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Feature

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When Does a Post-Petition Ordinary-Course Expense Become a Dischargeable Claim?

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In a chapter 11 case with a confirmed plan, when is a post-petition, pre-confirmation liability, one that the chapter 11 debtor incurred in the ordinary course of business and would normally be responsible to pay in the ordinary course, not an administrative expense but instead a dischargeable "claim"? The answer may now be "when it is in the Third Circuit," due to the recent decision in *Wright v. Owens Corning*.[1] If the post-petition, pre-confirmation warranty claim considered in the *Owens Corning* case had instead been presented in, among other courts, the Eighth Circuit under *Sanchez v. Northwest Airlines*[2] and the Sixth Circuit under *Caradon Doors v. Eagle-Picher Industries*,[3] it would have readily been characterized as an ordinary-course-of-business administrative expense and the lawsuit would have been allowed to proceed, irrespective of whether notice by publication of any claims bar date was sufficient.

Critical to understanding how the Third Circuit's opinion developed is the fact that there were two plaintiffs pursuing this class action, one (Patricia Wright) with a pre-petition claim and the other (Kevin West) with a post-petition claim. The plaintiffs' appellate briefs did not even present the argument that West's claim might be an ordinary-course administrative expense. Instead, to West's detriment, his claim got blown by the tailwinds of the Third Circuit's recent conversion on the topic of "what is a claim,"[4] and its related attention to the difficult issue of what constitutes adequate notice of a bar date to someone who does not yet know he or she has a "claim" because no injury has yet occurred. The result is an opinion that unnecessarily extends the reach of the term "claim" without due consideration to the consequences of that extension.

One Class Action, Two Differently Situated Plaintiffs

Owens Corning and related entities filed chapter 11 petitions in the District of Delaware in October 2000. One of the prime motivations for the bankruptcy filing was to deal with the company's liability for asbestos personal-injury claims, of which well over 100,000 had been filed.[5] The claims in this case involved roof shingles. In 1999, Wright contracted with a roofer to replace her roof and install new shingles, paying $12,875 for the roof replacement. Through the roofer, she purchased Owens Corning shingles, which she said came with a manufacturer's warranty that included 15 years of nonprorated coverage.[6]

In the bankruptcy case, an order set the general claims bar date in April 2002.[7] Owens Corning widely published notices of the claims bar date in

1 *Wright v. Owens Corning*, No. 11-2026, 679 F.3d 101 (3d Cir. May 18, 2012) (no pagination yet in published version).
2 *Sanchez v. Northwest Airlines Inc.*, 659 F.3d 671 (8th Cir. 2011).
3 *Caradon Doors and Windows Inc. v. Eagle-Picher Industries Inc. (In re Eagle-Picher Industries)*, 447 F.3d 461 (6th Cir. 2006).
4 Until *JELD-WEN Inc. v. Van Brunt (In re Grossman's Inc.)*, 607 F.3d 114 (3d Cir. 2010), the Third Circuit had adhered to its decision in *Avellino v. M. Frenville Co. (In re M. Frenville Co.)*, 744 F.2d 332 (3d Cir. 1984), which espoused an "accrual test" for determining what is a claim within the meaning of the Bankruptcy Code. *Frenville*'s holding was later restated in *Kilbarr Corp. v. Gen. Servs. Admin. (In re Remington Rand Corp.)*, 836 F.2d 825, 830 (3d Cir. 1988), as holding that "'the existence of a valid claim depends on (1) whether the claimant possessed a right to payment; and (2) when that right arose' as determined by reference to the relevant nonbankruptcy law." 607 F.3d at 119. In *Grossman's*, the Third Circuit described *Frenville* as having been accorded "universal disapproval" and concluded that "the widespread criticism of *Frenville*'s accrual test is justified." 607 F.3d at 121. Unmentioned was that the Second Circuit's current definition of "claim" is nearly identical to the wording in *Remington Rand. See Pension Benefit Guar. Corp. v. Oneida Ltd.*, 562 F.3d 154, 157 (2d Cir. 2009). The Second Circuit has the good sense, however, not to refer to its standard as an "accrual test."
5 Disclosure Statement to Fifth Amended Plan, (Dec. 31, 2005), *Owens Corning*, No. 00-03837, Dkt. no. 16569, pages 19 and 27.
6 450 B.R. at 544.
7 *Id.*, page 74.

numerous national and regional publications.[8] In August 2005, West paid a roofing contractor $10,825 to replace his roof, and the roofer installed Owens Corning shingles, which also came with a warranty.[9]

In September 2006, the bankruptcy court confirmed the debtors' reorganization plan.[10] Soon after, the debtors filed a notice of the entry of the confirmation order, the effective date of the plan and bar dates for certain administrative claims (the notice of effective date).[11] They published it in three national newspapers and one local newspaper.

In 2009, Wright and West first learned about problems with their shingles when they noticed water leaking through their roofs. Each contacted Owens Corning about the warranty and submitted a warranty claim. Owens Corning offered to pay Wright some compensation, but refused to replace her shingles; it simply denied West's warranty claim.[12]

In November 2009, Wright instituted a putative class action in federal court against Owens Corning. In an amended complaint, West was added as a named plaintiff and putative class representative.[13] Owens Corning moved for summary judgment, contending that the claims were discharged in its confirmed plan.

The district court granted Owens Corning's summary judgment motion;[14] the plaintiffs appealed. The Third Circuit agreed that both Wright and West held "claims" under the Bankruptcy Code but reversed in part and remanded, concluding that they were not afforded procedural due-process.

The Third Circuit's Opinion: A Closer Look

The plaintiffs advanced two arguments to the Third Circuit. They argued that the district court's application of *Grossman's* created "the unworkable result that persons who did not anticipate future tort actions at the time of a bankruptcy proceeding nonetheless possess claims that are discharged."[15] They further argued that the due-process analysis fell short.

Revisiting *Grossman's*, the *Owens Corning* panel seemed eager to clarify the standard enunciated. The court explained that the new rule is "an amalgam" of the "conduct test" and the "pre-petition relationship test,"[16] not one or the other.[17] Applying *Grossman's* to Wright and her "unknown future claim," the court easily concluded that she held a "claim" in the bankruptcy case.[18]

But whether West held a claim was "less obvious," the court wrote, "since he purchased the shingles post-petition but pre-confirmation.[19] The court noted that the *Piper* test changed "the focal point of the relationship [between the claimant and debtor] from the petition date to the confirmation date" to be "more consistent" with "the policies" of the Bankruptcy Code.[20] The court then restated and expanded the *Grossman's* test to hold that "a claim arises when an individual is exposed *pre-confirmation* to a product or other conduct giving rise to an injury that underlies a 'right to payment' under the Code."[21]

The court's analysis was flawed for at least two reasons. First, it failed to recognize that the *Piper* test has two parts, one of which retains its focus on the pre-petition conduct of the debtor, thus preserving a prepetition element in claims and creditor status.[22] The new *Owens Corning* test removes any reference to pre-petition activity.

Second, it suffers from a surprising lack of statutory analysis. The court noted that under § 1141(d)(1)(A) confirmation of a chapter 11 plan "discharges the debtor from any debt that arose before the date of such confirmation,"[23] and its analysis essentially stopped there. But the definition of "claim" under the Code is not limited to chapter 11 cases. The court did not justify a definition of "claim" that would be variable based on the chapter under which the case is proceeding. Further, the court bypassed the fact that § 1141(d)(1)(A) refers to "debt" and not "claim;"[24] that the Code defines a "creditor" as "an entity that has a claim against the debtor that arose at the time of or before" the petition date;[25] that the Code provides that proofs of claim may be filed by "creditors;"[26] and that notice of the case is to be provided to "creditors."[27] Having expanded the *Grossman's* test, the court then concluded that since West's "exposure" to Owens Corning's shingles occurred pre-confirmation, he also held a "claim" that was potentially dischargeable under the plan.[28]

The Missing Angle

Chapter 11 is designed to facilitate debtors continuing in business and reorganizing, and the Code aims to minimize the effect that a filing has on discouraging persons and entities from doing business with a company just because it filed for bankruptcy relief. Among other things, the Code allows debtors to make (and pay for) "ordinary-course-of-business" purchases for their businesses without court approval.[29] If a party in a post-petition transaction has not received payment from the debtor, it may apply to the bankruptcy court for payment as an administrative expense, representing the "actual, necessary costs and expenses of preserving the estate."[30] If payment is made in the ordinary course, no request to the court is needed.[31] Administrative expenses are generally distinguished from "claims."[32]

8 *Wright v. Owens Corning*, 450 B.R. 541, 546-547 (W.D. Pa. 2011).
9 *Id.* at 544-545.
10 *Id.* at 545.
11 Notice of Effective Date, *Owens Corning*, No. 00-03837, Dkt. no. 19659.
12 450 B.R. at 544-45.
13 *Id.* at 543.
14 *Id.* at 557.
15 *Slip op.* at 8. Some unworkability of *Grossman's* was implicit in *In re Rodriguez*, 629 F.3d 136 (3d Cir. 2010). Trying to apply *Grossman's* to a mortgage lender's post-petition collection of escrow claims—far afield from the product liability context—the *Rodriguez* court summed up the gist of *Grossman's* as being that "our focus should not be on when the claim accrues...but whether a claim exists," and proceeded to address whether a claim existed. 629 F.3d at 142.
16 *Grossman's* identified the conduct test mainly with a Fourth Circuit case, and identified the pre-petition relationship test with *In re Piper Aircraft Corp.*, 58 F.3d 1573 (11th Cir. 1995).
17 *Slip op.* at 10-11.
18 *Id.* at 12.
19 *Id.*
20 *Id.* (citing *Piper*, 58 F.3d at 1577-58, n. 5).
21 *Slip op.* at 13.
22 The *Piper* test is that an individual has a claim against a debtor manufacturer if: "(i) events occurring before confirmation create a relationship...between the claimant and the debtor's product; and (ii) the basis for liability is the debtor's pre-petition conduct in designing, manufacturing and selling the allegedly defective...product." *Grossman's*, 607 F.3d at 124-25.
23 *Slip op.* at 12-13 (citing 11 U.S.C. § 1141(d)(1)(A)).
24 "Debt" is defined in the Code as "liability on a claim." 11 U.S.C. § 101(12). Courts have typically regarded "debt" and "claim" as two sides of the same coin, without discussing the effect of the word "liability" in the definition of "debt."
25 *See* 11 U.S.C. § 101(10)(A).
26 11 U.S.C. § 501(a).
27 Fed. R. Bankr. P. 2002.
28 *Slip op.* at 13.
29 11 U.S.C. § 363(c)(1).
30 11 U.S.C. § 503(a) and (b)(1).
31 *See Wallach v. Frink America (In re Nuttall Equipment Co.),* 188 B.R. 732, 737 (Bankr. W.D.N.Y. 1995) ("In a business of any complexity, there are many administrative expenses—ordinary costs of doing business—for which no 'request for payment' is ever made to the Court (although the debtor is billed or charged in the normal course.").
32 *See* L. Bartell, "Straddle Obligations under Pre-Petition Contracts: Pre-Petition Claims, Post-Petition Claims or Administrative Expenses?," 25 *Emory Bankr. Dev. J.* 39, 41 (2008).

If an accident occurs post-petition due to the debtor's negligence, the resulting tort liability is also considered an administrative expense of the estate under the principles of the Supreme Court's *Reading Co. v. Brown*.[33] *Reading* was decided under a provision of the Bankruptcy Act (prior to 1978) that was carried over into § 503(b)(1) of the Bankruptcy Code. The principle is that "[t]ort liability is an expense of doing business, like labor or material costs, and should be treated the same way," as Judge Richard Posner summed it up.[34]

Under *Reading*'s principles, where post-petition ordinary-course-of-business transactions have led to lawsuits, courts have regarded them as "ordinary-course" administrative expenses and have allowed the lawsuits to proceed, notwithstanding the discharge provided in the debtors' confirmed plans.[35] In *Northwest Airlines*, an employee sued his employer alleging post-petition disability discrimination; the question was whether the claim had been discharged by the debtor's confirmed plan. In *Eagle-Picher*, a creditor sought to pursue post-petition, pre-confirmation claims against the debtor for contributory patent infringement and breach of contract, and the debtor maintained that the claims were discharged under its plan.

In both cases, the courts found that the claims involved post-petition liabilities incurred in the ordinary course of business, and consequently, they were not discharged by the debtors' confirmed plan. In both, attention was accorded to the debtors' notices setting bar dates for administrative claims. Each court observed that the debtors' notices carved out an exception for liabilities incurred in the ordinary course of business.[36]

As it turns out, Owens Corning's notice of effective date, with its bar dates for certain administrative claims, contained a similar exception, stating that "no request for payment of an Administrative Claim need be filed with respect to an Administrative Claim, which is paid or payable by a Debtor in the ordinary course of business."[37] As West's purchase of the shingles was surely an ordinary-course transaction, he would have benefited from the arguments that prevailed in *Northwest* and *Eagle-Picher*.

Practical Implications

The *Owens Corning* decision has the potential to present significant and presumably unintended concerns for product manufacturers seeking to reorganize. If this opinion had been in force when *Owens Corning* had commenced its chapter 11 case, then to satisfy obligations to provide proper notice to all customers purchasing its products post-petition and pre-confirmation, Owens Corning would probably need to alert all of its purchasers—and to the extent that the purchasers were roofers, it would need to alert the roofers to in turn alert *their* customers—that (1) Owens Corning is in bankruptcy; (2) by purchasing these shingles you have a "claim" in the bankruptcy case with respect to any problems that may arise with the shingles any time in the future; (3) notwithstanding the warranty that comes with these shingles, you are at risk of having your "claim" discharged in the bankruptcy case; (4) there may be a claims bar date applicable to you in the case and you should consult a lawyer about filing it; and (5) even if you do file a claim after purchasing these shingles but before problems, if any, arise, that claim would be regarded as contingent and consequently may be dischargeable for that reason.[38]

It would hardly seem sufficient notice to do less than that, but doing so would also hardly be a formula for preserving a debtor's business and its customers. *Owens Corning* does not appear to have taken into account that the practical impact of making post-petition, pre-confirmation claims dischargeable could actually be detrimental to a manufacturer's hopes to reorganize. All of this would have been avoided had the court considered that the post-petition warranty claim was an ordinary-course administrative expense. abi

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33 391 U.S. 471 (1968).
34 *In re Resource Technology Corp.*, 662 F.3d 472, 476 (7th Cir. 2011).
35 *See Northwest*, 659 F.3d 671; *Eagle-Picher*, 447 F.3d 461; and cases cited therein. *See also Resource Technology*, 662 F.3d at 475-77.
36 659 F.3d at 678; 447 F.3d at 467.
37 *See* n. 11, *supra*. The notice of effective date was not in the record on appeal.
38 *See In re Caribbean Petroleum Corp.*, Case no. 10-12553, Mem. Op. (Bankr. D. Del. May 24, 2012).