CHAPTER 5: INDIVIDUAL COMMISSIONER VIEWS
Dissent from Recommendation to Amend Section 724(b)
Babette Ceccotti

Revenue shortfalls experienced by local governments undoubtedly stem from any number of causes. The role of this relatively obscure section of the Bankruptcy Code in creating revenue shortages perhaps has been overstated in the drive to reverse a long-standing policy to protect the payment of wage and other priority claims in the most desperate bankruptcy cases.

Some updating of section 724(b) may be warranted in light of the expansion of claim priorities under section 507(a). Many who commented on the section 724(b) proposals, including a number of local taxing authorities, were not opposed to maintaining the subordination of tax liens to a limited list of priority claims that included wage priority claims under section 507(a)(3) and(4). Criticism regarding the operation of section 724(b) focused on other types of expenses entitled to payment ahead of tax liens, most notably, professional fees incurred in connection with a pre-conversion Chapter 11 case. Other complaints stemmed from examples where funds generated by the operation of section 724(b) may have compensated others in remote locations because the bankruptcy case was not filed in the community where the property was located. These are insufficient grounds to reverse an important policy originally intended to protect wage claims and Chapter 7 administrative expenses. Senate bill S. 1149, known as "The Investment in Education Act of 1997," 143 Cong. Rec. S8823 (September 4, 1997), correctly restores the wage priorities that are subordinated to ad valorem tax liens under the Commission's Recommendation.

Delineating the payment priorities involves making fundamental choices about the bankruptcy distribution scheme. Amendments to section 724(b) should not be undertaken without a more thorough and exacting review of the competing interests.
Dissent From Recommendation Regarding Small Business Chapter 11 Cases

Babette Ceccotti, Hon. Robert Ginsberg

The Commission's study of small business cases generated a substantial volume of testimony and written commentary from interested parties. The record gathered in the development of these proposals reveals widely divergent reactions both to the problems identified in the Recommendation and the proposed solutions. A number of the individual proposals are undoubtedly worthwhile. For example, the identification of necessary financial information to be generated by the debtor and establishing benchmarks which could indicate that a company is unable to reorganize (such as an inability to maintain insurance coverage) would offer additional structure where a lack of oversight otherwise leaves cases with no clear path to a resolution.

While a need for improved case management is evident from a review of the studies and case management programs in districts where local initiatives have already taken hold, whether the set of proposals comprising the Commission's Recommendation is the correct, "one size fits all" solution is a separate and more questionable notion. Unlike the 1994 small business amendments, which sought to simplify the process for less complicated cases, the Commission's Recommendation sets up a requirement-laden, inflexible program aimed primarily at removing cases from the system that cannot confirm plans in the limited time permitted. In effect, the Recommendation creates a double standard for access to Chapter 11 based on the amount of the debt.

If anything, the debate generated by the development of the proposal made a convincing case for encouraging local initiatives designed to address case management concerns in a particular district. For example, a study of ten Los Angeles Division bankruptcy judges submitted by then U.S. Trustee Marcy J.K.


2The prescribed time limits, the standards for obtaining extensions, the additional compliance requirements and the limitations on subsequent bankruptcy filings clearly would work to limit access to the bankruptcy system. Whether this raises potential constitutional questions has not been explored.
Tiffany identified various characteristics of the cases filed in that district, discussed the compliance mechanisms that grew out of the problems in that district, and reviewed their effectiveness. Undoubtedly, Judge Small and Judge Perris' efforts involved similar locally based studies. Rather than combine individual features of these and other, locally developed programs into one, substantively detailed, mandatory case management system, a better approach would have been to propose a process for the identification of case management issues and the development of local solutions.

The Recommendation unnecessarily reduces the flexibility that is one of the most valuable features of Chapter 11 and substitutes case micro-management through statutory and rules requirements. The judges would become gatekeepers and schedulers, severely constrained even in the granting of extensions. In addition, the proposed amendments to the standards for conversion or dismissal under section 1112 or appointment of an trustee under section 1104 would operate harshly to reduce the discretionary nature of the current provisions. While the Commission heard some complaints that extensions of time to meet basic compliance requirements were not being determined and applied realistically, the Recommendation has gone too far in taking away the courts' discretion in imposing remedies.

The portion of the nation’s economy supported by small business is highly interdependent, with small businesses often serving as suppliers to and buyers from other small businesses. Employees, businesses that buy and sell, taxing authorities, utility companies and many other entities suffer whenever a small business is forced to close or when assets are dissipated in a lengthy and expensive liquidation. Everyone benefits when these businesses and their owners have access to a bankruptcy system that provides an opportunity to save a viable business or, when a feasible reorganization is not possible, to liquidate efficiently. Yet, the Commission’s Recommendation would make reorganization more difficult for many failing companies.

The Recommendation presents a genuine concern that businesses, unable to scale the hurdles of the new requirements, will not even seek to reorganize. For

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3 As the Commission learned in its study of these issues, a persuasive argument can be made that few changes, if any, need to be made to the Bankruptcy Code or rules to produce better case management in a system where the judges take charge of case management. See, e.g., Bufford, 4 Amer. Bankr. Inst. L. Rev. at 85-86; Letter from Hon. A. Thomas Small to Stephen H. Case (Feb. 12, 1997).

4 Given the serious, substantive, and effective case management programs that have been initiated by bankruptcy judges, this is a curious and ironic feature of the Recommendation.

5 These proposals are not limited by the Recommendation to the "small" business cases.
those businesses and others who depend upon their existence, the merits of utilizing Chapter 11, e.g., enhancement of asset value, an orderly and collective resolution of claims, and the preservation of jobs, will not be available at all.

The $5 million debt definition raises the possibility that the term, “small business” as used in the Recommendation, could actually apply to a majority of the business cases filed in a district, as the Report concedes. Moreover, by its terms, the Recommendation applies to all “single asset” real estate cases as well. The Recommendation thus reveals an unmistakable sense that it is not the failing business lingering aimlessly in Chapter 11 that is the target so much as it is Chapter 11 itself. If that is the message of the Recommendation, then a more fundamental debate about Chapter 11 must be resolved--or at least the clear policy choices identified--before large scale case management proposals can be realistically considered.

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6While the ostensible rationale for the proposals is a lack of creditor oversight, no such distinction is made in the scope of the cases that would be subject to "small business" treatment.
Dissent from Recommendation to Make Bankruptcy Judges Article III Judges

By Commissioner Babette Ceccotti
Honorable Edith H. Jones
Commissioner James I. Shepard

This Commission has recommended that bankruptcy judges be appointed as Article III federal judges. Principal reasons for the recommendation include enhancing the prestige of the office, improving the quality of judges, streamlining bankruptcy procedure and reducing delay and expense. The Commission’s recommendation implies that the 350-plus new Article III trial judges created by their proposal would exercise only bankruptcy jurisdiction.

Congress has historically increased the size of the Article III judiciary only reluctantly, given the politics involved in affording one political party or the other an opportunity to increase the size of the judiciary, and the acute sensibility of the Judicial Conference on the subject. Congress’ failure to confer Article III status on the bankruptcy judges in 1978 has been attributed to forces such as these. In revisiting the issue after the Supreme Court’s decision in Northern Pipeline Construction Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982), Congress again declined to grant the bankruptcy courts Article III status and wrangled over the addition of dozens of other federal judgeships. There is little reason to expect that the proposal supported by a majority of our colleagues will not suffer the same fate as these earlier efforts.

But if there were a chance that this proposal would be considered legislatively, it should be rejected as unnecessary for several reasons.

First, none of the supporters of this proposal believe that there is a constitutional imperative to afford bankruptcy relief only through Article III courts. The system has not functioned that way for 100 years; no Supreme Court decision has suggested or intimated such a necessity. The question has always been that of properly and constitutionally

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allocating administrative and litigation responsibilities among trustees, bankruptcy judges, state courts, or Article III federal courts. To insist upon Article III status for bankruptcy judges applies a remedy much broader than the perceived problem.

If, as the Report suggests, the bankruptcy courts may be criticized as “insular and self-referential,” or even “pro-debtor,” it is not as a result of the judges’ lack of Article III status. Whether or not the bankruptcy judges are Article III judges, they will still hear only bankruptcy cases and the operative law to be applied will be the same. The Bankruptcy Code is designed to advance bankruptcy outcomes, such as reorganization and the discharge of claims, in a manner that intentionally disrupts non-bankruptcy obligations and relationships. It is the law itself that is insular in this regard. Transforming the bankruptcy judges into an Article III judiciary will not introduce a more “generalist” perspective into the system. If that is the goal, then it is the Bankruptcy Code that would have to change, not the judiciary.

Second, consistent with at least one study made available to the Commission, the number of bankruptcy decisions raising any jurisdictional issues has been declining steadily since the 1984 BAPFA amendments. Only a handful of reported opinions on jurisdictional issues were identified in 1995. Thus, to the extent that there remain uncertainties at the margins of bankruptcy court jurisdiction, the courts and parties seem to be functioning without the necessity of dispositive litigation or legislation. While bankruptcy jurisdictional problems are vexing in the few cases that pose them, there is no reason to conclude that they are more common than those of Article III courts, whose jurisdiction is limited by statute and which co-exist in a federal system of dual sovereignty. The bankruptcy community may lack perspective on the magnitude of the alleged problem.

With respect to the charge that uncertainty over the extent of bankruptcy court jurisdiction leads to litigation delay, the occasional, convoluted case

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8 See study prepared by Professor Susan Block-Lieb and submitted to the Working Group on Jurisdiction and Procedure at its October 19, 1996 meeting.

9 See supra n.2, reporting that approximately 1.5% of reported 1995 decisions involved a jurisdictional question.
history does not argue persuasively for this remedy, particularly given the recognized breadth of the court’s jurisdiction. Litigation over the court’s jurisdiction is generally a dispute over the proper forum for a particular action; the underlying dispute still must be resolved, whether in the bankruptcy court or elsewhere. The Commission’s recommendation to streamline the appeals process should produce far more tangible results in terms of reducing delay.

Third, contrary to the implication of the proposal, the prestige of bankruptcy courts has increased considerably since passage of the Bankruptcy Code. The quality of candidates applying for and being selected to bankruptcy judgeships has been very high. Further, the physical facilities used by the judges, their salaries and retirement plans, and their courts’ staffing have all been upgraded to levels fully appropriate to the volume and stature of their work. Given the current perquisites of office and the level of respect for bankruptcy judges within the profession, it is difficult to see how transforming the bankruptcy courts into Article III courts would materially improve the quality of this specialized judiciary.¹⁰

What the proposal ultimately fails to recognize is that the sweeping changes in bankruptcy case administration and bankruptcy court jurisdiction beginning with the 1978 revision has achieved the principal objectives identified by the 1973 Commission: it divorced the judges from purely administrative tasks, removed the historical taint of too-close association with trustees, and set the bankruptcy courts on a path, now completed, of elevating their status and recognition within the federal courts. The problems the Proposal addresses are old problems, long since solved.

Nevertheless, in the most unlikely event that Congress acts on legislation to make bankruptcy judges Article III judges, a serious flaw in the proposal should be pointed out. There is no practical way to bifurcate Article III trial responsibility. It will be difficult to run federal courthouses across the country in which Article III judges bear the same responsibility to try cases and administer their dockets and confront identical or overlapping issues of law -- but some of them are confined to bankruptcy

¹⁰ In fact, there is no evidence that it is likely that most sitting bankruptcy judges aspire to Article III status.
cases and others are exposed to the entire range of civil and criminal matters. The workloads are bound to be uneven at times, leading to calls to share resources. Culturally and practically, the Article III judiciary will have difficulty accommodating such an ungainly mixture of jurisdiction and judges and fulfilling its obligation to administer the judicial system efficiently. Of equal significance, this bifurcation would mark a historical first-step toward the creation of specialist Article III courts. This has been done only once in our history, with the creation of the Claims Court, which has a narrowly circumscribed docket and sits in Washington, D.C. Any decision to create “specialist” Article III bankruptcy judges must be made carefully and with full exploration of its consequences.

In sum, this Proposal is constitutionally unnecessary; it addresses jurisdictional problems that are rare in comparison to the large volume of cases the courts are handling without controversies; it attempts to cure a perceived lack of stature that has long since been overcome and, if history is any guide, it will go unheeded. The Commission should have rejected it. I [we] dissent.
New Additional Provision on Views of Four Commissioners on Hud Mortgages

Commissioners John A. Gose, Jeffery J. Hartley, Edith Hollan Jones, and James I. Shepard.

The Working Group on Single-Asset Real Estate did not have time to take up and present to the full Commission all the unique single-asset reality problems that were presented to it. One pressing problem that the Working Group considered relates to certain real-estate debt held by the United States Department of Housing and Urban Development ("HUD"). As understood by Commissioners Jones, Gose, Hartley and Shepard, who are endorsing the proposal set forth below, HUD finances low-income residential-housing projects and provides rent supplements to the tenants. When the project files Chapter 11, HUD must continue the rent payments, but its efforts to foreclose are inhibited by the automatic stay. HUD contends that frequently the owners during Chapter 11 fail to maintain the property. Thus, HUD must pay the rent supplements, HUD is denied the ability to foreclose and HUD cannot, unless it litigates, cause the rent-supplement money to be channeled into property maintenance. To compound the adverse effects on the federal government, in at least some cases, the primary purpose of the Chapter 11 filing is for the equity investors to postpone the payment of federal income taxes arising from debt cancellation on foreclosure.

The four subscribing Commissioners named above, on the basis of the foregoing, have concluded that HUD should receive specific relief in the Bankruptcy Code. Because of competing items for attention and other factors, the Single-Asset Real Estate Working Group was unable to submit a proposal about HUD mortgages to the full Commission. Accordingly, what follows is a recommendation of the four Commissioners named above, not a proposal by the full Commission.

The four Commissioners recommend that HUD should be entitled to relief from the automatic stay if the court finds (a) that the mortgage loan held by HUD was in default for more than 90 days prior to the entry of the order for relief; (b) that HUD provides rent-supplement payments for at least 25% of the units in the project; and (c) the debtor has failed to carry the burden of proof that the property has been and is in substantial compliance with the applicable health and public-safety standards, including compliance with HUD's section 8 housing assistance payments contract or other similar HUD requirement."
Chapter 5: Individual Commissioner Views

The Bankruptcy Administrator Program and the U.S. Trustee Program
Submitted by Commissioners Jeffery J. Hartley and John A. Gose

As part of the Commission’s overall review of the bankruptcy system, the Service to the Estate and Ethics Working Group considered various practical aspects of the administration of bankruptcy cases. The Working Group focused its attention on the two administrative programs presently in place, the United States Trustee Program (‘‘UST’’) and the Bankruptcy Administrator Program (‘‘BA’’). In a plenary voting session held on August 11-12, 1997, the Commission rejected the Working Group’s two alternative proposals designed to eliminate the Judiciary’s highly successful Bankruptcy Administrator Program by incorporating it into the UST system. On the first proposal, the vote was three in favor and five opposed; on the second proposal, the vote was two in favor and six opposed.

The Congress established the BA Program in 1986.1 Designed and developed in response to complaints and dissatisfaction with the UST Program, the BA Program was instituted in the six federal judicial districts in the states of Alabama and North Carolina. In fact, the Northern District of Alabama was one of the eighteen (18) pilot UST districts from 1978 to 1986, and it rejected the UST Program when it was expanded nationwide in 1986. The BA Program is housed in the Judicial Branch, while the UST Program is in the Executive Branch’s Department of Justice. The BA Program is presently due to “sunset” on October 1, 2002.2

At its regional meeting in Chicago on July 17, 1997, the Commissioners present heard and considered the comments of a panel of speakers concerning the existence of two separate administrative programs, housed in different branches of government, performing nearly identical functions. The panel included a BA, several present or former UST’s, the Deputy Director of the Executive Office for U.S. Trustees, several sitting district and bankruptcy court judges, a practicing lawyer, and several academicians, including Prof. David Epstein, a well-known bankruptcy lawyer and former law school dean. The comments of the panelists centered on two major issues - the constitutionality and the desirability of maintaining two administrative systems.

CONSTITUTIONALITY:


At the Commission’s regional meeting in Chicago, several panelists, notably those employed by the UST Program, favored the elimination of the BA Program, either by recommending to Congress that the BA’s sunset date “remain unchanged” or by requiring the immediate conversion of BA districts into the UST Program. Those in favor of the proposals relied heavily on the decision in *St. Angelo v. Victoria Farms*[^3], a 1994 decision from the Court of Appeals for the Ninth Circuit, which held that the BA Program is unconstitutional, as being violative of the uniformity clause of the Constitution.

Professor Epstein spoke convincingly in defense of having dual programs, and noted his discussions with several constitutional experts who, he said, believe that the existence of two systems does not rise to the level of a constitutional infirmity. Moreover, Prof. Epstein echoed the comments of District Judge David Coar, by pointing out the fact that the alleged lack of uniformity complained of in *St. Angelo* concerns the collection of user fees in UST districts, pursuant to 28 U.S.C. §1930(6), which are not collected in BA districts. The lack of uniformity, if any, is to be found in the collection of user fees, rather than in the mere existence of two program. Moreover, Francis Szczebak, Chief of the Bankruptcy Judges Division of the Administrative Office of the U.S. Courts, stated that legislation in the form of a housekeeping bill will easily solve the user fee problem. Mr. Szczebak indicated that legislation has been introduced to accomplish this as reflected in H.R. 2294 of the 105th Congress.

During the plenary voting session in Washington, D.C., several Commissioners argued that the Ninth Circuit’s finding concerning the BA Program was contained in dicta to the *St. Angelo* opinion, for no functional purpose germane to that case. In fact, one Commissioner called the ruling “gratuitous.”

**DESIRABILITY OF TWO PROGRAMS:**

At the Commission’s regional meeting in Chicago, Prof. Epstein and others addressed the desirability of having two programs, asking “Why have two programs? Why not have two programs? Prof. Epstein told the Commissioners that the BA Program is highly successful, and that it serves as a laboratory for developing more efficient and effective methods of administering cases. The Commissioners were reminded that the full Commission had voted 8-1 to accept several Chapter 11 proposals based on models developed in BA districts (commonly known as the “Small Business proposal), which had been discussed by two BA’s formerly invited to speak at the Commission’s meeting in San Diego in August 1996 and on many other occasions on an informal basis. In fact, the

[^3]: 38 F.3d 1525 (9th Cir. 1994).
“Small Business” proposal was widely praised by debtor and creditor alike at the June 1997 Regional Meeting in Orange Beach, Alabama.

The Commissioners learned that the BA Program is decentralized, that decisions are made in the field by BA’s who are actually practicing in the courts, and that because of the structure of the program, BA’s are able to respond to local initiatives and the judicial philosophy of the courts in which they practice. The Commissioners also learned that the last empirical study of the cost of the two programs was done by the General Accounting Office, which found that the BA Program operates at an average cost which is twenty-two (22%) percent lower than the UST Program.

Honorable Thomas Bennett, a bankruptcy judge from the Northern District of Alabama, offered the opinion that neither system is fully mature, as evidenced by the complaints leveled against the UST Program. Other panelists reminded the Commissioners that the UST Program is and has been heavily criticized for its unresponsiveness and seeming unwillingness to permit change. The UST Program is described, according to the panelists, as a top-heavy bureaucracy which perpetuates its own existence, and which is prone at times to institutional paralysis due to its sheer size. Further, Judge Bennett suggested to the Commissioners that the UST’s as employees of the Executive Branch, have direct conflicts of interest in cases involving other Executive Branch agencies, like the Internal Revenue Service.

THE COMMISSION’S PLENARY VOTE:

At its August 11-12, 1997 meeting, the Commission was asked to vote on two proposals to eliminate the BA Program. Immediately prior to those votes, however, the Commission considered three proposals designed to correct shortcomings in the UST Program, voting on two of the proposals (in favor, by majority, on both) and tabling the third. Comments and complaints about the UST Program had been heard by the Commission at four working group sessions devoted to the operation of the UST Program and the Commission responded by recommending that Congress make necessary changes to the UST Program.

Subsequently, the Commission was asked to vote on Proposal No. 10 which contained two alternative measures designed to eliminate the BA Program. The first alternative, to recommend to Congress that the BA’s sunset date “remain unchanged,” was challenged by several Commissioners regarding the proposal’s intent and potential ramifications. The first alternative elicited comments from the

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4 “The current statutory schedule providing for the incorporation of the Bankruptcy Administrator system into the U.S. Trustee system on October 1, 2002 should remain unchanged.”
Commissioners touching on all of the issues raised at the Chicago meeting and the Commission rejected the first alternative on a 3-5 vote.

The second alternative\(^5\) called for the immediate conversion of all BA districts into the UST Program. The Commissioners rejected the second alternative as well on a 2-6 vote.

**CONCLUSION:**

This is not the last time the bankruptcy community or Congress will consider this issue. At some point, we expect Congress will have to make a decision, the current statute notwithstanding, as to whether two administrative programs are appropriate. When this time comes, we are confident that Congress will realize that both the BA and UST programs are largely responsive, efficient and cost effective and should be left undisturbed.

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\(^5\)“The Bankruptcy Administrator system should be incorporated into the U.S. Trustee system earlier than the current statutory schedule.”
Chapter 5: Individual Commissioner Views

RECOMMENDATIONS FOR REFORM OF CONSUMER BANKRUPTCY LAW
BY FOUR DISSENTING COMMISSIONERS

Submitted by

The Honorable Edith H. Jones
Commissioner James I. Shepard

The assistance of Professor Richard E. Flint, Ms. Kelly J. Wilhelm, and Mr. Greg Kamen is gratefully acknowledged.

***** Commissioners John A. Gose and Jeffery J. Hartley concur with many of the substantive proposals in this dissent; however, they have written a separate concurrence.
INTRODUCTION

The Commission’s information-gathering concerning consumer bankruptcy has revealed a desperate need for changes in the Bankruptcy Code and its administration. As the number of consumer bankruptcies reaches unprecedented levels, paradoxically during prosperous economic times, the bankruptcy system’s shortcomings are increasingly obvious. First, the system lacks effective oversight or control over its integrity. Uncovering and penalizing abusive or fraudulent practices is haphazard, despite the duty of debtor and creditor attorneys, panel and Chapter 13 trustees, judges, U.S. trustees and bankruptcy administrators, and U.S. attorneys’ offices to maintain integrity.

Second, there is growing perception that bankruptcy has become a first resort rather than a last measure for people who cannot keep up with their bills. Lenders everywhere are reporting an increase in the number of bankruptcy petitions filed by people who were current on their debt payments. This phenomenon implies that bankruptcy relief is too easy to obtain, that the moral stigma once attached to bankruptcy has eroded, and that debtors are insufficiently counseled both about personal financial management and about the use of bankruptcy.

Third, apart from the urgent issues raised by increased filings, the law itself has proven unclear, leading to uncertain results and inconsistencies among and within circuits and even individual districts.

Fourth, the Bankruptcy Code offers opportunities for unjustifiable debtor manipulation by various means, including abuses of the automatic stay to fend off eviction, repetitious filings, and over-generous exemptions.

Fifth, some creditor abuses have been reported, particularly with respect to reaffirmations and dischargeability claims, but no case has been made for imposing additional far-reaching changes in creditors’ remedies because of such practices. The law
sufficiently addresses creditor overreaching, particularly if debtors’ counsel do their jobs.

The following proposals attempt (1) to enhance the integrity of the bankruptcy system, (2) to clarify the law, (3) to increase uniformity and decrease manipulation, and (4) to expose the shortcomings of key elements of the Consumer Framework espoused by five Commissioners.

We do not disagree with all of the recommendations in the Framework, however, although some of them clearly need to be reinforced. To facilitate comparing our position with that of the Framework, the Table of Contents substantially mirrors that in the Consumer Bankruptcy chapter and numbers the substantive recommendations consistently, as far as possible, with the Framework. Also, notes at the margin indicate whether our recommendations “agree” or “disagree” with the Framework, whether our proposal is “new” and not addressed by the Framework, or whether our proposal will “strengthen” a Framework recommendation.

To summarize our position vis-a-vis the Framework most briefly, the nine Commissioners agree on the need to

- create a national filing system;
- reinforce accountability and integrity in the bankruptcy system;
- promote pre- and post-bankruptcy debtor education;
- restrict abusive refilings;
- reward debtors who successfully complete Chapter 13 plans.

The four dissenting Commissioners disagree most strongly with the Framework proposals that

- do not go far enough to penalize or deter abuse;
- grant excessively generous exemptions;
discourage Chapter 13 repayment plans and encourage Chapter 7 liquidations;

- impose unnecessary restrictions on lenders in regard to reaffirmations, household goods, rent-to-own contracts and credit-card debt;

- do not meaningfully restrict abusive refilings or misuse of the automatic stay to prevent evictions.

Adoption of all of the attached recommendations would be highly desirable, but we make no pretense that they are a “Framework,” connoting interdependence or interrelatedness. Congress may approve some of these proposals and jettison or modify others.

Finally, in view of the close division among the Commissioners regarding consumer bankruptcy, we provide a general critique of the Framework because we strongly believe that its significant recommendations are misguided and unresponsive to the five basic conclusions stated above.
CONSUMER BANKRUPTCY

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* Because decisions on these issues were being made at the last minute, and/or because we are not fully agreed, no comments are included on these Recommendations. Judge Jones dissents separately on several of these provisions.
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I. EXECUTIVE SUMMARY

Dissenting Commissioners’ Recommendations for Reform of Consumer Bankruptcy Law

Heightened Requirements for Accurate Information

1.1.1 National Filing System.

A national filing registry should be established and maintained that would identify bankruptcy filings using social security numbers and other unique identifying numbers, such as driver’s license numbers, as well as photo ID.

1.1.2 Random Audits.

The U.S. Trustee should supervise random audits to verify the accuracy of representations made in debtors’ schedules. Cases would be selected for audit according to guidelines developed by the U.S. Trustee. A debtor’s discharge could be revoked or other penalties imposed based on deficiencies uncovered in an audit.

1.1.3 False Claims Rule.

There is no need for redundant rules to deter false claims.

1.1.4 Federal Rule of Bankruptcy Procedure 9011.

Bankruptcy Rule 9011 should be revised to require an attorney’s signature, subject to Rule 9011 sanctions, to the debtors’ lists, schedules, statements of affairs and of intention, and amendments thereto.

1.1A Additional Measures to Enhance Integrity.

In order to bolster the integrity of the system, the following specific reforms should be adopted:
• limit debtors' benefits from late-filed
amendments to schedules and statements of affairs;

- require debtors to submit copies of the last three years’ filed tax returns with their petitions;

- make discharge contingent on a trustee certificate of cooperation and statement that all relevant tax returns and other documents have been furnished to the trustee;

- require revocation of discharge if a random audit uncovers acts or omissions that justify this remedy;

- bar or revoke discharge if the debtor has made “material false statements or omissions” that “affect or could affect” the trustee’s administration or investigation of the assets of the estate; allow party who uncovers conduct barring discharge to obtain a non-dischargeable judgment for fees and costs;

- require identification of account numbers of the debts owed to larger commercial entities.

1.1.5 Financial Education.

All debtors in Chapter 7 and Chapter 13 should have the opportunity to participate in a financial education program.

1.1B Debtors’ Attorneys’ Fees.

Payment of consumer debtor attorneys’ fees should be structured to remove attorneys’ incentives to direct debtors’ filing choices toward any particular chapter for fee-related reasons and to encourage more effective debtor counseling and representation.
1.2.1-1.2.6 Uniform Federal Exemptions.

The uniform federal exemption proposal by the five-member majority far exceeds exemptions of most states and is misguided.

Reaffirmation Agreements and the Treatment of Secured Debt in Chapter 7

1.3.1 & 1.3.2 Reaffirmation Agreements.

There is no need to limit the availability of reaffirmation agreements. We recommend, however, that all reaffirmation agreements be approved by the Court following a hearing. The evidence at the hearing must establish that the agreement is voluntary, does not impose an undue hardship upon the debtor, and is in the debtor’s best financial interest.

1.3.3 Elimination of the “Ride Through” of Secured Debt.

Debtors should not be permitted to “ride-through” secured claims in bankruptcy and retain collateral via a de facto non-recourse loan so long as contract payments on the debt are made. Debtors must make a § 521 election to redeem, reaffirm, or surrender each asset subject to a security interest.

1.3.4 Purchase Money Security Interests in Household Goods of “Nominal” Value Should not be Voided.

These security interests should not be voided in bankruptcy.

1.3.5 Characterization of Rent-To-Own Agreements.

These agreements should not be specially regulated by bankruptcy but should be enforced according to state-law consequences.

1.4.1-1.4.6 Exceptions to Discharge. No Comment.

1.4.7-1.4.8 Objections to Discharge. No Comment.
1.5A Repayment Plans in Chapter 13.

Chapter 13's fairness to all should be enhanced in the following ways:

- payments under a Chapter 13 plan should be made simultaneously to secured and unsecured creditors for the life of the plan, as provided in the Framework;
- specific approval of 5-year plans should be codified;
- Chapter 13 plans should be reviewed annually and payments modified if a debtor’s income goes up or down;

1.5.1 Home Mortgage Debt.

Section 1322(b)(2) should be clarified to state that no debt secured principally by a debtor’s homestead may be stripped down.

1.5.2 Other Secured Debt.

a. Valuation of Retained Collateral -- Building on Associates Commercial Corp. v. Rash,¹ there should be a simple standard for valuing collateral and, consequently, lien interests: the mid-point between the wholesale and retail values of the collateral; the tax-assessed value of real property.

b. Interest Rate -- The interest rate on cramdown should reflect the lender’s risk of a forced loan to a Chapter 13 debtor. Presumptively, the contract rate of interest should apply.

1.5.5 Consequences of Non-completion in Chapter 13.

A default should be defined in Chapter 13 to include a debtor’s missing two consecutive payments and failure to catch up within 15 days of the due date for the second payment.

If a debtor defaults on a Chapter 13 plan by missing payments or otherwise, and if the case is converted to Chapter 7 for this or any other reason, the debtor shall forfeit the unique benefits of Chapter 13. All liens which had been stripped will be reinstated to their prebankruptcy contract terms, all ability to cure will be lost, and any tax restructuring will be withdrawn.

Consequences of Repayment Under Chapter 13 Plans.

1.5.7 **Superdischarge.** No Comment.

1.5.8 **Credit Reporting of Plan Completion and Debtor Education Program.**

Debtors who complete voluntary debtor education programs should have that fact noted on their credit reports. Debtors who complete Chapter 13 repayment plans should have their bankruptcy filings reported differently from those who do not. The Fair Credit Reporting Act should be amended accordingly.

1.5.9 **Credit Rehabilitation Programs.**

Credit rehabilitation by means of incentive loan programs to debtors who have successfully completed a Chapter 13 plan should be encouraged.

**Automatic Stay**

1.5B **Restriction on Successive Attempts to Obtain Bankruptcy Relief.**

We recommend the adoption of a simple rule to prevent repetitive filings by amending § 109 of the Bankruptcy Code to prohibit the availability of any relief for individuals under Title 11 for six years after either the dismissal or discharge of any previous case. We recommend a very limited exception to this absolute prohibition in exceptional cases.

1.5.6 **In Rem Orders.**

Bankruptcy courts should be empowered to issue *in rem* orders barring the application of a future automatic stay to identified property for a period of up to six years.
**1.5C Affidavit Practice.**

Relief from the automatic stay should be available to secured creditors upon a sworn motion supported by appropriate affidavits without the necessity of preliminary and final hearings when no one contests the creditor’s right to foreclose.

**1.5D Eliminate Residential Leases from Section 362.**

The automatic stay provided in § 362 of the Bankruptcy Code should not apply to bar an owner of residential realty from evicting a tenant/debtor and retaking possession of the realty, when the lease or rental agreement under which the tenant/debtor took possession has terminated, whether by its own terms or because of eviction processes.

**III. General Critique of the Framework**

The Consumer Bankruptcy Framework, and the process that led to its adoption, are seriously flawed.

**II. Recommendations for Reform of Consumer Bankruptcy Law**

**1.1.1. National Filing System**

A national filing registry should be established and maintained that would identify bankruptcy filers using social security numbers or other unique identifying information, such as driver’s license numbers, as well as photographic identification.

Copies of photographic identification materials bearing each debtor’s signature should be required to be attached to each petition; petitions lacking such identification should be rejected by the clerk and returned to the debtor(s) unfiled. In order to enhance the efficiency of the audit process and to assist the trustees in verifying information contained in the debtors’ schedules, debtors should also be required to attach to the petition copies of each debtor’s filed tax returns for the three most recent
Diligent trustees try to gather this information now. See letter of James H. Cosset, Bankruptcy Trustee, to National Bankruptcy Review Commission Consumer Working Group, May 9, 1997.

The Commission is proposing several amendments to control consumer debtors' access to the bankruptcy system. To enforce these constraints, a reliable national, multi-year database of bankruptcy filings is essential. This proposal envisions substantial changes in the clerks offices’ procedures to monitor filings. All debtors would be required to provide correct social security numbers, verifiable through the Social Security Administration database, and these numbers, together with physical identification such as photos as well as debtor names, would be used to cross-reference bankruptcy filings nationwide. Additional methods for implementing this proposal, including a mechanism to monitor the database and to facilitate error correction, could be developed by the court clerks.

1.1.2 Random Audits

The U.S. Trustee should supervise random audits to verify the accuracy of representations made in debtors’ schedules. Cases would be selected for audit according to guidelines developed by the U.S. Trustee. A debtor’s discharge could be revoked or other penalties imposed based on deficiencies uncovered in an audit.

The fairness of the entire bankruptcy process, both system-wide and in individual cases, depends on the accuracy of the information in the debtors’ files. Creditors’ decisions, trustee’s actions, court determinations, and policymakers’ decisions are all based on the representations debtors make in their schedules.

While Chapter 7 and Chapter 13 trustees currently attempt to review debtors’ schedules and uncover errors or hidden assets, no formal auditing mechanism exists in the bankruptcy system. The Commission repeatedly heard testimony that the
information reported in the debtors’ schedules is often unreliable. This is one of several proposals to enhance the integrity of the system, to improve the quality of the data, and to encourage debtors as well as their attorneys to be more careful and forthright in completing all filed documents. The proposed audits would be initiated within a reasonable time, not to exceed one year, after the case is filed.

Chapter 7 and Chapter 13 trustees should be authorized to conduct the random audits and to receive additional compensation for the costs of performing this duty. The Executive Office for U.S. Trustees would develop initial guidelines for the audit process and would be further charged with the responsibility to adjust these guidelines as needed, depending on actual experience with the audit program.

In a case in which an audit has been performed, the filing deadlines for objecting to the debtor’s discharge or the dischargeability of a debt should be tolled until sixty days following the completion of the audit, so that the trustee or another interested party would be able to act upon information developed by the audit. The auditor would be required to complete investigations within a reasonable time, subject to the U.S. Trustee guidelines. The auditor would report to the bankruptcy court and the U.S. Trustee inaccuracies in the schedules discovered during the audit.

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See, e.g., Testimony of William Whitford, Jan. 23, 1997, at page 86, line 4 through page 87, line 1:

JUDGE JONES: Those schedules are filed under penalty of perjury. Doesn’t that mean anything?

MR. WHITFORD: I’m sure it means something, yes.

JUDGE GINSBERG: The schedules are the great American novel. ... They run exactly backwards .... Instead of going through the expenses and seeing what’s available and then choosing relief based on that, they set the bottom line as to what choice they want to make, and then have the schedules add up to within a dollar or two of that amount. It’s done all the time. The data is useless.
Sections 727 and 1328 should be amended to provide that material inaccuracies (e.g., significant under-reporting of assets, falsely claiming exemptions) will result in the denial or revocation of discharge. In addition, such irregularities might subject the debtor to prosecution by the Department of Justice, depending on the seriousness of the inaccuracies or other circumstances. The debtor should be required to cooperate with the audit in any reasonable way necessary to the auditor; failure to cooperate will also justify denial of discharge.

1.1.3 False Claims -- Critique of Framework Proposal

The Framework proposal states:

Courts should be authorized to order creditors who file and fail to correct materially false claims in bankruptcy to pay costs and the debtors' attorneys fees involved in correcting the claim. If a creditor knowingly filed a false claim, the court could impose appropriate additional sanctions.

Noticeably absent from the Framework’s proposal is any attempt to maintain the present balance between creditors and debtors as directed by Congress. Where is a fee shifting proposal in the event a creditor is successful in defending a false claim suit brought by a debtor?

Debtors already have an adequate remedy for false claims filed by creditors. The United States Code makes it a crime, punishable by fine and/or imprisonment, to "knowingly and fraudulently present[] any false claim for proof against the estate of a debtor . . . ." This information is even printed on the official proof of claim form. The same section of the United States Code makes it a crime for a debtor to "knowingly and fraudulently make a false declaration"
in relation to his case. A review of the annotations to the Code following Section 152 and a Westlaw® search for citations to this section clearly establish that the problem of “false claims” arises overwhelmingly from debtors, not creditors. Yet, the Framework does not address this debtor abuse. The report of the dissenting Commissioners, however, contains several provisions which directly address this problem. Given the rhetoric of the Framework with regard to improving the integrity of the system, it is ironic that the true source of the problem was ignored. However, this oversight is consistent with the social-engineering agenda of the drafter(s) of the Framework. If creditors’ false claims were a real -- as opposed to merely a perceived -- problem of significant proportion, the United States Trustee’s office would have been overwhelmed by the handling of such offenses. However, no evidence was presented to the Commission to document such a problem during the extensive hearings conducted over the last year and a half.

As stated above, the debtor already has a remedy when a false claim involves a consumer debt. The debtor can use the provisions of the Fair Credit Billing Act, 15 U.S.C. § 1666 et seq. (which allows for a creditor to correct errors before any sanctions are imposed), and pursue an adversary proceeding under that statute, if he is not satisfied. Or, if a false claim is filed in a Chapter 13 case, the Chapter 13 Trustee may handle the matter. The Chapter 13 Trustee is required to address the issue of claims as part of his overall responsibility over a case. The debtor’s counsel should report any improper claims to the


For example, the only case in the annotations to 18 U.S.C.A. § 152 which explicitly deals with a creditor’s false proof of claim is Levinson v. United States, 263 F. 257 (3d Cir. 1920), in which it was held that the fact a creditor acted on the advice of his attorney in presenting the proof of claim was not a defense when the creditor did not fully disclose all material facts to his attorney. In contrast, at least 50 cases in notes 101-130 and 181-190 to § 152 concern various false statements or oaths by debtors.

See General Critique of the Framework, infra Part III.

trustee. If a complaint concerning the amount of a creditor’s claim is valid, the Chapter 13 trustee should object to the claim. The issue is then joined, without the debtor incurring substantial expense.

The Chapter 7 trustee also has a statutory obligation to object to improper claims. Thus, if false claims are a real problem, it is because the players in the system are not doing their jobs. Given the present obligations upon trustees and debtor’s counsel, together with the fact of the debtor’s discharge, it is highly improbable that a debtor will have to “pay the excess.” Finally, if the debtor seeks to reaffirm debt (including an obligation to “pay the excess”), either his attorney or the court should advise him not to reaffirm the improper portion of the debt.

The Framework’s position supposes that the debtor should receive the benefits of the bankruptcy laws cost-free. There is no reason, however, why a debtor should not have to find himself a competent attorney and incur some costs in order to obtain the benefits of the law. In addition, debtor’s counsel should be required to do their jobs in an ethical and proper fashion. Finally, it should be pointed out that the Commission has heard little on the subject of false creditors’ claims; in contrast, it has repeatedly heard that debtors’ schedules are generally incomplete and unreliable. In fact, one bankruptcy judge told the Commission that debtors’ schedules were often “fiction.” Why should this proposal be accepted in the absence of adequate consideration by the consumer working group? This proposal, like many proposals contained in the Framework, may be thought by its proponents to be debtor-friendly, but it is not consumer-friendly in the larger context of the active credit marketplace, of which the bankruptcy system is but a part.

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10 Federal Rule of the Bankruptcy Procedure 3007.


12 Paraphrasing the Framework, as no final version of its language was available when this was written.
1.1.4 Federal Rule of Bankruptcy Procedure 9011

Amend Rule 9011 to require an attorney signature to the debtor’s lists, schedules, statements of affairs and of intention, and amendments thereto.

Debtors’ counsel should take an active role in certifying the accuracy of the information contained in the debtors’ schedules, statements of affairs, and amendments thereto. Attorneys presently are not required to sign these official court documents because the Rule 9011 certification requirements do not apply to them. Requiring attorneys to sign schedules, as they are required similarly to certify all other pleadings filed at court, would clarify their responsibility to inquire into the accuracy of the

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13 F.R.B.P. 9011 reads:

Every petition, pleading, motion and other paper . . . except a list, schedule, or statement, or amendments thereto, shall be signed . . . The signature of an attorney or a party constitutes a certificate that the attorney or party has read the document; that to the best of the attorney’s or party’s knowledge, information, and belief formed after reasonable inquiry it is well grounded in fact . . . and that it is not interposed for any improper purpose, such as to harass, or to cause unnecessary delay, or needless increase in the cost of litigation . . . (emphasis added).

As it has been proposed to be amended, see Communication from the Chief Justice, the Supreme Court of the United States, dated April 15, 1997, the Rule would retain the exception from certification for lists, schedules, statements, and their amendments.

14 See supra note 11 and accompanying text. Under the currently proposed amendments, the rule would still not clearly apply to these papers. The amendments leave unsolved this particular problem. The revised Rule will also conform to Fed. R. Civ. P. 11, by allowing a party threatened with sanctions to “withdraw or correct” [amend] the challenged pleading voluntarily. The policy that supports voluntary amendments in ordinary federal court litigation does not apply in bankruptcy, where numerous parties may be involved for relatively small claims, and deadlines for action spawn gamesmanship. The onus must be placed squarely on the debtor and his counsel to file truthful, complete documents.
information, and will improve the quality of data in the bankruptcy files.

1.1A Additional Measures to Enhance Integrity

In order to bolster the integrity of the system, the following specific reforms should be adopted:

- limit debtors’ benefits from late-filed amendments to schedules and statements of affairs;

- require debtors to submit copies of the last three years’ filed tax returns with their petitions;

- make discharge contingent on a trustee certificate of cooperation and statement that all relevant tax returns and other documents have been furnished to the trustee;

- require revocation of discharge if a random audit uncovers acts or omissions that justify this remedy;

- bar or revoke discharge if the debtor has made “material false statements or omissions” that “affect or could affect” the trustee’s administration or investigation of the assets of the estate; allow party who uncovers conduct barring discharge to obtain a non-dischargeable judgment for fees and costs;

- require identification of account numbers of the debts owed to larger commercial entities.

A small percentage of debtors abuse the system in these ways, but the examples of abuse have attained notoriety and taint the public’s and creditors’ perceptions of the system. One creditor went so far as to describe the bankruptcy system as
“legalized theft.” Others have suggested that it can be a “haven for criminals” and creates significant opportunities to defraud creditors. This group of proposals tightens up the accuracy of the schedules and statements of affairs and facilitates notice to creditors by requiring a list of the debtor’s account numbers.

Congress should amend the discharge provisions in § 727 and in § 1328 so that discharge is barred if a debtor has made material false statements or has omitted material information from his schedules and statements of affairs, when such misstatements and/or omissions affect or could affect the trustee’s investigation of assets and administration of the estate. For these purposes, the law should make clear that amendments do not “cure” the misstatement. This is especially important because the Federal Rules of Bankruptcy Procedure limit the time within which objections to exemptions and objection to discharge complaints may be filed. Because amendments are currently liberally permitted to cure misinformation, some crafty debtors file carelessly or intentionally false schedules and statements, wait until more than sixty days after the first scheduled creditors’ meeting, and amend the schedules to disclose assets once an objection to the discharge complaint has become untimely. The time limit for objecting to discharge or dischargeability would be extended, however, in cases subject to audit, as previously suggested.

Any party in interest should be permitted to object to the debtor’s discharge on this basis. In the event a party successfully brings an action to bar the debtor’s discharge on this basis, that party should be compensated for his litigation expenses. To prevent misuse of the fee-shifting, the law should also permit


17 Federal Rules of Bankruptcy Procedure 4003, 4007.
fee-shifting if a party brings an action challenging discharge without substantial justification.

1.1.5 Financial Education

All debtors in Chapter 7 and in Chapter 13 should have the opportunity to participate in a financial education program.

Representatives from many parts of the consumer bankruptcy system—creditors, debtors, trustees, and judges—agree that debtors need to better understand how to manage their finances. Because debtors certainly will continue to be involved in consumer credit transactions after discharge, the policy of the fresh start and interests of creditors and society at large are furthered if debtors have the chance to learn personal financial management skills.

Criticism of debtor education has focused only on the timing, funding, or scope of such programs, not on the underlying premise that education would be beneficial and should be widely available. While the Commission endorses the exploration of various means to fund education programs and test their effectiveness, it does not prescribe a specific method or approach to the programs. In fact, extensive testimony and submissions have been furnished regarding successful consumer credit counseling efforts and post-bankruptcy education programs. Private industry, banks, credit unions, credit card issuers, not-for-profit organizations and Chapter 13 trustees offer such educational opportunities now; it seems certain that the increased number of bankruptcy filings will encourage additional initiatives. Both academicians and business interests are encouraged to study debtor education programs and recommend improvements.

Further, debtor participation in existing private-sector education programs must be voluntary; our goal is to make such programs more widely available. However, nothing herein should be interpreted as discouraging a bankruptcy judge from requiring any particular debtor to participate in an education program in an appropriate case.
1.1B Debtors’ Attorney Fees

_Payment of consumer debtor attorneys’ fees should be structured to remove attorneys’ incentives to direct debtors’ filing choices toward any particular chapter for fee-related reasons and to encourage more effective debtor counseling and representation._

The Commission has not proposed any specific changes to the Bankruptcy Code or Federal Rules of Bankruptcy Procedure with respect to the allowance and priority of attorneys’ fees in consumer bankruptcy cases. However, the Commission has identified problems in the system and some possible solutions. In considering fee reform, Congress should take care to balance the debtors’ need for cost-effective bankruptcy representation against the real expenses to attorneys of providing thorough service.

One of the most significant factors currently influencing consumer debtors’ choice between Chapter 7 and Chapter 13 is local legal culture, including the preferences and training of trustees, bankruptcy judges, credit counseling services, creditors and their attorneys, and debtors’ attorneys. Critics suggest that the number of Chapter 13 filings relative to Chapter 7s is linked to the ability of debtors’ attorneys to earn a higher fee in Chapter 13 cases than in Chapter 7 cases. Debtors’ attorneys are also able, under current law, to take advantage of priority status for the payment of their fees in Chapter 13, such that in many cases attorney fees are paid from the first funds a debtor pays to the Chapter 13 trustee for distribution to creditors. Because a debtor’s attorney is also a debtor’s creditor, the attorney has a conflict of interest when counseling a debtor as to

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19 National Bankruptcy Review Commission: Meeting (May 16, 1996)(testimony of William Whitford, Jerry Hermesch, Henry Hildebrand, and Richardo Kilpatrick); National Bankruptcy Review Commission: Public Meeting (April 19, 1996)(testimony of Prof. Jeffrey Morris). But see letter of Mallory B. Duncan, Vice President and General Counsel, National Retail Federation, dated June 16, 1997. Duncan argues that the opportunity to earn higher attorney fees in Chapter 13 cases was a positive incentive encouraging 50% more Chapter 13 filings in Atlanta.
choice of chapter under which to file. In addition, because Chapter 13 cases often require more legal work and continuing involvement of the debtor’s attorney than Chapter 7 cases, debtors may be left without effective representation after plan confirmation.

An egregious example of the ethical lapses possible is a bankruptcy “petition mill” attorney who was recently sanctioned in Houston, Texas. Among other lapses, firm paralegals often prepared schedules and documentation without serious investigation of the debtor’s personal financial condition; copies of the debtor’s signature were obtained to add to pleadings as needed; the disposable income schedules were manipulated to achieve desired payment levels; and debtors were left uninformed about progress in their cases.

In addition, criticism has been directed against debtors’ attorneys in Chapter 7 cases. The most strident complaints are those of debtors who complain that their attorneys abandon them after they file the petition and schedules and attend the meeting of creditors. Debtors’ attorneys respond that they make minimal services available to debtors at a low cost, and that they satisfy their ethical duty to inform their clients early in the process. Consequently, their low fees do not include the cost of representation in, for example, adversary proceedings or motions for relief from stay. Such additional services are frequently priced separately from the agreed fee for the bankruptcy filing.

One proposal for reforming the attorneys’ fee payment structure would require that fees be paid incrementally through the entire duration of the Chapter 13 plan. Debtors’ attorneys would then have a


21 See Order #72, In re Davila, Case #94-44142-H5-7, in which a sanction was imposed on attorney Frank Mann. This attorney has now also been disciplined by the State Bar of Texas.

stake in ensuring that plans are feasible and that debtors complete plans. A second proposal would require that at least a portion of the fees be held back until after payments to creditors have commenced. Debtors’ attorneys criticize both these proposals as requiring attorneys to provide services to debtors without clear expectation of receiving payment.

However, reformers should note that courts superintend the allowance of fees, and judges have the duty to police ethical violations and conflicts of interest between attorney and client. The proposed amendment to Federal Rule of Bankruptcy Procedure 9011 would give judges another source of information to allow more active supervision of debtors’ attorneys by the courts. Ethical lapses by attorneys can and should be more vigilantly pursued by the courts and bar association grievance committees.

1.2.1-1.2.6 Uniform Federal Exemptions -- Critique of Framework Proposal

The Framework advocates uniform federal bankruptcy exemptions that will replace the current law in which states can opt-out and apply, as most do, their state exemptions. It also sets, among other things, a personal property exemption of $20,000 per debtor, a homestead exemption of at least $20,000 and up to $100,000, and a “non-homestead homestead” allowance of $15,000, and it permits qualified retirement funds to be exempt.

Less than two weeks before the Commission’s report was completed, by a five-four vote, the Commission adopted a slightly modified version of the Uniform Federal Exemption proposal that had been approved in spring 1997 but later withdrawn. The only significant change from the proposal of last spring was to reduce the minimum homestead exemption from $30,000 to $20,000. This means that a couple seeking bankruptcy protection can, under the final Proposal, exempt $40,000 of personal property, equity in a home


24 See supra note 19 and accompanying text.
ranging from minimum $20,000 to maximum $100,000, and tax-qualified retirement funds.

Two features of this proposal are noteworthy. First, its manner of adoption is peculiar. At the Commission’s last public meeting in August, there appeared to be substantial agreement that if uniform, non-opt-out exemptions were going to be recommended, the Commission need not propose certain dollar values or criteria for uniform federal exemptions. We knew that Congress would bargain over the specific provisions in any event. Commissioner Hartley’s recommendation was therefore simply to propose uniform federal exemptions without any specific criteria. His proposal was to be included in a mail-in ballot.

To our surprise, when the ballot arrived, it contained two alternative exemption proposals, that of Commissioner Hartley and the alternative one that has now been adopted by a bare majority. Many of us had no forewarning that the second alternative would be offered. Indeed, we thought the Commission had declined to ask for specific dollar amounts on exemptions.

The other unfortunate feature of this exemption proposal is that it is too generous to debtors. As one credit union manager put it, this type of exemption schedule enables debtors to secure discharge from debts while holding onto considerably more assets than his average credit union customer. The proposal increases the $15,000 homestead exemption passed by Congress only three years ago, and its personal property allowance is much higher than those of all but two states. Responding to the Commission’s first uniform exemption proposal, which differed only in the amount of the minimum homestead exemption, Chapter 7 trustees observed that the proposed exemptions were overly generous. Under current exemption standards, nearly 95% of consumer bankruptcies are “no-asset” filings. The trustees estimated that the spring proposal would transform nearly all consumer bankruptcies into no-asset filings by substantially increasing exemption levels. Likewise, the U.S. Treasury Department analyzed the impact of the spring exemption proposal and concluded that it would allow couples to exempt sufficient assets to maintain their net worth in the top 60-70% of American households -- even without considering
retirement assets. The $40,000 in personal property exemptions, according to the Treasury Department, would raise the non-homestead exemption in 48 states; “the (bankruptcy-weighted) average non-homestead exemption level across the United States is only $10,000.”

Because the final exemption proposal was adopted at the last-minute, neither trustees nor the federal government was afforded the opportunity to analyze its consequences. Nevertheless, it seems clear that the Framework’s uniform exemptions remain extremely high compared to those available in most states, and they are much higher than those in the current federal exemptions. This exemption proposal most benefits the wealthier debtors who can and should afford to repay something to their creditors. It gives debtors a head start, not a fresh start.

Oddly, the Framework makes no attempt to prove that state exemption levels are currently inadequate. It simply describes state exemptions and says, contrary to the Treasury Department analysis, that this proposal lies in the mid-range of state laws. But there is no normative explanation for increasing exemption levels to benefit wealthier debtors.

Historically, exemption laws had five purposes: (i) to provide a debtor enough money to survive; (ii) to protect a debtor’s dignity and cultural and religious identify; (iii) to afford a means of financial rehabilitation; (iv) to protect the family unit from impoverishment; and (v) to spread the burden of the debtor’s support from society to his or her creditors. The Framework proposal’s broad generalities fail to connect these policies with its liberal exemption increases.

It is also highly likely that these liberal exemptions will translate into the filing of more
Chapter 7 liquidation cases, as debtors with the ability to repay some part of their debts will find it expedient instead to shelter more assets in Chapter 7. A combination of more-liberal exemptions with the Framework’s cramdown reaffirmations and tighter Chapter 13 requirement virtually assures that liquidation plans will become dominant.

The outer limits on these exemptions will perhaps discourage bankruptcy filings by people like celebrity debtors who would have previously taken advantage of some states’ unlimited homestead exemptions. We all applaud that result. On the other hand, the final proposal will enable many more individuals to escape their contractual obligations while maintaining levels of wealth that the vast majority of the American public do not enjoy. The image of the bankruptcy process will be further tarnished by this exemption proposal.

9. Reaffirmation Agreements -- Critique of the Framework Proposal

The Framework Proposal states:

11 U.S.C. § 524(c) should be amended to provide that a reaffirmation agreement is permitted, with court approval, only if the amount of the debt that the debtor seeks to reaffirm does not exceed the allowed secured claim, the lien is not avoidable under the provisions of title 11, no attorney fees, costs, or expenses have been added to the principal amount of the debt to be reaffirmed, the motion for approval of the agreement is accompanied by underlying contractual documents and all related security agreements, mortgages, or liens, together with evidence of their perfection, the debtor has provided all information requested in the required form motion for approval of the agreement, and the agreement
conforms with all other requirements of subsection (c).

The Bankruptcy Code currently provides for the voluntary reaffirmation of secured and unsecured debt. A reaffirmation agreement is a voluntary contractual obligation under which a debtor agrees to repay all or a portion of a debt to a particular creditor which would otherwise be discharged in bankruptcy. The Bankruptcy Code provides significant safeguards for debtors and outlines in detail the procedures that must be followed in order to create an enforceable reaffirmation agreement. The opponents of reaffirmation agreements argue that these agreements seriously undermine two of the basic policies inherent in consumer bankruptcy—a debtor’s fresh start and the equal treatment of creditors. We believe that reaffirmation agreements are helpful in ensuring the successful rehabilitation of debtors and in reducing the costs of credit to the millions of hard-working individuals who do not seek bankruptcy relief. In other words, reaffirmation agreements are not only debtor friendly, they are consumer friendly.

The evidence presented to the Commission clearly establishes that the identified problems surrounding reaffirmation agreements are, in large part, the result of the failure of debtors’ lawyers.

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28 See, e.g., Thomas C. Leduc, Michigan Credit Union League, Letter to the Consumer Working Group of the National Bankruptcy Review Commission, May 12, 1997 (noting that reaffirmation agreements are mutually beneficial for both the debtor and creditor). Mr. Leduc also stressed the importance of reaffirmations for the continued vitality of credit unions.

29 See Elizabeth Warren and Melissa Jacoby, Memorandum to Consumer Working Group, January 14, 1997 (identifying the settling of questionable nondischargeability actions by execution of reaffirmation agreements and the use of “rogue” reaffirmation agreements which were never approved by courts).

30 National Association of Consumer Bankruptcy Attorneys, Proposals for Improving the Consumer Provisions of the Bankruptcy Code, May 14, 1997. The largest association of debtors’ attorneys acknowledged to the Commission that most reaffirmation agreements were the result of underrepresented debtors. The
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creditors, and the courts to comply with Section 524(c)-(d) and Section 524(a)(2) of the Bankruptcy Code. These identified problems, while they detract from the integrity of the bankruptcy system, are not ones that call for changes in the law of reaffirmation. Thus, we recommend no substantive changes in the law, but emphasize the need for all parties involved in the bankruptcy process to comply with the present statutory Framework for reaffirmation agreements.

We do, however, recommend several minor procedural changes. We recommend that all reaffirmation agreements be approved by the Court following a hearing. The evidence at the hearing must establish that the agreement is voluntary, does not impose an undue hardship upon the debtor, and is in the debtor’s best financial interest. We further recommend that all reaffirmation agreements, when submitted to a court for approval, must be accompanied by an affidavit from the attorney whose signature appears on the petition (unless an order authorizing withdrawal and/or substitution has been approved by the Court) that the agreement is voluntary, does not impose undue hardship upon the debtor, and is in the best financial interest of the debtor. We contemplate that the attorney’s affidavit alone will not be sufficient to support entry of an order approving the reaffirmation agreement. Additional evidence will be needed.

association fails to acknowledge the reason for this underrepresentation -- the attorney who was paid to represent the debtor in the proceedings fails to continue the representation after the § 341 meeting.

31 See, e.g., In re Latanowich, 207 B.R. 326 (Bkrtcy. D. Mass. 1997)(outlining the conduct of Sears, Roebuck & Co. in failing to get court approval for “reaffirmation agreements” and attempting to enforce these void agreements).

32 The Honorable John C. Akard, United States Bankruptcy Judge, Northern District of Texas, Letter to Elizabeth Warren, February 19, 1997 (stating that he will tell a debtor that he can reaffirm a debt if he wants to, even though it does not look like a good deal to him as judge).

33 In re Avis, 3 B.R. 205 (Bkrtcy. S.D. Ohio 1980)(giving a historical survey of congressional approval of reaffirmation agreements and concluding that the best interest phrase used in § 524(c) was intended to mean only financial and economic best interest).
Debtors’ attorneys and the courts should take the responsibility to uphold the integrity of the system and refuse to recommend and/or approve reaffirmation agreements which place debtors in serious financial jeopardy.\textsuperscript{34} However, research on this subject does not demonstrate a problem of this kind is of great magnitude.\textsuperscript{35} In fact, nearly all of the reaffirmation abuse identified by the Commission could easily be remedied by a more serious and reflective investigation into the economics of the reaffirmation process by the two parties to whom Congress has already given this responsibility -- debtors’ attorneys and courts. To advocate the modification of the reaffirmation process because individuals are failing to take responsibility for their actions is ludicrous. It should be noted that the researchers who studied reaffirmations and noted the problems did not believe that abolishing reaffirmations was an appropriate response, as they do serve useful purposes for debtors as well as for creditors.\textsuperscript{36} It is not the current law which is at fault; it is the inability or unwillingness of the courts and/or the debtors’ attorneys to do their jobs and enforce it.\textsuperscript{37}

\textsuperscript{34} Studies presented to the Commission by researchers at Creighton University and by the Credit Research Center at Purdue University showed that, in a few isolated federal judicial districts, reaffirmed debt constituted a substantial portion of debtors’ post-discharge income. These sketchy statistical reports are an insufficient basis for the broad generalizations concerning reaffirmations contained in the Commission’s report. In addition, the authors of the Creighton study have reported errors in their preliminary analysis. Memorandum of Marianne Culhane and Michaela White to Melissa Jacoby, June 18, 1997.

\textsuperscript{35} Reaffirmations of secured debt in an amount exceeding the value of collateral constitute perhaps 10\% of all filed agreements. Marianne Culhane and Michaela White, letter to Commission, June 11, 1997. Moreover, the researchers did not measure or indicate whether any of these 10\% included any additional, new line of credit that might account for the difference.

\textsuperscript{36} Id.

\textsuperscript{37} The case law does establish that some courts take their jobs seriously. see, e.g., \textit{In re Latanowich}, 207 B.R. 326 (Bkrtcy. D. Mass. 1997) (noting that Bankruptcy Court has power to impose remedial sanctions including compensatory and punitive damages to ensure compliance with the discharge injunction); \textit{In re Izzo}, 197 B.R. 11 (Bkrtcy. D. R.I. 1996)(striking affidavit of attorney when it was clear
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The Commission was also well informed of the activities of certain creditors who sought reaffirmation agreements in direct contravention of the statutory procedures. Such actions are to be condemned, but once again, do not call for wholesale change in the present system. The specific problem should be forcefully addressed under the current law, as has been done in the case of Sears, Roebuck & Co.\footnote{38} What is needed is enforcement of current law -- not more legislation.

We would be remiss in our report if we did not call to Congress’ attention the fact that the Framework’s proposal to limit reaffirmation agreements to the value of the secured claim enforces no policy other than one of paternalism toward debtors. First, the reaffirmation proposal is contrary to the Framework’s avowal that it maintains the present balance between creditors and debtors. Under the Commission’s proposal, secured creditors will be unable to enter into agreements with debtors for the repayment of the undersecured portions of their claims, while unsecured creditors will be prohibited from entering into reaffirmation agreements. The resulting financial loss to the credit industry will be significant, while no other change suggested by the Commission balances the equation on their behalf.

Second, Congress and the courts have generally recognized that reaffirmation agreements are

that debtor could not make payments required under reaffirmation agreement); In re Hovestadt, 193 B.R. 382, 385-86 (Bkrtcy. D. Mass. 1996)(striking affidavit of attorney when Schedules I and J indicated that a debtor’s expenses exceeded the debtor’s income).

\footnote{38} United States Bankruptcy Judge Carol J. Kenner conducted an investigation that uncovered that Sears had over a ten year period, systematically pressured hundreds of thousands of bankrupt customers to reaffirm debts without receiving the required bankruptcy court approval. See In re Latanowich, 207 B.R. at 338 (“The court has issued an order to show cause why compensatory and punitive damages should not enter in each of the 2,733 other cases in which Sears has admitted that it obtained a reaffirmation from the debtor that it failed to file.”) The nationwide settlement will cost Sears nearly $300 million. Bruce Mohl, “Sears to Pay State, Residents $10.82 Million,” Boston Globe, September 4, 1997.
a two-way street. The debtor gets some benefit from the reaffirmation -- either the possibility of keeping collateral otherwise subject to a security interest or continued borrowing privileges under a particular credit arrangement. And the creditor gets the benefit of participating in the determination of its repayment terms. The Framework’s reading of legislative history revealing wariness of reaffirmation agreements is correct, as far as it goes, but Congress has given no indication of retreating from its position favoring all reaffirmation agreements.

Third, again contrary to the express goal of the Framework, limiting the amount payable on secured reaffirmation agreements will cause debtors to prefer Chapter 7 rather than 13. Under present law, a Chapter 7 debtor who does not intend to surrender property subject to a security interest has two methods by which to retain possession of the collateral—reaffirming the debt with the creditor, or redeeming the property by payment of the allowed secured claim. Redemption must be for a lump sum cash payment; installment redemption over the objection of the creditor is presently prohibited under section 722. Currently, the reaffirmation agreement may include both secured and unsecured components of the debt. If a debtor does not desire to reaffirm the entire amount of the undersecured debt, he must file a Chapter 13 bankruptcy, which enables him to strip the lien. Chapter 13, however, also requires the debtor to commit

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39 National Consumer Bankruptcy Coalition, “What’s Wrong with the Commission’s Consumer Bankruptcy Proposal,” July 18, 1997 (noting that in many instances, a continued line of credit which results from the reaffirmation is critical for a fresh start).


41 The original House Bills disallowed reaffirmation altogether (H.R. 31 and H.R. 32, 95th Cong. 1st Sess. (1977)); however, the bill which finally passed in the House contained provisions for limited reaffirmation. H.R. 8200, 95th Cong., 1st Sess. (1977). Senate amendments to that bill resulted in the final compromise which became the Bankruptcy Code of 1978. Reaffirmation of both secured and unsecured debt has been the law since that time. 11 U.S.C. § 524(c), as amended.

42 See, e.g., In re Bell, 700 F.2d 1053 (6th Cir. 1983).
payments of disposable income to the unsecured creditors.\footnote{In fact, Professor William Whitford asserts that reaffirmation of secured and undersecured debt under present law is a good idea. He argues that full reaffirmation is a better deal for a debtor than filing a Chapter 13, in which other creditors get a “free ride” because of a debtor’s desire to keep a particular item of collateral. Professor William Whitford, letter to Elizabeth Warren, March 15, 1997. It might be contended that because of the ready availability of reaffirmation agreements under current law, the filing of Chapter 7 is more attractive to many debtors than Chapter 13. Following this logic, it might be asserted that the incentives created by the Framework’s limitation on reaffirmations are no different from those in present law. Such a facile analysis would be wrong. First, unlike present law, the Framework says it intends to encourage Chapter 13 filings, but this proposal conflicts with the Framework’s intention. Second, to the extent present law on reaffirmations encourages Chapter 7 filings, this may indicate the need for other or stricter incentives for Chapter 13 plans.}

Under the Framework proposal, in either Chapter 7 (with a reaffirmation) or Chapter 13, the maximum amount the debtor will be required to pay on the secured debt is the stripped-down value of the collateral. In this scenario, there is no reason for a debtor to choose Chapter 13 and agree to make payments to the unsecured creditors. The Framework proposal gives him the benefit of a stripped-down lien, thus arbitrarily disadvantaging the secured creditor while conferring no corresponding benefit on unsecured creditors.

Fourth, as the Framework reaffirmation proposal introduces more complexity for less financial return, it may substantially discourage creditors from agreeing to reaffirmations on secured debts. In their place, however, creditors will have incentive to create a market for redemption-repurchase financing, in order to circumvent the controls in the Code on the terms of reaffirmations. Courts do not oversee redemptions at all. If secured creditors will not agree to reaffirm because they lose too much of their claim, while debtors have need to keep collateral, then they will all seek alternative sources of funding. Creditors would probably be willing to provide this financing, at “market” terms (i.e., high-interest terms), so that they can get full, immediate payment on their claims.
Such a result would hardly protect debtors from financially overburdening themselves post-petition.

Finally, it should be noted that the Framework’s proposal strikes at the very heart of individuals’ freedom to contract. The present Code provides sufficient safeguards to prevent overreaching and unfair advantage when debtors’ attorneys and the courts enforce the existing law. Drastic changes to remedy a problem which is already treated under present law are not justified. As indicated by testimony and documents received by the Commission, such changes will adversely affect the ability of debtors to rehabilitate financially.

1.3.3 Elimination of the “Ride-Through” of Secured Debt

Debtors should not be permitted to “ride-through” secured claims in bankruptcy and retain collateral via a *de facto* non-recourse loan so long as contract payments on the debt are made. Debtors must make a § 521 election to redeem, reaffirm, or surrender each asset subject to a security interest.

The Bankruptcy Code currently provides that the debtor must file a statement, with respect to secured debts, of the debtor’s intention to redeem collateral for a secured debt, reaffirm a debt, or surrender collateral. Debtors are to perform their stated intentions with respect to the collateral within 45 days after filing the statement of intention. Currently, these three choices are the only ones recognized in the Bankruptcy Code.

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44 11 U.S.C. § 521(2)(A). Reaffirmation is a voluntary agreement between a creditor and the debtor concerning a debt for which the debtor’s personal liability would otherwise be discharged. 11 U.S.C. § 524(c). The creditor may then enforce the agreement as a post-petition obligation not affected by the debtor’s discharge. Redemption, 11 U.S.C. § 722, allows a Chapter 7 debtor to redeem personal property from a lien securing a dischargeable consumer debt by paying the secured lender the lesser of the fair market value of its collateral or the amount of the claim on the date the petition is filed. Surrender permits a debtor to choose to give the collateral to the lienholder in satisfaction of the debt.

Some Circuit Courts of Appeals, however, have discerned that the debtor has a fourth option, when the debtor has a debt on which he was not in default when he filed his bankruptcy petition.\textsuperscript{46} In these circuits, the debtor may retain collateral without reaffirming the debt or redeeming the collateral. This split should be resolved by amending § 521 so that keeping collateral without redeeming or reaffirming is prohibited.

The bankruptcy laws are intended to provide a debtor a "fresh start" by allowing a debtor to discharge all dischargeable debts while retaining assets that are exempt.\textsuperscript{47} Allowing a debtor to retain property without reaffirming or redeeming gives the debtor a "head start" instead of a "fresh start." When the debtor rides his secured debt through the bankruptcy, he effectively converts a secured obligation from a recourse debt to a nonrecourse one. The result is an involuntary modification (from the creditor's view) of the original contract, after which the debtor has little incentive to protect the collateral.\textsuperscript{48}

Allowing the debtor to retain the collateral absent reaffirmation or redemption limits the remedies available to the creditor in the event of the debtor's default after discharge. Because the secured creditor may not enforce the debt against the debtor personally when the secured debt is permitted to "ride through," the creditor's only remedy in the event of default is to repossess or foreclose upon the collateral as quickly as possible after default. A superficial analysis might suggest that a debtor benefits from the

\textsuperscript{46} Cases holding that debtors may not retain the collateral without redeeming or reaffirming are In re Johnson, 89 F.3d 249 (5th Cir. 1996); Taylor v. AGE Credit Union (In re Taylor), 3 F.3d 1412 (11th Cir. 1993); In re Edwards, 901 F.2d 1383 (7th Cir. 1990). Cases holding that debtors may retain the collateral are Home Owners Funding Corp. of America v. Belanger (In re Belanger), 962 F.2d 345 (4th Cir. 1992); Lowry Federal Credit Union v. West, 882 F.2d 1543 (10th Cir. 1989).

\textsuperscript{47} See 11 U.S.C. §§ 727, 522.

non-recourse status of a “ride-through” of the secured debt. However, the benefit comes at the expense of certainty that the creditor will not allow a discharged debtor to cure a default, but will instead immediately foreclose his lien since that is his only remaining right. Creditors will have an incentive to declare a default on any pretense, however minor, in order to protect their interests.

1.3.4 Purchase Money Security Interests in Household Goods of “Nominal” Value -- Critique of the Framework Proposal

The Framework Proposal states:

Section 522(f) should provide that a creditor claiming a purchase money security interest in exempt property held for personal or household use of the debtor or a dependent of a debtor in household furnishings, wearing apparel, appliances, books, animals, crops, musical instruments, jewelry, implements, professional books, tools of the trade or professionally prescribed health aids for the debtor or a member of the debtors’ household must petition the bankruptcy court for continued recognition of the security interest. The court shall hold a hearing to value each item covered by the creditor’s petition. If the value of the item is less than $500, the petition shall not be granted; if the loan value is $500 or greater, the security interest would be recognized and treated as a secured loan in Chapter 7 or Chapter 13.

49 For example, not just nonpayment, but also failure to insure the collateral and failure to perform maintenance and upkeep on the collateral are typical events of default.
This proposal of the Framework drastically changes the present balance between creditors and debtors in the bankruptcy system with both procedural and substantive changes in the law. One can only assume that the increasing costs to creditors of participating in the bankruptcy process, combined with increasing losses from writing off debtors’ accounts, will lead to incrementally higher interest rates for all borrowers in the larger credit marketplace.

The suggested provision shifts the burden to prove claims. A claim filed under section 501 is “deemed allowed, unless a party in interest, . . . objects”.\(^5^0\) The proposal would automatically convert what would otherwise be a secured claim (assuming a secured proof of claim was filed) to an unsecured claim, unless the creditor, in addition to filing a proof of claim, affirmatively acted to confirm the perfected security interest. No justification has been advanced for this procedural change.

The legislative history of § 522(f)\(^5^1\) clearly establishes that Congress was seeking to remedy the problem of creditors taking blanket non-purchase money security interests in all of a debtor’s possessions as leverage to extract repayment on a debt. Congress did not state that purchase money liens had only hostage value. Interestingly enough, the proposal fails to note that in Chapter 13, the debtor already has the right to strip down purchase money liens.\(^5^2\) This proposal changes the law to permit a Chapter 7 debtor to gain some of the benefits of Chapter 13. Will this encourage more Chapter 7s? As in the case of the false claims proposal, this § 522(f) proposal is not aimed at any real problem. No public outcry has sought this reform, nor does any testimony justify it. It is merely one of the proponents’ perceived evils in the states’ general commercial law which needs to be remedied as part of their social-engineering agenda.


Article 9 of the Uniform Commercial Code provides for automatic perfection of purchase money security interests in consumer goods. However, in order for there to be perfection, there must first be a valid security interest. The Framework alludes to the "questionable validity" of purchase money security interests in many retail charge card agreements and acknowledges that most creditors realize their liens are not enforceable. So, is this a real problem, or is this like other proposals of the Framework -- part of an agenda to create a federal commercial law? The validity of such a lien is properly a question of state law.\(^53\) Once state law determination has been made, the next step should be to determine whether any overriding bankruptcy policy justifies not applying the state’s law. Both Congress and an earlier Commission found none; no overwhelming evidence supports such a change. The Framework has been driven by its social-engineering agenda;\(^54\) given the lack of substantial evidence, reference is made instead to individual anecdotes to show a larger problem. However, the logical conclusion is that the individual anecdotes are just that -- isolated events not reflecting a pattern.

The Framework’s argument in support of the change is spurious. The authors assert that the loss of or damage to personal property subject to these security interests could cause denial of discharge of the debt. The case law is clear, however, that unless a creditor can prove not only that the debtor knew of the security agreement (according to the proposal, this is rare), but also that the debtor knew that a transfer of the property was wrongful, the debt should be dischargeable.\(^55\)

This provision of the Framework is unnecessary. This problem has not been established or studied by the Commission. A competent debtor’s attorney will not have any problem avoiding a purported lien on the debtor’s pantyhose; nor, for that matter, will a creditor’s attorney have any difficulty in


\(^{54}\) See General Critique of the Framework, infra Part III.

\(^{55}\) 11 U.S.C. § 523(a)(6) covers willful and malicious conversion of collateral; see also In re Posta, 866 F.2d 364 (10th Cir. 1989).
recognizing the unenforceability of the lien. The problem is already addressed by the present law; no reform is needed.

1.3.5 Characterization of Rent-to-Own Agreements -- Critique of Framework Proposal

The Framework provides:

Consumer rent-to-own transactions should be characterized in bankruptcy as installment sales contracts.

The issue here is simple -- is a rent-to-own ("RTO") contract a "true lease" or is it a credit sale with a retained security interest under the Uniform Commercial Code? Senate Bill 540, in 1994, proposed to treat RTO contracts as credit sales rather than leases for purposes of Chapters 7 and 13. Congress rejected that proposal. Furthermore, as of 1994, 39 states have statutes which explicitly identify RTO contracts as true leases.\(^{56}\) The RTO business is a robust $2.8 billion industry with some 8,000 stores operating in the United States.\(^{57}\) Changes in the law that would affect such a significant economic segment should not be made lightly, particularly in the face of the above-referenced efforts of many state legislatures to direct their laws to the opposite result. Finally, under the federal Truth in Lending Act, a regulation has been promulgated which excludes rent-to-own contracts from the definition of credit sales.\(^{58}\) As one observer has pointed out,

[R]echaracteriz[ing] rent-to-own transactions as installment sales is misguided. It

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\(^{56}\) See Cooper, IDENTIFYING A TRUE LEASE UNDER U.C.C. SECTION 1-201137 (J. Wong, ed. 1995); see also In re Connelly, 168 B.R. 714 (Bkrtcy. W.D. Wash.) (holding that state statute’s characterization of RTO as lease is determinative for bankruptcy purposes).

\(^{57}\) WALL STREET JOURNAL, June 4, 1994, at A5.

\(^{58}\) 12 C.F.R. § 226.2(a)(16).
conflicts with well-settled federal law under the Truth in Lending Act. It flies in the face of special rent-to-own legislation enacted during the last 13 years in 45 states. It raises a serious issue of federalism in bankruptcy policy as expressed in prior United States Supreme Court decisions. It undercuts consumer choice in the marketplace and is certain to increase costs to consumers.\textsuperscript{59}

Ordinarily, the existence, nature and extent of a security interest in property is governed by state law.\textsuperscript{60} The Code does not define the term “lease.” The legislative history of the Code indicates that whether a lease is a security interest under the Code is to depend on its treatment under applicable state law. Thus, a determination of whether a RTO contract is a lease or a security agreement is properly a matter of state law and outside the scope of bankruptcy law.\textsuperscript{61}

By converting RTO contracts from leases to credit sales, debtors (at least in 39 states) reap a windfall in Chapter 13. If the RTO contract is a lease, a debtor may only retain possession of the leased goods by assuming the lease under 11 U.S.C. § 365(b). Such assumption requires the debtor to pay the total of the lease payments without modification. If the contract is treated as creating a secured interest, however, the debtor may modify the contract’s terms by stripping the lien down to the amount of the secured claim and treating the stripped portion as an unsecured debt -- which normally means less than full payment on the unsecured portion under a plan.

This part of the Framework has no place in Bankruptcy reform. It reflects the proponents’ dissatisfaction with the legitimate variances caused by state laws in our dual-sovereignty republic. The proponents are attempting to use the bankruptcy reform

\textsuperscript{59} Attorney Barkley Clark, undated memorandum to National Bankruptcy Review Commission: “A Brief Critique of the Commission’s Proposal to Recharacterize Rent-to-Own Transactions.”


\textsuperscript{61} See, e.g., \textit{In re Powers}, 983 F.2d 88 (7th Cir. 1993).
process as a method of creating a federal commercial code to replace state commercial law. This is but another example of an issue treated in the Framework in the absence of any working group discussion or evidence presented at any of the hearings. It is another attempt to impose the proponents’ social agenda upon the Code -- “these poor unsophisticated consumers need help.” Finally, it should be noted that this proposal, like many proposals contained in the Framework, may be thought by its proponents to be debtor-friendly, but it is not consumer-friendly. Low-income consumers will suffer when the availability of RTO items tightens up because the costs of doing business as a secured lender exceed those of lessors.

1.4.1 - 1.4.6 Exceptions to Discharge -- No Comment

1.4.7 - 1.4.8 Objections to Discharge -- No Comment

1.5A Repayment Plans in Chapter 13

Chapter 13 should be strengthened as follows:

- payments under a Chapter 13 plan should be made simultaneously to secured and unsecured creditors for the life of the plan, as provided in the Framework;

- specific approval of 5-year plans should be codified. See § 1325(d);

- Chapter 13 plans should be reviewed annually and payments modified if a debtor’s income goes up or down.

Chapter 13 plans embody in theory a debtor’s honest attempt to repay some portion of his obligations based on his “disposable income.” Unfortunately, the success rate of Chapter 13 plans is low: nationally,

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62 See General Critique of the Framework, infra Part III.

approximately two-thirds of the debtors do not complete their plans.\footnote{64} These proposed statutory carrots and sticks should be added to facilitate payments and discourage voluntary cessation of payments. Many courts with higher Chapter 13 plan success rates already routinely confirm five-year plans. That practice, often a convenience to debtors, should be codified though not required. Providing that payments will be made simultaneously on secured and unsecured debt encourages the debtor to complete the plan to obtain the desired debt relief.\footnote{65}

Some observers fear that Chapter 13 plans take too long to complete,\footnote{66} and that plan confirmation is a speculative process, because most debtors cannot predict with accuracy their future earnings. A better system would allow repayment plans to be completed based on actual income, rather than the speculative projections made in the plan proposal and confirmation process. One suggested solution is an annual review of plans based on debtors’ tax returns. Section 521 would be amended to require that Chapter 13 debtors

\footnote{64} Michael Bork & Susan D. Tuck, Administrative Office of the United States Courts, Bankruptcy Statistical Trends, Chapter 13 Dispositions (Working Paper 2), at 2. “Discharges comprised 36% of all cases terminated.” According to the same source, 63% were concluded by either dismissal (49%) or conversion to Chapter 7 and termination as such a case (14%).

\footnote{65} In a slightly different context, U.S. Bankruptcy Judge Arthur J. Spector, in a letter to the Commission dated March 14, 1997 (supra n. 8), had this comment: “[I]t seems that creditors holding dischargeable unsecured claims could be cheated out of dividends which they otherwise would be entitled to in Chapter 7 if the debtor defaults and the case is closed . . . .” This comment illustrates the harm to unsecured creditors of leaving payment of their claims to the end of a Chapter 13 plan, particularly when one considers, again, the present high rate of plan failure. See Bork & Tuck, supra note 58.

\footnote{66} But consider this comment: “In 1978 when the Code was adopted, most car loans were for three years and most families had only one vehicle. Consequently debtors could pay off their one vehicle and make a reasonable distribution to unsecured creditors in three years. With the advent of much longer car notes and multiple car families, it is often difficult to make any significant distribution to unsecured creditors in a three year plan.” U.S. Bankruptcy Judge John C. Akard, Letter to members of the Consumer Working Group of the National Bankruptcy Review Commission, March 26, 1997.
making payments under a confirmed plan must provide copies of all tax returns they file to their trustee. If a debtor’s reported income significantly changes, the trustee or any party in interest could move for the plan to be modified. Notice and opportunity for hearing would be required for any such modification. Debtors’ attorneys would be entitled to additional compensation for their representation of debtors at modification hearings.

1.5.1 Home Mortgage Debt

Section 1322(b)(2) should be clarified to state that no lien for a debt secured principally by a debtor’s homestead can be stripped down.

We take no position on this Framework’s proposal to strip home mortgage liens that had greater than 100% loan-to-value ratio when taken.

Courts have split on whether the Chapter 13 protection from lien-stripping granted to home mortgage lenders in § 1322(b)(2) applies if the loan collateral includes any interests besides the real property mortgage. Some of these decisions have undercut Congress’s intent to insulate home mortgage lending from the vicissitudes of bankruptcy. Congress itself

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68 “[S]ection 1322(b)(2) exist[s] because of the national policy in favor of home ownership . . . . The elimination of [the intended] protections for some home mortgages will force lenders to underwrite and price these loans as unsecured loans, making them more expensive to some borrowers and unobtainable to others.” William J. Perlstein, Esq., letter to National Bankruptcy Review Commission, June 4, 1997. Ms. Roe, see supra note 64, concurs: “ ‘[B]ankruptcy severity’ has an ultimate effect on the price of mortgage loans . . . . On the other hand, changes in the bankruptcy system that decrease bankruptcy severity will ultimately favorably impact the cost of home mortgages and will benefit those bill-paying consumers who are seeking financing for new homes.” Id.
has consistently rejected previous attempts to permit stripping of liens.\textsuperscript{69} A minor change to § 1322(b)(2) will eliminate the uncertainty and protect home mortgage lending whenever the homestead lien is the principal collateral for the debt.\textsuperscript{70}

1.5.2 Other Secured Debt

a. Valuation of Retained Collateral.

We recommend adoption of a simple standard for valuing collateral and, consequently, lien interests, under § 506(a): the replacement value standard described in Rash,\textsuperscript{71} on personal property, and tax-assessed value for real property.

Valuation of collateral in bankruptcy has not been debated by this Commission at all, a fact which may account for the shifting positions on the subject proposed in the Framework and by these dissenting recommendations.

The May version of the Framework recommended the midpoint between wholesale and retail values for personal property, and it eliminated any reference to real property valuation. The Framework also looked to the impending Rash decision for guidance. When Rash adopted a “replacement value” standard, however -- not to the Commission staff’s liking -- the staff generated a new proposal advocating wholesale value for personal property and a reduced-fair market value standard for real property. This standard was adopted by a five-


\textsuperscript{70} Mr. Perlstein suggested examples of what collateral would be affected by this proposal, so that their inclusion as collateral would not subject the lien to stripping: “fixtures, escrow accounts and other related collateral that are customarily part of a home mortgage transaction. . . . [this promotes] uniformity because of the [current] need to determine whether a particular item of collateral is part of the real estate under the law of a particular state.” Perlstein, letter to National Bankruptcy Review Commission, supra note 65.

four mail-in ballot vote. We have never discussed the ramifications of this standard in open session.

Valuation is the “third rail” of bankruptcy practice. Section 506(a), which the Supreme Court interpreted in Rash, cuts across every chapter of the Code, applies to every type of property imaginable and has enormous macro-economic consequences for lenders and strategic consequences for all parties in bankruptcy. A good argument can be made that the 1978 Code, in addressing the complexity of valuation, deliberately left the statutory language fuzzy in order to preserve judges’ flexibility to determine valuation in different circumstances. But the pervasiveness of the issue cries out for legal uniformity in like cases, in part to reduce the transactional costs of litigation, and the Supreme Court as well as this Commission have recognized the need for valuation rules.72

Unfortunately, the Commission’s process has not given us the time to study valuation properly or reach an informed judgment on it. The Framework position on valuation has vacillated; the dissenters’ position has wavered;73 we should confess that we had neither the time nor the opportunity to explore this subject. The Framework proposal is thoroughly staff-generated and staff-justified, and nearly all of it was composed after the vote was taken.

In lieu of recommending a new set of valuation standards, we advocate adopting the Rash “replacement value” standard for personal property and the tax-assessed value for real estate. These standards are wholly justifiable for several reasons.

First, Rash fairly interpreted the Bankruptcy Code’s language as recognizing two ways that a debtor deals with property: he uses it or disposes of it. 11 U.S.C. § 506(a). Rash held that if the debtor continues to use property subject to a security interest, the property has become subject to a forced loan by the creditor under terms set by bankruptcy law.

72 See In re Hoskins, 102 F.3d 311 (7th Cir. 1996).

73 A previous version of this dissent recommended the midpoint between wholesale and retail valuation for personal property.
The debtor “uses” this property so he does not have to go into the market for its replacement. Thus, “replacement value” becomes the touchstone for the amount of the creditor’s forced loan. This is a fair measure of the creditor’s opportunity cost in lending on equivalent collateral.

Second, the replacement value standard is not as difficult a concept as some commentators have suggested. The Court listed in footnote 6 of Rash some factors that may be properly deductible from retail value when a replacement value standard is calculated. They may or may not reduce replacement value to a proxy for wholesale value, as Judge Easterbrook has implied; in fact, it seems equally likely that replacement value will often be nearly the same as retail value for goods of like condition. Rash held that “whether replacement value is the equivalent of retail value, wholesale values or some other value will depend on the type of debtor and the nature of the property.” 117 S. Ct. at 1887, n.6. Caselaw will in short order coalesce around replacement value measures that are not as widely different as the pre-Rash cacophony of standards.

Third, replacement value more fairly corresponds with the creditors’ and debtor’s rights outside bankruptcy than does wholesale value. Valuing collateral strictly at wholesale provides a benefit to unsecured creditors and the debtor, in that the secured claim is set at its smallest reasonable value. When this valuation occurs in the context of confirmation of a plan, the collateral is valued to calculate the secured claim and determine what amount of the debtor’s finite available resources, whether Chapter 13

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76 The Framework describes wholesale value as a “midpoint” value for the collateral. This is a novel way to describe wholesale. The Framework cites only academic articles; no caselaw has employed a below-wholesale standard.
disposable income or Chapter 11 business revenues, will be distributed to pay secured claims and how much will remain to be prorated into the unsecured creditors’ dividend. However, the benefit is achieved entirely at the expense of the secured creditor, whose bargain was, in the beginning, to be paid retail price for the collateral, over time and with interest; repossessing the collateral was a second-best alternative to the terms of the original bargain. With this bankruptcy valuation rule, the secured creditor has been put in the position where the baseline value of his claim is determined without any reference at all to his original bargain, but rather is determined entirely based on the less-desired contingency. In contrast, unsecured claims are at least valued (even if not necessarily paid) according to their contract terms, without reference to any comparable “second-best” value.

Fourth, as previously noted, this Commission has not engaged in a dialogue on valuation, as did the Supreme Court before it issued Rash. There is no reason to suppose that the last-minute decision of five members of this Commission is better than that of the nearly-unanimous Supreme Court.

The tax-assessed value of real property makes sense for two reasons. First, reference to this value should completely eliminate litigation and the high costs of litigating and bargaining over real property value in a vast number of bankruptcy cases. Second, as better technology has been applied by most taxing authorities both to estimate and update property assessments, the value generated will be realistic and objective.

In contrast, the Framework’s proposal on real estate valuation recommends fair market value less hypothetical costs of sale. Although intellectually defensible, the fair market value standard invites litigation, especially when compared to the tax-assessed value. This fair market value proposal was never discussed in the Commission at all. It was not in the June version of the Framework. If it is a good idea, it is one that the Commission adopted utterly without forethought. What is more troubling in light of the Framework’s recommendation to permit lien-stripping on certain types of junior home mortgages is that this value standard may impinge upon that recommendation, making it easier to strip such liens.
The Framework does not comment on such an unfortunate possibility.

b. Interest Rate.

The non-default contract rate of interest should be applied in cramdown cases.

The choice of non-default contract interest rate is based on two premises. First, debtors should be bound to their original credit bargains to the extent possible even in bankruptcy cases. Second, the non-default rate represents a fair proxy for general market rates of interest applicable to the type of collateral the debtor wishes to retain.\textsuperscript{77}

The Framework’s proposal appears to advocate a bright-line interest rate at six-month Treasury bill rates plus 3%. We should all be able to borrow at this rate! This proposal was never discussed or voted on by the Commission. It also conflicts outright with the Framework’s earlier recognition that, in valuing property at wholesale value for cramdown purposes, the interest rate should allow the creditor to adjust for the risk of its forced loan. True to its usual approach, the Framework denies the creditor either a higher valuation or a reasonable interest rate.

1.5.5 Consequences of Non-completion in Chapter 13

The consequences for not completing a Chapter 13 plan should be amended as follows:

- a default should be defined in Chapter 13 to include a debtor’s missing two consecutive payments and failure to catch up within 15 days of the due date for the second payment;

- if a debtor defaults on a Chapter 13 plan by missing payments or otherwise, and if the case is converted to Chapter 7 for this or any other reason, the

\textsuperscript{77} See General Motors Acceptance Corp. v. Jones, 999 F.2d 63 (3d Cir. 1993).
debtor shall forfeit the unique benefits of Chapter 13. All liens which had been stripped will be reinstated to their prebankruptcy contract terms, all ability to cure will be lost, and any tax restructuring will be withdrawn.

The dismissal provisions in § 1307(c) should be amended to include, as a cause for conversion or dismissal, default on the Chapter 13 plan. Default would be defined as missing more than two plan payments. Section 1307 should be further amended so that conversion of a Chapter 13 case to a case under another Chapter cannot be abused to impair a creditor’s rights. For example, under the current system, debtors can begin a Chapter 13 plan, pay off secured creditors through a crammed-down plan according to the value of a stripped-down lien, and thereby convert all secured debt into non-recourse obligations. Then the debtors can convert to Chapter 7. Upon conversion, all debt is discharged, including unsecured debt that should have been paid under the plan but was not. Unsecured creditors who might have expected to receive a dividend under the plan receive nothing, and secured creditors have received less than full payment on their claims because of cramdown. The following amendment to § 1307 would prevent such manipulation of the system:

(g) Upon conversion of a case under Chapter 13 to one under another Chapter, creditors shall be restored to the same position they occupied immediately prior to the Chapter 13 filing. Payments made during the pendency of the dismissed or converted Chapter 13 case shall be applied to the debtor’s obligations.

Consequences of Repayment Under Chapter 13 Plans

1.5.7 Superdischarge. -- No Comment.

1.5.8 Credit Reporting Of Plan Completion and Debtor Education Program.

Debtors who complete voluntary debtor education programs should have that fact noted on their credit reports. Debtors who complete Chapter 13 repayment plans should have their bankruptcy filings
reportedly differently from those who do not. The Commission recommends that the Fair Credit Reporting Act be amended accordingly.

One of the ironies of the current bankruptcy system is that debtors who try to repay their debts in Chapter 13 may appear to have worse credit histories than those who quickly discharge debts in Chapter 7. Few credit reporters identify debtors who tried to repay or those who, in fact, completed substantial repayments. Debtors who choose Chapter 13 repayment plans should have their bankruptcy filings reported differently from those who do not. Moreover, differential reporting would give debtors an additional incentive to undertake repayment in Chapter 13.

“I have heard from auto dealers and lenders that it is better to file Chapter 7 if a debtor needs to get a loan on a car in the next several years, and I so advise my clients. This is a very significant incentive to avoid Chapter 13 for those debtors who need transportation...and who doesn’t need a car in order to work?” David C. Andersen, Attorney at Law, Letter to National Bankruptcy Review Commission, June 29, 1997.

Henry E. Hildebrand, a Chapter 13 trustee in Nashville, Tennessee, commented that in his district, about 46% of Chapter 13 plans paid 100% to creditors. By way of explanation of the reasons why creditors tend to receive more from Chapter 13 debtors in Tennessee compared to other parts of the country, Mr. Hildebrand explained that “[m]any of the trustees, certainly in the Southeast, have tried to get together with the credit bureaus to expand the record to show what dividend was paid in Chapter 13. And while we’ve succeeded in Tennessee, the Fair Credit Reporting Act doesn’t require that. . . . [I]t would help.” “American Bankruptcy Institute Roundtable—Consumer Bankruptcy Issues Facing the Commission,” ABI Journal, July/August 1996, at 33-34.

A number of attorneys have noted:

FAVORABLE TREATMENT ON CREDIT REPORTING IS THE MOST IMPORTANT OF ALL SUGGESTIONS TO ENCOURAGE CHAPTER 13 OVER CHAPTER 7. As an attorney who meets with approximately 1,500 potential clients per year, I know that the major reason people pick a payment plan over straight bankruptcy is the hope that it will look more favorable on their credit.
Chapter 5: Individual Commissioner Views

The Consumer Bankruptcy Reform Forum of the American Bankruptcy Institute unanimously endorsed this recommended change in credit reporting, as did the National Association of Consumer Bankruptcy Attorneys. These groups felt strongly that more information in the credit system would help debtors re-establish their credit following a bankruptcy and help creditors make better underwriting decisions.

1.5.9 Credit Rehabilitation Programs.

Credit rehabilitation by means of incentive loan programs to debtors who have successfully completed a Chapter 13 plan should be encouraged.

Both the fact that the debtor completed a repayment plan and that the debtor attended a debtor education program would be useful information for creditors in making subsequent credit decisions. The debtor should be considered more credit-worthy if he has completed these steps, and he should receive commensurate treatment, both in availability and in cost of credit, for having worked to repay his past creditors and having learned financial and credit management skills through education.


[Improved chapter 13 credit reporting] would also be a great incentive for debtors to propose a plan ... and would motivate them to stay in the plan in the later years when a lot of people either decide to convert to a chapter 7 once the secured debts are paid or when they find they are struggling in the middle part of the plan. I truly believe that this would motivate debtors to both file and complete chapter 13 plans and, again, it would also ensure that more money is paid to the unsecured creditors.


1.5B Restriction on Successive Attempts to Obtain Bankruptcy Relief

We recommend two alternatives to the problem of abusive refiling: (1) adopt a simple rule to prevent repetitive filings by amending § 109 of the Bankruptcy Code to prohibit, except in extraordinary cases, the availability of any relief for individuals under Title 11 for six years after either the dismissal or discharge in any previous case; or (2) eliminate the possibility of an “automatic” stay for those who refile within 180 days or who are spouses, co-owners or co-lessees of a person who filed in the previous 180 days.

The purpose of our proposal, which is the same as that contained in a prior version of the Framework, is two-fold. First, it is aimed directly at the increasing number of abusive repetitive filings by individuals who seek to hinder and delay creditors from either collecting debts or regaining possession of collateral. One of the purposes of bankruptcy relief is to relieve the honest debtor of oppressive indebtedness and permit him a fresh start. Serial filings can be an abuse of the provisions and the spirit of bankruptcy relief. Second, this recommendation is designed to impose financial responsibility and integrity upon individuals. Bankruptcy relief is a serious undertaking which needs to be fully appreciated by those who seek its protection. We believe that by making it clear that a potential debtor has only one chance every six years to enjoy the extraordinary protection of discharge from debt, bankruptcy relief will become what it should be—the last resort, not the easy resort. This recommendation will also stop many of the impulse filers who file to obtain some advantage and then either dismiss or convert their cases. As clearly indicated by the rising number of repeat filers, bankruptcy relief is becoming merely another form of financial planning for some and a tool to defeat creditors’ collection efforts for others. The profound moral implications and the serious financial ramifications of bankruptcy filings have too long been

82 Under the present statutory Framework, the Supreme Court has ruled that Congress has not categorically foreclosed all serial filing. Johnson v. Home State Bank, 111 S. Ct. 2150, 2156 (1991). The objective of this change is to categorically deny a debtor the ability to avail himself of multiple bankruptcy proceedings.
forgotten and were apparently lost during the Commission’s rush to “finish its work.” The Framework’s proposal to remedy this problem by tinkering with the availability of the automatic stay is clearly inadequate.\footnote{See, e.g., National Consumer Bankruptcy Coalition, “What’s Wrong with the Commission’s Consumer Bankruptcy Proposal,” July 18, 1997 (asserting that the absolute refiling bar ought to be ten years).}

The flat six year prohibition would be subject to a good-faith administrative exception in those cases where a debtor could show cause for the need to refile and to seek relief inside the six-year bar. This exception should be available in only rare cases. For example, the exception would cover the situation of a bankruptcy case dismissed because of administrative error when the debtor did not receive a discharge or a filing of which the debtor had no knowledge or understanding. To the extent that repeat filings now arise from debtors’ inability to make their Chapter 13 plan payments, we contemplate that debtors will need either to modify Chapter 13 plans to make them livable, or else convert to Chapter 7 and receive that discharge, instead of dismissing and refiling afresh for Chapter 13 relief.\footnote{Jill Sturdivant, Assistant General Counsel for Bank of America noted that this original proposal would resolve a vast majority of abusive filings. Letter to Richardo Kilpatrick from Jill Sturdivant, May 28, 1997. See also Memorandum of the National Bankruptcy Coalition, April 16, 1997 (also endorsing that proposal).}

While some may call this “bar” draconian,\footnote{Letter from Professor William C. Whitford to Elizabeth Warren, March 15, 1997 (noting that some restrictions on refiling are desirable but this proposal was drastic).} we believe that bankruptcy does have implications beyond the debtors and creditors involved in the cases. The Commission has repeatedly heard testimony concerning the economic impact upon non-debtors of the increasing number of filings. The bankruptcy process needs to be not only debtor-favoring, but also consumer-favoring in the larger sense. Too many hard-working individuals are paying more for credit as a direct result of the easy choice many take to file for bankruptcy relief. The Commission owed a
responsibility not only to those directly affected by adjustment of the process by which such relief is obtained, but also to those who are indirectly affected. The Commission failed to take into consideration the non-debtor and to make suggestions for change to improve the common good of the entire community. We believe that this absolute bar to refiling is the proper step to take for the common good of all.

Finally, asserting that a limit on serial filings is “draconian” is contrary to the history of American bankruptcy law. The legislative history of the 1978 Act also stated that “use of the bankruptcy law should be a last resort.” Congress criticized the inadequate supervision of wage-earner plans which “made them a way of life for certain debtors” by means of plan extensions, new cases, and newly incurred debts. Congress intended to discourage repetitive filings twenty years ago; it is high time to effectuate that goal.

Although some creditors are using current law to curb refiling problems, often through motions to dismiss Chapter 7 cases for cause under § 707(a) or, in Chapter 13 cases, under § 1307(c), these efforts are of limited success at best. Such efforts take time and cause additional expense to a creditor who is likely to suffer a loss or has already suffered a loss on account of the particular debtor whose case he seeks to dismiss. Creditors have no incentive to “throw good money after bad.” Trustees have no incentive to seek dismissal of cases upon which they depend for their livelihood. And courts simply do not have the resources presently to root out these abuses. Therefore, Congress should act to remove the unlimited ability of debtors to file cases and, perhaps, modify the incentive that motivates these sorts of filings in the first place -- the automatic stay.

A more limited approach to refiling than a six-year bar would solve this direct problem and render the stay non-automatic to serial cases where filed by a debtor within 180 days of each other. Such a debtor

86 3 Lawrence P. King, COLLIER ON BANKRUPTCY, App. Pt. 4-1209 (1997).

87 Id., at App. Pt. 4-1208.
would have to go to bankruptcy court and persuade the judge to issue a second or successive stay. This alternative proposal, which contains three parts, would also limit “team-tag” filings by spouses and members of a household. This proposal would be structured as follows:

1. Augment Remedy Under Section 109(g).

A. Section 109(g) now provides that a debtor is not eligible to refile for 180 days after: (a) the debtor’s case is dismissed for willful failure to obey an order of the court; or (b) the debtor voluntarily dismisses after a relief from stay motion is filed.

B. Under Section 109(g), if a new petition is filed within 180 days, the new case is subject to dismissal, but dismissal is not automatic or immediate, and the new case still creates a new automatic stay.

C. The effectiveness of Section 109(g) would be enhanced by providing that a refiling prohibited by § 109(g) does not create an automatic stay. The debtor could apply for a stay on notice and a hearing.

2. Automatic Limitations on Effect of Frequent Filing.

Where a debtor files a case that is dismissed or in which relief from stay is granted, and within 180 days after the earlier of the dismissal or relief from stay debtor files a second case that is dismissed or in which relief from stay is granted, and within 180 days after the earlier of the dismissal or relief from stay in the second case debtor files a third case, no automatic stay is created upon the filing of the third case, but debtor can apply for a stay on notice and a hearing.

3. Relief from Stay with Prejudice.

A. When a debtor files a case that is dismissed or in which relief from stay is granted, and within 180 days of the earlier of the dismissal or relief from stay, the debtor, debtor’s spouse, or a co-owner or co-lessee of debtor files a new case for an
improper purpose, the court may grant relief from stay with prejudice in the second case.

B. If the court grants relief from stay with prejudice, in any new case filed by debtor (or, where the order so provides, the debtor’s spouse, a co-owner, or a co-lessee) within 180 days after entry of that order, the automatic stay in the new case shall not apply to the action permitted under the order granting relief from stay with prejudice.\textsuperscript{88} The debtor may apply for a stay on notice and a hearing.

C. The court may enter an order granting relief from stay with prejudice only upon an express finding that the second case was filed for an improper purpose. Such an order may not be entered merely on basis of a stipulation of the parties or on the basis of the debtor’s failure to contest a request for such relief.\textsuperscript{89}

In stark contrast to our bright-line proposals, the Framework permits two repeat filings and does not squarely prohibit successive filings. It recommends that the filing of a petition by an individual does not operate as a stay if the individual has filed two or more petitions for relief under Title 11 within six years of filing the instant petition for relief and if the individual has been a debtor in a bankruptcy case within 180 days prior to the instant petition for relief. The Framework says that on a third filing, the court may impose a stay for cause shown, subject to such conditions and modifications as the court may impose.

This proposal, quite simply, does not achieve its intended result of curtailing abusive repetitive

\textsuperscript{88} Where the movant sought to have the order bind parties other than the debtor in the second case, the motion would have to be served on the second debtor’s spouse, or the co-owner or co-lessee.

\textsuperscript{89} The express finding is required to prevent creditors from routinely inserting “with prejudice” provisions in all stipulations and motions. the court would be able to grant relief with prejudice through stipulation or after debtor’s default, but only after making an independent determination that a factual basis for such relief exists. It would be like taking a guilty plea.
It is far too narrow to be effective with respect to a great many abusive refilers, and it may be easily circumvented by careful planning. The “three strikes” approach might bar an additional petition only when the second case was still open within 180 days of the debtor’s third filing. On the 181st day, the third filing is permissible. The evidence shows that multiple filings are particularly problematic for mortgage creditors (although certainly all creditors are affected). This proposal actually institutionalizes a debtor’s “right” to forestall foreclosure at least twice by carefully-timed filings and justifies the use of bankruptcy for manipulation rather than debt relief. An additional weakness of this provision is its philosophical acceptance of debtors who “live” in bankruptcy. This is not a provision whose drafters believe bankruptcy to be an extraordinary remedy, but it is instead a tool to be used routinely and infinitely, so long as the uses are at least six months apart. Nor will the Framework proposal have any impact upon abusive “Chapter 20” filings.

As to in rem orders, the Framework recommends that section 362 should be amended to provide that the

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90 For example, the Framework proposal would not have alleviated the problems reported by Herbert Piller, President of Merit Industries, in his letter to Commission Chairman Brady Williamson, July 30, 1997:

We have had 6 homes that we sold to people only to first have the husband go bankrupt on a Chapter 13 with their plan due in 3-4 months. Then the wife goes bankrupt taking another 3-4 months to work out a plan. After 6-8 months go by they WITHDRAW their bankruptcy filings and start again. Another 6-8 months go by and then finally they do the same tactic again.

The judge says, “his hands are tied because they can do this under the current laws.” [And under the Framework proposal, as well].

In the meantime, I’ve had zero money coming in for 12-15 months for several homes—is this fair? Is this what bankruptcy laws are for?
filing of a petition by an individual does not operate as a stay with respect to property of the estate transferred by an individual who was a debtor under Title 11 within 180 days of the filing of the petition, unless the court grants a stay with respect to such property after notice and a hearing on request of the debtor.

Likewise, the limited applicability of the in rem orders portion of the Framework’s proposal renders it somewhat ineffective to deal with the problem it addresses, and it would be completely unhelpful to landlords dealing with eviction problems. That is why we propose our own recommendations to deal with these particular problems, infra Parts 1.5.6 (“In Rem Orders”) and Part 1.5D (“Residential Leases”).

1.5.6 In Rem Orders

Bankruptcy courts should be empowered to issue in rem orders barring the application of a future automatic stay to identified property for a period of up to six years.

In rem orders should be an appropriate and available remedy for a creditor that could show the debtor had transferred property or fractional shares of property or that a present co-owner of the property filed a separate, additional bankruptcy petition to avoid creditor foreclosure or eviction.\(^9\) Some courts already issue such orders, with instructions that they

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\(^9\) For examples of the sorts of fraud perpetrated by such filings, see the “Materials on the Issue of Refiling in Consumer Bankruptcy” presented by U.S. Bankruptcy Judge Geraldine Mund on April 17, 1997, as well as her Letter to Melissa Jacoby and the National Bankruptcy Review Commission dated June 23, 1997. See also the Letter to the National Bankruptcy Review Commission of Michael S. Polk, dated April 15, 1997, in which he writes,

[L]ender losses attributable to these abuses is extreme. . . . A bar on repetitive filings is helpful; however, the ability and authority of the Bankruptcy Court to issue some form of “prospective” or “in rem” relief order against future debtors, upon a finding of abuse, is necessarily appropriate. Many Judges do not believe they have such authority without specific statutory foundation.
be recorded as equitable servitudes running with the land.\textsuperscript{92} A subsequent owner of the property who also files for bankruptcy (or the same owner in a subsequent filing) could petition the bankruptcy court to have the servitude set aside, allowing for the imposition of the stay to protect the property. The court would have discretion to grant such a petitioning debtor stay relief so that innocent parties who were not a part of a scheme to wrongfully hinder foreclosure or eviction can be protected. Of course, even in the absence of a scheme, the equities of a particular case may still favor permitting a creditor to foreclose.

This proposal\textsuperscript{93} should be effective against the typical participants in this type of abuse -- existing co-owners of property, often spouses, who subsequently or repetitively file bankruptcy petitions.\textsuperscript{94} It may be helpful also to amend the rules to require that all known existing co-ownership interests in any property listed as property of the estate must be disclosed in the schedules; creditors seeking initial relief from the automatic stay would be permitted to notice both the debtor and these co-owners concerning the hearing of the lift-stay motion, if feasible. Notification of co-owners might reduce the incentive for subsequent filings -- as well as making them more risky, in that they would more clearly be fraudulent, abusive filings made in bad faith.

\textsuperscript{92} See, e.g., In re Snow, 201 B.R. 968 (Bkrtcy. C.D. Cal. 1996).

\textsuperscript{93} It should be noted that this proposal is in addition to, and does not duplicate or render unnecessary, the other proposals to limit repetitive filings. These different methods of correcting this problem attack different methods of abuse of the system. As one bankruptcy judge noted, “I also support the restriction on serial filing (although I recognize that in some jurisdictions, some form of in rem power will still be necessary.)” U.S. Bankruptcy Judge Arthur J. Spector, letter to National Bankruptcy Review Commission, March 14, 1997.

\textsuperscript{94} “Mortgage servicers routinely see debtors and their spouses filing separate and successive petitions to increase the time that they can live in their home without making payments.” Janet S. Roe, letter to National Bankruptcy Review Commission, November 12, 1996, at 4. See also, e.g., In re Lester, Case #96-47131-H4-13 (Bkrtcy. S.D. Tex. 1997), Report and Recommendation of Contempt to the District Court.
1.5C Affidavit Practice.

Relief from the automatic stay should be available to secured creditors upon a sworn motion supported by appropriate affidavits without the necessity of preliminary and final hearings when no one contests the creditor’s right to foreclose.

The automatic stay is the most important relief granted to consumer debtors under the Bankruptcy Code. The stay shelters debtors from creditors’ collection efforts while they resolve their financial affairs in Chapter 7 or in Chapter 13. Stay relief is currently granted to debtors immediately upon the filing of the case through the earliest of the time of closing of the case, of dismissal of the case, or of the grant or denial of discharge. The stay may, however, be lifted with respect to a particular creditor, on motion of a party in interest, and after notice and a hearing, for cause. Such cause may consist of the lack of adequate protection of the creditor’s interests or a showing that the debtor does not have equity in the property, and the property is not necessary to an effective reorganization.

Unnecessary cost and systemic inefficiency justify reform of the procedure for lifting the stay when such creditor relief is uncontested. Corporate creditors (most are corporations) must currently be represented by counsel, at ever-increasing cost.

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95 11 U.S.C. § 362(c)


97 Id.

98 As one judge noted, “I do not believe the aggregate costs of unnecessary motion practice is trivial.” Ronald Barliant, United States Bankruptcy Judge, Memorandum to the Honorable Robert E. Ginsberg, Vice Chair of the National Bankruptcy Review Commission, June 4, 1997.

Currently, a motion for relief from stay is required in all cases, even when debtors agree voluntarily to surrender collateral.100 Finally, preliminary and final hearings in these uncontested proceedings inefficiently diverts court resources from real disputes.

Section 362 should be amended to provide a more efficient summary procedure for the resolution of motions for relief from stay. Summary relief from stay should be granted on sworn motion, without the necessity of a hearing, if the motion establishes the statutory basis for such relief101 and the debtor receives adequate notice in order to enable him to contest the motion. Once fifteen days have passed, the requested relief should be granted if no response or opposition to the motion has been filed. The debtor’s notice should have been sufficient to allow him to respond. No reason justifies requiring a creditor to prove a second time in court, and to pay attorneys to do, what is already established presumptively by its proof of claim -- that is, the validity and extent of its security interest. In all but a few cases, which can easily be resolved as contested matters heard by court, the proposed affidavit procedure should be fair to all parties.

This recommendation adopts the current local practice of some bankruptcy judges, in which motions for relief from the stay which contain negative notice language are filed together with affidavits and forms of default order lifting the stay. In one such district, default orders are entered, without hearing, if debtors fail to respond or request a hearing within fifteen days after the date of filing of the motion.102

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F.2d 398 (5th Cir. 1981).


102 Judge John C. Akard, letter to the National Bankruptcy Review Commission, May 12, 1997, at 8; Judge Robert W. Alberts, letter to the Commission, May 7, 1997 (recommending maximum 14-day duration of stay in Chapter 7 cases to facilitate
To accomplish this reform, we recommend that Congress amend section 362 by inserting the following new subsection (e) and renumbering the following subsections:

(e)(1) A party seeking relief from the stay under subsection (d) of this section may, at any time after the filing of the petition, file a sworn motion for relief from stay setting forth all the facts necessary for such relief. Such a motion shall be accompanied by notice of the right of any adverse party to file a response and request a hearing under subsection (f) of this section, and to file opposing affidavits.

(2) The motion for summary determination shall be served forthwith on the debtor and any potentially adverse party. Any party opposing the lifting of stay must file affidavits in opposition to the motion and request a hearing, if a hearing is desired, prior to the expiration of 15 days after the date of filing of the motion for summary determination.

(3) On the 16th day after the filing of the motion for summary determination, the court shall enter an order granting summary relief from the stay if no adequate opposition has been filed.

1.5D Eliminate Residential Leases from Section 362

The automatic stay provided in § 362 of the Bankruptcy Code should be modified so that the stay does not apply to bar a lessor of residential realty from evicting a tenant/debtor and retaking possession of the realty, when the lease or rental agreement under which the tenant/debtor took possession has terminated, whether by its own terms or because of judicial eviction processes.

uncontested repossessions); Judge Barliant, memorandum to the Honorable Robert E. Ginsberg, supra note 93.
The Commission has heard powerful testimony and received over three hundred letters, including, at last count, seven from members of Congress, concerning persistent, systematic abuse of the automatic stay by residential tenants who have successfully forestalled eviction for months by filing a bankruptcy petition. Typically, once in bankruptcy, the tenants refuse to pay rent and cost the landlords hundreds of dollars in lost rents and legal fees to pursue bankruptcy remedies. This tactic is particularly egregious when one considers that under many states’ laws, the tenant/debtor whose lease has expired or who has been evicted retains no property interest in the tenancy or residential realty that could ever have become property of the estate. If the tenancy is not property of the estate, then it is not shielded by the automatic stay.

The problem of tenant bankruptcy abuse has raged in the Central District of California (which furnished statistics to the Commission), but it is by no means confined there. Landlords and members of the National Multihousing Council flooded the Commission with letters from all over the country relating their personal experiences and unjustifiable


104 For example, Bankruptcy Judge Vincent P. Zurzolo so concluded, with respect to California law, in the case In re Smith, 105 B.R. 50, 53-54 (Bkrtcy. C.D. Cal. 1989).

105 One Florida property management company, for example, wrote, “What we have begun to witness, however, is an increasing number of residents faced with eviction who are filing for bankruptcy with the sole purpose of delaying the eviction.” Ms. LuAnne Acton, Area Property Manager for Jackson Management Group, letter to National Bankruptcy Review Commission, June 4, 1997.
financial losses.\textsuperscript{106} Many of these letters were written by individual landlords of patently modest means who can ill afford to lose months of rent and hire an attorney to evict a tenant.\textsuperscript{107}

It is no defense of this abuse to contend that bankruptcy law is needed to “protect” the tenant/debtors.\textsuperscript{108} State law eviction procedures are

\textsuperscript{106} One landlord wrote of a particularly large loss:

A skilled group of tenants, who knew more about tenancy rights and laws than most lawyers, managed to stay in my rental home for six months rent free, while causing more than $20,000 in damages . . . . The health department had sited \textit{sic} them. It took four hearings, none of which did the tenants attend, before I could gain possession again. After the $40,000 in damage, legal fees, and lost rent, the marshall finally evicted them . . . . If these people had stolen $40,000 they would be in jail.

Ms. Patty Boge, letter to National Bankruptcy Review Commission, February 2, 1997. As another landlord, Mr. Wynn Sandberg, summed it up, “The automatic stay only delays things longer [than the 45-90 days already spent in the eviction process] and adds more expense to an already expensive process for the property owner. There are many small operators who cannot afford any additional delay.” Letter to National Bankruptcy Review Commission, June 8, 1997. The Commission has received other letters relating similar anecdotes from landlords in California, Louisiana, Virginia, Florida, Tennessee, Arizona, Pennsylvania, Colorado, New Jersey, Texas, North Carolina, and Alabama. Landlords from virtually every state have written to the Commission urging reform, even when they have not personally been affected by this type of abuse.

\textsuperscript{107} One landlord, Ms. D. Kay Harrison, wrote the following: “Our net income [from a 12-plex apartment building] for 1994 was $1,535. For 1995 it was [a net loss of] $2,306.” Letter to National Bankruptcy Review Commission, January 27, 1997.

\textsuperscript{108} This is particularly true when one considers the larger economic impact of higher rents upon non-debtor tenants. As pointed out by one landlord, “This adds unnecessary costs to the ownership of rental property which, in fact, must be added to the rental rates which means that someone else is bearing the cost.” Mr. Marvin G. Dole, letter to National Bankruptcy Review Commission, June 11, 1997.
fair, sophisticated and fully protective of tenant rights.\textsuperscript{109}

Therefore, § 362(b) should be amended to make clear that the automatic stay does not bar eviction of a residential tenant whose lease or rental agreement has expired or of one who has been or is being evicted for cause by his landlord. In the alternative, Congress may wish to consider amending § 362(a)(3) to make clear that a residential tenancy that has expired or been terminated prior to the filing of the bankruptcy petition does not become property of the estate, such that acts to obtain possession of the rented or lease residential realty are not barred by the stay.

\textbf{III. General Critique of the Framework}

Metaphorically, consumer bankruptcy legislation can be viewed as a “field of dreams.” Since enactment of the Bankruptcy Code in 1978, over ten million debtors have sought relief under its provisions.\textsuperscript{110} Hundreds of millions of dollars in debts have been discharged. There appears to be no foreseeable reduction in the numbers lining up for a chance to “play” for the “home team.” The “visiting team” -- the creditors -- also play on the same field. Debtors view winning in terms of discharge from debt obligations; creditors, however, view winning in terms of the number of dollars they collect through this federally operated debt collection system. Neither

\textsuperscript{109} “We have researched this issue and have not found any state eviction statute that allows non-judicial evictions. Moreover, as you know, one of the primary justifications for [this] proposal is that a tenant in a state court eviction proceeding is provided extensive due process rights through that proceeding.” Clarine Nardi Riddle, letter to National Bankruptcy Review Commission, July 7, 1997.

“team” is concerned about the effects of the game upon the hundreds of millions of Americans who play a different game with different rules in which debts are repaid without the intervention of the ever-burgeoning federal bureaucracy necessary to support the bankruptcy system. These other Americans view the bankruptcy game with a jaundiced eye, and feel that the rules need to be changed. While much of this perception is the result of high-profile players, who are not abusing the rules, as well as the staggering increase in the number of overall players in recent years, the general consensus in America today is that something needs to be done.

Congress heard the outcries of the general population and has started the ball rolling toward change. The need for improvement and updating of consumer bankruptcy legislation was the stated objective for the congressional creation of the Bankruptcy Review Commission.\footnote{See H.R. REP 103-835, at 59 (1994), reprinted in 1994 U.S.C.C.A.N. 3340, 3368. The Commission was charged with reviewing, improving, and updating the Code. \textit{Id.} at 3368. This all inclusive Act of 1994 made the most significant and substantial changes in the Code itself since in enactment. \textit{Id.} at 3340.} During the signing ceremony of the Bankruptcy Reform Act of 1994,\footnote{Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994). \textit{See, e.g.}, Gregg, Checklist for the Commission, 14 AM. BANKR. INST. J. 35 (1995).} President Clinton cited its creation of the Bankruptcy Review Commission as the new law’s most significant measure.\footnote{Statement by President William J. Clinton upon signing H.R. 5116, reprinted in 1994 U.S.C.C.A.N. at 3372-2.} The President stressed the need for the Commission to review and suggest changes in some of the serious policy issues raised in the Bankruptcy Code. The National Bankruptcy Review Commission\footnote{Title VI of the Bankruptcy Reform Act of 1994 establishes the Commission, outlines its duties, provides a method for the selection of its members, and addressed various fiscal matters related to the Commission. Bankruptcy Reform Act of 1994 at §§ 601-610, 108 Stat. at 4147-4150.} has been conducting extensive hearings in an attempt to accomplish its statutory mandate to provide Congress with suggestions for improving and updating the
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In the area of consumer bankruptcy, five members of the Commission support the controversial portions of a Framework they propose as the model for consumer bankruptcy reform. While suggesting some noncontroversial modifications, the Framework marks a drastic change in the direction of consumer bankruptcy. Initially, the Commission identified two significant problems to be remedied: the lack of uniformity\(^\text{116}\) in the treatment of similar

\[^{115}\] The House Report accompanying the legislation noted only:

\[T]\he Commission should be aware that Congress is generally satisfied with the basic Framework established in the current Bankruptcy Code. Therefore, the work of the Commission should be based upon reviewing, improving, and updating the Code in ways which do not disturb the fundamental tenets and balance of current law.

H.R. REP. 103-835, at 59 (1994), \textit{reprinted} in 1994 U.S.C.C.A.N. 3340, 3368. An earlier Senate Report relating to S. 1985 (which also contemplated the creation of a review commission in almost identical language to that which was contained in the bill signed by the President) also compared the new commission’s work to the earlier Burdick Commission. S. REP. 102-279, at 85. The Senate Report noted that unlike the Burdick Commission this commission was not “designed or empowered to rewrite the entire Bankruptcy Code,” but that it was to study the functions and balances of the present Code and provide Congress with recommendations to address areas where the Code might be “improved and modernized.” \textit{Id.} at 85-86.

Under its charter, the Commission is to deliver to Congress on October 20, 1997, its report which represents its conclusions and recommendations for legislation. Bankruptcy Reform Act of 1994, 108 Stat. at 4149.

\[^{116}\] This lack of uniformity leads to serious concerns about the ability of the present system to satisfy and fulfil basic notions of justice. If individual creditors or debtors who are substantial similar are treated differently dependent solely upon the court in which they find themselves located, the system is seriously flawed. The Commission is clearly aware of the unfairness and the lack of cost effectiveness that this lack of uniformity breeds. However, despite the acknowledgment of the lack of similar treatment for equals by all participants in the system, no one has raised the issue which is the subject of this article -- the need for a coherent philosophy of consumer bankruptcy.

This admitted lack of uniformity is ironic in the face of the fact that the lack of uniformity of practice and procedure was the primary reason given to abandon

In large part this lack of uniformity is seen as a direct result of the wide latitude of discretion which the various judges feel that they are allowed to exercise. Whether the judges see this as the residuary of the equitable nature of bankruptcy proceedings, or their use of equitable powers to interpret the Code, or otherwise is unascertainable. This disparate treatment (from state to state, district to district, city to city, and judge to judge) leads to a lack of uniformity and predictability that similar cases will be treated alike. This leads to serious concerns as to the intrinsic justice of the consumer bankruptcy process. The lack of uniformity also raises concerns concerning the cost effectiveness of the process from both the creditor and debtors perspective.

Examples of a lack of uniformity abound especially in Chapter 13 cases. Bankruptcy judges across the country implement the provision of Chapter 13 in a widely divergent manner. First, there is no agreement on the minimum level of payments necessary for the implementation of a Chapter 13 plan; some courts approve only 100% plans, while others routinely approve plans that result in little, if any, percentage payments to the unsecured creditors. Compare In re Fields, 190 B.R. 16 (Bank. D. N.H. 1995)(court can approve a zero distribution plan to unsecured creditors); In re Anderson, 173 B.R. 226 (Bankr. D. Colo. 1993)(there is no minimum payment requirement for unsecured debt in Chapter 13); In re Tobiason, 185 B.R. 59 (Bankr. D. Neb. 1995)(except in cases of assault or attempted murder court should not find bad faith based on size of payments to unsecured debts) with In re Carver, 110 B.R. 305 (Bankr. S.D. Ohio, 1990)(a plan does not satisfy the good faith requirement if there are only small percentage payments to creditors whose claims would be nondischargeable in 7). Furthermore, the length of the plans vary from judge to judge, often unrelated to the percentage of payout. Compare In re Smith, 130 B.R. 102 (Bankr. D. Utah, 1991)(length of plan is a relevant consideration in determining whether plan is confirmed in good faith) with In re Tobiason, 185 B.R. 59 (Bankr. D. Neb. 1995)(plan which proposes to pay less than 100% satisfies good faith even though length of plan less than 36 months). Finally, there is no uniformity in valuation determinations involving lien stripping. Compare In re Murray, 194 B.R. 651 (Bankr. D. Ariz. 1996)(vehicle should be valued at wholesale value) with In re Mitchell, 191 B.R. 957 (Bankr. M.D. Ga. 1995)(vehicle to be valued at average between wholesale and retail values). The court in In re Valenti, 105 F.3d 55 (2d Cir. 1997), noted the three categories of cases making valuation determinations: (1) those
applying the collateral’s wholesale value, (2) those applying the retail value, and (3) those using some amount in between wholesale and retail value. In this case the court held that a bankruptcy court must consider the purpose of the valuation and the proposed disposition and use of the collateral when valuing a creditor’s allowed secured claim, for the purposes of a Chapter 13 plan’s confirmation. In the Fifth Circuit, the starting point for valuation of collateral which the debt proposes to retain and use as part of its Chapter 13 plan is what the creditor would obtain if it reposessed and sold the collateral pursuant to the security agreement. Matter of Rash, 90 F.2d 1036 (5th Cir. 1996), rev’d sub nom. Associates Commercial Credit Corp. v. Rash, 117 S. Ct. 1879 (1997).

Chapter 7 is also not immune from a lack of uniformity. A review of various judicial opinions concerning the application of the substantial abuse dismissal power, 11 U.S.C. § 707(b), leads to no general principles. Although the credit industry in 1974 had hoped that Congress would pass legislation which would have required a debtor to file Chapter 13 if he had sufficient income projected to fund a plan, Congress rejected this proposal. Instead, Congress enacted 707(b) which permits a court to dismiss a Chapter 7 petitioner upon a finding of substantial abuse. In spite of Congressional rejection of the “income test”, several courts have adopted such a test. See, e.g., In re Harris, 960 F.2d 74, 77 (8th Cir.) (rejecting an inquiry of “egregious behavior” on the part of the debtor as a necessary condition for dismissal under 707(b)); In re Kelly, 841 F.2d 908, 914-15 (9th Cir. 1988) (noting a finding that a debtor can fund a Chapter 13 plan, alone will justify granting a motion to dismiss under section 707(b)). Other courts have taken a more equitable approach and investigated the “totality of circumstances,” not just the ability to fund a Chapter 13 plan. See, e.g., In re Green, 934 F.2d 568, 572 (4th Cir. 1991). The equitable approach is arguably more consistent with the language of the statute. 11 U.S.C. § 707(b) (“There shall be a presumption in favor of granting the relief required by the debtor.”). Another clear area of lack of uniformity concerns the issue of whether a debtor who is current on his payments under the terms of a note and security agreement must either reaffirm, redeem, or return the property under Section 521(2)(A) of the Code. Compare In re Belanger, 962 F.2d 345 (4th Cir. 1992) (allowing retention without reaffirmation); Lowry Federal Credit Union v. West, 882 F.2d 1543 (10th Cir.) (allowing retention without reaffirmation) with In re Johnson, 89 F.3d 249 (5th Cir. 1996) (finding that debtor cannot retain property without redeeming or reaffirming); In re Taylor, 3 F.3d 1512 (11th Cir. 1993); In re Edwards, 901 F.2d 1383 (7th Cir. 1990) (holding that 1984 amendments to the Code do not support notion that debtor can retain property without reaffirming debt).
The Commission has been told of debtors who file repeatedly to avoid either foreclosure by mortgagees or eviction by landlords. The Commission has been told that there is little accuracy of the debtors’ schedules. On the other hand, the Commission has been told of creditors who threaten frivolous dischargeability adversaries in order to extract ill-advised reaffirmation agreements. More recently, the disclosure by Sears concerning the taking of reaffirmation agreements without court approval has raised eyebrows.

“[M]ost debtors are processed like cattle by trustees. Most of them never see a judge. The gravity of the bankruptcy process is thereby diminished.” Frank M. Hensley, letter to Elizabeth Warren, July 28, 1997. There is a distressing lack of accountability throughout the bankruptcy system. One attorney wrote, “The great majority of 341 meetings [creditor meetings per § 341 of the Code] are hollow rituals in which the trustee asks a routine series of questions duplicating the sworn schedules, and there is no other appearance of any substance.” Kenneth J. Doran, letter to National Bankruptcy Review Commission, July 26, 1996. The Commission heard extensive testimony at its May 16, 1996 meeting in San Antonio, Texas, that § 341 meetings are typically only five or ten minutes long, because as many as 50 of them may be scheduled to take place within a single hour; that creditors are often not permitted to participate meaningfully either because of time constraints or because they do not have an attorney representative present to speak for them; that false information on debtors’ bankruptcy documents is common and is routinely permitted to be corrected by amendment without any consequences, or, when consequences are threatened (such as non-dischargeability of a particular debt or a total bar to the debtor’s discharge), the debtor then converts his case to one under Chapter 13 where such actions cannot be pursued; that debtors frequently fail to appear for such meetings or examinations conducted pursuant to Fed. R. Bankr. P. 2004; and that no participants in the system have adequate resources or incentives to actively combat fraudulent activity. See testimony of Lenore Baughman, senior staff attorney for Chrysler Financial Corp.; Richard E. Flint, professor, St. Mary’s University School of Law; Jerry Hermesch, Vice President, Citibank; Henry Hildebrand, Chapter 13 Trustee; Jean Ryan, attorney; Henry Sommer, attorney; and Stanley Spence, Vice President and associate general counsel, Pentagon Federal Credit Union, at the afternoon session of the May 16, 1996 meeting for full text of their comments on the system’s integrity.

118 The Commission has been told of debtors who file repeatedly to avoid either foreclosure by mortgagees or eviction by landlords. The Commission has been told that there is little accuracy of the debtors’ schedules. On the other hand, the Commission has been told of creditors who threaten frivolous dischargeability adversaries in order to extract ill-advised reaffirmation agreements. More recently, the disclosure by Sears concerning the taking of reaffirmation agreements without court approval has raised eyebrows.
contrary to Congress’s intent, the Framework dramatically expands the ability to debtors to discharge debt, changing the balance in the present system between debtors and creditors to be more debtor-favoring.

This surprising result of the Commission’s work was as unnecessary as it was self-inflicted. The Framework was developed and presented to the Commission as a package, although constructed of disparate elements, and the Commissioners were required to vote on a take-it-or-leave-it basis. The process was unfair and led to a skewed result. A better and fairer approach would have been to list all the elements important in consumer bankruptcy and engage in debate over the alternatives for each element. As it is, no meaningful point-by-point debate ever took place; the clock ran out on the Commission just when the issues had been defined. No compromises were possible or even attempted. The Framework thus embodies a radically different philosophical view of bankruptcy law than the recommendations of the four-member dissenting group.

For both public policy and practical reasons the most significant parts of the Framework are flawed and should be rejected. The proponents of the Framework are disgruntled with what they see as defects in the laws of certain states. Therefore, the Framework seeks to create a federal law of commercial transactions in an attempt to evade the effect of the Butner decision. Seen in its best light, the Framework reflects the well-intentioned aspirations of individuals who live in ivy-covered towers who have no real day-to-day experience with the law they are seeking to reform. The sum of their knowledge of consumer bankruptcy is the incomplete raw data from selected judicial districts from which they draw “undisputable” conclusions and make recommendations, and the culled and selected portions of the Commission’s hearings and materials forwarded to the Commission which reflect and support their preconceived ideas of problems and need for reform.

One basic defect in the Framework is philosophical. The Framework is based upon two major assumptions: first, that debtors are financially

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disadvantaged through no fault of their own; and second, that debtors are inadequately represented in the bankruptcy process. From these two assumptions come the Framework’s inevitable conclusion: that as a matter of social justice, it is necessary to level the playing field by insuring that debtors are treated better under the reformed Code than they were before. As a result, much of the Framework can be characterized as social engineering designed to redistribute wealth, rather than bankruptcy reform. Redistributionism characterizes all of the Framework’s most far-reaching proposals: the limit of reaffirmation agreements; the voiding of security interests in household goods; recharacterizing rent-to-own contracts as security devices in order to limit their enforceability; generously increasing exemptions.\textsuperscript{120}

The tragedy of the Commission’s review process has been that the largest affected group has been left out: the legions of hard-working individuals who live within their means and pay their bills. They have been entirely unrepresented. As a consequence, the Framework implicitly assumes that its proposed changes will have no broader effects. We disagree. Many of the proposed changes will adversely affect this group through increased prices for goods, added borrowing costs, and reduced credit availability.

The Framework studiously ignores the external economic consequences of bankruptcy filings, portraying bankruptcy instead as a self-contained system, an analgesic for whatever ails debtors. But the impact upon the general economy and non-bankrupt citizens cannot be denied. If the Framework does nothing to stem the flood of increasing bankruptcy petitions during prosperous times, then a cataclysm of filings, whose damage we cannot foresee, will ensue with the next recession.\textsuperscript{121} Further, the debtor-friendly remedies in the Framework are not consumer-friendly. To take one example, the Framework’s recommendation to void liens on household goods with a “value” less than $500 per items markedly increases the risk for sellers of those goods. Sellers can only avoid losses from

\textsuperscript{120} Each of these proposals is more specifically discussed \textit{supra}.

\textsuperscript{121} It is already estimated that the bankruptcy system will discharge $40 billion in debt this year, imposing costs of about $400 per household nationwide. \textit{cite.}
such prophylactic provisions by (a) increasing costs and interest rates to all customers and (b) limiting or denying credit to more marginal customers. A two-tier credit system will take over, widening the gap between “haves” and “have-nots” and unfairly penalizing lower-income people who handle credit responsibly.

Finally, it is no answer to deflect criticisms of the Framework with the old saw that “everyone is unhappy, therefore it must be fair.” The disadvantages crafted in the Framework for debtors lie in the remote possibility of a random audit of their petitions, exposure to mild minimum template payments in Chapter 13, and a three-strikes condition on refiling for bankruptcy relief. Offsetting these occasional disadvantages are more generous exemptions and debtor-protection measures.

Creditors’ unhappiness stems, however, from Framework proposals that will pervasively affect general lending practices and the cost of credit to all consumers, while doing little to encourage repayment of debt. We will all pay the price of a Framework which is designed to aid debtors and penalize creditors. Unfortunately, lower-income citizens who struggle to and do pay their bills responsibly will be the foremost victims of the Framework.
COMMISSIONERS GOSE AND HARTLEY: CONCURRENCE WITH CONSUMER DISSENTING OPINION

Commissioners John A. Gose and Jeffery J. Hartley concur with the dissent; however, they do not necessarily share all of the views and statements contained therein.

Without question, the most contentious issues to be considered by the Commission relate to consumer bankruptcy. As Commission deliberations begin, one glaring shortcoming became more and more apparent -- the lack of meaningful data regarding consumer bankruptcies would force decisions to be made largely on an anecdotal basis. This unreliable information, coupled with the strong philosophical divisions inherent in all socioeconomic systems, has had, at best, mixed results.

Initially, the Commission’s work on consumer bankruptcy issues was intended to improve the entire system by promoting efficiency, increasing uniformity and decreasing costs. For various reasons, the Commission’s deliberations were unable to adhere to its own stated and agreed upon to process. While the working group concept was effective for the most part, it was not as successful regarding this most important and visible issue. As a result, the Commission adopted what is commonly now known as the consumer “Framework”. Supporters claim that the Framework is a viable alternative to the current consumer bankruptcy system. We disagree.

After much consternation and discussion, the Framework was finally adopted by the full Commission on a tenuous 5-4 vote. The closeness of this vote reflects the
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sharply divided viewpoints and the competing expectations that individual Commissioners have for the consumer bankruptcy system. On one hand, you have those who think the consumer system is too permissive lacking any measure of personal responsibility. On the other hand, however, you have those Commissioners who view the concept of a “fresh start” as sacrosanct, something to be protected at all costs. The truth actually falls somewhere in the middle.

The availability of bankruptcy protection and a “fresh start” are cornerstones to the American insolvency system and should be treated accordingly. When an individual files bankruptcy they immediately receive a tremendous advantage over their creditors by way of the automatic stay. This benefit should be coupled with a corresponding amount of responsibility. But, in the current consumer system, this burden of responsibility is often not met and it is here that the tension is greatest.

Who should control the ebb and flow of a case, the debtor or the creditors? Much of the evidence presented to the Commission contends that the debtor has too much postpetition discretion. But in all fairness, manipulation of the bankruptcy system comes from all sides -- debtors, creditors, trustees and, sometimes, even judges. To stifle some of this manipulation, the Framework offers some worthwhile suggestions with which we agree:

- A national filing system
- Heightened requirements for accurate information
- Random audits
- Financial education
- Measures to enhance the integrity of the system
But where the Framework falls short is its attempt to simplify and improve the system while maintaining its current balance. The basis for our votes against the Framework is that in comparison to the current consumer system, it is not an improvement. Unfortunately, the Framework was put forth on a “take it or leave it” basis. In an attempt to “balance” competing proposals, the Framework actually offers uncertainty, confusion and increased litigation. Many of its substantive proposals are both unfeasible and, if adopted, would put unnecessary strain on the current consumer system.

Congress gave the Commission limited instruction as to what specific changes they envisioned for the current consumer system. They did state, however, that the fundamental tenants of the current bankruptcy system should not be disturbed. Nevertheless, the Framework offers wholesale changes with uncertain results.

Judge Jones’ counter proposal to the Framework, defeated on an equally close 4-5 vote, avoids the fatal all-or-nothing approach and was offered as a collection of individual amendments. The Jones proposal is admittedly less debtor-friendly than either the current system or the Framework and promotes more debtor responsibility.

The Jones’ proposal expands the obligations on individual debtors who choose to file bankruptcy. Because of the dramatic increase in the number of consumer bankruptcies and the comparable amount of money that moves through the system, it is more important than ever that the integrity of the system be protected and, if possible, improved. In our view, many of Judge Jones’ proposals accomplish
this goal more efficiently than the Framework. The most positive aspects of the
Jones’ proposal include:

- Enhancement of Federal rule of Bankruptcy Procedure 9011
- Limited benefit from late filed amendments to schedules and statements of affairs
- Required submission of tax returns with a petition
- Affirmative statement by trustee that necessary documentation has been furnished
- Banning or revocation of discharge for material false statements or omissions
- Enhanced regulation of debtor’s attorney’s fees
- Reasonable uniform federal exemptions
- Protection of various contract rights
- Enhanced use of affidavit practice

Our concurrence with Judge Jones’ proposal results from a combination of our agreement with many of its substantive proposals as well as the need to offer an alternative to the Framework.

When it became apparent that the Framework would be adopted by a slim majority, it became equally apparent that an alternative, Judge Jones’ alternative, should also be put forth as well. Because of the Framework’s limited utility, Congress is going to be searching for options. Judging from the comments and submissions received to date the Framework is largely unpopular in the bankruptcy community.
Next year, if Congress begins the bankruptcy reform process as anticipated, the current system, the Framework and Judge Jones’ proposal, are excellent places to begin the debate.

The national dialogue fostered by the Commission’s deliberations of consumer reform and the divergence of the two proposals put forth is exactly what Congress had in mind when establishing this panel. It would have been a mistake for the Commission to not offer competing proposals. This is an instance when more is better. Although far from perfect, this report and its competing consumer proposals will be an enormous benefit as future policy decisions are made.

The Commission has created an abundant record of widely divergent views that could only be collected through the apparatus of such a commission. Individuals representing interest never involved in the policy making process have finally had an opportunity to participate. This benefit and its long range, positive effects cannot be overstated. We never understood the Commission’s role as the problemsolver of all the current consumer system’s ailments. The Commission’s role was to offer alternatives and options. We have accomplished this goal.
ADDITIONAL DISSENT TO RECOMMENDATIONS
FOR REFORM OF CONSUMER BANKRUPTCY LAW

Submitted by Honorable Edith H. Jones
and Commissioner James I. Shepard
The assistance of
Professor Richard E. Flint and
Ms. Kelly J. Wilhelm is gratefully acknowledged
I. General Observations

The consumer bankruptcy recommendations of a five-four majority of the Commission speak volumes about the error of entrusting reform to defenders of the institution that needs reforming. Many of these recommendations are not only unrealistic, they are simply deaf to the public debate over and frustration with this nation’s bankruptcy system. And in conspicuous areas, the majority recommendations are also mute. It is foolish not to view with alarm the fact that 1.2 million people filed for bankruptcy relief in 1996, nearly 30% more than in the previous year, and that a similar proportional increase appears to be happening during 1997. When filings rise dramatically while unemployment is declining, it is inevitable that the next economic downtown will produce a cataclysm of filings. When the

122 It must be reiterated that as of Tuesday, October 7, I have not seen either a final version of the Reporter’s Introduction to the Consumer Bankruptcy Chapter or final text of this Chapter. Yet these documents will go to the printer tomorrow. The drafting process has been timed to prevent a fair opportunity for dissent. If, therefore, these comments do not prove fully responsive to the Commission’s final report, the reasons for their shortcoming are apparent.
cataclysm occurs, the stability of our credit-driven economy could be shaken.

The Commission’s response to this reality, novel in our history, is silence. The reporter’s introduction to consumer bankruptcy purports to conclude that the cause of the high rate of bankruptcy filings is debt. That controversial conclusion\textsuperscript{123} is about like saying that the cause of the high rate of divorce is marriage. Even if the debt-causes-bankruptcy theory is portentous, it is founded in politics and economics, not law. Because neither the reporter nor any member of this Commission is an economist, it is out of our bailiwick to speculate on the economic causes of increased filings. But if too much debt is the source of the bankruptcy problem, Congress should address it directly rather than indirectly through bankruptcy law. This Commission’s

\textsuperscript{123} See, e.g., Morgan & Toll, “Bad Debt Rising,” Current Issues in Economics and Finance, March 1997, published by the Federal Reserve Bank of New York (“Charge-offs on credit card loans are rising sharply. While many analysts blame this trend on an expanding supply of credit cards, a closer look reveals the importance of two demand factors -- wealth and the share of the population at peak borrowing age -- in explaining the increase in bad debt.”)

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report should not be taken seriously on purely economic issues.

There remains a normative question which is very much within our competence to evaluate: whether a bankruptcy law that permits well over one million people a year to break their contracts and discharge debts -- during “good times” -- is functioning correctly. In this respect, the five-member majority tome on consumer bankruptcy is silent. Silence serves a number of purposes. It furthers the interest of those who file consumer bankruptcy petitions, many of whom advocated from the beginning of the Commission that the bankruptcy law wasn’t broken, and the Commission shouldn’t fix it. Silence stifles debate over whether bankruptcy relief should be means-tested like all other programs available in the social safety net. Silence ignores creditors’ complaints that their interests are systematically short-changed by the Framework, while those of debtors are enhanced.

Silence also obscures the impact of the Framework proposals, by concealing that those proposals
create even more incentives than now exist to seek bankruptcy relief and that they favor Chapter 7 discharge over Chapter 13 repayment plans. Nowhere, as far as I can tell, does the Framework justify these untoward consequences. The Framework induces more people to seek bankruptcy relief by significantly increasing exemptions; by treating reaffirmations as installment redemption on discounted collateral; by voiding liens on any household good less than $500 “value;” by degrading rent-to-own contracts from rental agreements to security interests; and by allowing full dischargeability of any credit card debt incurred within the authorized credit limits more than thirty days before bankruptcy. The general lesson from these changes is: go on a shopping spree and declare bankruptcy in thirty-one days. The Framework is silent on any notion of personal responsibility for one’s debts.

Similarly disadvantageous to creditors and to bill-paying Americans who bear the hidden bankruptcy tax,124 the Framework effectively discourages Chapter 13 filings. This effect results (1) from allowing the

124 See the means-testing discussion, infra.
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debtor to make no more payments on secured debt in Chapter 7 (through reaffirmation) than would be required in a Chapter 13 cramdown plan, (2) from measures that may increase Chapter 13 payment requirements without increasing debtors’ incentives to file in Chapter 13, and (3) from enhancing the exemption levels. The synergistic effect of these changes is skewed toward increasing use of Chapter 7.

The Framework’s silence about its impact on Chapter 7 filings is unsurprising, because it is completely irreconcilable with the early versions of the Framework that purported to enhance and encourage the use of Chapter 13. The Framework has in fact departed entirely, and entirely without explanation, from its initial premises. In March, the Framework was initially presented to the public as an integrated plan calculated to make the debtor’s choice between Chapters 7 and 13 relief consequential. The Framework sought to enhance use of Chapter 13 and to balance debtors’ and creditors’ rights. As a tradeoff for this first Framework’s attempt to ban all reaffirmations, the use of Chapter 13 would
afford secured creditors higher and more certain payments on unsecured deficiency claims.\textsuperscript{125}

As it matured into the final product, none of the first Framework’s aims have been preserved. The five-member Framework sent to Congress in fact blurs the line between Chapter 7 and Chapter 13 significantly by conflating reaffirmations and installment redemption. As its general thrust is to encourage Chapter 7 liquidations rather than repayment plans, unsecured creditors have no corresponding assurance of receiving payments in Chapter 13. Other measures that would have protected creditors appeared in the March draft and were inexplicably dropped thereafter, removing any pretense of balance between debtors and creditors. The five-member majority proposals that go to Congress, unlike earlier drafts of the Framework, have dropped the following provisions: a more rigid limit on serial filings; affidavit practice to speed up relief from the automatic stay; reliance on the impending Rash decision for valuation for collateral; and

\textsuperscript{125} Whether the early versions of the Framework could have achieved these goals, or whether they were somewhat miccurate, is a matter for another day.
dismissal of failed Chapter 13 plans rather than automatic conversion to Chapter 7. Admittedly, the present Framework eliminates the wholesale stripping of junior home mortgages, but the Framework remains, on balance, disrespectful of the state-law rights of secured creditors.

Elsewhere, several of us have identified other “process” and substantive objections to the consumer Framework. In particular, the General Critique of the “Framework” lays bare the unstated political and economic assumptions which guide that document. Consistent with all of those objections, I have additional serious objections to recommendations and omissions of the consumer bankruptcy chapter. These are:

- The Commission’s failure to consider mean-testing for consumer bankruptcy relief;

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126 See the Dissent on “Process” and the Recommendations for Reform of Consumer Bankruptcy Law by Four Dissenting Commissioners.
• the Commission’s failure to address changes to § 707(b), and “substantial abuse” provision; and

• the Framework’s recommendations for dischargeability of student loans, credit card debt, the Chapter 13 superdischarge, and state court default judgments.

Congress should consider means-testing for consumer bankruptcy relief; it should amend § 707(b); and it should decline to accept the Commission’s recommendations that enhance discharge of debts for unjustifiable reasons.

II. **Means-Testing Bankruptcy Relief**

In 1980, just after the Bankruptcy Code was passed and amid an economic recession, annual filings stood at slightly over 330,000. Sixteen years later, following a sustained period of economic growth, the number of filings has risen suddenly and dramatically
from just under a million to 1.2 million consumer bankruptcies in 1996. The disproportionate increase has continued in the first part of 1997.

We now have an anomalous situation in which unemployment is falling but bankruptcy is rising. Moreover, it has been estimated that Americans pay a hidden bankruptcy tax of $300-400 per household as the losses occasioned by higher bankruptcies are redistributed through higher-priced goods and services.\textsuperscript{127}

This is not the place to speculate on all of the causes of increased filings. But no one suggests that the filings are any longer demographically confined to the lowest socioeconomic groups or those who have irrevocably lost their jobs or have become physically disabled -- seeking bankruptcy protection has become more and more common among fully employed middle- and upper-class people. See Appendix attached hereto. More disturbingly, many debtors are now filing for bankruptcy

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protection before actually defaulting on debt. Id. As Congressman Pete Sessions recently described it, bankruptcy is “for some people . . . just another tool of financial management.” Further, contrary to the implications drawn by many bankruptcy practitioners and academics before the Commission, the rapid increase in filings cannot mean that the bankruptcy system requires amendment to soften its impact on debtors. If it were unfair to them, there would not be a vast migration toward bankruptcy when, as we see today, employment prospects seem brighter than ever.

In part, the bankruptcy boom springs from the intention of the 1978 Code. The drafters of the Code, many of whom have actively influenced this Commission’s work, consciously sought to remove the social stigma from filing bankruptcy. The Code, for instance, replaced the term bankrupt with “debtor” and described a case filing as seeking an “order for relief.” If you craft a social welfare statute, people soon learn to appreciate the benefits of seeking welfare.
Social and moral changes have also accelerated the trend to accepting bankruptcy as a feature of "normal" life. Movie stars, governors and "famed heart surgeons" have taken advantage of the process to discharge their debts, so why shouldn’t ordinary Americans? To take just one example from the wealth of bankruptcy-promoting advertising and literature a book titled Debt Free! offers "Your Guide to Personal Bankruptcy without Shame."  

A prominent bankruptcy judge once commented to me that when he graduated from law school around 1950, there were two things that "people never did: divorce and bankruptcy." This comment captures an insight often overlooked by those who make their living from the bankruptcy process. Declaring bankruptcy has a moral dimension. To declare bankruptcy is to break one’s contracts and agreements. Our society cannot function if it becomes widely acceptable to do this. In fact, the sanctity of contract -- enforced by the rule of law -- animated the growth, development and prosperity of the

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Western world. Enforceable contracts permit economic freedom to flourish and provide opportunity for all precisely because they are the product of voluntary action rather than state-sponsored preferences, priorities, or corruption. To regress from a norm in which contracts are enforceable threatens the foundation of our economic engine.

Beyond contracts and mere transactional effects are the distrust, disaffection and misunderstanding that erupt in a society which broadly permits such promise-breaking as occurs in bankruptcy. The large number of heartfelt and often poignant letters received by the Commission from creditors who were short-changed by debtors in bankruptcy attests to this sad reality. No doubt, bankruptcy is a necessary feature of Judeo-Christian capitalist societies, but to advance the equally moral goals of protecting social cohesion and general welfare, it cannot become more than an act of grace available to those who are truly and seriously needy. We must not, to paraphrase Senator Moynihan and former Treasury Secretary Lloyd Bentsen, “define bankruptcy deviancy downward.”
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Finally, bankruptcy has a macroeconomic effect on the cost and availability of credit. Graphically demonstrating this impact are hundreds of letters the Commission has received from credit unions. Credits unions’ losses in bankruptcy directly affect their loan rates and practices, and in the past three to four years, those losses have dramatically increased. Other lenders, large and small, have had similar experiences. The rising number of bankruptcies will increase interest rates for all consumers and will cause businesses to scrutinize credit more closely and discriminate among borrowers. The real losers as the supply of consumer credit tightens are those at the bottom of the ladder. In the final analysis, bankruptcy “reforms” that favor bankrupts do not favor bill-paying customers. Without further belaboring what should be an obvious point, bankruptcy as a social welfare program is subsidized by creditors and, through them, by the vast majority of Americans who struggle and succeed to make ends meet financially.

In light of these considerations, it is hard to justify why the Commission has not formally considered
means-testing for bankruptcy relief, as a device to limit
the adverse consequences of the filing explosion.
Several factors have contributed to this failure. First,
the advocates of means-testing received no encouragement
or assistance from the Commission’s staff. Second, the
creditor community has until recently been reluctant to
articulate a concrete proposal for means-testing. Third,
the professionals who have been heavily involved in the
Commission process exhibit the general reluctance of the
legal profession to contemplate “reform” that may disturb
their customary practices. Fourth, analogizing the
bankruptcy system to the welfare office, or to similar
programs that routinely engage in means-testing,
discomfits bankruptcy professionals. Finally, it is a
complex task to create fair and efficient means-testing
criteria that would not administratively bog down the
bankruptcy courts.

If the Commission had engaged in this important
debate, we might have considered at least five different
options for means-testing. It appears that the primary
considerations in setting up such a program are fairness
and ease of administration together with the maximum
feasible simplicity. The point of means-testing is to permit Chapter 7 discharge and liquidation of debt only to those debtors who are truly unable to repay their debts in the future. Those debtors who are income-earning, however, should not receive the benefits of the full discharge and the automatic stay to the extent that they are able to repay creditors the secured and a portion of the unsecured debts they have incurred. Each of the following proposals, listed in no particular order of importance, has the potential to accomplish the objective of means-testing within the noted constraints.

1. Section 707(b) could be amended to require that the court dismiss or convert the case of a debtor who has filed for Chapter 7 if, on the motion of a party in interest or the U.S. Trustee, it is found that the debtor has the ability to repay a portion of his debts in Chapter 13. This option would permit debtor-selection of bankruptcy relief to begin with, utilizing creditor oversight and the courts to determine the appropriateness of that relief within statutory guidelines. The provision might set as a threshold the debtor’s ability
to pay back 10% of unsecured debt within five years, or any other amount chosen by Congress.

2. Any debtor whose family income exceeded $35,000 or $40,000 per year, a solid middle-class income, might be permitted to file for Chapter 7 liquidation relief only by agreeing to pay for and submit to a full bankruptcy audit conducted by the panel trustee.

3. A presumptive income ceiling for the availability of Chapter 7 relief could be defined. Thus, any debtor whose family income exceeded an average middle-class income, say $35-40,000 per year, would presumptively be required to seek Chapter 13 repayment plan relief unless the debtor could establish extraordinary and compelling circumstances justifying Chapter 7 liquidation. Those circumstances could be codified and should include no less than serious and costly medical or health conditions; unique family circumstances (large number of dependents); being a fraud victim; or being out of work and unemployable for a sustained period of time.
4. A “least-common-denominator” means test would automatically channel any debtor seeking bankruptcy relief into a Chapter 13 proceeding if she is able to repay a minimum level of unsecured debt within five years. This proposal is administratively feasible, because it uses the information now recorded on the debtor’s bankruptcy Schedules I and J, reflecting income and monthly expenditures, and derives the debtor’s “disposable income” from those charts. A debtor and her attorney would immediately discern whether Chapter 7 or 13 relief was permitted and would so certify to the court. Court intervention would be required only for challenges to the certification or questions raised by the U.S. Trustee. The reform proposals of Four Dissenting Commissioners include proposals to enhance the integrity of debtor’s schedules and thus, one hopes, to limit manipulation of this alternative.

5. The needs-based test suggested by some creditors derives from the assumption that all debtors should be directed into a Chapter 13 repayment plan to the extent their family income exceeds average costs of living in their area, as determined by statistics from
the Bureau of Labor Statistics. Immediate questions are raised about the complexity and fairness of this proposal, but those objections may be allayed in various ways. First, BLS statistics are already in use in one form or another by Chapter 13 trustees as a gauge against excessive expenditures claimed by Chapter 13 debtors. Second, if BLS statistics are fair geographically, they can be administratively disseminated to bankruptcy courts, trustees and debtors’ attorneys and promptly updated. Third, the use of similar measures by family courts and tax collection agencies in working out debtor payment plans suggest their feasibility for bankruptcy plans. Fourth, the statute could except debtors from this standard under circumstances in which its application would be clearly unjust. Finally, to the extent this standard would require debtors to make higher payments than they presently contemplate, it is because such debtors have higher expenses and, presumably, higher income-earning history than average Americans. The proposal is therefore a progressive one, which would have its smallest impact on low-income debtors.
Three vehement objections to means-testing bankruptcy relief, and requiring many income-earning debtors to pay back some portion of their debts, have been frequently voiced. The first is that, given the current high failure rate of cases in Chapter 13, it can hardly be expected that when debtors are forced into debt payment plans, they will be more likely to complete their court-ordered obligations. While this is certainly a possibility, it is mitigated by the alternative that such debtors would face. If they did not complete their Chapter 13 plans, their cases would be dismissed, and they would again be at the mercy of creditors. The option of converting to Chapter 7 liquidation in a means-testing regime would necessarily be limited for those debtors who originally qualified only for Chapter 13 payment plans. It should also be noted that none of the presently-conceived means-testing proposals requires a particularly draconian level of debt repayment. Moreover, once debtors become well aware that their earning capacity will limit the debt relief to which they may be entitled, they can plan their lives accordingly. It is patronizing and short-sighted to assert that debtors are too stupid and undisciplined to adjust their
expenditures to the default standards that society will maintain.

Second, it is often cavalierly asserted by bankruptcy professionals that requiring people to repay some portion of their debts amounts to unconstitutional “involuntary servitude.” One court appropriately dismissed this odd notion as follows:

Debtors further argue that § 707(b) is unconstitutional as a violation of the 13th Amendment in that the statute “could force persons into a state of involuntary servitude,” debtors’ brief p. 9. [Under Section 707(b), debtor’s liquidation petition may be dismissed if the debtor could repay significant debt in a Chapter 13 case.]

The 13th Amendment proscribes slavery or its functional equivalents, e.g. peonage, U.S. v. Kozinski, 487 U.S. 931, 941-42, 108 S. Ct. 2751, 2759, 101 L.Ed.2d 788, 804ff. (1988). As noted above, § 707(b) is intended to
prevent debtors who are capable of paying their just debts from discharging them by misuse of an extraordinary privilege to which they are not properly entitled. If this violates the 13th Amendment, then it would seem that having to pay one’s just debts is “slavery” or “peonage” -- put another way, debtors would read the 13th Amendment as if it provided a Constitutional right to a Chapter 7 discharge! The great majority of Americans who work hard to pay off their voluntarily-incurred debts might be a bit surprised to hear the Protestant Ethic described as “slavery.” Judicial review of voluntarily-filed Chapter 7 cases for abuse does not force anyone to work and does not force debtors to divert any part of their income to payment of debts. Such judicial review merely requires debtors who already work and have enough income to pay their debts to “take their chances” under State law if they refuse to meet their obligations, by refusing in turn to grant equitable intervention to protect such
debtors from State debt-collection mechanisms where insufficient cause for such intervention has been shown.

In re Tony Ray Higginbotham, 111 B.R. 955, 966-97 (Bankruptcy N.D. Oklahoma 1990); see also In re Koch, 109 F.3d 1285, 1290 (8th Cir. 1997) ("Congress is free to limit Chapter 7 protection to truly needy debtors who cannot fund a Chapter 13 plan . . . .").

A third complaint by those who resist means-testing is that debtors cannot pay back anything, according to some empirical studies, or alternatively, there is no good proof that they can repay a portion of unsecured debts. I am not an economist or statistician and will not debate these hypotheses, although they are strongly controverted.129 Having been a member of the Commission’s Consumer Bankruptcy Working Group, however, and having read the thousands of pages submitted to us on consumer bankruptcy, I draw two firm conclusions. First,

129 See, e.g., the work of Dr. Michael E. Staten for Krannert Graduate School of Management, Purdue University.
too many letters from lenders and news articles depict instances of filings by people with steady jobs whose lifestyles got out of control or who gambled (sometimes literally) with their finances and lost. See, e.g., Appendix hereto. If they have steady income, and no exceptional problems such as physical disability, it does not seem unfair for society to ask them to repay some of their unsecured debts. Second, if by some chance it is true that no debtor can afford to repay some unsecured debts, then the critics of means-testing will be vindicated by that very program. No means-testing proposal I have seen would impoverish anyone with an impossible level of debt repayment. On the contrary, if all debtors are so needy as the means-testing critics contend, none of them will qualify for debt repayments, and all will receive a Chapter 7 discharge.

The arguments for means-testing are clear and are also consistent with accepted public policy for similar situations. Means-testing is not a radical idea. We already use it to determine child care benefits, Medicaid benefits, social security benefits, supplemental security income, food stamp benefits and student aid
benefits at the federal level alone. Moreover, as one professor has put it:

Lack of means testing creates the moral hazard problem of allowing abusers to self-select their own debt remedy. This can do nothing but exacerbate abuse. Would we, for example, allow welfare recipients to select their own benefits? Would we allow golfers to determine their own “gimmies”? Of course not. So why allow debtors to select their own remedy? Would they not simply act in their own interest on average, therefore exacerbating abuse? The answer is probably “yes,” so means testing (or some other gate keeping” machinery) is the only way to eliminate this moral hazard.

Letter from James J. Johannes, Firstar Professor of Banking and Director, Puelicher Center for Banking Education, University of Wisconsin-Madison, to Mr. Brady Williamson (June 17, 1997).
The Commission has in my view neglected its duty to investigate alternatives to the present-day reality of excessive bankruptcy filings. I hope that Congress will take up the challenge.

APPENDIX

The following is a sample of the letters this Commission has collected testifying to the need for means-testing. As these letters describe, lenders have begun to observe many of their clients file for bankruptcy who have neither missed a loan payment nor demonstrated inability to pay some portion of their debts. If this trend continues, many lenders predict that this phenomenon will place upward pressure on interest rates in order to compensate lending institutions for the increased levels of loan losses from bankruptcy as well as the expense of employing new credit monitoring systems.
1. Letter from Mark R. Leeper, Manager, River Valley Credit Union, Ames, Iowa, to National Bankruptcy Review Commission 1 (May 16, 1997):

The real problem is that too often people are allowed to file for bankruptcy and walk away from entire sums of debt when they have good jobs and steady income. There should be more restrictions on Chapter 7 bankruptcies that would force people to go through Chapter 13 instead. While Chapter 7 Bankruptcy is justifiable in situations where someone is hopelessly buried in debt with little means of making any sort of payment due to health, loss of job, etc., I have seen that the majority of cases our credit union has been involved in, the people have good jobs, steady income and a debt load that is not insurmountable to
overcome[,] and yet they can walk away from the entire indebtedness without paying a dime. Bankruptcy should offer “relief,” not a “free ride.”


The credit union has experienced a tremendous increase in bankruptcy filings over the last two years. We have recorded a 100 percent increase in bankruptcies since 1995. Our losses due to bankruptcy have escalated from $500,000.00 in 1995 to $1,150,000.00 in 1996. The losses due to bankruptcy in the first two quarters of 1997 are over
$900,000.00 and we are receiving a greater number of filings each month.

Many of our members are current on their loans when we received their bankruptcy petition and we are unable to determine the reason why they have filed.


Just in the past 21 months, we have experienced an increase in charge offs at an annual rate of 65%, of which bankruptcy is responsible for 60-80% of that figure.
The largest trend among our members who file bankruptcy displays the alarming trait of lack of discipline in the handling of their financial affairs. Many have suffered no loss of income from job loss or illness. Far too many have better than average incomes and the ability to repay a good portion of their debts. Most are current when they file for relief under bankruptcy.

4. Letter from Allen Chamberland, Vice President, Fort Kent Federal Credit Union, Fort Kent, Maine, to Gretchen L. Jones, Vice President, ME Credit Union League 1 (Aug. 4, 1997):

In the last few years, we have been hit by a rash of bankruptcies; many are of the “new” type whereas the creditor has always been
current, and is now, and then you get the notice in the mail... I cannot speak for other financial institutions, but I estimate the percentage of members who filed for bankruptcy in my Credit Union who could have readily paid off their debts within a 1, 2, or 3 year percentage is 80%. Filing bankruptcy is now a joke -- there is no shame or stigma associated with it. I have even been approached by bankrupt members who caused us a loss that "they will have to go somewhere else" if we don’t consider refinancing their one remaining, re-affirmed loan with us.

5. Letter from Cheryl L. Forsman, Montgomery County Teachers Federal Credit Union, Rockville, Maryland, to National Bankruptcy Review Commission 1 (Aug. 6, 1997):
Although the typical bankrupt member is delinquent on an MCT loan account, more and more we are seeing members file for bankruptcy protection who are current with us. In response, we have stepped up our efforts to reach out to members who might be experiencing financial difficulties.


   Approximately 30% of our members are not delinquent when they file for bankruptcy. In other words, we have no prior knowledge of any problem. This is a new trend previously unheard of three years ago. As a result of this trend,
along with the general increases in bankruptcy losses, we have been forced to employ a credit monitoring system which identifies those members delinquent with other creditors but not delinquent with us.


As a lender, we are aware situations arise that filing bankruptcy is the only alternative available. A radical change in household income may take some individuals down the path to bankruptcy. However, recently, we have seen an increase in filings
from individuals who have not experienced any financial change.

8. Letter from Frank Hallum, Jr., Senior Vice President, Community/Educators’ Credit Union, Rockledge, Florida, to National Bankruptcy Review Commission 1 (June 17, 1997):

We are seeing bankruptcies that cause loan losses from members with current loans and with incomes and assets that appear they have the ability to pay debts, even if it is at a reduced amount. Bankruptcies have accounted for over 31% of our loan losses during 1995 and 1996. For the first six months of 1997, bankruptcies have accounted for almost 54% of loan losses. It will be impossible to provide credit at the present interest rates if loan losses from bankruptcies continue to
escalate as they have during the past two years.


Recently we have seen a great number of our members file for bankruptcy and have never had a late payment in their life with us. For some unknown reason, without being in arrears on any of their loans with us, they decide to file bankruptcy. This means to us that the members may be using bankruptcy as [a] “head start rather than a “fresh start.”
III. Revise Section 707(b)

Section 707(b) of the Bankruptcy Code permits dismissal of a Chapter 7 petition when granting the relief would constitute “substantial abuse” of the bankruptcy process, and the following prerequisites are met: the debtor must be an individual, his debts must be primarily “consumer” debts, and the motion to dismiss may only be brought by the U.S. Trustee or the court, sua sponte. The term “substantial abuse” is undefined and the Supreme Court has not addressed the issue. Section 707(b) has engendered widely split authorities, but the idea behind it is crucial to maintaining integrity in the bankruptcy system. Procedural and substantive changes are required to make this provision effective.

At the very least, this section should be amended to provide procedurally that (a) motions to dismiss for inappropriate use of Chapter 7 may be brought by creditors and panel trustees, as well as U.S. Trustees and the court; (b) the limitation to consumer debts is removed; (c) the presumption in favor of the debtor is eliminated; and (d) attorneys’ fees may be imposed on a
creditor who seeks § 707(b) dismissal without substantial justification.

It is also perhaps unnecessarily pejorative to label a debtor’s conduct as “substantially abusive” because he filed for Chapter 7 relief. Courts have apparently been uncomfortable finding that many debtors’ conduct has risen to a level that sounds so extreme. If the statute were reworded so that it did not label debtors this way, but instead merely dealt with “inappropriate use” of liquidation relief, the results might be more consistent.

Detractors of § 707(b) fear that expanded use of such motions against Chapter 7 debtors will increase the number of people who will attempt Chapter 13 instead, even those who cannot afford to do so.\textsuperscript{130} In response, it should be recognized that in most cases in which the debtor truly cannot afford to fund a Chapter 13 or Chapter 11 plan, § 707(b) motions are denied. When such

\textsuperscript{130} See, e.g., Professor Jean Braucher, Memorandum to the National Bankruptcy Review Commission, July 8, 1997.
motions are granted against debtors who cannot afford to repay, it is because the courts have found, based on the evidence before them, that the debtors did something dishonest or in bad faith. Honest but unfortunate debtors who truly need liquidation relief do not get their Chapter 7 cases dismissed as abusive of the system. In any event, increasing the number of Chapter 13 petitions relative to Chapter 7 filings is a worthwhile goal. If tightening this Code section achieves that goal, then this section should be amended.

The current restrictions on standing to bring a motion under this section should be relaxed. Creditors and panel trustees should be allowed to participate in the policing of the bankruptcy system to prevent the sorts of abuse contemplated by this provision. They are the parties most likely to uncover the information necessary to pursue a dismissal on account of abuse. While U.S. Trustees have stepped into the breach, their resources and basic knowledge of each individual case are limited. Courts are ill-suited ethically and informationally to initiate § 707(b) actions and should have this responsibility lifted from their shoulders.
Because creditors may make inappropriate use of § 707(b) actions to harass debtors unfairly, a fee-shifting provision, like that contained in § 523(d),\textsuperscript{131} should be added to balance the opposing interests involved.

As a corollary to this proposed change, the existing language “but not at the request or suggestion of any party in interest” must be eliminated, resolving disagreement among the courts on the legitimacy of the “tainted” motions brought by U.S. Trustees after a creditor has suggested that the Trustee investigate a particular case for abuse.\textsuperscript{132}

\textsuperscript{131} 11 U.S.C. § 523(d) provides:

If a creditor requests a determination of dischargeability of a consumer debt under subsection (a)(2) of this section, and such debt is discharged, the court shall grant judgment in favor of the debtor for the costs of, and a reasonable attorney’s fee for, the proceeding if the court finds that the position of the creditor was not substantially justified, except that the court shall not award such costs and fees if special circumstances would make the award unjust.

\textsuperscript{132} See, e.g., In re Morris, 153 B.R. 559 (Bankr. D.Or. 1993).
Section 707(b) should also be amended to clarify the types of debtor conduct that constitute inappropriate use of liquidation relief. Some income-earning debtors with the ability to repay some or all of their debts appear to be inappropriately seeking Chapter 7 relief.

Four circuit courts have differed on the proper standards to apply to a § 707(b) motion. All of them regard a debtor’s ability to repay at least some debts as a relevant factor; the differences between the four “tests” revolve around the role or necessity of other factors in addition to ability to pay as adequate grounds for a § 707(b) dismissal.\(^{133}\)

\(^{133}\) See In re Kelly, 841 F.2d 908 (9th Cir. 1988)(ability to pay debts, standing alone, justifies § 707(b) dismissal, although other justifications could also be found; here debtors were able to repay 99% of unsecured debt in 3 years); In re Walton, 866 F.2d 981 (8th Cir. 1989)(ability to fund a Chapter 13 plan is “primary” factor, which justifies non-dismissal when debtor is ineligible for Chapter 13 relief; these debtors able to fund 100% 5-year or 67% 3-year plan); In re Krohn, 886 F.2d 123 (6th Cir. 1989)(Chapter 13 eligibility not a dispositive factor -- Constitution does not grant “right” to discharge, United States v. Kras, 409 U.S. 434, 446-47 (1973); however, ability to pay not sufficient basis, without more; rule requires both lack of honesty and lack of need for liquidation relief); In re Green, 934 F.2d 568 (4th Cir. 1991)(ability to pay, alone, cannot justify dismissal, and is not even “primary” factor; other evidence of abuse must exist under “totality of the circumstances”); Matter of Lybrook, 951 F.2d 136 (7th Cir. 1991)(in dicta, Judge Posner stated ability to pay is “important” factor).
Substantive reform of § 707(b) is complex and has occasioned numerous suggestions to the Commission.\textsuperscript{134} Courts are uncertain about the types of conduct that constitute “substantial abuse” under this section. The presumption in the last sentence of paragraph (b), that Chapter 7 relief should be granted, is also somewhat problematic. The vagueness of the statute has hindered its effectiveness. Section 707(b) would become more useful, however, by the inclusion in the statute of a nonexclusive “laundry list” codifying types of debtor conduct that constitute inappropriate use or abuse as well as the proper role of debtor eligibility vel non for

\textsuperscript{134} See, e.g., Joseph Patchan, Director of the Executive Office of U.S. Trustees, letter to Commission, Feb. 38, 1997 (requesting clarification of the grounds for § 707(b) motions and recommending expansion of standing to bring such motions); Thomas C. Leduc, Michigan Credit Union League, letter to Commission, May 27, 1997 (recommending that standing be expanded, that creditors should pay debtors’ defensive attorneys’ fees when such motions are not granted, and that the presumption language should be changed); Hon. Sid Brooks, U.S. Bankruptcy Judge, letter to Commission, July 2, 1997 (suggesting that the restriction to “primarily consumer debts” is discriminatory and inequitable, and that the timing rules impair judges’ and trustees’ ability to adequately identify abuse soon enough to act); Attorney Richardo Kilpatrick, letter to the Hon. Edith H. Jones, Commissioner, July 15, 1997 (suggesting that standing be broadened, that the restriction to consumer debts be eliminated, and that more specificity of grounds is needed). This list of writers is merely illustrative and in no way exhaustive. The Commission received dozens of letters suggesting these and similar changes to make § 707(b) a more effective tool for policing and protecting the integrity of the bankruptcy system.
bankruptcy relief under other chapters (11, 12, or 13) of the Bankruptcy Code.

The amendments should be cast as a nonexclusive definition of “substantial abuse” and the presumption in favor of the debtor should be eliminated as unnecessary. The following situations have been used as grounds for granting § 707(b) motions:

- bad faith filing of the petition;

- intent or ability to discharge only one or a very small number of debts, regardless of the total amount of such debts;

- lack of need for liquidation relief because the debtor has the ability to pay a significant portion of his dischargeable debts from his disposable income without regard to the availability to a particular debtor of other types of bankruptcy relief;
• failure to accurately and timely disclose all financial information;

• likelihood that amendments to schedules made in the face of a § 707(b) motion are not good faith efforts to accurately disclose a debtor’s financial condition;

• failure to comply with all statutorily-imposed duties;

• likelihood that the debtor sought bankruptcy relief in order to gain an unfair advantage over a particular creditor; or

• loading up on credit purchases shortly before filing for liquidation.

Over 120 reported bankruptcy court cases have considered § 707(b) motions. Several courts addressed standing issues, when motions were brought by someone
other than the court or the U.S. Trustee. However, most of the cases are, essentially, ability to pay or ability to fund cases, either following the Ninth Circuit’s rule or using amendment of schedules (particularly when amendment occurred in the face of the motion) to find “lack of honesty.” Another factor often used to bolster ability to pay/fund as a basis for a dismissal was demonstration that the debtor had been living an extravagant lifestyle or living on credit for some time pre-petition while making no attempt to trim

\[135\] See, e.g., In re Jones, 60 B.R. 96 (Bankr. W.D. Ky. 1986).

\[136\] On July 1, 1997, a Westlaw search in the Bankruptcy Court database (FBKR-BCT) with parameters “707(b)” & “substantial abuse” produced a cite list containing 212 cases. After eliminating cases which were not directly determining a § 707(b) motion, unreported cases, and cases which had subsequent reported appellate decisions, 122 remained. Of these, in 42 cases, the courts denied the motions to dismiss, for reasons varying from inability to repay a significant amount (18, or about 40%) and the debtors’ ineligibility for relief under another chapter (3) to findings that the debtors did not have “primarily consumer debts” (5) and, incredibly, one bankruptcy judge’s perception that Congress, in enacting § 707(b), did not actually intend these motions to really be brought. See In re Joseph, 208 B.R. 55 (9th Cir. B.A.P. (Cal.) 1997. Of the remaining 80 cases in which the motions to dismiss were granted, ability to repay was not a factor in only 8 cases, and 12 more were decided on a “totality of the circumstances” basis, leaving 60 in which ability to pay was cited as the sole or at least “primary” factor motivating the dismissal. However, of the 12 “totality” cases, in only 5 of them was ability to pay not one of the determinative factors. Consequently, the debtors’ ability to pay their debts motivated, either entirely or in substantial part, 67 out of 80 dismissals (about 80%). In total, ability to pay (or lack thereof) was a determinant in 85 out of these 122 cases (about 70%).
the budget or otherwise pay creditors. Many courts have required budget-trimming and on that basis have discerned a debtor’s ability to pay. One court, criticizing a debtor’s monthly clothing allowance, stated that a debtor with financial problems “shouldtighten the belt he is wearing instead of buying a new one.”\textsuperscript{137} In other cases, intent to discharge one particular debt while reaffirming or otherwise providing for payment of all other debts will, together with ability to pay, compel dismissal.

In some cases, \textsection 707(b) motions were granted for substantial abuse of the bankruptcy system. For example, an unemployed debtor on welfare falsely and fraudulently stated on two credit card applications that he was self-employed and earning $29,000 per year and then took approximately $178,000 in cash advances ($60,000 lost as gambling debts, $60,000 spent on luxury items for household, and $50,000 improvidently lent to a gambling acquaintance who absconded with the money and has never been seen again).\textsuperscript{138}


Another case involved the debtor’s pre-petition spending of his retirement fund.\textsuperscript{139} The debtor had been “downsized” from his job, and his accumulated retirement benefits were distributed to him. He then went on a two-year spending spree, during which time he exhausted all his retirement funds without paying off his credit card debt, which he increased during the two-year period. This man, with a business degree and some graduate courses, plus many years of business experience, was employed as a security guard at $6.00 per hour when he filed for bankruptcy protection. The court found his petition to be substantially abusive.

The elimination of the restriction in § 707(b) to those cases primarily involving consumer debt is justified for three reasons. The limit is arbitrary. Its vagueness has led to considerable litigation. It has caused unjust results.\textsuperscript{140} Its application is further

\textsuperscript{139} In re Ragan, 171 B.R. 592 (Bankr. N.D. Ohio 1994).

\textsuperscript{140} These three reasons were discussed in the opinion In re Tanenbaum, No. 96-22908-SBB (Bankr. S.D. Colo., Jan. 26, 1997)(furnished to Commission by the Hon. Sid Brooks, United States Bankruptcy Judge). See also In re Genti, 185 B.R. 368 (Bankr. M.D. Fla. 1995)(excluding non-dischargeable consumer debts when determining whether debts were primarily consumer, and characterizing as non-
complicated by the fact that two different tests are used to determine whether debt is “consumer” debt or not: the “profit-motive” test and the “household or personal use” test. Some debts are not clearly either business debts or consumer debts; examples are tort liabilities, wage-earners’ investment-related debts, and student loans. Student loans are sometimes characterized as business debts, even when the debtor does not own a business. Similarly, a debtor-employee who has investment losses may be characterized as having business debts, even though he does not own a business, because the losses/debts are incurred for the purpose of making a consumer a doctor’s debts owed as a result of a capital loss realized on the sale of his home and debts owed to his ex-wife’s family for paying his way through medical school; the doctor and his new wife represented that they needed liquidation relief because the doctor had quit his job the day of the hearing on the § 707(b) motion so that they could become medical missionaries to Africa; In re Marshalek, 158 B.R. 704 (Bankr. N.D. Ohio 1993)(tort judgment was found not a consumer debt); In re Restea, 76 B.R. 728 (D. S.D. 1987)(doctor’s debts found not consumer debts because related to his medical practice); In re Bell, 65 B.R. 575 (Bankr. E.D. Mich. 1986); In re Almendinger, 56 B.R. 97 (Bankr. N.D. Ohio 1985)(debtor owed credit card debt for cash advances used to unsuccessfully play the stock market; characterized as “business” debt).


142 See, e.g., In re Gentri, 185 B.R. 368 (Bankr. N.D. Fla. 1995).
profit. Tort liabilities are incurred neither for the purpose of making a profit nor for “personal or household use.”

Whether these amendments to § 707(b) are made or not, the section could be employed as a device to implement means-testing of debtors. Clearly, a debtor who sought liquidation relief when he fit the parameters for Chapter 13, as discussed earlier in this dissent, would have inappropriately filed his Chapter 7 petition such that it should be dismissed.

IV. Dischargeability Issues

A. General Observations

While the Commission’s Report acknowledges that it “did not undertake the task of honing the list [of exceptions to discharge] down,” it did recommend certain clarifications and amendments to enhance fairness to all parties, to achieve uniformity in the law, to alleviate
confusion, and to reduce the costs of litigation. However, a review of the suggested changes to Section 523(a) reveals a noticeable shift in the present balance of the law to a decidedly anti-creditor position. While the changes suggested by the Commission’s Report might achieve its stated goal of uniformity, the price to creditors and to society as a whole is far too great. The goals sought to be achieved by the Commission through changes in dischargeability policy can be achieved without distorting the basic creditor-debtor balance of the present law. Although a fundamental purpose of consumer bankruptcy is the discharge of certain obligations, that purpose must be juxtaposed with and limited by legitimate concerns about culpable debtor conduct, the maintenance of the integrity of the bankruptcy system, and common societal good. Given the rising numbers of bankruptcy filings and the increasing amounts of debt being discharged through bankruptcy proceedings, it is incumbent that any recommendations for change in dischargeability policy be accompanied with an

\footnote{National Bankruptcy Review Commission, REPORT ON CONSUMER BANKRUPTCY [Draft] (“REPORT”), at 79.}
evaluation of the impact of the decision upon both the debtor-creditor relationship and society as a whole. As will be shown below, the Commission’s Report failed to take this part of the process into consideration when arriving at its recommendations.

B. Dischargeability of Student Loans

The Commission’s Report recommends that the provision of the Bankruptcy Code which makes student loans [other than loans for medical education governed by special federal legislation] nondischargeable in both Chapter 7 and Chapter 13 be overturned.\textsuperscript{144} The Commission’s recommendations are based upon several conclusions: the present undue hardship exception is subject to “disparate multi-factor approaches;”\textsuperscript{145} many of the present defaults are from fly-by-night trade or

\textsuperscript{144} REPORT, at ___.

\textsuperscript{145} Id. at ___. The Report cites no cases for this assertion, it merely lists numerous law review articles. While this assertion may have some validity, the Commission failed to address this narrower problem; instead it merely advocated the repeal of the nondischargeability.
technical schools which often do not even provide educational services;\textsuperscript{146} and its rejection of the premise that the nondischargeability of student loans is necessary for the continued viability of the guaranteed student loan program.\textsuperscript{147} The Commission’s proposal will clearly eliminate any confusion or nonuniformity of decisions in the area of dischargeability of student loans. However, in reaching its decision the Commission discounted all the evidence presented to it on the impact this change would have on the continued viability of the guaranteed student loan program.\textsuperscript{148} Instead, the

\textsuperscript{146} Id. at ___. This problem could be remedied by more careful monitoring of the various schools. Once again, the existence of this problem does not justify the Commission’s recommendation.

\textsuperscript{147} Id. at _____. This whole section of the Report is based upon non-statistical documentation from the Government Accounting Office.

\textsuperscript{148} See, e.g., Letter from Judge Samuel L. Bufford, \textit{et al} (May 8, 1997) (detailed review of discharge and dischargeability commissioned by the Commission’s Reporter recommending only amending the repayment period to five years); Letter from Marshall S. Smith, Acting Deputy Secretary, United States Department of Education (July 29, 1997) (opposing proposal to eliminate the nondischargeability of student loans); Letter from Ernest T. Freeman, President and Chief Executive Officer, The Educational Resources Institute (a non-profit corporation administering student loans); Letter from Michael Richter, Utah Association of Student Loan Administrators (September 19, 1997) (same); Letter from Nadine Barrett, Accountant Principal, Eastern Washington University, Student Financial Services (September 18, 1997) (same); Letter from Ernest T. Freeman, President and Chief Executive Officer, The Education Resources Institute (September 18, 1997) (same); Letter from Alisa Abadinsky, Associate Director Student Financial Services, University of Illinois at
Commission relied upon non-statistical information provided to it by the General Accounting Office that implied that the student loan program was instituted with default in mind and that the taxpayers were intended to pick up the tab for students’ inability to repay loans.\textsuperscript{149} Furthermore, the Commission’s proposal is based upon its own admission that in many cases the present cost of certain education does not translate into sufficient income to repay the loans,\textsuperscript{150} and therefore, society needs to treat these loans as mere grants or subsidies whose costs must be borne by taxpayers.

Section 523(a)(8) provides useful and practical boundaries concerning educational loans by (1) preventing abuse of the educational loan system with restrictions on the ability to discharge student loans shortly after graduation and (2) safeguarding the financial integrity of governmental entities and nonprofit institutions who

\textsuperscript{149} REPORT at ____.

\textsuperscript{150} The reason that the Commission excepts from its radical proposal the HEAL program is that “[t]he presumption of adequate income to repay such loans is stronger in these cases”. REPORT at __.
participate in education loan programs. The nondischargeability of guaranteed student loans helps to maintain the solvency of educational lending programs in order to enlarge access to higher education. Congress has within the last six years reviewed the advisability of nondischargeability and determined that it should remain.\footnote{The Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 100-508 (1990), amended the discharge provision of Chapter 13 to provide that a Chapter 13 debtor would not receive discharge of his educational loans, making the discharge identical to that of a Chapter 7 debtor. As originally enacted this amendment to Chapter 13 would have expired on October 1, 1996. However, that sunset provision was repealed by Section 1558 of Pub. L. No. 102-325 (enacted on July 23, 1992).}

The Commission’s Report shows a lack of understanding of guaranteed student lending practices. First, creditors in the majority of these cases lend money to individuals who might not qualify for credit under traditional credit criteria. The borrowers usually lack an established asset base or income-generated track record and have no collateral to justify the loan. The loan is made with the view that it is an investment in the borrower’s future ability to generate income as a result of the increase in human capital due to education.
Further, the lender is well aware that it takes time following graduation for a student to develop a career and sufficient earning capacity to repay the loan. In fact, this projected increased earning potential achieved through education is the primary factor considered by a lender in making loans under the student loan program.\textsuperscript{152} The unique character of educational lending led Congress to enact special lender protection under the bankruptcy laws. The Commission’s comparison of educational loan creditors to creditors who lend debtors money to buy pizza highlights the naivete of the Commission’s understanding of the student guaranteed lending industry.

The Commission’s Report is more an indictment of schools which do not adequately educate or train the students than it is a justification for making these loans nondischargeable.\textsuperscript{153} If shortfalls in the educational system are the problem, it should be addressed directly. Blame for a perceived lack of

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\textsuperscript{152} Letter from Ernest T. Freeman, President and Chief Executive Officer, The Educational Resource Institute (a non-profit corporation administering student loans) (September 18, 1997).
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\textsuperscript{153} See REPORT at _____.
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training or benefit should not be imposed on the taxpayers or the many non-profit institutions who provide funds to students. Congress has already made the public policy choice that the potential for abuse in the educational loan system outweighs the debtor’s right to a fresh start.

Finally, the Commission’s treatment of student loans as a “subsidy” similar to the GI Bill is a gross mischaracterization and a disservice to those who earned their right to GI Bill benefits.\(^{154}\) It is highly unlikely that Congress contemplated that the student loan guarantee program was a mere mirage -- just a method to give students a cash subsidy or grant at the taxpayer’s expense. The nondischargeability provision is intended to maintain the solvency of educational lending programs and thus promote access to higher education.\(^{155}\) Our present Code recognizes that through the hardship

\(^{154}\) No one who was educated under the GI Bill views it as a subsidy. It is part and parcel of the benefit bestowed by a grateful nation to individuals who are willing to put their lives on the line to protect this nation.

\(^{155}\) Letter from Marshall Smith, Acting Deputy Directors; United States Department of Education (July 29, 1997) (strongly denouncing the Commission’s proposal to eliminated 523(a)(8)).
exception under certain circumstances some of these loans cannot be repaid. If the Commission felt that the hardship discharge needed to be clarified to ensure some degree of uniformity, it could have proposed that solution.\footnote{156}

In closing, it should be pointed out that there was no public outcry presented to the Commission for elimination of this exception. In fact, the report directed to be prepared by the Commission’s Reporter did not recommend the repeal of this section.\footnote{157} The overwhelming evidence received by the Commission opposed this repeal. If this repeal occurs, non-profit entities and governmental units will be forced to raise their fees to cover the rising losses. Non-profit entities may

\footnote{156} Some have suggested that much of the confusion and uncertainty concerning dischargeability of student loans could be clarified by adoption of the test suggested in \textit{Brunner v. New York State Higher Education Services Corp.}, 831 F.2d 385 (2d Cir. 1987). \textit{See also Pennsylvania Higher Education Assistance Agency v. Faish}, 72 F.3d 298, 305 (3rd Cir. 1995) (discussing the good faith necessary to satisfy the undue hardship exception).

\footnote{157} Memorandum from Judge Samuel L. Bufford, Judge Eugene Wedoff, Prof. Jeffrey Morris, \textit{et al} (May 8, 1997).
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discontinue providing loans;\textsuperscript{158} and taxpayers will just end up picking up the tab.\textsuperscript{159} The concerns raised by these constituencies were overlooked by the Commission. The proposed recommendation, like many finally approved by the Commission, was just not supported by the record before it.

This section should remain unaltered in both Chapter 7 and 13.

C. Credit Card Debt

There is uniform agreement that Section 523(a)(2)(A) is ill-equipped to deal with the question of the nondischargeability of debt incurred from the use of a credit card in those cases which do not involve actual

\textsuperscript{158} Letter from Ernest T. Freeman, President and Chief Executive Officer, The Educational Resource Institute (September 16, 1997) (the elimination of the exception to discharge will have disastrous effects upon the non-profit entities who make these loans).

\textsuperscript{159} Letter from National Consumer Bankruptcy Coalition dated July 14, 1997 (noting that the Commission’s recommendation would invite substantial abuse and result in multimillion dollar losses to taxpayers).
fraud in the application for the card. The Commission correctly identifies the multitude of problems facing the courts as they have attempted to apply this section of the Code to the use of credit cards. The Commission then notes that the proliferation of cards and bankruptcy filings demand more orderliness in approaching the issue of nondischargeability debts incurred with properly obtained credit cards.

However, the Commission’s Report fails to identify the problem which it is trying to remedy. Instead, it merely assumes that some credit card debt is to be nondischargeable [no reason given], and then draws a bright line rule for the sole purpose of bringing some uniformity into the area. Its arbitrary thirty-day rule is totally disingenuous. Discharge is to be given to the “honest but unfortunate debtor;” in large part, debts are to be denied discharge due to the bad conduct of the debtor. The Commission’s proposal is devoid of any discussion of the moral turpitude of the debtor or his

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161 REPORT at ____.
intentional wrongdoing as a basis for the nondischargeability of credit card debt.

The thirty-day period is also purely arbitrary and has no basis in reality. If its purpose is to balance rights of debtors and credit card lenders by assuring a period in which abuse of credit cards will not be tolerated while also forcing lenders to be more careful in extending credit, it fails. The proposal explicitly renders fully dischargeable all credit card debts incurred within the credit limits 31 days or more before bankruptcy. This is an open invitation to abuse and manipulation. Further, there is no way creditors can have an opportunity to forestall such abuse by tightening credit because not even one billing cycle would elapse from the dates of abuse until the debtor filed bankruptcy.

Like so many of the Framework proposals, this one will discourage extensions of credit to marginal borrowers. It may be debtor-friendly, but is in no way consumer-friendly.
The Report is correct in that the common law fraud principles should not apply in their entirety to credit card debt. Thus, issues such as whether the debtor knowingly made a misrepresentation or intended to deceive the creditor, or whether the creditor justifiably relied to his detriment on a misrepresentation, should not be the touchstones for this new nondischargeability section. The Report is also correct in its conclusion that a bright-line rule would necessarily reduce judicial time and resources. However, the Commission’s proposal is a type of rough justice that totally misses the mark. It seriously undermines the integrity of the bankruptcy process by failing to equate nondischargeability to any concrete standard. Outside of taxes and family support obligations, certain debts are considered to be nondischargeable for the simple reason that the conduct of the debtor was not at an acceptable level. The evidence before the Commission clearly identified the evil which needed to be addressed -- the incurring of credit card debt while a person either contemplated bankruptcy [pre-bankruptcy planning] or had no reasonable ability to repay the debt [constructive fraud].
The following proposal addresses the evil and attempts to impose some degree of uniformity into the bankruptcy process. The goal of this proposal is to prevent a debtor from discharging credit card debt when he knew or reasonably should have known that he had no expectation of repaying it. In line with Congress’s earlier decision to add section 523(a)(2)(C) (the “luxury goods” provision), a new section should be added to Section 523 as follows:

All debts incurred through credit card use within sixty (60) days before the order for relief under this title are presumed to be nondischargeable. A debtor may rebut this presumption by showing the following: (1) that at the time a particular credit card debt was incurred, the debtor was not contemplating bankruptcy and (2) that at the time a particular credit card debt was incurred, a reasonably prudent person [not the debtor] would have expected that there was an ability to repay the debt.
This proposal addresses culpable conduct, as nondischargeability policy ought to do. Moreover, enactment of this provision should not prevent applicability of section 523(a)(2)(A) or (B) if, before the sixty-day period, the debtor incurred credit card debt with intent to defraud.

D. Issue Preclusion in the Case of True Defaults

The Commission’s proposal is an attempt to require bankruptcy courts to apply the federal rule of collateral estoppel to state court no-answer default judgments. Specifically, the Report proposes that issues that were not actually litigated and necessary to a prior state court judgment should not be given preclusive effect in a bankruptcy dischargeability proceeding. The reason for this proposal is the concern that although nondischargeability is a matter of federal law, the “geographic location of a prior default judgment” has

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162 REPORT at ___.

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become determinative of whether a debtor will have the opportunity to litigate a nondischargeability case.\footnote{163}

This is a significant change from the standpoint of all federal court procedure. It carves out an exception to the general rule that federal courts, including bankruptcy courts, are to give such state proceedings the “same full faith and credit . . . as they have by law or usage in the courts of such States . . . from which they are taken.”\footnote{164} In \textit{Marrese v. American Academy of Orthopedic Surgeons}, 470 U.S. 373, 380, 105 S. Ct. 1327, 1331–32 (1985), the Supreme Court stated:

> The preclusive effect of a state court judgment in a subsequent federal lawsuit generally is determined by the full faith and credit statute . . . . This statute directs a

\footnote{163} \textit{REPORT} at ___.

federal court to refer to the preclusive law of the State in which judgment was rendered.

The court continued by noting that the statute does not permit federal courts to employ their own rules of *res judicata*, but commands the federal courts [and bankruptcy courts are federal courts] to accept the rules chosen by the state. Later, the Supreme Court noted that "collateral estoppel principles do indeed apply in discharge exception proceedings pursuant to a § 523(a)."\(^\text{165}\)

Parties may invoke the doctrine of collateral estoppel in certain circumstances to bar relitigation of issues relevant to discharge. The application of state law of collateral estoppel, however, does not deprive the bankruptcy court of its ultimate duty to determine the legal issue of dischargeability. The circuit courts have

had no problem in carrying out their statutory duty even in the case of true default judgments.\textsuperscript{166}

In addition to the lack of uniformity arising from the use of the various states' collateral estoppel rules, the Commission also notes that many of these true defaults are the result of the financial inability of debtors to defend themselves or a misunderstanding of the significance of the state court proceeding.\textsuperscript{167} This analysis is one-sided. All other federal courts are bound by 28 U.S.C. § 1738 and, even if this exception were enacted, bankruptcy courts would still be bound by 28 U.S.C. § 1738 in all of their other proceedings. This proposal seeks to circumvent the state judicial process and the multitude of state court remedies both direct and collateral which are available to the diligent defendant who suffers a default judgment. Further, the change overlooks the fact that the determination of whether

\textsuperscript{166} See, e.g., \textit{In re Pancake}, 106 F.3d 1242 (5th Cir. 1997); \textit{In re Calvert}, 105 F.3d 315 (6th Cir. 1997) (absence of a statutory exception to § 1728 collateral estoppel applies to true default judgments in bankruptcy dischargeability proceedings in those states which would give such judgment that effect).

\textsuperscript{167} REPORT at \underline{1188}. 
there is a claim in the first place is, and will remain, a question of state law.\textsuperscript{168} Why bankruptcy courts would want to assume responsibility for relitigating state laws claims is a mystery; it is no mystery, however, why debtors would seek to avail themselves of the opportunity to relitigate, especially in the bankruptcy court’s debtor-friendly environment.

In attempting to justify its position, the Commission equates this change to the present bankruptcy court analysis of domestic relations obligations. Under the Code, a bankruptcy court is not bound by the state court’s characterization of domestic relations obligation, but it is required to make an independent determination of the true nature of the obligation for dischargeability purposes.\textsuperscript{169} The Report fails to note however, that this fact was clearly stated in the legislative history of Section 523(a)(5)\textsuperscript{170} as necessary

\textsuperscript{168} See, e.g., In re Johnson, 960 F.2d 396 (4th Cir. 1992).

\textsuperscript{169} See, e.g., Sylvester v. Sylvester, 865 F.2d 1164 (10th Cir. 1989); Benich v. Benich, 811 F.2d 943 (5th Cir. 1987).

in order to ensure that the underlying public policy relating to the protection of divorced spouses and dependent children was given effect. However, even in these cases, bankruptcy courts look for guidance from the state courts in the interpretation of domestic relations obligations. \(^{171}\) In the case of true defaults, there is not one shred of legislative history which supports the Commission’s position to amend 28 U.S.C. § 1738 to eviscerate true defaults in the case of discharge litigation in bankruptcy proceedings. To permit 28 U.S.C. § 1738 to be used to determine whether one has a claim, but then to refuse to follow its dictates in determining whether that claim is dischargeable is inconsistent and a bad policy choice.

\(^{171}\) *See, e.g., In re Spong*, 661 F.2d 6 (2d Cir. 1981).

E. The Superdischarge in Chapter 13

The Commission’s Report discusses its reasons for keeping the superdischarge in Chapter 13 in only the briefest and most simplistic terms.\textsuperscript{172} It notes that the superdischarge encourages debtors to complete a Chapter 13 plan in order to get a broader discharge than would be available in a Chapter 7 case.\textsuperscript{173} The Report asserts that the superdischarge encourages Chapter 13 filings with the resulting increase in distributions to the creditor body as a whole and the economic rehabilitation of the debtor through improved budget practices and a fresh start.\textsuperscript{174} Notwithstanding this ringing endorsement of the superdischarge, the Report reluctantly notes that the vast majority of Chapter 13 debtors do not need the

\textsuperscript{172} REPORT at ___.

\textsuperscript{173} At least one court has agreed with this analysis. Ravenot v. Rimgage, 669 F.2d 427, 428 (7th Cir. 1982).

\textsuperscript{174} REPORT at ___.

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superdischarge.\textsuperscript{175} Furthermore, the Commission’s position is disingenuous, as the evidence clearly establishes that the superdischarge is not a relevant factor in the decision to file Chapter 13.\textsuperscript{176}

The dischargeability in Chapter 13 of debts that are not dischargeable in a Chapter 7 represents a distorted policy judgment that it is better for a debtor to attempt to repay certain types of debts over the life of a plan than to have these debts hanging over the debtor’s head.\textsuperscript{177} The superdischarge is a misplaced piece of social legislation. The very integrity of the bankruptcy process is called to task when, pursuant to the superdischarge, a debtor walks free and clear of any further liability for an intentional shooting of a

\textsuperscript{175} Id.

\textsuperscript{176} See, e.g., T. SULLIVAN, et al, AS WE FORGIVE OUR DEBTORS, at 246-53. These authors make a compelling case that the decision to file a Chapter 13 case as opposed to a Chapter 7 case is more dependent on the local legal culture than by other factors. By local legal culture the authors of this work mean the actors in the legal system [lawyers and judges] who direct debtors toward one choice or the other. See also Sullivan, Warren & Westbrook, Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankruptcies 1981-1991, 68 AM. BANKR. L.J. 121, 143 (1994).

victim, or for the defrauding of private citizens of hard earned money, or for theft from an estate by a fiduciary, or for tax obligations due Uncle Sam. What positive social policy is promoted by permitting these debts to be discharged without full payment? Bankruptcy laws have historically given the honest and financially distressed debtor a fresh start. To continue the discharge of these debts is a national disgrace. The availability of a superdischarge, even if rarely used, is a source of severe public resentment. The Commission should have had no difficulty urging Congress to repeal this abomination.

There are presently sufficient incentives to file a Chapter 13, separate and distinct from the superdischarge. The ability to cure defaults on secured property to prevent foreclosure or repossession, the ability to strip down liens to the value of the underlying collateral, and the co-debtor stay already constitute incentives to file Chapter 13. Other

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proposals by the Commission encourage debtors to remain in a Chapter 13 until all payments are made. For example, the Commission’s recommendation that all payments be made to both priority, secured, and unsecured creditors during the life of the plan will encourage the honest debtor to remain in Chapter 13 and, thus maximize the recovery to unsecured creditors. Further, the Commission’s proposal to change the manner in which credit reporting agencies treat Chapter 13 will somewhat increase the incentives to finish a Chapter 13 plan.

The logic of the Report is flawed. Bankruptcy discharge is for the honest but unfortunate debtor. The dishonest and immoral debtor should not be permitted to discharge debts involving morally and socially reprehensible conduct. To argue that repayment of a portion of such debt is sufficient sanction for culpable conduct misses the entire point. The bankruptcy process is larger than its simple impact upon the debtor and his creditors -- the entire community is affected. The integrity of the system demands that wrongdoers not
receive a discharge. Discharge should be seen as society’s humanitarian response, motivated by notions of charity to an individual debtor; however, the debtor, the recipient of that act of charity, should be a worthy recipient as reflected in his prebankruptcy actions toward others. The failure to treat a creditor with inherent honesty and justice can and should result in a denial of the dischargeability of that debt.

Seeing specific examples of its abuse, Congress has continually narrowed the scope of the superdischarge. The task of narrowing should be finished by finishing off the superdischarge. The superdischarge satisfies no justifiable social policy and only encourages the use of

179 Letter from Francis M. Allegra, Deputy Associate Attorney General, U.S. Department of Justice (June 18, 1997) (“We are unconvinced that providing a (fresh start) under the Chapter 13 superdischarge to those who commit fraud or whose debts result from other forms of misconduct is desirable as a policy matter”).


Chapter 13 by embezzlers, felons, and tax dodgers.\textsuperscript{182} There is no reason for its continued existence.

SEPARATE STATEMENT OF COMMISSIONER EDITH H. JONES

Although I do not wish to burden this Report further, I am compelled to point out that I cannot participate in the discussion of the Seminole case, an important decision describing the limits of federal courts jurisdiction over suits against non-consenting states. This case raises issues that are sure to come before my court, and inasmuch as the Commission’s statements concerning Seminole cannot possibly furnish the basis for legislative action and are purely advisory, I stand recused.

Further, it is inappropriate for the Commission to have requested and printed CBO criticism of the Visa and Purdue studies on consumer bankruptcy. The Commission is being used as a stalking-horse to take sides in an ongoing academic debate over economic issues in consumer bankruptcy. I will not enter this debate. The Commission should not have been used this way.

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*************** Commissioner John A. Gose agrees with this statement.
Beyond that, to make the record clear, I particularly endorse the following proposals of the Commission:

- Streamlining appeals by routing them directly to courts of appeals;
- Small Business Chapter 11 Proposal;
- Single Asset Real Estate Proposal;
- Amendments to the preference laws for small creditors;
- Dissenting Commissioners’ Recommendations on Consumer Bankruptcy;
- Dissent on certain Chapter 11 Issues.
Two of my suggestions, voted down by the Commission, deserve further consideration by Congress:

- the “Tithing Proposal” to relieve churches and charities from being sued in fraudulent conveyance law;

- clarifying the law to insure that divorce-related property settlements remain non-dischargeable.

Finally, I am committed to the dissent on “Process”. Similar “Process” problems continue. For some strange reason, and over the express Commission vote to the contrary, Professor Gross’s report on debtor education is going to become part of the Appendix. Likewise included there is the Morris/Wedoff report on dischargeability issues, most of which we either rejected or did not consider. Congress should not gain any misimpression that these documents, although generated for the Commission by well-intentioned authors, have any more significant role in our recommendations than the thousands of other documents the Commission received.
I owe a great debt to the loyalty and hard work of my secretaries, Ranell Hopkins and Linda James, and my law clerks, Meredith A. Duncan, Jeffrey Kubin and Andrew Wisch in these last difficult days preceding our submissions to the Report.
DISSENT TO THE COMMISSION’S RECOMMENDATIONS:

PARTNER AS DEBTOR

By HONORABLE EDITH H. JONES:

The Bankruptcy Code does not satisfactorily address the issues arising from partnership or limited liability company (LLC) bankruptcies. Thus, I applaud the Commission’s efforts to lend stability and sense to this currently muddled area of bankruptcy law. I applaud those proposals that would treat members or managers of LLCs consistently with partners in partnerships and that would exclude partnership, LLC and analogous relationships from 11 U.S.C. § 365; partnerships and LLCs are not properly governed by the “executory contract” provisions of the Code. Unfortunately, I think other changes adopted by the Commission will adversely affect the development of partnership law outside the bankruptcy area and will impose higher transactional costs on the vast majority of partnerships that will not go bankrupt. I must respectfully dissent from those other proposals.
My criticisms of the partnership proposals are friendly ones. The proposals clearly attempt to accommodate state law and pre-existing partnership agreements to a great degree; my only objection is that they ought to go further in that direction. I have been persuaded by the response of Professor Ribstein\textsuperscript{1} to these proposals, and my comments largely parallel those he and others in the transactional field have expressed.

Before proceeding further, it is useful to summarize the alternate proposals that I believe Congress ought to consider for adapting bankruptcy law to members of partnerships, LLCs and analogous firms. First, 11 U.S.C. § 365 (executory contracts) should not apply to such entities. Second, the law should clarify the enforceability of partnership and analogous agreements regarding rights of bankrupt partners. Third, neither 11 U.S.C. § 362 (the automatic stay) nor any other Code provision should interfere with the effectuation of these agreements. Fourth, a bankrupt member’s rights in a

\textsuperscript{1} Professor Larry E. Ribstein, GMU Foundation Professor of law, George Mason University, Co-author of Allen R. Bromberg and Larry E. Ribstein, \textit{Bromberg & Ribstein on Partnership} (1988); Ribstein and Keatinge, \textit{Limited Liability Companies}.  

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partnership or analogous firm and whether these rights are property of the estate under section 541 and subject to control and disposition under section 363 should be governed by state law.

Several general principles inform these recommendations. First, partnerships and LLCs are important, extremely flexible investment vehicles and reflect detailed and costly planning. Ribstein Letter, at 2. Mandatory bankruptcy rules, added to the federal, state and tax laws that appertain, increase the complexity of what is already a daunting drafting task. Id.

Second, “state competition and experimentation are more likely to produce rules that efficiently balance partner and creditor interests than imposing a single federal law.” Id. The uniformity of federal law, stated as a justification for displacing state laws, is in

doubt, because the Commission’s proposals -- particularly regarding the definition of “ipso facto” clauses -- are just as likely to produce divergent caselaw as have the precedents applying section 365 to partner bankruptcies. Professor Ribstein adds that where uniformity is necessary to reduce creditors’ costs, his research demonstrates that “states move in this direction on their own.” Id.

Third, “state partnership law is better able than federal law to take into account rapidly changing circumstances affecting business organizations.” Id. Tax law provides a particular source of uncertainty. Bankruptcy law should free states and firms to deal with regulatory changes.

Fourth, as Professor Ribstein notes, “by trumping state law rights, bankruptcy law may give partners and creditors perverse incentives to initiate costly and unnecessary bankruptcy proceedings.” Id. If bankruptcy law provides parties a potential recovery or right that does not exist under the partnership agreement or state law, opportunities exist for forum-shopping.
For instance, a partner might initiate a personal bankruptcy in order to utilize the no-*ipso facto* rule advanced by this Commission’s proposal. *Id.* A partner with a cash-flow problem but whose assets exceed liabilities could obtain a benefit for himself while imposing bankruptcy costs on creditors and non-debtor partners. *Id.* As another example, an undersecured creditor might be able to use a bankruptcy proceeding to avoid a low buyout provision under the debtor’s partnership agreement, if federal bankruptcy law creates a more favorable buyout formula. *Id.*

Fifth, the experience of lawyers in transactional practices suggests that creditors who deal with partners as borrowers generally realize the risks they are taking in relying on the partnership interest for repayment and can adjust to those risks legally and economically. If lenders are unable to protect themselves adequately, by requesting more security or higher interest rates or shorter payout periods, that is their oversight and not a general problem with which bankruptcy should be concerned. Insofar as the Commission’s proposals imply that a partner’s creditors
need special protection, the assumption is counter-intuitive. Moreover, what bankruptcy law appears to give with one hand -- in attempting to increase the value of a partner’s interest for the benefit of creditors -- it probably takes away with the other hand by fostering litigation and bankruptcy’s high transactional costs.

Finally, to the extent that these proposals might allow debtors to remain as active partners/LLCs contrary to state law or *ipso facto* clauses, and would authorize the forced substitution of a new partner/LLC member in a partnership/LLC, they might create value for the debtor’s estate where none would have existed under state law. Bankruptcy law should not, however, be in the business of creating value, but only in fairly distributing the debtor’s property among creditors according to standards determined by extrinsic law. *Butner v. United States*, 440 U.S. 48 (1979). I recognize that the proposals attempt to interfere with state and contract rights as little as possible, but the provisions to which I refer will inevitably be over-utilized because of their potential for creating value that parties to the proceeding would not otherwise enjoy.
With this background, I have particular objections to three specific parts of the partnership bankruptcy proposals.

A. *Ipso Facto Clauses*

Although *ipso facto* clauses that have the effect of terminating or modifying parties’ rights to a contract based on insolvency, financial condition, commencement of a bankruptcy case or appointment of a trustee are not ordinarily enforceable in bankruptcy, I believe a distinction must be drawn between their enforceability in contractual relationships and in partnership or LLC agreements. Invalidating *ipso facto* clauses in contracts is essentially different from interfering with the complete business organization. Contractual *ipso facto* clauses may be viewed as bilateral solutions to damage and performance questions that would otherwise arise during a bankruptcy. Partnership and LLC agreements, however, are the constitutional documents for business organizations. Breach of such agreements does not have a simple bilateral effect, as would a contract breach. Rather, the effects of breach ripple throughout
the organization. Further, the business organization documents, or state law by default, represent a carefully bargained-for multilateral assessment of the rights and interests of the affected members of the organization. *Ipso facto* clauses founded on bankruptcy or insolvency provide a clean cut way to identify a threat to the organization and supply its solution by, for instance, automatically expelling a bankrupt partner.

The Commission’s proposals would result in a world without *ipso facto* clauses to protect partnerships/LLCs in the event of a member’s bankruptcy. In such a world, considerably more adroit legal drafting would be required to solve the problems that arise on bankruptcy of a partner or LLC member without referring to the member’s bankruptcy or financial condition. Moreover, it is not clear that creditors are better off in such a world, for their optimal remedy is probably to share in the expelled member’s buyout from the firm.

Consider an example. The general partner of a real estate partnership falls seriously in arrears in his financial contributions. On filing bankruptcy, however,
with the *ipso facto* clause invalidated, and no other clause permitting expulsion, that partner would continue to make decisions concerning the running of the partnership.\(^3\) But is it not intuitively obvious that the bankrupt partner will be participating in the firm with much different goals in mind than those of other partners? The partner is in no position to contribute credit to the organization (in the form of vicarious liability); the partner may not fully bear his load of the firm’s debt during the bankruptcy; and the partner’s perspective on future earnings, which may go to creditors, may well diverge from the firm’s interests. See Ribstein, *Expelling Bankrupt Partners*. The essential community of interest among the organization’s members has been severed by the bankruptcy.

Professor Ribstein’s letter makes additional points. He advises that members should be allowed to provide for automatic expulsion of a bankrupt partner and to fix a price in the agreement that is triggered by

\(^3\) A previous version of these proposals limited the application of the automatic stay to certain kinds of intra-partnership actions. The final version of the proposals does not do so, and I infer that the partners would be prevented from expelling this partner without first gaining approval of the bankruptcy court.
bankruptcy. Ribstein Letter, at 3. First, *ipso facto* provisions are efficient state law rules, which the Commission’s proposal invalidates. *Id.* State law “recognizes that non-debtor partners and LLC members often need to sever their relationship with bankrupt partners because of their different incentives and interest in the firm following bankruptcy”. *Id.* Professor Ribstein continues:

Accordingly, state law provides by default for the expulsion of bankrupt partners and LLC members and for payment for their interests in the firm. State law also permits enforcement of partnership and LLC agreement provisions for payment of less than the market value of the bankrupt partner’s interest. This accommodates the partners’ cash-flow and other problems that could result when a partner’s bankruptcy triggers a sudden buyout obligation.
Second, the [Commission] proposal undoubtedly will give rise to litigation over whether a buyout price or expulsion is an "ipso facto" provision. For example, is a buyout price enforceable if it applies only to partner bankruptcy and partner divorce? This hardly "fosters predictability" as the Proposal asserts.

Third, as discussed in my working paper, [Expelling Bankrupt Partners] there is no compelling bankruptcy interest at stake. There is clearly no problem with expulsion of bankrupt partners, and indeed this may be in creditors’ interests if it is the best way to ensure a buyout of the bankrupt partner. Even if the bankruptcy estate is denied some value by reason of the "ipso facto" provision, this is no
different from the effect of secured creditors’ priority. Such state law rights have been upheld for good reasons and . . . there are equally good reasons to apply state partnership law and partnership agreements in bankruptcy. [One may] recognize the potential concern that partners may create “spendthrift trusts” for themselves by making investments in partnerships that creditors cannot reach. But because this tactic also hurts solvent partners, it is mainly a problem in the sort of eve-of-bankruptcy context that is covered by fraudulent conveyance law. Thus, per se invalidation of such provisions is unnecessary.
B. Management Rights

Both Professor Ribstein and Richard Levin\(^4\) forcefully criticize the novel proposal to include a partner’s management rights as part of the “property of the estate,” contrary to state law. Creditors are entitled under state partnership law only to the debtor’s “economic” interests in the firm. Only a few rogue bankruptcy cases have held otherwise. Including management rights as part of the debtor’s estate raises a Pandora’s box of complex questions concerning valuation, transfer, the debtor’s rights and a trustee’s role that obscure rather than clarify creditors’ entitlements. I agree with these experts’ conclusion that the debtor’s management rights should not become part of the debtor’s bankruptcy estate. If they do not, then there is no need to provide, as the proposal attempts to do, for exercise of management rights by a trustee. Mr. Levin draws a helpful analogy to illuminate the proposal’s lack of conceptual coherence:

In the corporate context, the trustee cannot take over the debtor’s role as an officer or director of a corporation just by virtue of becoming trustee of the debtor’s estate. To be sure, the trustee as a shareholder may elect a new board and take over the corporation that way, but that is different from stepping into the shoes of an individual for employment or management purposes.

Mr. Levin further points out:

A disputing partner should not be able to use the bankruptcy laws to prevent his ouster from the

\(^{4}\) Mr. Levin is now a partner at Skadden, Arps and was a principal legislative aide when the 1978 Bankruptcy Code was enacted. His view of the Commission’s partnership proposal appears in a letter to Ms. Liz Holland, Commission staff member, June 13, 1997.
partnership/LLC, anymore than a corporate officer should be able to retain his position by filing a bankruptcy petition.

If *ipso facto* clauses are permitted, in most cases, the partnership/LLC agreements, or by default state law, would permit expulsion and buying out the bankrupt partner. No management rights would remain to be dickered about.

C. Transferability and Valuation of a Partnership or LLC Interest

Given the history of partnership law and the reality of the unique relationships that exist among partners, it is incredible to contemplate the Commission’s proposal, the first of its kind in my understanding, that would allow a partnership interest to be sold and the purchaser forced upon unwilling non-debtor partners. To enunciate this recommendation, it seems to me, is to refute it. The Commission proposal would, however, change the law and under certain circumstances permit the court to order either the sale of the bankrupt partner’s interest and admission of the buyer into the firm or the buyout of the bankrupt partner or member.

Professor Ribstein summarizes the reasons for questioning this proposal:

Under state partnership law, a partner’s creditor is entitled to a charging order and, under some statutes and case law, to judicial foreclosure of this charging order that would make the creditor essentially the assignee of the partner’s interest. However, even foreclosure would not necessarily entitle the creditor to a buyout, and as assignees creditors may not be able to dissolve the firm or otherwise obtain the value of the partner’s or member’s interest.
These rules involve a complex adjustment of the rights of creditors and non-debtor partners worked out on a statute-by-statute and case-by-case basis under state law. For the general policy reasons discussed above, it is inappropriate to supplant this state law development with a federal provision. Moreover, special federal rules would give partners’ creditors a perverse incentive to put partners into bankruptcy so that they can realize more on the partners’ interests than they could under state law. This would trigger substantial bankruptcy costs merely to satisfy the selfish objectives of a few creditors.

Ribstein Letter, at 4.

The Commission’s proposal on forced buyout of a partner interest, though somewhat less troubling than forced substitution, attempts to defer to state law and partnership/LLC agreements. The proposal allows enforcement of (non-ipso facto) partnership/LLC governing documents that restrict transfers of membership, but “only if” the partnership/LLC pays the “buyout price”; the “buyout price” is defined as the highest non-bankruptcy-related value provided in the documents, or if there is none, a “fair price”. The forced buyout provision permits the court to fix reasonable payment terms, balancing the needs of the debtor’s estate and the firm. It is not the buyout I object to so much as the court’s authority to fix a price for it.

The perceived evil that this proposal seeks to avert is sub-market buyout valuations that would unfairly penalize creditors of a partner/LLC debtor. Professor Ribstein questions the utility of this proposal:

The problem of sub-market-value buyouts is not normally a serious one, however. Partnership buyout
provisions typically are triggered by any partner dissociation, including those resulting other than from bankruptcy. If the partners were willing to deny market value to themselves on retirement or to their estates on death without knowing in advance whether they would be the surviving or remaining partners then the price presumably reflects both the costs and benefits of sub-market-value buyout even if a particular buyout ultimately is triggered by bankruptcy. Creditors’ interests do not justify invalidating such a clause.

Ribstein, Expelling Bankrupt Partners, at 14.

The Commission’s “fair price” provision ignores the ability of a partner’s creditors to ascertain the partnership’s buyout terms and adjust their credit decisions accordingly. The provision also affords redundant creditor protection. If the partner’s buyout provision has been set at zero or unrealistically low to hinder, defraud or delay creditors, fraudulent conveyance and other laws already address the problem.

Finally, the Commission’s proposal invites distracting litigation over whether a buyout provision was “on account of” bankruptcy if the provision also covers other events, such as partner divorce. Clever drafters could make the interpretation of this provision difficult. Enforcing state law and thereby the partnership/LLC agreements offers on balance a clear, efficient, fair and inexpensive means to distribute the debtor/partner’s interest among the creditors.

CONCLUSION

Before Congress enacts these provisions, which change the rights that partners have among themselves and with regard to creditors of a bankrupt partner, it should look closely at the consequences for partnership/LLC law development generally and consider whether an additional
layer of regulation of these extremely inventive types of business organizations is really needed. The bankruptcy tail should not wag the formidable investment dog that has been created by modern partnership/LLC law.
DISSENT FROM CERTAIN COMMISSION
RECOMMENDATIONS ON GENERAL ISSUES
IN CHAPTER 11

Submitted by

The Honorable Edith H. Jones

The assistance Professor Barry Adler
and Mr. J. Robert Fowler, Jr.
is gratefully acknowledged.
Chapter 5: Individual Commissioner Views

DISSENT FROM CERTAIN COMMISSION RECOMMENDATIONS ON GENERAL ISSUES IN CHAPTER 11

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I. INTRODUCTION

Less than 24 hours remain until the October 8 deadline the Chairman has imposed for submitting the Commissions’s report to the GPO, 12 days before it is due to Congress. We have not been furnished with a final copy of the report covering Chapter 11 issues or of the reporter’s introduction thereto. We did not receive even a rough draft of the reporter’s introduction until last Saturday morning, October 4.

The drafting process has been disorderly. Commissioners must struggle with nearly a thousand pages of draft and attempt to write dissents from an incomplete product. We have not had a fair chance to coordinate dissents or comments on the general Chapter 11 issues. Time has artificially been called, and all requests for extensions have been denied.

Disingenuously, the Report fails to acknowledge that several of the most important general Chapter 11 proposals, the subjects of this dissent, passed only by 5-4 votes. As with the 5-4 split on consumer issues, these 5-4 splits reflect deep philosophical and practical differences among the Commissioners. The Report does not explain to Congress the reasons for these serious differences, as it should have done. This dissent, written under an impossible deadline, hopes to illuminate the importance of what the Commission did -- and what it failed to do.

II. REDUCING COST AND DELAY -- MEDIATORS AND OTHER REMEDIES

Although the Reporter’s Introduction and the General Chapter 11 proposals do not acknowledge it, there is serious debate in business and academic circles over the efficacy of American Chapter 11 reorganization law.5

The Commission’s review of Chapter 11, dominated by bankruptcy professionals and academic defenders of Chapter 11, never engaged the debate, but Congress should know it exists.

Setting that larger debate aside due to the press of time, it is important to note that the Report acknowledges that transactional expenses, delay and legal uncertainty plague Chapter 11 of the Bankruptcy Code and should be reduced. Transactional expenses incurred for lawyers, accountants, appraisers and investment bankers do little to enhance the value of the reorganizing entity or the pot available for creditors. Delay imposes debilitating costs on the debtor and creditors. Legal uncertainty, rooted in the very structure of Chapter 11, is a significant source of both expense and delay. I contend, however, that the goal of reducing costs and inefficiency was not met at all in the proposals from which I dissent. In fact, the Commission did not vote or act upon proposals that would actually reduce cost and delay.

The whole point of the majority’s proposals on absolute priority and classification is to shift
bargaining power in favor of the debtor and to move from firm rules to a standardless approach that invites litigation over significant confirmation issues. Where there is more room for litigation, there will be more expense and delay in reorganizations. The impact of the post-confirmation modification and pre-bankruptcy waiver proposals will be similar: those proposals are not only vague, they create a vast reservoir of new rights for debtors, inviting debtors to exercise leverage over creditors that has little to do with the business issues with which reorganization should be preoccupied. Finally, the recommendation to provide interim protection for non-debtor parties before the assumption or rejection of an executory contract explicitly refuses to adopt the most obvious standard of compensation: the contract rate. Costs and delay are not reduced by this proposal’s reference to legal nostrums such as “restitution principles,” especially where, as here, the non-debtor party is forced to go to court to get its rights recognized.

On all these matters of great practical import in reorganization cases, the Commission majority chose against simplicity, clear rules, lower costs, and less litigation and in favor of Chapter 11 debtors over creditors. While making these explicit choices, however, the proposals from which I dissent consistently fail to explain their implicit assumptions. These assumptions include: debtors need the enhanced leverage and ability to litigate; there are too few confirmed plans, and these proposals are necessary to assure more confirmations; the debtor lacks sufficient control in Chapter 11; and the court, which must render decisions on these vague new standards, is a forum preferable to the marketplace. All these propositions underlie the majority’s proposals, all are highly controversial, and none are justified in this Report.

There are other dogs that did not bark. An overarching feature of today’s reorganization business is the proliferation of vulture investors, who buy distressed claims and stocks low and hope to sell out fast and high. Distressed debt buyers can participate in a Chapter 11 company’s equity, subordinated debt, bank debt, or asset sales. The impact of such parties on
these proposals should have been addressed by the Report. Perhaps, in fact, these proposals seek without saying so to mute the effect of vulture investors. One well-known debtor’s lawyer worries: “[The vultures] don’t care about fixing the [bankrupt] business. They say, ‘Let the market take care of that’ . . . . There’s a greater emphasis on the purpose of Chapter 11 as a way not to rehabilitate businesses but to get creditors paid.”

The final mysterious silence of the Report lies in its failure to discuss concrete proposals to get creditors paid more quickly and certainly. The Report does not refer to submissions by large trade organizations, including the National Housewares Manufacturers Association, the National Lumber & Building Material Dealers Association, and the National Food Manufacturers Credit Group, which represent thousands of American businesses and hundreds of thousands of employees. These groups are usually trade creditors, the most beleaguered class in bankruptcy. They sought reform of reclamation law and exclusivity periods, but they got nowhere with the Commission. Their interests are most seriously hurt by the delay, cost, and legal uncertainties in Chapter 11. Congress should listen to them.

The Report also neglects to deal with limits on exclusivity, plan mediators, incentives to efficiency built into attorney and professional fees, and other measures that would directly reduce cost and delay. Fortunately, however, on one occasion, the Commission was privileged to hear testimony from experts who grapple directly with proposals to reduce costs and delay. Because these experts’ credentials entitle their views to serious consideration by Congress, I reproduce portions of their statements throughout this dissent.

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1. Professor James J. White\(^7\)

In my view, it's wrong to think of a Chapter 11 as essentially a judicial proceeding. And the way I think of drawn-out Chapter 11s is to say they are like a beehive of activity in which each bee is trying to steal the wealth from somebody else who is also in the hive. And the longer we let it go on, the more likely it is that I, if I am a particularly aggressive and clever bee, will get somebody else's money.

It is my hypothesis, therefore, that the longer a Chapter 11 goes, the more reallocation of wealth that will occur, contrary to what Congress probably intended when it put down its priorities.

And secondly, that the larger the cost -- that is, in my view, the direct and indirect costs of Chapter 11 are more or less parallel to time. Many of the people in Chapter 11s charge by the hour or, in case of investment bankers, by the month. And the longer the hours and the longer the months, the larger the direct costs.

My hypothesis is: It is also true that the indirect costs will grow, because the business is not run well when it's under the supervision of a court and is subject to committees who are fighting one another. That leads, in my view, to bad decisions, wrong investments, and to the failure to make investments that probably should be made.

At least on the surface, a proposal for the reduction in the time and for the

\(^7\) Robert A. Sullivan Professor of Law, University of Michigan School of Law; co-author of James J. White & Robert S. Summers, Uniform Commercial Code (4th ed. 1995).
simplification of Chapter 11 should be noncontroversial. There is no one that I know of that publicly will speak in favor of delay, and there is no one that I know of who takes the position that a business has a right to linger for a long period in Chapter 11 in order to wait till the next upturn in the economy so that it might get healthy.

Privately, however, I suspect there are many of us who would like to see Chapter 11 as elaborate and complex and continued. I have charged Harvey Miller with that in print, and the way Harvey rose to the bait suggests to me that I was right.

... 

So my view, I guess, is there are a certain number of people -- not excluding law professors, who like to teach complicated rules like this, and not excluding bankruptcy judges, who but for Chapter 11 would be condemned to live on an intellectual dung hill, I think.

One smart bankruptcy judge in the Midwest said to me -- I said, "What if Chapter 11 were appealed? What would you do?" He said, "I would resign."

... 

But I suspect that even the bankruptcy judges are not completely objective about this. And even they would find it -- would have the kind of reaction that I instinctively have when somebody attacks tenure or the right to teach only three hours a week as opposed to 40, like I should, I suppose.

In any event, let me suggest -- my argument, I guess, basically is that we should change -- that you can't speed up Chapter 11s
without changing the incentives of the parties to some extent.

And I have at least three proposals to change those incentives. These will not meet with wide acclaim necessarily; though these are only suggestions, and there are other things you could do that might have the same impact.

In other words, my argument to you is: Instead of saying, "Should we change this little section 1129," you ought to think about the question, "As an operational process, are there things we can do to it, maybe in Chapter 13 or Chapter 3, that will make the incentives different so that it will make people want to get done sooner?"

Let me give you three suggestions that I have. First, of course, is the possibility -- that will be suggested and elaborated on by Mr. Sigal -- of appointing a trustee. And there are a variety of other proposals that are around in different writing about trustees.

In my view, the virtue of a trustee is not that the trustee will run the business better than the existing management. The virtue of the trustee is that he is a threat to existing management. And if I, as the manager, know that I will be threatened before I -- when I go into bankruptcy or while I'm in bankruptcy, that may change my attitude and will change my behavior as a manager or as a debtor in possession. So I would second Mr. Sigal's suggestion for the appointment of a trustee.

Secondly, I would argue for a modification of section 507(b), maybe a modification of 507(a).
507(b) now says if I, as a secured creditor, ask for the stay to be lifted, I am denied and I am given adequate protection, and that protection proves to be inadequate, to the extent of the inadequacy I have a priority claim.

One might change that rule in a way I have suggested in the paper I will give you afterwards which would automatically give the secured creditor that right.

Now, the consequence of that, of course, is that there will be a large number of people who will be looking at secured creditors who will say, "If we drag this out and if we, in effect, take money out of the pockets of secured creditors, that will ultimately come out of our pockets, because they will rank above us in the distribution." And assuming there are enough assets to pay at least the priority creditors, that will change the motivation.

Now, I realize that Harvey and lots of other people will squeal like pigs stuck under a fence, because they will say, "Well, you'll never be able to hire a lawyer, you'll never be able to hire an accountant, unless you can assure that he will be paid."

I doubt that's true as an empirical matter. But even if it is true, you will be able to find some people, and the motivation for them is to get done quickly.

The third proposal I would make is to consider the reversal of section 361 -- or amendment of 361 to reverse that -- Timbers of Inwood\(^8\) -- which said that you do not get opportunity costs if you're a Chapter 11 -- or

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if you're a security creditor in Chapter 11. That, too, would have the same consequence.

And I would argue that the Supreme Court was not entirely true to the indubitable equivalence argument or language in section 361 when it did that.

I conclude with just two points. And I am sure there are more clever ways than I have suggested to modify Chapter 11 in order to increase the speed.

Let me conclude with two points. One: The Commission, in my view, should devote careful thought to the question, "How can Chapter 11s be made to go faster?" Everybody, at least publicly, acknowledges that would be important and desirable.

Second, I would argue that the speed of Chapter 11s will quicken only if you change the incentives of the players. It is not enough simply to change 1121 and say to a judge, "You've got to order -- end the exclusivity period in two months, or one month, or something like that."

So I endorse the possibility of shortening that period. But I think it better to modify things like section 507, like Timbers, or like setting up a trustee.

2. Dean Douglas Baird\textsuperscript{9} cautioned the Commission to reform bankruptcy law with clear rules rather than vague, open-ended tests to reduce costs and create uniformity:

I would just remind everyone of the first principle of legislative reform, which is part

\textsuperscript{9} Dean Douglas G. Baird, University of Chicago School of Law, co-author of \textit{Baird & Jackson, Cases, Problems & Materials on Bankruptcy} (2d ed. 1990).
of the Hippocratic Oath, which is "First, do no harm."

Also, remember that in law, 95 percent is often perfection. The best is very frequently the [enemy of the good] . . .

. . . if you have unclear rules, you're going to have less uniformity. A judge in Chicago is going to treat things differently than a judge in Delaware or a judge in New York. That invites people picking different judges and different places on the base of the kind of treatment that receive.

[Next] . . . the less clear the rules, one thing that's more certain than anything else is the higher the cost of the bankruptcy. The less certain the rules, the more vague the standard, the more you have a seamless web that needs to be unraveled.

Now, obviously, with change, there's always going to be a little litigation, and that's okay. But unclear rules themselves, vague standards themselves are an opportunity for litigation, an opportunity for lawyers to write long briefs, an opportunity to have longer and more complicated discussions.

Vague rules lead to longer and more expensive bankruptcies, higher fees for lawyers. Not something that's in the interest of unpaid workers, tort victims, or nearly anyone else.

And my final concern is something that, again, I think is a little bit subtle. The impulse is to have bankruptcy judges do equity and to look out for people. And the more vague the rule and the less clear-cut and the more discretion the bankruptcy judge has over that domain, you might think the more compassionate we're going to be for the people who can't protect themselves.
I worry about exactly the opposite. If you have unclear rules, the people who are going to benefit the most from them are the most sophisticated parties with the most expensive lawyers. A world in which you have unclear rules, unclear priorities, unclear consequences in bankruptcy is a world in which there is an opportunity for people who can't protect themselves to be left with the short end of the stick.

And it's for all those reasons that I would urge both caution in bankruptcy reform and to be very careful about the consequences of bankruptcy reform, and to remember the success stories of the Reform Act and before then.

And I think the characteristics of the most successful bankruptcy reforms we've seen in the past have three basic characteristics: You have judges who are acting as judges, who are looking at the law and trying to resolve disputes in the context of an adversarial system.

Secondly, you have judges who are willing to take advantage of market mechanisms when they're available. They're not always available. But if market mechanisms are available and judges aggressively seek them out, it turns out that those have been very successful since 1978.

And finally, bankruptcy judges, like every other official, have to witness the temptation to be a social engineer. We simply don't know enough to entrust in anyone -- and especially a judge who can't be immersed in the facts and can't be cozy with the facts and the business -- we can't entrust in anyone the job of being a social engineer. Everything we've learned about markets and how markets work tells us that that's a big mistake.
And when you combine those things together, I think it suggests that the Commission, in a number of the ways it has looked at Chapter 11 cases, should be extremely cautious.

3. Mr. Mike Sigal\textsuperscript{10} recommended the appointment of a plan mediator after a certain period in the litigation process to bring the parties seriously and definitively to the bargaining table:

As a backdrop, let me say that I think it's undeniable that bankruptcy reorganization legislation is an integral component of the capital market system. It permits a private-sector solution to economic distress, whereas in many other parts of the world you end up with a public-sector solution.

On the other hand, I think our system that we have today takes too long, costs too much. And I don't think it really has the confidence of the American public, and that's an important ingredient of how this government works.

I don't think that -- I think we need something that balances both the need to have bankruptcy reorganization in appropriate cases that preserves jobs and that maintains certain values, at the same time without bringing in negatives of it taking too long, costing too much, and adversely affecting this country's great strength, which is its capital-raising ability in both the capital and private credit markets.

\ldots

\textsuperscript{10} Meyer O. Sigal, Partner, Simpson, Thacher & Bartlett, Vice Chair, ABA Business Bankruptcy Committee.
[My proposal is] this: The debtor in possession would have a defined period of time -- maybe longer than the four months that now exists, maybe six months -- to file a plan of reorganization. After that time, any creditor or other party in interest could file a plan of reorganization.

If a reorganization was not confirmed within some other defined period of time that the Commission would choose -- say a year -- the court would appoint a plan mediator.

Now, the plan mediator would not be a traditional trustee. The plan mediator would not run the business. The debtor in possession would stay in place and run the business. The plan mediator's sole focus should be the reorganization plan. The plan mediator would be a neutral, would have no economic interest in the outcome.

And I think that lots of -- today, I think there are quite a lot of people that would create a pool from which plan mediators would come from. These would include restructuring professionals, retired judges and attorneys, law professors, and even practicing attorneys.

The goal is to achieve a consensual resolution among the parties. But in order to prevent parties from stonewalling the mediation process, the plan mediator would have the power to ultimately propose a reorganization plan or to report to the court that he or she didn't believe a reorganization plan was possible.

I would not suggest a plan mediator if there had already been a Chapter 11 trustee appointed, which is already in neutral. And I would give the court some discretion not to have a plan mediator if a reorganization was on the verge of being confirmed or if there
was some other compelling reason not to appoint a plan mediator.

...  

And in my view, having a plan mediator appointed will have two impacts. One is: The fact that it's out there will force people to take it very seriously; that if they want to do it themselves, they have to do it themselves within a reasonable time that the Commission would determine.

And secondly, if they don't do it themselves, then what you would have is, instead of the litigation that happens in court now about whether there should be exclusivity or extended and all that stuff, you would simply permit parties to do a financial restructuring, a business restructuring with the aid of a neutral that has some experience in the area. And it may well be business experience as opposed to legal experience, while at the same time you've got the aura of the Federal Court in the background.

This Commission could have had an invigorating debate over proposals made by Professor White, Mr. Sigal and the other experts quoted herein. Unfortunately, the opportunity was lost.

DISSENT FROM SPECIFIC PROPOSALS

III. ABSOLUTE PRIORITY AND EXCLUSIVITY (Commission Rec. 2.4.14)

Richard Breeden\textsuperscript{11}, Former Chairman of the Securities Exchange Commission, spoke at a May 1997 NBRC forum in Washington, D.C. and eloquently explained the

\textsuperscript{11} President and CEO, Richard C. Breeden & Co.
larger financial context in which the absolute priority rule plays a key role:

> [W]hen one starts tinkering with [the absolute priority concept], you should know that in capital market terms, you are tinkering with a live nuclear bomb.

And I say that because there are approximately $16 trillion today invested, trading all day long today in the American economy, in securities predicated on calculations of the tradeoff between risk and return.

And to the extent that we alter in ways that are ambiguous, subjective, imprecise, and unpredictable the way in which capital will be handled in the event of an insolvency, you are at risk of changing those calculations of risk and reward and people's ability to make an accurate projection early on in the game, which is a predicate for their actual investment.

...

So this risk-and-reward calculus is absolutely critical to the formation of technology and the formation of young companies.

We have come a long way. We have today a greater ability to calculate risk and to model it, the methodologies, through derivatives. And the option-pricing models that have come along out of our trading markets have given us a better ability to quantify risk than ever before, up to the point of insolvency.

And that is where I think we have a weakness, an inability to then make accurate predictions of how capital will be handled and how the relative priorities set forth in contracts -- in securities, which are nothing
more than contracts, of course -- will, in fact, be handled by the courts.

... And I'll end on what I think the result would be. Capital markets are very, very rational. You can't always understand everything. Not all information is available. It isn't always reliable.

When information or the ability to analyze risk isn't certain, it doesn't mean that there will be no investment, but the market will take a discount. If the market isn't sure about something, it will just say, "Well, I might be willing to lend 95 percent against that portfolio of assets in a normal circumstance. But because I have some uncertainty, I'm only going to be willing to lend 70 percent instead."

... So markets, when faced with uncertainty, immediately, immutably, always start discounting. And that discount is a discount that isn't just applied in the case of statutes that apply to all companies in the economy. The discount isn't just applied to the people who are insolvent.

The discount, in capital terms, will get applied to the new companies that aren't yet created, to the live companies that aren't going to go insolvent but might, because no one knows who will.

And therefore, the cost of capital and the availability of capital to companies throughout the economy will change. That cost of capital will rise. And for the smallest, most difficult-to-finance companies, the job of finding capital will be that much harder.
So one has to be terribly careful that in trying to make it possible for people like me to come in and rehabilitate companies -- and I'm trying to save 150 jobs in Syracuse, New York, which is not blessed with the world's highest rate of job growth -- it is important to have some tools to be able to try to fix companies where they're fixable. I happen to believe that is socially important.

But at the same time, you have to do that in a way that protects the capital market's expectations and protects creditors. Or else I wouldn't have a chance to raise money for our future growth, and people like me or people who are simply entrepreneurs trying to create other companies wouldn't be able to do so because of too much risk.

The absolute priority rule represents the Bankruptcy Code's respect for contractual rights created by mutual consent. The rule ensures that a firm can not thwart state law priorities by retaining an interest in the reorganized firm over the objection of an impaired class of creditors. This expectation that contractual rights will be respected, even in insolvency, is critical to the availability of capital, particularly to the new ventures that drive the American economy. The five-member Commission proposal ignores the macroeconomic effects described by former Chairman Breeden.

The majority’s proposal codifies a new value exception to the absolute priority rule in exchange for lifting the debtor’s exclusive right to propose a plan when the debtor moves to confirm a new value plan. Although the existing uncertainty about the survival of the new value exception under the Code needs to be eliminated, the majority is not correct in reasoning that "[a]ny recommendation made by the Commission that would settle the long-debated question on the new value exception would benefit the collective negotiation process." The majority’s proposal would not have a salutary effect on Chapter 11 cases, but would lead to more delay in Chapter 11, increase the ability of old
equity to extort value from creditors, and leave intact or even exacerbate much of the uncertainty about the scope of the new value exception.

First, we should not codify a new value exception to the absolute priority rule: a debtor should not be able to force creditors to accept a plan that violates state law priorities. Second, the majority’s proposal to codify a new value exception will not eliminate, and in fact may worsen, many of the problems it attempts to address.

1. There Should be no New Value Exception to Absolute Priority.

If there is real going concern value in a business, and that value can only be maintained if old equity keeps an interest in the reorganized firm, then there is no reason why creditors and equity will not come to a reasonable, negotiated agreement which allows both equity and creditors to share the going concern value. The absolute priority rule ensures that creditors do not have to accept equity’s continued participation unless creditors decide that the contribution from old equity is needed and is at the right price.

Equity has an incentive to shade the facts in its favor: if it proposes a new value plan, equity will have an incentive to undervalue the firm and overvalue its own contribution. Conversely, if the plan purports to satisfy all claims, equity has an incentive to overvalue the firm. A hard and fast absolute priority rule is necessary to give equity the proper incentive to disclose information and make a realistic assessment of the firm’s value. Without the absolute priority rule, equity’s incentives to make full disclosure are reduced, except perhaps as is necessary to co-opt a class of creditors for cram-down purposes. Plus, bankruptcy judges, who are ill-equipped to value the reorganized entity and equity’s contribution to it, are then placed
in the position of making decisions that should be left to creditors.\textsuperscript{12}

Obviously, there is no reason to cut off the firm’s equity as a source of new capital contributions to the firm. The absolute priority rule does not do this: if creditors believe the firm is more valuable with equity’s participation than without, they are free to accept a violation of the absolute priority rule to allow this. In fact, equity often participates even though creditors are not paid in full.\textsuperscript{13} This may be because equity brings value to the firm or it may be because procedural advantages already in the Code necessitate that equity be “bought off” in order to get a reorganization plan proposed.\textsuperscript{14} Regardless of the reason, there should be little doubt that if old equity offers true value, the parties can reach an agreement for its participation. However, creditors, who would be free to reject equity’s participation outside of bankruptcy, should make the decision, not a bankruptcy judge.

\textsuperscript{12} As the Supreme Court has stated:

The Court of Appeals may well have believed that petitioners or other unsecured creditors would be better off if respondents’ reorganization plan was confirmed. But that determination is for the creditors to make in the manner specified by the Code. 11 U.S.C. § 1126(c). Here, the principal creditors entitled to vote in the class of unsecured creditors (i.e., petitioners) objected to the proposed reorganization. This was their prerogative under the Code, and courts applying the Code must effectuate their decision.


Chapter 5: Individual Commissioner Views

The presence of the exception replaces the negotiation-based solution fostered by the absolute priority rule with a litigation-based solution and its accompanying delay, expense and uncertainty. Not only does the very existence of the exception increase the leverage of the debtor to force creditors to take a deal they would not otherwise take, but the resort to litigation siphons value away from the reorganizing entity and to bankruptcy lawyers.

Furthermore, even considering only those courts which believe that the new value exception survives in the Code, few of the new value plans that have been proposed have been confirmed.15 Debtors fail more often than they succeed with respect to each of the five requirements from Case v. Los Angeles Lumber.16 Further, the majority of filed new value plans are in single-asset real estate cases where the benefits of reorganization under Chapter 11 are the most attenuated.17 Thus, the new value exception has promoted additional litigation and cost without significant confirmations of new value plans. Whether the five-member majority proposal will change this situation is anyone’s guess.

The delay, expense and uncertainty created by codifying a new value exception will have negative consequences for the availability of capital. The uncertainty created by the debtor’s increased power to force creditors to take a deal they would not otherwise take will cause the capital market to discount the expected returns from a particular extension of credit. This means that capital will cost more, and all business, especially small, startup ventures that provide the bulk

15 See Memo of Bankruptcy Judge Tom Carlson to Edith Jones, dated November 7, 1996. Judge Carlson’s memo indicates that only 20% of new-value plans were held to have met the Los Angeles Lumber requirements.

16 308 U.S. 106 (1939).

17 See Memo from Judge Carlson, supra, note 5 (60.3% of filed new value plans surveyed were single-asset cases).
of job creation in this country, will be hurt. This proposal may benefit the debtor once in bankruptcy, but, ex ante, all businesses suffer.

2. In Codifying a New Value Exception, the Majority’s Proposal is Deficient.

The majority’s proposal as it exists has serious shortcomings: (i) the proposal leaves untouched, and may even magnify, major sources of uncertainty in the new value exception; (ii) the supposed safeguard for creditors is illusory and will cause additional delay and expense, and (iii) the proposal will undermine the Commission’s small business proposal by holding out false hope for failing businesses.

i. Uncertainty

As an initial matter, the proposed amendment does not explicitly include the five requirements laid down in Case v. Los Angeles Lumber -- new, money or money’s worth, substantial, necessary, and reasonably equivalent. Although the majority explanation of the proposal may mean that the Los Angeles Lumber factors are intended to be retained, it is dangerous not to state that intention explicitly in the proposal rather than expecting courts to turn to the legislative history to reach this conclusion. A court might read the plain language of this proposed reform and conclude that the change both overrules the requirements of Los Angeles Lumber and overturns Northwest Bank Worthington v. Ahlers. This is not an idle fear: Freddie Mac and a

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20 See Letter from Dean S. Cooper, Associate General Counsel of Freddie Mac, to Brady Williamson (June 3, 1997) ("The proposal as currently approved by the
prominent debtor’s lawyer have already suggested that this proposal overrules Los Angeles Lumber.

Furthermore, even if the requirements are included in the code, each of the requirements has engendered significant litigation and their meaning is far from certain. There is no attempt in the proposal to reduce this uncertainty by clarifying what any of the requirements means. The proposal doesn’t even define who “old equity” is, in this era of claims-trading! The increased uncertainty regarding whether the five requirements still exist at all will further increase the cost of bankruptcy and, accordingly, the cost of capital.

ii. Removal of Exclusivity

Mr. Hugh Ray questioned the effectiveness of the majority proposal to limit exclusivity when a debtor moves to confirm a new value plan:

The proposal purports to level the playing field by allowing competing plans.

Commission does not [codify Los Angeles Lumber”]).

21 Letter from Corinne Ball, Esq., to Panel Members for ABA Chapter 11 Subcommittee Spring Lunch Panel (Feb. 3, 1997) (enclosing overhead sheet listing criteria of Los Angeles Lumber as follows: “Necessity” -- no longer required; “Reasonably Equivalent Value” -- no longer required; What Happened to “Substantial” and “Money or Money’s Worth?”).

22 See Memo of Bankruptcy Judge Tom Carlson to Edith Jones, dated November 7, 1996 (noting that in proposed new value plans, “new” requirement was litigated in 46% of cases, “money’s worth” in 36%, “substantial” in 43%, “reasonably equivalent” in 49%, and “necessary” in 35%).

23 Partner, Andrews & Kurth, Immediate Past Chair of the Business Bankruptcy Committee of the ABA’s Business Law Section; Member, Council of the ABA Business Law Section.
It has been my experience in 30 years of doing this sole stuff that since competing plans have been allowed, that really isn't a meaningful remedy for creditors. The simple reason is that in cases where I have been successful in 1121 motions, in getting exclusivity lifted, the judges in some cases have refused to allow me to solicit or, in some cases, distribute a creditor's plans. So being allowed to file was not enough.

And even in cases where you can distribute a plan, usually the only meaningful plan that a creditor can file is a liquidation plan, which is not what a creditor wants to do.

The creditors do not have the access to information without signing a confidentiality agreement with the debtor. That agreement, of necessity, will usually prohibit -- because it's called a "confidentiality agreement" -- the disclosure of the debtor's operating activities to other potential bidders.

Usually the best bidder is a competitor, and certainly we don't want that person to know what their operating results are and how they operate. So when you give a creditor the right to file a competing plan, usually you've given very little.

The other problem is that when you look at competing plans, they often cause quite a mess. And the judges simply don't want to fool with them. And it has been my experience that almost all of them don't want to fool with them and it's something that they hate to see, because, again, usually one of the competing plans is a liquidation plan. So I don't think this is a meaningful relief for the creditors.

Under the majority’s proposal, exclusivity is not lifted until the debtor moves to confirm a non-
consensual, new value plan. Without further development, this is not meaningful protection for creditors. First, why wait until the debtor attempts to cram down the plan, i.e., after a creditor class has rejected the plan, before lifting exclusivity? Developing a competing plan takes time, especially in complex cases. The longer we wait to lift exclusivity, the longer the market forces on which the proposal relies to keep the debtor in check are kept at bay. Furthermore, the debtor has the information needed to develop alternative plans. Either exclusivity must be lifted earlier, e.g., when the debtor files a new value plan, or the information necessary to develop competing plans must be made available earlier. Otherwise, once exclusivity is lifted, the process must be delayed to allow creditors to obtain information and develop an alternative plan, causing more delay, expense, and lawyers’ fees, or the ability to propose alternative plans will provide no meaningful protections for creditors.

The proposal also provides no protection to creditors from false solvency claims. If a debtor proposes a plan that allows equity to participate but

24 The proposal makes no attempt to justify waiting so late to lift exclusivity, despite the fact that the problems associated with this delay and suggestions for earlier termination have been repeatedly brought to the attention of the Commission. See, e.g., Memo from Barry Adler to Professor Elizabeth Warren, dated August 12, 1996; Memo of Karen Cordry, NAAG Bankruptcy Counsel to Edith H. Jones, dated January 22, 1997; Statement of Hugh Ray, NBRC Panel on Corporate/Small Business Bankruptcies, dated May 1997; Statement of Certain Members of Ad Hoc Group of Secured Creditors, dated May 14, 1997.

25 The presence of the new value exception, combined with exclusivity until the debtor moves to confirm a new value plan, also creates an incentive for equity to hold back on its best offer and low-ball the initial proposal. See Memo of Karen Cordry, National Association of Attorneys General Bankruptcy Counsel, dated January 22, 1997. For example, in the Celotex case, at least according to one participant (a creditor committee), the debtor insisted that its initial offer was the best it could make and obtained an opinion from an investment bank verifying that claim. However, the debtor’s final proposal, made approximately 18 months later after exclusivity had been lifted, valued the company at twice the original proposal. See id.
purports to satisfy all creditors’ claims, exclusivity would not be lifted under the proposal. A creditor who doubts the debtor’s valuation of the firm would not be allowed to propose an alternative plan until the debtor’s plan ran its course, perhaps with much of the firm’s value.26

There are other limitations on the ability of competing plans to provide meaningful assistance to creditors. Due to the limitations on solicitation, creditors voting on the debtor’s plan may not be aware of the possibility that another party plans to propose an alternative.27 In addition, there may be parties willing to propose a plan who are not creditors, but the proposal appears to make no provision for allowing them to participate.28 Furthermore, removal of exclusivity may prove particularly worthless in small Chapter 11 cases by placing undue burdens on unsecured creditors who are already marginalized in such cases.29

26 See Memo from Barry Adler to Elizabeth Warren, dated August 12, 1996 (proposing that exclusivity be lifted when the debtor files a “plan that provides for property to be received or retained by an entity other than (i) a holder of an allowed claim; or (ii) a holder of an interest with an allowed fixed liquidation preference or an allowed fixed redemption price”).


28 Indeed, one would expect that those most capable of submitting competing plans would be parties other than a creditor, such as a competitor. See Statement of Hugh Ray, NBRC Panel on Corporate/Small Business Bankruptcies, May 1997.

29 Many of these questions could be eliminated if creditors were allowed to credit-bid the value of their claims. If the claims held by creditors exceed the value of the firm’s assets plus the proposed new value contribution, why should the creditors lose to equity’s lower bid?
iii. The majority proposal undercuts the Commission’s Small Business Proposal.

The Commission’s Small Business Proposal repeatedly expressed the desire to retain the absolute priority rule. Whether that desire was retained, I have not had time to figure out. But it is obvious that this new value proposal deliberately intends to affect small businesses. It boasts of this result. By emphasizing the importance of “old equity” in small, closely held businesses, the proposal may well doom Ahlers.

This proposal should not apply to businesses covered by the Small Business Proposal for two reasons. Principally, it affords a backdrop against which a debtor can always threaten to attempt to confirm a plan within the 150-day limit of that proposal and thus cause creditors to compromise unfavorably to their priority positions to save the high costs of a contested confirmation. Alternatively, the debtor can use a “new-value plan” as an excuse to continue in Chapter 11 beyond the 150-day deadline. Second, as Judge Carlson’s memo demonstrates, cramdown plans in small business Chapter 11's nearly always failed in the past. See supra, n.20. This proposal may represent a triumph of hope over experience. In any event, it foreordains the sort of manipulation that must be avoided if the Small Business Proposal is to accomplish its purpose.

3. Conclusion

Removal of exclusivity is an inadequate protection, and even at its best will only increase the time required to confirm a plan. Increasing the time in Chapter 11 becomes a strategic advantage for the debtor, allowing it to extract more from creditors, and a benefit to lawyers and other bankruptcy professionals. This impact could be devastating to the Commission’s Small Business Proposal.

Although codifying a new value exception eliminates uncertainty about the existence of the exception, it leaves significant uncertainty regarding
the requirements for and scope of the exception. Codifying a new value exception adds to the debtor's power, increases costs and litigation, and enriches bankruptcy attorneys. The supposed safeguard of lifting exclusivity when the debtor moves to confirm a new value plan does not provide real protection to creditors and benefits the debtor and bankruptcy attorneys.

Although the proposal may benefit the debtor once in bankruptcy, it has the unmistakable effect of raising the cost of capital. As Dean Baird reminded the Commission, we must remember the “first principle of legislative reform,” borrowed from the Hippocratic Oath, “which is ‘First, do no harm.’” It makes no sense to adopt this proposal, especially when a simple rule disallowing new value plans over creditors’ objections could reduce reliance on judicial valuations and provide the certainty necessary to maintain a lower cost of capital.

IV. CLASSIFICATION OF CLAIMS (Commission Rec. 2.4.15)

The majority proposes to amend § 1122 of the Bankruptcy Code to permit classifying similar claims in different classes -- and to treat them differently under an ensuing plan of reorganization -- if there is a “rational business or financial justification” for doing so. The proposal is justified on three bases. First, it is said to clarify current inconsistent caselaw. Second, the proposal is said to afford flexibility to a debtor to deal with a supplier or other creditor whose services are critical to reorganization, allowing the debtor more efficiently to focus on business needs during reorganization. Third, the proposal claims to enhance the prospects of successful reorganization by facilitating plans without, however, permitting

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gerrymandering of classes simply to obtain votes and to satisfy § 1129(a)(10).\textsuperscript{31}

This proposal should be rejected. For reasons explained below, it meets none of its stated objectives. Rather than clarify the standard for claims classification, it creates additional legal and practical uncertainty concerning the determination of what are “rational business or financial justifications.” The flexibility sought to be conferred on the debtor is likely to become a straitjacket, as competing creditors exploit the debtor’s newfound “flexibility” with pressure to improve their positions. Finally, to the extent the proposal substitutes a rule of equal treatment of similarly situated claims for case-by-case unequal treatment, it inspires yet another source of bargaining, maneuvering and litigation in an already intricate plan process and must delay rather than speed up the reorganization effort. The proposal, fundamentally antithetical to state law requirements of equal treatment for similarly situated creditors, effectively creates a new, \textit{ad hoc} priority scheme, sacrificing certainty and predictability for the debtor’s short-term objective of confirming a plan. The proposal overlooks, however, that its disruption of contractual expectations and state-law entitlements will have economic consequences beyond the reorganization world and will inspire contractual counter-measures by lenders and creditors and more conservative lending decisions.

1. \textbf{The Proposal}

The proposal permits differentiated treatment in bankruptcy of claims that outside it are legally similar. Such classification and separate treatment may occur without the agreement of the affected creditors. While other uses of the proposal are advanced, it also intends to permit a debtor to give preferential treatment to creditors, e.g.s., a supplier, landlord, employees, 

\textsuperscript{31} This provision requires the acceptance of one impaired class of creditors in order to confirm a plan.
unions, who are perceived to be in a position to make credible threats to inflict loss on the debtor during or after reorganization. As Professor Picker has put it:

Instead of courts serving as a bulwark against these threats -- instead of the Bankruptcy Code operating as a commitment device that prevents the debtor from doing what it might otherwise have no desire to do -- debtors will routinely face pressure to give special treatment to particular groups of creditors.

In that regard, we can be confident about the consequences of this proposal. Interested parties will have every incentive to posture, to bluster, to suggest the harm that they can inflict, all in an effort to receive priority and distribution. We do not want to encourage this behavior. This is just about transferring wealth from one group of creditors to another.\(^{32}\)

It should be emphasized that under current law, creditors can voluntarily agree that a plan will prefer a group beyond its minimum Chapter 11 entitlement. It happens all the time. This proposal, however, paves the way for nonconsensual preferences.

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\(^{32}\) Professor Randal C. Picker, Designing Verifiability: Boyd’s Implications for Modern Bankruptcy Law (draft paper presented to University of Pennsylvania Bankruptcy Conference 4/25/97).
2. Why the Justifications for the Proposal Fail

   a. The Proposal Will Not Clarify the Law

One may readily concede that current interpretations of § 1122 are conflicting and inconsistent without, however, conceding the principle that creditors whose claims would be similarly situated at state law ought to be treated equally to each other in bankruptcy.\(^{33}\)

Unfortunately, the proposal will clearly lead to its own set of interpretational difficulties. What is a rational business or financial justification? May a debtor classify in separate classes claimants that it intends actually to treat the same under the plan, on the theory that each “class” deserves its separate voice in the plan? How compelling must a “rational business or financial justification” be if, for instance, alternative suppliers are available or employees’ skills are fungible in the employment market? Can part or all of a “rational business justification” include the debtor’s goal to confirm a plan? If so, where does one draw the line between this proposal and gerrymandering classes for confirmation?

Even more unfortunate, this group of questions will be added to the questions that already exist concerning classification! In order to afford separate treatment to similarly situated creditors under the proposal, there is an underlying assumption that but for the separate treatment, those creditors were otherwise entitled to equal treatment. The proposal, however, avowedly makes no effort to resolve current caselaw inconsistencies and determine what are “similarly situated” claims. Consequently, whenever a party objects to a differential classification, it must first persuade the court that the claims subject to this treatment were

\(^{33}\) The proposal devotes many pages to describing these problems. I will not repeat or critique that analysis here.
in fact “similarly situated” and then dispute whether there is a “rational business or financial justification” for distinguishing among the claims.

Rather than solve the current problems, this proposal blithely confounds them.34

b. The Proposal Will Not Ultimately Afford a Debtor Increased Flexibility to Deal with Claims and to Concentrate More Closely on Business Aspects of Classification.

“Business flexibility” allegedly demands differential classification of otherwise similarly situated claims based on a “rational business or financial justification.” The proposal lists hypothetical circumstances in which “flexibility” might be helpful, cases in which (a) bank debt will be treated separately from trade debt, (b) a “unique” supplier will be preferred over other suppliers, and (c) employee retirement contributions would be paid in cash ahead of commercial debt holders.35 The proposal also endorses the result in a recent case, in which employee claims for workers compensation were separately classified and paid in full, while identical claims, owed through subrogation to the company’s workers compensation insurer, received much less favorable treatment.36

34 The Commission could have spent its resources more profitably by drafting language that will clarify existing caselaw, and for instance, articulate a firm rule of equal treatment and classification for claims that are similarly situated at state law.

35 Peculiarly, the proposal lists as a separate example a case in which “small trade creditors” are treated preferentially because they cannot await repayment. This preference is already embodied in § 1122(b), so the example would appear superfluous unless the proposal intends to change this portion of § 1122.

36 See In re Chateaugay Corp., 89 F.3d 942 (2nd Cir. 1996).
Freddie Mac asked incredulously whether this Proposal would permit a court to classify separately a lender’s deficiency claims and trade creditors’ unsecured claims. Clearly it would.

Viewing the proposal in light of these examples, three questions arise. First, will business objectives be furthered by the classification flexibility accorded the debtor? Second, at what cost to the debtor’s reorganization will the flexibility be purchased? Third, who will pay for the separate treatment of otherwise similarly situated claims? In my view, none of the answers to these questions favors the proposal.

First, the proposal and its rationale are somewhat schizophrenic. The proposal is expressed in extremely permissive language, as it allows separate treatment of similarly situated claims based simply on a “rational” business or financial justification. As every first-year law student knows, the “rational basis test” is one of the easiest for the proponent of a position to satisfy in all of American law. The proposal could have required “rational business necessity,” “compelling business necessity,” “compelling business justification,” “objective business demands,” or any number of more demanding formulations. That it did not suggests the broad discretion conferred on the debtor to discriminate among creditors.

At odds with the permissive language, the examples given to justify the proposal suggest some slight standard of business necessity. So the interpretive question arises, whether “rational” in this context will mean more than it does in other areas of law and if so, how much more. Just what is a rational business or financial justification, based on these examples? In how many cases can one really suppose that a particular supplier offers “unique” advantages to the debtor or that the labor market is so inflexible that a

37 Letter from Freddie Mac Associate General Counsel Dean S. Cooper to Brady Williamson (June 3, 1997).
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given pool of employees, who hold pre-petition claims against the debtor, will cling to their jobs throughout reorganization and be essential to the success of the reorganized company? Is there really a need for a debtor to discriminate between the residual unsecured claim of the bank and the unsecured trade claims, and if so, what is that need? On examination, the proposal’s standard of “rational business or financial justification” is so amorphous as to offer a rubber-stamp to the debtor who chooses to discriminate among creditors. There will seldom be business objectives so pressing as to require separate treatment in the plan, but some rationalization can always be prepared under the proposal.

An equally unpalatable prospect is that the proposal will create business demands where none previously existed. As Professor Picker explained, supra, the proposal allows the debtor to cave in and offer special treatment to any creditor which is able to bludgeon, bluff and litigate its way to that treatment. In other words, the “flexibility” envisioned by the proposal is really an invitation to aggressive creditors to attack; creditors will be encouraged to make their special claims upon the debtor and to negotiate into favored treatment. In an environment where all formerly similarly situated claims may become unequal, we must presume that many creditors will exert pressure for preferential treatment from the debtor. The result will be opposite to that intended by the proposal: rather than going forward on the business aspects of reorganization, the debtor will become mired in haggling over the special claims of otherwise similarly situated creditors.

38 Because the rational business justification is open-ended, it is hard to see how it can prevent the gerrymandering of classes by means of artful classifications. Only a poorly-lawyered debtor would fail to conceive a rational business justification for preferring one group of creditors in a separate class.

39 Beyond the scope of § 1122 but presenting similar overreaching problems, are the first-day orders in which secured creditors often obtain preferred treatment from debtors eager for post-petition financing.

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Allowing a debtor to discriminate between similarly situated claims imposes costs on the reorganization in two ways. First, as Professor Picker observed, it transfers wealth from the disfavored to the favored creditors. Second, it may cause the debtor to settle for more expensive terms in the reorganization plan than would otherwise be necessary. Buying peace with obstreperous creditors -- always a factor in Chapter 11 -- will be more costly as new groups of creditors, unshackled from their state law priorities, demand special treatment. The result may be a reorganized debtor burdened with heavier financial obligations. Both the debtor and its creditors will ultimately pay for the "flexibility" of classification based on rational business or financial justification.

Another way to look at the proposal is to ask why the decision to grant special treatment to claims should be removed from the affected creditors and placed in the hands of the debtor and courts. Nothing currently prevents creditors from voluntarily agreeing to accord special treatment to groups such as labor or suppliers where business necessity counsels such a course of action. Why should similarly situated creditors be forced to accept second-class status without their consent?

Finally, if a real notion of business necessity, as opposed to mere convenience and the short-term impulse to confirm a plan, underlies the proposal, why not implement the concept directly by providing preferred status to certain types of claims? For instance, the claims of labor unions or of essential suppliers or customers could be identified, much as small claims are currently identified for special treatment. The nebulous character of the proposal would thus be alleviated in favor of recognizing the groups most likely to benefit from it in practice. At the same time, collateral litigation by other creditors could be prevented.

\[40\text{ See fn.2 supra.}\]
3. The Proposal’s Effects on Confirmation

No doubt the proposal is accurate in hypothesizing that, if the debtor is given free rein to classify similarly situated creditors differently, it will be easier to satisfy § 1129(a)(10) and confirm plans of reorganization. Confirmations will be achieved by diluting creditor consent, but there is no assurance that more confirmations will lead to more successful business rehabilitations.

The principle of creditor consent has long been an essential feature of reorganization and composition plans. Former Chapter XI permitted differential treatment of similarly situated claims, but it also required a plan to be approved by a majority vote in number and amount of each class. Chapter XI did not authorize cramdown, and it could not forcibly modify secured debt. The current Code diluted these consent provisions, albeit with a general rule of equal treatment for similarly situated creditors, by requiring a majority vote in amount of the claims in only one impaired class. Under the proposal, the requirement of creditor consent virtually vanishes, replaced by the debtor’s unilateral ability to alter pre-existing claim entitlements by creating classes based on “rational business or financial justification.” The proposal does not explain why creditor consent should be diluted again, when every plan of reorganization depends upon the creditors’ continuing “investments” in the debtor. The proposal purports to decry “gerrymandering” of claims simply to confirm a plan over creditor opposition, but it imposes no real obstacle to that tactic.

To mitigate the impact of potentially unfair treatment of similarly situated creditors, the proposal assures us that ultimate plan confirmation must still conform to the “no unfair discrimination” rule.\(^\text{41}\) Shifting to the point of confirmation the determination of whether creditors in an otherwise equal class have been unfairly treated provides weak protection. First, although it is logically conceivable, it does not seem

likely that a court which had earlier upheld a “rational business justification” for treating similarly situated creditors differently would later find that the plan “unfairly discriminates” against the treatment of those same creditors. Second, when a large case reaches the confirmation stage, there is tremendous pressure on the judge to confirm the reorganization plan and declare the process a success. If any facts or opinions can be adduced to suggest that payment of one group of creditors in cash is not unfairly preferential to another group of creditors, otherwise similarly situated, who are paid in promissory notes, the judge will be hard put to find unfair discrimination. This is particularly true where a long and torturous bargaining process, inevitable in big Chapter 11 cases, preceded the confirmation hearing.

Assuming that the proposal enhances the likelihood that plans will be confirmed, its proponents still bear a heavy burden to demonstrate why evading a necessity for creditor consent is acceptable. Perhaps the creditor skepticism accurately reflects the low probability of successful Chapter 11 rehabilitation. Under current reorganization law, the likelihood of successfully consummating a Chapter 11 plan, even in high-profile bankruptcies, is distressingly low. Many confirmed plans provide only for liquidation, while other debtors utilize repetitive Chapter 11 filings. It would seem reasonable to inquire why, under the proposal, when the approval of an even smaller number of creditors is obtained, the prospects for successful debtor rehabilitation will increase. Yet no attempt has been made to suggest that successful rehabilitations are now inhibited by the lack of cooperation between the debtors and critical suppliers or the failure to grant preferential compensation under plans. The proposal, in sum, is not justified or justifiable in terms of enhancing the likelihood that businesses will be successfully and fully rehabilitated under Chapter 11.

4. Impact of the Proposal on Chapter 11 and on the National Economy

As has just been noted, the proposal may fulfill its role of encouraging the confirmation of plans, but it does so in a vacuum, without considering the costs of the altered confirmation process or whether it will increase the number of successful business rehabilitations. Unfortunately, neither the costs nor the impact on the reorganization success rate favors adoption of the proposal.

The proposal has other adverse implications with respect to the ground rules of Chapter 11. First, because it tends to substitute negotiation and litigation for clear priority rules, it will foster disputes, delay and increased administrative costs in Chapter 11 cases. By contrast, a clear rule of equal treatment for similarly situated creditors would speed up the Chapter 11 process. Second, the proposal may reopen the old debate about paying creditors outside the plan, as it permits naked preferences to be granted within the plan. There is no principled reason to suggest that a creditor with leverage, e.g., a “unique supplier,” deserves preferential treatment in the plan, while in the early stages of a case such more-than-equal treatment is not permissible. Similarly, the proposal essentially condones the granting of preferences in the bankruptcy plan, while § 547 prohibits pre-bankruptcy preferences, even though they may be motivated by dire business necessity. In summary, the proposal appears to aim for one goal: the confirmation of plans. The goal is achieved by sacrificing principles of equal treatment of similarly situated creditors; the superiority of rules to ambiguous standards; protecting a debtor from overbearing creditors; protecting the reorganization process from unnecessary transactional and administrative costs; and enforcing the requirements of consent to reorganization plans. It is not at all clear that the proposal furthers the goal of business rehabilitation.

From a larger perspective, the proposal must be viewed in light of general commercial law and the flexibility of our economy. It can easily be demonstrated that where lenders encounter increased
uncertainty in the terms of recovering the value of their loans following default, two consequences will follow. Interest rates will rise and the terms of lending will become more onerous, or lenders will become skittish about lending to novel ventures. The proposal cites examples in which the unsecured claims of lenders or sureties, which otherwise hold equal status with other unsecured claims under state law, might be granted less favorable treatment because of creative classification decisions. The lessons of potential uncertainty are not lost on lenders, who must adjust their risk evaluations proportionately. Good loans will not be made to companies who could otherwise repay them. The economy will not profit from jobs that would otherwise be created and entrepreneurship that has been stifled.

Another consequence of the proposal is that if a class of creditors is subjected to uneven treatment in a number of cases, that class will probably urge Congress to pass corrective “special interest” legislation, further complicating bankruptcy law and the collateral economic picture.

Obvious conclusions are these: the proposal will not facilitate an increased number of business rehabilitations, whether or not it nominally increases the number of plan confirmations. By increasing the uncertainty of repayment in bankruptcy cases, it will have adverse macro-economic consequences on extensions of credit and will discourage good investments. If there is a serious need for preferential treatment of limited classes of creditors, those terms should be built into the law directly. Otherwise, a rule of equal treatment for creditors whose claims are similarly situated in state law or by the terms of federal bankruptcy law should prevail, unless the parties otherwise agree.

V. POST-CONFIRMATION MODIFICATION OF PLANS (Commission Rec. 2.4.19)

The majority’s proposal to allow modifications up to two years after confirmation will only increase the uncertainty associated with Chapter 11. While the
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proposal acknowledges that the extra two years “might lessen the perceived finality of the confirmation process,” there is no doubt that the proposal will lessen the actual finality of plan confirmation and consummation: that is what the proposal is expressly designed to do. In effect, the proposal will mean that even in these few cases where a plan is confirmed and consummated, creditors are stuck in the Chapter 11 process for another two years.

It may be true that, in some cases, both the debtor and creditors would be better off if the plan could be modified post-consummation. If so, there is no reason that the parties can not provide for this in the plan itself by including mechanisms that lead to alternative outcomes based upon specified contingencies or that allow for the parties to modify the plan under certain conditions. Although I do not believe this is prohibited under the current Code,\(^43\) perhaps an amendment specifically allowing parties to provide a mechanism for plan alteration would be beneficial.

However, even if post-consummation modification might be beneficial in a few cases, it is a mistake to include an automatic two-year period for modifications. The primary purpose of limiting modification to the pre-consummation period was to ensure finality.\(^44\)

A debtor’s creditors and interest-holders commit themselves to the governance of a particular mode of reorganization by acquiescing to confirmation of a plan, and by relying upon the terms and character of that plan in accepting it. Their rights under the plan then vest upon substantial consummation. The generalized public interest in

\(^{43}\) Section 1122(b)(6) allows the plan to “include any other appropriate provision not inconsistent with the applicable provisions of this title.”

\(^{44}\) See In re Charterhouse, Inc., 84 B.R. 147, 152 (Bankr. D. Minn. 1988).
finality in court determinations, and the Bankruptcy Court’s specific interest in the integrity of its remedies, would both be prejudiced by allowing modification of a confirmed Chapter 11 plan when the parties’ rights have been settled in such a fashion.\footnote{45}

Creditors will discount their expected returns based on raising the cost of capital ex ante. In addition, the lack of assurance that a confirmed plan will be the final plan will make creditors less willing to agree to consensual plans. As the Ninth Circuit Bankruptcy Appellate Panel stated:

Congress drafted § 1127(b) to safeguard the finality of plan confirmation. If this were not the case, a proponent of a plan could file an endless series of motions to modify the plan, at every bump in the road, seriously jeopardizing the incentive for creditors to vote in favor of the plan.\footnote{46}

The majority reasons that the proposal will be harmless because, although the “window of opportunity to modify” is widened, the proposal does “not otherwise liberalize the strict rules that define the parameters of permissible modifications. The “strict rules” referred to are the requirements of §§ 1122, 1123 and 1129—the same rules that governed the original plan confirmation. This defense admits the proposal’s main flaw: a plan negotiated and confirmed as the “final” plan can be modified at any time for two years subject only to the same requirements that governed the original plan

\footnote{45}{Id. (citations omitted).}

\footnote{46}{In re Antiquities of Nevada, Inc., 173 B.R. 926, 928 (B.A.P. 9th Cir. 1994) (citations omitted).}
confirmation. In other words, there is no “final” plan until two years after confirmation.

As a result, this “proposal seems destined to increase litigation, not diminish it.”\textsuperscript{47} Although the “substantial consummation” inquiry may become less important, all the highly litigated elements of plan formulation, solicitation, and confirmation can be revisited during the two-year period. As Professor Adler has opined:

\begin{quote}
Rare is the case where financial return is exactly what is expected. Equity holders may receive more or less than anticipated. Debt holders may be repaid or not, and even if repaid may earn a rate of interest better or worse than they might have demanded with the benefit of hindsight. Thus, it seems likely that within two years of confirmation someone will be unhappy with the terms of a plan and will have an incentive to go to court to modify. What is a court’s charge? To continually adjust entitlements for two years as information or conditions change? This would be folly.\textsuperscript{48}
\end{quote}

The majority also suggests that the proposal might stop some serial Chapter 11 filings. Even as articulated by the majority, this is not a powerful argument for the proposal. In exchange for a two-year period applicable to all debtors in which the debtor never really leaves Chapter 11, there is a slight possibility that some debtors who would otherwise refile might not if given the chance to modify the plan. This is not a good bargain.

\textsuperscript{47} Memo of Barry Adler to Edith H. Jones, dated July 15, 1997.

\textsuperscript{48} Id.
Furthermore, it might be predicted that most modifications will not be to the creditors' benefit. Although creditors are likely to discount the returns expected under the plan because of the possibility of modification, the courts are not:

With the luxury of a two-year adjustment period, a court might confirm a plan that pays the obligations of creditors seemingly satisfactory obligations. If things go poorly in the first two years, however, the court might simply reduce those obligations on the request of the debtor, thus making the initial satisfaction merely illusory.\textsuperscript{49}

Just the threat of reopening the confirmation process to request a modification can give the debtor (or creditor if it is the plan proponent) substantial leverage.

Finally, the importance of the finality provided by § 1127(b) should be underscored. Consider the results of a recent study of Chapter 11 cases:

To begin with, the chances of a Chapter 11 case being confirmed are slim; only 17 percent even make it to confirmation. Of those that are confirmed, a quarter may be converted or dismissed for failure to comply with the plan. Out of the remaining survivors, 60 percent will ultimately yield consummated plans. And of these, approximately 25 percent will liquidate pursuant to their plans. Thus, the net end result is that out of all Chapter 11 cases filed, only 6.5 percent of these cases will culminate in a

\textsuperscript{49} Id.
consummated plan and a rehabilitated debtor.\textsuperscript{50}

As a result of this proposal, even in those 6.5 percent of cases in which the debtor proposed a reorganization, confirmed a plan, and was able to substantially consummate the plan, the creditors are not out of the woods: the debtor has two years to propose modifications of the plan and, once again, subject all participants to another round of the Chapter 11 process. For the few cases that actually produce a confirmed and consummated plan, the Code should not render the effort meaningless.

VI. Unenforceability of Prebankruptcy Waivers of Bankruptcy Provisions (Commission Rec. 2.4.5)

The Commission’s proposal states that except as elsewhere provided in Title 11, neither contractual provisions nor even prior bankruptcy reorganization orders can waive or restrict “any rights or defenses provided by Title 11.” There is one exception for issues resolved between the debtor and governmental units acting in their police or regulatory power.

A fundamental principle of bankruptcy law is that pre-existing contractual obligations should be preserved to the extent possible. The majority’s proposal to nullify all pre-bankruptcy waivers throws this principle on its head, making evisceration of contracts in bankruptcy the rule, rather than the exception. Sophisticated parties should be able to contract for an alternative to the bankruptcy default rules. Even if some waivers should not be given effect, it is absurd to disregard mutually negotiated (and beneficial) waivers in many circumstances. The public would have been better served by a nuanced proposal to

\textsuperscript{50} Susan Jensen-Conklin, Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law, 97 COM. L.J. 297, 329 (Fall 1992).
limit prebankruptcy waivers only in certain, clearly “bad” situations. The current proposal is breathtakingly vague.

As an initial matter, waivers should be presumed enforceable. The bankruptcy code is a set of default rules for dealing with the problem of financial distress,

[b]ut when the debtor and creditors have anticipated the possibility of a race among creditors, and either have solved it privately, or decided that the race is in their mutual best interest as compared to a costly bankruptcy process, the standard [collective action justification] for bankruptcy vanishes. Can anyone seriously contend that bankruptcy is better than an alternative for debtors and creditors who affirmatively choose the alternative?\(^{51}\)

Even acknowledging some of the problem waivers highlighted in the majority’s proposal, there are numerous examples of waivers that are so clearly unobjectionable as to be beyond dispute. First, consider the asset-securitization industry, which now involves trillions of dollars in assets.\(^{52}\) Companies transfer their receivables and other rights to payment to a bankruptcy-remote entity, which issues debt secured by the receivables. The “bankruptcy remote vehicle” has no business other than holding and servicing the receivables purchased from the underlying company. As part of the transaction, various waivers of bankruptcy rights by the selling company are necessary to ensure that the payment

\(^{51}\) Memo of Barry Adler to Edith Jones, dated July 15, 1997. I am grateful for Professor Adler’s comments on this proposal.

\(^{52}\) Memo from Martin Bienenstock to Elizabeth Warren on behalf of the Association of Financial Guaranty Insurers, dated February 19, 1997.
The securitization of all types of financial assets increases the capital available for consumer loans and has lowered the cost of borrowing for consumers. However, uncertainty as to the consequences for these bankruptcy remote vehicles when the underlying businesses file for bankruptcy disrupts this market. The Commission staff was aware of this, and even received proposals to clarify that property transferred to asset-securitization devices were not part of the underlying businesses’ estates. However, the proposal on pre-bankruptcy waivers not only does not address the concerns about current uncertainty surrounding these vehicles, but instead creates more uncertainty about the status of asset-securitization devices by casting doubt on any attempt to restrict the debtor’s rights to be asserted in bankruptcy.

A second example involves waivers made as part of workout agreements that do not specifically refer to bankruptcy but could affect a debtor’s “rights” once bankruptcy is filed. Some of the many types of provisions include extensions of loan maturity, the granting of new collateral, “springback” terms, arbitration clauses, and consent judgments. The proposal is unabashedly vague about what “similar provisions” it voids besides waiver of the automatic stay. In fact, it appears to directly threaten workouts by saying, “A bankruptcy court is free to consider the circumstances concerning a prior workout attempt . . . .”

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53 Memo from Martin Bienenstock, supra, note 5. For example, when the Tenth Circuit concluded that a seller of accounts receivable retained a property interest in the accounts, thus subjecting the accounts to the automatic stay, the resulting legal uncertainty prevented effective assessment of asset-securitization devices by credit rating agencies. See id. (citing Steven L. Schwarcz, “Octagon Gas’ Ruling Creates Turmoil for Commercial and Asset-Based Finance,” NEW YORK LAW JOURNAL, August 4, 1993).
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Insincerely, the proposal denies that it might “alter the preclusive effect of judgments generally;” nothing in the proposal’s language, besides its limited protection of governmental entities, so provides.

Perhaps the most common type of waiver is a waiver of the protections of the automatic stay. The debtor typically receives consideration in return for this concession, such as better financing terms or a specific benefit as part of a workout.\textsuperscript{54} In the reported cases, these agreements are negotiated where the debtor has a single asset or a non-operating pool of assets.\textsuperscript{55} Given the cost of bankruptcy and the low probability that there is any going concern value to preserve, these cases are sensible candidates for pre-bankruptcy waivers. Nonetheless, the proposal makes no provision for these circumstances, instead adopting a blanket rule disallowing all pre-bankruptcy waivers. This makes no sense, and the proposal makes no attempt to justify this rule in a single-asset or non-operating asset context. The debtor is once again given the hold-up power over the bankruptcy process despite the negotiated, mutually beneficial agreement otherwise.

\textsuperscript{54} See, e.g., In re Cheeks, 167 B.R. 817, 819 (Bankr. D.S.C. 1994): Perhaps the most compelling reason for enforcement of the forbearance agreement is to further the public policy in favor of encouraging out of court restructuring and settlements. ... In the instant case the Debtor received relief under the forbearance agreement approximating that which would have been available in a bankruptcy proceeding. The pending foreclosure sale was canceled, the foreclosure action was dismissed, and the Debtor gained an opportunity to start a new payment schedule which would prevent further action as long as she made the payments she agreed to make. To allow her now to receive the full benefits resulting from reimposition of the automatic stay as to [the mortgage] would be inconsistent with this Court’s oft-stated skepticism regarding serial bankruptcy filings.

\textsuperscript{55} See Robert K. Rasmussen and David A. Skeel, Jr., The Economic Analysis of Corporate Bankruptcy Law, 3 AM. BANKR. INST. L. REV. 85, 98 (1995).
The majority seems overly obsessed with preserving going concern value, regardless whether it exists in a given case. Rather than approach the problem of waivers that seriously threaten viable reorganizations directly, it eliminates all pre-bankruptcy waivers no matter how mutually beneficial. Several alternative approaches for dealing with undisclosed waivers have been suggested in the literature, but are not addressed by the majority.56

Although giving a favorable nod in its written discussion to the competing policy of encouraging out-of-bankruptcy settlements and workouts, the proposal completely ignores that policy. Voluntary resolution of a firm’s financial distress outside of bankruptcy often is cheaper and more efficient than proceeding through a lengthy Chapter 11 reorganization proceeding. Unfortunately, this proposal undercuts incentives for out-of-court workouts, because the parties have no assurance that virtually any agreement reached outside of bankruptcy will be respected in bankruptcy.57

56 See, e.g., Barry E. Adler, Financial & Political Theories of American Corporate Bankruptcy, 45 STAN. L. REV. 311 (1993); Alan Schwartz, Contracting about Bankruptcy, 13 J.L. ECON. & ÔRG. 127 (1997); Rasmussen and Skeel, supra, note 6 (discussing filing system as means to inform other creditors of waiver agreements); Marshall E. Tracht, Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law, 82 CORNELL L. REV. 301, 349-55 (1997) (proposing that waivers should be presumed effective, but subject to challenge on narrow grounds, e.g., that the secured creditor is reallocating value away from unsecured creditors, that the lender has taken advantage of an unsophisticated borrower, that there has been substantial change in circumstances since the waiver was executed, or that “extraordinary public interests” justify abrogating the waiver); Rafael Efrat, The Case For Limited Enforceability of a Pre-Petition Waiver of the Automatic Stay, 32 SAN DIEGO L. REV. 1133, 1155-65 (1995) (proposing that after creditor shows that waiver is “fair, freely entered into, and supported by consideration” and that the debtor has no equity in the property, then court would hold that the property is not necessary for an effective reorganization as a matter of law); Steven L. Schwarcz, Freedom to Contract About Bankruptcy, working draft submitted to Commission (Aug. 7, 1997).

57 See letter from Honorable Paul Mannes, Bankruptcy Judge for the District of Maryland, on file with the Commission (“[T]here are numerous times where the
that a creditor must still litigate the enforceability of the waiver in the bankruptcy proceeding does not provide justification for eliminating any possibility of enforcement whatsoever. Indeed, perhaps that is an argument for clarifying circumstances in which waivers are enforceable.58

This proposal seems to serve no one well except bankruptcy attorneys. No matter why or under what circumstances a waiver was negotiated, all bets are off in bankruptcy. The going concern value the majority is so anxious to preserve will be siphoned away by the increased delay in Chapter 11 and more protracted hearings on lifting the stay. This gives the bankruptcy attorneys new work and the debtor new power, but that power in bankruptcy will be offset by tougher credit terms for all businesses.

VII. OTHER ISSUES

A. Section 365, Interim Protection and Obligations of Nondebtor Parties (Commission Rec. 2.4.3)

B. Clarifying the Conditions for Sales Free and Clear of Liens and Interests (Commission Rec. 2.4.11)

C. Consensual Releases of Nondebtor Parties Through Bankruptcy (Commission Rec. 2.4.12)

The rapid approach of the artificial deadline for submission of this dissent prevents extended discussion of these proposals. A few words are in order, nevertheless, to explain why each of them needlessly

58 See Tracht, supra, note 7, at 349-50.
increases costs and uncertainty, and why two of the proposals may expand bankruptcy jurisdiction beyond its constitutional limit.

The Commission recommendation 2.4.3 purports to clarify existing law by providing that the non-debtor party to an “executory contract” governed by section 365 is entitled to receive compensation until the debtor elects to assume or breach the contract. It is important to clarify the current mish-mash of law. The obvious clarification, however, would have been to apply the contract price to interim performance. The National Bankruptcy Conference so recommended in its Report, Reforming the Bankruptcy Code, at 214. The Commission’s language is troublesome because, first, it requires a creditor to go to court to enforce its rights under this proposal, totally contrary to the self-executing rights that would be desirable. Second, its measure of damages, in which the contract price is “only one factor to be considered,” is so vague as to be no improvement on existing law.59

The proposal that would clarify conditions for sales free and clear of liens and interests, amending sections 363(f), is founded on an assumption that bankruptcy sales always yield superior value to liquidation sales. See Commission Rec. 2.4.11. With due respect, this is an assumption that lacks proof in the Commission Record. Even more problematic, I question whether bankruptcy courts should be allowed to sell property in which the debtor’s equity has been reduced to zero by the existence of unsatisfied liens. The remote possibility that reduction of the secured creditors’ deficiency claims will affect distributions from the

59 Section 365(d)(3) requires timely performance of all obligations arising under a non-residential real property lease until a decision is made by the debtor on assumption or rejection. The protection for landlords would appear to be plain in this provision, but according to one bankruptcy expert, even this level of clarity does not prevent litigation and manipulation. See Letter of September 22, 1997 from Preston T. Towber, Hirsch & Westheimer, to Edith H. Jones. The Commission’s Proposal obviously does not remedy this type of problem; it doesn’t even recognize it.
estate is not sufficient to create a reasonable nexus between the sale and the bankruptcy case.

Finally, I have a similar objection to the recommendation that would allow a plan proponent to solicit consensual releases of non-debtor parties through bankruptcy. Commission Rec. 2.4.12. Section 524(e) seems quite explicit in currently prohibiting this result, regardless what some aberrant courts may have held. Section 524(e) makes obvious sense: bankruptcy should have nothing to do with liabilities of non-bankruptcy parties to their creditors. Authorizing the courts to permit such solicitations will undoubtedly complicate the plan process and give debtors yet another holdup incentive.
Dissent From

Procedural Recommendations to the Bankruptcy Code:

Police and Regulatory Exception Under

11 U.S.C. § 362(b)(4) & (b)(5)

by James I. Shepard

Commissioners John A. Gose and Edith H. Jones concur in this dissent; they do not, however, subscribe to all of the views and statements contained herein.

Introduction.⁶⁰ There are a number of serious problems with the section of the report entitled, Procedural Recommendations to the Bankruptcy Code: Police and Regulatory Exception Under 11 U.S.C. § 362(b)(4) & (b)(5). This section addresses the concerns raised by the government with respect to sections 362 and 105. In many respects it goes beyond those matters that were discussed by the Commission, much less those which the Commission formally adopted in the form of a proposal. Indeed, in some respects, its tone appears to be contrary to positions taken in earlier Commission documents, including the Government Working Group A, Working Group Proposal # 7: Section 362(b)(4) draft of November 8, 1996.

This dissent notes certain specific concerns about the report that should be corrected. To provide fairness and balance to the report the entirety of the January

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⁶⁰ The subject of this section of the report and this dissent, the exercise of the police and regulatory power by governmental agencies, illustrates that bankruptcy has grown too important to entrust to those who work within the bankruptcy system—the drafting of bankruptcy laws should not be left to those who have a vested interest in the implementation of those laws. Unfortunately, the Commission has been studying the fish from inside the fish bowl when it should have been studying the fish from the broader perspective outside the tank.
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Throughout the report a certain document is identified as the “DOJ/NAAG proposal.” This label was attached to that document by the author of this dissent to distinguish it from a proposal prepared by the Commission staff. In fact, this proposal was prepared at the request of the author by several individuals including representatives of the U.S. Department of Justice and the National Association of Attorneys General (N.A.A.G.). The purpose of the proposal was to clarify the needs of the governments and to fairly state the interests of the respective parties. The proposal was not officially approved by any governmental agency or the National Association of Attorneys General. Thus, the January 1997 proposal should properly be entitled something other than the “DOJ/NAAG proposal.” Ms. Cordry, Bankruptcy Counsel at N.A.A.G. notes that it was not an official position taken by the National Association of Attorneys General or any federal, state or local governmental agency, but was merely an effort undertaken at the author’s request to assist in further developing these concepts in line with various discussions that had taken place to that point. While the concepts in the proposal have been generally endorsed by Attorneys General in various sign-on letters to the Commission and Congress, this particular document was never submitted to them, nor were they asked to review or endorse it. As such, it would be inappropriate to attribute it directly to that group, when it was submitted under the author’s auspices. A copy of that proposal is attached to this dissent. Thus that proposal is identified in this dissent as the “January 1997 proposal.”

Initially, the relative perspectives of the various parties and the function of the bankruptcy system within American jurisprudence must be considered. In viewing the bankruptcy system in its proper perspective, one must ask, Has bankruptcy law elevated the private interests of the debtor and the creditors over the public interests? The Constitution states that Congress shall have the power to “establish . . . uniform Laws on the subject of Bankruptcies throughout the United States.” Bankruptcy law is established in federal law to achieve uniformity as a part of the regulation of commerce and to prevent fraud where debtors may have property located in other states. The bankruptcy process is but one function of government, a substructure within the panoply of governments, both state and federal, which must provide for all citizens. Governments’ role, state, federal and local, in the bankruptcy system is unique because they function not only, or even most importantly, as a creditor; they must serve their primary roles of regulators and service providers. Private creditors have no corollary roles in performing such governmental functions as adopting and administering policies related to the exercise of police power, tax power, federally mandated programs, public finance obligations, or regulatory powers. The government that establishes and administers the

61 Throughout the report a certain document is identified as the “DOJ/NAAG proposal.” This label was attached to that document by the author of this dissent to distinguish it from a proposal prepared by the Commission staff. In fact, this proposal was prepared at the request of the author by several individuals including representatives of the U.S. Department of Justice and the National Association of Attorneys General (N.A.A.G.). The purpose of the proposal was to clarify the needs of the governments and to fairly state the interests of the respective parties. The proposal was not officially approved by any governmental agency or the National Association of Attorneys General. Thus, the January 1997 proposal should properly be entitled something other than the “DOJ/NAAG proposal.” Ms. Cordry, Bankruptcy Counsel at N.A.A.G. notes that it was not an official position taken by the National Association of Attorneys General or any federal, state or local governmental agency, but was merely an effort undertaken at the author’s request to assist in further developing these concepts in line with various discussions that had taken place to that point. While the concepts in the proposal have been generally endorsed by Attorneys General in various sign-on letters to the Commission and Congress, this particular document was never submitted to them, nor were they asked to review or endorse it. As such, it would be inappropriate to attribute it directly to that group, when it was submitted under the author’s auspices. A copy of that proposal is attached to this dissent. Thus that proposal is identified in this dissent as the “January 1997 proposal.”

62 U.S. CONST. art. I, § 8, cl. 3.


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bankruptcy system is also obligated to provide for the public safety and welfare of all citizens. The bankruptcy system, a system that serves the needs of only a limited spectrum of society, should not be allowed to impede or unduly burden that larger governmental function.

The commencement of a bankruptcy case imposes the most powerful injunction provided by law without the opportunity for a prior hearing, the stay of proceedings under section 362 of the Bankruptcy Code. All that is necessary is to sign and file a form and to pay a fee. This stay of proceedings is available to all debtors regardless of the merits of their case and initially enjoins, among other things, nearly all actions pursuant to state, federal or local law which may affect the debtor or the estate, including the collection of taxes, many aspects of the regulation of business, and the licensing and enforcement activities of most regulatory agencies. Together with the court’s equitable jurisdiction under section 105(a) of the Bankruptcy Code debtors have a formidable array of tools with which to achieve results and obtain benefits not available through any other means. Thus, the extent to which governmental regulatory actions are exempted from this initial stay of proceedings is crucial.

A provision within the Chemical Weapons Convention Implementation Act would clarify the exceptions to the section 362 automatic stay of proceedings to remove any doubt whether or not the police or regulatory power can be exercised against property of the estate. Under the Bankruptcy Code, as it presently stands, a governmental agency charged with protecting the public in the case of manufacturing, trafficking or holding certain hazardous or illegal goods, such as diseased livestock, counterfeit goods, and other hazardous materials held by the debtor, runs the risk of sanctions for violating the section 362 stay of proceedings if it carries out its duties under law and seizes the offensive material without prior permission from the bankruptcy court.

Those who oppose the amendment in the Chemical Weapons Bill which excepts police and regulatory action from portions of the section 362 stay of proceedings contend that a bankruptcy judge must be the arbiter of which laws

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64 Chemical Weapons Implementation Act of 1997, S. 610 (May 23, 1997); hereinafter the Chemical Weapons Bill or the CWB.

65 One Assistant Attorney General told the author of this dissent that an employee of a state regulatory agency was threatened with sanctions for violation of the stay of proceedings if they removed the patients from a nursing home where the electrical wiring was arcing in the walls, creating a substantial fire hazard.
enacted by Congress will be enforced. The report appears to advocate their view that the government should be precluded from acting against property of the estate, no matter what the exigency of the circumstances, unless it first obtains bankruptcy court approval, even where a state court has already determined that the government’s actions are necessary. They argue that a law, enacted by Congress for the public protection and with full knowledge that it may prove financially burdensome to some to comply therewith, nevertheless can be enjoined upon the unilateral decision of a bankruptcy judge. Moreover, the court’s rulings need not be made on the basis of the law’s constitutionality but, rather, can be based simply on the exercise of a “seat of the pants” sense of equity, for the private benefit of the debtor and its creditors, thereby jeopardizing the interests of the public for whose benefit the law was passed. This position is totally untenable. The power to determine whether or not a law should be enforced should not be transferred from our elected representatives to appointed federal judges, merely to assist in the reorganization of a particular debtor. Nonbankruptcy law provides for injunction of government actions only in the most exceptional cases; that authority should not be expanded merely because of the debtor’s asserted financial distress.

Does Congress really want to give bankruptcy lawyers and judges the power to determine whether or not a Congressional enactment shall be followed, based on purely commercial considerations? How many members of Congress, who worked hard to obtain passage of an important piece of legislation at the behest of their constituents, are willing to give up to the bankruptcy judges the power to decide whether or not that law will be enforced? Are those who are protected by the laws which require seizure and destruction of counterfeit products, for instance, willing to entrust the determination of whether or not those laws will be enforced to bankruptcy lawyers and judges? Any bankruptcy law, rule or power which subverts, negates, supplants, subjudgetes, or subordinates nonbankruptcy laws intended to protect the people frustrates government of the people and cannot be tolerated. Bankruptcy judges cannot become demigods and the Bankruptcy Code cannot be the source of omnipotent power.

The Report. Specific Defects.

First, there are concerns about the entire structure of this section of the report. It is unfocused, by design apparently, having initially been prepared to serve as a discussion paper for a meeting of the Commission held in Detroit, Michigan, on June 20, 1997. As such, it serves no particular role in the Commission’s report. If it is merely meant to be a historical recitation of what the Commission discussed, it is far longer than necessary. If it is meant to reflect the full range of the issues and the Commission’s position thereon, it is neither fully accurate nor complete. For
instance, it does not make clear that the Commission appeared to be supportive of
at least a limited expansion of the stay exceptions until the Chemical Weapons Bill
was introduced. Moreover, the report suggests that the Commission decided against
those pending proposals when, in fact, the issues were essentially treated as moot
once the Chemical Weapons Bill passed the Senate. In short, the report seems to be
merely an effort to rewrite history and the Commission’s discussions.

Second, the draft does not fairly present the January 1997 proposal. It
paraphrases the proposed amendment to section 362 contained in that proposal,
without ever actually quoting it. By doing so, the report fails to disclose the fact that
the January 1997 proposal, like the Chemical Weapons Bill, explicitly carves out
enforcement of money judgments from the expanded stay exceptions that are being
proposed. The result is that the January 1997 proposal is presented as if it proposed
a far more drastic revision to the Code than was actually being discussed. That
mischaracterization is underscored by the use of a quotation found in footnote 98,
that the “proposal would allow government agencies to pursue actions ‘to collect,
assess, or recover a claim against the debtor that arose before the commencement of
the case . . . .’” while omitting the language in the proposal which specifically
restricts the exercise of the police or regulatory power to the enforcement of a
judgment “other than a money judgment.” This mischaracterization furthers the
misleading impression that the government is seeking to be able to collect money
judgments. The January 1997 proposal clearly and explicitly disavows any such
intention.

Third, the report uncritically quotes, at footnote 98, the opposition of the
Commercial Law League of America and Bernard Shapiro. However, the concerns
they express, if truly valid, about which there are serious doubts, would militate in
favor of removing the exception to the stay for governmental actions altogether. It
certainly makes no sense to suggest that the government should be required to go
through the process of initiating and conducting the entire investigative and litigation
process, without challenge by the debtor as to its bona fides, and only then, at the
very last moment, have the bankruptcy court reconsider everything that has gone
before. The Code already presumes that the government knows what the limits are
of police and regulatory actions and will not deliberately violate them. If the debtor
wishes to challenge that assumption in a particular case, it certainly should be
expected to raise that issue as soon as the government begins its action, rather than
to wait until final action is imminent and then claim that all that went before was
voided by the stay.

Nor, in the great majority of the cases, is there any validity to Mr. Shapiro’s
suggestion that the government can simply do anything it wants with respect to the
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debtor’s property without any prior judicial review. Just because the automatic stay doesn’t apply to an action, doesn’t mean that the other statutory or constitutional requirements applicable outside of bankruptcy law have somehow become obsolete. The bankruptcy court is surely not the only entity capable of carrying out judicial review of the government’s proposed actions.

**Fourth,** lifting a stay is not always an expeditious matter, contrary to the suggestion on page 32 and footnote 100.\(^{66}\) Thus, the report expresses the bias of those who advocate the expansion of the power of the bankruptcy courts by requiring government regulators to first seek the permission of the bankruptcy court before being permitted to protect the public, as required by nonbankruptcy law. Moreover, if the bankruptcy court refuses to lift the stay, appealing that decision can be an excruciatingly long process.\(^{67}\)

**Fifth,** the opening sentence in the second full paragraph on page 33, is inaccurate where it states that, “The circuit courts, as well as other lower courts, that have addressed this issue [of the application of § 362(a)(3)] have not adopted the literal construction.” While one would hope that all courts would agree that section 362(a)(3) should not be applied to police and regulatory actions, the reality is that the court are distinctly *split* on the issue. The report eventually goes on to recognize that split, but inappropriately downplays it at the beginning of this discussion. Moreover, even where the courts do adopt this position, they recognize that they must do so *despite* the literal language of section 362(a). It is grossly unfair for the government to be left in such a precarious position. Nor should the report minimize the need for change by underplaying the existing problem. If the Commission agrees that this is the desired reading of the Code, then it should support the government’s proposed amendments; not pretend that there is no need for them. Indeed, even if the cases were unanimous, why should there be a problem with changing the language to more clearly reflect that consensus?

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\(^{66}\) The use of quotations from a publication authored by Karen Cordry, NAAG Bankruptcy Counsel, at footnote 100 and 125 is inappropriate. Both quotes are taken out of context in a misplaced effort to suggest that there is support for the report’s position, a support which the drafters surely know does not exist. Read in context, the first quote merely suggested what *should* happen when a motion to lift the stay is filed, not what actually happens in such cases. The second quote was part of a discussion of the practical realities of dealing with judges who take an expansive view of their powers. It did not purport to state what she thinks the law is or should be.

\(^{67}\) See, *e.g.*, McCrory Corp. v. State of Ohio, 1997 WL 148071 (S.D. N.Y. 1997) (stay imposed in 1994 to bar states from assessing responsible officers; district court ruled that the bankruptcy court had erred and lifted stay in March 1997—well over two years later).
Sixth, there are several problems with the cases that are cited for various propositions on page 39. For instance, the cases cited in the second paragraph of footnote 129, do not support the proposition for which they are cited. Neither In re Thomas nor In re Bridge discussed whether or not forfeiture is a police or regulatory matter and both noted that section 362(b)(4) does not apply to the kind of postpetition actions that were involved there, in any event. Also on page 39, it is not at all clear why Thomas is quoted at all. The only point seems to be to say that civil forfeiture is a bad thing and that bankruptcy should be a way to avoid it—which would seem to be a comment beyond the Commission’s jurisdiction. As to Ryan, its summary rejection of the notion that forfeiture serves a police and regulatory purpose is not entitled to much weight. Congress and state legislatures have repeatedly decided that forfeiture is an important weapon in the war on drugs. It is not up to a bankruptcy judge to unilaterally reject that conclusion. Finally, Bridge simply does not support the proposition it is cited for in footnote 131.

Seventh, it is difficult to discern what the purpose is of the section purportedly dealing with the Chemical Weapons Bill, itself. If the point of this section of the report is to assist Congress with respect to its consideration of the bill, then the draft’s perfunctory discussion and its failure to relate the language in the bill to what occurred during the Commission process precludes that possibility. It would appear that the report is intended to suggest that the Commission opposes the CWB, but such a position has never been discussed or voted on by the Commission, which leaves the report without a punch line. The result is a discussion that starts and ends nowhere.

Eighth, the report then shifts to a discussion of section 105. This part of this section of the report is probably the most objectionable. It turns the thrust of the discussions and the Working Group’s position on its head; the position of the Working Group was clearly expressed in a draft proposal prepared at the direction of the Commissioners serving as a Working Group. Issues regarding sections


71 Government Working Group Proposal # 5: Section 105, October 8, 1996 draft. A more modest proposal was prepared and submitted by Carlos J. Cuevas, a copy of which is attached, which proposed amending 11 U.S.C. § 105 to clarify that the standards enunciated by the Supreme Court in Younger v. Harris, 401 U.S. 37 (1971),would apply when police or regulatory action is enjoined.
The Government Working Subgroup briefly discussed the Cuevas proposal but concluded that there was insufficient time remaining for the Commission to give full consideration to the issues addressed therein and no action was taken.

72 For purposes of public hearings on the discussion of governmental issues the Commission was divided into two groups at its meetings in Santa Fe, New Mexico, and San Diego, California. There were only six Commissioners present in Santa Fe, thus the tax issues were heard by Commissioners Alix, Shepard and Williamson; the panel was moderated by Stephen H. Case, Senior Advisor. The General Government Issues were heard by Commissioners Ceccotti, Ginsberg and Hartley and the Reporter. Because the General Government Issues panel, moderated by Prof. Elizabeth Warren, failed to recommend any form of action with regard to issues considered extremely important to the participants several of the issues were revisited by another panel of Commissioners at its meeting in San Diego on October 19, 1996, in spite of the characterization by Prof. Warren of several of the issues discussed in Santa Fe as having been “resolved.” See Issues List, on file with the Commission, prepared and distributed to the Commissioners in advance of the San Diego meeting. Thereafter, jurisdiction of the issues related to 11 U.S.C. § 362(b)(4) for purposes of drafting the various versions of the proposals and moderating the continuing discussions remained with Prof. Warren.


attached hereto. That draft which emerged from the Santa Fe meeting has never been changed or retreated from by the Working Group.

The government representatives were concerned, however, that the provisions in Working Group Proposal # 5 and its companion proposal # 7, which dealt with the automatic stay, were not yet adequate to address their concerns. Accordingly, at the government’s request, all of these issues were opened for further discussion at the San Diego meeting. The Commissioners participating in the general government panel discussion at that session included Ginsberg, Ceccotti, Williamson, and Judge Edith Jones. Neither at the San Diego meeting nor thereafter has any Commissioner objected to the position taken in Proposal # 5, although it has never been formally ratified by the Commission as a whole. Rather, at that meeting, and continuing thereafter, the government continued to urge the Commission to adopt its proposed changes to section 105, rather than rest with the endorsement of the government’s construction of the existing language that is contained in Proposal #5. No formal action was ever taken thereon by the Commission.

Thus, as of the last meeting in August, it appeared that the Commission’s position was that expressed in Working Group Proposal # 5. The report, however, takes a position drastically at odds with the Working Group Proposal, and the discussions and positions previously taken by a number of Commissioners, even though the new position was never even raised with the Commission, much less put to a vote. I most strenuously dissent from this usurpation of the Commission’s authority. 76

76 These changes were presumably made at the direction of the Reporter, Professor Warren without consultation with or direction by the Commission. This action is further rendered suspect by other concerns raised to the Commission about Professor Warren’s actions with respect to proposal dealing with the treatment of the bankruptcy stay. During the time that the Commission was considering the governments’ problems with 11 U.S.C. §§ 362(b)(4) and 105(a), the Commission was informed that she may have been instrumental in causing the National Bankruptcy Conference to reverse its published position with respect to the recommendation to repeal 11 U.S.C. § 362(a)(3).

To my surprise, the current version of the Report of the NBC Committee on Stays and the Secured Creditor does not include [the recommendation to repeal 11 U.S.C. § 362(a)(3)], although it was part of the Report of that Committee published in 1994. . . . I have learned that the recommendation was eliminated from the Report at the October 1996 meeting of the NBC . . . based on the request of Prof. Elizabeth Warren and Robert A. Greenfield of Stutman, Treister & Glatt.
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It is impossible to tell from the current draft that the discussion about section 105 arose from the government’s concerns and its desire to clarify section 105 to keep it from being used inappropriately. As can be seen from brief review of Proposal #5, the Working Group agreed that the government’s position on the scope of the section was correct, but concluded that the problem was not so severe that it warranted changing the Code’s language. Instead, it referred to “aberrational cases” which Judge Ginsberg contended were issued by “rogue judges.” In response to that position, the government supplied the Commission with additional evidence at the San Diego meeting, describing the extent of the problem, and later provided further voluminous submissions to the same effect. As the government well documented, its enforcement efforts are severely hampered by the delays and additional costs caused by litigation under this section even if the government eventually wins. The problem is exacerbated if the government loses on hearing before the bankruptcy court and must wait until it convinces a higher court to overturn the stay.77

Letter of April 24, 1997 from Sally S. Neely, Esq. to Commissioners Gose, Hartley and Shepard, on file with the Commission; a copy of the memorandum circulated to the Conferees in that regard was enclosed with Ms. Neely’s letter, also on file with the Commission. Copies of these documents were provided to the other members of the Commission by the author of this dissent. The National Bankruptcy Conference statement of positions that was eventually filed with the Commission did oppose the action recommended in Working Group Proposals #5 and 7, despite the original position of the Committee, taken in 1994. See Statement of the National Bankruptcy Conference, prepared for the Commission’s meeting of January 22–23, 1997, on file with the Commission. No action was taken with regard to these concerns.

77 As the government’s cases show, about half the cases initially are decided against the government. Of those, virtually all are reversed on appeal when the government has the time and the resources to take up an appeal, and where the passage of time has not made the matter moot. The cases in which a governmental agency has been forced to defend against a debtor’s attempt to bar governmental police or regulatory action are unending. See, e.g., Board of Governors v. MCorp Financial, 502 U.S. 32 (1991) (sustaining reversal of injunction issued by the district court sitting in bankruptcy against Federal Reserve Board’s administrative proceeding to require the debtor to recapitalize its subsidiary banks); In re Ludlow Hospital Society, Civ. Act No. 96-30064 (Bankr. D. Mass. Oct.15, 1996) (reversing bankruptcy court’s injunction against enforcement of Medicare’s time limits for filing a loss of sale claim; district court held that bankruptcy court lacked power under § 105 to except the debtor from federal regulatory requirements); Matter of Brennan, 198 B.R. 445 (D. N.J. 1996) (reversing bankruptcy court injunction that temporarily barred the pursuit of a civil fraud action by the state against the debtor, who had filed bankruptcy after being convicted on federal fraud charges and ordered to pay $75 million dollars, during the time a court-appointed examiner was looking into the debtor’s affairs); In re USAfrica Airways Holdings, Inc., 192 B.R. 641 (Bankr. D. Del. 1996) (reversing bankruptcy court’s injunction staying DOT from reallocating debtor’s air service authority; the court reasoned that DOT’s reallocation was “critical public business” and excepted from the automatic stay); In re 1820-1828 Amsterdam Equities, Inc., 191 B.R. 18 (S.D. N.Y. 1996); (reversing decision of bankruptcy court that temporarily stayed civil and criminal
actions against landlord because bank was proceeding with repairs); In re Capital West Investors, 186 B.R. 497 (N.D. Cal. 1995) (reversing decision of bankruptcy court that confirmed plan that removed standard provisions from HUD loan agreement that the bankruptcy court thought were unnecessary in the particular case); In re Hansen, 164 B.R. 482 (D. N.J. 1994); (reversing bankruptcy court’s injunction which forced municipalities to renew debtor’s motel license; injunction had been sought to protect the debtor’s race discrimination suit against the municipalities; district court reasoned that the bankruptcy court lacked jurisdiction over the civil rights suit and lacked authority to enjoin the municipalities’ regulatory authority); In re Baker & Drake. Inc., 35 F.3d 1348 (9th Cir. 1994); (reversing decision of lower courts that barred enforcement of law requiring taxi drivers to be employees rather than independent contractors); In re Hucke, 992 F.2d 950 (9th Cir.) (reversing decisions of lower courts that had barred revocation of a convicted sex offender who had been allowed to pay restitution in lieu of jail sentence but who had then failed to comply with that obligation), cert. denied, 114 S. Ct. 178 (1993); In re Olympia Holding Corp., 161 B.R. 524 (M.D. Fla. 1993); (reversing bankruptcy court decision that had barred ICC from “any proceeding that would require the debtor to proceed before the ICC”; while the district court agreed that intervening case law had made the initial action the ICC sought to pursue totally unauthorized, it held that the bankruptcy court’s injunction was overbroad and would have prohibited matters that the ICC could legally pursue); In re Horizon Air. Inc., 156 B.R. 369 (N.D. N.Y. 1993); (upholding TRO issued by bankruptcy court against FAA’s revocation of debtor’s operating certificate and withdrawing reference to hear preliminary injunction; although the district court denied subsequently a preliminary injunction, the FAA was unable to enforce its emergency revocation order for three weeks); Wilner Wood Products Co. v. Maine, 128 B.R. 1 (D. Me. 1991); (reversing bankruptcy court decision that had barred state’s effort to enforce denial of emissions license while appeal from denial was pending); In re Heldor Industries. Inc., 131 B.R. 578 (Bankr. D. N.J. 1991) (held that 11 U.S.C. § 363 sale of property could take place without compliance with state environmental law that imposed requirements on such sales; decision was entered even though prior to that date the state and the parties had reached agreement on how compliance should take place and the state withdrew its objections to the sale), vacated as moot, New Jersev DEP v. Heldor Industries. Inc., 989 F.2d 702 (1993)); United States v. Wheeling-Pittsburgh Steel Corp., 818 F.2d 1077 (3rd Cir. 1988) (reversing district court’s decision that bankruptcy filing justified modification of consent decree to remove timetable for completing cleanup action); In re Compton Corp., 90 B.R. 798 (N.D. Tex. 1988); (reversing bankruptcy court decision that had barred government tribunal from liquidating the amount of overcharges by oil company); In re Professional Sales Corp., 56 B.R. 753 (N.D. 111.1985) (reversing bankruptcy court decision that barred EPA from revoking interim status permit for hazardous waste site); In re Braniff Airways. Inc., 700 F.2d 935 (5th Cir. 1983) (reversing bankruptcy court’s use of 11 U.S.C. § 105 to require FAA to reassign landing slots to debtor); In re Vel Rey Properties. Inc., 174 B.R. 859 (Bankr. D. D.C. 1994) (court refused to enjoin operation of city laws and regulations so as to allow trustee to operate property without complying therewith); In re Florida Bay Banks. Inc., 156 B.R. 673 (Bankr. N.D. Fla. 1993) (court sanctioned debtor for its frivolous attempt to use § 105 to bar state enforcement action); Matter of Catalano, 155 B.R. 224 (Bankr. D. Neb. 1993) (court refused emergency motion seeking to bar condemnation of unsafe housing); In re Grace Coal Co. Inc., 155 B.R. 5 (Bankr. E.D. Ky. 1993) (denying motion to bar state from prohibiting mining by debtor during pendency of license renewal process); In re Newport Assembly Restaurant. Inc., 142 B.R. 22 (Bankr. D. R.I. 1992) (court would not bar state from suspending liquor license for nonpecuniary violations); In re Carib-Inn of San Juan Corp., 905 F.2d
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Justice delayed by an inappropriate injunction is still justice denied, even if the injunction is eventually lifted—all to the potential harm of those who are not parties to the case, the citizens of the country who are not in bankruptcy but are affected by the debtor’s actions.

The report not only ignores this evidence, but, at page 42, states to the contrary, that section 105 is “applied sparingly” and that “courts generally do not apply such power freely.” Those statements are not based on any empirical data and completely fail to come to grips with the government’s detailed evidence. Some thirty-five published decisions on the topic, and undoubtedly many more unpublished orders, does not suggest a minor problem. Two recent unreported decisions are representative. In In re Luskin’s, Inc., the District Court was forced to reverse a bankruptcy court which had barred the appeal of a liability determination in a consumer protection case merely because it involved monetary restitution issues.

561(1st Cir. 1990) (affirming district court’s refusal to enjoin NLRB litigation of amounts owing to employees for back pay); In re Security Gas & Oil. Inc., 70 B.R. 786 (Bankr. N.D. Cal. 1987) (denying motion to bar cleanup order during reorganization—but stating that 28 U.S.C. § 959 does not apply to liquidations and implying that order would be barred in such a case); Matter of Commonwealth Oil Refining Co., Inc., 805 F.2d 1175 (5th Cir. 1986) (affirming lower courts’ denial of motion to bar EPA from requiring debtor to comply with provisions regulating hazardous waste facility); Matter of 1600 Pasadena Offices, Ltd., 64 B.R. 192 (Bankr. M.D. Fla. 1986) (denying motion to enjoin city’s revocation of building permit); In re Wengert Transportation, 59 B.R. 231 (Bankr. N.D. Ind. 1986) (denying motion to bar state from conducting financial responsibility determination); Matter of Nicholas, Inc., 55 B.R. 212 (Bankr. D. N.J. 1985) (denying motion to bar NLRB from investigating and hearing unfair labor practice charges); In re Beker Industrial Corp., 57 B.R. 611 and 57 B.R. 632 (Bankr. S.D. N.Y. 1986) (denying an injunction and a stay of its order that allowed the Florida Land and Water Adjudicatory Commission to continue its administrative actions); Matter of Williston Oil Corp., 54 B.R. 10 (Bankr. D. N.J. 1984) (denying motion to bar state from requiring debtor to either properly close, abandon or operate oil wells); In re Farmers & Ranchers Livestock Auction, Inc., 46 B.R. 781 (Bankr. E.D. Ark. 1984) (denying motion to bar governmental investigation and license revocation proceeding); In re Thomassen, 15 B.R. 907 (BAP 9th Cir. 1981) (upholding bankruptcy court’s refusal to enjoin medical license revocation proceeding); In re Prindle Leasing Co., Inc. et al., No.96-30327, Adv. Pro. 96-3131 (Bankr. D. Ct.) (debtor unsuccessfully sought to enjoin state prosecutor from proceeding against corporate officer on a bad check charge).

78 Citations to these cases, see fn.18, above, and others have been provided to the Commission and its staff. The failure of the report to refer to those cases indicates that those who caused this section of the report to be drafted failed to seek a balanced view.

In *Matter of Long Distance Services, Inc.*, a bankruptcy court issued an *ex parte* temporary restraining order to prevent the state from continuing litigation of restitution and penalty issues in a consumer protection case, merely because the debtor claimed that the state was seeking a really *big* penalty. Nothing in either sections 362 or 105 that suggests that the exceptions depend on whether the debtor’s misdeed warrants only a small penalty, or whether it has engaged in truly colossal misconduct. It would be truly disturbing to suggest that the more egregious the debtor’s actions, the more it would be protected by the Code!

There are other problems with the report and the cases cited. For instance, the nearly identical cases cited in footnotes 143 and 144 deal with injunctions to protect the bankruptcy court’s jurisdiction in a particular proceeding—they do not stand for the proposition an action by the state which does not interfere with the jurisdictional scheme of the Code, but which is merely burdensome to the debtor, may be barred. As such, they do not support the more generalized proposition for which they are cited.

The paragraph beginning on page 44 and which carries over to page 45, is clearly nothing more than an unrestrained attempt by the reporter to editorialize under the guise of the Commission’s imprimatur. The statements are flatly contrary to existing law, contradict statements made by Commissioners in their discussions in Santa Fe and San Diego, and go far beyond anything that the Commission has voted on or agreed to. This portion of the report argues for exactly the position that the appellate courts have repeatedly rejected—that the needs of the debtor are enough to allow a bankruptcy court to enjoin bona fide police and regulatory actions.

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The proposal cites a single case at footnote 141 for the limited nature of section 105. In fact, there are numerous cases that make this point, which has been echoed by virtually every Court of Appeals. The strict line they take on the use of section 105 is totally at odds with the expansive view that the report supports. *See, e.g.*, *In the Matter of Carlson* (Carlson v. United States), No. 96-2959, 1997 U.S. LEXIS 26247 (7th Cir. Sept. 23 1997) (“In regard to § 105(a), although a bankruptcy court is a court of equity, it cannot use its equitable power to circumvent the law.”); *In re Baker & Drake, Inc.*, 35 F.3d 1348 (9th Cir. 1994); *Chiasson v. J. Louis Matherne and Assoc.*, 4 F.3d 1329 (5th Cir. 1993); *In re Eagle-Picher Industries, Inc.*, 963 F.2d 855 (6th Cir. 1992); *In the Matter of Commonwealth Oil Refining Co., Inc.*, 805 F.2d 1175 (5th Cir. 1986); *In re Western Real Estate Fund, Inc.*, 922 F.2d 592 (10th Cir. 1990); *see generally* Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988). By downplaying this extensive litany of cases which preclude the use of Section 105 as an independent basis for enjoining nonbankruptcy law, the report conceals the degree to which its recommendations would work a change in existing law.
Moreover, it suggests that it should be up to a bankruptcy court—not an elected legislature—to balance the needs of all parties who might be affected by actions of the debtor. The Commission has not recommended, and if seriously suggested, likely would reject, such judicial usurpation of authority.

As in other areas noted above, there are problems with the cases cited by the report, with respect to both the validity of how the cases are characterized and the merits of endorsing the positions for which they are cited. For instance, the court in *Metro Transportation Co.*,82 cited at footnote 150 of the report, decided that the bankruptcy court had an independent right to disregard the determinations of the duly constituted Administrative Law Judge and the Public Utility Commission and, instead, accept the recommendations of their staff, which had taken a more accommodating view towards the debtor’s arguments. A cursory reading of this case would suggest that there are major full faith and credit problems with such a process, certainly not one the Commission should endorse.

Similarly, there are major problems with using a standard like “threatening the assets of the estate,” particularly when this is coupled with cases that suggest that the costs of litigation constitute such a threat.83 Of the cases cited in footnote 151, only *Superior Forwarding, Inc.*84 actually held that costs of litigation, standing alone, can be such a threat. In the other cases, the agency apparently had no right to bring the suit at all. As such, they are hardly authority for a broad generalization of using section 105 to enjoin litigation, merely because it costs money to defend. Under such a standard it would be a rare police and regulatory case, indeed, that could go forward. In any event, the holding in *Superior Forwarding, Inc.* has been severely undercut, if not overruled, by the Supreme Court’s decision in *Mcorp.*85

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83 It should also be noted that statements in other cases that refer to “threats to assets of the estate” as being a valid basis for a § 105 injunction were merely dicta. As such, they never defined what such a threat could be, and did not, in fact, find that any such threat existed from the government’s action. As a result, this phrase has largely (and correctly) disappeared from use; its resurrection by use in this report is highly objectionable. It will cause nothing but mischief.


The report’s use of amorphous standards like “extraordinary circumstances,” or “significant or unwarranted threat to estate assets,” would simply be a green light to debtors to file these actions routinely and would encourage the bankruptcy courts to grant even more injunctions. The Commission’s discussions concluded with a strong endorsement of the government’s view that section 105 should not be applied to bona fide police in regulatory actions that would, hopefully, help to stem the tide of frivolous litigation. The report’s language, to the contrary, will only encourage the filing of such cases. Finally, the report’s apparent suggestion that criminal cases involving monetary offenses are generally “bad faith prosecutions” amounts to blatant misrepresentation; the report fails to balance the single case that it cites with even one of the numerous cases that take the opposite point of view.  

Ninth, the Commission has never voted on, and only briefly discussed, any potential issues arising from the Supreme Court’s decision in Seminole Tribe of Florida. Thus, any discussion that suggests that the Commission has taken any position on the case, its impact on bankruptcy jurisdiction, or what the effect should be with respect to other Commission proposals, is entirely inappropriate. In addition, the statement on page 46 of the report that relief pursuant to Ex Parte Young is worthless, because it is impossible to know in advance what action a state official plans to take, is not correct. It is obvious that, in most cases, the government will demand compliance or file a complaint or make a phone call before taking any specific action against a debtor. The debtor is certainly free at that point to bring suit against the governmental agency to enjoin its actions before they have any material effect on the debtor or its estate. And, even if property may be seized without notice in some circumstances, this still does not mean that one cannot sue the official for return of the property in most cases. More importantly, this is an enormously complex area which is only beginning to be explored. There is little point in the report venturing into this subject with a superficial discussion that says little and recommends less.

In short, this section of the report fails to give a balanced presentation of the issues and fails to support the propositions expressed therein with adequate legal

86 See, e.g., United States v. Truxler Hosiery Co., Inc., 796 F.2d 723 (4th Cir. 1986); In re Fussell, 928 F.2d 712 (5th Cir. 1991), cert. denied, 502 U.S. 1107 (1992); In re Davis, 691 F.2d 176 (3d Cir. 1982); Barnett v. Evans, 673 F.2d 1250 (11th Cir. 1982); In re Schake, 154 B.R. 270 (Bankr. D. Neb. 1990).

analysis. The discussion does not accurately reflect what the Commission has discussed and agreed to, it only presents the unilateral views of the reporter. The report’s discussion of the Chemical Weapons Bill and the police and regulatory exception to the automatic stay is not only superfluous, but highly imprudent. Congress created this Commission to review the bankruptcy law and recommend appropriate legislative changes. In implementing the Chemical Weapons Treaty, however, Congress was obliged to and chose to act in advance of the Commission’s recommendations and the Senate voted overwhelmingly to amend this statutory provision. It is hard to see how the mere discussion by the Commission’s staff of the impact of the automatic stay on government’s police and regulatory authority, following a very brief and very limited discussion of the Commission at its meeting in Detroit, contributes anything to a dialogue already actively engaged in Congress. More likely, this discussion will be viewed as officious meddling in the process, an attempt to influence the House of Representatives to reject or modify a legislative change unanimously adopted by the Senate.
Department of Justice/N.A.A.G. Proposal:

11 U.S.C. §§ 105, 362

Protection of Governmental Police and Regulatory Powers

January 17, 1997

Overview

The filing of a bankruptcy petition creates an automatic stay under section 362(a) that enjoins, *inter alia*, a) the initiation or continuation of civil actions against the debtor relating to prepetition claims (sec. 362(a)(1)), b) the enforcement of a prepetition judgment against the debtor or against property of the estate (sec. 362(a)(2)), c) any act to obtain possession of property of the estate or to exercise control over property of the estate (sec. 362(a)(3)), or d) any act to collect, assess, or recover a prepetition claim against the debtor (sec. 362(a)(6)). The Bankruptcy Code contains exceptions in sections 362(b)(4) and (5) that mirror the scope of the automatic stay provisions in section 362(a)(1) and (2). These sections exempt the government, in the exercise of its essential police and regulatory functions, from the bars on initiating actions against the debtor on prepetition claims and from enforcing prepetition judgments, other than money judgments, against either the debtor or against property of the estate. However, the provisions of sections 362(b)(4) and (5), unlike the other subsections of 362(b), do not except government police and regulatory actions from the other limitations in section 362(a), particularly the bar on taking action to obtain possession of, or control, property of the estate and the prohibition on “acts” to collect, assess or recover prepetition claims. Because of this distinction, and because of the overlapping nature of the prohibitions contained in section 362(a), it has been argued that police and regulatory actions which the government is allowed to take by virtue of sections 362(b)(4) and (5) are still barred because of section 362(a)(3) and/or 362(a)(6).

Examples of the types of actions that are at issue here include government actions to deny or revoke licenses to parties engaged in fraud, incompetent work, negligent operation of a nursing home; to seize and/or destroy contaminated or
defective goods or diseased livestock; to bar products made in violation of federal labor laws from entering interstate commerce; and to carry out forfeiture actions against contraband or the instrumentalities of unlawful activity such as drug dealing. To the extent that section 362(a)(3) and/or (6) apply to such activities because they result in exercising control over or taking possession of property of the estate, or because they are “acts” to collect a claim, they seriously hinder the ability of government entities to carry out important police and regulatory functions that are essential to protecting the safety and welfare of their citizens.¹ This proposal seeks to eliminate that ambiguity while preserving the distinction between governmental actions seeking to enforce a monetary judgment and other police and regulatory actions by the government.

That is, even true police and regulatory actions may result in judgments that are purely monetary. While the Code has always preserved the right of governmental agencies to litigate and liquidate such claims; it has required that the actual collection of the amounts determined in such actions must be subject to the processes and priorities of the Bankruptcy Code. Other governmental actions may result in mixed judgments. A remedial order under the National Labor Relations Act may include both a reinstatement order for an illegally discharged employee—which is not a money judgment and which may be enforced during the case and a back pay order for the wages lost prior to the reinstatement—which is a money judgment and which can only be collected through the process of filing a proof of claim. This proposal intends to maintain this distinction, while clarifying the ability of the government to enforce nonmonetary police and regulatory judgments that affect property of the estate.

An additional portion of the proposal deals with proposed changes to section 105. This section of the Bankruptcy Code supplies an important tool to bankruptcy courts to assist them in carrying out their requirements under the Code.² Congress

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¹ In many cases, the governmental regulatory injunctive actions would not necessarily create a “claim,” under the government’s analysis of the breadth of that term. However, at least some actions concededly would fall within that definition and some courts construe a “claim” more broadly than does the government. As a result, 11 U.S.C. § 362(a)(6) also poses a threat, albeit a lesser one, to legitimate governmental regulatory activities.

² “The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.” 11 U.S.C. § 105(a).
Because of the interrelated nature of 11 U.S.C. §§ 362(b)(4) and (5), and to emphasize that these changes only apply to police and regulatory actions and not to attempts to collect monetary judgments, we have suggested combining these two subsections into one.

has placed limits on the use of this power, but many debtors have argued that courts should use this discretionary power to enjoin the police and regulatory actions of government entities if those actions might have had adverse effects on the reorganization efforts of the debtor. The present language and, in our view, the appropriate view of section 105 do not support this interpretation of the provision, which potentially wreaks havoc on the ability of the government to protect the welfare of its constituents. However, in light of the large number of cases in which the issue is litigated and the willingness of a substantial number of courts to enter such orders, it was concluded that clarifying language should be included to define the substantive and procedural standards for when such orders may be entered against a police or regulatory action by the government.

The Recommendations

The Commissioners agreed that the Commission should recommend the following statutory amendment to 11 U.S.C.§ 362(b)(4) and (5):³

11 U.S.C. § 362(b)(4) should be amended to read as follows:

(b) the filing of a petition under section 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay-

. . .

(4) under subsection (a)(1), (2), (3), and (6) of this section, of the commencement or continuation of an action or proceeding by a governmental unit to enforce such governmental unit’s police and regulatory power, including by the enforcement of a judgment other than a money judgment, obtained in an action or

³ Because of the interrelated nature of 11 U.S.C. §§ 362(b)(4) and (5), and to emphasize that these changes only apply to police and regulatory actions and not to attempts to collect monetary judgments, we have suggested combining these two subsections into one.
proceeding by the governmental unit to enforce such governmental unit’s police or regulatory power;

[delete existing subsection (5)]

The Commissioners also agree that the Commission should recommend the following statutory amendments to 11 U.S.C. § 105 to ensure that the authority given to governmental authorities under Section 362 is not unduly infringed by use of the bankruptcy court’s discretionary authority.

The following language should be added to Section 105:

(e) In issuing an injunction, the court shall apply the standards and procedures applicable to a district court under nonbankruptcy law, except to the extent procedures are modified by the Federal Rules of Bankruptcy Procedure.

(f) A police or regulatory act of a governmental unit that is not stayed or proscribed by a specific provision of this title may be enjoined only to the extent authorized by nonbankruptcy law.

Background

The filing of a bankruptcy petition stays the commencement or continuation of most proceedings against the debtor and property of the debtor’s bankruptcy estate.\(^4\) For the most part, parties wishing to pursue actions against the debtor or against property of the estate must obtain permission from the bankruptcy court. This automatic stay generally applies to all creditors, including government entities that are acting as creditors.\(^5\)

The Bankruptcy Code provides several governmental exceptions to the automatic stay that allow police and regulatory actions to go forward. Under section \(11 U.S.C. § 362(a)(1)\).

\(^4\) See Hillis Motors, Inc. v. Hawaii Automotive Dealers’ Ass’n, 997 F.2d 581, 586 (9th Cir. 1993); In re University Medical Center, 973 F.2d 1065, 1073 (3d Cir. 1992); In re Pearson, 917 F.2d 1215 (9th Cir. 1990), cert. denied, 112 S. Ct. 514 (1992).
362(b)(4), a proceeding by a government unit to enforce its police or regulatory power is not subject to the stay of such actions contained in section 362(a)(1).\(^6\) In this regard, the Supreme Court stated in 1990 that it was “not persuaded . . . that the automatic stay provisions have any application to ongoing, nonfinal administrative proceedings.”\(^7\) The legislative history indicates that Congress created this carve-out to permit the continuation of proceedings by governmental units to “stop violation of fraud, environmental protection, consumer protection, safety, or similar police or regulatory laws.”\(^8\) Similarly, 11 U.S.C. § 362(b)(5) excepts the enforcement of prepetition judgments, other than money judgment, obtained in action or proceeding by governmental unit to enforce such governmental unit’s police or regulatory power from the stay in section 362(a)(2) of such actions.\(^9\)

Yet, the language of these exceptions stops short of giving government entities carte blanche in fulfilling their police and regulatory functions. Unlike other exceptions to the stay which remove certain actions completely from the coverage of the stay, the current governmental exceptions only exempt police and regulatory actions from certain portions of the stay. Thus, an act to “obtain possession . . . or to exercise control” over property of the estate pursuant to police and regulatory power is not exempted specifically from the automatic stay.\(^10\) This becomes relevant when a government agency (e.g., Federal Aviation Administration, local zoning authorities, mining regulators), wants to revoke or suspend a license in which the

\(^6\) “The filing of a petition . . . does not operate as a stay under subsection (a)(1) of this section, of the commencement or continuation of an action or proceeding by a governmental unit to enforce such governmental unit’s police or regulatory power.” 11 U.S.C. § 362(b)(4). See also Board of Governors of the Federal Reserve System v. MCorp Financial, Inc., 112 S. Ct. 459 (1991) (Federal Reserve Board’s administrative proceedings against debtor excepted from stay by section 362(b)(4)).

\(^7\) MCorp, 112 S. Ct. at 464.


\(^9\) “The filing of a petition . . . does not operate as a stay . . . under subsection (a)(2) of this section, of the enforcement of a judgment, other than a money judgment, obtained in an action or proceeding by a governmental unit to enforce such governmental units’s police or regulatory power.” 11 U.S.C. § 362(b)(5).

bankruptcy estate has an interest.\textsuperscript{11} By the same token, the government is often in the position of seizing and even destroying tangible assets under its police and regulatory powers. This could include fruit that may be infested with Mediterranean fruit flies, livestock at risk for “mad cow” disease, children’s nightwear which is coated with flammable chemicals, goods which have been “tainted” because they were manufactured in violation of the Fair Labor Standards Act, mislabeled prescription drugs, and the fruits and instrumentalities of crime.

Similarly, an act to “collect, assess, or recover” a prepetition claim is also not exempted from the automatic stay, even if the claim is one arising out of a purely police and regulatory action.\textsuperscript{12} Taken literally, section 362(a)(6) is so broad that it swallows up everything that is also covered by sections 362(a)(1) and (2). Thus, despite the presence of language exempting specific types of governmental actions from portions of the automatic stay, other, overlapping provisions in the stay still remain and, it can be argued, bar the government from taking those actions which are otherwise authorized.

Not all courts are troubled by this apparent conflict; some have taken a flexible approach and concluded that section 362(b)(4) and (5) permit government agencies to take the necessary actions with respect to property of the estate to enforce police or regulatory powers without seeking bankruptcy court permission.\textsuperscript{13}

\textsuperscript{11} Most agree that a licensee holds at least some proprietary interest in a license, an interest that becomes property of the estate upon the filing of a bankruptcy petition. See, e.g., In re Gull Air, 890 F.2d 1255 (1st Cir. 1989); In re Draughon Training Inst., Inc., 119 B.R. 921 (Bankr. W.D. La. 1990).

\textsuperscript{12} 11 U.S.C. § 362(a)(6) stays “any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title.”

\textsuperscript{13} See, e.g., Cournoyer v. Lincoln, 790 F.2d 971 (1st Cir. 1986) (section 362(b)(4) exempts town’s removal of used truck parts from debtors’ property, which had violated zoning ordinance); In re Yellow Cab Cooperative Ass’n, 96 K 256, 1996 WL 520497 (D. Colo. Sept. 12, 1996) (reversing bankruptcy court’s order enjoining public utilities commission from prohibiting debtor from transferring taxis to another company); In re Universal Life Church, Inc., 191 B.R. 433, 442 (E.D. Cal. 1995) (automatic stay does not bar revocation of tax-exempt status); Carr and Company Investments, Ltd. v. St. Tammany Parish Policy Jury, 88-0542, 1989 WL 65530 (E. D. La. June 13, 1989) (property rezoning exempted from stay under section 362(b)(4)); In re Heritage Village Church & Missionary Foundation, Inc., 87 B.R. 401, 404 (D.S.C. 1988) (section 362(b)(4) precludes bankruptcy court from enjoining revocation of debtor’s tax-exempt status), aff’d, 851 F.2d 104 (4th Cir. 1988); Vaspourakan, Ltd. v. Licensing Bd. for the City of Boston, 85 B.R. 189 (D. Mass. 1988) (board’s refusal to transfer liquor license to debtor not stay violation); In re Synergy Development
Traditionally, however, exceptions to the automatic stay have been construed narrowly.\textsuperscript{14} Moreover, the obvious structural difference between the limited stay exceptions contained in sections 362(b)(4) and (5) and the broader exceptions contained in other portions of section 362(b) have convinced many courts that the former sections must be interpreted more strictly. These factors have, therefore, led many courts to read section 362(b)(4) and (5) literally and thus hold that sections 362(a)(3) and (6) stay even legitimate police and regulatory attempts to the extent that they affect property of the estate or that they enforce prepetition nonmonetary judgments, limiting the exceptions’ application to the proceedings that lead to the determination that exercising such control is necessary.\textsuperscript{15}

A further problems arises when the bankruptcy court is urged to use its discretionary authority to impose a stay under Section 105 in a situation where the automatic stay does not apply. To this end, a court can exercise injunctive powers to supplement the automatic stay provided by section 362\textsuperscript{16} and may enjoin an action

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\textsuperscript{14} See, e.g., Hillis Motors, Inc. v. Hawaii Automobile Dealers’ Ass’n, 997 F.2d 581, 590 (9th Cir. 1993).

\textsuperscript{15} See, e.g., In re Draughon Training Institute, Inc., 119 B.R. 921 (Bankr. W.D. La. 1990) (although school license revocation proceeding was within section 362(b)(4) exception, actual revocation of school license violated automatic stay); In re Cattle Congress, Inc., 179 B.R. 588 (Bankr. N.D. Iowa 1995) (revocation of gaming facility license violated automatic stay), remanded on other grounds, 91 F.3d 1113 (8th Cir. 1996). Accord In re Hillis Motors, Inc., 997 F.2d 581 (9th Cir. 1993) (holding that section 362(b)(4) does not except acts that are described by section 362(a)(3), although also holding that commerce department’s action of dissolving corporation was not police or regulatory action). See also In re Horizon Air, Inc., 156 B.R. 369 (N.D.N.Y. 1993) (district court issuing temporary restraining order against F.A.A. revocation of flight operating license for alleged safety violations pending resolution of preliminary injunction hearing).

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if the court determines that the action would interfere with administration or progress of a bankruptcy case, or if equitable considerations require that the court stay the action. In interpreting this provision, most courts have held that section 105 powers must be exercised in connection with a substantive Code provision.\textsuperscript{17}

In light of the specific exemption granted for police and regulatory actions, and the absence of a specific Code provision allowing debtors to violate existing state or federal law, it is reasonable to conclude, and indeed most courts have concluded, that courts are not authorized to use section 105 to enjoin police and regulatory government actions that are taken to protect the health and welfare of other citizens, assuming that these actions would be legal in a nonbankruptcy context. However, other courts have concluded that they are allowed to utilize this discretionary power where, in their view, the equities favor the debtor’s reorganizational needs over the police and regulatory goals to be served by the statute.

Reasons for the Proposed Change

As illustrated by the split in the case law, the current police and regulatory exceptions are not sufficiently inclusive to ensure that a government agency can enforce its valid police or regulatory powers without being held to have violated the automatic stay, and without facing the possibility of being subject to a discretionary stay under section 105. Congress enacted sections 362(b)(4) and (5) to permit certain government actions to go forward when necessary to enforce laws that implicate public safety and welfare; the proposed amendment would clarify what steps government entities may take, when acting in a valid exercise of their police and regulatory powers, without having to re-litigate the matter in the bankruptcy court. Absent the exemption of these actions from sections 362(a)(3) and (6), to the extent proposed below, the government’s ability to protect its citizenry would be seriously compromised.

The federal government supplied a list of almost 20 different statutory authorities that allow it to seize property; states and local governments have numerous additional provisions authorizing such actions. Many such actions must

\textsuperscript{17} See, e.g. United States v. Pepperman, 976 F.2d 123, 131 (1992); In re Murgillo, 176 B.R. 524, 532 (Bankr. 9th Cir. 1994), (citing Norwest Bank Worthington v. Ahlers, 108 S. Ct. 963 (1988)).
be taken on an expedited or emergency basis and would be seriously impacted by a requirement that the government must seek relief from the stay before it can act. We are unprepared to accept the view that the mere filing of a bankruptcy petition should allow a debtor to automatically preclude the government from exercising the necessary power to seize property to protect the health and safety of its citizens. Absent the government’s continuing right to enforce such laws, there is a strong temptation for a debtor to skirt them in order to obtain a financial benefit or to salvage value from assets which would otherwise be destroyed to protect the public safety, health, or welfare.

Amendments need to be made to both sections 362(b)(4) and (5) for the same reason: despite the breadth of the exceptions they grant to the stay imposed under sections 362(a)(1) and (2), respectively, governmental actions continue to be subject to the much broader and less defined stay provisions in sections 362(a)(3) and (6). Because, it is clear that the drafters of the Code deliberately wrote the stay provisions to be as broad as possible and designed them to have overlapping coverage, actions which are to be allowed must be excepted from all applicable provisions of the stay, not just some of them. Thus, while section 362(b)(5), for instance, allows the government to enforce a judgment against property of the estate, this does not solve the problem posed by sections 362(a)(3) and/or (6), because, on their face, they appear to forbid those very actions. While we believe that this conflict should not exist—and that the exceptions explicitly granted in sections 362(b)(4) and (5) demonstrate the proper scope of the governmental exception—we believe the changes proposed here are necessary to ensure that the government may move forward in this area with a degree of confidence.

We also believe that clarifying these sections will benefit all parties by removing an ambiguous section that tends to encourage unnecessary litigation. Even if the government eventually wins every challenge brought under these sections, the expense and delay incurred in such a process is a serious impediment to the enforcement process. We are also motivated to fully correct the problem so that we do not, inadvertently, create other ambiguities that lead to negative implications about the breadth of the exception that we are advocating.

The net result of the proposal is that, assuming the action is determined to be a proper police or regulatory action, the government may:
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a) Investigate, file complaints, litigate and determine the substantive merits of matters involving the debtor whether or not the conduct occurred pre- or postpetition;

b) Take similar steps with respect to liquidating monetary amounts associated with such police and regulatory actions, whether such amounts are owed to the government or to third parties, such as consumers or employees;

c) Complete the appeals process with respect to any such actions;

d) Enforce nonmonetary judgments obtained in such actions, whether obtained pre- or postpetition, and whether or not the enforcement results in exercising control, or taking possession of property of the estate.

The government may not use this exception to allow it to bring an action which does not constitute a police or regulatory action (unless that action is allowed elsewhere, such as the exemption contained in section 362(b)(9) with respect to tax collection activities). **Nor may it enforce a final monetary judgment, even if the judgment arises in a police or regulatory action.**

Having determined what the proper scope of governmental actions during the case should be, the Commissioners also concluded that that freedom of action should normally not be subject to curtailment by way of a section 105 injunction. In our view, that Code provision does not provide courts with the authority to contravene legislative prerogative on an ad hoc basis. We believe that this represents the correct—and the majority—view of the law. However, the evidence submitted by the government indicates that they are subject to repeated litigation over this issue, that approximately half of the cases are decided adversely to them initially and only corrected upon appeal, and that the constraints of ongoing events and limited resources precludes them from appealing some adverse rulings, thereby leaving them subject to an improper stay. The likelihood of at least initial success on the merits, therefore, ensures the continued filing—and granting—of such motions unless and until the statute is amended to plainly bar this use of the bankruptcy court’s authority.

Thus, the proposal to amend section 105 contains two parts: first, a requirement that the court consider the motion using the normal standards and procedures applicable to granting an injunction under nonbankruptcy law: i.e., there must be a showing of irreparable harm and a likelihood of success on the merits, and
the balance of harms must favor the debtor. Second, injunctions of police or regulatory actions that are not otherwise stayed or proscribed (such as by section 525) may not be enjoined unless authority to do so exists in nonbankruptcy law—i.e., under a Younger v. Harris-type standard, for instance.¹⁸

**No Expansion of Scope of Exceptions to Automatic Stay**

This proposed change is *not* intended to alter the substantive scope of the section 362(b)(4) and (5) governmental exceptions to the automatic stay.¹⁹ The distinctions between “purely pecuniary” and “police and regulatory” matters have been developed by the case law and would remain in full force and effect.²⁰ The

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¹⁹ The proposed amendment would not change the outcome when courts hold that an act does not fall within an agency’s police and regulatory powers. See, e.g., In re University Medical Center, 973 F.2d 1065 (3d Cir. 1992) (withholding Medicare payments was enforcement of contractual rights, not police and regulatory action, and violated automatic stay); In re Farmer’s Market, Inc., 792 F.2d 1400, 1043 (9th Cir. 1986) (refusal to transfer liquor license due to nonpayment of taxes violated automatic stay); In re Corporacion de Servicios Medicos Hospitalarios de Fajardo, 805 F.2d 440 (1st Cir. 1986) (department of health’s revocation of debtor’s operating license was not police and regulatory action, but was contractual action); In re North, 128 B.R. 592 (Bankr. D. Vt. 1991) (state suspension of chiropractor’s license to compel debtor to pay taxes was not within police and regulatory powers); In re Massenzi, 121 B.R. 688 (Bankr. N.D.N.Y. 1990) (insurance department’s revocation action against debtor was triggered by debtor’s failure to pay debt and violated stay); In re St. Louis South Park II, Inc., 111 B.R. 260 (Bankr. W.D. Mo. 1990) (forfeiture of nursing home debtor’s certificate of need not police and regulatory action, violated stay); Island Club Marina Ltd. v. Lee Co., Fla., 32 B.R. 331, 336 (Bankr. N.D. Ill. 1983) (due to lack of evidence that agency’s withdrawal of building permit was pursuant to police and regulatory power, violated stay). See also In re Medicar Ambulance Co., Inc., 166 B.R. 918 (Bankr. N.D. Cal. 1994) (suspension of Medicare payments not police and regulatory action, violated stay). Cf. In re Orthotic Center, Inc., 193 B.R. 832 (N.D. Ohio 1996) (Medicare overpayments not property of estate, but if they were, suspension would not violate stay because it was within police and regulatory powers).

²⁰ Courts generally use one of several similar tests to discern the nature of the government’s action. Using the “pecuniary purpose test,” a court assesses whether the proceeding relates primarily to the protection of the government’s pecuniary interest and not to public policy matters. In re Eddleman, 923 F.2d 782, 791 (10th Cir. 1991); United States v. Nicolet, Inc., 857 F.2d 202 (3d Cir. 1988). “The terms ‘police and regulatory power’ as used in those exceptions refer to the enforcement of state laws affecting health, morals, and safety but not regulatory laws that directly conflict with the control of the res or property of the bankruptcy court.” Hillis Motors, Inc. v. Hawaii Automobile Dealers’ Ass’n, 997 F.2d 581, 591 (9th Cir. 1993) (citing In re Missouri v. United States Bankr. Ct. for the E.D. of Ark., 647 F.2d 768, 776 (8th Cir. 1981), cert. denied, 102 S. Ct. 1035 (1982) (state liquidation of grain warehouse violated stay)). One court has offered a slight variation
recommendation would not permit government agencies to use section 362(b)(4) to enforce its own, purely contractual rights without seeking automatic stay relief, nor would it allow a government entity to revoke a license merely as a means to collect a debt from the debtor or to advance the pecuniary interest of the government.

Thus, this proposal does not purport to address or resolve disputes underlying the frequent litigation over whether an action is purely pecuniary or police and regulatory, nor does it alter the potential consequences for acting in violation of the automatic stay (e.g., sanctions, contempt) if the government’s exercise of control over property of the estate is challenged and ultimately found not to be police or regulatory. The proposal only would ensure that government agencies have the proper tools to carry out their police and regulatory responsibilities. Similarly, the amendments to Section 105 are meant to clarify the appropriate limits for application of that section, not to provide the government with new rights.

Competing Considerations

To the extent that these changes clarify that the government may control or take possession of certain assets of the debtor’s estate, this may make a reorganization more difficult or impossible or may deprive other creditors of the value that could be obtained through disposal of those assets. Plainly, this tends to defeat the legitimate hopes of both of those groups. To the extent that certain police or regulatory policies are given a broad scope as a prophylactic measure and may not actually be necessary in a particular case, requiring the debtor to adhere to them may

on the pecuniary purpose test: “as a general matter, section 362(b)(4) does not include governmental actions that would result in a pecuniary advantage to the government vis-à-vis other creditors of the debtor’s estate.” In re Commonwealth Companies, Inc., 913 F.2d 518, 523 (8th Cir. 1990) (emphasis added). The “public policy test” focuses on whether the proceedings are intended to effectuate public policy or whether they are adjudications of private rights. NLRB v. Edward Cooper Painting, Inc., 804 F.2d 934 (6th Cir. 1986). In any event, the explication and development of this concept is not at issue with respect to these proposed amendments.

21 In re University Medical Center, 973 F.2d 1065, 1074 (3d Cir. 1992) (withholding Medicare payments not police and regulatory), citing In re Corporacion de Servicios Medicos Hospitalarios, 805 F.2d 440, 445 (1st Cir. 1986).

22 See, e.g., cases cited in notes 11 & 12. Nor does the proposed amendment affect what would constitute property of the estate in the first instance. See, e.g., Pension Benefit Guaranty Corp. v. Braniff Airways, Inc., 700 F.2d 935, 942 (5th Cir. 1983) (court prohibited from using section 105 to protect landing slots since slots are not property of estate). Cf. In re Gull Air, Inc., 890 F.2d 1255 (1st Cir. 1989) (debtor had limited proprietary interest in landing slots).
hinder or doom a reorganization which could otherwise take place. However, the Commissioners concluded that the needs to protect legitimate governmental actions to protect the public health, safety, and welfare, outweigh this benefit to a single debtor. To the extent that Congress believed that certain requirements could appropriately be waived for entities suffering financial difficulties, it could do so in those laws. Allowing a bankruptcy filing, standing alone, to automatically accomplish that aim would likely only to encourage parties to violate the law and then seek refuge in the bankruptcy courts.

Nor, the Commissioners concluded, is it appropriate to allow bankruptcy judges to make ad hoc determinations as to which laws should be applied to which debtors. First, requiring a government to prove the reasons and necessity for each of its laws every time it seeks to enforce them against a particular debtor would obviously be unduly burdensome. Indeed, laws in general are meant to be obeyed by all—the mere fact that a violation by a particular individual might not really harm anyone has never been thought to justify a failure to obey the law. Thus, requiring the government to prove that specific harm would result from this specific debtor’s violations could prove to be an impossible task. Second, a bankruptcy judge is not, realistically, in a position to take into account the multitude of interests that go into the balance struck by the legislature. Faced with the parties at hand, the judge will be hard-pressed to consider the impact that his decision will have on the debtor’s competitors who must continue to comply with laws and regulations and the surrounding community which is protected by them, particularly if other parties are encouraged to file bankruptcy as a way of escaping legislation that they view as unduly burdensome. Again, in our view, Congress or state legislatures are in a better position to judge when and how exemptions from the laws should be granted and how such exemptions will impact on those not receiving them.

Some might also conclude that this proposed change supplies additional leverage to government entities, enabling them to pursue mere pecuniary actions without court authority or supervision. Those who take this position might argue that bankruptcy courts can resolve lift stay actions expeditiously and therefore it is not an undue burden on government entities to require them to move to have the stay lifted before they take police and regulatory actions with respect to property of the estate. However, the Commissioners who deliberated on the issue determined that the proposed statutory changes do not broaden the range of actions that can be pursued without bankruptcy court authority. Thus, there would be no change in the treatment of government actions that constitute mere debt collection, and debtors and trustees would retain their tools for challenging the propriety of such actions. Governments seeking to rely on the exemption in the new section 362(b)(4) would act at their own
risk in determining that they are engaged in a police and regulatory function. They would still be subject to sanctions should they attempt to utilize these provisions for purely pecuniary purposes.

On the other hand, if governmental entities are to be allowed to continue to exercise their police and regulatory powers, then it makes little sense to burden them and the courts with ruling on motions that should be granted virtually automatically. The only effect of such a process would be to impose additional costs on the government, the debtor and the creditors, while delaying enforcement actions which may need to be taken with great dispatch. Accordingly, we are of the view that these provisions strike the proper balance between the needs of the government to protect the public and the desire to assist debtors in their efforts to reorganize.
A Proposal to Amend 11 U.S.C. § 105

prepared by

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July 8, 1997

The following is a proposal to amend the Bankruptcy Code by the addition of new section 105(e) as follows:

(e) The court may issue an order enjoining a governmental unit’s commencement or continuation of a proceeding to exercise its police or regulatory power only if the court finds that the governmental unit is proceeding in bad faith or in clear violation of the law and absent an injunction there will be immediate irreparable harm to the debtor.

Historical and Revision Note

This proposal expressly adopts for bankruptcy the well-established standard for obtaining injunctions against governmental units exercising their police and regulatory powers in administrative and civil enforcement proceedings in a non-bankruptcy context. At present, neither the Bankruptcy Code, nor its legislative history provides a standard for granting injunctions pursuant to Bankruptcy Code Section 105(a) against police and regulatory enforcement actions. This uncertainty encourages forum shopping and the misuse of bankruptcy because defendants in police and regulatory actions use bankruptcy as an offensive weapon rather than as a shield to protect a financially distressed business.

In Younger v. Harris, 401 U.S. 37 (1971), the Supreme Court barred federal courts from interfering with state criminal prosecutions except in extraordinary circumstances. The Court invoked principles of comity and federalism as well as the ancient maxim that equity will not enjoin a criminal prosecution. Subsequently, in Huffman v. Pursue, 420 U.S. 592 (1972), the Supreme Court extended Younger to civil police and regulatory actions brought by state and local officials. The Court held that the extraordinary circumstances referred to in Younger encompasses cases where the danger of irreparable loss is both great and immediate, and where the state
proceeding is conducted in order to harass, or otherwise is in bad faith, or is flagrantly and patently unconstitutional. *Id.* at 611.

A similarly high threshold is applicable to govern the granting of injunctions against police and regulatory actions by federal agencies. As the Supreme Court explained in *Schlessinger v. Councilman*, 420 U.S. 738, 756 (1975), the practical considerations underlying *Younger* are similar to those barring intervention in administrative agency proceedings because of the exhaustion of remedies doctrine. The Court stated:

The latter rule, looking to the special competence of agencies in which Congress has reposed the duty to perform particular tasks, is based on the need to allow agencies to develop the facts, to apply the law in which they are peculiarly expert, and to correct their own errors.

In developing the exhaustion of remedies doctrine, the Court has been mindful of the dangers of forum shopping, and it has stated “Judicial review . . . should not be a means for turning a prosecutor into a defendant.” *FTC v. Standard Oil of California*, 449 U.S. 232 (1980). This rationale is equally applicable in a bankruptcy case, as Congress stated throughout the legislative history of the Bankruptcy Code that it did not intend for the bankruptcy court to provide a haven from law enforcement. Indeed, the *Younger* standard is necessary to respect the principles of federalism, comity and separation of powers underlying the preceding cases. These constitutional values cannot be defeated simply because enjoining a law enforcement action might be more conducive to the financial rehabilitation of a debtor.

**Government Working Group A**

**Working Group Proposal # 5: Section 105**

**Background**

Section 105 of the Bankruptcy Code supplies an important tool to bankruptcy courts to assist them in carrying out their requirements under the Code.¹ Congress

¹ “The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No Provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or
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has placed limits on the use of this power, but occasionally courts have used section 105 to enjoin temporarily the police and regulatory actions of government entities if those actions might have had adverse effects on the reorganization efforts of the debtor. The present language and majority view of section 105 do not support this interpretation of the provision, which potentially wreaks havoc on the ability of the government to protect the welfare of its constituents.

The Proposal

The Commissioners in Government Working Group A agreed that no statutory change was necessary or appropriate, but endorsed advisory language to be included in the final report of the Commission:

*In its report, the Commission should reaffirm that section 105 is not meant to be and should not be interpreted to expand the injunction capacity of bankruptcy courts beyond what the statute specifically authorizes; therefore, courts should not use section 105 to stay the police and regulatory actions of government entities that would be allowable in a nonbankruptcy context.*

Reason for the Recommendation

In interpreting this provision, most courts have held that section 105 powers must be exercised in connection with a substantive Code provision. To this end, a court can exercise injunctive powers to enforce the automatic stay provided by section 362 and may enjoin an action if the court determines that the action would interfere with administration or progress of a bankruptcy case, or if equitable considerations require that the court stay the action.

making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.” 11 U.S.C. § 105(a).

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However, not all postpetition actions taken against the debtor violate the automatic stay. For obvious reasons, the Bankruptcy Code does not permit debtors to use the automatic stay to protect themselves from police and regulatory actions of governmental agencies.\textsuperscript{4} It is reasonable to conclude, and indeed most courts have concluded, that courts are not authorized to use section 105 to enjoin police and regulatory government actions that are taken to protect the health and welfare of other citizens, assuming that these actions would be legal in a nonbankruptcy context.

The Commissioners in Government Working Group A endorsed this interpretation of section 105; the Code provision does not provide courts with the ability contravene legislative prerogative. The Commissioners also agreed that while a few courts have reached conclusions contrary to this view, those decisions have been aberrational and largely have been corrected by reviewing courts. In deciding not to propose changes to the statute to correct a limited number of aberrational cases, the Working Group members indicated their concern that altering the language of section 105 could have unanticipated consequences; there was little to be gained by correcting the outcome in a few cases at the risk of creating a new wave of litigation as a result of a statutory change.

Therefore, the Commissioners recommended that the Commission’s final report address the issue and include advisory comments, but they saw no need and no proper place for any statutory amendment in this regard. Representatives of several governmental agencies indicated their satisfaction with this determination.

\section*{Competing Considerations}

Section 105 authorizes a court to take actions \textit{sua sponte}, in which case a court is not subject to any affirmative evidentiary standards beyond compliance with the language of the statute itself.\textsuperscript{5} Debtors that seek section 105 injunctions must file adversary proceedings and are usually required to satisfy the standards commonly associated with preliminary injunctions. Some have argued that courts should be required to meet at least the preliminary injunction standards. Because the

\begin{itemize}
\item \textsuperscript{4} See 11 U.S.C. § 362(b)(4).
\item \textsuperscript{5} See \textit{In re L & S Industries, Inc.}, 989 F.2d 929 (7th Cir. 1993).
\end{itemize}
Commissioners concluded that the limitations on the injunctive powers of courts are clear vis-à-vis police and regulatory actions, which were the focus of the discussion, there was not Commission support for such an amendment.
Dissent From Chapter 12 Report: Debtor Eligibility

by James I. Shepard, John A. Gose and Edith H. Jones.

Commissioner Jeffery J. Hartley concurs with the dissent; he does not, however, necessarily share all of the views and statements contained herein.

The Chapter 12 report addresses issues contained in a proposal adopted by the Commission, i.e., the issues of whether the Sunset Provision should be eliminated and whether the calculation of Chapter 12 trustee’s compensation should be based upon direct payments to creditors. The report then contains language which advocates increasing the eligibility limitation for filing Chapter 12 cases from $1.5 million dollars to $2.5 million dollars. Unfortunately this proposal reflects badly upon the process by which the Commission has conducted its business.

The proposal was briefly discussed at a meeting of the Working Subgroup in Seattle, Washington, on April 18, 1997, where it didn’t generate enough support to merit a vote—the discussion notes of that meeting reflect only that “Commissioners Williamson, Gose and Shepard [the members of the Subgroup] . . . agreed to investigate whether the chapter 12 eligibility cap is sufficient or whether it needs to be raised.” Thereafter, without the benefit of any further discussion among the members of the Subgroup or, apparently, any other Commissioners, or further investigation of the issue as contemplated by the Subgroup, the proposal was presented to the Commission in the Mail Ballot of August 5, 1997, where it drew only four votes in favor of its adoption; four votes were cast against the proposal, the Chair declined to take the opportunity to break the tie.6

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6 This is but one of numerous issues and proposals which have been advanced under the supposed auspices of the Commission, but without any indication of who is advancing the proposal or why it is being considered, contrary to the established procedures under which the Commission has functioned. The language in the report advocating the increase in the Chapter 12 eligibility limitation is found in the body of the report as if it had been adopted by the Commission in a regular fashion. Prior to the October 3, 1997, draft of the report, however, there was no indication that it had, in fact, been adopted been by the Commission. The inclusion of the proposal on the August 5th mail ballot and in an earlier draft of the report, in brackets, see Chapter 12: Bankruptcy Relief for Family Farmers, draft of August 25, 1997, on file with the Commission, was entirely without attribution. There was no indication of who was responsible for causing the proposal to appear on the mail ballot or in the August 25, 1997, draft of the report, nor was there any explanation as to why it was placed in the body of the of the August 25th draft of the report and not in a dissent authored
The report refers to statistics and information which have not been presented to or considered by the Commissioners and appear for the first time in a draft version of the report dated October 3, 1997; this information was not contained in the only other draft of the report, dated August 25, 1997; the Commissioners have had no opportunity to consider or respond to this information, none of this information had been made available to the Commissioners prior to the ballot of August 5th, 1997. Thus the presentation of this material in this manner reflects only the work of the Commission staff and the views of whomever is advocating this change. By presenting the case for increasing the eligibility limits in the “Reporter’s Notes” it is apparently intended to provide a gloss of, at least, subliminal approval by the Commission, the statements in the text are hardly neutral, when such has not been demonstrated.

Once again the process by which this Commission was forced to conduct its business is called into question—the fact of submitting a report which advances a controversial proposal in such a backhanded manner detracts from the credibility of the entire report and the integrity of the Commission process itself. Whether resort to this process is an attempt to force the defacto adoption of the proposal is not clear. What is clear is that this proposal to increase the eligibility limit is badly conceived and inadequately explored.

The Code and the proposal establish eligibility based on the debtor’s aggregate debt. Yet, the principal focus of the discussion in support of the increase in the eligibility limits is inflation, principally in the value of farm land. While there generally is a direct relationship between the value of farm land and farm debt, mortgage indebtedness often being the largest single debt owed, such is not always the case, but more importantly, the Commission has heard no testimony regarding the composition of current farm debt loads, there has been no discussion or testimony of that aspect of the farm economy. Further, while the proposal would lead the reader to believe that farm values have increased substantially in comparison with historical prices, the Commission has neither sought nor received evidence or testimony in that regard. Anecdotal evidence indicates that in reality farm values are just now approaching pre-1980 levels. The information presented to the

by the person or persons who are advancing the proposal. During a telephone conversation on Sunday, October 5, 1997, a member of the Commission’s staff indicated that Chairman Williamson has now determined to cast his vote in favor of the proposal to increase the eligibility cap; the fact of this belated vote has not been communicated, as of Wednesday, October 8, 1997, to the Commissioners, other than the appearance of the proposal in the report. Presumably, Chairman Williamson has now chosen to break the tie; he has not, however, as yet, acknowledged responsibility for the proposal.
Commission prior to its vote, in the form of only one staff memorandum, is devoid of any such documentation. As noted above, the report now contains additional information not found in an earlier draft, presumably to attempt to deflect the shortcomings of the August 25, 1997, draft as expressed by the author in a critical response to that document.

Further, the cause/effect relationship between the Nation’s economy and farm debt has never been examined by the Commission. The $1.5 million dollar aggregate debt limit was established shortly after the time when farm values and their encumbering debts had appreciated to their still, all time historical highs; the values may have plummeted in response to the Carter administration’s grain embargo but the debts incurred in relation to the extremely high commodity prices and rapid inflation in the price of farm land were still high. The value of farm real estate may not soon exceed the levels attained in the early 1980’s, absent such other factors, inasmuch as the real value of farm land is greatly dependent on the prices of the commodities it will produce. Because the farm economy in many areas is heavily dependent upon the world market for grain and the Federal price support programs the price of farm land generally reflects the state of current and anticipated farm commodity prices. Numerous other factors enter into the psychology which drives the price of farm land, farm debt levels and the farm economy, none of which have been considered by the Commission.

While the cause and effect of debts and appreciation in land values may be debated, one fact is inescapable, the Commission has heard no testimony regarding the farm economy and there has been no attempt to draw conclusions and apply them to current conditions. The proposal to increase the Chapter 12 eligibility was

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7 As the owner of interests in farms in North Dakota and Iowa and living and practicing in Fresno County, California, where agriculture is the dominant industry, the author is aware of the market value of farm land across the country. The value of farm land in Iowa, in some locations, is now approaching the levels attained in the early 1980’s; some North Dakota farmland is now worth less than it was in the early 1980’s.

8 In reality, a study of the farm crisis of the 1980’s may likely reveal that it was caused more by high interest rates, rates which were more than double present rates and at their peak in the early 1980’s nearly triple present rates, than by high debt levels. The interest charged on an adjustable rate farm loan, on which the author was personally obligated, nearly doubled during this period of time, necessitating the liquidation of other assets to service the debt; debt service which was manageable before the dramatic increase in rates.

9 Because the USDA price support programs have recently been substantially restricted for some commodities the price of farm products will not likely increase to the level as was experienced in the 1970’s during the Hunt Brothers/Cook family soy bean war.
advanced solely upon a brief discussion in the April 18th meeting of the Working Subgroup in Seattle, mentioned above, and four letters to the Commission, one from a Chapter 12 trustee who would presumably profit by the change he advocates.

Further, there has there been no attempt to determine the characteristics of the “family farm” that deserves the additional rights provided by Chapter 12. Indeed, many in the farming community agree that much of what used to be considered “family farming” is now being conducted by agri-businesses. Additionally, the views and suggestions of those who would be most negatively impacted have neither been sought nor heard. The Commission has not had the benefit of testimony from such parties as the Farm Service Agency (formerly Farmer’s Home Administration), Metropolitan Life Insurance Company or the Federal Land Bank Association, institutions which finance most of the farm lending on real estate in the United States. Nor have the views been heard of the United States Department of Agriculture, Commodity Credit Corporation, the Production Credit Association or local banks and other creditors who extend operating loans to farmers and who would suffer the most by the adoption of this proposal. Before considering such a proposal the Commission should have the benefit of farm economists who could provide the “big picture” analysis of the effect of a 67% increase in the eligibility limit. The failure to analyze the factors which generated the “farm crisis” of the 1980’s, factors which may or may not arise again, is a major shortcoming of the proposed report; these factors have neither been explored or discussed.

The shortcomings and defects in the report and the deceptive process by which the proposal is being advanced lead to the conclusion that this is simply a rush to enlarge the ambit of the use of “sweat equity” at the expense of farm lenders and the vast number of farmers who will never file bankruptcy\textsuperscript{10} but who must pay the bill for those who do not pay. There may be valid reasons for enlarging the group for whom the benefits of Chapter 12 should apply but because the consequences of such action are far ranging it cannot be done hastily.

\textsuperscript{10} In preparing land title abstracts during the peak of the farm crisis in Iowa, the Butler County Abstract Company learned that only approximately one in four tracts of farm real estate was encumbered.
DISSENT FROM THE PROCESS OF WRITING

THE COMMISSION’S REPORT

Submitted by Commissioners John A. Gose,

Edith H. Jones and James I. Shepard

The value of the Commission’s report lies not only in the proposals which were adopted but in the hundreds of pages of supporting text, as well. Given that the report may stand as a paradigm for the creation of not only future legislation, but scholarly debate and judicial guidance for years to come, it is essential that the text truly reflects the findings and conclusions of the Commission. In many ways, the supporting text, which will be seen as a resource for guidance in understanding the Commission’s motivations and goals, is nearly of equal importance with the proposals themselves. If the text misstates the significance of the events that led to the adoption of any particular proposal those that read and rely on the report as the only written statement of what the Commission recommends will be mislead; the presentations of the Commission’s findings and conclusions can easily become a vehicle for creating false impressions. The process by which the report and supporting text were created is therefore of extreme importance. If the process fails to honor the integrity of the Commission’s work the report itself will fail and the public will be deceived.

To that end, therefore, in reading the report the following must be clearly understood:

1. While the individual proposals were debated and adopted over the preceding two years, the draft
versions of the report, containing the proposals and their supporting text now appearing in the report, for the most part, were not given to the Commissioners for their review and comments until shortly before the deadline for submission of dissents; the vast bulk of the hundreds of pages of text was not delivered to the Commissioners until two or three days before. Within a few days of the submission of our dissents we had never seen the consumer and business bankruptcy chapters, two of the most significant sections of our report; the list of proposed items to be included in the appendix did not arrive until the day the dissents were due.

2. The drafts provided were constantly augmented and substantially changed with each version; the changes were not identified as would be done with normal drafting techniques, except occasionally; the Consumer Bankruptcy and General Chapter 11 sections grew by approximately 80 pages between drafts, which, given the limited amount of time available, rendered their review almost impossible. Thus, those Commissioners writing dissents were required to chase a moving target; it was extremely difficult to identify, analyze and respond to new material as each iteration arrived - it was nearly impossible to write a dissent without knowing what the report contained.

3. Largely created by the reporter, the report contains many interpretations and characterizations which often do not reflect the Commission’s work. The report, for instance, does not reveal that the Commission never voted to endorse any theory for the increase in consumer bankruptcy filings and, in fact, split five to four on most consumer recommendations; or that meaningful debate on many significant issues was very limited or nonexistent - the “Consumer Framework” was presented as a “take-it-or-leave-
it” package, with no opportunity to identify discrete problems and proposed solutions.

4. The report fails to reflect the Commission’s vote on each proposal, which on many critical issues was divided five to four; the report does not indicate that the Commissioners’ views on many issues were deeply polarized and that there was little attempt to create a consensus. There is no indication of the depth and nature of this chasm as to the Commissioners’ philosophical and practical positions in regard to the consumer bankruptcy crisis and its potential solutions. The statement that certain proposals maintain “balance” within the system or that certain proposals “enhance the integrity” of the system are nothing more than value judgements, personal opinions intended to create a more favorable reception for the views expressed; “balance,” like beauty, is entirely in the mind of the beholder.

5. The Kowalewski report, which has been made a part of the appendix, is identified in the appendix table of contents as a report of the Congressional Budget Office. While the cover letter accompanying the report is printed on Congressional Budget Office letterhead stationary, the analysis and conclusions are clearly Mr. Kowalewski’s and not those of the CBO. The inclusion of Mr. Kowalewski’s report in the appendix when it has not been studied or discussed by the Commission at any of its proceedings is entirely gratuitous - this is just another skirmish in the reporter’s fight with the credit card industry. While we have no strong feelings for the credit card industry this oleaginous approach is simply not fair.
Chairman's Note:

Hon. Edith Jones has written 225 pages in dissenting opinions to express her disagreement with many of the proposals adopted by the Commission. Whether or not joined by other Commissioners, her dissenting opinions—read with the majority views in the first four chapters of the report—will help Congress, the bankruptcy community and the public understand the complexity and the importance of the issues addressed by the Commission and the diversity of perspective about those issues.

The process of preparing a report of more than a thousand pages has been, for the Commission's professional staff, challenging and exhausting. The analytical narrative in the report discusses the 172 proposals adopted by the Commission in a series of votes, decided by at least a majority, over the last 16 months. The staff has been writing and circulating the "final" report for at least that long, in a sense, because the analysis is based largely on the research memoranda prepared by the staff and circulated in advance of every meeting on each issue to each of the Commissioners. It also is based on the memoranda prepared for other proposals, more than 100 in all, that the Commission did not adopt. This process has been, as it should be, a dynamic process. The Commissioners and the judges, lawyers, academics and others following the Commission's work repeatedly offered suggestions and comments that were incorporated into the staff's continuous research and drafting.

On any given issue, the analysis in the report embodies the point of view of at least five Commissioners, and the report notes the specific votes on important issues where the Commission divided. There no doubt are sentences or paragraphs in the report that one majority Commissioner might have written differently, but there cannot be five (let alone nine) authors and editors for each line in the report. In the subject areas where the Commission's vote was divided, the report does not pretend to reflect every Commissioner's view, but it does attempt faithfully to reflect the majority Commissioner's view and to discuss competing considerations. The dissent no doubt faithfully reflects the view that did not prevail and, together, the majority and dissenting views provide Congress with a full and accurate picture of the Commission's discussions.

The majority and dissenting positions and views have long been apparent, established formally with the Commission's public votes and established informally in the free and open discussions at the Commission's meetings. Any
Commissioner not in the majority on a given issue was able from the moment of any vote to begin fashioning a dissent or to try to persuade others to change their position. Throughout the last two months, the report sections have been drafted and redrafted by the staff -- developed, expanded, and improved as the staff worked to give Congress the fullest, most complete report that it could. All the work was done with the direct involvement of the Commissioners and those interested in the Commission's work.

The procedural dissent that concludes Chapter 5 provides an opportunity to close the report appropriately—with a final acknowledgment of the integrity, scholarship, dedication, and hard work that the Commission staff demonstrated every day. The staff's ability and enthusiasm under trying circumstances have been remarkable. Their commitment to improving the American bankruptcy system, by giving more than a year of their professional lives to the Commission and helping fashion its recommendations, has been inspirational.