Washington University Law Review

Volume 72
Issue 3 *Interdisciplinary Conference on Bankruptcy and Insolvency Theory*

1994

Getting a Handle on Late-Manifesting Claims: A Comment

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GETTING A HANDLE ON LATE-MANIFESTING CLAIMS: A COMMENT

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The problem of how to define and treat contingent claims is one of the most vexing issues with which bankruptcy law must contend. Professor Heidt has tackled a very difficult and unwieldy problem. When it comes right down to it, perhaps the only truth on which everyone can agree in this area is that there are no easy answers.

Professor Heidt contends in her article that at least part of this claims problem is with the Bankruptcy Code itself, specifically the Code's failure to account for what she calls the shifting paradigm of debt: she says the Code is "fifteen years old and fourteen years out of date."[1] I am going to argue by contrast that the claims dilemma is not really a problem with the current Bankruptcy Code or with a shifting paradigm of debt; rather, it is a problem of timing and information that defies any neat solution, and certainly any solution that can be drafted into the Bankruptcy Code.

I. THE *PIPER* CASE

One normally thinks of the contingent claims issue as arising primarily in the context either of environmental liabilities or of mass tort exposure, such as asbestos-related claims. A very recent case, however, serves as a reminder that the slippery slope of claims uncertainty may be lurking even in what may seem to be the most straightforward of business bankruptcies. In *In re Piper Aircraft Corp.*,[2] the debtor airplane manufacturer filed Chapter 11, and during the reorganization, ultimately attempted a sale of assets to a third-party buyer. That sale included a provision for a set-aside to provide for parties who would be injured in the future by planes that were manufactured by Piper prepetition.

The question arose in that case whether these future victims had claims cognizable in bankruptcy. The court said no, that although Congress intended the definition of claims to be broad, there had to be a limit and

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1. Kathryn R. Heidt, *The Changing Paradigm of Debt*, 72 WASH. U. L.Q. 1055 (1994).

2. 162 B.R. 619 (Bankr. S.D. Fla. 1994), *aff'd*, 168 B.R. 434 (S.D. Fla. 1994).

these future injuries went beyond that limit.[3] The court in *Piper* pointed to some practical problems of victim identifiability, and then distinguished the *Manville* asbestosis case on that basis as well: in *Manville* the court had some idea who the future plaintiffs would be; in *Piper* they could be anybody in the world.[4]

The *Piper* court then described three different theories that courts have used to determine just how broadly the Code's definition of "claim" ought to be construed. The narrowest of these theories is the "accrued state law claim" theory. Under that approach, there is no claim cognizable in bankruptcy until the claim has been deemed to accrue under state law.[5] If this theory were applied in the *Piper* case, future victims of injuries from already-manufactured airplanes would not be claimants in this bankruptcy.

At the other extreme from the first theory is the so-called "conduct test," in which a claim exists in bankruptcy as long as the debtor's conduct that gives rise to the ultimate liability has already occurred at the time of the bankruptcy filing.[6] In *Piper*, the conduct test would have recognized the future tort victims as claimants because the debtor had already manufactured the planes that would cause these predicted future injuries.

The court in *Piper* ultimately rejected both of the above theories and embraced yet a third approach to the claims issue: that "claims" in bankruptcy should only be recognized for those individuals who had some type of prepetition relationship with the debtor.[7] The anticipated future victims of plane crashes in the *Piper* case flunked this test because they would not necessarily have had a particular relationship with Piper prior to the filing. Thus, the judge in *Piper* refused to recognize these future victims by refusing to appoint a representative for them in this case.

By refusing to account now for the interests of these future plaintiffs, the *Piper* court misses a larger point about the purpose of bankruptcy. In approaching the issue of how to define claims, one should begin with the premise that we want an approach that separates the issue of asset distribution from the issue of optimal asset deployment.[8] That is, the

3. *Piper*, 162 B.R. at 629.
4. *Id.* at 626-27.
5. *Id.* at 624.
6. *Id.* at 624-25.
7. *Id.* at 625-27.
8. *See* Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 118 (1984) (suggesting that a goal of bankruptcy is to deploy the company's assets as a single owner would).

optimal approach to the claims issue is the one that best enables the reorganizing debtor to create the biggest pie possible.

Such an approach would be one that *does* account for and deal with contingent but unidentified claimants such as those in *Piper*. If you think of reorganization as a hypothetical sale of the assets of the company in bankruptcy, it follows that you would want the sale to be free and clear not just of all liens, but also of all foreseeable liabilities that relate to pre-petition acts of the debtor.[9] By taking this approach, you are probably helping these late-manifesting claimants because this approach will serve to maximize the proceeds of the asset sale to which these claimants will ultimately look for recovery.[10] Furthermore, if we do not account for and discharge these claims, these future plaintiffs may not recover anyway if a rash of such undischarged claims puts the reorganized entity completely out of business.[11]

Given the facts of *Piper*, the court's refusal to adopt the broadest possible definition of "claim" will not cause many problems in the narrow context of that case, since the probable significance of late-manifesting victims was not that great. On the other hand, one could imagine a *Piper*-like case with only slightly different facts in which the court's definition of "claim" would prove disastrous for the future victims that the court refused to recognize as claimants.

II. A *PIPER* VARIATION

Suppose, for example, that two years prior to filing, Piper manufactured a certain model of airplane, the DX-13, that over time proved to have an extremely high rate of design defects. Assume that Piper files bankruptcy, in part due to a series of products liability lawsuits involving the DX-13.

9. *See In re* UNR Indus., 20 F.3d 766, 770 (7th Cir. 1994) ("People pay less for assets that may be snatched back or otherwise affected by subsequent events. . . . By protecting the interests of persons who acquire assets in reliance on a plan of reorganization, a court increases the price the estate can realize ex ante, and thus produces benefits for creditors in the aggregate.").

10. I say "probably" because there is one case where the late-manifesting claimant is better off by not being recognized as a claimant in bankruptcy. That is the case where there are a sufficiently low number of such late-manifesting claimants so that payment of these claims will not put the reorganized entity out of business at a later point. In that case, if late-manifesting claimants do not have "claims" in bankruptcy, they collect 100-cent dollars at a later point from the reorganized entity.

11. *See In re* Johns-Manville Corp., 36 B.R. 743, 746 (Bankr. S.D.N.Y. 1984), *appeal denied*, 39 B.R. 234 (S.D.N.Y. 1984) ("[A] resolution of the interests of future claimants is a central focus of these reorganization proceedings. Any plan emerging from this case which ignores these claimants would serve the interests of neither the debtor nor any of its other creditor constituencies in that the central short- and long-term economic drain on the debtor would not have been eliminated.").

Imagine that Piper's assets are worth $100 million if liquidated piecemeal, but that the company is worth $150 million if sold as a going-concern (net of all liabilities).

In this hypothetical, suppose that the present value of all of Piper's future DX-13-related liability is $100 million and that Piper's additional indebtedness totals $150 million. The fact that the future DX-13 liability is projected to be so large would not change the holding in the actual *Piper* case. In *Piper*, remember, the court denied claimant status to the unknown future injury victims on the basis that they had no prepetition relationship with the debtor. In the hypothetical fact pattern given here, the future victims, though predictably more numerous, have no greater prepetition relationship with the debtor than in the real *Piper* case.

Imagine what would happen to these future victims under the hypothetical facts. The company would file Chapter 11, propose a plan of reorganization to its recognized claimholders, and presumably emerge from bankruptcy. The emergence from bankruptcy would likely be short-lived, however, as additional DX-13 lawsuits would inhibit Piper's cash flow and ultimately force another bankruptcy—this time perhaps a liquidation. In the liquidation, any as-yet-unmanifested tort victims would be completely unable to recover to the extent they were not recognized as claimants, since following liquidation there would be no entity left to pay future claims.

III. HOW DEFINING CLAIMS AFFECTS THE COLLECTIVE ACTION PROBLEM

The problem with *Piper*'s "prepetition relationship" limitation on the definition of claims is that it fails to recognize one of the primary purposes of bankruptcy law: solving state law's collective action problem. Under state-law collection procedures, there is essentially a first-come, first-served system.[12] Thus, whenever a debtor experiences cash-flow problems that threaten its ability to pay its debts as they come due, each individual creditor has an incentive to pursue its remedies as quickly as possible.

This incentive to dismantle the debtor will exist even in cases where all of the creditors would agree that the debtor's assets are worth more as a going-concern than they are liquidated piecemeal. There at least two reasons why individual creditors might take actions which would destroy a debtor's going-concern value. The first is that creditors are often widely

12. *See* DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 3-25 (2d ed. 1990) (providing an overview of state-law collection processes).

dispersed, and therefore transactions costs might prevent the creditors from getting together as a group to discuss the possibility of temporarily forgoing their individual collection rights.

The second reason why individual creditors might take actions that are contrary to the interests of the creditor group is the fear of opt-outs. Even if the creditors could get together as a group, there is nothing under state law which could bind an individual creditor who did not wish to forgo its individual collection rights.

As one of its primary functions, bankruptcy responds to this state-law collective action problem in a way that makes possible the preservation of going-concern values. Bankruptcy helps overcome the problem of dispersed creditors by bringing together in a single forum the entire creditor group. Bankruptcy takes care of the opt-out problem with the automatic stay, which prevents any individual opportunism once the petition has been filed.[13]

In the hypothetical Piper case proposed above, a failure to recognize the future tort victims as bankruptcy claimants would be a failure to utilize bankruptcy's unique role in preserving going-concern values. As long as the bankruptcy court could not account for those future tort liabilities stemming from prepetition acts of the debtor in the reorganization plan, the Chapter 11 process would be ineffective in overcoming the collective action problem.

The reason that a refusal to recognize the future tort victims in the actual *Piper* case did not pose the problem just described is that the predicted size of the late-manifesting claims was not large enough to threaten the postbankruptcy life of the debtor.[14] In the asbestos manufacturer cases, the projected future liability *has* been large enough to pose such a threat. Therefore, these liabilities have been dealt with as part of the plan.[15] The most crucial difference, then, between *Piper* and the asbestos cases is the *magnitude* of the late-manifesting claims, *not* the existence of a "pre-petition relationship" with the debtor.

This observation about differences in magnitude, however, is not to suggest that the scope of the "claim" definition should depend on the

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13. *See* 11 U.S.C. § 362 (1988).

14. The judge in *Piper* essentially conceded this fact. *See Piper*, 162 B.R. at 625 n.9 ("[O]nly a very small percentage of Piper aircraft will be involved in crashes, and only a fraction of those crashes are likely to result from prepetition manufacturing or design defects.").

15. *See* DAVID G. EPSTEIN ET AL., BANKRUPTCY 799-803 (1993) (describing how the major mass tort cases have accounted for future tort victims in their plans of reorganization).

projected magnitude of the late-manifesting injury in question. To rely on relative magnitude as a benchmark for defining claims would be problematic for at least three different reasons.

First, a reliance on predicted future magnitude would create a line-drawing exercise in which the relevant line would be impossible to pinpoint in any meaningful way. Second, even if the place to draw the line were clear, the court's limited ability to predict the actual future magnitude of the late-manifesting harm would still serve as a barrier to the usefulness of such an approach.

Finally, as a statutory matter, the Code's definition of "claim" suggests no such limitation in scope based on predicted future magnitude.[16] If the Code definition of "claim" suggests anything, it suggests the broadest possible scope for recognition of claims in bankruptcy. And, as the above discussion of the collective action problem suggests, there are also good policy reasons for a broad reading of the "claim" definition. Thus, courts that have espoused the "conduct test"—which says that a claim exists at filing if the debtor's conduct that will ultimately give rise to the claim has already taken place—seem to have best effectuated both the language and the policy of the Bankruptcy Code.

IV. ADDRESSING PROBLEMS WITH THE CONDUCT TEST

Adopting the "conduct test" as the appropriate way to define claims in bankruptcy would not, of course, solve all of the problems associated with late-manifesting harms such as those at issue in *Piper*. Even in a world in which bankruptcy courts used the broadest possible definition of "claim," the problem of delayed manifestation would raise at least four distinct issues with which a court might have to contend in a given case.

The first such issue would be notice. From the debtor's perspective, the key reason to include in its reorganization plan the broadest possible class of claimants is to give the debtor the benefit of the bankruptcy discharge.[17] Claimant status is a double-edged sword for all entities so recognized: it means they get to participate in distribution of the bankruptcy estate, but, in return, they must give up any rights to sue the reorganized debtor. Because discharge effectively deprives the affected creditor of a property right, due process dictates that the debtor must employ appropriate

16. Bankruptcy Code § 101(5)(A) defines "claim" to mean "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(5)(A) (1988).

17. *See* 11 U.S.C. § 1141(d) (1988) (defining scope of Chapter 11 discharge).

procedures in attempting to notify such parties.[18]

The second problematic issue, somewhat related to the first, is adequate representation. In cases where effective notice is all but impossible due to lack of information about the identity of the claimants, it is imperative that the court assign some party to represent the interests of these as-yet-unknown parties whose rights are being affected by the reorganization.

The third problem, one that even the broadest definition of claim simply cannot solve, is knowing whether in any given case there will be *any* individuals who will be injured in the future by acts already committed by the debtor. In environmental and mass tort cases, it is sometimes obvious that late-manifesting injuries will be occurring. In other cases, however, one could imagine situations in which virtually nobody could guess at the time of the debtor's filing that acts already taken by the debtor will have future injurious consequences.

The fourth issue, like the third one discussed immediately above, is information-related. Even where the existence of delayed harms is clear, the extent of those future injuries may be far from clear. Yet, in order to proceed with a Chapter 11 plan that accounts for these future injuries, a debtor must make some estimate of just what that magnitude will be.

One device that bankruptcy courts could use to ameliorate the effects of the obstacles described above would be to force the debtor to utilize the insurance market to help account for the uncertainties created by late-manifesting claimants. For example, in the hypothetical variation of *Piper* that was suggested above, the future victims of the DX-13 were projected to be owed a total of $100 million while other claimants were said to be owed $150 million. Therefore, the DX-13 victims should be entitled to forty percent of the value of the reorganized Piper, a total of $60 million.

A court could have the debtor set aside the $60 million in a fund to be drawn upon in the future by DX-13 victims, perhaps with a cap set on an individual victim's recovery. However, under an insurance approach, the debtor would be required to use the same amount of money to buy an insurance policy. The policy would cover future DX-13 victims for a certain fixed percentage, less than 100 cents on the dollar, of whatever damage the future victims could prove to the insurer.

The court-appointed representative of the future victims could solicit bids from the insurance market, and the bidding process could also serve as

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18. *Johns-Manville*, 36 B.R. at 754 ("[T]he concept of dischargeability of claims cognizable in the reorganization may require a showing that due process has been achieved in binding unknown putative claimants to a plan of which they may or may not have had notice.").

means by which the court could obtain better information about the actual magnitude of the late-manifesting claims. In the context of voluntary creditors, the use of insurance to fund unknown future liabilities is quite common. For example, a company that has made promises to retirees about future medical benefits might be required to purchase an annuity to fund those promises, even though at the time of the firm's reorganization the scope of those promises cannot be known with any precision.[19]

The insurance approach would offer at least two advantages over a straight trust fund system. The first is that the bids which came in would give the judge valuable information about the likely extent of future harms arising from the debtor's prepetition acts. Although independent actuaries can be helpful, a party, such as an insurer, whose own money would be at stake would likely provide a more reliable indicator of projected future harm. The information provided by those insurance companies that submitted bids might well cause the judge to readjust its original estimate of the projected future liability. Where that proved to be the case, the percentage of the reorganized firm allocated to the future victims would have to be adjusted accordingly, thus affecting the funds available for the insurance policy.

Second, an insurance policy would make it less likely that the fund would be exhausted before the latest-manifesting victims become known.[20] Put another way, the insurance approach shifts some of the risk of underestimation from the future victims to the insurer. The portion of that risk that would be shifted to the insurer would be in part a function of whatever cap the chosen policy places on either total victims to be compensated or total dollars to be paid out.

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19. *See In re* UNR Indus., 20 F.3d 766 (7th Cir. 1994).

20. This is a problem that the Manville Trust has faced. *See* EPSTEIN ET AL., *supra* note 15, at 802.