have been destroying unjustifiably the appealability of lender preference clauses, thereby permitting lenders to enjoy the benefits of those possibly illegal clauses without appellate scrutiny. Some courts have taken the opposite extreme and have vacated their own earlier grants of those clauses.[173] Unfortunately, courts doing so have been destroying finality in the process, since the retraction of the lender's preferences by the bankruptcy court has come after the time for filing an appeal has expired.[174] This disregard of finality has been justified erroneously by the invocation of the discarded "administrative order" doctrine.[175] Subpart IV.A. explains that modification of a final financing order, even one containing lender preference clauses, should only be done pursuant to the strict requirements of rule 60(b) of the Federal Rules of Civil Procedure,[176] and not

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the judgment is entered, than about appeals, which usually must be filed within 10 days of the entry of the judgment. FED. R. BANKR. P. 8002(a).

172. *See, e.g.*, *In re* Ellingsen MacLean Oil Co., 834 F.2d 549, 605 (6th Cir. 1987).

173. *See* Otte v. Manufacturers Hanover Commercial Corp. (*In re* Texlon Corp.), 596 F.2d 1092, 1100–01 (2d Cir. 1979); *In re* Monach Circuit Indus., 41 Bankr. 859, 862 (Bankr. E.D. Pa. 1984). The court in *In re* FCX, Inc., 54 Bankr. 833, 839 (Bankr. E.D.N.C. 1985), stated in dicta that it had authority to consider out of time a motion to reconsider a financing order containing a cross-collateralization clause. The lender in that case had agreed, however, that the initial order would not be final, but would instead be subject to approval at a subsequent full hearing. *Id.*

174. An appeal must be filed within 10 days of the entry of the order being appealed from, FED. R. BANKR. P. 8002(a), although an extension for up to 20 days may be granted within the original 10-day period. *Id.* at R. 8002(c). In *Texlon*, the financing order was entered on November 1, 1974. The motion to modify the order was made on January 16, 1975. *Texlon*, 596 F.2d at 1094–95. In *Monach*, the financing order was entered on October 8, 1982, while the motion for reconsideration was filed in February 1984. *Monach*, 41 Bankr. at 860.

175. *See infra* note 182 and accompanying text.

176. FED. R. CIV. P. 60(b) provides the grounds for relief from a final judgment:

On motion and upon such terms as are just, the court may relieve a party or a party's representative from a final judgment, order, or proceeding for the following reasons: (1) mistake, inadvertence, surprise, or excusable neglect; (2) newly discovered evidence which by due diligence could not have been discovered in time to move for a new trial under Rule 59(b); (3) fraud (whether heretofore denominated intrinsic or extrinsic), misrepresentation, or other misconduct of an adverse party; (4) the judgment is void; (5) the judgment has been satisfied, released, or discharged, or a prior judgment upon which it is based has been reversed or otherwise

pursuant to the administrative order doctrine. Subpart IV.B. then applies rule 60(b) to the financing order context to determine when relief might be granted under that rule.

The leading case ignoring principles of finality to take away a lender preference clause is *Texlon*,[177] discussed briefly in the Introduction.[178] In that case, lender preference clauses were granted in an *ex parte* financing order entered on the very day that the Chapter XI petition was filed. Long after the time for filing an appeal of that order had expired, and after the case had been converted to a Chapter VII liquidation, the bankruptcy trustee asked the bankruptcy court to modify its original financing order to eliminate the lender's preferences.[179] The bankruptcy court refused to alter its order because of that order's finality.[180]

The Second Circuit surprisingly held on appeal that the bankruptcy judge had the power to modify its earlier order pursuant to the ancient bankruptcy doctrine regarding "administrative orders," despite finding that relief was not warranted under rule 60(b).[181] The administrative order doctrine allows the revision of bankruptcy administrative orders at any time, as long as no rights have vested in reliance on the order.[182] Since the lender had been repaid in full for the postpetition loans made, the *Texlon* court held that the lender did not lose any vested rights by

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vacated, or it is no longer equitable that the judgment should have prospective application; or (6) any other reason justifying relief from the operation of the judgment.

FED. R. BANKR. P. 9024 applies rule 60(b) to bankruptcy cases, subject to a few delineated exceptions not relevant to the issues considered in this Article. This incorporation follows the lead of rule 9024's predecessor, FED. R. BANKR. P. 924 (1973) (repealed 1983). With regard to the decision to adopt the Federal Rules generally to bankruptcy practice, see Fed. R. Bankr. P. Adv. Comm. Introductory Note 16 (1973).

Rule 60(b), which provides a comprehensive listing of grounds for obtaining relief from a final judgment, *see* FED. R. CIV. P. 60(b) (Adv. Comm. Note 1946) ("It is obvious that the rules should be complete in this respect and define the practice with respect to any existing rights or remedies to obtain relief from final judgments."), is designed to accommodate the conflicting policies of giving finality to judgments but also of correcting unjust judgments. *See* Comment, *Rule 60(b): Survey and Proposal for General Reform*, 60 CALIF. L. REV. 531, 533 (1972) [hereinafter *Rule 60(b) Survey*].

177. *Texlon*, 596 F.2d at 1092.

178. *See supra* notes 10–12 and accompanying text.

179. The facts are discussed at *Texlon* 596 F.2d at 1094–95. The time delay in seeking the reconsideration was approximately two and one-half months. *See supra* note 174.

180. *In re* Texlon Corp., 3 Bankr. Ct. Dec. (CRR) 1013, 1017 (Bankr. S.D.N.Y. 1977), *rev'd*, 596 F.2d 1092 (2d Cir. 1979).

181. *Texlon*, 596 F.2d at 1100–01.

182. *See* 2A COLLIER ON BANKRUPTCY, *supra* note 49, ¶ 39.18, at 1489–92 (14th ed. 1978). "Administrative orders" are those orders addressing general administrative matters involved in the bankruptcy administration which are not necessarily adversarial, and which are thus entered initially "in the absence of adversary parties 'informally and without notice or hearing.'" *Id.* at 1489. Common examples are orders allowing compensation to attorneys or directing the surrender of exempt or burdensome property. *Id.* at 1490. The leading cases are Pfister v. Northern Ill. Fin. Corp., 317 U.S. 144 (1942), *see infra* note 194, and Wayne United Gas Co. v. Owens-Illinois Glass Co., 300 U.S. 131 (1937), which stated the doctrine in terms of a broad inherent authority of the bankruptcy court. *See infra* note 193. Numerous cases prior to *Texlon* also had followed the basic principle of those two Supreme Court cases. *See, e.g.*, Feldman v. Trans-East Air, Inc., 497 F.2d 352, 355 (2d Cir. 1974); Commercial Credit Corp. v. Skutt, 341 F.2d 177, 181 (8th Cir. 1965); Federal Land Bank v. Hansen, 113 F.2d 82, 84 (2d Cir. 1940).

modification of the order.[183] The promise of additional preferential treatment for the lender's prepetition claim was not considered a protectable vested right.[184]

Unfortunately, *Texlon* is the leading case on the issue and has been followed by a number of courts.[185] The *Texlon* court's resurrection of the administrative order doctrine as a basis for granting relief from judgments outside of rule 60(b) was erroneous.[186] This mistaken invocation of the administrative order doctrine virtually eliminates the concept of finality in bankruptcy, thereby causing several pernicious effects. Reorganizations may be threatened if people cannot do business with the debtor with the assurance that benefits granted to them will be honored once the time for appeal has expired.[187] The integrity of the bankruptcy system and of the judicial process is undermined by post hoc re-evaluations of orders many months or even years after those orders are entered. Furthermore, the development of the substantive bankruptcy law, particularly important with regard to lender preference clauses because of the current debate over their validity, is facilitated by the early resolution of disputed issues on appeal.

On a more basic level, however, the propriety of applying finality principles in bankruptcy is not even an issue. The Supreme Court has decreed that the same finality principles applicable to civil proceedings generally also apply to bankruptcy proceedings, subject to a few carefully delineated exceptions tailored to particular bankruptcy situations. This decision, embodied in the 1973 Bankruptcy Rules of Procedure extant at the time of the *Texlon* decision, has been carried forward in subsequent revisions of the Bankruptcy Rules, and is implemented in several places in the current Bankruptcy Rules.[188]

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183. *Texlon*, 596 F.2d at 1101. The *Monach* court scheduled a hearing to determine whether the lender was entitled to a lien or priority for the money lent pursuant to the financing order. *In re* Monach Circuit Indus., 41 Bankr. 859, 862 (Bankr. E.D. Pa. 1984). In Montco, Inc. v. Barr (*In re* Emergency Beacon Corp.), 666 F.2d 754, 757 (2d Cir. 1981), a leading case involving relief under rule 60(b) from a certificate of indebtedness, the court found that the lender had not changed its position in reliance on the order granting the certificate. In Bill Roderick Distrib. v. A.J. Mackay Co. (*In re* A.J. Mackay Co.), 50 Bankr. 756, 760 (D. Utah 1985), the court invoked its equitable powers to permit modification of a confirmed reorganization plan, but remanded to the bankruptcy court with instructions to take appropriate steps to protect the reliance of the debtor's principal on the order confirming the plan.

184. The court stated the test to be "whether . . . the court will be able to reestablish the rights of the opposing party as they stood when the original judgment was rendered." *In re* Texlon Corp., 596 F.2d 1092, 1101 (2d Cir. 1979). This test does not regard as protectable prejudice any expectation of an increased profit on the prepetition claim. *See* Tabb, *supra* note 5, at 144–45; *see supra* notes 62 and 76–78 and accompanying text.

185. *See infra* notes 206–07 and accompanying text.

186. This conclusion is shared by Bohm, *supra* note 20, at 306–07, and Ordin, *supra* note 20, at 175–76, who also argue for the substantive validity of cross-collateralization. *See* Bohm, *supra* note 20, at 294–305; Ordin, *supra* note 20, at 176–80. As discussed in detail in this Article, I believe the issues of substantive validity and procedural protection are distinct and that confusion can result from a failure to separate the two.

187. *See* Ordin, *supra* note 20, at 176.

188. As stated earlier, *see supra* note 176, FED. R. BANKR. P. 9024, following the lead of prior FED. R. BANKR. P. 924 (1973) (repealed 1983), incorporates FED. R. CIV. P. 60, granting more liberal rights of relief from orders than contained in rule 60 only with regard to motions to reopen a case or to reconsider a claim. Complaints to revoke a Chapter 7 discharge or to revoke a Chapter 11 or a Chapter 13 confirmation must be filed within the statutory time limits specified by the applicable Code sections. FED. R. BANKR. P. 9024(2), 9024(3). The impact of rule 9024's promulgation on the administrative order doctrine will be discussed shortly. *See infra* notes 189–204 and accompanying text. FED. R. BANKR. P. 9023, again excepting only motions to reconsider claims, incorporates FED. R. CIV. P. 59, which provides that motions for a new trial or to alter or amend a judgment must be served not later than 10 days after the entry of a judgment. A judgment is effective when entered, pursuant to FED. R. BANKR. P. 9021, and rule 9022 requires service of a notice of

The *Texlon* court's resurrection of the administrative order doctrine in 1979 is particularly puzzling in light of the following language in the 1973 Advisory Committee Note to Bankruptcy Rule 924 (the predecessor to current rule 9024): "These rules do not preserve the features of the practice pertaining to so-called 'administrative orders,' which have been regarded as subject at any time to reconsideration by the referee or to review by the district court without regard to the limitations of [section] 39c of the Act."[189] The Advisory Committee Note also stated that "the limitations prescribed by Rule 60(b) on the availability of relief by motion from a judgment or order are now entirely appropriate in bankruptcy cases."[190] Leading bankruptcy commentators have understood the foregoing language to mean exactly what it says: that relief from *all* types of bankruptcy judgments or orders, whether those orders are informal, nonadversarial and "administrative," or formal judgments in adversary proceedings, may only be obtained pursuant to rule 60.[191]

The *Texlon* court, despite its awareness of the Advisory Committee Note to rule 924,[192] held that the administrative order doctrine survived the promulgation of rule 924 for at least two reasons. First, the court stated that rule 924 had not overruled the two principal Supreme Court cases, decided in 1937[193] and 1942,[194] that had

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entry of a judgment on contesting parties and on others as directed by the court, but makes clear that any failure to give this notice does not affect the requirements for filing an appeal, except as noted in the rules specifically governing appeals.

The appellate rules contained in Part VIII of the Bankruptcy Rules further show the Supreme Court's decision to equate bankruptcy practice with civil practice with regard to finality and reviewability. Rules 8001 and 8002 make clear that the timely filing of a notice of appeal is an absolute prerequisite to the maintenance of the appeal. Indeed, the standard period of time for filing the notice of appeal is only 10 days, as opposed to 30 days for regular civil actions. *Id.* R. 8002(a). The Advisory Committee Note to rule 8002 explains that "[t]he shortened time is specified in order to obtain prompt appellate review, often important to the administration of a case under the Code." *Id.* R. 8002 (Adv. Comm. Note 1987). The advantages supposedly flowing from such speedy action would be undermined by a rule freely permitting out of time modifications.

189. FED. R. BANKR. P. 924 (Adv. Comm. Note 1973).

190. *Id.*

191. *See* 9 COLLIER ON BANKRUPTCY, *supra* note 49, ¶ 9024.06, at 9024-7 (interpreting rule 9024: "The Bankruptcy Rules have abolished the distinction by which administrative orders were regarded as subject to review at any time without regard to the limitations of Section 39c of the former Bankruptcy Act. Relief from judgments and orders, whether the result of an adversary proceeding or not, are now subject to the limitations set out in Rule 60 as adopted by Bankruptcy Rule 9024."); *see also* 13 COLLIER ON BANKRUPTCY, *supra* note 49, ¶ 924.05, at 9-136 (14th ed. 1977) (similarly interpreting rule 924, the predecessor to present rule 9024); Ordin, *supra* note 20, at 175.

192. *In re* Texlon Corp., 596 F.2d 1092, 1101 (2d Cir. 1979).

193. Wayne United Gas Co. v. Owens-Illinois Glass Co., 300 U.S. 131 (1937). In *Wayne*, a petition for reorganization under § 77B of the Bankruptcy Act was dismissed by the district court on March 2, 1936. No appeal was properly filed within the 30 days allowed by the Bankruptcy Act, and thereafter, on April 24, a petition for rehearing of the dismissal order was filed with the district court. The district court granted the petition for rehearing, heard the case on the merits, and again dismissed the petition for reorganization. A timely appeal from this second dismissal order was taken, but the Fourth Circuit held that the district court was without power to rehear the petition, that the first dismissal thus controlled, and that the appeal from the second dismissal must be dismissed. The Supreme Court reversed, holding that the district court as the court of bankruptcy had the equitable discretion to rehear the petition for reorganization even after the time for appeal of the first order of dismissal had expired, and that the time for appeal then must be counted from the second dismissal. *Id.* at 135–38. The Court stated that the bankruptcy "court has the power, for good reason, to revise its judgments upon seasonable application and before rights have vested on the faith of its action." *Id.* at 137.

194. Pfister v. Northern Ill. Fin. Corp., 317 U.S. 144 (1942). *See infra* notes 195–204 and accompanying text for a critique of the *Texlon* court's application of *Pfister*. *Pfister* dealt with a slightly different situation than *Wayne* and extended the rule of *Wayne*, that the *trial* court has power to hear untimely motions for rehearing, to state that an *appellate* court has power to hear untimely appeals, a completely different issue. *See infra* notes 200–01 and accompanying text. The farmer debtor had filed for an Agricultural Composition and Extension under § 75 of the Bankruptcy Act, and the

established the administrative order doctrine, since the Advisory Committee Note did not specifically refer to those cases by name.[195] Second, a General Order in Bankruptcy applying the Federal Rules to bankruptcy cases[196] was in force at the time of the 1942 decision, *Pfister v. Northern Illinois Finance Corporation.*[197] The court's argument apparently was that if general order 37 did not preclude application of the administrative order doctrine, then neither did rule 924, because each incorporated rule 60 into bankruptcy practice.

The first and strongest response to the *Texlon* court's arguments is that, as discussed above, the 1973 Advisory Committee Note to rule 924 unambiguously declared that the administrative order doctrine no longer applied in bankruptcy.[198] Why a reference to particular case names would be required in addition to a reference to the principles of those cases is entirely unclear. Furthermore, in 1973 the Bankruptcy Rules, including of course rule 924, controlled inconsistent statutory provisions[199] and necessarily then also controlled judicially developed bankruptcy procedural doctrines. The Rules were promulgated by the Supreme Court itself, which had decided the earlier cases.

The *Texlon* court's cryptic reference to the *Pfister* case and general order 37, explained above, is off base for several reasons. First, the *Pfister* court held that the *appellate* court had the power to consider out of time petitions.[200] *Texlon* used that case as authority to hold that the *trial* court itself had the power,[201] an entirely different matter.

Second, even the specific holding of *Pfister* is no longer good law. *Pfister* held that section 39c, which provided that a petition for review of a bankruptcy referee's order must be filed within ten days, did not limit the power of the reviewing court[202]

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conciliation commissioner (the equivalent of today's bankruptcy judge for purposes of the procedural analysis) entered certain orders in that case. After the expiration of the 10-day time period specified in Act § 39c for appeal to the district court (called a "petition for review"), a petition for rehearing of the original orders by the commissioner was sought. Unlike *Wayne, see supra* note 193, the petition for rehearing was denied, and appeal then was sought within 10 days. *Pfister*, 317 U.S. at 145–47. The appeal was dismissed. The Supreme Court affirmed, holding that the time for appeal ran from the entry of the original order, since the petition for rehearing had been denied. *Id.* at 151. However, the Court clarified the basis for the dismissal. The district court thought that it was without power to entertain the appeal, given the expiration of the time for filing the petition for review. The Supreme Court concluded that the district court did in fact have the *power* to hear the untimely appeal, thus extending the *Wayne* doctrine: "The entire process of rehabilitation, reorganization or liquidation is open to reexamination out of time by the District Court, in its discretion, and subject to intervening rights." *Id.* at 152. The 10-day time limit of § 39c was interpreted as a limitation on the right of the "person aggrieved" to obtain review and not as a limit on the appellate court's power to entertain untimely appeals. *Id.* at 152–53; *see infra* notes 202–04 and accompanying text. However, the Court then held that the facts would have supported a dismissal by the district court if that court had exercised its discretion as to whether to hear the untimely appeal, and thus the dismissal should be affirmed. *Pfister*, 317 U.S. at 153–54.

195. *Texlon*, 596 F.2d at 1101.

196. General Order in Bankruptcy 37, promulgated 305 U.S. 677, 698 (1939). General Orders in Bankruptcy were promulgated by the Supreme Court and regulated practice and procedure in bankruptcy cases until the promulgation by the Court of the Rules of Bankruptcy Procedure in 1973.

197. 317 U.S. 144 (1942). *See Texlon*, 596 F.2d at 1100 n.9, 1101.

198. *See supra* notes 189–91 and accompanying text.

199. *See* Pub. L. No. 88-623, 78 Stat. 1001 (1964) (28 U.S.C. § 2075 was amended in the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 247, 92 Stat. 2672 (1978), to give statutes priority over conflicting rules.)

200. Pfister v. Northern Ill. Fin. Corp., 317 U.S. 144, 151–53 (1942); *see supra* note 194.

201. *In re* Texlon Corp., 596 F.2d 1092, 1100–01 (2d Cir. 1979).

202. The reviewing court in *Pfister* was the district court. *Pfister*, 317 U.S. at 147; *see supra* note 194. The district

to hear the matter in its discretion at any time, but instead was only "a limitation on the 'person aggrieved' to file such petition as a matter of right."[203] On the contrary, the current appellate rules found in Part VIII of the Bankruptcy Rules make clear that a timely notice of appeal is a jurisdictional prerequisite to the appellate court hearing the appeal.[204]

Texlon has generated substantial confusion.[205] Several cases erroneously have cited the rule of the two early Supreme Court cases relied upon by *Texlon* as well as *Texlon* itself as synonymous with the provisions of current Bankruptcy Rule 9024.[206] Many other cases cite *Texlon* as blanket authority for the bankruptcy court to modify a final order at any time.[207] Numerous courts persist in stating that the administrative order doctrine provides a basis independent of rule 9024 for the bankruptcy court to modify its orders.[208] Fortunately, however, the post-*Texlon* circuit court opinions, including one in the Second Circuit, reflect a subtle pulling back from the *Texlon* rationale, with those courts stating that the bankruptcy court's power to modify its own orders now is found exclusively in rule 9024.[209] If this is true, as the foregoing

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court sat as the "court of bankruptcy," and appointed the conciliation commissioner in § 75 Agricultural Extension and Composition cases. *Pfister*, 317 U.S. at 145 n.1.

203. *Id.* at 153. *See supra* note 194.

204. Montco, Inc. v. Barr (*In re* Emergency Beacon Corp.), 666 F.2d 754, 758 (2d Cir. 1981). Several other reasons exist for rejecting the *Texlon* court's invocation of *Pfister*. The *Pfister* court did not consider at all the possible effect of rule 60 (via general order 37), but instead focused solely on the effect of Act § 39c. *Pfister*, 317 U.S. at 148–53. Second, even if the Court had considered the effect of rule 60(b) in *Pfister*, it would have been considering a rule fundamentally different from the one in force today and at the time *Texlon* was decided, since rule 60(b) was changed in 1946 to cover inclusively the grounds for obtaining relief from a final judgment. *See* 7 MOORE'S FEDERAL PRACTICE ¶ 60.18[8], at 60–145 (2d ed. 1987) [hereinafter MOORE].

205. Although most courts have followed *Texlon* blindly, *see infra* note 207 and accompanying text, some courts have recognized the confusion created by *Texlon* as to whether the administrative order doctrine continues to have validity independent of rule 60(b). *See, e.g., In re* Shaffer, 8 Bankr. 497, 500 (Bankr. E.D.N.Y. 1981).

206. *See In re* Klein, 58 Bankr. 816, 818–19 (Bankr. E.D. Pa. 1986); *In re* FCX, Inc., 54 Bankr. 833, 839 (Bankr. E.D.N.C. 1985); Georgia Steel, Inc. v. Citizens & Southern Nat'l Bank (*In re* Georgia Steel, Inc.), 25 Bankr. 790, 794 (Bankr. M.D. Ga. 1982) (court read *Texlon* as having been decided under rule 60(b); the Second Circuit in fact expressly rejected rule 60(b) as a basis for relief, *see In re* Texlon Corp., 596 F.2d 1092, 1099–1100 (2d Cir. 1979)). The district court in Bill Roderick Distrib. v. A.J. Mackay Co. (*In re* A.J. Mackay Co.), 50 Bankr. 756, 760–61 (D. Utah 1985), read *Wayne* as being overruled by Bankruptcy Rule 8002 (which sets the time period for filing an appeal), but nevertheless stated that the principle of *Wayne* still survives.

207. Big Shanty Land Corp. v. Comer Properties, 61 Bankr. 272, 283 (N.D. Ga. 1985); *Mackay*, 50 Bankr. at 759–60; *In re* Featherworks Corp., 36 Bankr. 460, 462 (E.D.N.Y. 1984); *In re* Futuronics Corp., 5 Bankr. 489, 496 (S.D.N.Y. 1980); Allis-Chalmers Credit Corp. v. Nordyke (*In re* Nordyke), 43 Bankr. 856, 860–61 (Bankr. D. Ore. 1984); *Georgia Steel*, 25 Bankr. at 794; *Shaffer*, 8 Bankr. at 500–01; Menna v. Murphy (*In re* Murphy), 1 Bankr. 736, 738 (Bankr. S.D. Cal. 1979); Flushing Sav. Bank v. Parr (*In re* Parr), 1 Bankr. 453, 455 n.2 (Bankr. E.D.N.Y. 1979).

208. *See, e.g., Mackay*, 50 Bankr. at 759; *Futuronics*, 5 Bankr. at 498; *Shaffer*, 8 Bankr. at 500. A number of cases citing a similar principle trace their lineage not through *Wayne* or *Pfister* but instead through Central Ill. Co. v. Irving Trust Co. (*In re* Pottasch Bros.), 79 F.2d 613, 615 (2d Cir. 1935). *See* Brielle Assoc. v. Graziano, 685 F.2d 109, 111–12 & n.1 (3d Cir. 1982) (involving reconsideration of claims and stating that the bankruptcy court has inherent authority to reconsider a disallowed claim and is not dependent on Bankruptcy Rule 307, which conferred a similar power); *In re* Lintz West Side Lumber, 655 F.2d 786, 789, 791 (7th Cir. 1981) (involving modification of an abandonment order). Authors of these and other decisions are particularly fond of quoting the following language from *Pottasch*: "Why it is desirable that their orders [referring to referees, the predecessors to bankruptcy judges], *ruat coelum*, should be as immutable as the Twelve Tables, once the ink is dry, we cannot understand." *Pottasch*, 79 F.2d at 616. The case itself, however, merely decides that referees have the *same* power as a district judge to modify their orders. At the time the case was decided, the Federal Rules of Civil Procedure had not been adopted, and the power of modification had not been incorporated into rules 59 and 60, as they are today for district judges and bankruptcy judges alike.

209. *In re* Whitney-Forbes, Inc., 770 F.2d 692, 697 (7th Cir. 1985) (motion to vacate sale order; court stated that "the long delay of the trustee in presenting his claim is relevant to the pre-Rule 924 compelling equities theory, but in light of Rule 9024 it is more appropriate to address the delay issue by direct reference to Fed. R. Civ. P. 60(b)") (citations

discussion argues, then *Texlon* is wrong, and the administrative order doctrine is dead. Unfortunately, not all district courts and bankruptcy courts have fully understood this subtle disavowal of *Texlon*, and they continue instead to follow its holding.[210]

A final reason exists for concluding that the administrative order doctrine no longer applies. The 1973 Bankruptcy Rules sought "to emphasize the judicial in contradistinction to the ministerial functions of the referee in bankruptcy administration and to enhance the dignity of the office as that of the principal judge of the bankruptcy court."[211] This purpose was consistent with the recommendation in the Bankruptcy Commission Report issued the same year,[212] a recommendation strongly endorsed and implemented in the 1978 Bankruptcy Code.[213] The nationwide implementation of the United States Trustee system in 1986[214] cemented the separation of the administrative and judicial functions, with the bankruptcy judge now to function as just that, a judge. Such a role is inconsistent in theory and in practice with the administrative, supervisory role of the judge which the administrative order doctrine would necessitate.

B. *The Limited Availability of Relief Under Rule 60(b)*

If *Texlon*'s invocation of the administrative order doctrine is abandoned, it will be evident that, apart from appeal, relief from a final financing order should only be granted pursuant to the provisions of rule 60(b) of the Federal Rules of Civil Procedure.[215] This subpart explores the potentially appropriate bases under rule 60(b)

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omitted); *In re* Emergency Beacon Corp., 666 F.2d 754, 758 (2d Cir. 1981) (after citing the *Texlon* rule, the Second Circuit states "[w]e agree with this result in light of the powers granted the bankruptcy judge by Bankruptcy Rule 924" and further that "[t]he amenability of a final order to modification by the bankruptcy court itself, however, is governed by Bankruptcy Rule 924, which incorporates Fed. R. Civ. P. 60"); Taylor v. Lake (*In re* Cada Investments), 664 F.2d 1158, 1161 (9th Cir. 1981) (after quoting *Wayne*, the court states "[t]his power is now formalized in Bankruptcy Rule 924, which makes Federal Rule of Civil Procedure 60 applicable to bankruptcy cases . . . ."). *See also* Bialac v. Harsh Investment Corp. (*In re* Bialac), 694 F.2d 625, 627 n.2 (9th Cir. 1982) (court in text noted that "a bankruptcy court has wide latitude to reconsider and vacate its own prior decisions," and then in footnote identified that power as emanating from FED. R. CIV. PROC. 60(b)).

210. A review of the lower court decisions after the 1981 opinion in *Emergency Beacon*, in which the Second Circuit stated clearly that rule 60(b) provided the sole basis for relief, *see supra* note 209, indicates that those courts have not fully adopted the reasoning of *Emergency Beacon*. Most courts have not even cited *Emergency Beacon*, but instead have only cited *Texlon*. *See Big Shanty*, 61 Bankr. at 283; *Mackay*, 50 Bankr. at 759–60; *Featherworks*, 36 Bankr. at 462; *Klein*, 58 Bankr. at 818–19; *Nordyke*, 43 Bankr. at 860. Other courts have cited both *Texlon* (or *Wayne* and *Pfister*) and *Emergency Beacon*, apparently believing that those cases stand for the same rule, although differing as to what that rule is. *See, e.g.*, *In re* Asusa, 47 Bankr. 928, 930–31 (S.D.N.Y. 1985) (stand for general rule of unlimited power of reconsideration); *FCX*, 54 Bankr. at 839 (same); *Georgia Steel*, 25 Bankr. at 794–95 (stand for general rule that relief is available under rule 60(b)). Some courts have correctly followed *Emergency Beacon*. *See, e.g.*, *In re* Flagstaff Foodservice Corp., 14 Bankr. 462, 464 (Bankr. S.D.N.Y. 1981) (opinion by Judge Babitt, who rendered the bankruptcy court opinion in *Texlon*, that finality should have been respected, *see supra* notes 11 and 180 and accompanying text).

211. 1973 COLLIER PAMPHLET EDITION, BANKRUPTCY ACT AND RULES, *Advisory Comm.'s Int. Note to the Prelim. Draft* A-363, A-365.

212. *See* REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, 93d Cong., 1st Sess., pt. I, at 5–8 (1973).

213. *See* H.R. REP. NO. 595, 95th Cong., 1st Sess. 89–91 (1977), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6051–53.

214. *See* Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3088 (1986).

215. Rule 60(b) in six separate subsections sets out possible grounds for relief. *See supra* note 176. Any rule 60(b)

for granting relief from a financing order containing lender preference clauses: judicial error,[216] fraud or misrepresentation by the lender,[217] and inadequate notice.[218]

Rule 60(b)'s fundamental purpose is to reconcile the sometimes conflicting principles of finality of judgments and justice in an individual case.[219] General statements as to the appropriate standard governing the granting of relief under rule 60(b), which vary,[220] are not very helpful in the abstract,[221] as the bankruptcy court in each case must exercise its equitable discretion carefully in deciding whether to overturn a final judgment.[222] The party seeking relief has the burden of proving by clear and convincing evidence some reason for the court to override the baseline policy favoring repose.[223] A rule 60(b) motion is not available as an alternative to appeal.[224]

Two points of particular relevance to the financing order context may be made. First, the safe harbor provision of Bankruptcy Code section 364(e), which applies to appeals,[225] does not in any way limit the availability of relief under rule 60(b),[226]

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motion must always be brought within a reasonable time, *see In re* Whitney-Forbes, Inc., 770 F.2d 692, 697 (7th Cir. 1985); 9 COLLIER ON BANKRUPTCY, *supra* note 49, ¶ 9024.04, at 9024-5 (except for void judgments under 60(b)(4), *see Whitney-Forbes*, 770 F.2d at 697; 7 MOORE, *supra* note 204, ¶ 60.25[4], at 60-241; 11 C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE, § 2862, at 197 (1973); or actions predicated upon a "fraud upon the court," *see Whitney-Forbes*, 770 F.2d at 698; *In re* Emergency Beacon Corp., 666 F.2d at 759; *Rule 60(b) Survey*, *supra* note 176, at 532, which may be brought at any time), with an additional one year time limit imposed for motions brought under subsections (1), (2), and (3). *Whitney-Forbes*, 770 F.2d at 697; *Emergency Beacon*, 666 F.2d at 758; *In re* Asusa, 47 Bankr. 928, 931 (S.D.N.Y. 1985); FED. R. CIV. P. 60(b); *Rule 60(b) Survey*, *supra* note 176, at 531. The savings clauses of rule 60(b) preserve independent actions in equity for relief from the judgment, *see* 7 MOORE, *supra* note 204, ¶ 60.18[8], at 60-146 to -147, ¶ 60.31, at 60-348, and recognize the court's inherent power to set aside any judgment for fraud upon the court. *See id.* ¶ 60.33, at 60-351. Otherwise, rule 60(b) is intended to state the inclusive grounds for relief. *See supra* note 176.

216. *See infra* notes 229–50 and accompanying text.

217. *See infra* notes 251–57 and accompanying text.

218. *See infra* notes 258–62 and accompanying text and subpart V.D.

219. Commonwealth of Pennsylvania State Employes' [sic] Retirement Fund v. Durkalec (*In re* Durkalec), 21 Bankr. 618, 620 (Bankr. E.D. Pa. 1982); Williams v. Cal Indus. (*In re* Ireco Indus.), 2 Bankr. 76, 84 (Bankr. D. Ore. 1979); 9 COLLIER ON BANKRUPTCY, *supra* note 49, ¶ 9024.03, at 9024-3, ¶ 9024.04, at 9024-4 to -5; 7 MOORE, *supra* note 204, ¶ 60.18[8], at 60-138. A study of rule 60(b) concluded that the courts generally were doing a good job of effecting this reconciliation. *Rule 60(b) Survey*, *supra* note 176, at 539.

220. This variation is most noticeable with regard to the catch-all provision, rule 60(b)(6). *See infra* notes 244–48 and accompanying text.

221. *See* 11 C. WRIGHT & A. MILLER, *supra* note 215, § 2857, at 158–59 (of "limited usefulness").

222. *See, e.g.*, *In re* Emergency Beacon Corp., 666 F.2d 754, 760 (2d Cir. 1981); *In re* Klein, 58 Bankr. 816, 819 (Bankr. E.D. Pa. 1986); *Emergency Beacon*, 48 Bankr. at 362; 7 MOORE, *supra* note 204, ¶ 60.18[8], at 60-140; 11 C. WRIGHT & A. MILLER, *supra* note 215, § 2857, at 157. The factors typically considered in exercising that discretion are set out at 7 MOORE, *supra* note 204, ¶ 60.19, at 60-164 to -166, and at 11 C. WRIGHT & A. MILLER, *supra* note 215, § 2857, at 160–62. The only exception to this rule is that a court considering whether to set aside a judgment as void actually has little or no discretion, its inquiry instead being limited to ascertaining whether or not the judgment in fact is void, with relief being virtually mandatory if the judgment is found to be void. *See* 11 C. WRIGHT & A. MILLER, *supra* note 215, § 2862, at 197. In the normal case where discretion is exercised, appellate review is predicated on an abuse of discretion standard. *See In re* Chung King, Inc., 753 F.2d 547, 551 (7th Cir. 1985); *Emergency Beacon*, 666 F.2d at 760; First Nat'l Bank v. Roach (*In re* Roach), 660 F.2d 1316, 1318 (9th Cir. 1981); *Klein*, 58 Bankr. at 819; 7 MOORE, *supra* note 204, ¶ 60.19, at 60-154; 11 C. WRIGHT & A. MILLER, *supra* note 215, § 2857, at 158.

223. *See* 7 MOORE, *supra* note 204, ¶ 60.28[3], at 60-323 (burden of proof); 11 C. WRIGHT & A. MILLER, *supra* note 215, § 2860, at 189 (standard of proof); 9 COLLIER ON BANKRUPTCY, *supra* note 49, ¶ 9024.05, at 9024-6 ("extraordinary remedy").

224. Ackermann v. United States, 340 U.S. 193, 198 (1950) (rule 60(b)(6) specifically); 7 MOORE, *supra* note 204, ¶ 60.18[8], at 60-140 (rule 60(b) generally).

225. *See supra* subparts III.A. and III.C.

226. *See In re* Ellingsen MacLean Oil Co., 65 Bankr. 358, 360 n.2, 364 n.6 (W.D. Mich 1986) (dictum); *In re* Monach Circuit Indus., 41 Bankr. 859, 862 (Bankr. E.D. Pa. 1984) (dictum). The Sixth Circuit in *Ellingsen* also noted that the complaining unsecured creditors could have sought relief under rule 60(b) instead of appealing, and that if they

which applies to motions to the bankruptcy court for relief. Second, the limitations of rule 60(b) apply only to *final* judgments or orders.[227] Thus, if the bankruptcy judge enters an *interlocutory* financing order only because of the exigent circumstances,[228] the court would be free to modify that order at any time unrestricted by rule 60(b).

Unsecured creditors attacking lender preference clauses by a rule 60(b) motion are likely to allege that the bankruptcy court committed a legal error in approving the clauses.[229] As noted earlier, the validity of those clauses is an open question,[230] and even those courts authorizing such clauses do so only in extreme cases.[231] Although I believe that bankruptcy courts should deny approval to lender preference clauses initially,[232] once granted those clauses should not be overturned by the bankruptcy court on the ground of legal error. Relief properly should be granted only on appeal, not under rule 60(b). However, several rule 60(b) grounds have been asserted to support relief for judicial error.

Rule 60(b)(1), referring to relief for "mistake,"[233] is the most obvious basis for seeking relief for judicial error. The majority interpretation of that subsection, properly followed by the Second Circuit in *Texlon*,[234] rejects using rule 60(b)(1) as a basis for correcting a legal error by the trial court, but instead limits that rule to cases involving the mistake of the moving party or his attorney.[235] Even minority approaches allowing some relief for judicial error under rule 60(b)(1) would not provide solace for objecting creditors in the financing order context.[236]

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had done so the barriers of Code § 364(e) would not have applied. *In re* Ellingsen MacLean Oil Co., 834 F.2d 599, 604 (6th Cir. 1987).

227. 7 MOORE, *supra* note 204, ¶ 60.26[4], at 60-251, 256. Rule 60(b) on its face states that "the court may relieve a party . . . from a *final* judgment, order, or proceeding for the following reasons . . . ." FED. R. CIV. P. 60(b) (emphasis added).

228. An example is *In re* FCX, Inc., 54 Bankr. 833, 839 (Bankr. E.D.N.C. 1986), in which the bankruptcy court entered the initial financing order only upon the stipulation of the lender that the order would be subject to final approval at a subsequent, fully noticed hearing. This "two-step" procedure is discussed *infra* at notes 307, 310, and 329 and accompanying text.

229. This argument was apparently raised in *In re* Texlon Corp., 596 F.2d 1092, 1099–1100 (2d Cir. 1979), and has been raised in the § 364(e) context by the creditors in *Ellingsen* in their petition for certiorari to the Supreme Court. Petitioner's Brief for Certiorari at 7–12, Unsecured Creditors' Comm. v. First Nat'l Bank & Trust (*In re* Ellingsen Maclean Oil Co.), 56 U.S.L.W. 3739 (U.S. Apr. 14, 1988) (No. 87-1718).

230. *See supra* note 20 and accompanying text.

231. *See, e.g., In re* Vanguard Diversified, Inc., 31 Bankr. 364, 366 (Bankr. E.D.N.Y. 1983); *FCX*, 54 Bankr. at 840.

232. *See* Tabb, *supra* note 5; *supra* subpart III.A.

233. See *supra* note 176 for the complete text of rule 60(b)(1).

234. *In re* Texlon Corp., 596 F.2d 1092, 1100 (2d Cir. 1979).

235. *See In re* Emergency Beacon Corp., 666 F.2d 754, 759 (2d Cir. 1981); *In re* Shaffer, 8 Bankr. 497, 500 (Bankr. E.D.N.Y. 1981) (following *Texlon*); 11 C. WRIGHT & A. MILLER, *supra* note 215, § 2858, at 176–78.

236. Some courts allow relief if the rule 60(b) motion is filed within the time for appeal, *see* 7 MOORE, *supra* note 204, ¶ 60.22[3], at 60-188 to -194, and the leading federal practice commentators cite this as the only defensible basis for granting relief under rule 60(b)(1) for purely legal error. *Id.* ¶ 60.22[3], at 60-186; 11 C. WRIGHT & A. MILLER, *supra* note 215, § 2858, at 178-80 (although these authors prefer not giving relief for judicial error under 60(b)(1), *see id.* at 176–78, on the theory that doing so undermines finality and the procedures for relief under FED. R. CIV. P. 59(e)). Since the time for filing an appeal in federal civil litigation is 30 days under the Federal Rules, FED. R. APP. P. 4(a)(1), this minority approach provides objecting creditors 20 days in addition to the 10 days allowed under FED. R. CIV. P. 59 for seeking relief from the trial court. In bankruptcy practice, however, the time for appeal is only 10 days, FED. R. BANKR. P. 8002(a), and this approach thus would not provide any additional relief for objecting creditors to that already allowed under rule 59, which is incorporated into bankruptcy practice by rule 9023. *See supra* note 188.

Nor may a judicial error be corrected pursuant to rule 60(b)(4)[237] as a "void" judgment. The fact that the bankruptcy court made an error of law, even a gross error, does not render the judgment *void*.[238] The Second Circuit in *Texlon* correctly so held.[239] The scope of rule 60(b)(4) is exceedingly narrow; most orders are valid and not void.[240] Generally, the only void orders are those entered outside the subject matter jurisdiction of the court, or without personal jurisdiction over the parties, or in violation of due process of law.[241] An erroneous order regarding creditor priorities, the problem raised by lender preference clauses, is still within the jurisdiction of the bankruptcy court, and does not violate due process unless entered without notice, a question to be discussed in Part V.

No plausible argument may be made that subsections (2), (3), or (5) of rule 60 apply in the case of judicial error,[242] which then leaves only the residual power to grant relief found in subsection (6).[243] Some confusion appears in the bankruptcy

237. *See supra* note 176 for the complete text of FED. R. CIV. P. 60(b)(4).

238. *See In re* Whitney-Forbes, Inc., 770 F.2d 692, 696 (7th Cir. 1985); *Texlon*, 596 F.2d at 1099; *In re* Emergency Beacon Corp., 48 Bankr. 356, 362 (S.D.N.Y. 1985); *Shaffer*, 8 Bankr. at 500; 7 MOORE, *supra* note 204, ¶ 60.25[3], at 60-239; 11 C. WRIGHT & A. MILLER, *supra* note 215, § 2862, at 198.

239. *In re* Texlon Corp., 596 F.2d 1092, 1099 (2d Cir. 1979).

240. *Whitney-Forbes*, 770 F.2d at 696; 7 MOORE, *supra* note 204, ¶ 60.25[2], at 60-225.

241. *Whitney-Forbes*, 770 F.2d at 696-97; Owens-Corning Fiberglas Corp. v. Center Wholesale, Inc. (*In re* Center Wholesale, Inc.), 759 F.2d 1440, 1448 (9th Cir. 1985); Randbre Corp. v. Ladney (*In re* Randbre Corp.), 66 Bankr. 482, 485 (Bankr. S.D.N.Y. 1986) (due process defect alleged); *In re* Photo Promotion Assoc., 53 Bankr. 759, 761 (Bankr. S.D.N.Y. 1985) (due process defect alleged); Williams v. Cal Indus. (*In re* Ireco Indus.), 2 Bankr. 76, 82–83 (Bankr. D. Ore. 1979) (subject matter jurisdiction defect alleged); 7 MOORE, *supra* note 204, ¶ 60.25[2], at 60-227 to -228 (usurpation), 60-229 (lack of jurisdiction), 60-236 (due process violation); 11 C. WRIGHT & A. MILLER, *supra* note 215, § 2862, at 198–200.

242. Rule 60(b)(2) allows relief in the case of newly discovered evidence, and 60(b)(3) for fraud and other misconduct, neither of which bears on the issue of giving relief for judicial error. Rule 60(b)(5) applies if "the judgment has been satisfied, released, or discharged, or a prior judgment upon which it is based has been reversed or otherwise vacated, or it is no longer equitable that the judgment should have prospective application." While neither of the first two (b)(5) bases may apply, the latter ground, regarding the inequity of continuing to give the judgment prospective application, arguably could support giving relief for judicial error in granting lender preference clauses, since those clauses typically continue to have a prospective effect, until the prepetition claim is entirely paid. Certainly the rule applies to any judgment with a prospective effect. *See* 7 MOORE, *supra* note 204, ¶ 60.26[4], at 60-256 to -258, -261 to -262; 11 C. WRIGHT & A. MILLER, *supra* note 215, § 2863, at 205. However, the rule would not apply to rectify a legal error, because the *sine qua non* of the rule is that circumstances must have changed. *See id.* at 206–07. As the Supreme Court said in the leading case, "We are not at liberty to reverse under the guise of readjusting." United States v. Swift & Co., 286 U.S. 106, 119 (1932). In the Chapter 11 financing context, it is unlikely that circumstances would have changed within the meaning of 60(b)(5) when the disappointed unsecured creditors move to strike the lender preference clauses previously granted. Indeed, the most likely change of circumstances that would have occurred would be that the lender would have financed pursuant to the financing order. This change militates *against* granting relief, because of the arguable reliance of and change of position by the lender. *See supra* notes 49–50 and 60–81 and accompanying text for a discussion of the reliance issue in the § 364(e) context. Bankruptcy courts sometimes are willing to grant rule 60(b)(5) relief if doing so would facilitate the chances for a reorganization. *See, e.g.*, Westinghouse Credit Corp. v. Prime, Inc. (*In re* Prime, Inc.), 26 Bankr. 556, 558 (Bankr. W.D. Mo. 1983) (adequate protection order in favor of secured creditor modified to protect opportunity for reorganization). Again, however, this argument fails when applied to the financing area. The pro-reorganization argument is invoked by *lenders* trying to protect their preferences, *see supra* notes 65–66 and accompanying text, not by objecting unsecured creditors. Indeed, the attack often comes after the reorganization case has converted to Chapter 7. *See, e.g.*, *Texlon*, 596 F.2d at 1095; *In re* Monach Circuit Indus., 41 Bankr. 859, 860 (Bankr. E.D. Pa. 1984).

243. *See supra* note 176 for the complete text of rule 60(b)(6). The subsection is a residual ground for granting relief, *see* 7 MOORE, *supra* note 204, ¶ 60.18[8], at 60-145, ¶ 60.27[1], at 60-264, and is mutually exclusive of the first five grounds. *See In re* Emergency Beacon Corp., 666 F.2d 754, 758 (2d Cir. 1981); *In re* Emergency Beacon Corp., 48 Bankr. 356, 363 (S.D.N.Y. 1985); *In re* Asusa, 47 Bankr. 928, 931 (S.D.N.Y. 1985); *In re* Shaffer, 8 Bankr. 497, 500 (Bankr. E.D.N.Y. 1981); *Ireco*, 2 Bankr. at 84; 7 MOORE, *supra* note 204, ¶ 60.27[1], at 60-266; 11 C. WRIGHT & A. MILLER, *supra* note 215, § 2864, at 217.

cases as to the appropriate standard for applying rule 60(b)(6). Several cases state that a liberal application is warranted because of the peculiar procedural nature of bankruptcy cases and because of the importance of achieving a successful reorganization.[244] These statements come dangerously close to resurrecting the administrative order doctrine under the guise of a rule 60(b)(6) motion[245] and as such, should not be followed.

Instead, relief under rule 60(b)(6) should be granted only in extraordinary circumstances, or in cases of extreme or undue hardship.[246] The Second Circuit took this approach in a leading bankruptcy case considering the propriety of granting rule 60(b) relief from an order granting a certificate of indebtedness.[247] Rather than stating a more liberal basis for obtaining relief than those found in subsections (1) through (5), subsection (6) presents a more demanding standard.[248]

No matter what the standard is under rule 60(b)(6), proof of more than just judicial error should be required to obtain relief.[249] More than under any other provision of rule 60(b), courts applying rule 60(b)(6) must be careful not to let it become a substitute for appeal, because of its generality and because it does not contain any set outside time limit. The danger of rule 60(b)(6) becoming a substitute for appeal would be particularly acute if relief could be obtained under that subsection for judicial error.[250]

The argument that relief under rule 60(b) should not be available based solely on

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244. *See In re* Durkalec, 21 Bankr. 618, 620 (Bankr. E.D. Pa. 1982); *see also* C.I.T. Corp. v. Johnson & Morgan Contractors (*In re* Johnson & Morgan Contractors), 29 Bankr. 372, 374 (Bankr. M.D. Pa. 1983) (following *Durkalec*); International Coins & Currency, Inc. v. Listronics, Inc., 26 Bankr. 254, 255 (Bankr. D. Vt. 1982); *Ireco*, 2 Bankr. at 84.

245. For example, the *FCX* court cited *Wayne* and *Pfister*, the foundation cases for the administrative order doctrine, as supporting the principle of rule 60(b)(6). *In re* FCX, Inc., 54 Bankr. 833, 839 (Bankr. E.D.N.C. 1985).

246. *Emergency Beacon*, 666 F.2d at 759; 7 MOORE, *supra* note 204, ¶ 60.27[1], at 60-269. As noted by one commentator, "It is intended to be a means for accomplishing justice in exceptional situations; and, so confined, does not violate the principle of finality of judgments." *Id.* ¶ 60.27[2], at 60-274. The court considering a rule 60(b)(6) motion has only a narrow range of discretion, *see In re* Chung King, Inc., 753 F.2d 547, 550 (7th Cir. 1985), and in exercising that discretion must consider the impact a modification of the order would have on the substantive rights of the parties involved. 11 C. WRIGHT & A. MILLER, *supra* note 215, § 2864, at 213.

247. *Emergency Beacon*, 666 F.2d at 755–61. In that case, the Second Circuit affirmed a 1978 order vacating a 1976 order to the extent that it had authorized the debtor in possession to issue a certificate of indebtedness to a lender with accompanying priority and lien status. *Id.* at 755. The bases for modifying the 1976 order were (1) that the bankruptcy court never intended to approve the certificate and never conducted a hearing on that issue directly, but instead the debtor's counsel, who prepared the 1976 order which the court signed, unilaterally slipped in the provision authorizing the certificate, *id.* at 755–57; and (2) even if the court had considered the request for a certificate initially, it probably would have declined to grant approval, *id.* at 760–61. The Second Circuit determined that rule 60(b)(1) did not apply, because the court never even intended to authorize the certificate, and that rule 60(b)(3) did not apply, because the bankruptcy court had not found that a fraud had been proven, *id.* at 759, although the main reason for this finding seems to be that the trustee who sought the modification did not really argue the fraud ground. Instead, the court gave relief under rule 60(b)(6), finding that "the circumstances in the present case were extraordinary." *Id.*

248. *See* 11 C. WRIGHT & A. MILLER, *supra* note 215, § 2857, at 160.

249. *See In re* Shaffer, 8 Bankr. 497, 500 (Bankr. E.D.N.Y. 1981); 7 MOORE, *supra* note 204, ¶ 60.27[2], at 60-276 to -277. The *Texlon* court similarly declined to find that relief was merited for legal error under rule 60(b), although that court did not mention the possibility of relief under 60(b)(6) expressly, but confined its discussion to 60(b)(1) and 60(b)(4). *In re* Texlon Corp., 596 F.2d 1092, 1099–1100 (2d Cir. 1979).

250. A party who chooses to seek relief for a legal error only through a rule 60(b) motion does so at the peril of losing his or her right to appeal, however, since the filing of a 60(b) motion does not affect the finality of a judgment, and the time for filing an appeal continues to run. 7 MOORE, *supra* note 204, ¶ 60.29, at 60-327. Conversely, a timely motion under rule 59(b) or 59(e) tolls the time for filing an appeal until that motion is exhausted. *Id.*

a claim that the bankruptcy court committed judicial error in approving the lender preference clauses presupposes that the court's decision was based on truthful, fairly presented evidence. If the debtor or the lender intentionally misrepresented or withheld evidence, then relief should be available under rule 60(b)(3).[251]

A leading Second Circuit case dealing with the application of rule 60(b) to bankruptcy financing orders stated that "[o]rdinarily clause (3) is invoked where material information has been withheld or incorrect or perjured evidence has been intentionally supplied."[252] Clause (3) focuses on the fraud of the party adverse to the movant, here the lender, and asks whether it would be inequitable for that party to retain the benefit obtained initially by its misconduct.[253] Because of the general policy favoring finality, the movant has the burden of proving such misconduct by clear and convincing evidence.[254]

In a proper case, however, relief should be granted.[255] As mentioned earlier, no court will grant lender preference clauses except on the proof of certain elements establishing the urgent need for financing and the unavailability of such financing except on the preferential terms sought.[256] If the objecting unsecured creditors can prove by clear and convincing evidence that the lender obtained a lender preference clause by intentionally misrepresenting the existence of one of the substantive prerequisites for that clause, relief under rule 60(b)(3) should be granted.[257]

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251. *See* Bohm, *supra* note 20, at 311–12 n.76. Earlier I argued that such activity also should support a finding that the lender was not in good faith and thus should not be entitled to the safe harbor of § 364(e). *See supra* notes 162–71 and accompanying text. Rule 60(b)(3) provides that relief may be granted for "fraud (whether heretofore denominated intrinsic or extrinsic), misrepresentation, or other misconduct of an adverse party."

252. *In re* Emergency Beacon Corp., 666 F.2d 754, 759 (2d Cir. 1981). *See also In re* Georgia Steel, Inc., 25 Bankr. 790, 795 (Bankr. M.D. Ga. 1982); *In re* Futuronics Corp., 5 Bankr. 489, 498 (S.D.N.Y. 1980) (denying attorneys' fees because of misrepresentations and improper conduct). In *Ellingsen*, the district court stated that the proper recourse for the objecting creditors based on their allegation that the debtor and lender contrived an emergency and "duped" the bankruptcy court into signing the order would have been to bring a rule 60(b) motion. *In re* Ellingsen MacLean Oil Co., 65 Bankr. 358, 363 (W.D. Mich. 1986).

253. 7 MOORE, *supra* note 204, ¶ 60.24[5], at 60-211. If the fraud is not by an adverse party, the proper basis and procedure for relief is a motion under 60(b)(6) or on a "fraud on the court" theory, or by independent action, but not under 60(b)(3). *Id.* at 60-216 to -217.

254. *See* 7 MOORE, *supra* note 204, ¶ 60.24[5], at 60-217 (burden and standard of proof); *id.* ¶ 60.37[1], at 60-379 (standard of proof); 11 C. WRIGHT & A. MILLER, *supra* note 215, § 2860, at 189 (burden of proof); *id.* § 2861, at 195 (standard of proof).

255. For example, relief was granted under rule 60(b)(3) with regard to a cash collateral order in *Georgia Steel*, 25 Bankr. at 795. In that case the lender knowingly withheld information from the debtor and the bankruptcy court about the extent of its security interests in certain vehicles of the debtor. The court thus was misled into entering an order which conferred substantially greater benefits on the lender than the court expected or intended.

256. *See supra* note 79.

257. For example, a cross-collateralization clause should be granted only if, among other things, the debtor proves that no alternative financing can be obtained on acceptable terms and that the lender will not lend without the clause. *In re* Vanguard Diversified, Inc., 31 Bankr. 364, 366 (Bankr. E.D.N.Y. 1983). If the lender would have lent even without the clause, or if the lender or debtor knew that alternative financing on acceptable terms was available, but misrepresented those facts to the court, then the bankruptcy court should not hesitate to strike the clause pursuant to rule 60(b)(3). Such a scenario also would undermine the lender's good faith under § 364(e). *See supra* notes 162–71 and accompanying text.

The motion in such a case probably would have to be entered within one year after the order was entered, since rule 60(b) provides an outside time limit of one year for actions under 60(b)(3). Although fraud may be attacked in three ways: by a 60(b)(3) motion, by a motion alleging "fraud upon the court," or by an independent action in equity, *see* 7 MOORE, *supra* note 204, ¶ 60.33, at 60-350 to -351, the type of fraud discussed in this Article would be characterized as "intrinsic fraud," *see id.* ¶ 60.24[5], at 60-211, which may be raised only under 60(b)(3). *See* 11 C. WRIGHT & A. MILLER, *supra* note 215, § 2861, at 195–96. Even though the one-year time limit does not apply to actions for fraud upon the court, *see* 7 MOORE, *supra* note 204, ¶ 60.24[4], at 60-210, or to independent actions, nondisclosure or misrepresentation by a party

The final fact situation raising a possibility of relief under rule 60(b) is where the financing order was entered after little or no notice to the affected creditors, a pervasive occurrence in the bankruptcy financing context.[258] As will be explored in detail in the following Part, rules 60(b)(4) and 60(b)(6) might apply in such a case.[259] Relief under rule 60(b)(4) will be given only if the financing order is void, which will occur only in the rare case in which the order was entered in violation of procedural due process.[260] Even if the notice inadequacies are not severe enough to rise to the level of a due process violation, relief still may be obtained under rule 60(b)(6).[261] Courts are more inclined to grant relief under rule 60(b) when the aggrieved party has not yet had a meaningful chance to be heard on the merits, the desire for finality in such a case giving way to the desire for justice.[262]

V. The Notice Problem: Large Cases and Little Time

A. *Overview of the Problem*

Given the emergency circumstances under which financing orders are often entered,[263] inadequacy of the notice of and opportunity for a hearing on a requested order often is raised as a basis for seeking to overturn that order, both in appeals[264] and in motions for reconsideration. Given the commonality of the notice issues dealt with in both of those contexts, this Part separately explores the notice problem, suggesting a framework for resolving notice questions in bankruptcy generally, and then applying that framework to the two types of attacks on financing orders considered in this Article.

The notice issue has proved troublesome in bankruptcy cases.[265] Much confu-

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or their attorney does not constitute "fraud upon the court," *see id.* ¶ 60.33, at 60-360 to -362; 11 C. Wright & A. Miller, *supra* note 215, § 2870, at 253–54, 256, and may not form the basis for an independent action. *See* 7 Moore, *supra* note 204, ¶ 60.33, at 60-350, ¶ 60.37[1], at 60-376. Judge Ordin's suggestion that *Texlon* could have been handled on a "fraud upon the court" theory, *see* Ordin, *supra* note 20, at 176, thus is close to the mark; the proper characterization instead is a rule 60(b)(3) motion for fraud or misrepresentation. Fraud upon the court contemplates instead an actual interference with the impartial functions of the court, such as bribery. *In re* Whitney-Forbes, Inc., 770 F.2d 693, 698 (7th Cir. 1985).

258. *See supra* notes 33 and 40 and accompanying text.

259. *See infra* notes 324–25 and accompanying text.

260. *See supra* note 241 and *infra* notes 311–12 and 328 and accompanying text.

261. *See, e.g., In re* Columbia Motor Express, 49 Bankr. 216, 220 (Bankr. M.D. Tenn. 1985) (relief granted under rule 60(b)(6) when no notice given of an application for a § 364(c) financing order). *See also* Amick v. Hotz (*In re* Atlantic, Pac. & Gulf Oil Co.), 101 F.2d 311, 313 (8th Cir. 1939).

262. *See Columbia Motor*, 49 Bankr. at 220; *In re* Ireco Indus., 2 Bankr. 76, 83–84 (Bankr. D. Ore. 1979); 7 Moore, *supra* note 204, ¶ 60.27[2], at 60-276; 11 C. Wright & A. Miller, *supra* note 215, § 2857, at 160.

263. *See supra* notes 33 and 40 and accompanying text.

264. The notice deficiency argument is used in two different ways in the context of an appellate attack on a financing order. The first is to establish the bad faith of the lender so as to avoid mootness under § 364(e). *See supra* note 172 and *infra* notes 321 and 323 and accompanying text. Once mootness has been avoided, then inadequate notice can be used to show that the prerequisite of "after notice and a hearing" imposed by the substantive sections of § 364 was not satisfied. *See, e.g., In re* American Resources Mgmt. Corp., 51 Bankr. 713, 721 (Bankr. D. Utah 1985).

265. For example, the court in *In re* Graphic Arts Lithographers, 71 Bankr. 774, 777 (Bankr. 9th Cir. 1987), held that it did not even have to reach the issue of the adequacy of the notice given, since it held the appeal was moot under § 364(e). The court thus failed to recognize that inadequate notice itself can be a basis for establishing bad faith by the lender, or even that the order could be void as a violation of procedural due process. Interestingly, and inexplicably, the court cited with approval the decision of Credit Alliance Corp. v. Dunning-Ray Ins. Agency (*In re* Blumer), 66 Bankr.

sion has resulted from a failure to distinguish the different situations in which notice may be required, and the different notice issues that may arise. Those issues include: who is entitled to notice, discussed in subpart V.B.; the adequacy of the notice and opportunity for a hearing given, examined in subpart V.C.; and, finally, the legal effect when the notice given is found to be inadequate, applied in subpart V.D. to appeals of financing orders under section 364(e) and to motions for relief from a judgment under rule 60(b).[266]

B. *Who is Entitled to Notice?*

The answer to this question defines who has standing to attack final bankruptcy orders on the ground that they failed to receive adequate notice.[267] In a large reorganization case involving thousands of creditors and shareholders, the expenditures of time and money resulting from requiring notice to all of those persons of all proposed orders in the case would be prohibitive. Furthermore, as illustrated by the financing situation, actions sometimes must be taken on an emergency basis in a reorganization case in order to save the possibility of reorganizing at all.[268] Requiring prior notice to be given to the thousands of creditors and shareholders might defeat the efficacy of that urgent action. Yet, our system of justice has long adhered to the concept that persons must be given notice and an opportunity to be heard before they may be deprived of "property."[269] The dilemma in reorganization cases is recon-

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109, 113–14 (Bankr. 9th Cir. 1986), which held that the financing order was void because due process had not been satisfied.

In *Texlon*, the Second Circuit did not even address the possibility that due process might apply, even though the order had been entered *ex parte*. The court said only that the Act did not require notice, and thus the financing order was not void. *In re* Texlon Corp., 596 F.2d 1092, 1099 (2d Cir. 1979). Despite that conclusion, the court went on to avoid the order in part because of its *ex parte* nature, but pursuant to the discarded administrative order doctrine. *See supra* subpart IV.A. Those courts that have recognized the problems inherent in trying to reconcile the creditors' right to notice with the need to keep reorganizations alive, such as *In re* Sullivan Ford Sales, 2 Bankr. 350, 355 (Bankr. D. Me. 1980), have struggled with the difficulty of the problem.

266. In addressing these questions, the distinction between statutory (or rule) and constitutional notice requirements must be borne in mind. Those requirements are not necessarily coextensive in all cases. Obviously, a statute or rule purporting to authorize notice below the constitutional procedural due process minimum is ineffective. For example, in *In re* Garland Corp., 6 Bankr. 456, 461 n.12 (Bankr. App. D. Mass. 1980), the court noted that § 364(e) could not bar a constitutional challenge. *Accord*, *Blumer*, 66 Bankr. at 113. *But see* Owens-Corning Fiberglas Corp. v. Center Wholesale, Inc. (*In re* Center Wholesale, Inc.), 759 F.2d 1440, 1451 (9th Cir. 1985). However, a statute or rule may well impose notice requirements more demanding than the Constitution. *See infra* notes 308–10 and accompanying text. Ascertaining which is violated may be critical for determining the appropriate remedy. A constitutionally deficient order is void, *see infra* notes 311–12 and accompanying text, while orders entered after insufficient notice only under a statute or rule will be more difficult to overturn. *See Center Wholesale*, 759 F.2d at 1448.

267. Thus, in *In re* Photo Promotion Assoc., 53 Bankr. 759, 762–63 (Bankr. S.D.N.Y. 1985), an unsecured creditor who personally did not receive any notice of a financing order was held not to have been deprived of due process when the unsecured creditors' committee received notice of and consented to the order. *But see In re* Nordyke, 43 Bankr. 856, 861 (Bankr. D. Ore. 1984), in which the court stated that any creditor who does not receive notice has standing to raise the notice deficiency. This conclusion assumes, however, that all creditors are entitled to notice of all matters in a Chapter 11 case, a conclusion disputed below. *See infra* notes 277–91 and accompanying text. The Ninth Circuit in *Center Wholesale* stated that a creditor must have a property right affected by a financing order to have standing to attack that order by a rule 60(b) motion. *Center Wholesale*, 759 F.2d at 1445–46. *But see Blumer*, 66 Bankr. at 112. Unsecured creditors do not have such a property right. *See Garland*, 6 Bankr. at 462.

268. *See Sullivan Ford*, 2 Bankr. at 355.

269. U.S. CONST. amend. V. *See* Mullane v. Central Hanover Bank & Trust, 339 U.S. 306, 313, 318 (1950) ("exceptions in the name of necessity do not sweep away the rule that within the limits of practicability notice must be such as is reasonably calculated to reach interested parties"); *In re* Delafield Dev., 54 Bankr. 442, 444 (Bankr. E.D. Wis.

ciling these sometimes competing policies. If notice may be given to *representatives* of affected creditor and shareholder groups, the reconciliation is much easier to effect.

The Bankruptcy Code gives a minimal amount of general guidance as to the requirements for notice and the opportunity for a hearing. Notice of the commencement of the case must be given.[270] After commencement, a number of orders, including financing orders, may be entered only "after notice and a hearing," a defined term of art.[271] Under this standard notice generally must be given.[272] The Code does not address the issue of *who* is entitled to notice when the term "after notice and a hearing" is used.

The Bankruptcy Rules of Procedure partially fill in this statutory gap and state who is entitled to notice. While rule 2002 requires all creditors and shareholders to receive notice of certain critical matters,[273] rule 4001(c), which covers financing orders, does not require notice to be given to all creditors, but instead permits notice to representatives of creditors.[274]

The distinctions drawn in the Rules as to which matters must be noticed to all creditors and which only to a representative group are, for the most part, right on target. Whether individual notice should be required, or whether notice to a

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1985). The Tenth Circuit in *Reliable Elec. Co. v. Olson Constr. Co.*, 726 F.2d 620, 623 & n.5 (10th Cir. 1984), stated that the right to be heard is not any the less even though the ultimate result almost certainly would not have been changed had the party been allowed to state its views. *See also* Coe v. Armour Fertilizer Works, 237 U.S. 413, 424 (1915).

270. 11 U.S.C. § 342(a) (1982 & Supp. IV 1986). Congress believed that due process required this notice to be given to all creditors and shareholders. H.R. REP. No. 595, 95th Cong., 2d Sess. 331 (1977), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6288; S. REP. No. 989, 95th Cong., 2d Sess. 42 (1978), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5828.

271. 11 U.S.C. § 102(1) (1982) provides:

(1) "after notice and a hearing", or a similar phrase—

(A) means after such notice as is appropriate in the particular circumstances, and such opportunity for a hearing as is appropriate in the particular circumstances; but

(B) authorizes an act without an actual hearing if such notice is given properly and if—

(i) such a hearing is not requested timely by a party in interest; or

(ii) there is insufficient time for a hearing to be commenced before such act must be done, and the court authorizes such act . . . .

272. See *infra* note 309 and accompanying text for a discussion of whether prior notice may be dispensed with under Code § 102(1) even in an emergency situation. Even those cases recognizing such a possibility state that the circumstances permitting dispensing with notice are extremely rare and that a full noticed hearing after the fact must be held as soon as is feasible. *See, e.g., In re* Sullivan Ford Sales, 2 Bankr. 350, 356–57 (Bankr. D. Me. 1980) ("exceptional scrutiny" required).

273. FED. R. BANKR. P. 2002. For example, all creditors must receive 20 days notice by mail of the time to vote on a plan, *id.* R. 2002(a)(6), and 25 days notice of the plan confirmation hearing, *id.* R. 2002(b)(2).

274. FED. R. BANKR. P. 4001(c) provides:

(c) Obtaining Credit. (1) **Motion; Service.** A motion for authority to obtain credit shall be made in accordance with Rule 9014 and shall be served on any committee appointed under the Code or its authorized agent, or, if no committee has been appointed, on the creditors listed on the list filed pursuant to Rule 1007(d), and on such other entities as the court may direct. The motion shall be accompanied by a copy of the agreement. (2) **Hearing.** The court may commence a final hearing on a motion for authority to obtain credit no earlier than 15 days after service of the motion. If the motion so requests, the court may conduct a hearing before such 15 day period expires, but the court may authorize the obtaining of credit only to the extent necessary to avoid immediate and irreparable harm to the estate pending a final hearing. (3) **Notice.** Notice of hearing pursuant to this subdivision shall be given to the parties on whom service of the motion is required by paragraph (1) of this subdivision and to such other entities as the court may direct.

The rule 1007(d) list referred to in rule 4001(c)(1) must contain the 20 largest unsecured creditors. FED. R. BANKR. P. 1007(d) (1987).

representative instead should suffice, should depend on what is being noticed. If the notice is of a matter that specifically affects the particular creditor in an individualized way, such as something affecting the creditor's own claim, then that creditor should receive individual notice.[275] No representative would have sufficient identity of interest to protect adequately the creditor's interest.

If, however, the matter being noticed affects a class of creditors in an identical way, then notice to a group adequately representing that class should suffice. Financing orders containing lender preference clauses fall within this latter category, since the effect of those clauses is to prefer the lender's prepetition unsecured or secured claim over the claims of the entire class of unsecured creditors.[276] The tradeoff supporting the granting of such clauses, the supposed enhancing of the possibility of a successful reorganization, would benefit each member of the unsecured creditor class in an identical way. In this type of case, adequate representation, contemplated by rule 4001(c), should be enough to protect the rights of the class.

Does the representative notice provided for by rule 4001(c) comport with due process, however? In the specific bankruptcy context there is little law on this precise question, with differing general views expressed by the courts.[277] The only direct holding upheld notice to only the official creditors' committee.[278] Most of the constitutional bankruptcy notice cases have dealt with an individual creditor's claim or lien being affected, with individual notice then required.[279]

The better view is that due process does not require all unsecured creditors to receive individual notice of all matters taking place in a Chapter 11 reorganization case. Such an inflexible view of due process, which might by endangering the

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275. One example is notice of a bar date for filing claims. *See, e.g.*, New York v. New York, N.H. & H.R.R., 344 U.S. 293, 296 (1953); Reliable Elec. Co. v. Olson Constr. Co., 726 F.2d 620, 623 (10th Cir. 1984); *In re* Intaco P.R., Inc., 494 F.2d 94, 98 n.8, 99 (1st Cir. 1974); *In re* Harbor Tank Storage Co., 385 F.2d 111, 114 (3d Cir. 1967); Randbre Corp. v. Ladney (*In re* Randbre Corp.), 66 Bankr. 482, 485 (Bankr. S.D.N.Y. 1986) (claim expungement). Another example is notice of a proceeding affecting a lien of the creditor, such as a request for a priming lien under § 364(d). *See, e.g., New York*, 344 U.S. at 296; Union Trust Co. v. Illinois Midland Ry., 117 U.S. 434, 460 (1886); Ray v. Norseworthy, 90 U.S. (23 Wall.) 128, 136 (1875); *In re* Center Wholesale, 759 F.2d 1440, 1448–50 (9th Cir. 1985); Coursey v. International Harvester Co., 109 F.2d 774, 777–78 (10th Cir. 1940); *In re* Mannington Pottery Co., 104 F. Supp. 506, 514–17 (N.D. W. Va. 1952); Tabb, *supra* note 5, at 130 n.110; Tondel & Scott, *supra* note 49, at 45. Indeed, in such instances due process requires individual notice. *See, e.g., New York*, 344 U.S. at 296; *Center Wholesale*, 759 F.2d at 1448–50.

276. *See supra* note 6.

277. Representative notice was upheld in *In re* Photo Promotion Assoc., 53 Bankr. 759, 762–63 (Bankr. S.D.N.Y. 1985). A number of courts have implicitly upheld notice to a representative group. *See, e.g., In re* Garland, 6 Bankr. 456, 461, 463 (Bankr. App. D. Mass. 1980); *In re* Adamson Co., 29 Bankr. 937, 941 (Bankr. E.D. Va. 1983); Anderson-Walker Indus. v. Small Bus. Admin. (*In re* Anderson-Walker Indus.), 3 Bankr. 551, 552 (Bankr. C.D. Cal. 1980); *In re* Sullivan Ford Sales, 2 Bankr. 350, 354 (Bankr. D. Me. 1980). *See infra* note 299. Other courts in dictum have suggested that due process requires individualized notice to all unsecured creditors of all reorganization matters. *See, e.g.*, A.H. Robins Co. v. Piccinin, 788 F.2d 994, 1015 (4th Cir.), *cert. denied*, 479 U.S. 876 (1986); Reliable Elec. Co. v. Olson Constr. Co., 726 F.2d 620, 623 (10th Cir. 1984); *In re* Blumer, 66 Bankr. 109, 114 (Bankr. 9th Cir. 1986); Sapir v. Coppinger Color Lab (*In re* Photo Promotion Assoc.), 72 Bankr. 606, 612 (Bankr. S.D.N.Y. 1987) (quoting *Blumer*). In none of those cases was the possibility of representative notice considered. Each involved either a total absence of notice to anyone, or a lack of notice of an individual matter to the particular creditor.

278. *Photo Promotion*, 53 Bankr. at 762–63. In that case an unsecured creditor that had not received notice of an application for a financing order challenged the order on due process grounds. The court rejected the challenge on the ground that the unsecured creditors' committee had notice of and consented to the financing order.

279. *See* cases cited *supra* note 275.

reorganization as a whole effectively defeat the interests of the very unsecured creditors supposedly to be protected, is not required by the cases[280] or by the logic of the fifth amendment. Instead, the flexible command of due process[281] is satisfied by the initial notice of the pendency of the case to all creditors, and by notice of the particular action to an adequate representative group.

The class action cases, which present the closest analogy to bankruptcy reorganization cases,[282] support this interpretation of due process. In mandatory class actions,[283] although all class members will be bound by a judgment,[284] a majority of courts have held that due process does not require notice to all class members even of the institution of the action and of the class certification proceeding. Those holdings are based on the idea that adequate representation sufficiently protects the due process rights of absent class members.[285]

Even in those mandatory class action cases requiring *initial* notice,[286] and in rule

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280. *See, e.g.*, *Photo Promotion*, 53 Bankr. at 762–63.

281. *See, e.g.*, Memphis Light, Gas & Water Div. v. Craft, 436 U.S. 1, 15 n.15 (1978); Mullane v. Central Hanover Bank & Trust, 339 U.S. 306, 314 (1950); *A.H. Robins*, 788 F.2d at 1014; *In re* Stanley Hotel, 15 Bankr. 660, 665 (D. Colo. 1981).

282. A bankruptcy reorganization case is most analogous to the limited fund cases under FED. R. CIV. P. 23(b)(1)(B), which provides for the prosecution of a class action if:

> (1) the prosecution of separate actions by or against individual members of the class would create a risk of . . .
> (B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests . . . .

The Advisory Committee Note to the 1966 amendment to rule 23 states:

> In various situations an adjudication as to one or more members of the class will necessarily or probably have an adverse practical effect on the interests of other members who should therefore be represented in the lawsuit. This is plainly the case when claims are made by numerous persons against a fund insufficient to satisfy all claims.

FED. R. CIV. P. 23 (Adv. Comm. Note 1966).

The analogy to bankruptcy reorganization cases is evident.

283. By "mandatory" is meant the application of the judgment in the class action to all members of the class, who have no right to be excluded from the operation of the judgment. This mandatory feature applies to actions under Federal Rules 23(b)(1) and 23(b)(2), but not to those under 23(b)(3). FED. R. CIV. P. 23(c)(3).

284. *See, e.g.*, Larionoff v. United States, 533 F.2d 1167, 1183 (D.C. Cir. 1976), *aff'd*, 431 U.S. 864 (1977); Wetzel v. Liberty Mut. Ins., 508 F.2d 239, 254–57 (3d Cir.), *cert. denied*, 421 U.S. 1011 (1975); 7B C. WRIGHT, A. MILLER & M. KANE, FEDERAL PRACTICE AND PROCEDURE § 1786, at 191–94 (2d ed. 1986).

285. *See* Citizens Envtl. Council v. Volpe, 364 F. Supp. 286, 288 (D. Kan.), *aff'd on other grounds*, 484 F.2d 870 (10th Cir. 1973), *cert. denied*, 416 U.S. 936 (1974); C. WRIGHT, A. MILLER & M. KANE, *supra* note 284, § 1786, at 194–97; Note, *Proposed Rule 23: Class Actions Reclassified*, 51 VA. L. REV. 629, 654 (1965).

Support for the representative view can be found even in the seminal *Mullane* case, which involved the question of what notice to trust beneficiaries was required of a judicial proceeding to settle finally the accounts of the trustee of a common trust fund. In that case, as in a bankruptcy reorganization affecting the rights of unsecured creditors, "[t]he individual interest does not stand alone but is identical with that of a class." *Mullane*, 339 U.S. at 319. While the Court did hold that notice by publication was insufficient as to known present beneficiaries, *id.* at 318, the Court went on to note that notice to most of the class would "safeguard the interests of all, since any objection sustained would inure to the benefit of all," *id.* at 319. Certainly the class action cases have interpreted *Mullane* as allowing notice to representatives of specific matters within a case to suffice to protect the procedural rights of the whole class. *See supra* note 284 and *infra* notes 286–90 and accompanying text.

286. *See, e.g.*, Hoston v. United States Gypsum Co., 67 F.R.D. 650, 658 (E.D. La. 1975); Richmond Black Police Officers' Ass'n v. City of Richmond, 386 F. Supp. 151, 158 (E.D. Va. 1974); Brandt v. Owens-Illinois, Inc., 62 F.R.D. 160, 171 (S.D.N.Y. 1974).

23(b)(3)[287] cases in which initial notice is required,[288] due process usually has not been held to require absent class members to receive notice of all *subsequent* proceedings within the case that might affect the interests of the class.[289] Instead, the initial notice of the proceeding is considered sufficient to allow the individual class member to appear in the case and to monitor subsequent activities.[290]

The argument that due process is satisfied by initial notice of the case to all interested parties and by subsequent notice to representatives only does not run afoul of cases holding that general notice of the pendency of a reorganization case is not sufficient notice of an order barring individual claims unless filed by a particular date.[291] Those cases have required individual notice of the bar order. They are

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287. FED. R. CIV. P. 23(b)(3) provides in part that a class action may be maintained if the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The rule goes on to state some factors relevant to the court's determination. The Advisory Committee Note to the 1966 amendments to rule 23(b)(3) states:

> In the situations to which this subdivision relates, class-action treatment is not as clearly called for as in those described above, but it may nevertheless be convenient and desirable depending upon the particular facts. Subdivision (b)(3) encompasses those cases in which a class action would achieve economies of time, effort, and expense, and promote uniformity of decision as to persons similarly situated, without sacrificing procedural fairness or bringing about other undesirable results.

FED. R. CIV. P. 23(b)(3) (Adv. Comm. Note 1966).

288. *See, e.g.*, Gert v. Elgin Nat'l Indus., 773 F.2d 154, 159 (7th Cir. 1985); *In re* Warner Communications Sec. Litig., 618 F. Supp. 735, 746 & n.3 (S.D.N.Y. 1985), *aff'd*, 798 F.2d 35 (2d Cir. 1986); 7B C. WRIGHT, A. MILLER & M. KANE, *supra* note 284, § 1786, at 188.

289. *See, e.g.*, Sanders v. John Nuveen & Co., 463 F.2d 1075, 1082 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972); Harris v. Graddick, 615 F. Supp. 239, 244 (M.D. Ala. 1985); 7B C. WRIGHT, A. MILLER & M. KANE, *supra* note 284, § 1793, at 298. FED. R. CIV. P. 23(d)(2) provides for permissive notice of such matters:

> In the conduct of actions to which this rule applies, the court *may* make appropriate orders: . . . (2) requiring, for the protection of the members of the class or otherwise for the fair conduct of the action, that notice be given in such manner as the court may direct *to some or all* of the members of any step in the action . . . . (emphasis added).

The permissive nature of the rule is confirmed by the Advisory Committee Note, which states that "Subdivision (d)(2) does not require notice at any stage, but rather calls attention to its availability and invokes the court's discretion." FED. R. CIV. P. 23(d)(2) (Adv. Comm. Note 1966).

The only exception to this principle is contained in FED. R. CIV. P. 23(e), which requires the giving of notice of a proposed dismissal or compromise of the action. 7B C. WRIGHT, A. MILLER & M. KANE, *supra* note 284, § 1797, at 340, 359–60.

290. *See* 7B C WRIGHT, A. MILLER & M. KANE, *supra* note 284, § 1786, at 189–90.

Any consideration of the class action cases must take into account the Supreme Court's decision in Eisen v. Carlisle & Jacquelin, 417 U.S. 156 (1974), in which the Court held that the notice requirement of rule 23(c)(2) mandated giving individual notice and not publication notice to each of the 2,250,000 easily identifiable class members, *id.* at 175–77. The Court based its decision directly on the language of the rule, and not on due process, although it certainly intimated that the rule was derived from the dictates of due process. *Id.* at 174–75. The Court expressly rejected arguments that notice to only part of the class could be justified either because of the tremendous cost of individual notice to all identifiable class members or on a theory that adequate representation would exist. *Id.* at 175–77.

Eisen is distinguishable from an application for a bankruptcy financing order. First, of course, any bankruptcy proceeding has the overriding consideration of minimizing expense in order to facilitate the possible financial reorganization of the troubled debtor. Second, the matter being noticed in *Eisen* affected each class member in an individual way, since a rule 23(b)(3) class action by its very nature requires notice of institution of the action so that potential class members may decide whether or not to participate in the class. Financing orders, however, do affect creditors identically, and thus representative notice should suffice. *See supra* notes 275–76 and accompanying text. The better analogy in the class action context is to notice of matters *after* the institution of the action, which need not be individually noticed, *see supra* note 289 and accompanying text, because those matters impact on the now-determined class identically.

291. *See, e.g.*, New York v. New York, N.H. & H.R.R., 344 U.S. 293, 297 (1953); Reliable Elec. Co. v. Olson

distinguishable from financing order cases, however, because the action being noticed affected the specific creditor in an individual way by the direct deprivation of a property right. In the financing order context, as noted above, the class interest is identical, and thus notice to a representative should suffice.

If representative notice in general does satisfy due process, the only question is whether the representative group being noticed fulfills the requirements of adequacy of representation[292] and, related thereto, of typicality.[293] In a class action case those questions must be decided specifically by the court in certifying the class and approving the class representative.[294] Although such rigid controls to ensure adequacy and typicality do not exist in bankruptcy cases, the representative group required by rule 4001(c) to be noticed should be adequate.

The preferred group designated by rule 4001(c) is the official committee of unsecured creditors, if one has been formed.[295] That committee is an adequate representative; the Bankruptcy Code itself mandates that the committee be representative.[296] If no committee has been formed, as may often be true if the financing order is presented in the first days of the case,[297] the rule instead allows for notice to the twenty largest unsecured creditors.[298] The statutory mandate of representativeness then does not exist.[299]

Despite this concern, notice to the twenty largest unsecured creditors still should

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Constr. Co., 726 F.2d 620, 622 (10th Cir. 1984); *In re* Intaco P.R., Inc., 494 F.2d 94, 99 (1st Cir. 1974); *In re* Harbor Tank Storage Co., 385 F.2d 111, 115 (3d Cir. 1967); *In re* Randbre Corp., 66 Bankr. 482, 485 (Bankr. S.D.N.Y. 1986).

292. In the class action context adequacy of representation is indispensable to maintaining the action. *See* FED. R. CIV. P. 23(a)(4); 7B C. WRIGHT, A. MILLER & M. KANE, *supra* note 284, § 1765, at 262–63, 266–68. *See also* Hansberry v. Lee, 311 U.S. 32, 42–43 (1940).

293. Typicality also is a prerequisite to maintaining a class action. *See* Fertig v. Blue Cross, 68 F.R.D. 53, 57 (N.D. Iowa 1974); FED. R. CIV. P. 23(a)(3); 7B C. WRIGHT, A. MILLER & M. KANE, *supra* note 284, § 1764, at 228.

294. *See* FED. R. CIV. P. 23(c)(1); 7B C. WRIGHT, A. MILLER & M. KANE, *supra* note 284, § 1785, at 89–90.

295. FED. R. BANKR. P. 4001(c)(1). 11 U.S.C. § 1102(a)(1) (1982 & Supp. IV 1986) requires the United States Trustee to appoint a committee of unsecured creditors in every Chapter 11 case. *Id.* Section 1103 specifies the powers and duties of such a committee. For a discussion of creditors' committees under the Code, *see* Andrews, *The Chapter 11 Creditors' Committee: Statutory Watchdog?*, 2 BANKR. DEV. J. 247 (1985); DeNatale, *The Creditors' Committee Under the Bankruptcy Court— A Primer*, 55 AM. BANKR. L.J. 43 (1981).

296. 11 U.S.C. §§ 1102(a)(2), (b)(1) (1982 & Supp. IV 1986). Former 11 U.S.C. § 1102(c) (Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, tit. I, § 1102(c), 92 Stat. 2549, 2626 (1978)) provided further that the court could change the membership of an existing committee to ensure adequate representation of the claims in that class. This section was repealed as part of the 1986 legislation instituting the United States Trustee system nationwide, which gave a larger administrative role to the United States Trustee, but it is unlikely that the repeal of that subsection was intended to change in any way the requirement that the committee of unsecured creditors be representative. Furthermore, the committee members are fiduciaries of the entire class. *See* DeNatale, *supra* note 295, at 56–58.

297. *See, e.g., In re* Sullivan Ford Sales, 2 Bankr. 350, 352 (Bankr. D. Me. 1980). The formation of the creditors' committee usually takes a number of weeks, varying in detail according to local practice and the nature of the case. The normal procedure is for the United States Trustee to send notice of the formation meeting to the largest creditors, taken from the rule 1007(d) list. *See supra* note 274. The Code states that the committee "shall ordinarily" consist of the seven largest claim holders. 11 U.S.C. § 1102(b)(1) (1982 & Supp. IV 1986).

298. FED. R. BANKR. P. 4001(c)(1).

299. Those 20 creditors do not clearly have a fiduciary duty to the unsecured creditor body as a whole. Two leading financing order notice cases under the Code assumed that all creditors had to be noticed when no committee had been formed. *See Sullivan Ford*, 2 Bankr. at 354; *In re* Adamson Co., 29 Bankr. 937, 941 (Bankr. E.D. Va. 1984). They did not consider the possibility, however, of notice to the 20 largest creditors. Other cases have stated that such notice is enough, *see, e.g., In re* Vanguard Diversified, Inc., 31 Bankr. 364, 365 (Bankr. E.D.N.Y. 1983) (20 largest); *In re* Borne Chem. Co., 9 Bankr. 263, 265 (Bankr. D.N.J. 1981) (10 largest), and indeed in the absence of an official committee is required. *See In re* Garland Corp., 6 Bankr. 456, 458 n.2 (Bankr. App. D. Mass. 1980) ("The nonexistence of an official Creditors' Committee does not excuse the failure to attempt notification of the twenty largest unsecured creditors.").

be sufficient. First, those twenty creditors have claims of the same class or rank as the entire body of unsecured creditors, and accordingly will be affected by the entry of the financing order in a way identical to the whole class. Thus, their arguments made even in their pure self interest would, to the extent successful, "inure to the benefit of all."[300] Second, the unsecured creditors' committee almost always will be formed from that very group of the twenty largest unsecured creditors,[301] and the same entities thus are likely to receive the notice in either case.

C. *What Constitutes Adequate Notice?*

Deciding that a party is entitled to notice still leaves the question of what length and form of notice is required to satisfy the requirements of the Constitution, Bankruptcy Code, and Bankruptcy Rules. The Bankruptcy Code provides only that the notice must be "appropriate in the particular circumstances."[302] Less notice is required in an emergency situation than in a nonemergency case.[303] The important question is how much less, since applications for financing orders routinely are presented on an emergency basis.[304]

The Bankruptcy Rules are more explicit than the Code as to the notice requirements for financing orders. Rule 4001(c) states that "[t]he court may commence a final hearing on a motion for authority to obtain credit no earlier than fifteen days after service of the motion."[305] Since an absolute fifteen day rule would cause hardships in emergency financing cases, rule 4001(c) allows the court to conduct a hearing before the fifteen day period expires, but provides that at that hearing "the court may authorize the obtaining of credit only to the extent necessary to avoid immediate and irreparable harm to the estate pending a final hearing."[306] After this emergency hearing, the court then is to hold a final hearing on full notice.[307]

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300. Mullane v. Central Hanover Bank & Trust, 339 U.S. 306, 319 (1950).

301. *See supra* note 297.

302. 11 U.S.C. § 102(1)(a) (1982). *See supra* note 271 for the complete text of § 102(1).

303. *See, e.g.*, Unsecured Creditors' Comm. v. First Nat'l Bank & Trust (*In re* Ellingsen MacLean Oil Co.), 834 F.2d 599, 605 (6th Cir. 1987); *In re* Public Leasing Corp., 344 F. Supp. 754, 756, 758 (W.D. Okla. 1972); *Garland*, 6 Bankr. at 458 n.2; *In re* Monach Circuit Indus., 41 Bankr. 859, 861 (Bankr. E.D. Pa. 1984); *In re* Stanley Hotel, 15 Bankr. 660, 665 (D. Colo. 1981); *In re* Sullivan Ford Sales, 2 Bankr. 350, 355 (Bankr. D. Me. 1980).

304. *See Initial Financing Restrictions*, *supra* note 19, at 1691–92, 1699. *See also* Montco, Inc. v. Barr (*In re* Emergency Beacon Corp.), 666 F.2d 754, 760 (2d Cir. 1981) (stating in dictum that *ex parte* financing orders are the norm and thus are permissible).

305. FED. R. BANKR. P. 4001(c)(2). *See supra* note 274 for the complete text of rule 4001(c).

306. FED. R. BANKR. P. 4001(c)(2). This standard, obviously analogous to the standard for a temporary restraining order, *see* FED. R. CIV. P. 65(b)(1), is derived from an important early Code financing order case. *See Sullivan Ford*, 2 Bankr. at 355–57.

307. Even before rule 4001(c) was promulgated, a number of bankruptcy courts had followed the suggestion of *Sullivan Ford* and had structured two-step hearing procedures to accommodate the debtor's emergency needs and the procedural rights of creditors. *See, e.g.*, *In re* Center Wholesale, 759 F.2d 1440, 1449 n.21 (9th Cir. 1985) (approving such a practice in dictum); *In re* Garland, 6 Bankr. 456, 458 (Bankr. App. D. Mass. 1980); *In re* FCX, Inc., 54 Bankr. 833, 837–39 (Bankr. E.D.N.C. 1985); *In re* Roblin Indus., 52 Bankr. 241, 244 (Bankr. W.D.N.Y. 1985); *In re* Sheehan, 38 Bankr. 859, 863 (Bankr. D.S.D. 1984); *In re* Vanguard Diversified, Inc., 31 Bankr. 364, 365, 366 (Bankr. E.D.N.Y. 1983); *In re* Antico Mfg., 31 Bankr. 103, 104 (Bankr. E.D.N.Y. 1983). The *Roblin* case is illustrative. The initial hearing was held on one day telephonic notice to the 20 largest creditors, and the final hearing five weeks later on notice to all creditors. *Roblin*, 52 Bankr. at 242. Even in the leading case upholding an initial *ex parte* financing hearing, *Public*

The rule apparently does not permit dispensing with prior notice even in the emergency case, since it uses the mandatory wording "shall."[308] Whether the Code allows for an emergency exception to the prior notice requirement is a debated point.[309] The due process cases do not require prior notice, as long as a noticed hearing is held before rights are finally fixed.[310] Thus, if a lender preference clause is only tentatively approved at an *ex parte* hearing without notice, subject to final approval at a properly noticed hearing, no constitutional problems should exist. If, however, the lender preference clause is entered as part of a *final* order *ex parte* and without notice, that order is probably unconstitutional as a violation of due process.[311] The order then would be void and not protectable under section 364(e) or rule 60(b).[312]

Even if the initial order were not final, thus removing the constitutional

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Leasing, 344 F. Supp. at 755, a subsequent noticed hearing was held which ratified the actions taken at the earlier hearing. *Id.* at 755–56.

308. FED. R. BANKR. P. 4001(c)(3) provides that "[n]otice of hearing pursuant to this subdivision *shall* be given" to the required parties (emphasis added).

309. The statute supports a construction that notice may never be dispensed with. The hearing requirement is expressly stated to be subject to possible waiver in an emergency case. 11 U.S.C. § 102(1)(B)(ii) (1982). No similar exception is stated for the notice requirement, and indeed a statutory precondition to the no-hearing exception is that notice be given. A permissible inference is that prior notice is always required. *See In re* Texlon Corp., 596 F.2d 1092, 1099 (2d Cir. 1979) (dictum); *In re* Blumer, 66 Bankr. 109, 113 (Bankr. 9th Cir. 1986); P. MURPHY, CREDITORS' RIGHTS IN BANKRUPTCY § 8.05, at 8-8 n.3 (1980); Weintraub & Resnick, *supra* note 20, at 90; *see also* Grundy Nat'l Bank v. Looney (*In re* Looney), 823 F.2d 788, 791 (4th Cir. 1987) (§ 362 context). *Sullivan Ford*, on the other hand, suggested that in an extreme emergency prior notice might be foregone, and in such a case proposed adoption of an *ex parte* procedure similar to that for obtaining a temporary restraining order without notice pursuant to FED. R. CIV. P. 65(b). *In re* Sullivan Ford Sales, 2 Bankr. 350, 355–57 (Bankr. D. Me. 1980). This suggestion has been echoed by a number of courts. *See, e.g., In re* Columbia Motor Express, 49 Bankr. 216, 218 (Bankr. M.D. Tenn. 1985); *In re* Monach Circuit Indus., 41 Bankr. 859, 861. Perhaps the point is largely academic if, as is suggested in the text accompanying note 314 *infra*, it is very unlikely that there could be a financing emergency so dire that no prior notice whatsoever could be given. This is true only if courts follow the lead of *Sullivan* and refuse relief on an "emergency" basis when the facts do not indicate that the reorganization will fail if a few hours or even days notice is given.

A hearing may not be required, however. In an emergency the court is empowered to authorize the act requested without an actual hearing. 11 U.S.C. § 102(1)(B)(ii) (1982). *See Center Wholesale*, 759 F.2d at 1449 n.21; *Texlon*, 596 F.2d 1092, 1099 (dictum); Bradshaw v. Waldschmidt (*In re* London, Inc.), 70 Bankr. 63, 65 (Bankr. E.D. Wis. 1987); *Columbia Motor*, 49 Bankr. at 218; *In re* Adamson Co., 29 Bankr. 937, 939 (Bankr. E.D. Va. 1984); *Sullivan Ford*, 2 Bankr. at 354. The statements by the legislative leaders accompanying the presentation of the final form of the Bankruptcy Reform Act of 1978 to Congress, which is in effect the equivalent of the conference report for that law, noted with regard to § 102(1):

> In very limited emergency circumstances, there will be insufficient time for a hearing to be commenced before an action must be taken. The action sought to be taken may be taken if authorized by the court at an ex parte hearing of which a record is made in open court. A full hearing after the fact will be available in such an instance.

124 CONG. REC. H32,393 (1978) (remarks of Rep. Edwards); 124 CONG. REC. S33,993 (remarks of Sen. DeConcini).

310. *See, e.g.,* Union Trust Co. v. Illinois Midland Ry., 117 U.S. 434, 456 (1886); A.H. Robins v. Piccinin, 788 F.2d 994, 1014 (4th Cir. 1986); *Center Wholesale*, 759 F.2d at 1449 n.21; Smith v. First Fed. Sav. & Loan Ass'n, 58 Bankr. 603, 605 (W.D. Pa. 1986); *Sheehan*, 38 Bankr. at 863; Tabb, *supra* note 5, at 130 n.110; *Initial Financing Restrictions*, *supra* note 19, at 1691.

311. *See, e.g.,* Memphis Light, Gas & Water Div. v. Craft, 436 U.S. 1, 16 n.17 (1978); *In re* Center Wholesale, 759 F.2d 1440, 1449–50 (9th Cir. 1985); *Blumer*, 66 Bankr. at 114; *Garland*, 6 Bankr. at 462 n.17; *Adamson*, 29 Bankr. at 939. Several cases have failed to note the due process problem inherent in a completely *ex parte* financing order. *See, e.g., Texlon*, 596 F.2d at 1099; *In re* Public Leasing Corp., 344 F. Supp. 754, 755–56 (W.D. Okla. 1972); *Columbia Motor*, 49 Bankr. at 218–20. Entry of an *ex parte* final order also would constitute a violation of § 102(1), *see supra* notes 270 and 309 and accompanying text, and rule 4001(c). *See supra* note 308 and accompanying text.

312. *See, e.g., Center Wholesale*, 759 F.2d at 1448–50 (rule 60(b)(4)); *Blumer*, 66 Bankr. at 113–14 (§ 364(e)); *In re* Randbre Corp., 66 Bankr. 482, 488 (Bankr. S.D.N.Y. 1986) (rule 60(b)(5)); *see also Asusa*, 47 Bankr. at 931; *In re* Photo Promotion Assoc., 53 Bankr. 759, 761–62 (Bankr. S.D.N.Y. 1985).

impediment, the stricter requirement of prior notice imposed by rule 4001(c) makes sense. A court which already has made findings of fact and conclusions of law sufficient to support the approval of lender preference clauses at an initial hearing might be predisposed to hold the same way at a final hearing, tacitly reversing the burden of proof at the final hearing.[313] The counter argument is that the pro-reorganization goal must always be paramount, and that prior notice must be dispensed with if necessary to save the reorganization in an extreme emergency. It is difficult to conceive of a financing emergency so urgent that even overnight notice cannot be given.[314] Yet, once any exception to the prior notice rule is recognized, the possibility of abusing that exception appears. The regular invocation of other supposedly extreme measures in the financing context[315] suggests that this concern might not be unduly speculative. In summary, rule 4001(c) properly provides that the appropriate representative group must receive prior notice even of a temporary emergency authorization.

Assuming then that some prior notice must be given, the question is what amount and form of notice is required. The seminal case of *Mullane v. Central Hanover Bank & Trust Company* dictates that the notice must be sent by a method reasonably calculated to reach the party entitled to receive the notice and must give that party sufficient time and information to exercise in a meaningful way its right to be heard.[316]

The first aspect, that the notice be sent in a way reasonably calculated to reach the intended audience, has not been a problem in the financing order cases.[317] The requirements of timeliness and specificity have caused more problems for the

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313. In other words, the court would essentially demand that the unsecured creditors objecting to the clause show why the initial order should not have been entered, instead of strictly requiring the debtor and lender to prove why the lender preference clause should be granted.

314. As noted above, *see supra* note 309, even the *Sullivan Ford* court, which recognized the possibility of dispensing with notice, refused to do so under the facts presented. *In re* Sullivan Ford Sales, 2 Bankr. 350, 357 (Bankr. D. Me. 1980).

315. Lender preference clauses are a current example. An example under the prior Act was the granting of superpriority status to lenders. *See* Tabb, *supra* note 5, at 168 & n.334.

316. The constitutional minimum is stated by Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306, 314–15 (1950):

> An elementary and fundamental requirement of due process in any proceeding which is to be accorded finality is notice reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections. The notice must be of such nature as reasonably to convey the required information, and it must afford a reasonable time for those interested to make their appearance.
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> . . . .
>
> But when notice is a person's due, process which is a mere gesture is not due process. The means employed must be such as one desirous of actually informing the absentee might reasonably adopt to accomplish it. (citations omitted).

317. One potential tension between the cases and rule 4001(c) may develop over whether telephonic notice alone is sufficient. The cases have approved such a form of notice. *See, e.g., In re* Ellingsen MacLean Oil Co., 834 F.2d 599, 605 (6th Cir. 1987); *In re* Blumer, 66 Bankr. 109, 113 (Bankr. 9th Cir. 1986); *In re* Anderson-Walker Indus., 3 Bankr. 551, 552 (Bankr. D. Me. 1980); Weintraub & Resnick, *supra* note 20, at 90; *contra, Sullivan Ford*, 2 Bankr. at 354. The Rules, however, require service of the motion requesting authority to obtain credit, FED. R. BANKR. P. 4001(c)(1) (1987), which must be done either by mail or in a way authorized by Federal Rule 4. *Id.* R. 9014, 7004. This would eliminate any argument that service of the motion itself could be accomplished by telephone. The service requirement probably only applies to the final hearing under rule 4001(c) and not to a temporary emergency authorization.

courts.[318] The distinction between a temporary and a final authorization is relevant to the outcome, with the courts more lenient if the order entered is subject to review at a later hearing on full notice.[319] Rule 4001(c) does not address the amount of notice required for the temporary hearing,[320] leaving the courts free to assess on a case-by-case basis the adequacy of the time given, considering all of the circumstances. The next subpart suggests a framework for resolving the issue of the adequacy of the notice given.

D. *Application of a Notice Framework to Section 364(e) and Rule 60(b)*

This subpart addresses the question of what remedy is available to objecting creditors if a notice violation has occurred and proposes a framework for resolving notice issues. The two possibilities for relief are those considered in this Article: reversal of the financing order on appeal[321] or vacation or modification of the order by the bankruptcy court on a motion to reconsider.[322] An appellate attack must overcome the mootness limitations of section 364(e), thus requiring the objecting creditors to prove either that the lender acted in bad faith[323] or that the order was void as a violation of due process. A rule 60(b) motion will succeed if the order is void,[324] or, even if the order is not void, relief may be granted "for any other reason" under rule 60(b)(6).[325] While unavailable in normal circumstances, this latter provision

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318. A rough pattern seems to be evolving. If one day notice or less is given, the courts are inclined to grant relief. *See, e.g.*, *In re* Center Wholesale, 759 F.2d 1440, 1448–50 (9th Cir. 1985) (one day); *In re* Texlon Corp., 596 F.2d 1092, 1094, 1098 (2d Cir. 1979) (none); *Blumer*, 66 Bankr. at 114 (none); *In re* Columbia Motor Express, 49 Bankr. 216, 217 (Bankr. M.D. Tenn. 1985) (none); *In re* Monach Circuit Indus., 41 Bankr. 859, 860–61 (Bankr. E.D. Pa. 1984) (none); *In re* Adamson Co., 29 Bankr. 937, 941 (Bankr. E.D. Va. 1984) (one day); *Sullivan Ford*, 2 Bankr. at 357 (one day); *but see Ellingsen*, 834 F.2d at 605 (one day, no relief); *In re* Public Leasing Corp., 344 F. Supp. 754, 755–56 (W.D. Okla. 1972) (none, no relief). If two or more days notice is given, the courts invariably uphold the adequacy of the notice. *See, e.g.*, *In re* FCX, Inc., 54 Bankr. 833, 839 (Bankr. E.D. N.C. 1985) (four days); *In re* Sheehan, 38 Bankr. 859, 860–63 (Bankr. D.S.D. 1984) (three days); *In re* Vanguard Diversified, Inc., 31 Bankr. 364, 365 (Bankr. E.D.N.Y. 1983) (three days); *Anderson-Walker*, 3 Bankr. at 552 (up to two days).

Probably the leading recent case finding a financing order void as a violation of due process because of inadequate timeliness and specificity is the Ninth Circuit's decision in *Center Wholesale*, 759 F.2d at 1448–50. Owens-Corning, a lien creditor, was given only one day notice of a hearing on the debtor's motion requesting authority to use cash collateral and to grant under 11 U.S.C. § 364(d) (1982) another lender a security interest in Owens-Corning's collateral senior to that held by Owens-Corning (*i.e.*, a priming lien). Although a fully noticed hearing was held a few weeks later, the bankruptcy judge interpreted the initial order as final and not subject to modification. The Ninth Circuit held that Owens-Corning had been deprived of due process. *Center Wholesale*, 759 F.2d at 1448–50. The court suggested strongly that no constitutional problem would have existed if the order entered at the first hearing had been subject to modification at the second hearing. *Id.* at 1449 n.21. The court also was influenced by the fact that Owens-Corning had a specific property interest, its lien, which was being impaired. *Id.* at 1445–46. A general unsecured creditor asserting a more general potential impairment resulting from a lender preference clause may not have been as successful. Finally, the notice given did not clearly indicate that a priming lien was being sought. *Id.* at 1449.

Currently the Advisory Committee Note to rule 4001 details the matters to be contained in the motion. FED. R. BANKR. P. 4001 (Adv. Comm. Note 1987).

319. *See supra* notes 307 and 310–11 and accompanying text.

320. The main limitation imposed by the rule is that the court at the temporary emergency hearing only authorize the obtaining of credit in the amount necessary to respond to the emergency. FED. R. BANKR. P. 4001(c)(2) (1987). *See supra* notes 306–07 and *infra* note 340 and accompanying text.

321. *See supra* subparts III.A. and III.C.

322. *See supra* Part IV.

323. *See supra* subpart III.C.

324. FED. R. CIV. P. 60(b)(4). *See supra* notes 241 and 311–12 and accompanying text.

325. *See supra* notes 261–62 and accompanying text.

does give the bankruptcy court considerable discretion to protect against notice deficiencies.

The due process question was explored in the preceding subparts. With regard to lender preference clauses, due process should only require that notice be given to an adequate representative group of unsecured creditors.[326] The amount of notice necessary causes courts more difficulty. The question is whether enough notice was given so that the representative creditors had time to prepare properly for and appear at the hearing.[327] The financing order generally is considered void, and thus subject to attack either on appeal, since section 364(e) would be inapplicable, or under rule 60(b)(4), if no notice is given and the order entered at the initial hearing is accorded finality.[328] Conversely, if the order entered at the initial hearing is not final, but instead subject to modification at a later hearing on full notice, no due process violation will be found.[329] The problem cases arise when some minimal amount of notice is given and the order entered is final.[330] In the context of lender preference clauses, overnight notice should be sufficient to satisfy due process. The urgency with which financing orders often are entered supports a lenient due process interpretation.[331] This approach would be consistent with the proposed scheme outlined below.

Even if the order is not void, the lender still runs the risk of being found to be in bad faith under section 364(e) or of having the order vacated or modified under rule 60(b)(6). Initially, a distinction should be noted between section 364(e) and rule 60(b)(6), with the latter possibly permitting broader relief. Establishing bad faith on the part of the lender for purposes of section 364(e) requires appealing unsecured creditors to link the lender personally to the notice deficiency. Generally, responsibility for giving notice of applications for financing orders rests with the debtor in possession, and not with the lender. Under rule 60(b)(6), fault of the party benefiting from the order is a sufficient but not a necessary basis for granting relief.[332] Instead, detriment to the aggrieved party, here the unsecured creditors, would suffice.[333] Courts should not hesitate to make the linkage required under section 364(e) to

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326. *See supra* notes 271–91 and accompanying text.

327. *See supra* notes 316 and 318–19 and accompanying text.

328. *See supra* notes 311–12 and accompanying text.

329. *See supra* note 310 and accompanying text.

330. As suggested in note 318 *supra*, the vast majority of courts have been willing to grant relief when creditors were not given at least two days notice of the application for the financing order. *See, e.g., In re* Center Wholesale, 759 F.2d 1440, 1448 (9th Cir. 1985) (one day); *In re* Blumer, 66 Bankr. 109, 114 (Bankr. 9th Cir. 1986) (none); *In re* Garland, 6 Bankr. 456, 458 n.2 (Bankr. App. D. Mass. 1980) (none) (dictum); *In re* Columbia Motor Express, 49 Bankr. 216, 218–19 (Bankr. M.D. Tenn. 1985) (none); *In re* Monach Circuit Indus., 41 Bankr. 859, 860–61 (Bankr. E.D. Pa. 1984) (none); *In re* Adamson Co., 29 Bankr. 937, 938–41 (Bankr. E.D. Va. 1984) (one day); *In re* Sullivan Ford Sales, 2 Bankr. 350, 353–57 (Bankr. D. Me. 1980) (one day). *In re* Ellingsen MacLean Oil Co., 834 F.2d 599, 605 (6th Cir. 1987) (one day), and *In re* Public Leasing Corp., 344 F. Supp. 754, 755–56 (W.D. Okla. 1972) (none), stand out as the principal exceptions.

331. The attorneys for the objecting unsecured creditors are likely to be familiar already with the types of legal issues encountered at financing hearings, since those issues recur from case to case. *See, e.g., In re* Sheehan, 38 Bankr. 859, 861–62 (Bankr. D.S.D. 1984). Factual development by the objecting creditors at the hearing usually is only in the form of cross-examination of principals of the debtor and lender, and thus insufficient time to obtain and prepare direct evidence probably would not change trial strategy in most cases.

332. *See* 11 C. WRIGHT & A. MILLER, *supra* note 215, § 2864, at 213.

333. *See* 7 MOORE, *supra* note 204, ¶ 60.24[5], at 60-216.

implicate a lender for notice deficiencies, since the lender in practice dictates if, when, and on what terms the financing will be made. The debtor has little independent say.[334] Beyond this distinction, this Article asserts that the bases for giving relief based on inadequate notice should be the same whether raised under section 364(e) or under rule 60(b)(6).

The critical question is what sort of notice deficiencies will be sufficient to establish a basis for relief under section 364(e) or rule 60(b)(6). A leading bankruptcy treatise considering the notice problem under section 364(e) states the view that bad faith should not be imputed lightly in such cases, because of the fact that short notice is indeed a fact of life in the financing context.[335] In addition, bankruptcy lending can only be encouraged if lenders have some certainty in dealing with debtors in possession. Having said that, however, lenders should not be absolved absolutely of any possible notice deficiencies. The scheme suggested below will provide ample certainty to lenders and yet protect the procedural needs of unsecured creditors.

My proposal is: (1) that the protection of the lender should be tied to compliance with the notice provisions of the Bankruptcy Code and Bankruptcy Rules, and especially with Bankruptcy Rule 4001(c), and (2) that a series of presumptions should be applied depending on various factors, particularly the amount of notice given. In all cases, notice to the appropriate representative group should suffice.

On the one hand, if no prior notice is given and the order entered is final, then the lender will not be protected, because of the violations of due process,[336] Code section 102(1),[337] and rule 4001(c).[338] If, on the other hand, the fifteen days notice required by rule 4001(c) is given, then the lender should conclusively be protected. Furthermore, if the order entered at the initial emergency hearing is tentative only, expressly subject to the bankruptcy court's final approval at the fifteen day hearing, then again the lender's protection should be established conclusively, as long as at least overnight notice was given of the initial hearing.[339] Thus, the lender can be certain it will be protected against notice deficiency arguments if it insists that fifteen days notice be given before entry of the final order, and overnight notice before entry of a tentative order.

The difficult case, then, is the common one falling between the two extremes of no notice and fifteen days notice, when prior notice is given, but a hearing is held and a final authorization to obtain credit is granted *before* the fifteen-day period expires. Rule 4001(c) in such a situation only allows the court to authorize that financing needed to get the debtor through the emergency, *i.e.*, to the fifteen-day

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334. *See supra* note 19 and accompanying text. A lender concerned about being protected under § 364(e) would be able to insist that the debtor give the minimal notice probably necessary to afford the lender protection. If the proposal outlined below is adopted, the lender's certainty would be enhanced.

335. *See* 2 COLLIER ON BANKRUPTCY, *supra* note 49, ¶ 364.06, at 364-16.

336. *See supra* notes 311-12 and 328 and accompanying text.

337. *See supra* notes 270 and 309 and accompanying text.

338. *See supra* note 308 and accompanying text.

339. As noted above, due process in such a case would not require prior notice of the initial hearing. *See supra* notes 310 and 329 and accompanying text. Rule 4001(c)(3) appears to require prior notice even in the emergency case, *see supra* note 308 and accompanying text, a requirement that I assert is wise. *See supra* notes 313-15 and accompanying text.

hearing.[340] Accordingly, the lender should not be protected for any amounts lent prior to the fifteen-day hearing in excess of the debtor's needs for that period.

As to amounts lent for use during the fifteen-day period which are necessary to the debtor in possession, a series of presumptions should be invoked to determine the protection of the lender. If less than overnight notice is given, a strong presumption against the adequacy of the notice should be raised. This presumption should be rebuttable only upon proof of circumstances necessitating same-day notice by clear and convincing evidence. A total failure of prior notice should never be allowed. If at least overnight notice is given, the presumption should be reversed, now favoring the adequacy of the notice.[341] Because the normal amount of notice dictated by rule 4001(c) is not being given, the presumption of adequate notice in such a situation should be rebuttable by proof by only a preponderance of the evidence either (1) that the notice given was insufficient to allow the objecting creditors to prepare meaningfully for the hearing[342] or (2) that more notice could have been given with no reasonable likelihood of risk to the reorganization.[343]

With regard to this latter point, objecting unsecured creditors should be able to deny the lender protection under section 364(e) and attack the order under rule 60(b)(6) by successfully arguing that the debtor and the lender were at fault, "whether by design or neglect,"[344] in creating the emergency. The allegation typically would be that the debtor and lender knew of the need for financing and could have acted upon that need[345] at least fifteen days in advance, but delayed filing the application for financing until right before the financing was needed, thus circumventing the full procedural protections to which the unsecured creditors are entitled.[346] Such a practice must be strongly discouraged, lest it become habit-

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340. FED. R. BANKR. P. 4001(c)(2). *See also* Ordin, *supra* note 20, at 180.

341. Note that this presumption would change the result in the majority of one-day notice cases. *See supra* notes 318 and 330.

342. *See, e.g., In re* Center Wholesale, 759 F.2d 1440, 1448–49 (9th Cir. 1985).

343. The circuit court in *Ellingsen* stated that the issue was not what notice could have been given, but whether the notice given was adequate. *In re* Ellingsen MacLean Oil Co., 834 F.2d 599, 605 (6th Cir. 1987). The *Sullivan Ford* court, on the other hand, did consider the amount of notice that could have been given. *In re* Sullivan Ford Sales, 2 Bankr. 350, 355 (Bankr. D. Me. 1980). *Accord In re* Adamson Co., 29 Bankr. 937, 941 (Bankr. E.D. Va. 1984). The vision of the *Ellingsen* court is too narrow. The whole lender protection issue turns on the reconciliation of a number of competing policies, and the reconciliation effected may depend on the comparative strength or weakness of the underlying facts supporting those policies. One of those policies is that interested parties be given adequate notice before their rights are affected; another is that lenders be treated fairly. If lenders do not give as much notice as they easily could have, thereby straining the adequacy of the notice to the very limits, little is gained by invoking an all-or-nothing approach as to the adequacy of the notice viewed in isolation. The inequitable conduct of the lender which contributed to the notice problem should be considered by the court in deciding whether the lender should be protected.

344. *Sullivan Ford*, 2 Bankr. at 354.

345. In many cases the debtor and lender will be aware of the need for financing well in advance of actually working out the details of that financing. Indeed, the lender may be reluctant to finance at all. The time before the lender and debtor have agreed in substance to the basic financing terms should not be counted against the lender for purposes of the delay argument. The difficulty of monitoring the activities of the debtor and lender in this regard are obvious, but there really is no alternative that would not be grossly unfair to the lender.

346. Such an argument was made by the creditors in *Ellingsen*, but so far has been rejected on appeal based on insufficient proof. *Ellingsen*, 834 F.2d at 605; *In re* Ellingsen MacLean Oil Co., 65 Bankr. 358, 363 (W.D. Mich. 1986). In *In re* Stanley Hotel, 15 Bankr. 660, 665 (D. Colo. 1981), the trustee delayed several months in seeking financing after knowing of the need for it, and the court, although upholding the notice given, suggested that the trustee's delay was relevant to resolving the notice issue. In *Sullivan Ford*, 2 Bankr. at 354–55, the court in denying emergency financing relief gave considerable weight to the fact that the application for financing had been delayed even after the need was

forming for bankruptcy lenders. If no "at-fault delay" is established, then the presumption should be in favor of upholding the adequacy of the notice given.

The remaining difficulty is whether the lender should be protected as to those parts of the emergency order not dealing directly with the postpetition financing but packaged as part of the order, such as lender preference clauses. The lender would argue that it would not have lent even for the emergency period without the lender preference clauses and that those clauses thus are absolutely necessary to the emergency financing contemplated by rule 4001(c).[347] Because of the permanent and potentially deleterious effect of lender preference clauses on the rights of unsecured creditors,[348] and the tangential relation of those clauses to the postpetition financing,[349] I propose that lenders should not be protected as to lender preference clauses granted in a final order before the fifteen-day period expires. Instead, such clauses should in all cases be authorized only tentatively at the initial hearing (again after at least overnight notice), with that authorization subject to final approval at the fifteen-day hearing.

VI. CONCLUSION

Bankruptcy long has operated under a cloud of suspicion and mystery in the eyes of most of the legal profession, and certainly in the eyes of the public. This negative image probably has contributed in part to the refusal of Congress to grant article III status to bankruptcy judges.[350] Two components of this perception are that bankruptcy cases are governed by arcane and incomprehensible procedures and that the substantive rights of parties may be disregarded with impunity in bankruptcy. In recent years affirmative steps have been taken to eliminate whatever truth there may be in those two perceptions and to upgrade the standing and status of bankruptcy. The Supreme Court promulgated the Rules of Bankruptcy Procedure in 1973, using a basic premise of equating bankruptcy procedure to civil procedure generally.[351] The Bankruptcy Reform Act of 1978[352] sought to make substantive bankruptcy law fairer, simpler, and more cohesive.

Despite these efforts, however, bankruptcy cases in general and Chapter 11 cases in particular continue to suffer from poor press. The view persists that reorganization proceedings are unfair and arbitrary. Unfortunately, there is much truth in this

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known. The court noted that the party seeking relief is in a position to manipulate the timing and that such manipulations may prejudice other interested parties, thereby requiring the court to assume the role of watchdog to protect the rights of the affected parties. The court was concerned about the possibility of intentionally delayed applications becoming a habit for debtors and lenders. *Id.* at 355. *Accord Adamson*, 29 Bankr. at 941.

347. *See In re* Adams Apple, 829 F.2d 1484, 1488 (9th Cir. 1987).

348. *See supra* notes 6 and 8 and accompanying text. For example, a clause waiving attacks on a prepetition collateral position precludes any future challenge to the validity of that security.

349. *See supra* notes 61–62 and 76 and accompanying text.

350. *See generally* Countryman, *Scrambling to Define Bankruptcy Jurisdiction: The Chief Justice, the Judicial Conference, and the Legislative Process*, 22 HARV. J. ON LEGIS. 1 (1985) (discussing the behind-the-scenes maneuvering leading up to the passage of the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1978)).

351. *See supra* note 176 and accompanying text.

352. Pub. L. No. 95-598, 92 Stat. 2549 (1978).

observation. Recent developments involving the utilization of lender preference clauses in Chapter 11 cases, discussed in this Article, only serve to bring further disrepute to the beleaguered institution that is Chapter 11. Lenders have been able to take advantage of emergency situations to extract preferential treatment for their prepetition claims, thereby gaining an advantage over other unsecured creditors. Those preferential benefits in many cases have been shielded from even the possibility of appellate review because of the improper application of Code section 364(e) and other doctrines limiting appealability.

Conversely, if the financing order has become final and the time for filing an appeal has expired, courts must be willing to hold that the game is over with regard to the challenged provisions in the particular case, unless some extreme notice deficiency or fraud is proven. Freely allowing out-of-time revisions of final orders, as a number of courts have done, will only inspire further belief in the "kangaroo court" nature of bankruptcy cases.

Finally, some certainty is needed in reconciling the need to act quickly in emergency situations and the need to protect the rights of interested creditors to receive notice and be heard. This Article has outlined a proposed method for analyzing notice issues in Chapter 11 cases.

Bankruptcy cases today operate much more in the light of day than in the past. The loose procedures and rough "justice" common in earlier days no longer are appropriate. Tightening up the application of rules regarding appealability, finality, and notice in the financing order context would constitute an important step in the right direction.