No. 08-1254

IN THE

Supreme Court of the United States

ZURICH AMERICAN INSURANCE COMPANY,
Petitioner,

v.

LEXINGTON COAL COMPANY, LLC,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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Before the decision below, it was settled law that when a creditor provides goods or services to a debtor in bankruptcy, its claim for payment is entitled to administrative-expense priority. As this Court held in *Reading Co.* v. *Brown*, 391 U.S. 471, 483 (1968), costs "ordinarily incident to operation of [the debtor's] business" receive administrative priority. That priority is critical: without it, parties would be unwilling to risk dealing with debtors. And without the goods, services, and credit necessary to operate their businesses during bankruptcy, debtors would be unable to reorganize, or even liquidate in an orderly fashion—frustrating the

basic purpose of bankruptcy and harming debtors and creditors alike.

The lower court acknowledged that the insurance Zurich provided "was critical to the Debtors' operations. Without [it], the Debtors would have been unable to operate their business[.]" Pet. App. 10a-11a. Yet it held that the deductibles the debtor was contractually obligated to pay for that insurance—obligations the court found "will inevitably arise" and "reach well into the millions of dollars," *id.* 28a n.17—were not administrative expenses. It reasoned that because the deductibles would not come due until after the debtor's liquidation, their payment would not benefit the estate. *Id.* 27a, 33a. Accordingly, it concluded, Zurich could not recover for the deductibles in bankruptcy, but only from the post-liquidation debtor—a "right to recover [that] exists in theory but is not enforceable in practice." *Reading*, 391 U.S. at 478.

That reasoning cannot be reconciled with *Reading*'s core holding: in evaluating whether a claim warrants administrative priority, the question is not whether *payment* of the claim would benefit the estate, but whether the claim stems from the debtor's operations during bankruptcy. And it is in square conflict with decisions of other courts of appeals recognizing that *all* obligations relating to a debtor's operations during bankruptcy are entitled to administrative priority, even if the debtor liquidates before those obligations would otherwise mature. The Sixth Circuit's conclusion that Zurich's claim for deductibles would not arise until after the debtor's liquidation, when it would mature under state law, likewise conflicts with decisions of other courts of appeals holding that unmatured claims—including contract claims—are nonetheless claims entitled to payment in bankruptcy.

Respondent Lexington attempts to distract attention from these important legal questions by repeatedly sounding two themes: that this case is a mere contract dispute controlled by the terms of the insurance policies; and that the issue presented is "narrow," "rare," "unique," and limited to these specific facts. Each of these contentions is wrong. This case does not present a question of contract law, but a question of bankruptcy law: whether obligations arising from the debtor's conduct during bankruptcy, but maturing only later, are nonetheless claims in bankruptcy entitled to administrative priority. And, far from being limited to the facts of this case, this question arises in a wide variety of circumstances—including, for example, on-going environmental obligations arising from the debtor's operations in bankruptcy. *See* State Amici Br. 18-19.

As the amici demonstrate, the questions presented here are critically important to creditors, shareholders, and employees of companies in bankruptcy—as well as those companies themselves. In light of the nation's economic crisis and the wave of bankruptcies of major corporations that has already begun, this Court should resolve these issues now.

I. THE COURTS OF APPEALS ARE DIVIDED ON WHETHER FUTURE OBLIGATIONS ARISING FROM A DEBTOR'S CONDUCT DURING BANKRUPTCY ARE ADMINISTRATIVE EXPENSES

Zurich's petition demonstrated that the decision below squarely conflicted with decisions of the First, Second, and Fourth Circuits: *In re Hemingway Transport, Inc.*, 993 F.2d 915 (1st Cir. 1993); *In re Klein Sleep Products, Inc.*, 78 F.3d 18 (2d Cir. 1996); *In re Merry-Go-Round Enterprises, Inc.*, 180 F.3d 149 (4th Cir. 1999). Lexington attempts to distinguish these cases

by arguing that they arose on different facts. That is irrelevant. Each case presents the same legal question: whether obligations arising from the debtor's operations during bankruptcy are entitled to administrative priority even if the debtor liquidates before those obligations would otherwise come due. And each reaches a result that cannot be reconciled with the Sixth Circuit's holding here.

Lexington first argues (Opp. 12-13) that *Hemingway* considered "post-confirmation obligations in connection with environmental obligations under CERCLA," and "[t]his case has nothing to do with CERCLA liability." To be sure. But Lexington does not dispute the key points that put *Hemingway* squarely in conflict with the decision below: The claimant there, Juniper, which purchased contaminated property from the debtor during its bankruptcy, sought administrative-expense priority for environmental clean-up costs that would come due, if at all, only after confirmation, that it might never incur, and whose amount was uncertain. The First Circuit rejected the argument that administrative priority was unavailable because future clean-up would not benefit the estate, holding that the proper inquiry was whether the *consideration* received from Juniper (the contaminated property's purchase price) benefited the estate. And it granted administrative priority to the estimated future clean-up costs. 993 F.2d at 929-930, 934. There can be no doubt that Zurich would have prevailed under this analysis.

Lexington's only other attempt to distinguish *Hemingway* is to quote a passage from that decision—"[o]nly 'actual' administrative expenses, not contingent expenses, are entitled to priority payment under ... §503(b)(1)(A)," 993 F.2d at 930—that Lexington contends (Opp. 13-14) supports the Sixth Circuit's conclu-

sion that future payment obligations cannot be administrative expenses.

Lexington misunderstands that passage, which, as its context makes clear, addresses an entirely different issue. Under CERCLA, both the debtor and Juniper were potentially liable for clean-up costs. The First Circuit thus had to determine whether Juniper's claim for future clean-up costs should be disallowed under §502(e)(1)(B), which (to avoid double recovery) requires disallowance of contingent contribution claims by entities that are co-liable with the debtor. If Juniper were co-liable with the debtor under CERCLA, its "contingent" claim for future clean-up costs could not be allowed. The passage on which Lexington relies simply clarifies that the §502(e)(1)(B) limitation on allowance of "contingent" claims applies to administrative expenses as well as pre-petition claims.

But the First Circuit made perfectly clear that if Juniper surmounted §502(e)(1)(B) by proving that it was *not* co-liable with the debtor, its claim for future clean-up costs would receive administrative priority despite being "contingent." The court's holding is unmistakable: if §502(e)(1)(B) does not apply, Juniper's "claim for past *and future* response costs should be estimated and allowed as administrative expenses entitled to priority." 993 F.2d at 934 (emphasis added); *see id.* at 936. The Sixth Circuit's decision is in direct conflict with that holding.

Lexington similarly attempts (Opp. 15-16) to limit *Klein Sleep* and *Merry-Go-Round* to their facts, arguing that each turned on an express contractual provision for acceleration of future rent obligations in case of breach. Initially, *Klein Sleep* nowhere indicates that the lease there contained any such provision. More

fundamentally, neither decision focused its analysis on the lease's terms or framed the question as one of contract law. Rather, each stands for the proposition that, when the debtor enters a contract during bankruptcy, "*all* liability under the [contract]" is an administrative expense. *Klein Sleep*, 78 F.3d at 22.

Indeed, both *Klein Sleep* and *Merry-Go-Round* rejected the precise arguments Lexington advanced, and the lower court adopted, here. In *Klein Sleep*, the trustee contended that after the debtor decided to liquidate and the trustee surrendered the premises, the estate derived no benefit from the lease, and future rent thus was not an administrative expense. That argument, the Second Circuit explained, "relies on an unduly narrow view of the benefit conferred on an estate when a trustee assumes" a contract. 78 F.3d at 24. Because the lease was assumed during bankruptcy and the debtor enjoyed its benefits before liquidating, the landlord was entitled to administrative priority for *all* lease obligations.

Merry-Go-Round similarly held that future rent under a lease assumed and then repudiated following a decision to liquidate was an administrative expense. It reasoned that the expense was "actual" because it "arose out of a post-petition transaction" with the debtor, and "necessary" because the lease benefited the debtor before liquidation. 180 F.3d at 157-158. "If landlords ... are not guaranteed to receive ... administrative priority on future rent, then they would have little incentive" to do business with debtors. *Id.* at 158. Far from being limited to its facts, the court explained, "this same argument could be equally applied to any other ... executory contract." *Id.*

This case is no different from *Klein Sleep* and *Merry-Go-Round*. Here, as there, the debtor assumed a contract necessary to continue its business in bankruptcy. Here, as there, the reorganization failed and the debtor liquidated, leaving it unable to fulfill its contractual obligations. Here, as there, the contract nonetheless conferred an unmistakable benefit upon the debtor's estate, and—under the reasoning of the Second and Fourth Circuits—all liability under the contract is thus entitled to administrative priority.

Ultimately, Lexington's arguments reduce to one mistaken assertion: that a claim's allowability and priority are controlled by the contract's terms, and that Zurich could not "accelerate" the date the deductibles would come due under the policies by asserting a claim for those deductibles in bankruptcy. That contention reflects a thoroughgoing misunderstanding of how bankruptcy works. Because bankruptcy's purpose is to distribute a limited estate among all identifiable creditors, most courts of appeals treat unmatured or contingent payment obligations, including obligations under a contract, as claims in bankruptcy. *See, e.g., In re Stewart Foods, Inc.*, 64 F.3d 141, 144 (4th Cir. 1995) (a creditor's pre-petition claim for future payments under a contract "is not defeated simply because his right to the individual payments had not yet become due as of the date of the bankruptcy filing"); Pet. 21-29. That is not an improper "acceleration" of the contract's payment terms, but simply a function of bankruptcy's requirement that all claims be liquidated by a date certain. The question here is whether administrative expenses—which are merely post-petition claims—should be treated any differently. The First, Second, and Fourth Circuits have concluded that they should not be, and that all obligations stemming from a debtor's con-

duct during bankruptcy, including future-arising obligations, are administrative expenses. The Sixth Circuit's holding cannot be reconciled with those decisions.

II. This Case Is An Appropriate Vehicle For Resolving The Entrenched Split Of Authority Regarding When A Bankruptcy Claim Arises

As Zurich's petition demonstrated, the courts of appeals are in disarray regarding one of the most basic questions in bankruptcy: when a "claim" arises that can be asserted—and potentially discharged—in bankruptcy. By holding that Zurich could not recover for future deductibles in the bankruptcy, but could proceed only against "the dissolved estate," Pet. App. 24a, the court below concluded that Zurich's claim would arise only after the bankruptcy, when a right to payment would accrue under state law. *See also id.* 33a-34a; Pet. 21-22. In doing so, it adopted the minority position previously endorsed by the Third Circuit, and exacerbated the existing split of authority.

Lexington readily acknowledges (Opp. 21-22) the long-standing and entrenched division of authority on this critical issue of bankruptcy law. And it does not deny that the lower court held that Zurich's claim would arise only post-bankruptcy—indeed, it endorses that position. Opp. 32 ("[T]he obligation to reimburse the deductibles will not even arise by contract until [after confirmation]. Claims incurred post-confirmation are simply ordinary creditor claims against the post-confirmation debtor."). Instead, Lexington contends—in an argument spanning many pages, but ultimately reducing to a single point—that the split is not implicated here because it involves only the construction of §101(5), which defines "claim" to include "unmatured" and "contingent" rights to payment. To receive admin-

istrative priority, Lexington argues, a claim cannot be unmatured or contingent.

Lexington's contention that the split is not implicated is simply wrong. The court below did not hold that Zurich had a claim in bankruptcy while denying that claim administrative priority; rather, it held that Zurich would have a claim only after bankruptcy, against the "dissolved estate." Pet. App. 24a. It thus took sides in the split regarding when a claim arises.

Even if the court had held only that unmatured obligations cannot be administrative expenses, however, this case would still implicate that split. Administrative expenses are simply claims that arise during bankruptcy. Pet. 22-23. And, as discussed in Part I, other courts have held—contrary to Lexington's position—that administrative expenses include unmatured obligations arising during bankruptcy. If those courts are correct, this case presents the question whether Zurich's claim for future deductibles arose, and could thus be asserted as a priority claim, during bankruptcy. If they are not correct, this case still presents the question whether Zurich could assert a non-priority claim in bankruptcy. In short, it makes no difference that this case involves an administrative-priority claim: to have an administrative claim, Zurich must first have a claim under §101(5). This case thus enables this Court to resolve the question that has long divided the courts of appeals: when a claim—be it a pre-petition claim or a post-petition administrative claim—arises under the Bankruptcy Code.[1]

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[1] Lexington also points (Opp. 23-24) to another Sixth Circuit case, *In re Sunarhauserman, Inc.*, 126 F.3d 811, 818 (6th Cir. 1997), that contains a sentence that could be read to reject the

III. THE DECISION BELOW WRONGLY RESOLVES AN IMPORTANT ISSUE AND WARRANTS IMMEDIATE REVIEW

The Sixth Circuit's decision is a dramatic departure from the basic principles set out by this Court. As *Reading* held, administrative expenses—the "'actual and necessary costs'" of preserving the estate—include all "costs ordinarily incident to operation of a business." 391 U.S. at 483. The deductibles here are the debtor's payment for insurance necessary for its business. Under *Reading*, those obligations are entitled to administrative priority.

Lexington argues (Opp. 17) that *Reading* is relevant only to "a select group of difficult to classify claims," and has no bearing on contract claims. That is untenable: *Reading* construed the administrative-priority statute in light of basic bankruptcy purposes. 391 U.S. at 475-476. That construction governs *all* administrative expenses, not some "select group." And it refutes the lower court's conclusion that the deductible obligations conferred no "benefit" on the estate; the state-mandated *insurance* unquestionably conferred a benefit by permitting the business to operate. *See id.* at 483; *see also, e.g., In re H.L.S. Energy Co.*, 151 F.3d 434, 437-439 (5th Cir. 1998) (satisfying obligation to plug unproductive oil wells "benefited" estate by permitting operation of business in accord with state law).

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state-law accrual theory. But as the petition explained (Pet. 25 n.9), that sentence, which did not discuss *In re M. Frenville Co.*, 744 F.2d 332 (3d Cir. 1984), or any other decision in the split, has been disregarded by subsequent Sixth Circuit decisions—the decision below and *CPT Holdings, Inc.* v. *Industrial & Allied Employees Union Pension Plan*, 162 F.3d 405 (6th Cir. 1998), which have expressly or implicitly endorsed the Third Circuit's *Frenville* line of authority.

Moreover, the Sixth Circuit's incorrect decision will have serious and broad repercussions. As the State amici demonstrate, it threatens to disrupt the sound operation of bankruptcy law at precisely the time when our nation's economy depends on its smooth functioning. Insurers will be unwilling to offer low-cost deductible policies, endangering debtors' ability to obtain necessary insurance. More generally, lenders and vendors will hesitate to deal with debtors if all obligations arising from those dealings will not receive priority.

Lexington attempts to blunt the impact of the Sixth Circuit's misguided decision by repeatedly claiming that the issue presented is "narrow" and "rare." Not so. Initially, Lexington is wrong that the policy here, under which the insurer advances deductibles, is "unique." Opp. i. It is, in fact, a common arrangement when the insured is a company rather than an individual. Indeed, some states *require* such an arrangement for workers' compensation insurance. *See* Cal. Ins. Code §11735(e)(3). Moreover, as the State amici explain (Br. 17), the same issues arise with respect to self-insured companies, which include such large companies as Chrysler and General Motors, both now in bankruptcy. When such companies become insolvent, state funds pay injured workers and assert claims in bankruptcy. If such claims did not receive administrative priority, many state funds would face insolvency themselves.

More broadly, on the Sixth Circuit's view, any vendor providing goods or services to a debtor while requiring payment in the future would risk going unpaid if the debtor liquidates before payment would otherwise come due. And, as the State amici explain (Br. 18-19), the same legal question arises in scenarios involving involuntary creditors, such as environmental clean-

up costs that result from a debtor's operations in bankruptcy, but continue after the bankruptcy's conclusion. Under the Sixth Circuit's reasoning, States (or the EPA) could never recover in bankruptcy for such future clean-up costs, and if the debtor liquidates, would have no effective recourse against it.

Finally, Lexington repeatedly emphasizes Zurich's attempts to obtain collateral to secure the debtor's obligations, arguing that the issue presented arises only because some collateral failed. But the collateral is entirely irrelevant to whether Zurich has a claim for deductibles entitled to administrative priority. Initially, Lexington's focus on collateral begs the question presented: if, as Lexington contends, Zurich has no claim in bankruptcy for the deductibles, but can proceed only against the dissolved post-bankruptcy entity, collateral from the debtor would not protect Zurich. Moreover, contrary to Lexington's suggestion, administrative creditors routinely seek and obtain collateral, in part to protect against administrative insolvency—the risk that the estate will have insufficient assets even to pay administrative claims. Indeed, most loans to debtors-in-possession are secured by collateral. *See* 11 U.S.C. §364(c) (contemplating that debtors-in-possession will obtain secured loans). But it does not follow that such lenders' claims do not enjoy administrative priority. In short, the existence of collateral has no bearing on the important unresolved issues presented here—issues that arise in a wide variety of bankruptcy cases and merit this Court's review.

CONCLUSION

The petition should be granted.

Respectfully submitted.

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