UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF	)	
	)	
HEARTLAND PROMOTIONS, INC.,	)	CASE NO. BK94-81541
	)	
DEBTOR	)	CH. 11

MEMORANDUM

Before the Court is a Motion to Make Payments to Customers of the Debtor (the Motion). Hearing was held on January 24, 1995. Appearing on behalf of debtor was Jeffrey Wegner of Kutak, Rock, Omaha, Nebraska. Appearing on behalf of the Creditors' Committee was Robert Bothe of McGrath, North, Mullin & Kratz, P.C., Omaha, Nebraska. Appearing on behalf of Donnelly was Frank Schepers of Kennedy, Holland, Delacy & Svoboda, Omaha, Nebraska. Appearing on behalf of Bobley Harmann were Terrence Michael of Baird, Holm, McEachen, Pedersen, Hamann & Strasheim, Omaha, Nebraska. Steven Cohen also appeared on behalf of Bobley-Harmann. This memorandum contains findings of fact and conclusions of law required by Fed. Bankr. R. 7052 and Fed. R. Civ. P. 52. This is a core proceeding as defined by 28 U.S.C. § 157(b)(2)(M) and (O).

Background

This debtor sells a variety of consumer goods through advertising placed in credit card billing envelopes. The debtor contracts with banks and retailers to obtain permission to insert advertising material in their customer billing envelopes. The banks receive a fee for permitting such advertising and, in some cases, receive a commission based upon sales generated through credit card purchases of such merchandise. On the petition date, the debtor owed certain banks and retailers for the services provided by those banks and retailers. The services had been completed and there was no continuing contractual arrangement between the debtor and these banks and retailers. Many of the banks and retailers have informed the debtor that they would be willing to enter into new, post-petition, contractual arrangements with the debtor only if their prepetition claims are paid promptly. The debtor has determined that entering into new business relationships with these entities would be of benefit to the estate and has requested permission of the Court to pay these prepetition claims on the condition that the banks and retailers enter into binding post-petition contracts which will be of benefit to the debtor's business.

The prepetition arrearages owing to the banks and retailers total $246,103.00. The debtor has the ability to promptly pay the prepetition arrearages owing to the banks and retailers.

Although there is no statutory authority for the request made by the debtor, the debtor suggests that there is a long-standing doctrine called the "necessity of payment rule" which has been judicially created and acknowledged for more than 100 years which authorizes the bankruptcy court to permit such payments.

Decision

The motion for authority to pay certain prepetition claims in consideration for post-petition business is denied.

Discussion

The "necessity of payment rule," which permits a bankruptcy court to authorize the payment of pre-petition debt when the payment will contribute to the rehabilitation of the debtor, was first recognized by the Supreme Court in Miltenberger v. Logansport Ry. Co., 106 U.S. 286, 1 S. Ct. 140, 27 L. Ed. 117 (1882). The Supreme Court authorized the granting of a first lien, ahead of pre-existing lienholders, to employees for prepetition wage claims and to prepetition creditors that had supplied materials and interline traffic exchanges to a railroad in a situation where failure to make such payments after the railroad went into receivership would result in the cessation of the railroad business.

Under Miltenberger and its prodigy of railroad reorganization cases, three separate legal doctrines have developed. One is the "doctrine of necessity" which applies to the payment of prepetition wage and benefit claims. The second is the "necessity of payment rule," which applies to the payment of prepetition claims for materials and supplies, where failure to make the payments will threaten the rehabilitation of the debtor. The third is the "six months rule," which permits claims for services and goods supplied to a railroad six months before filing bankruptcy to be paid as administrative expense priority claims from a debt fund. This doctrine is now codified at 11 U.S.C. § 1171(b) and limited to railroad cases by 11 U.S.C. § 103(g). Russell A. Eisenberg & Frances F. Gecker, The Doctrine of Necessity and its Parameters, 73 MARQ. L. REV. 1, w2-3 (1989) (publication page references are not available for this document on Westlaw. For this reason, the page number designation w# refers to the page of the printed reproduction downloaded from Westlaw) [hereinafter this article shall be referred to as Doctrine]. Modern bankruptcy cases often do not distinguish between each doctrine, especially the "necessity of payment rule"

and the "doctrine of necessity" and therefore, the courts use the doctrines interchangeably.

Heartland is proposing that this Court recognize the "necessity of payment rule." The "necessity of payment rule," was first applied outside of the context of a railroad case by the Second Circuit in Dudley v. Mealey, 147 F.2d 268 (2d Cir.), cert. denied, 325 U.S. 873, 65 S. Ct. 1415, 89 L Ed. 1991 (1945). The Dudley court actually purported to use the "six month rule" to justify its authorization to pay prepetition creditors. Id. at 271. However, the analysis used, which relied upon the fact that the debtor's business would be threatened without making these payments, is appropriate under the "necessity of payment rule." See Id. (stating that the debtor's continuing existence would be threatened unless certain prepetition creditors were paid); Doctrine, supra at p 2 (discussing the distinguishing characteristics of the three doctrines).

Judge Learned Hand opined in Dudley that the payment of prepetition general unsecured claims was necessary in a hotel reorganization where the alternative was cessation of business. 147 F.2d at 271. The judge decided that the rule applied beyond railroad companies and other public-service companies. He concluded that even in a non-public service bankruptcy case, unless some prepetition trade creditors are given some type of priority, debtors will not be able to continue in business because prepetition unsecured creditors will refuse to provide essential goods post petition or require that debtor pay for essential materials on a cash basis. Id.

Dudley is not authority to extend the "necessity of payment rule" outside the context of railroad cases. Applying Dudley beyond the context of a railroad reorganization was rejected in the Commission Report, which Congress considered during the discussion prior to adoption of the 1978 Bankruptcy Code[1]. Charles Jordan Tabb, Emergency Preferential Orders in Bankruptcy Reorganizations, 65 AM. BANKR. L.J. 75, 100 n. 153 and accompanying text (1990) (citing REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, 93d Cong., 1st Sess., pt. I, at 219-20 (1973)) [hereinafter this article shall be designated as Emergency].

Circuit courts which have discussed the propriety of the "necessity of payment rule" since the adoption of the Bankruptcy Code or have discussed preferential pre-confirmation payments to general unsecured creditors have overwhelmingly declined to

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[1]Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. § 101 et al. (1994)) [hereinafter this act shall be referred to as the Bankruptcy Code].

extend the rule beyond railroad reorganization cases. In Southern Ry. Co. v. Johnson Bronze Co. (In re Johnson Bronze Co.), the Third Circuit held that a general unsecured creditor was not entitled to have a prepetition contractual indemnification claim against the debtor to be treated as superior to claims of other general unsecured creditors, and therefore, the bankruptcy court was not authorized to rely upon 11 U.S.C. § 105(a) to grant the creditor a superior priority over other general unsecured creditors. 758 F.2d 137, 140-41 (3d Cir. 1985). The court stated that the right of bankruptcy courts to use 11 U.S.C. § 105(a) to establish priorities within a class is limited to the remedies available in the Bankruptcy Code:

> [S]ection 105(a) does not authorize the bankruptcy court to create rights not otherwise available under applicable law....The court may not by granting a priority which it deems equitable set aside the clear congressional mandate that no such priority shall be accorded. Pepper v. Litton, 308 U.S. 295 [60 S. Ct. 238, 84 L. Ed. 281] ... is not to the contrary. That case holds that a court of bankruptcy under its equitable powers may disallow or subordinate a particular claim in bankruptcy which, because of the fraudulent nature of the claim or the bad faith or improper conduct of the claimant, ought not in equity and good conscience to be allowed or paid on a parity with other claims. It does not hold that the court may set up a sub-classification of claims within a class given equal priority by the Bankruptcy Act and fix an order of priority for the sub-classes according to its theory of equity.

Id. at 141 (quotations and citation omitted).

In Official Comm. of Equity Sec. Holders v. Mabey, the Fourth Circuit held that the Bankruptcy Courts could not authorize selective pre-confirmation payments to unsecured prepetition creditors under the Bankruptcy Code. 832 F.2d 299 (4th Cir. 1987), cert. denied, 485 U.S. 962, 108 S. Ct. 1228, 99 L. Ed. 2d 428 (1988). In Chiasson v. J. Louis Matherne & Assocs. (In re Oxford Management), the Fifth Circuit, while not specifically discussing the "necessity of payment rule" or railroad companies, nevertheless, found that the Bankruptcy Code, specifically 11 U.S.C. § 105, does not authorize a bankruptcy judge to use post-petition funds to pay prepetition claims. 4 F.3d 1329, 1334 (5th Cir. 1993). In Crowe & Assocs. v. Bricklayers and Masons Union Local No. 2, the Sixth Circuit held that a bankruptcy court did not have the authority to enjoin a

union from striking against the debtor to force payment of prepetition pension fund payments. 713 F.2d 211 (6th Cir. 1983). The Sixth Circuit commented on the authority for bankruptcy courts to use equitable powers even when failure to do so will result in irreparable harm to the reorganization process:

> We recognize that this legal result casts upon Crowe inequities. Even if Crowe desired to make the delinquent payments, the bankruptcy court may not permit it to do so. Crowe might have to liquidate because of a strike concerning demands over which it has no control. But Crowe has no control over many economic forces which affect the outcome of its reorganization.

Id. at 273.

In In re B & W Enters., Inc., the Ninth Circuit asserted that the "necessity of payment rule" was developed for the protection of trustees of a railroad who were being coerced into paying prepetition debts in exchange for the continuation of necessary supplies for the business operations and, therefore, refused to apply the rule to a bankruptcy case other than a railroad reorganization. 713 F.2d 534, 537 (9th Cir. 1983) ("The Necessity of Payment Rule was created for and has been applied only to railroad cases").

Commentators addressing the "necessity of payment rule" generally agree with the circuit courts -- that the "necessity of payment rule" should not be extended beyond railroad cases under the Bankruptcy Code. Doctrine, supra p. 2, at w3 (stating the "necessity of payment rule" and the "six month rule" are limited to railroad cases and have no application to non-railroad Chapter 11 cases, but the "doctrine of necessity" does apply to general Chapter 11 cases); Emergency, supra p. 3, at 100 (stating that the public policy interest in a railroad case is so paramount as to justify the "necessity of payment rule," and in non-railroad cases, the lack of a public interest creates the need for a new policy would that would require a debtor to either guarantee that all general unsecured creditors will be paid in full under the plan, which would be difficult to do in the early stages of a bankruptcy case, or require that all creditors receiving a preferential payment agree to later return any funds received in excess of what the creditor was entitled to receive pro rata under the bankruptcy plan); Patricia L. Barsalou, Preferential First Day Orders -- A Question for Congress, 1994 ABI JNL. LEXIS 2702, *4-*5 (June 1994) (stating that both the "six month rule" and the "necessity of payment rule" were applicable only in railroad reorganization cases, but that only the "six month rule" was preserved in the Bankruptcy Code).

Even though the circuit courts have generally rejected the "necessity of payment rule" and even though most authorities concede that the rule does not apply to non-railroad cases, several bankruptcy courts and district courts have authorized preferential payments to prepetition creditors when the debtor's rehabilitation efforts are threatened without such payments. The "necessity of payment rule" and the "doctrine of necessity" have been merged into a hybrid doctrine based on the principle of business necessity under the "necessity of payment rule," but generally applied only to cases for prepetition employee wage, benefit or workers' compensation claims, which would fall under the "doctrine of necessity."

Heartland suggests In re Ionosphere Clubs, Inc., 98 B.R. 174 (Bankr. S.D.N.Y. 1989), is representative of decisions which permit debtors to pay prepetition claims such as those Heartland desires to pay. Under the facts of the case, a union moved the court for an order directing the debtor to pay the prepetition priority wage, salary and medical benefits of employees of the debtor who belonged to the union, but were on strike (inactive employees). The debtor had already paid the prepetition claims in full of the non-striking employees who were not on strike. Id. at 175.

Ionosphere held that bankruptcy courts were empowered under 11 U.S.C. § 363(b)(1) to authorize preferential payments to certain prepetition creditors. 98 B.R. at 175. Section 363(b)(1) states: "The trustee, after notice and hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." The court found that its power under Section 363(b)(1) was not absolute, but could only be used if a sound business reason existed to pay prepetition creditors. Ionosphere, 98 B.R. at 175. The court decided that retaining current employees was a sound business reason for paying the employees for their prepetition claims. Id.

Ionosphere also determined that authority existed under 11 U.S.C. § 105(a) to issue an order to carry out the provisions of Title 11. 98 B.R. at 175. The court cited both the "doctrine of necessity" and the "necessity of payment rule" as authority to permit payments to certain prepetition creditors. Id. at 175-76. It listed the major railroad cases which arose in the circuit courts after the Supreme Court decided Miltenberger. See Id. at 176 (listing railroad cases which authorized the preferential payment of prepetition claims under the "necessity of payment rule," "doctrine of necessity," or the "six month rule" in railroad cases). The court then stated that even if this airline case was not covered by the Railway Act and thus not exactly the same type of case as the railroad cases, the doctrine applied to the airline industry because of Judge Learned Hand's analysis in Dudley.

Ionosphere created the new hybrid of the two doctrines. The court did not distinguish between the "necessity of payment rule" and the "doctrine of necessity." The arguments that the court made in favor of its decision are based on the "necessity of payment rule." For example, the court relied on Dudley which, as was discussed above, analyzed the "necessity of payment rule" and the "six month rule." The court's ultimate decision was based on an evaluation of the threat to the business, which is typically a "necessity of payment rule" justification.

Other non-railroad bankruptcy decisions have authorized prepetition payment of employee wage or benefit claims, but based the decision on a resurrection of the "necessity of payment rule." In Michigan Bureau of Workers' Disability Compensation v. Chateaugay Corp. (In re Chateaugay Corp.), the court held that it was authorized to permit payment of prepetition wages and salaries, reimbursement expenses, and employment benefits because prepetition preference payments are authorized by In re Penn Cent. Transp. Co., 467 F.2d 100, 102 n. 1 (3d Cir. 1972), which was a railroad reorganization case. Chateaugay, 80 B.R. 1987 (S.D.N.Y. 1987). In In re Gulf Air, Inc., the court held that the "necessity of payment rule" authorized the bankruptcy court to allow debtor to pay prepetition wage and benefits claims of employees and that such payments were necessary for a successful reorganization. 112 B.R. 152 (Bankr. W.D. La. 1989). See also Pension Benefit Guar. Corp. v. Sharon Steel Corp. (In re Sharon Steel Corp.), 159 B.R. 730 (Bankr. W.D. Pa. 1993) ("necessity of payment rule" authorized the payment of prepetition wage claims where the payment is necessary to permit the effectuation of the rehabilitative purposes of the Bankruptcy Code); In re Quality Interiors, Inc., 127 B.R. 391 (Bankr. N.D. Ohio 1991) (payment of prepetition claim for wages outside of the Chapter 11 Plan is generally prohibited. However, the court found that an exception exists so that the bankruptcy court may authorize the payment of certain prepetition claims, pursuant to 11 U.S.C. § 105, if the debtor is unable to reorganize under Chapter 11 without making such a payment. The court cited Chateaugay for authority to permit debtors to pay prepetition wage claims, especially when it is apparent that such claims will ultimately be priority claims pursuant to 11 U.S.C. § 507(a)(3)); In re NVR L.P., 147 B.R. 126 (Bankr. E.D. Va. 1992) (bankruptcy court can use 11 U.S.C. § 105(a) of the Bankruptcy Code to permit payment of prepetition obligations when essential to the continued operation of the debtor, but not in case where no business need is shown for such discrimination. The claim was for prepetition employee incentive compensation.)

Although following the language of the wage and benefit cases cited above, some recent cases appear to be creating an entirely new doctrine. For example, in In re UNR Indus., Inc., the court held that the need to pay prepetition workers' compensation claims for asbestos exposure was necessary under the

"necessity doctrine" to maintain the workers' morale in the work place, and categorized the prepetition claims as for a "good or service," as opposed to a wage or benefit. 143 B.R. 506 (Bankr. N.D. Ill. 1992). The court distinguished the "necessity of payment rule" from the "necessity doctrine" by calling the former the predecessor to the "necessity doctrine." Id. at 520. However, neither of the cases cited by the court, In re Quality Interiors, Inc., 127 B.R. 391 (Bankr. N.D. Ohio 1991) and In re Eagle-Picher Indus., Inc., 124 B.R. 1021 (Bankr. S.D. Ohio 1991), mention the "necessity doctrine" nor state the "necessity of payment rule" is a predecessor to the "necessity doctrine." Id. at 519-20. The "necessity doctrine" demonstrates how each court has broadened this doctrine in each new case because the UNR court, even though the case was a wage case, held:

> [T]he Necessity Doctrine may be used to permit a debtor to pay the pre-petition claims of suppliers or employees whose continued cooperation is essential to the debtor's successful reorganization."

Id. at 520. Thus, the court integrated the "necessity of payment rule" into non-railroad Chapter 11 cases and approved its use to pay suppliers as well as wage and benefit claims.

Some courts are now willing to permit the payment of prepetition claims in instances where the prepetition creditors are not employees holding wage or benefit claims and apply the "necessity of payment rule" to non-railroad reorganization cases. In In re Eagle-Picher Indus., Inc., the court cited to a medical benefits case, In re Structurlite Plastics Corp., 86 B.R. 922, 929-33 (Bankr. S.D. Ohio 1988), for the proposition that Chateaugay, infra p. 7, (which was based on a second circuit railroad case) was most in accord with the spirit of Chapter 11. Eagle-Picher, 124 B.R. 1021, 1022-23 (Bankr. S.D. Ohio 1991). The court found that the debtor may pay the prepetition claim of an unsecured creditor, a tool maker, if the debtor can show that such payment is necessary to avert a serious threat to the debtor's rehabilitation. Id. at 1023. See also Doctrine, supra p. 2, at w9-11 (discussing cases where the bankruptcy court permitted prepetition unsecured claims to be preferentially paid pre-confirmation, but where such cases did not involve employee claims. Primarily these are cases in which the prepetition claimholders are suppliers, consumers or foreign creditors of the debtor, and the consequences of not paying these creditors is seriously detrimental to the debtor's reorganization).

At least two courts below the circuit level have strictly adhered to the position of the circuit courts and have held that bankruptcy courts are not authorized to order preferential payments to prepetition creditors in exchange for a business benefit to the debtor. In re FCX, Inc., 60 B.R. 405 (E.D.N.C.

1986) (a bankruptcy court could only deviate from the rules of priority and distribution set forth in the Bankruptcy Code in the instance of inequitable conduct on the part of the claimant, and therefore, bankruptcy court could not authorize the payment of prepetition unsecured claims for wages, taxes and unpaid purchases of grain. In addition, 11 U.S.C. § 105(a) does not authorize a bankruptcy court to subordinate a particular claim unless authorized under applicable law); In re Revco D.S., Inc., 91 B.R. 777 (Bank. N.D. Ohio 1988) (the Bankruptcy Code does not authorize the payment of prepetition trust fund taxes prior to the confirmation of the plan, except under the assumption of executory contract section).

Conclusion

Based on this analysis of the "necessity of payment rule" and corollary doctrines, this Court finds that it can not approve Heartland's motion to pay prepetition creditors who are not parties to a current executory contract with Heartland. The Court of Appeals for the Eighth Circuit has not ruled on the issue presented, but has taken the position that a bankruptcy court's equitable powers under 11 U.S.C. § 105(a) "may only be used to further the policies and provisions of the Code." Bird v. Carl's Grocery Co. (In re NWFX, Inc.), 864 F.2d 593, 595 (8th cir. 1989) (citing Johnson v. First Nat'l Bank, 719 B.2d 270, 273 (8th Cir. 1983)). There is no provision in the Bankruptcy Code which authorizes this Court to permit Heartland the opportunity to pay prepetition creditors so that Heartland may enter into new post-petition agreements with those same creditors. Even if the "necessity of payment rule" is not absolutely restricted to railroad cases, this Court is reluctant to apply Section 105(a) authority to doctrines of law that are not endorsed by the Bankruptcy Code, and which encourage pre-confirmation discriminatory treatment of one group of claimholders with the same apparent rights as another, not favored, group.

In addition, Heartland has not shown that failure to enter into new contracts with these prepetition creditors will threaten Heartland's rehabilitation efforts. The only cases which have authorized preferential payments to unsecured creditors who are not employees or former employees of the debtor have approved such payments only when the threat to the debtor has been serious, that is, when the very continuation of the debtor is at risk.

Heartland has shown that it will receive a benefit. The opportunity to pay some prepetition creditors who, in exchange, will continue to do business with a debtor before having to pay the prepetition creditors that are of no continuing business interest to the debtor will benefit this and any other debtor in bankruptcy. The goal of Chapter 11, to rehabilitate the debtor by encouraging profitable post-petition activities, has to be

balanced with the Bankruptcy Code's other policy of treating creditors equitably. To allow the payments as requested will not be fair to those other unsecured claimholders with similar unpaid prepetition claims.

If Heartland needs the post-petition business with the prepetition claimants, Heartland can propose a plan which authorizes immediate payment of these particular claims upon confirmation. The fact that the debtor is involved in litigation with others should not cause the debtor to ignore its need to get on with the bankruptcy case, propose a plan and disclosure statement, and move toward confirmation.

Heartland's motion is denied.

Separate journal entry to be entered.

DATED: February 1, 1995

BY THE COURT:

/s/ Timothy J. Mahoney
Timothy J. Mahoney
Chief Judge

Copies faxed by the Court to:

BOTHE, ROBERT	341-0216
SCHEPERS, FRANK	397-8450
MICHAEL, TERRENCE	344-0588

Copies mailed by the Court to:
Jeffrey Wegner, The Omaha Building, 1650 Farnam Street, Omaha, NE 68102
United States Trustee

Movant (*) is responsible for giving notice of this journal entry to all other parties (that are not listed above) if required by rule or statute.

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF	)	
	)	
HEARTLAND PROMOTIONS, INC.,	)	CASE NO. BK94-81541
DEBTOR(S)	)	
	)	CH. 11
	)	Filing No.
Plaintiff(s)	)	
vs.	)	JOURNAL ENTRY
	)	
	)	DATE: February 1, 1995
Defendant(s)	)	HEARING DATE: January 24, 1995

Before a United States Bankruptcy Judge for the District of Nebraska regarding Motion to Make Payments to Customers of the Debtor.

APPEARANCES

Jeffrey Wegner, Attorney for debtor
Robert Bothe, Attorney for Creditors' Committee
Frank Schepers, Attorney for Donnelly
Terrence Michael and Steven Cohen, Attorneys for Bobley-Harmann

IT IS ORDERED:

Motion to Make Payments to Customer of the Debtor is denied. See memorandum this date.

BY THE COURT:

/s/ Timothy J. Mahoney
Timothy J. Mahoney
Chief Judge

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