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TO: The Solicitor General

FROM: Elizabeth Warren /s/ EW

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RE: Petition for Certiorari for CMC Heartland Partners v. Union Pacific Railroad Company

I have no doubt that every party who comes to the Justice Department asking for help persuading the Supreme Court to grant certiorari argues that the legal issue presented to the court is of the utmost consequence. In this case, however, the claim that the disputed legal issue relates to the very heart of an important part of the legal system is not even a slight exaggeration. The extent to which a bankruptcy filing resolves all the claims based on the debtor's pre-filing past is a question that goes to the essence of what bankruptcy should accomplish.

The Seventh Circuit opinion in *CMC Heartland Partners v. Union Pacific Railroad Company*—like that of the Third Circuit in *In re Frenville Co.*—sharply narrows the range of options available to a bankrupt business to deal with all the parties who may claim its assets. If allowed to stand, the implications of these decisions of failing businesses, for those who are trying to put the assets of those businesses back into productive use, for those who face uncompensated injuries, and for those who have other claims against the business are profound. This is not a simple case of debtor versus creditor, a decision in which favoring one party necessarily injures

another. Instead, this is question about the scope of the bankruptcy laws, about whether they provide a final opportunity to separate the activities of the debtor's pre-bankruptcy past from those of its post-bankruptcy future, and whether all claimants from that past have a right to treatment on an equal footing. When a broad question of scope has been raised by the circuit courts, it deserves the timely attention of the Supreme Court. This is particularly so where, as here, there is a growing conflict among the circuits on the proper resolution to that question.

In this case, long after the Milwaukee Railroad (predecessor in interest to CMC Heartland) filed its bankruptcy and confirmed a plan of reorganization, Union Pacific Railroad is now alleging that it has a right to collect on its pre-bankruptcy indemnification claim. toxic spills—and had a full opportunity to participate in the bankruptcy which it took advantage of, the company claims that the indemnification obligation survived. According to Union Pacific, the only obligations that were discharged in bankruptcy were those indemnification claims it might assert under the laws as they stood at the moment of the bankruptcy discharge. The Seventh Circuit agreed, holding that any new legal basis for liability against a party to whom the debtor once owed indemnification, such as the passage of another environmental law, was adequate to revive the moribund indemnification claim. If this view of claims revival stands, any change in status that creates a new payment obligation for beneficiaries of indemnification, such as a change in state caselaw or statutory law, creates a new claim against a post-bankruptcy entity. This result threatens the essence of a bankruptcy discharge.

Background: The Claims Process in the Bankruptcy System

A few years ago, I was asked by the Federal Judicial Center to write a summary of the operation of the business bankruptcy system, explaining the most important features in non-technical language for use by the non-specialist federal

courts. In the resulting book,[1] which was reviewed by judges throughout the federal system before publication, claims are featured prominently in the first substantive chapter. I explain the starting point of bankruptcy law for both liquidations and reorganizations:

> A profound shift in the relationship between debtors and creditors occurs at the filing of a bankruptcy petition. A new estate is created, comprising both the legal and economic interests of the old debtor and the collective economic and legal interests of the creditors. Creditors lose their individual collection rights against the debtor, and they are forced to deal with an estate operating on behalf of all the creditors.[2]

This fundamental shift is captured more vividly in the claims process:

> The transformation of claims against a debtor into claims against an estate protects the collective nature of the bankruptcy proceeding. By converting creditors' claims against the pre-bankruptcy debtor to claims against a bankruptcy estate, the Code gives the estate manager a position to account for, to monitor, and to value each charge against the estate's assets.[3]

The extent to which the bankruptcy system forces all parties who may call on the debtor for payment into a collective proceeding is governed by the interpretation of the claims provisions first in the Act in section 77 and then in the

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[1] Elizabeth Warren, *Business Bankruptcy* (Federal Judicial Center 1993).

[2] *Id.* at 61.

[3] *Id.* at 61-62.

Code in section 101(5). If this provision is given a narrow reading, the impact on the bankruptcy process is profound: bankruptcy will deal with less than all of the obligations arising from the pre-bankruptcy behavior of the debtor. If the provision is read broadly, then a bankruptcy case may reasonably deal with all the obligations incurred by the debtor, creating a cleavage between the debtor's pre-filing past, which will be dealt with collectively, and the debtor's post-filing future, in which parties may deal individually with the surviving entity.

The practical implications of this difference are enormous. If an obligation of the debtor is not dealt with in the bankruptcy, then the obligation may survive after the bankruptcy case is completed. In some cases, this means that creditors who have a claim tied to the debtor's pre-bankruptcy past may disrupt the debtor's post-bankruptcy future. A claimant who is not dealt with in the collective bankruptcy proceedings, for example, and whose claim is therefore not processed and paid on par with other claimants, may come back to the surviving business after a plan is confirmed to assert claims for compensation that disrupt the post-filing debtor's business.

The Importance of this Issue to the Bankruptcy System

The question of what claims shall be covered in a bankruptcy proceeding involves the distributional issues at stake in any bankruptcy action:

> The claims process is critical to the distributional objectives of the Code. As claims are estimated, valued, and assigned certain priority rights, the distributional scheme of the bankruptcy system comes to life. Whether an obligation owed by a debtor becomes a claim—and can thus be discharged—raises a critical distributional question among competing creditors. Similarly, the discharge of claims or the rewriting of payment

obligations over time necessarily distributes the assets of the estate among competing parties.[4]

If a creditor is denied the opportunity to participate in a final distribution by a failing debtor, the Bankruptcy Code fails to deliver its promised equality of treatment. Similarly, if a creditor can profit from reserving some part of its claim and later collect more from the surviving business, the distributional goal of equality of treatment among creditors is also violated.

A corollary to the equality-of-distribution argument is the reinvestment argument. A principle function of bankruptcy is to preserve the going concern value of a failing business, permitting the business to remain intact rather than to be liquidated for pro rata distribution to its creditors. The creditors of the failing business must be paid at least as much as they would have gotten in the liquidation (a requirement of § 1129(a)(9)), and the going-concern premium can fund higher payments. The business, and the jobs it supplies, can be preserved without imposing additional injury on the creditors. A large part of preservation of going-concern value depends on new capital investment. New money can flow into a business only if the new investors can be certain that old liabilities have been identified and dealt with.

One reason the bankruptcy laws use a very expansive definition of "claim" is to resolve ALL claims—potential and actual, matured and unmatured, contingent and non-contingent, liquidated and unliquidated. If there were unresolved claims outstanding, then new investments in the failing business would be sharply curtailed. Investors would buy assets at lower prices from liquidation sales rather than invest in reorganizing businesses.

In the late 1980s, I engaged in a lengthy debate with Professor Douglas Baird about bankruptcy policy.

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[4] *Id.* at 61.

Notwithstanding our differences on a number of points about striking the appropriate balance between debtors and creditors, we agreed on the critical importance of including all parties who may raise a claim against a debtor for its pre-filing behavior in a single bankruptcy action:

> The bankruptcy system equalizes the treatment of creditors and parties affected by business failure when timing variations leave them with very different formal rights. . . . The Code generally minimizes the consequences of timing differences among the debtor's prepetition creditors as it reorders claims based on an underlying similarity of rights. [footnote omitted][5]

Any decision, such as those in *CMC Heartland* and *Frenville*, that leaves the new business with the risk of unknown, unquantifiable losses that may arise in the future directly undercuts the ability of the business to reorganize in bankruptcy, to maximize its returns to its unpaid creditors and to survive as an employer. If a shift in state law suddenly imposes new losses on a business long after its reorganization is complete, the cost of investing in bankrupt business has just risen sharply.

One final point about the impact of a decision about when a bankruptcy claim arises is in order. That question is implicated in the most difficult cases facing the courts over the next dozen years. Environmental claims, product liability claims, and mass tort claims, for which we have currently only seen the tip of the iceberg, are multiplying against American businesses. A significant number of those businesses will find their way into the bankruptcy courts in the next two decades. At the same time, emerging business practices mean that large

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[5] Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 Mich. L. Rev. 336, 358-59 (1993).

business purchases are now routinely accompanied by indemnification clauses, so that all companies—including those facing financial difficulties—are more likely to have a collection of outstanding indemnification obligations. If the Seventh Circuit opinion in *CMC Heartland v. Union Pacific* stands, every change in state law that alters the potential responsibility of a party—extensions of statutes of limitations, expansions in the sweep of liability principles, development of third-party liabilities—will threaten to unravel bankruptcy reorganizations long-since thought to be settled. Financial reorganization of complex entities will become almost impossible.

If hastily made judicial decisions constrain the reach of the bankruptcy system to deal with the problems identified here, it will be no victory for judicial economy. Instead, decisions creating false boundaries that limit which claims can be collectively treated in a bankruptcy case will spawn countless more cases, as parties dispute whether their particular facts fall inside or outside the newly modified claims definition. Moreover, parties will spend the intervening time maneuvering for position in and out of the bankruptcy system rather than submit their difficulties to a single forum for a unified resolution. Variations in state law, rather than uniform interpretation of the federal bankruptcy laws, will dominate the system. Only by keeping the scope of bankruptcy discharge orders broad, as Congress intended and as the Supreme Court has thus far consistently ruled, can bankruptcy serve as a forum to resolve multiple disputes without expending endless resources on disputes about whether the proceedings include all the disputants.

The kinds of obligations drawn into the bankruptcy process as claims against the estate powerfully affect both the collective nature of the bankruptcy proceedings and the distributional impact of bankruptcy. The lines that are drawn to determine which obligations are included within the bankruptcy discharge are the lines that determine whether the

bankruptcy goals of equality of treatment among creditors and preservation of the going concern value of a business can be realized.

Any decision that limits the scope of bankruptcy discharge orders has a powerful impact on the bankruptcy system. Such a decision will constrain the ability of the parties to settle all disputes related to a debtor's pre-bankruptcy past in a single forum. It will encourage both strategic behavior and multiple lawsuits. It will undermine the central principle of the federal bankruptcy laws—to treat like claimants alike—leaving those with pre-filing injuries to a collective treatment in the bankruptcy proceeding while those whose injuries arise later founder alone, sometimes receiving much better subsequent treatment and other times receiving no compensation at all.

I urge the Justice Department to support the granting of the Petition for Certiorari in *CMC Heartland Partners v. Union Pacific Railroad Company*. The issue will not disappear, and continued uncertainty and division among the circuits will only heighten the costs imposed on all the parties who are trying to deal with claims against a failing company.