APPENDIX F-2

Report of the United States Department of Justice Bankruptcy Working Group
THE REPORT

OF THE

DEPARTMENT OF JUSTICE

BANKRUPTCY WORKING GROUP

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In the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106, the Congress established a National Bankruptcy Review Commission (the Commission) to examine the bankruptcy laws and make recommendations to Congress for further reforms. In pursuing this mandate, the Commission has reached out to debtors, creditors, consumers, judges and governmental entities, including the Department of Justice, seeking every possible perspective on what should be reformed and left unchanged in our nation's bankruptcy laws.

In an effort to be an active participant in this important process, the Department of Justice, in May of 1996, convened a Bankruptcy Working Group (the Working Group) that includes over 90 of its most experienced bankruptcy lawyers, including personnel from the Department's litigating divisions, U.S. Attorneys offices and U.S. Trustee Program. In reviewing the bankruptcy laws, the Working Group has sought to maintain an appropriate balance between providing debtors with a "fresh start" and maintaining the integrity of important government interests. Those governmental interests extend not only to the obvious interests of the United States and its taxpayers as the most common creditor in bankruptcy, but also to the patriae interests of the government in protecting its citizenry, maintaining and improving access to the courts, and ensuring that bankruptcy justice is dispensed through a system that is fair and consistent with the Constitution. With these goals firmly in mind, the Working Group has prepared this preliminary report, which contains recommendations and observations. The Department of Justice and the Working Group look forward to working closely with the Commission as its strives to promote fairness and efficiency in our nation's bankruptcy laws.

The following is an outline of the Working Group's recommendations:

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I. ADMINISTRATION AND INFRASTRUCTURE ISSUES

A. Maintain the District Court's Involvement in Adjudicating Bankruptcy Matters

The Commission is considering several proposals to streamline the bankruptcy system by broadening the jurisdiction and authority of the bankruptcy courts, while diminishing the district court's involvement. We recommend against adopting these proposals for two reasons. First, the proposals, if adopted, could lead to the bankruptcy system being declared unconstitutional under Article III of the Constitution, as they would weaken, perhaps fatally, the argument that the bankruptcy courts are "adjuncts" of the district courts. Second, at least one of the proposals -- allowing appeals of bankruptcy court decisions to be heard, in the first instance, in the courts of appeals -- might further complicate, rather than streamline, the bankruptcy system.

1. The Constitutional Issue

In Northern Pipeline Construction Co. v. Marathon Pipeline Co., 458 U.S. 50 (1982), the Supreme Court found the 1978 Code's grant of jurisdiction to bankruptcy judges unconstitutionally broad because it conferred Article III authority on judges who lack the life tenure and salary security of Article III judges. Congress responded by passing the Bankruptcy Amendments and Federal Judgeship Act of 1984 (BAFJA), Pub. L. No. 98-353, 98 Stat. 333. BAFJA vests jurisdiction over bankruptcy cases in the district courts and allows the district courts to refer cases to the bankruptcy courts, which are expressly made units of the federal district courts. 28 U.S.C. §§ 151, 157, 1334. See In re Clay, 35 F.3d 190, 193 (5th Cir. 1994). BAFJA specifies the so-called "core matters" as to which bankruptcy judges may issue final orders and reserves other matters for final decision by the federal district court.

Whether this new system achieves a constitutional result has been debated in the courts, although the decisions to date have upheld the constitutionality of BAFJA. In defending BAFJA, the Department relies upon two key legal propositions:

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1 See, e.g., Mankin v. Munn, 823 F.2d 1296 (9th Cir. 1987), cert. denied, 485 U.S. 1006 (1988); In re Rheuban, 128 B.R. 551, 563 (Bankr. C.D. Cal. 1991) (listing cases that have so held); Credithrift of America v. Lawson, 52 B.R. 369 (E.D. Kentucky 1985); Cf. St. George Island v. Pelbam, 104 B.R. 429, 430 (Bankr. N.D. Fla. 1989) (suggesting that the Supreme Court "undoubtedly feels that Congress did not cure all the constitutional ills" in enacting BAFJA).

2 The United States may intervene in disputes between private parties to defend the constitutionality of any Act of Congress. 28 U.S.C. § 2403(a). On numerous occasions, the Department of Justice has exercised this authority to defend bankruptcy court jurisdiction against Article III challenges. See, e.g., Diamond Abrasives Corporation v. Tempo Technology Corporation, C.A. No. 95-438 (D. Del.); In re Finevest Foods, Inc., 143 B.R. 964 (continued...)
issues concern "public" rights and thus can be adjudicated by an Article I court -- the bankruptcy court -- with little or no involvement by an Article III court. Second, we argue that, even if core matters concern "private" rights, the bankruptcy court can adjudicate them because it is an "adjunct" of the district court. While the "public rights" defense would be unaffected by the Commission's draft proposals, the "adjunct" argument might be seriously weakened.

The Marathon plurality rejected the "adjunct" argument as applied to the prior bankruptcy system because the 1978 Act improperly vested "all essential attributes of judicial power of the United States in the 'adjunct' bankruptcy court." Marathon, 458 U.S. at 85. The plurality emphasized several of these "attributes of judicial power." First, the bankruptcy courts could adjudicate "not only traditional matters of bankruptcy, but also 'all civil proceedings arising under title 11.'" Id. Second, the bankruptcy courts were not merely factfinding tribunals but could "exercise 'all of the jurisdiction' conferred by the Act on the district courts." Id. Third, they "exercise[d] all ordinary powers of district courts, including the power to preside over jury trials, the power to issue declaratory judgments, the power to issue writs of habeas corpus, and the power to issue any order, process, or judgment appropriate for the enforcement of the provisions of Title 11." Id. (citations omitted). Fourth, bankruptcy court judgments were subject to review only under the "clearly erroneous" standard. Id. Finally, bankruptcy courts could issue final, binding, and enforceable judgments. Id. at 85-86. The plurality concluded that "the 'adjunct' bankruptcy courts created by the [1978] Act exercise jurisdiction behind the facade of a grant to the district courts, and are exercising powers far greater than those lodged in the adjuncts approved" in prior Supreme Court cases. Id. at 86. See also Commodity Futures Trading Commission v. Schor 478 U.S. 833, 851 (1986).

In describing the constitutional significance of the "adjunct" status of the bankruptcy courts, the Department relies upon a combination of the procedural safeguards enacted in BAFJA. These include the appeal of core adjudications to the district court, the district court's authority to refer core matters to the bankruptcy court and to withdraw the reference, and the appointment of bankruptcy judges by the courts of appeal. 28 U.S.C. §§ 151, 152(a), 157, & 158. The courts have found these safeguards indicative of the bankruptcy courts' adjunct status in upholding BAFJA.³ If adopted, the Commission's draft proposals would significantly diminish the role of district courts in the bankruptcy process and thus weaken the "adjunct" status of the bankruptcy court.

²(...continued)

³ See, e.g., In re Hester 899 F.2d 361, 367 (5th Cir. 1990) ("The bankruptcy court functions as an adjunct of the district court and, indeed, the constitutionality of the bankruptcy court's jurisdiction rests on that fact and on the careful supervision that the district court is bound to provide over the bankruptcy court."); In re General American Communications Corp. 130 B.R. 136, 155 (S.D.N.Y. 1991); In re Production Steel, Inc., 48 B.R. 841, 845 (M.D. Tenn. 1985).
court -- perhaps so much as to convince the courts to declare a revised bankruptcy system unconstitutional.

2. Commission Draft Proposals

a. District Court Review

From a constitutional perspective, the most significant of the Commission's draft proposals is to eliminate district court review of core matters. The exercise of review authority by the district court over legal issues presented in core appeals is significant in establishing the bankruptcy court's status as an adjunct to the district court. Reviewing core matters is the principal way that district courts retain the essential attributes of judicial power, which we believe is key to the constitutional inquiry. See In re Corporacion de Servicios Medicos Hospitalarios de Fajardo, 805 F.2d 440, 443 (1st Cir. 1986) ("the constitutional status of bankruptcy courts and the Bankruptcy Code itself compel district courts to undertake such review"); In re Production Steel, Inc., 48 B.R. 841, 842, 845 (M.D. Tenn. 1985) (listing other cases).

Moreover, allowing direct appeal to the courts of appeals could complicate, rather than streamline, bankruptcy appeals. For example, the core/non-core split in bankruptcy litigation could lead to substantial inefficiencies in appellate practice under this proposal. If the bankruptcy court found a proceeding to be core, thus limiting appeal to the circuit court, any party to the appeal could challenge the circuit court's jurisdiction on the ground that the matter is non-core. Indeed, all parties to the appeal could challenge the bankruptcy court's determination, leaving no party to defend the circuit court's jurisdiction. If the circuit court determined that the matter was non-core, it would need to remand to the bankruptcy court, and the district court would have to enter a final order before another appeal could be taken. 28 U.S.C. § 157(c) (1). Conversely, if the bankruptcy court determined that the matter was non-core, it could issue only a report and recommendation for district court review. Id. If the court of appeals subsequently determined that the proceeding was core, that court would have to remand to the bankruptcy court for entry of a final, appealable order, and the appellate process would restart.

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4 See generally, Melodie Freeman-Burney, "Jurisdiction under the Bankruptcy Amendments of 1984: Summing Up the Factors," 22 Tulsa L.J. 167, 192 (1986) ("The major constitutional controversy is focused upon whether Congress has subjected the adjunct authority of bankruptcy judges to sufficient district court supervision so that district courts retain the essential attributes of judicial power").

5 The bankruptcy court must determine expressly whether a proceeding is core or non-core. 28 U.S.C. § 157(b)(3). That determination, however, is appealable. Teton Exploration Drilling, Inc. v. Bokum Resources Corp., 818 F.2d 1521, 1527 (10th Cir. 1987) (Baldock, J., dissenting) (citing 1 L. King, Collier on Bankruptcy ¶ 3.01[2][c] (15th ed. 1996)).
In addition, under the proposal, litigants presumably would find it more difficult to obtain an emergency stay from the courts of appeal than the district courts, thus increasing the likelihood of moot appeals.6 And, one could reasonably expect that the courts of appeals, which, in line with 28 U.S.C. § 1292, rarely review non-final orders, will not be as amenable to interlocutory appeals as the district courts are currently. We believe that the problems with core/non-core matters, as well as the inability to obtain stays and interlocutory appeals, would significantly dilute the benefits of direct appeals.

b. Contempt Powers

The Commission is also considering recommending that bankruptcy courts exercise the full range of district court contempt powers.7 Adoption of this proposal again would undercut the bankruptcy court's "adjunct" status.

Arguably, the contempt power is among the "essential attributes of judicial power" emphasized by the Marathon plurality in striking down the 1978 Act. Marathon, 458 U.S. at 85 (discussing 1978 Act's granting bankruptcy courts "power to issue any order, process, or judgment appropriate for the enforcement of the provisions of Title 11"). Those circuit courts

6 The Department recently defended bankruptcy jurisdiction from constitutional attack related to a moot appeal. A party appealed a bankruptcy court's order approving the debtor's sale of assets. The sale apparently had been consummated an hour after the bankruptcy court's approval, and the debtor moved to dismiss the appeal as moot. The objecting party responded by challenging the Code on the ground that it effectively denied Article III court review of bankruptcy court orders approving asset sales. The district court rejected this challenge, reasoning, in part, that the objecting party should have attempted to obtain an emergency stay from the district court. In re Tempo Technologies, Inc., Civ. Nos. 95-438/95-478 (D. Del. June 25, 1996).

7 Some courts construe the Code as already granting civil contempt power to bankruptcy courts. See In re Skinner, 917 F.2d 444, 447-48 (10th Cir. 1990); In re Walters, 868 F.2d 668, 669 (4th Cir. 1989); but see In re Baker & Getty Financial Services, Inc., 954 F.2d 1169, 1173 (6th Cir. 1992); In re Kaiser Steel Corp., 911 F.2d 380, 392 (10th Cir. 1990); In re United Missouri Bank of Kansas City, 901 F.2d 1449 (8th Cir. 1990).
that have addressed the issue since Marathon find constitutional support for bankruptcy court civil contempt authority. See In re Skinner, 917 F.2d at 448-50; In re Walters, 868 F.2d at 669-70. Cf. In re Sequoia Auto Brokers Ltd., Inc., 827 F.2d 1281 (9th Cir. 1987). But, these decisions are predicated primarily upon the "public rights" doctrine, rather than the "adjunct" status of bankruptcy courts. An exception is Skinner, where the court also addressed the "adjunct" theory, noting that "the delegation of civil contempt power to bankruptcy courts does not 'impermissibly remove[ ]... 'the essential attributes of the judicial power' from the Article III district courts and...vest[ ] those attributes in a non-Article III adjunct,' since the district courts retain the power of de novo review of the bankruptcy courts' findings of fact and conclusions of law in civil contempt proceedings." Skinner, 917 F.2d at 450 (quoting Marathon; citation omitted). This statement, of course, implies that, absent de novo district court review, the exercise of civil contempt power by bankruptcy courts raises "adjunct" concerns. Further, with regard to criminal contempt power, the Fifth Circuit has noted that recognizing such power in the bankruptcy court "engenders serious constitutional issues." In re Hipp, Inc., 895 F.2d 1503, 1511 (5th Cir. 1990).

c. Jury Trials

Another proposal being studied by the Commission -- authorizing the bankruptcy courts to conduct jury trials without consent of the parties -- could also lead to constitutional problems. The Marathon plurality expressly deemed authority to conduct jury trials an "essential attribute of judicial power." Marathon, 458 U.S. at 85; see also In re Clay, 35 F.3d 190, 192 (5th Cir. 1994) ("authority to conduct a jury trial is an essential attribute" of judicial power). Indeed, the Fifth Circuit has gone so far as to state (albeit in dictum) that the "inadequacy of district court review of jury trials is fatal to delegation to adjuncts." In re Clay, 35 F.3d at 193. In so concluding, the Fifth Circuit presumed that, under Marathon, "adjuncts" must be subject to "adequate" (apparently de novo) appellate review. It then reasoned that de novo review of jury findings is impossible, both because the Seventh Amendment prohibits it and because de novo review of jury findings is impractical. Id. at 193-94.9

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8 See also In re Ragan, 3 F.3d 1174 (8th Cir. 1993) (holding that bankruptcy court's order of criminal contempt did not violate the Constitution because bankruptcy court provided for de novo review by district court). See also Laura B. Bartell, "Contempt of the Bankruptcy Court -- a New Look," 1996 U. Ill. L. Rev. 1, 56 (concluding that affording bankruptcy courts contempt powers would "insidiously undermine" the constitutional foundation of BAFJA); William S. Parkinson, "The Contempt Power of the Bankruptcy Court Fact or Fiction: The Debate Continues," 65 Am. Bankr. L. J. 591, 621 (1991) (concluding that bankruptcy courts may not constitutionally exercise contempt powers "because contempt proceedings involve issues between two private parties -- matters which are squarely within the definition of 'private rights' which must be adjudicated by an agency with article III status").

9 See also Beard v. Braustein, 914 F.2d 434 (3d Cir. 1990); see generally, Lawrence W.
Although we disagree with this reasoning,\(^9\) we can ignore neither Marathon's emphasis on jury trial authority in striking down the 1978 Act, nor the subsequent cases that have expressed constitutional concerns with allowing bankruptcy courts to conduct jury trials. See In re Stansbury Poplar Place, Inc., 13 F.3d 122, 128 (4th Cir. 1993) (holding that bankruptcy courts lack statutory authority to conduct jury trials and avoiding addressing Article III "constitutional issue lurking in the background"); In re Grebill Corp., 967 F.2d 1152, 1157 (7th Cir. 1992) (same); In re United Missouri Bank, 901 F.2d at 1456-57 (same).\(^{11}\) Like the Fifth Circuit in Clay, these courts have observed that having a potential of de novo review by a district court clashes with the Seventh Amendment's finality of jury factual findings. See, e.g., In re American Community Services, 86 B.R. 681, 689 (D. Utah 1988).

d. Withdrawal of the Reference and Personal Injury Claims

The Commission is also considering whether to eliminate mandatory withdrawal of the reference under 28 U.S.C. § 157(d). That provision currently requires district courts to withdraw the reference upon timely motion "if the court determines that resolution of the proceeding requires consideration of both title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce." As we understand it, the Commission's proposal would make all reference withdrawals permissive. In addition, the circumstances that now require withdrawal of the reference would be cited as an example of "cause" that would justify withdrawal.

With the courts already construing the mandatory language of Section 157(d) in a narrow fashion, this dilution of the district court's obligation to entertain federal cases gives us great pause. We suspect it will likewise concern consumers, investors, employees and others for whose

\(^{9}\)(...continued)

\(^{10}\) We disagree with the implication that "adjuncts" to Article III courts must be subject to de novo review. In our view, ordinary appellate review is adequate, provided additional safeguards exist, as they do under the current bankruptcy system. Moreover, we question whether conducting jury trials is an "essential attribute of judicial power." Arguably, the jury acts as a check on the bankruptcy court, thus diminishing its authority, not increasing it. See In re Ben Cooper, Inc., 896 F.2d 1394, 1403 (2d Cir. 1990), cert. denied, 500 U.S. 928 (1991) ("jurors are less likely to feel pressure from the executive and legislative branches than are bankruptcy judges, who depend on the other branches for reappointment to office").

\(^{11}\) See generally, Mitchell Hall, "Granfinanciera, Northern Pipeline, and 'Public Rights': May a Bankruptcy Judge Presides Over a Jury Trial?" 80 Ky. L.J. 499, 530 (1992) (concluding that Congress may not constitutionally permit bankruptcy judges to conduct jury trials).
Withdrawal of the reference has at least two rationales. First, while the courts dispute whether Section 157(b) is part of the Congressional response to the Article III problems identified in Marathon, at least some courts believe that mandatory withdrawals are constitutionally necessary. Second, and more importantly, withdrawals of references ensure an efficient division of labor. Bankruptcy courts were meant to "provide expertise and efficiency" in the "adjudication of bankruptcy matters." In re National Gypsum Co., 145 B.R. at 541. When dealing with the interpretation of non-bankruptcy statutes, however, the district courts provide greater expertise. See In re American Freight Systems, Inc., 150 B.R. 790, 793 (D. Kan. 1993) ("[t]he purpose of §157(d) is to take from the bankruptcy courts those matters requiring the application of non-bankruptcy federal statutes affecting interstate commerce and give them to the district courts which have more experience in applying those laws"); AT&T v. LTV, 88 B.R. 581, 583 (S.D.N.Y. 1988) ("Section 157(d) reflects Congress's perception that specialized courts should be limited in their control over matters outside their areas of expertise"). The district court also provides a forum which brings a more generalist approach to federal law enforcement. Thus, withdrawals maintain an efficient and fair system of adjudication.

Nevertheless, the district courts have evinced a strong tendency to construe narrowly even Section 157(d)'s mandatory provisions, much less its discretionary ones. Although a few courts have gone the other way, a majority require, although no such requirement can be found in the plain language of Section 157(d), "substantial and material consideration" of a non-Code federal statute necessary for the resolution of the proceeding. Many courts have gone farther, holding protection the federal laws were passed and solvent entities who, unlike their bankruptcy competitors, will remain subject to federal district court enforcement actions.

12 Compare In Re White Motor Corp., 42 B.R. 693, 697-99 (N.D. Ohio 1984) (Section 157(d) is part of the solution to the constitutional problems of Marathon); In re National Gypsum Co., 145 B.R. 539, 541 (N.D. Texas, 1992) ("judicial derivation of the type of cases that warrant mandatory withdrawal" are "informed by the dictates of Marathon") with In Re Anthony Tammaro, Inc., 56 B.R. 999, 1005 (D.N.J. 1986) ("there is nothing in Marathon which constitutionally or otherwise requires federal law issues to be decided by an Article III court").

13 Mandatory withdrawal was granted to the Secretary of Labor using a "literal" test of Section 157(d) in Martin v. Friedman, 133 B.R. 609, 612 (N.D. Ohio 1991). The court found that the resolution of the proceeding would require "consideration of ERISA." Thus the court followed the minority of courts in not applying a "substantial and material consideration" test.

14 See, e.g., In re C-TC 9th Ave. Partnership, 177 B.R. 760, 763 (N.D.N.Y. 1995) (withdrawal mandatory only if the resolution of the claims requires the substantial and material consideration of a non-Code federal statute which has more than a de minimis impact on interstate commerce); In re White Motor Corp., 42 B.R. at 705. But see Contemporary Lithographers v. (continued...)
that to have "substantial and material consideration" there must be more than routine application of a federal statute to facts.\textsuperscript{15} Other courts are even stricter, requiring that either issues of first impression or a conflict between the non-Code statute and the Bankruptcy Code exist.\textsuperscript{16} Finally, courts have imposed the burden of proof upon the moving party.\textsuperscript{17} Although the unambiguous language of Section 157 does not impose these restrictions, the courts have utilized them to deny mandatory withdrawal.

Given this reluctance to assume jurisdiction where withdrawal is mandatory, we are less than sanguine about the prospects of this provision being used if all withdrawals are made permissive. By retaining the mandatory withdrawal provision, the proper balance between the respective areas of expertise of the bankruptcy courts and the district courts can be maintained.

\section*{3. Conclusion}

The current Bankruptcy Code establishes a delicate balance between district court oversight and bankruptcy court autonomy. The "adjunct" constitutional defense of bankruptcy court jurisdiction rests upon continued district court oversight. To the extent the Commission's draft proposals increase bankruptcy court authority while chipping away at district court oversight, they might tip the balance toward an unconstitutional result. We recommend against

\footnote{(...continued)}

\textsuperscript{14} \textit{Hibbert}, 127 B.R. 122, 127 (M.D.N.C. 1991) (finding that the non-Code law must be actually considered and must be determinative in resolving the dispute, but need not also "be so vague and uncertain as to require 'significant interpretation'").

\textsuperscript{15} \textit{See, e.g.}, \textit{In re Ponce Marine Farm, Inc.}, 172 B.R. 722, 724 (D. Puerto Rico 1994); \textit{In re Horizon Air, Inc.}, 156 B.R. 369, 373 (N.D.N.Y. 1993).

\textsuperscript{16} \textit{See, e.g.}, \textit{In re C-TC 9th Ave. Partnership}, 177 B.R. at 764; \textit{In re American Body Armor & Equipment, Inc.}, 155 B.R. 588, 590 (M.D. Fla. 1993). \textit{But see In re McCrory Corp.}, 160 B.R. 502, 505 (S.D.N.Y. 1993) (mandatory withdrawal does not require that the non-Code statute be unsettled or that the case involve issues of first impression). Indeed, a minority of courts have even gone so far as to require that there be substantial and material consideration of title 11 in addition to substantial and material consideration of a non-Code federal statute. \textit{See, e.g.}, \textit{In re Anthony Tammaro}, 56 B.R. at 1006 (requiring that "both Title 11 and non-Code federal law consideration be substantial and material"); \textit{Brizendine v. Montgomery Ward & Co.}, 143 B.R. 877, 879 (N.D. Ill. 1992) (withdrawal not required because proceeding required consideration of the Interstate Commerce Act but not of the Bankruptcy Code).

these draft proposals because the limited procedural benefits they would achieve are not worth the risk they pose to the constitutional status of the bankruptcy system.

**B. Limit the Jurisdictional Grant of 28 U.S.C. § 1334(b).**

The jurisdictional grant of 28 U.S.C. 1334(b) is overly broad and illogical. That section currently reads:

> Notwithstanding any Act of Congress that confers exclusive jurisdiction on a court or court other than the district courts, the district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11 or arising in or related to cases under title 11.” (Emphasis supplied.)

The problem lies with the highlighted subordinate clause. It is too broad because it indirectly grants to a non-Article III court jurisdiction that is broader in subject matter than that of any Article III court outside bankruptcy. By exercising this jurisdiction, bankruptcy courts can, for example, expand a debtor's substantive rights beyond those available to non-debtors. We believe this is inappropriate. The clause is also illogical in that it literally excludes from the paragraph's otherwise comprehensive grant of coexclusive jurisdiction cases that lie within the exclusive jurisdiction of the district courts.

In any event, to permit bankruptcy judges to adjudicate matters which federal law commits to other courts is simply bad policy. The effect is to make bankruptcy a universal "wild card" for a host of otherwise exclusive federal processes. With their attention properly focused on the expeditious adjustment of debtor-creditor relationships, bankruptcy courts should not be expected to undertake review of matters that non-bankruptcy federal law commits to specialized tribunals. Exercise of the bankruptcy courts' broad jurisdiction can in some instances frustrate other statutory policies as important as those the Code seeks to advance.

For example, during the Mohawk Airlines bankruptcy, the Federal Aviation Administration ("FAA") issued an emergency order revoking Mohawk's operating license, concluding that for a period of over eight months, Mohawk had operated aircraft that were not in airworthy condition. Under 49 U.S.C. § 1486(a), judicial review was obtainable in the court of appeals for the local circuit or for the District of Columbia (at Mohawk's option). However, 28 U.S.C. §§ 157 and 1334(b), applied literally, gave the bankruptcy court jurisdiction as well. Mohawk asked the bankruptcy court to restrain the FAA from enforcing the revocation, alleging that the public would be "inconvenienced" and that the violations the FAA found were little more than clerical errors. After ex parte consideration of the debtor's allegations, the bankruptcy court issued a temporary restraining order enjoining the FAA from enforcing the revocation order and from "interfering with the operation of the business of [Mohawk] by reason of any matter alluded to in the FAA [Revocation] Order."
Unlike bankruptcy courts, courts of appeals often review such administrative decisions and are familiar with the appropriate deferential standards of review and due process requirements. In Mohawk, for example, review should have been limited to whether the FAA's determination was "a clear error of judgment' lacking any rational basis in fact." Contrary to this standard, the bankruptcy court held a full evidentiary hearing that spanned three days, thus nullifying the "wide deference" that should be accorded the FAA and the obvious public safety concerns underlying such deference.

Another key area that has been affected by the overbreadth of Section 1334(b) involves the review of government contract decisions, which ordinarily are committed to the Court of Federal Claims or the boards of contract appeals. In Gary Aircraft Corp. v. United States, 698 F.2d 775 (5th Cir.), cert. denied, 464 U.S. 820 (1983), the Fifth Circuit first considered whether bankruptcy courts have the jurisdiction to hear government contract claims. Faced with competing proceedings scheduled simultaneously before a bankruptcy court and the board of contract appeals, the Fifth Circuit sanctioned the latter, finding:

One has merely to look at the vast body of case law, digests, and treatises to realize that government contracting law is complex, technical, esoteric, important and monumental. The raison d'etre of the various Boards of Contract Appeals is that both expertise and uniformity are needed to resolve adequately and fairly questions within the purview of government contracting law.

698 F.2d at 779. The court concluded that when a specialized administrative forum exists for adjudicating government contract disputes, a bankruptcy court has no discretion and "should defer liquidating of a government contracting dispute to the Board of Contract Appeals." Id.

Recently, some erosion of this sensible rule occurred. For example, in In re Murdock Machine & Engineering Co. of Utah, 990 F.2d 567 (10th Cir. 1993), the Tenth Circuit disagreed with the Fifth Circuit and held that each contract case must be evaluated on a case-by-case basis. It found that:

Because of the bankruptcy court's duty to timely determine and quantify creditor's claims, we believe the bankruptcy court correctly held that it had discretion to

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18 Nevada Airlines v. Bond, 622 F.2d 1017, 1021 (9th Cir. 1980).


20 The Mohawk case was eventually resolved by the district court withdrawing the proceeding from the bankruptcy court and conducting an expedited hearing subject to the deferential standard of review. See In re Horizon Air, Inc., 156 B.R. 369 (N.D.N.Y. 1993).
defer or to determine itself whether the government had a viable claim against the
bankruptcy estate.

_Id._ at 571. And in _Quality Tooling, Inc. v. United States_, 47 F.3d 1569 (Fed. Cir. 1995), a
divided panel held that deferral was not required in "relatively straightforward" contract disputes.
However, the majority failed to consider that even in seemingly "straightforward" government
contract disputes, issues can arise requiring application of "esoteric" rules. _Murdock Machine_
and _Quality Tooling_ threaten the uniformity of government contract law, the fair and even-handed
application of the laws to all government contractors (including those not in bankruptcy), and the
fiscal interests of the United States.

To reverse the current policy, we propose that Section 1334(b) be redrafted as follows:

Except where an Act of Congress confers exclusive jurisdiction on an
administrative body or court or courts, the district courts shall have original but
not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in
or related to cases under title 11.

This amendment is consistent with recent Supreme Court pronouncements on the doctrine
of primary jurisdiction, including _Reiter v. Cooper_, 113 S. Ct. 1213, 1220 (1993), where the Court
stated that doctrine "requires the court to enable a 'referral' to the agency, staying further
proceedings so as to give the parties reasonable opportunity to seek an administrative ruling." _See
also_ Louis J. Jaffe, "Primary Jurisdiction," 77 _Harv. L. Rev._ 1037, 1055 (1964). The proposed
amendment requires the bankruptcy court -- which retains exclusive jurisdiction over the case --
to defer to other tribunals in certain proceedings that invoke the tribunals' special competence and
thus assures that those specialized tribunals will hear the proceedings that Congress has
designated to them.

C. Limit the Bankruptcy Court's Power
to Issue Injunctions Under Section 105

Section 105(a) of the Code gives bankruptcy judges broad authority to issue "any order,
process, or judgment that is necessary or appropriate to carry out the provisions" of the
Bankruptcy Code. This includes the power to issue orders for injunctive relief. In the context

(continued...)
of an adversary proceeding, the bankruptcy court's power to enter an injunction is limited by the provisions of Federal Rule of Bankruptcy Procedure 7065, which incorporates by reference most of the provisions of Federal Rule of Civil Procedure 65, governing injunctions in district court. Other than in the context of an adversary proceeding, however, no rule governs the bankruptcy court's power to issue an injunction.

Perhaps because of the broad scope of the bankruptcy court's jurisdiction, the scope of the bankruptcy court's power to enter an injunction pursuant to Section 105 has been interpreted broadly. Some courts have held that during the pendency of bankruptcy proceedings, the bankruptcy court may enjoin actions by creditors not only against debtors (which already are prohibited by Section 362), but also against third parties where the action might affect the debtor's estate or ability to reorganize. In some instances, usually as part of an order confirming a plan of reorganization, courts have gone even further and permanently enjoined creditors from bringing

21(...continued)

issued pursuant to § 105 must be obeyed unless the injunction is successfully challenged either in the bankruptcy court itself or on appeal).

22 The one difference is that Bankruptcy Rule 7065 allows a debtor, trustee or debtor in possession to obtain a temporary restraining order or preliminary injunction without complying with Federal Rule of Civil Procedure 65(c), which requires that any party other than the United States, as a prerequisite for the issuance of temporary injunctive relief in its favor, to give security for the payment of damages which may be incurred if it is subsequently determined that any party has been wrongfully restrained.

23 Title 28, § 157(a) contains essentially the same language as Section 1334, stating that a district court may provide for the referral to the bankruptcy judges for the district of "any or all cases under title 11 and any or all proceedings arising under title 11 or arising in or related to a case under title 11."

24 See, e.g., Celotex Corp. v. Edwards, 115 S. Ct. 1493 (1995) (judgment creditor may not collaterally attack injunction preventing motion against supersedeas bond posted by surety of debtor); In re L & S Industries, Inc., 989 F.2d 929, 932 (7th Cir. 1993) ("a bankruptcy court can enjoin proceedings in other courts when it is satisfied that such proceedings would defeat or impair its jurisdiction over the case before it"); Willis v. Celotex Corp., 978 F.2d 146 (4th Cir. 1992) (bankruptcy court had power under Section 105 to enjoin proceedings against sureties on supersedeas bonds where sureties would then seek to enforce their rights against collateral provided by the debtor); In re G.S.F. Corp., 938 F.2d 1467, 1474 (1st Cir. 1991) (bankruptcy court may enjoin the initiation or continuation of judicial proceedings outside bankruptcy against third parties during the pendency of a chapter 11 case if those proceedings might result in an adverse impact on the administration of the chapter 11 case).
actions against third parties.\textsuperscript{25} Indeed, at least one circuit court has held that the normal prerequisites for issuance of an injunction do not apply to a bankruptcy court issuing an injunction under Section 105.\textsuperscript{26}

The injunctive power of bankruptcy courts should be subject to the same limits that apply to other federal courts. We urge that Section 105 be modified to impose a requirement that no injunction be issued by a bankruptcy court except in compliance with the requirements of Rule 65(a) & (b). Alternatively, we urge the Commission to recommend that a new Bankruptcy Rule be adopted, applicable to all proceedings in bankruptcy and not just adversary proceedings, which imposes the limitations of Rule 65(a) & (b) on the issuance of any injunction by a bankruptcy court.

D. Automatic Stay Issues

1. Eliminate Ambiguity in the Statutory Stay of Section 362(a)(1)

The statutory stay imposed under Section 362 of the Code at the commencement of a case prohibits actions "to recover a claim against the debtor that arose before the commencement of the case under this title." 11 U.S.C. §362(a)(1), Cl. II. This prohibition is in addition to the protection provided against "the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor..." 11 U.S.C. §362(a)(1), Cl. I. Further protection against actions to enforce judgments, obtain possession of property of the estate, or create and perfect liens is specifically enumerated in

\textsuperscript{25} See, e.g., \textit{In re A.H. Robins Co.}, 880 F.2d 694 (4th Cir. 1989) (affirming court order approving reorganization plan which contained permanent injunction prohibiting suits against non-debtor third parties, including the debtor's directors and attorneys, and its insurer and insurer's attorneys). \textit{See also Monarch Life Insurance Co. v. Ropes & Gray}, 65 F.3d 973 (1st Cir. 1995) (collateral estoppel precluded suit against attorneys who represented both debtor and plaintiff, the debtor's former parent company, where order confirming plan contained injunction which prohibited commencement or continuation of any proceeding against various non-debtor third parties, including the plaintiff, and their respective officers, directors, employees, attorneys and other agents). \textit{But see In re American Hardwoods, Inc.}, 885 F.2d 621 (9th Cir. 1989) (bankruptcy court lacks power to enjoin permanently a creditor from enforcing a state court judgment against non-debtor officers of the debtor corporation).

\textsuperscript{26} See \textit{In re L & S Industries, Inc.}, 989 F.2d at 932 (although Seventh Circuit law normally requires a party to show (i) that it does not have an adequate remedy at law, (ii) that it will suffer irreparable harm if an injunction is not issued, and (iii) that it has some likelihood of success on the merits, a bankruptcy court may enjoin proceedings in other courts without meeting two of these three normal prerequisites so long as the moving party can establish a likelihood of success on the merits).
the subsections which follow Section 362(a)(1). The broad and ambiguous language of clause II of section 362(a)(1) appears to serve no purpose of its own and should be eliminated to prevent future misconstruction.

The origin of clause II to section 362(a)(1) is unclear. The legislative history explained the addition as a "provision [that] is beneficial and interacts with section 362(a) (6), which also covers assessment, to prevent harassment of the debtor with respect to pre-petition claims." The specific language of Section 362(a)(6) prohibits "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title." To the extent that clause II of section 362(a)(1) merely duplicates the protection provided under Section 362(a)(6) of the Code, it is unnecessary.

Analysis of the two provisions reflects that "[t]he wording of paragraph (6) is somewhat similar to that of paragraph (1) but applies to any 'act' whether or not that act is related to a 'proceeding'." 2 L. King, Collier on Bankruptcy ¶362.04 at 362-45 (15th ed. 1996). It is unclear whether either the "action or proceeding" language of section 362(a)(1) or the "act" language of section 362(a)(6) results in any greater or more unique protection. Collier on Bankruptcy suggests that the use of the word "act" in section 362(a)(6) should cover any action to initiate or continue legal proceedings to recover a claim against the debtor. Id.

Clause II of section 362(a)(1) has been used to justify an extension of the automatic statutory stay protection to non-debtors. The extension of bankruptcy protection to non-debtor parties is an emerging issue. Perhaps bankruptcy protection should be extended to nondebtors


29 See In re Colonial Realty Company (FDIC v. Hirsch), 980 F.2d 125 (2d Cir. 1992)(stay under Section 362(a)(1) held to prevent continuation of FDIC action to recover funds transferred by debtor to his spouse).

in unique circumstances. "Automatic" protection to nondebtors, however, is plainly unwise and seemingly unintended. For example, interpreting clause II to protect nondebtors undermines the special protection provided under Section 1301 of the Code. Read literally, clause II would prevent suits against guarantors and sureties of the debtor; yet the stay is not typically construed that broadly. See, e.g., Credit Alliance Corp. v. Williams, 851 F.2d 119 (4th Cir. 1988) (Section 362(a)(1) found not to protect guarantor with no discussion of clause II). Clause II is unnecessary at best and should be eliminated.

2. Clarify that Section 362(a)(6) Does Not Limit Non-Harassing Acts by a Creditor to Assess a Claim Against the Debtor

Section 362(a)(6) of the Code stays "any act to collect, assess, or recover a claim against the debtor." This language is too broad, as it encompasses such innocuous creditor acts as hiring a collection attorney or computing the bill. Fortunately, courts, for the most part, have held that it applies only to coercive and harassing conduct which comprises part of the debt collection process and not conduct that is informative and does not seek to collect a pre-petition debt. As the Ninth Circuit noted in Morgan Guaranty Trust Co. v. American Sav. & Loan Assoc., 804 F.2d at 1491: "[p]resentment and other requests for payment unaccompanied by coercion or harassment do not appear to fall within the prohibitions of section 362(a)." Likewise, according to Collier on Bankruptcy, Section 362(a)(6) is:

intended to prevent creditor harassment of the debtor in attempting to collect pre-petition debts. The conduct prohibited ranges from that of an informal nature, such as telephone contact or dunning letters, to more formal judicial and administrative proceedings that are also stayed under paragraph (1). Simple ministerial acts, such as presentment of a note, are not included.


32 Morgan Guaranty Trust Co. v. American Sav. & Loan Assoc., 804 F.2d 147, 1491 (9th Cir. 1986), cert. denied, 482 U.S. 929 (1987) (the presentment of notes of a bankrupt maker are not barred by section 362(a) absent coercion or harassment); United States v. Nelson, 969 F.2d 626 (8th Cir. 1992) (FmHA county supervisor's letter to debtor's counsel explaining loan servicing options was not an action to collect barred by the stay); Brown v. Pennsylvania State Employees Credit Union, 851 F.2d 81, 84 (3d Cir. 1988) (a letter sent to a debtor stating that no future loans would be made without reaffirmation of an existing debt did not violate the stay); In re Sambo Restaurants, Inc., 754 F.2d 811, 816 (9th Cir. 1985) (communications that set forth fact of debt do not violate stay). Cf. In re Patterson, 967 F.2d 505, 513, (11th Cir. 1992) (holding that Credit Union's suspension of services to debtor violated stay).
Despite the clear weight of authority making the distinction between coercive collection efforts and non-harassing creditor conduct, some courts have applied the stay to non-harassing, non-collection conduct. For example, in In re Bicoastal Corp., No. 89-8191-BKC-8P1 (Bankr. M.D.Fla. May 3, 1990), aff’d, No. 90-629-CIV-T-3a98C (M.D.Fla. July 19, 1990), the district court held that a final decision by an agency’s contracting officer -- which is an agency’s formal statement of the existence and amount of its claim, and not an act to "collect, assess, or recover" a prepetition claim against the debtor -- violated the automatic stay. Debtors invoke Section 362(a)(6) to frustrate or invalidate the decision, not to protect themselves from harassment, but to gain time to appeal beyond that allowed by 11 U.S.C. §108(b).

In light of decisions like In re Bicoastal Corp., modification of Section 362(a)(6) is needed. Such modification of Section 362(a)(6) will not abrogate the protections afforded debtors in subsections 362(a)(3) through (a)(5), which protect debtors’ property and will promote efficient administration of contracts by government agencies. Accordingly, we recommend that Section 362(a)(6) be amended to apply only to coercive or harassing conduct and to exclude expressly acts required by contract or applicable law to assess or fix liability.\(^{33}\)

3. Clarify that Acts Violating the Automatic Stay Are Voidable, Not Void

Section 362(d)(1) of the Code allows the bankruptcy court to grant relief from the automatic stay "by terminating, annulling, modifying, or conditioning" the stay for cause upon request of a party. The courts agree that the power to annul authorizes the relief to be retroactive even to the date of the filing of the bankruptcy petition.\(^{34}\) Thus, under Section 362(d)(1) acts in violation of the automatic stay may be validated as if the violation had never occurred.

The courts are split, however, as to whether acts violating the automatic stay are void or voidable. Acts that are void are without effect whatsoever, \textit{i.e.}, nullities, whereas acts merely voidable are effective unless and until voided by the bankruptcy court. The First, Second, Ninth, Tenth and Eleventh circuits hold that acts violating the stay are void,\(^{35}\) while the Fifth and Federal

\(^{33}\) We also recommend that Section 362(a)(6) be clarified so that it does not overlap with the litigative actions and proceedings dealt with in Section 362(a)(1). Alternatively, Section 362(b)(4) and (b)(5) could be amended to make clear that Section 362(a)(6) does not prevent police and regulatory actions meant to be excepted under (b)(4) and (b)(5).

\(^{34}\) See 2 L. King, \textit{Collier on Bankruptcy} ¶ 362.07(15th. ed. 1996)("[t]he use of the word `annulling' permits the order to operate retroactively, thus validating actions taken by a party at a time when he was unaware of the stay").

\(^{35}\) See, \textit{e.g.}, Franklin Sav. Ass’n v. OTS, 31 F.3d 1020, 1022 (10th Cir. 1994); Hillis Motors, (continued...)
circuits hold that such acts are voidable.\textsuperscript{36} The First, Third, and Sixth Circuits seem to go both ways.\textsuperscript{37}

This split in circuits is, in one sense, merely semantic because the outcomes tend to be the same. Courts applying the "void" interpretation carve out exceptions based upon equitable principles, thereby retroactively validating actions which would normally be void. In validating void acts, courts generally consider three factors: (i) whether the creditor had knowledge of the bankruptcy, (ii) whether the debtor's unreasonable behavior contributed to maintaining the violator's ignorance, and (iii) whether the violator would be unfairly prejudiced if the stay was not

\textsuperscript{36} Bronson v. United States, 46 F.3d 1573 (Fed. Cir. 1995); Picco v. Global Marine Drilling Co., 900 F.2d 846, 850 (5th Cir. 1990); Sikes v. Global Marine, Inc., 881 F.2d 176 (5th Cir. 1989).

\textsuperscript{37} Compare \textit{In re Siciliano}, 13 F.3d 748 (3d Cir. 1994) (panel seems to espouse the "voidable not void" approach) with \textit{In re Ward}, 837 F.2d 124 (3d Cir. 1988) (acts in violation of the stay are void); and compare \textit{Easley v. Pettibone Michigan Corp.}, 990 F.2d 905, 911 (6th Cir. 1993) ("actions taken in violation of the stay are invalid and voidable and shall be voided absent limited equitable circumstances") with \textit{In re Smith}, 876 F.2d 524, 526 (6th Cir. 1989) (act in violation of the stay are void).
annulled. Those circuits that find acts in violation of the stay to be voidable rather than void, in effect apply these same equitable principles in reaching their results.

The real distinction between holding an act in violation of the automatic stay void, as opposed to voidable, is who bears the burden of moving the court to annul the stay or validate the sanctioned action. Where the violation is deemed void ab initio, the creditor generally bears the burden of moving to have the stay annulled. However, if the violation of the stay is voidable, then the debtor generally bears the burden to "affirmatively challenge creditor violations of the stay." Schwartz v. United States (In re Schwartz), 954 F.2d 569, 571 (9th Cir. 1992).

Courts that apply the "void" interpretation rely primarily upon the debtor protection policy considerations of the Bankruptcy Code to support their holding. Yet relieving the debtor from this obligation can encourage debtors to withhold notice of their bankruptcy to creditors to gain advantages against their unsuspecting creditors. Indeed, most of the cases addressing this issue turn on whether the debtor properly notified the creditor of the bankruptcy or whether the debtor unreasonably delayed in objecting to the stay violation. By making violations of the stay voidable, instead of void, such gamesmanship would be discouraged.

38 Calder v. Job (In re Calder), 907 F.2d 953 (10th Cir. 1990) (court denied debtor's objection to filing of judgment creditor's proof of claim stating that debtor's failure to provide notice of his bankruptcy to the opposing party in a state court proceeding until just before a final judgment was entered against him was deceptive and unreasonable); Matthews v. Rosene, 739 F.2d 249 (7th Cir. 1984) (lachès barred debtor's attempt to avoid a state court judgment entered nearly three years before on the basis of the automatic stay); In re Smith Corset Shops, Inc., 696 F.2d 971 (1st Cir. 1982) (debtor was not entitled to protection of automatic stay where its principal remained "stealthily silent" regarding its bankruptcy while a creditor, without knowledge of the bankruptcy, obtained a default judgment and execution in a state court trespass and ejectment action); In re Confidential Investigative Consultants, Inc., 170 B.R. 739, 752 (Bankr.N.D.Ill.1995); In re Philgo Realty Co., 185 B.R. 676 (Bankr. E.D.N.Y.1995) (where debtor remained "stealthily silent" during litigation in state court, court granted relief from the stay retroactive to date of filing of petition); In re Rothenberg, 173 B.R. 4, 14 (Bankr. D.D.C.1994).

39 See, e.g., Bronson v. United States, 46 F.3d 1573 (Fed.Cir. 1995) (where the Federal Circuit, in finding that the IRS' assessment of penalties against the debtor in violation of stay was voidable, noted as support for its decision that the debtor had failed to contest his tax liability in the bankruptcy proceeding and delayed in raising the violation of the stay issue until after the statute of limitations for assessment had run).

40 Id.; Albany Partners, Ltd. v. Westbrook (In re Albany Partners, Ltd.), 749 F.2d 670, 675 (11th Cir. 1984).
Further, the burden to challenge the stay violation is fairly placed upon the debtor. After all, the debtor always is aware of the bankruptcy, while the creditor may not be. In any event, the Code should be structured to discourage debtors from profiting from their own misconduct. For example, in *Schwartz v. United States*, 954 F.2d 569 (9th Cir. 1992), the debtor was able to have his IRS' tax assessment held void, despite the fact that he had not notified the IRS of his bankruptcy petition, and had not objected to the tax assessment during his first bankruptcy, when the assessment was made.

Because of the split in circuits and the resulting confusion in applying this section, Section 362(d)(1) should be amended to clarify that actions taken in violation of stay are voidable, not void.

4. Clarify the "Willful" Conduct Standard and the Types of Damages Available for Stay Violations

Under Section 362(h), "[a]n individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees...." The judicial construction of term "willful" in this section is in disarray. Some courts hold that a good faith belief that an act is not a violation of the automatic stay is irrelevant to determining that the violation is "willful." Others decline to award damages if the violation is the result of excusable neglect or a good faith belief that the conduct does not violate the stay. In addition, courts are split on whether a debtor may recover attorneys' fees if the debtor suffered no other

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41 See *In re Goodman*, 991 F.2d 613, 618 (9th Cir. 1993) (willful violation does not require specific intent to violate the automatic stay; good faith belief that it was not a violation not relevant to whether the act was willful); *In re Taylor*, 884 F.2d 478, 482 (9th Cir. 1989) (quoting *In re Bloom*, 875 F. 2d 224, 227 (9th Cir. 1989)); *In re Smith*, 170 B.R. 111, 117 (Bankr. N.D. Ohio 1994) (sanctions under 11 U.S.C. §362(h) not precluded by "good faith" reliance on counsel's advice); *In re Xavier's of Belville, Inc.*, 172 B.R. 667 (Bankr. M.D. Fla. 1994) (violation of the stay only requires the act be deliberate; no specific intent to violate the stay is necessary).

42 See *In re University Medical Center*, 973 F.2d 1065 (3d Cir. 1992) (act based on good faith reliance on "persuasive legal authority" which violates the stay not willful); *In re Hamrick*, 175 B.R. 890, 893 (W.D.N.C. 1994) (letter to the debtor demanding payment was not a "willful" violation of the automatic stay where it resulted from an "innocent clerical error"); *In re A & C Elec. Co., Inc.*, 188 B.R. 975, 980 (Bankr. N.D. Ill. 1995) (creditor's rational reliance, albeit misplaced, on prior precedent negated any willfulness); *In re Atkins*, 176 B.R. 998, 1008 (Bankr. D. Minn. 1994) (creditor's negligent omission is not a "willful" violation of stay); *In re Raper*, 177 B.R. 107, 109 (Bankr. N.D. Fla. 1994) (act based upon good faith reliance on legal authority not willful violation of the stay).
This lack of uniformity, in turn, creates uncertainty, enhances the prospect of litigation, and promotes disparate results. Clarification is clearly justified.

The jurisprudence which holds sanctionable a reasonable good faith belief that an act is excepted from the automatic stay is not only inconsistent with the intent of Congress, but also bad policy. Congress specified the acts that are stayed upon the commencement of a bankruptcy case in Section 362(a). Some of those acts are described in broad terms, such as "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." Likewise, Congress created 18 express exceptions to the application of the automatic stay under Section 362(b). Some of the broader exceptions clearly implicate public safety, health, and welfare, and speedy and sometimes confidential action is clearly contemplated, e.g., 11 U.S.C. §362(b) (1) and (4).

Congress thus anticipated that parties would take action that they deemed, in good faith, to be excepted from the automatic stay without obtaining court approval. Further, Congress recognized that a threat to the public health, safety, and welfare outweighs the debtor's interest in being afforded a 'breathing spell' for purely economic reasons. In such a case, good faith reliance on advice of competent counsel after disclosure of all material facts should be a defense to a claim under Section 362(h). Otherwise, entities, especially government regulators, may be dissuaded from taking reasonable and lawful action against a debtor which, if taken promptly, would avert the risk of injury to innocent persons and property.

In addition, no award of attorneys' fees and costs should be permitted in the absence of other pecuniary loss. Inadvertent, but harmless, violations of the stay are inevitable. The Bankruptcy Code should not spawn litigation in such instances. Successful bankruptcy practice emphasizes cooperation possibly more than any other area of the law; parties with limited resources should be encouraged to apply those resources to their successful reorganization and not pursue actions that do not result in injury. Indeed, there is ample leeway to award actual and punitive damages, including attorneys' fees and costs, for violations of the stay that result in pecuniary loss. The bankruptcy courts are vested with equitable powers which allow them to fashion more appropriate, and less divisive, means of redressing inadvertent and harmless

43 See In re Belcher, 189 B.R. 16, 18-19 (Bankr. S.D. Fla. 1995) (court awarded only $20.00 of $1,400.00 request for attorneys' fees since "counsel could have prevented this whole fiasco by a simple notice to [the creditor] at the time of filing," there was no benefit to the debtor.); In re Brock Utilities & Grading, Inc., 185 B.R. 719 (Bankr. E.D.N.C. 1995) (no award under § 362(h) where the debtor suffered no injury as result of IRS inadvertent computer generated demand for payment and the costs of bringing motion to sanction the IRS were the only damages suffered by debtor); In re Houseworth, 177 B.R. 557 (Bankr. N.D. Ohio 1994) (attorneys' fees not allowed if debtor could have prevented creditor's mistaken violation); In re Beair, 168 B.R. 633, 638 (Bankr. N.D. Ohio 1994) (general discussion of standards for recovery).
violations of the stay as opposed to allowing a windfall to aggressive, opportunistic advocates. As at least one court has observed, awarding damages in the case of an inadvertent violation absent actual damages "in today's computer-controlled financial world, would amount to nothing less than a windfall for debtor's attorneys where no true injury results." Hamrick, supra at 893. Congress should not countenance such a result.

Accordingly, we recommend that Section 362 be modified to provide expressly that: (i) a reasonable, good faith belief that the act committed in violation of the stay is excepted therefrom may be raised as defense to a claim under Section 362(h); and (ii) attorneys' fees and costs may be awarded under Section 362(h) only upon a showing of some other actual pecuniary loss or injury.

E. Amend the Actual Notice Provisions of Section 523(a)(3)

Under current law, a debt in an individual debtor's case is not discharged if not listed or scheduled in time for the creditor to file a timely proof of claim (or, if required, to file a timely request for determination of discharge), unless the creditor had notice or actual knowledge of the case in time for such filing. 11 U.S.C. § 523(a)(3) (A) and (B). Thus, where a creditor has notice or actual knowledge of the case, the debt is discharged, despite the debtor's failure to list the creditor on the schedules or mailing.44

Ostensibly, Section 523(a)(3) punishes a debtor for a failure to list or schedule a particular debt. In practice, however, Section 523(a)(3) places an undue burden on an unscheduled creditor that learns of the bankruptcy proceeding through an outside source, but does not learn of the actual bar dates.45 In such cases, the majority of courts interpret Section 523(a)(3) to require the creditor to take immediate, affirmative action to learn the bar dates and, if necessary, seek an extension of time to file a complaint for determination of dischargeability.46

44 The debtor, at least in theory, must account for his debts. Upon the filing of a bankruptcy petition, a debtor is required to file with a clerk of the court a list all known creditors and a schedule of assets and liabilities. 11 U.S.C. § 521. The clerk is responsible for sending notices of the bankruptcy proceedings, including a 30 day notice pursuant to Bankruptcy Rule 4007 advising creditors of the bar date for filing requests for determinations of discharge, to all scheduled creditors.

45 For example, a creditor may learn of a pending bankruptcy proceeding fortuitously from a third party, In re Walker, 149 B.R. 511 (Bkrtcy.N.D.Ill. 1992); through an attorney, In re Compton, 891 F.2d 1180 (5th Cir. 1990); or through informal notice from the debtor, In re DeWalt, 961 F.2d 841 (9th Cir. 1992).

46 See, e.g., In re Compton, 891 F.2d 1180; In re Green, 876 F.2d 854 (10th Cir. 1989); In re Alton, 837 F.2d 457 (11th Cir. 1988); Neeley v. Murchison, 815 F.2d 345 (5th Cir. 1987).
The Code should encourage a creditor's receipt of meaningful notice before its debts are discharged. Current law unfairly places upon the creditor the burden of knowing or discovering the impact of bankruptcy on a debt and the steps necessary to protect a creditor's rights. Further, it invites abusive behavior. That is, unscrupulous debtors can knowingly omit a debt from their schedules yet informally advise the creditor that they are in bankruptcy. This seeks to exploit uninformed or less zealous creditors who fail to act timely to protect themselves upon learning of the pendency of a bankruptcy. As the Ninth Circuit recognized, this section punishes creditors for a situation caused by the debtors, by holding creditors to the highest standards of due diligence, while at the same time rewarding debtors for their negligence or intentional neglect. In re Dewalt, 961 F.2d at 850.

The debtor's incentive to omit a known creditor is especially great if the creditor has knowledge that would bar the debtor's discharge. If the debtor's case has "no assets," this unscrupulous strategy costs nothing. Two circuits hold that unscheduled debts are discharged where no bar date is established; they reason that the exception is not invoked because, where no proofs of claims are filed, the unscheduled debt is just as capable of "timely filing" as the scheduled debts. Judd v. Wolfe, 78 F.3d 110 (3rd Cir. 1996); In re Beezley, 994 F.2d 1433 (9th Cir. 1993). This reasoning effectively reads Section 523(a)(3) out of no assets cases. Further, two other circuits allow debtors to "amend" schedules to add the omitted creditor after the discharge has become effective. Matter of Stone, 10 F.3d 285 (5th Cir. 1994); In re Stark, 756 F.2d 547 (1985). Thus, these debtors need not risk giving notice to the creditor who could prevent their discharge yet can still, most likely, get the omitted creditor's debt discharged.

In addition, courts are split over the sufficiency of notice between cases of individual debtors and those of corporate debtors in Chapter 11. In a Chapter 11 reorganization, the creditor has a "right to assume" that it will receive future notices required by the Code before his claim is forever barred. City of New York v. New York, New Haven & Hartford Railroad Co., 344 U.S. 293 (1953). Several circuits hold that a creditor's actual knowledge of the bankruptcy imposes no duty of inquiry; rather, due process requires formal notice before a claim can be discharged. Yet, numerous circuit courts hold that section 523(a)(3) (B) does not offend due

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47 The "right to assume" future notices has its genesis under the former Bankruptcy Act, where the Bankruptcy Judge was responsible for setting filing dates. Under the Code, filing dates in Chapter 7 cases are set in either the statute or in the Bankruptcy Rules. E.g., Rule 4007(c) requires a creditor to file a complaint to determine dischargeability within 60 days from the first meeting of the creditors.

48 See In re Maya Constructions, Co., 78 F.3d 1395, 1399 (9th Cir. 1996); In re Spring Valley Farms, 863 F.2d 832, 834 (11th Cir. 1989); Broomall Indus. v. Data Design Logic Systems, 786 F.2d 401, 405 (Fed. Cir. 1986); Reliable Electric Co. v. Olson Construction Co., 726 F.2d 620, 622 (10th Cir. 1984).
process by requiring creditors with actual knowledge of a bankruptcy proceeding to act to protect their rights.\textsuperscript{49} Fairness and consistency requires that this split in the circuits be resolved.

We recommend a "bright line" rule -- that debts known to the debtor that are not listed in the debtor's schedule are not discharged. Our amendment would continue to allow the discharge of a nonscheduled debt in case of an unknown creditor who, nevertheless, had notice or actual knowledge of the individual debtor's case. This discharge, however, would be expressly conditioned on such creditor receiving the notice in time to participate meaningfully in the case which is, after all, the point of receiving notice. To participate meaningfully means more than the opportunity to file a proof of claim. Many bankruptcy proceedings have no assets where no proofs of claim are filed, yet creditors still have important interests at stake. For example, they may wish to object to discharge. If denied that opportunity by a failure to receive notice, the creditor's debt should not be discharged.

We propose that Section 523(a)(3) be amended as follows:

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt --

\* \* \*

"(3) neither listed nor scheduled under section 521(1) of this title in time to permit the creditor to participate in the case except in the case of a creditor who is unknown to the debtor and who had notice or actual knowledge of the case in time to participate. To participate in the case shall include the timely opportunity, if any, to file a proof of claim, object to discharge and, in the case of a debt of a kind specified in paragraphs (2), (4), or (6) of this subsection, request a determination of the dischargeability of the debt;"

\textsuperscript{49} See In re Williamson, 15 F.3d 1037 (11th Cir. 1994); In re Sam, 894 F.2d 778, 782 (5th Cir. 1990); In re Green, 876 F.2d 854, 857 (10th Cir. 1989); In re Price, 871 F.2d 98, 99 (9th Cir. 1989); Alton v. Byrd, 837 F.2d 457, 460 (11th Cir. 1988).
II. BUSINESS AND PARTNERSHIPS ISSUES

A. Provide for the Expendituous Conversion or Dismissal of Reorganizations Not Likely to Succeed

The Bankruptcy Code should be amended so that cases with little or no chance of confirmation are quickly identified and then expeditiously converted or dismissed.

While, generally, there is need for more empirical data about the operation of the bankruptcy system, available statistics -- particularly the fact that 90 percent of Chapter 11 bankruptcies eventually result in liquidation -- do suggest that many Chapter 11 bankruptcies drag on and could be dismissed or converted much earlier in the process. A recent study suggests that the key to shortening the time to the dismissal or conversion of a case is to place the bankruptcy judge in the position to determine early on whether a feasible reorganization is possible. See Hon. Samuel L. Bufford, "Chapter 11 Case Management and Delay Reduction: An Empirical Study," 4 Am. Bankr. Inst. L. Rev. 85 (1996). In that study, Judge Samuel Bufford found that a procedure under which the bankruptcy judge assessed likely feasibility in most cases within four months of filing, reduced by 24.1 percent the time to confirmation of Chapter 11 plan, shortened by 44.1 percent the time to conversion under chapter 7; and diminished by 53.5 percent the time to dismissal of a typical nonviable chapter 11 case. Overall, the time until the disposition of the cases in the study decreased by 45.4 percent. Id.

The U.S. Trustee Program currently is exploring the creation of a National Bankruptcy Research Database. We urge the Commission to endorse efforts, such as this, to gather data that would illuminate the discussion of bankruptcy policy. See Elizabeth Warren, "Bankruptcy Policymaking in an Imperfect World," 92 Mich. L. Rev. 336, 376 (1993) ("An analysis of actual outcomes depends on empirical evidence, which is currently missing from the bankruptcy debates").

The most comprehensive study of Chapter 11 bankruptcies was conducted by Ed Flynn of the Administrative Office of United States Courts. This study of 2,395 Chapter 11 cases with confirmed plan found that it took a median of nearly 22 months to reach confirmation. It also found that only 17 percent of the cases studied actually resulted in confirmation. The study found that about one-third of confirmed plans were liquidating plans, thus leaving only about 10 percent of the cases studied resulting in a successful reorganization. See Ed Flynn, Admin. Off. of U.S. Cts., Statistical Analysis of Chapter 11 13 (Oct. 1989), discussed in Hon. Samuel L. Bufford, "Chapter 11 Case Management and Delay Reduction: An Empirical Study," 4 Am. Bankr. Inst. L. Rev. 85 (1996).

Other studies also indicate that adopting more effective case management procedures can reduce the time associated with dismissing, converting and confirming cases. See also Lisa Hill Fenning & Craig A. Hart, "Measuring Chapter 11: The Real World of 500 Cases," 4 Am. Bankr. Inst. L. Rev. 119, 161 (1996).
The Commission has been studying ways to promote the expeditious dismissal or conversion of Chapter 11 cases. As part of this analysis, we recommend that the Commission consider amending 28 U.S.C. § 586 to permit the United States Trustee to file reports on the progress of Chapter 11 cases, with financial analysis of the debtor and, where possible, an estimate of the likelihood of the debtor reaching confirmation. The authority to issue these reports would significantly enhance the ability of the United States Trustee to move cases through the bankruptcy system and would assist the court in more quickly determining viability.

The benefits from reducing delays in Chapter 11, particularly in converting or dismissing unfeasible reorganizations, could redound to all involved in the bankruptcy system. It could benefit debtors by removing the dark, financial cloud that lingers over reorganizations. For debtors who can demonstrate viability, credit could be reestablished more quickly with suppliers and critical customers retained; for those debtors who are less fortunate, the transaction costs of bankruptcy could be reduced. Reducing delays could benefit creditors, including the United States, by limiting the expenses involved in bankruptcy, accelerating the payment of debts and the release of collateral. Finally, more expeditiously converting or dismissing Chapter 11 cases could reduce the workload of bankruptcy judges, allowing them to concentrate their efforts on other bankruptcy matters.

While the bankruptcy system would benefit from avoiding drawn out Chapter 11 proceedings doomed to failure, we do not believe that accomplishing this requires, as some have contended, eliminating the concept of debtor-in-possession (DIP). The drafters of the Bankruptcy Code of 1978 evaluated the two structures of reorganization that existed under the Bankruptcy Act: Chapter X, that required the appointment of a trustee, and Chapter XI, that permitted the debtor to continue to operate the business. H.R. No. Rep. 95-595, 95th Cong. 1st Sess. 232-34 (1977). Congress designed Chapter 11 to give the debtor an opportunity to reorganize before losing possession of the business, concluding:


While Chapter 11 filings represent less than 3 percent of the bankruptcy case load, a 1991 study of bankruptcy court workload indicates that 36.7 percent of case-related work time is spent on such cases. See Gorden Bermant, et al., "A Day in the Life: The Federal Judicial Center's 1988-1989 Bankruptcy Court Time Study," 65 Am. Bankr. L. J. 491, 493-94 (1991). This study also reported that 27.4 percent of court time was spent on adversary proceedings. Judge Bufford has speculated that half of that time is spent in Chapter 11 cases, so that, in total, bankruptcy judges spent over half their time during the study period on Chapter 11 cases. Hon. Samuel L. Bufford, "Chapter 11 Case Management and Delay Reduction: An Empirical Study," 4 Am. Bankr. Inst. L. Rev. 85, 92 n.50 (1996).
The public and the creditors will not necessarily be harmed if the debtor is continued in possession in a reorganization case, as has been demonstrated under current chapter XI. In fact, very often the creditors will be benefitted by continuation of the debtor in possession, both because the expense of a trustee will not be required, and the debtor, who is familiar with his business, will be better able to operate it during the reorganization case.

Id. at 233. The drafters framed Chapter 11 in the Bankruptcy Code to permit the debtor to continue in possession after the filing, 11 U.S.C. §§ 1107, 1108, unless cause exists for appointment of a trustee, 11 U.S.C. § 1104, with an exclusive 120 day period after the filing to file a plan, and an exclusive 180 day period after the filing to obtain the necessary acceptances of the plan, 11 U.S.C. § 1121.

We believe that the historical rationale for a debtor's continued possession remains viable. Calls for abandoning the "debtor in possession" structure of Chapter 11 often rely on claims that the current structure "takes too long," it "costs too much," it gives the debtor "too much control," and does not foster reorganization of ongoing enterprises. See Lynn M. Lopucki, "Chapter 11: An Agenda for Basic Reform," 69 Am. Bankr. L. J. 573, 573-79 (1995) (summarizing the major criticisms of chapter 11). While these criticisms may be subject to debate, we believe that the overarching goals of reducing cost and delay, while fostering reorganizations, can be accomplished by expeditiously evaluating the potential for a successful reorganization and without appointing a trustee in every case. Indeed, it is far from clear that allowing debtors to remain in possession is responsible for any the problems experienced by the bankruptcy system -- the 10 percent of reorganizations that do succeed might well be attributable to allowing the debtor to reorganize, while the 90 percent of failures might occur regardless.

B. Clarify the Status of an Executory Contract In the "Limbo" Period Between Filing and Assumption/Rejection Requiring a Debtor to Comply with the Contract Unless Expressly Excused by the Bankruptcy Code

Section 365 of the Code gives a DIP the right to assume or reject an executory contract or unexpired lease. Pursuant to Section 365(d)(2), the DIP may assume or reject the executory contract or unexpired lease of personal property or residential real property at any time before the confirmation of a plan of reorganization. Upon request of a non-debtor party to an executory contract or unexpired lease, a bankruptcy court may -- but need not -- order the DIP to assume or reject the contract or lease within a "reasonable time." 11 U.S.C. §365(d)(2). The period of time for assuming or rejecting a lease of non-residential real property is 60 days after the date of the filing of the petition or within such additional time as the court orders. Case law has held that the

This situation has developed through the lower courts interpretation of the Supreme Court ruling N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513 (1984). The Bildisco decision specifically held that the filing of a petition in bankruptcy makes the executory contract or unexpired lease unenforceable until it is formally accepted by the DIP.\textsuperscript{57} If it is not assumed within this time, such lease is deemed rejected and surrendered to the non-debtor party. 11 U.S.C. §365(d)(4).

In the 1994 amendments to the Bankruptcy Code, Congress limited the time for a debtor to accept or reject leases in liquidations and non-residential real property leases in all cases. \textit{See}\ 11 U.S.C. §§ 365(d)(1) & (4). The purpose of these amendments, as explained in the legislative history of the 1994 Act, is to specify that:

The amendment to subsection (d) specifies that 60 days after the order for relief the debtor must perform all obligations under an equipment lease, unless the court, after notice and a hearing and based on the equities of the case, orders otherwise. This will shift to the debtor the burden of bringing a motion while allowing the debtor sufficient breathing room after the bankruptcy petition to make an informed decision.


The rationale of these amendments should be applied to all executory contracts, not just equipment leases. Except in equipment leases, under the current Code, a non-debtor contractee is held in "limbo" at the mercy of the debtor, prior to the assumption of the contract. During the period from the date of filing until the date on which the DIP rejects or assumes the contract, the non-debtor party is bound to perform while the DIP is not bound to do anything. The debtor thus can sit back and reap the benefits of a residential real property or personal property executory contract from the date of the order for relief up to and including the date of confirmation of the plan -- a period that often exceeds a year. The creditor, on the other hand has no ability to enforce the terms of the contract and is without recourse as to damages or terms of the contract\textsuperscript{58}. The present state of the Code does not allow requests for relief from stay during this post-petition, pre-assumption period.\textsuperscript{59} Instead, the non-debtor party at the time of rejection has an

\textsuperscript{57} This situation has developed through the lower courts interpretation of the Supreme Court ruling N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513 (1984). The Bildisco decision specifically held that the filing of a petition in bankruptcy makes the executory contract or unexpired lease unenforceable until it is formally accepted by the DIP. \textit{Id.} at 532.

\textsuperscript{58} A non-debtor party can bring a motion to request the court to order the trustee/DIP to determine within a "specified period of time" whether the contract will be assumed or rejected. 11 U.S.C. §365(d)(2).

\textsuperscript{59} The courts that have denied relief have asserted that until the contract is assumed it does not become part of the bankruptcy estate. \textit{In re Tonry}, 724 F.2d 467, 469 (5th Cir. 1984).
administrative claim for post-petition value of services. This claim can only be made for the "reasonable value of the services received," Philadelphia Co. v. Dipple, supra, at 174, which often is less than the amount specified in the executory contract. If the DIP does not receive any benefits the non-debtor party may have at best a general unsecured claim against the estate. The non-debtor party thus is effectively without any alternatives for relief and clearly left in an inequitable position.

To change this, we recommend that the Bankruptcy Code be amended to provide under Section 365(d)(2) as follows:

(2) In a case under chapter 9, 11, 12, or 13 of this title, the trustee must assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor within 60 days after the order for relief, but the court, on the request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease. (bold indicates additions.)

In addition, we recommend that a new paragraph be inserted under subsection (d) that provides:

( ) Notwithstanding the provisions for assumption or rejection provided in paragraphs (1) and (2), the parties (including the trustee or DIP) are bound to comply with the terms of any executory contract or unexpired lease of residential real property or of personal property prior to the motion for assumption or rejection. The court may, during the 60 day period prior to assumption or rejection, upon request of the debtor grant relief from the provisions of the contract for cause.

These amendments follow the standards set forth by Congress when they adopted the 1994 amendments and should be incorporated for the same reasons.

Under these provisions, the debtor and other parties to the contract would be bound by the terms of an executory contract. The debtor would, any time after the date of filing the order for relief, but prior to an actual motion to assume or reject, be allowed to bring a motion requesting relief from the terms of the executory contract. At the same time, the debtor would have breathing room to make a decision regarding assumption or rejection, protected by the automatic operation of Section 362. At the time the motion requesting relief from the executory contract is brought, the court could hear the equities of the case and elect to order the requested relief or otherwise. The non-debtor, in the meantime, could proceed to operate as if the contract has been assumed or apply for relief from the automatic stay.

Bildisco, 465 U.S. at 531. The non-debtor party may also have a general unsecured claim for any accrued unpaid rent due under the contract pre-petition as well as for any damages for amounts due under the remaining term of the lease.
C. Clarify the Applicable Non-Bankruptcy Limitations on a Debtor's Ability to Assume a Government Contract

Section 365 of the Code allows a debtor to assume or reject an executory contract with specific exceptions. In this regard, Section 365(c) provides, in pertinent part, that "[t]he trustee may not assume ... any executory contract ... if ... applicable law excuses a party, other than the debtor, to such contract ... from accepting performance from ... an entity other than the debtor ... and ... such party does not consent to such assumption ...." 11 U.S.C. §365(c). In our view, this language poses a simple hypothetical test: if the debtor could not assign the contract, the debtor may not assume it.

The Department has argued that the courts must apply the plain language of this statute and deny assumption if any law excuses the nondebtor from accepting performance. In particular, the Department has stressed that "applicable law" for this purpose includes the Assignment of Claims Act. The Assignment of Claims Act, commonly referred to as the Anti-Assignment Act, declares: "No [government] contract . . . shall be transferred by the party to whom such contract . . . is given to any other party, and any such transfer shall cause the annulment of the contract . . . transferred, so far as the United States are concerned." 41 U.S.C. § 15. In our view, because the Anti-Assignment Act prohibits the assignment of most government contracts, a debtor may not assume most government contracts under Section 365(c).

The Third Circuit adopted this reading of Section 365(c) in In re West Electronics, Inc, 852 F.2d 79, 83 (3d Cir. 1988), holding that the hypothetical test for determining whether the debtor can assume the contract is whether, "under applicable law, could the government refuse performance from 'an entity other than the debtor or the debtor in possession'" (emphasis in original). Id. at 103. "The literal meaning of the words chosen by Congress," the court reasoned, "clearly requires the analysis and conclusion we have just articulated and we are confident that it is what Congress intended." Id. Other courts, however, have held that: (i) Section 365(c) applies only to nondelegable personal service contracts; (ii) the phrase "applicable law" in Section 365

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For example, contracts "to make a loan, or extend other financing or financial accommodations" are unassumable. 11 U.S.C. § 365(c)(2).

See In re Optimum Merchants Servs., 163 B.R. 546, 554-55 (Bankr. D. Neb. 1994) (rejects West Elecs.'s hypothetical test; holds that Section 365(c) only applies to personal services contracts); In re Terrace Apartments, 107 B.R. 382 (Bankr. N.D. Ga. 1989); In re Fulton Air Serv., 34 B.R. 568 (Bankr. N.D. Ga. 1983) (Section 365(c)(1) applies only to nondelegable personal service contracts).
means laws other than general prohibitions against assignment;\textsuperscript{63} and (iii) Section 365(c) applies only to contracts which the debtor wishes to assign to a third party and not to those it wishes to assume and perform itself must be rejected.\textsuperscript{64} While various courts have explicitly rejected these limitations,\textsuperscript{65} the effectiveness of Section 365(c) has been somewhat diminished.

None of the judicial limitations on Section 365(c) has textual support. Section 365(c) states, without limitation, that if "applicable law" prohibits an assignment, the debtor cannot force an assumption or assignment on its contracting party. Regardless of the policy reasons one might perceive for restricting the scope of this exception to the debtor's power to assume executory contracts, the dispositive statutory language simply will not bear the weight of the strained interpretations proposed by some courts. As the Fifth Circuit declared in reversing a district court that had accepted such a limitation, "[n]othing in the statute authorized the district court to depart from the express language of § 365(c)." \textit{Braniff}, 700 F.2d at 943. Whatever "the impetus for Congress' enactment of § 365(c)," the \textit{Braniff} court concluded, "the drafters actually codified a much broader principle. Surely if Congress had intended to limit § 365(c) ... its members could have conceived of a more precise term ...." \textit{Id}. Because "applicable law" plainly includes a statute such as the Anti-Assignment Act, courts "must enforce the statute according to its terms." \textit{Id}. That is, because the Anti-Assignment Act prohibits a contractor from assigning a government contract to a third party and "applicable law" is an exception to a debtor's power to assume or assign its contracts, a debtor cannot assume an executory contract absent the United States consent.

\textit{In In re James Cable Partners, L.P.}, 27 F.3d 534 (11th Cir. 1994), the Fourth Circuit reached this conclusion in an effort to reconcile the plain language of Section 365(c) with Section 365(f)(1), which states that: "[e]xcept as provided in [§ 365(c)], notwithstanding a provision in an executory contract ... or in applicable law, that prohibits, restricts, or conditions the assignment of such contract ... the trustee may assign such contract ...." \textit{Id}. Because "applicable law" plainly includes a statute such as the Anti-Assignment Act, courts "must enforce the statute according to its terms." \textit{Id}. The court of appeals saw these two sections as being in conflict, reasoning that if Section 365(c) meant all applicable non-bankruptcy law, Section 365(f)(1) would be superfluous.


Despite the seemingly clear import of the law, the confusion among the circuits and lower courts is widespread and makes litigation by governmental attorneys difficult. For these reasons, Section 365(c) should be modified to make clear that the Anti-Assignment Act and other similar statutes bar debtors from assuming contracts.

D. Amend Section 1129(a)(10) to Require that the Qualifying Class Be Impaired Substantially

Section 1129(a)(10) of the Code, conditioning confirmation of a plan of reorganization on acceptance by at least one impaired class, has resulted in artificial impairment and other forms of class manipulation, thereby circumventing the intent of the section to provide to dissenting creditors, especially in single-asset cases, a degree of protection against cramdown of a plan which modifies their debt.

Section 1129(a)(10) was amended by BAFJA to ensure that if any class of claims is impaired under a proposed plan of reorganization, at least one such class must accept the plan, excluding acceptance by any insider, in order for it to be confirmed. The section was intended to provide a degree of protection to dissenting creditors who, under the prior Bankruptcy Act, had no leverage, even in single-creditor cases, to prevent cramdown of a plan that modified their debt. Prior to 1984, confirmation was conditioned upon acceptance of the plan by at least one class of claims. Since creditors with unimpaired claims were not allowed to vote but were deemed to have accepted the plan, courts were divided over whether this "deemed acceptance" by an unimpaired class was sufficient" or whether an affirmative vote by an impaired class was required. The 1984 amendment to Section 1129(a)(10) was intended to clarify that only an affirmative vote by an impaired class can satisfy the requirement.

Whether a claim or interest is impaired is determined by reference to Section 1124 of the Code. Under that section, a claim or interest is impaired unless, among other things, the plan "leaves unaltered the legal, equitable and contractual rights to which such claim or interest entitles the holder..." 11 U.S.C. §1124. One problem with this definition is that while the term "impair" is commonly understood to mean to worsen in some way, 68 Section 1124 has been construed not to require the alteration to be material as opposed to nominal, 69 or even to be adverse to the

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Webster's New Collegiate Dictionary (5th Edition 1977) defines the term "impair" to mean "to make worse by or as if by diminishing in some material respect...."

creditor. The courts have held that the alteration can even be favorable, improving the position of the creditor, while still causing that creditor's claim to be treated as impaired for purposes of Section 1129(a)(10).

An incentive, therefore, exists to manipulate or gerrymander classes by, for example, impairing a friendly class which can nonetheless be counted on to vote in favor of the plan. This is often referred to as artificial impairment. Similarly, in single-asset cases with few creditors, there exists the incentive to "manufacture" creditors by intentionally incurring debts prior to, and in contemplation of, filing the bankruptcy petition so as to enhance the ability to create a friendly creditor class. Although courts once held that under Section 1129(b)(1) artificial classification was both unfair, discriminatory, and thus prohibited, that is no longer the prevailing view. Artificial classification is commonly accepted today as a legitimate method by which to obtain dischargeability questions. For example, Section 1144 of the Code provides for revocation of discharge if the order of confirmation was obtained through fraud.

One of the leading cases initially addressing artificial impairment was In re Pine Lake Village Apartment Co., 19 B.R. 819 (S.D.N.Y. 1982), in which the court ruled that the practice was unfairly discriminatory under Section 1129(b)(1). A series of subsequent cases followed the ruling in Pine Lake. However, a new line of cases developed in the mid 1980's which departed from that analysis and upheld the practice. See Peter E. Meltzer, "Disenfranchising the Dissenting Creditor Through Artificial Classification or Artificial Impairment," 66 Am. Bankr. L.J. 281, 290-294 (1992).
confirmation of a plan. The protection that Section 1129(a)(10) was intended to afford is, thereby, circumvented.

The Commission on the Bankruptcy Laws of the United States recommended in their 1973 report that the concept of impairment be defined to include material and adverse effect on the claim. Commission on the Bankruptcy Laws of the United States, Report of the Commission on the Bankruptcy Laws of the United States, H. Doc. 93-137 (Part II), 93d Cong., 1st Sess. 252 (1973). Congress did not follow that recommendation when amending Section 1129(a)(10) in 1984, although the reasons why are unclear from the legislative history. We believe there are obvious benefits in employing such a requirement. First, requiring material and adverse impairment, i.e., substantial impairment, would more closely achieve the result which Congress apparently intended -- to afford some degree of protection to dissenting creditors, especially in single-asset cases, who, under the prior Bankruptcy Act, had no leverage to prevent cramdown of a plan which was uniformly opposed by affected creditors. Second, requiring substantial impairment would serve to reduce or eliminate artificial impairment of classes in an effort to find or create a friendly class of impaired creditors since it is unlikely that the class would remain friendly if its claims were materially and adversely affected. As a result, classes impaired under a plan would more likely be the result of the legitimate efforts of the debtor to reorganize, rather than the manipulation or gerrymandering of classes for the sole purpose of obtaining affirmative votes. Likewise, in single-asset or other cases with few creditors, a requirement of substantial impairment would serve to reduce or eliminate the pre-filing manufacturing of creditors.

The requirement of material and adverse effect on the claim was part of the prior Bankruptcy Act, but the terms were eliminated by amendment. It can, therefore, be argued that the failure of Congress to retain those concepts indicates that they should not, and were not intended to, be part of the process of satisfying Section 1129(a)(10). At least one commentator has noted, however, that Congress did not in the prior Bankruptcy Act:

enunciate what specific methods of treatment would produce 'material and adverse' effect. As a result, the concept of 'material and adverse' effect was developed by caselaw interpretation. Such case-by-case interpretation, however, generated

See Linda J. Rusch, "Gerrymandering the Classification Issue in Chapter 11 Reorganizations," 63 U. Colo. L. Rev. 163, 205 (1992) ("Based upon an analysis of the Code's language, legislative history, structure, and purposes, and an analysis of pre-Code law, this article concludes that such classification is a permissible tool that can be used by the debtor to create a confirmable plan.")

See In re Barrington Oaks General Partnership, 15 B.R. 952, 959 (Bankr.D.Utah 1981) ("Impairment originated with, if it was not derived from, Section 107 of the [prior Bankruptcy] Act, former 11 U.S.C. Section 507, which provided that 'creditors' or 'any class thereof' was 'affected' for purposes of a plan' only if their or its interest shall be materially and adversely affected thereby.")
'inherent ambiguities.' To resolve these ambiguities, Congress enacted new Code section 1124...\(^77\)

The House Report on the 1978 bankruptcy amendments states that Section 1124 was intended "to indicate when the contractual rights of creditors...are not materially affected."\(^78\) Thus, the failure of Congress to retain the specific terms does not necessarily indicate an intention to abandon the results accomplished by those terms.

Section 1129(a)(10) should be amended to require the qualifying class under that section to be substantially impaired. Substantial impairment should be defined to mean a material and adverse effect on the impaired claim.

**E. Amend Section 1129(a)(10) to Allow Cramdown Only Where a Majority of All Impaired Claims Votes for the Chapter 11 Plan**

Under Chapter XII of the Bankruptcy Act, debtors were able to invoke the cramdown provisions even where the plan had not been accepted by any dissenting creditor whose claim was impaired thereunder. In amending Section 1129(a)(10) to require the assent of at least one class of impaired claims, Congress attempted to rectify that situation. As noted above, the amendment to Section 1129(a)(10), however, has not achieved the result that Congress intended.

In the foregoing segment, we recommend the Commission consider requiring that qualifying classes under Section 1129(a)(10) be "substantially impaired" -- a defined phrase that, contrary to some court decisions, would follow the everyday meaning of the phrase. Another part of the solution to this problem would be to amend Section 1129(a)(10) to condition confirmation, and thus cramdown, on obtaining affirmative votes by a majority of impaired classes rather than just one such class.\(^79\) There are several advantages to employing such an approach.

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One commentator has indicated that Section 1129(a)(10):

causes debtors to attempt to create friendly creditors, to impair classes that need not be impaired and to manipulate the classification. This causes secured creditors to purchase claims, and causes all parties to expend considerable time and attorneys fees litigating such issues. If Congress still believes this serves some important reorganization purpose sufficient to justify the time and expense of the parties and the courts, it ought to redefine the voting process to specify what kind of creditor support it deems essential, and how that support should be voiced.
First, it would effectively prevent or reduce the persistent manipulation of claims classification since the debtor would not be able to single-out one class for most-favored treatment but would instead have to consider all impaired classes in formulating a plan of reorganization. Second, such an approach would encourage more even-handedness and less discrimination in the calculation of the amount that each impaired class receives on their claims. Third, it would be in keeping with the approach that Congress has taken of requiring some indication of creditor support for a plan before it can be confirmed. Finally, such a threshold requirement would have the added benefit of encouraging debtors or other plan proponents to place similarly situated creditors together in the same classes.

One might argue that this amendment would give impaired creditors an effective veto power over confirmation, especially in single-asset and other cases with few creditors. However, it should not be forgotten that cramdowns in single-asset real estate cases led to enactment of Section 1129(a)(10), and in many single-asset cases, that subsection already provides the impaired creditor with effective veto power. Nonetheless, to abate concern over how such a requirement would affect other cases with few creditors, the provision could be triggered only when a threshold number of impaired classes exist.

F. Clarify that Valuation of a Secured Claim Under Section 1129(b)(2) Should Be as of the Date of Filing of the Petition

Section 1129(b)(2) of the Code provides the basis for what is commonly known as the "fair and equitable" test. It requires simply that the plan of confirmation meet certain standards of fairness as to creditors or security holders. This is particularly important in cases where machinery/equipment may depreciate from the date of filing to the effective date of the plan. Where the plan does not meet these standards, it cannot be approved by the court. Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939). The premise of this "cramdown" subsection is that it permits confirmation of the plan notwithstanding nonacceptance by an impaired class if that class and the classes lower in priority are treated in accordance with the absolute priority rule.

Section 1129(b)(2)(A)(i)(II) contains language specifically addressing the issue of valuation of a secured claim. It states that the plan must provide that each holder in each secured class receive at least "the allowed amount of such claim, of a value, as of the effective date of the plan,...". The accompanying legislative reports also indicate that Congress intended that the property be valued "as of the effective date of the plan," including secured claims. H. Rep. No. 595, 95th Cong., 1st Sess. 414-15 (1977). The majority of the courts have followed this line of thinking in determining that the property of the estate should be valued at the time of the effective

The majority rule is that property is valued at the time of confirmation. \(^{80}\) However, a minority of courts has held the date of valuation should be the date of filing of the petition. \(^ {81}\)

Two other Code sections should be considered in making a determination as to the date to be used for valuation of a secured claim: Sections 502(b) and 506(a). Section 502(b) provides that when a proof of claim is filed, the claim is "deemed allowed, unless a party in interest ... objects". Subsection (b) provides that when there is an objection the court "shall determine the amount of such claim ... as of the date of the filing of the petition, ...". Courts that hold the date of petition should be used for valuation have relied on this section. \(\text{In re Beard, supra.}\) Section 502 when read in concert with Section 506(a) further supports the position that the date of the filing of the petition should be used as the date of valuation. Section 506(a) equates the claim to the "value of such creditor's interest in the estate's interest in such property" and indicates that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition...." Finally, Section 552(a) should be considered as to the post-petition effect on the secured status. Section 552(a) states the general rule that a pre-petition security interest does not reach property acquired by the estate or debtor post-petition.

When applying the aforementioned Bankruptcy Code sections in concert, the conclusion can easily be drawn that the secured claim should be valued as of the date of the filing of the petition. \(^{82}\) This interpretation is also consistent with the equitable concept that "those who bear the risk should benefit from the increase in value." In our view, it necessitates an amendment to the Code to set the date of valuation at the date of filing of the petition. In particular, we urge that Section 1129(b)(2)(A)(i)(II) be amended to read:

\[
\text{(A) With respect to a class of secured claims, the plan provides --}
\]

\[\]

The majority rule is that property is valued at the time of confirmation. \(\text{See, e.g., In re Ahlers, 794 F.2d 388, 401 (8th Cir. 1986), rev'd on other ground, Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988).}\)


This minority position was furthered as recently as January, 1996 when the U.S. Bankruptcy Court in M.D. Pennsylvania held in \(\text{In re Wood, 190 B.R. 788 (Bankr. M.D. Pa. 1996) that the applicable date for valuing a mortgagee's allowed secured claim in order to cramdown the claim was the date of filing of the petition. Id. at 795. Wood provides an expansive list of case citations in support of the proposition that the date of valuation should be the date of filing of the bankruptcy. Id. at 791 n.1.}\)
(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value as of the date of the order for relief, of at least the value of such holder's interest in the estate's interest in such property;
III. CONSUMER ISSUES

A. Maintain the Efficacy of Chapter 13, While Exploring More Uniform Procedures to Increase the Reliability of the Process

Among the consumer bankruptcy problems identified by the Commission is that only about 33 percent of all Chapter 13 cases filed are completed. In addition, uniformity is lacking in the way Chapter 13 cases are administered, as well as in the minimum levels of distribution to unsecured creditors. There is too much potential for abuse in preparing schedules and in determining disposable income, without any effective oversight over these processes. Exemption levels are widely disparate since states can opt out of the federal exemptions and many have. The filing of Chapter 13 petitions is prevalent in some parts of the country, while in other parts of the country, the local practice is to file Chapter 7 petitions instead.

Chapter 13, however, has its good sides, as well. It affords debtors a fresh start, while providing creditors with an equitable portion of the debtor's future income. Chapter 13 is advantageous to creditors, including the United States, in that it encourages repayment of debt at a higher percentage than when the debtor files a Chapter 7 case and liquidates non-exempt assets. The United States collects millions of dollars of taxes and other claims in Chapter 13 that otherwise might not be paid or could be collected only at great expense. Debtors also benefit by having up to sixty months to pay their debts with the prospect of reestablishing credit with lenders if the Chapter 13 case is successful.

The Commission and its Consumer Bankruptcy Working Group have discussed the current system for handling consumer bankruptcy cases, with some sentiment expressed that current Chapters 7 and 13 be combined essentially into a single chapter. Under the single chapter consumer bankruptcy system under consideration, the options currently available in Chapter 7 and Chapter 13 would not be linked together. The ability of the debtor to refile a subsequent petition within six years would be curtailed. The new chapter would include specific provisions dealing with the most common forms of debt, such as residential mortgages, car loans, and taxes. Some form of systematic auditing of debtors would be established.


A Chapter 7 case in which a debtor reaffirms much of the debt has many characteristics of a Chapter 13 case; and a Chapter 13 case in which the plan provides for zero payments to unsecured creditors has many characteristics of a Chapter 7 case. Furthermore, it has become commonplace for debtors to file a Chapter 13 petition immediately after getting a Chapter 7 discharge to obtain all the benefits of both chapters, including the superdischarge. Under these circumstances, the suggestion that elements of Chapter 7 and 13 be combined is intriguing. Our concern is that a single chapter for consumer cases would discourage the commitment of future income to satisfy debts by having a bias in favor of liquidation.

While we are currently unprepared to endorse the developing concept of a single consumer debtor chapter, current Chapter 13 does have a number of serious problems that require attention. To begin with, steps should be taken to minimize the potential for fraud and abuse under Chapter 13. The scope and purpose of Chapter 13 have been altered by the increase in the eligibility limits of Section 109(e). Chapter 13 will now become the preferred means for many professionals to reorganize their debts in order to avail themselves of the superdischarge under Section 1328(a) for those taxes and other debts than cannot be discharged under Chapter 7. No longer will Chapter 13 be dominated by "blue collar" wage earners, as has been the case. However, creditors and the Chapter 13 standing trustees who will face this change in the debtor population do not have the time or the resources to investigate the financial background of debtors with significant and varied assets and complex financial dealings. The coalescence of these factors further increases the prospect for fraud and abuse.

The degree of fraud and abuse in Chapter 13 cases is difficult to gauge because empirical data is lacking. However, based on her concerns that fraud is prevalent in bankruptcy, the Attorney General, in February of this year, announced that the Department would undertake a bankruptcy fraud initiative. The Department believes that Chapter 13 debtors should be made more accountable and the procedures under that Chapter should be more equitable. Chapter 13 should be encouraged as a means by which debtors reestablish credit and creditors receive the highest distribution possible, and not as a means by which debtors avoid their liabilities through concealment and misrepresentation.

B. Serial and Sequential Filings Should Either
Not Be Permitted or Severely Curtailed

1. In General

Serial filings should not be permitted or should be severely curtailed. In most contexts, the filing of frivolous suits designed solely for delay is subject to sanctions. See, e.g., Fed. R. Civ. P. 11; 26 U.S.C. §6673 (Tax Court can impose a penalty of $25,000 for frivolous positions or when proceedings are instituted or maintained primarily for delay). In bankruptcy, however, such conduct is often condoned. Debtors all too frequently file meritless petitions without any fear of sanctions. After filing and dismissing a petition, debtors can exploit the automatic stay and frustrated their creditors for the cost of an additional filing fee. The sequential filing of bankruptcy to take advantage of attributes of different chapters of Title 11 should also be eliminated. Debtors should be required to select and choose their remedy. The current system imposes unnecessary and undesirable costs on debtors, creditors, and the bankruptcy courts.

2. Dismissal and Refiling

The incidence of serial filings seems to vary from jurisdiction to jurisdiction, but the number of cases is not insubstantial. Serial filings are abusive when debtors file a petition simply to frustrate a creditor without intending to liquidate or reorganize. The petition may then be dismissed by the court or voluntarily, only to be refiled to stay collection further. This process is open to exploitation and, indeed, is exploited by tax protestors and other scofflaws without any downside risk or cost other than the filing fee.

Section 109(g) of the Code proscribes serial filings within 180 days of the dismissal of a previous case, but only if the prior case was dismissed for willful failure of the debtor to comply with orders of the court, or for failure to prosecute, or for a voluntary dismissal by the debtor after a request for relief from the automatic stay was filed. These grounds for disapproving sequential filings are extremely narrow. Although the concept of good faith or its converse, bad faith, are not expressly found in Section 109, some courts will dismiss a second or third filing for "bad faith" citing Section 1325(a) -- others will not. Moreover, the courts' conceptions of "good" and "bad" faith are inconsistent and subjective. For example, in In re Barrett, 964 F.2d 588 (6th Cir. 1992), the court found that although the first Chapter 13 petition was filed in bad faith and a second Chapter 13 petition was filed in bad faith, the bankruptcy court was not clearly erroneous
in finding that a third Chapter 13 petition was filed in good faith. Moreover, even where a serial filing is clearly within its scope, some courts have held that Section 109(g) is permissive rather than mandatory. In re Luna, 122 B.R. 575 (9th Cir. BAP 1991).

Section 109(g) should be amended to impose more stringent limitations on serial filings. In particular, we urge that after a case is dismissed for any reason and another petition is filed within 180 days, the automatic stay should not apply except pursuant to an order of the court on motion of the debtor after notice and a hearing. Having invoked the jurisdiction of the court in a case dismissed within 180 days of the second filing, the debtor should have the burden of demonstrating that the dismissal and refiling do not constitute an abuse of the bankruptcy process before the protections of the automatic stay apply and before creditors have to endure the disruption to their collection efforts and incur bankruptcy-related expense once again.

3. Sequential Filings


Multiple filings lead to several unintended and undesirable consequences, the most common of which is that recourse debt, by virtue of the discharge, is converted into nonrecourse debt, and creditors are prevented from sharing in any premium for unsecured debt under the reorganization plan. Another repercussion is that debtors are able to redeem property under terms contrary to the Code's redemption statutes. Also, debtors are able to discharge portions of their debts and thereafter come within Chapters 13's debt limitations.

The bankruptcy system is abused by the chapter "18," "19," and "20" filings. The Supreme Court in Johnson noted safeguards to creditors' rights inherent in the Bankruptcy Code, e.g., the requirement that, under Section 1325(a)(3), a plan be proposed in good faith and, under Section 1325(a)(4), that it assure unsecured creditors a recovery commensurate with what would be expected in a Chapter 7 liquidation. 501 U.S. at 87-88. We believe that to the extent Congress has established different conditions and benefits in the various chapters of the

Another illustration of abusive filings condoned by the courts is In re Oglesby, 158 B.R. 602 (E.D. Pa. 1993), where the bankruptcy court confirmed a plan over objections after four filings. The District Court remanded for additional findings. Id.
Bankruptcy Code, a debtor should not be able to avoid conditions and secure benefits by sequential filings.

The current law prevents multiple filing only for 180 days and then only where the earlier case was dismissed for "willful failure to abide by court orders" or was dismissed by the debtor after stay relief was requested. 11 U.S.C. § 109(g). Some courts have resorted to issuing injunctions to prohibit additional petitions in bankruptcy for longer than 180 days relying upon a strained interpretation of 11 U.S.C. § 349(a). Lerch v. Federal Land Bank, 94 Bankr. 998 (N.D. Ill. 1989); In re Jolly, 143 Bankr. 383 (E.D. Va. 1992). The only court of appeals to consider the issue ruled that Section 349(g) does not allow extending the bar to filing beyond that allowed by Section 109(g). In re Frieouf, 938 F.2d 1099 (10th Cir. 1991), cert. denied, 502 U.S. 1091 (1992) (each clause in Section 349(a) is separate, and "for cause" only modifies the discharge provision). See also In re Prud'homme, 161 Bankr. 747 (Bankr. E.D.N.Y. 1993) (court dismissed case but refused to grant creditor's request for 18 month bar from refiling under section 349(a) because other remedies were available and such relief could not be granted without the filing of a proper adversary action); In re Cooper, 153 Bankr. 898 (D. Colo.), aff'd, 13 F.3d 404 (10th Cir. 1993) (debtor may not be barred from refiling absent a showing of the conditions set forth in § 109(g); In re Earl, 140 Bankr. 728 (Bankr. N.D. Ind. 1992) (bankruptcy court can prohibit the filing of future petitions under §105(a) where such filings would abuse the bankruptcy process).

Section 349(a) should be modified to allow expressly the bankruptcy court to bar future filings for cause. Several amendments would offer protection against such abuses:

- Section 109 of the Code should be amended by adding at the end thereof:

  "(h) Notwithstanding any other provision of this section, a person may not be a debtor under chapters 11, 12, or 13 of this title who received a discharge under chapter 7 or who had a chapter 11 plan of reorganization liquidating all, or substantially all of the property of the estate, confirmed within six years before the filing of the petition."

- Section 1129 of the Code should be amended by adding at the end thereof:

  "(e) In its order confirming the plan, the bankruptcy court shall prohibit the filing of a petition for relief under title 11 by the debtor or any entity wholly-owned by debtor within two years of the date of confirmation without leave of the bankruptcy court upon good cause shown."

- Section 1325 of the Code should be amended by adding at the end thereof:

  "(d) In its order confirming the plan, the bankruptcy court shall prohibit the filing of a petition for relief under title 11 by the debtor or any entity wholly-owned by
debtor within two years of the date of confirmation without leave of the bankruptcy court upon good cause shown."

Section 349(a) of Code should be amended by deleting "; nor does the dismissal of a case under this title prejudice the debtor with regard to the" and insert instead "and does not prevent the debtor from" and inserting "and (h) and sections 1125 and 1325" after "in section 109(g)."

The suggested revisions prohibit a debtor from using a preliminary Chapter 7 or liquidating Chapter 11 to strip away unsecured debt prior to reorganizing. Thus, the revisions would prohibit chapter “18”, “19” and “20” bankruptcies. In addition, the revisions allow prohibition, on the likely penalty of contempt, successive filings done merely to gain unfairly the advantage of the automatic stays.

C. Adopt a Stricter "Good Faith" Standard

Chapter 13 contains no explicit "good faith" filing requirement, but lack of good faith in filing is sufficient cause for dismissal under Section 1307 (courts can dismiss or convert for cause). In order to be confirmed, a Chapter 13 plan must be proposed in good faith and may not be proposed by any means forbidden by law. 11 U.S.C. § 1325(a)(3). The term "good faith" is not defined by statute and, generally, the courts have used a "totality of the circumstances" test in ascertaining good faith of a proposed Chapter 13 plan. The determination regarding good faith is fact-intensive. While the totality of circumstances test may allow the courts some flexibility, its application by the courts has created doubt as to the meaning of good faith and has subjected both debtors and creditors to disparate treatment.

An increasing number of Chapter 13 petitions are being filed to deal with debts that are not dischargeable in Chapter 7. Often these Chapter 13 cases closely follow the completion of a Chapter 7 bankruptcy. While it has been held that good faith is lacking where the sole purpose of the Chapter 13 filing is to discharge an obligation that otherwise would not have been

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In re Lilley, 1996 WL 426797 (3d Cir. 1996); In re Love, 957 F.2d 1350 (7th Cir. 1992); In re Eisen, 14 F.3d 469 (9th Cir. 1994); In re Grier, 986 F.2d 1326 (10th Cir. 1993).

Various factors are reviewed by the courts, including such factors as: the amount of payments and surplus, the debtor's ability to earn, the probable duration of plan, the accuracy of plan's statements, preferential treatment between classes of creditors, the types of debts discharged, the frequency with which the debtor has sought bankruptcy relief, and the motivation and sincerity of debtor for modification of secured claims. See In re Robinson, 987 F.2d 665 (10th Cir. 1993); Matter of Tobiason, 185 B.R. 59 (Bankr. D. Neb. 1995).
discharged,\textsuperscript{91} that result varies from court to court when the "totality of circumstances" test is used. For example, anomalous results have obtained in cases involving debts incurred as a result of criminal conduct, when courts have given weight to prefiling conduct.\textsuperscript{92} Uniformity is needed.

Good faith needs to be defined by amending Section 1325(a)(3). The various factors considered by the courts, particularly those mentioned above, to determine the existence of "good faith" should be identified in the statute. Good faith should also be made an explicit requirement for filing, by amending Section 1322 to approve the prompt dispatch of "bad faith" bankruptcies before a considerable amount of time and resources are spent on the confirmation process.

D. Discharge

1. Conform the Discharge under Chapter 13 to the Discharge under Chapters 7, 11 and 12

Section 1322(a)(2) of the Code provides that a Chapter 13 plan must provide for deferred cash payments in full of all claims entitled to priority under Section 507. Section 1328(a) of the Code grants a debtor a discharge upon completion of payments under a plan of "all debts provided for by the plan or disallowed under section 502" except for debts provided for under Section 1322(b)(5) (claims having a due date after the completion of the plan), debts excepted from discharge under Section 523(a)(5), (8) or (9), or criminal fines, including restitution. The net effect of these provisions is that upon completion of payments in a Chapter 13 case, a debtor will be discharged of debts that would not be discharged in a Chapter 7, 11, or 12 proceeding. A Chapter 13 debt adjustment plan complies with the requirements of Chapter 13 by classifying such debts as general unsecured claims and paying them at the same percentage rate as other unsecured claims -- zero in many districts.

The apparent rationale for giving debtors a superdischarge in Chapter 13 is to encourage debtors to file under Chapter 13 rather than under Chapter 7.\textsuperscript{93} The effect of the superdischarge is that a debtor can use Chapter 13 to avoid debts attributable to fraud, such as embezzlement,

\textit{In re Schaitz}, 913 F.2d 452 (7th Cir. 1990).


Ponzi schemes or medicare fraud, misrepresentations and intentional torts, as well as tax debts attributable to fraudulently filed tax returns or to unfiled returns. When the Bankruptcy Code was initially enacted, Chapter 13 debtors were also able to discharge debts for educational loans, criminal fines, penalties, and restitution, and tort damages attributable to drunk driving. The Congress eventually closed those loopholes\(^94\) and should also close the loophole available to perpetrators of fraud, intentional tortfeasors and tax cheats.

We submit that the Chapter 13 discharge should be identical to the discharge available in a Chapter 7, 11, or 12 proceeding. A debtor's commitment to make his or her "disposable income" available to creditors for three years does not justify the broad Chapter 13 discharge. All that need be paid to an unsecured creditor under a Chapter 13 plan is the amount that would be paid under a Chapter 7 liquidation. See 11 U.S.C. § 1325(a). Since the minimum required return to the creditor in a Chapter 13 proceeding is governed by the likely return in a liquidation under Chapter 7, the discharge that the debtor receives for debts in a Chapter 13 should be the same as that permitted under Chapter 7. It is fundamentally unfair to sacrifice the interest of creditors whose claims would not be discharged under Chapter 7 to encourage payments to other creditors.

The need to except fraudulently incurred debts from Chapter 13 discharge is particularly compelling in cases of fraud perpetrated against the United States.\(^95\) Various federal statutes impose onerous civil damages or penalties upon those who engage in fraud.\(^96\) Sections 523(a)(2) and (4) excepts from discharge those debts incurred by individual debtors through fraud. The


\(^95\) The impact of the superdischarge on tax claims attributable to misconduct is discussed in Part V E. 1., infra.

\(^96\) For example, the civil RICO statute imposes treble damages on those found to have violated the RICO provisions relative to mail or wire fraud. See 18 U.S.C. §§ 1961, 1962 and 1964. The False Claims Act (FCA) likewise imposes treble damages and also provides for penalties of between $5,000 and $10,000 for each fraudulent claim presented to the United States. See 31 U.S.C. § 3729-3731.
fraud exceptions to discharge apply in Chapters 7, 11 and 12, but do not apply in Chapter 13 because of the superdischarge.\textsuperscript{97}

The primary body of law utilized by the United States in combatting fraud is the False Claims Act (FCA). In \textit{United States v. Halper}, 490 U.S. 435, 448-449 (1989), the Supreme Court recognized that although FCA damages constitute civil remedies, they actually serve the traditional goals of criminal punishment, \textit{i.e.}, retribution and deterrence. As such, we believe a civil fraud debt should be afforded the same protection from Chapter 13 discharge as criminal fines and restitution are afforded under Section 1328(a)(3). This could be accomplished by modifying Section 1328(a)(3) to include the debts specified in Section 523(a)(2) and (4).

The superdischarge primarily affects debts attributable to the debtor's misconduct. Section 523(a) sensibly and justifiably denies a discharge for such debts. Encouraging such debtors to discharge debts attributable to their misconduct by filing Chapter 13 petitions is questionable public policy that brings the bankruptcy system into disrepute. The amendments we propose would be consistent with the congressionally stated principal that "the bankruptcy laws are not a haven for criminal offenders." S. Rep. No. 989, 95th Cong., 1st Sess. 51 (1978).

\textbf{2. Debts for Which a Creditor Has Not Received Timely Notice of Petition Filing}

Section 523(a)(3) applies to cases under Chapters 7, 9, 11 and 12, and provides that debts are not dischargeable if they are not listed and scheduled in time for the creditor to file a timely proof of claim, or to file an action under Section 523(2), (4) and (6) in applicable cases. Section 523(a)(3) does not apply to Chapter 13 proceedings, however, and no similar provision is included in Section 1328. Rather, with few exceptions, Section 1328(a) provides that if a debt is "provided for" by a plan, it is discharged. In addition, Bankruptcy Rule 3002(c), which provides that claims must generally be filed within ninety (90) days of the first meeting of creditors (or a longer time period for the United States) contains no exception for lack of notice to a creditor.

The courts have held that the debt of a creditor who did not receive notice of a Chapter 13 bankruptcy is not discharged. Some of the decisions are based on the principle that "fundamental due process mandates that a creditor be given notice and an opportunity to participate." See \textit{In re Avery}, 134 B.R. 447 (Bankr. N.D. Ga. 1991); \textit{In re Cole}, 146 B.R. 837 (D. Colo. 1992).\textsuperscript{98} 

\begin{footnotesize}
11 U.S.C. § 1328(a). However, 1328(b) does exempt such debts from discharge, but the application of that subsection is severely limited to hardship situations.

The Fifth Amendment of the Constitution provides that "[n]o person . . . shall . . . be deprived of...property, without due process of law . . ." The Supreme Court has stated that "[a]n elementary and fundamental requirement of due process in any proceeding which is to be (continued...)
\end{footnotesize}
Another line of decisions, which includes *In re Tipton*, 118 B.R. 12 (Bankr. D. Conn. 1990), hold that the debtor's failure to give the creditor notice of the bar date in time for the creditor to file a proof of claim foreclosed the possibility that the creditor's claim could be "provided for" in a Chapter 13 plan. The court in *Tipton* reached this decision even though the plan apparently contained generic language providing for no payments to the relevant creditors. Such language has been held to be sufficient to discharge debts by other courts.

Section 1328 should be amended specifically to incorporate by reference Section 523(a)(3) to clarify that a debt will not be discharged absent notice to the creditor of the filing of the bankruptcy. A discharge should not occur when any creditor suffers prejudice as a result of the debtor's failure to timely list and schedule the debt with the proper address.

E. Clarify the Definition of "Disposable Income"

Section 1325(b)(1)(B) provides that if the holder of an allowed unsecured claim objects to the confirmation of a Chapter 13 plan, the court may not approve the plan unless, *inter alia*, the plan provides that all of the debtor's projected disposable income to be received in the three-year period beginning on the date that the first payment is due under the plan will be applied to make payments under the plan. For purposes of this provision, "disposable income" is defined as "income which is received by the debtor" and which is: (i) "not reasonably necessary to be expended for the maintenance or support of the debtor or a dependent of the debtor;" or (ii) "if the debtor is engaged in business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business." 11 U.S.C. § 1325(b)(2). As noted by one court, the legislative history of these provisions "is singularly vague and unenlightening," *In re Jones*, 55 B.R. 462, 465 (Bankr. D. Minn. 1985), leaving the courts to struggle with the meaning of these terms, often leading to incongruous results. We recommend that the term "disposable income" be clarified and that greater guidance be provided to the courts concerning its application.

(...continued)

accorded finality is notice reasonably calculated, under all circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections." *Mullane v. Central Hanover Bank and Trust Co.*, 339 U.S. 306, 314 (1950).


*See In re Gregory*, 705 F.2d. 1118 (9th Cir. 1983); *In re Border*, 116 B.R. 588 (Bankr. S.D. Ohio 1990).
What is included in disposable income has been subject to considerable litigation where the debtor claims income is exempt from inclusion. The result is disparate treatment of debtors and creditors between jurisdictions, as well as time-consuming litigation. The definition of disposable income should be expanded in the interests of uniform application. For example, the definition should be amended to make it clear that disposable income includes all sources of income available to the debtor during the term of the plan, including any retirement, disability, workers compensation, and pension benefits available to the debtor, and tax refunds received. Further, where a debtor has full use and benefit of income, it should be included as disposable income. Otherwise, the debtor receives a windfall when he is allowed to claim expenses but is not required to offset them with all available money.

In addition, "disposable income" is currently defined to include only the income received by the debtor. While logical, the definition does not make it clear that income from a nonfiling spouse, a dependant, or a third party business associate is a legitimate consideration when determining the reasonable amount necessary for maintenance and support, or for the continuation, preservation or operation of a business. 11 U.S.C. § 1325(b)(2)(A) and (B). The definition of disposable income should be expanded to take into consideration both the income and expenses of such persons.

A debtor's representations about expenses are frequently self-serving and padded, particularly regarding charitable contributions, entertainment, vacations, and luxury items. Even though expenses are reviewable by the bankruptcy court, many courts are reluctant to require that such expenses be limited to necessities. Debtors having both higher income and higher living expenses (and large debts) are found to have little disposable income. Clarification of the appropriate treatment of charitable contributions, entertainment expenses, vacation costs, and amounts spent on recreational equipment and vehicles and other luxury items would, therefore, be helpful.

F. Create a Uniform Period for Objecting to Claimed Exemptions Which Allows Sufficient Time for Creditors to Object

Section 522(l) of the Bankruptcy Code requires a debtor to file a list of property that the debtor claims is statutorily exempt from distribution to creditors and further provides that "[u]nless a party in interest objects, the property claimed as exempt on such list is exempt." While the section does not provide any time limits for filing an objection, Rule 4003 of the Federal Rules of Bankruptcy Procedure provides that the trustee or a creditor must file any objection to the property claimed as exempt within 30 days of the conclusion of the meeting of creditors or within 30 days of any amendment to the list, unless further time is granted by the court within the 30-day period.

Despite the absolute terms of Rule 4003, several courts held that objections could be filed after the applicable time limit if there was no statutory basis for the claimed exemption or, under a slightly more difficult standard for the creditor, where there was no "good-faith" statutory basis for the claim. In 1992, however, the Supreme Court resolved any question of the interpretation or application of Section 522(l) and Rule 4003 in Taylor v. Freeland & Kronz, 503 U.S. 638 (1992). There, the Supreme Court held that, regardless of whether the debtor had a colorable basis for claiming the property exempt, no objection to the claimed exemption could be filed after the period provided for in Rule 4003. Id. at 643-645. This holding allowed the debtor to exempt $110,000 from the estate that neither federal nor state exemption provisions would have permitted and the creditors, with claims of approximately $23,000, went unpaid.

See, e.g., In re Bradlow, 119 B.R. 330, 331 (Bankr. S.D. Fla. 1990); Barnes v. ITT Financial Services (In re Barnes), 117 B.R. 842, 845 (Bankr. D. Md. 1990); In re Duncan, 107 B.R. 754, 757 (Bankr. W.D. Okla. 1988). These cases, generally relying on the plain language of Rule 4003, held that an untimely objection must be stricken, regardless of the merits of the claimed exemption.

The courts reasoned that, because Section 522(l) refers to property claimed as exempt under Section 522(b), there is an implicit requirement in Section 522(l) that there be a statutory basis for the claimed exemption under Section 522(b) and that no timely objection was required if the debtor's claimed exemption was invalid under state or federal law. See, e.g., Sherk v. Texas Bankers Life & Loans Ins. Co. (In re Sherk), 918 F.2d 1170, 1174 (5th Cir. 1990); Stutterheim v. First State Bank, Alemena (In re Stutterheim), 109 B.R. 1010, 1013 (D. Kan. 1989); In re Bennett, 36 B. R. 893, 894 (Bankr. W.D. Ky. 1984); In re Velis, 109 B.R. 64, 65 (Bankr. D. N.J. 1989); Geekie v. Owen (In re Owen), 74 B.R. 697 (Bankr. C.D. Ill. 1987).

Courts applying this standard reasoned that, so long as the debtor had a good faith statutory basis for claiming property as exempt, a creditor could not pursue an untimely objection regardless of whether the property was actually subject to exemption. See, e.g., In re Peterson, 920 F.2d 1389, 1393 (8th Cir. 1990); In re Dembs, 757 F.2d 777, 780 (6th Cir. 1985); In re Indvik, 118 B.R. 993, 1002 (Bankr. N.D. Iowa 1990); In re Staniforth, 116 B.R. 127, 130-131 (Bankr. W.D. Wis. 1990).
Although the Taylor decision removes any question as to when objections must be filed, the flat 30-day period for filing objections to claimed exemptions does not fairly balance the rights of creditors to collect their debts from non-exempt property with the needs of debtors for certainty. While a statutory adoption of either the "no statutory basis" or the "good faith" statutory basis standards applied by many courts prior to the Supreme Court decision would prevent debtors from being able to make nonexempt property exempt by declaration, those standards have the disadvantage of being open-ended. Therefore, the period for filing objections should be left as a fixed period, however, the time limit should be changed. Instead of the present 30-day period, a creditor should be permitted to file objections to claimed exemptions up to the last date on which the creditor could file a timely proof of claim.\textsuperscript{105} Similarly, the trustee should be permitted to file an objection to claimed exemptions within the period during which a private creditor could timely file a proof of claim.\textsuperscript{106}

Using the proof of claim filing period has several advantages. First, the period is not unduly long, therefore the debtor's need for certainty in dealing with property is not significantly affected. Second, because the objection time is the same as that for filing proofs of claim, creditors will be focused on determining the chances of recovery and, therefore, will have a reason for examining the debtor's schedules and claimed exemptions. Finally, a rule tying the objection date to the proof of claim filing deadline has the simplicity of eliminating just one more separate time period that creditors must remember in bankruptcy matters.

G. Claims

1. Expressly Authorize Modification of Confirmed Plans to Provide for Timely Filed Proofs of Claim

Debtors filing Chapter 13 cases must file their proposed plans with their bankruptcy petitions or within 15 days of the date of the filing of the petition unless the court enlarges the

In Chapter 7 liquidations, Chapter 12 family farmer debt adjustments and Chapter 13 individual debt adjustments, using the proof of claim bar date would provide a 90-day period in which private creditors could file objections to claimed exemptions, measured from the first date set for the meeting of creditors, and a 180-day period in which governmental units could file an objection to claimed exemptions. Rule 3002(c) of the Federal Rules of Bankruptcy Procedure; 11 U.S.C. §502(b)(9). In Chapter 11 individual reorganizations, the time for filing objections would be the same as that fixed by the court for filing claims. Rule 3003(c)(3) of the Federal Rules of Bankruptcy Procedure.

The period for the trustee would be 90 days from the first date set for the meeting of creditors in Chapter 7, 12 and 13 proceedings and on whatever date the court set the bar date in Chapter 11 proceedings.
Debtors are required to begin making payments to the trustee in accordance with the proposed plan within 30 days of the filing of the proposed plan. 11 U.S.C. § 1326(a)(1).

In Chapter 13 individual debt adjustment cases, private creditors must file their claims within 90 days of the first date set for the meeting of creditors. Rule 3002(c) of the Federal Rules of Bankruptcy Procedure. Governmental units must file their claims within 180 days of the date of the order for relief. 11 U.S.C. § 502(b)(9).


As to the failure to properly provide for a claim as required by the Bankruptcy Code, the courts have held that the plan is res judicata and the creditor bound by whatever treatment the debtor has provided for it. In re Toth, 61 B.R. 160, 166-167 (Bankr. N.D. Ill. 1986); 11 U.S.C. § 1327(a); see also 5 L. King, Collier on Bankruptcy ¶ 1329.01[b] at 1329-5 (15th ed. 1996).
If the actual allowed amounts of claims when known adversely affect confirmation of the plan, modification of the plan after confirmation can be addressed under § 1329, or conversion or dismissal for cause under § 1307.

1 Judge Keith Lundin, Chapter 13 Bankruptcy § 5 (at p. 7) (1990).

The general practice should be that Chapter 13 plans are amended upon the filing of a timely proof of claim after confirmation where the plan does not properly provide for the claim or the case is dismissed or converted, if appropriate. See Kathleen A. McDonald, "To Confirm or Not to Confirm: a Chapter 13 Plan Before the Claims Bar Date", XI ABI Jour. 31 (1992). Some jurisdictions actually enter an interim confirmation order. Id. Others treat the confirmation order as subject to amendment. Little case law specifically addresses this issue.111

Section 1329 should be amended to require the debtor to move for post-confirmation modification of the plan where the plan does not provide for the creditor's timely filed claim in accordance with the requirements of the Bankruptcy Code, and to clarify that creditors and the trustee may file a motion under such circumstances.

2. Clarify the Debtor's Ability to Change the Status of a Secured Claim in the Plan Without Challenging the Lien

Section 1327(c) states that "except as otherwise provided in the plan or in the order confirming plan, the confirmation of a plan vests all property of the estate in the debtor." Section 1327(c) does not state what happens to liens post-confirmation. As such, an issue arises when a Chapter 13 plan fails to provide for a secured creditor's lien after confirmation of the plan. Moreover, some debtors attempt to invalidate a lien by classifying a secured claim as unsecured and then arguing that the lien is extinguished upon confirmation. Debtors argue that because the confirmed plan vests all property in the debtor except as otherwise provided for in the plan, only those liens that are retained attach to the debtor's property. Consequently, a creditor can lose its lien simply by the debtor not providing for the lien in the plan or by inserting language that makes the lien contingent upon the creditor's filing of a proof of claim.

These arguments are contrary to the longstanding tradition of bankruptcy law that a lien passes through bankruptcy unaffected. The Supreme Court on at least three occasions since 1990 has followed this rule, most recently holding in Dewsnup v. Timm, 112 S.Ct. 773, 779 (1992),

The court in In re Linkous, 141 B.R. 890, 895 (W.D. Va. 1992) aff'd, 990 F.2d 160 (4th Cir. 1993), noted the absence of case law or commentary relating to the treatment of claims timely filed after confirmation and that are altered by the confirmed plan. The district court found that a confirmed plan could not preempt the claims allowance process and was not res judicata under the circumstance. The decision was affirmed on different grounds.
that permitting the involuntary reduction of the amount of a creditor's lien for any reason other than payment on the debt "is contrary to basic bankruptcy principles."\textsuperscript{112} The rule was first enunciated in \textit{Long v. Bullard}, 117 U.S. 617, 621 (1886).\textsuperscript{113} Despite these historical and legal antecedents, the axiom regarding liens passing through bankruptcy unaffected has been under recent attack.

The Seventh Circuit's decision in \textit{In re Penrod}, 50 F.3d 459 (7th Cir. 1995), supports the argument that liens can be affected by a bankruptcy. In \textit{Penrod}, the Seventh Circuit held that a livestock lien had been extinguished upon confirmation of a Chapter 11 plan of reorganization. The court found that although the general rule that liens pass through bankruptcy unaffected is still good law, where a creditor actively participates in a case, the creditor can lose its lien if it does not pursue retention of its lien in a plan. \textit{Id.} at 462. The Court based its reasoning on Section 1141(c), which provides in part that after confirmation of a plan, property dealt with under a plan vests in the debtor free and clear of all interests and claims. \textit{Id.} at 463. Consequently, the failure to retain a lien in a confirmed plan could result in the lien being invalidated.\textsuperscript{114}

By contrast, in a Chapter 13 case decided shortly after \textit{Penrod}, the Fourth Circuit rejected Penrod's holding without actually discussing the case. In \textit{Cen-Pen Corp. v. Hanson (In re Hanson)}, 58 F.3d 89 (1995), the debtor attempted to invalidate a lien on a residence by listing the secured claim as unsecured. The creditor did not object to the classification and the plan was confirmed with language that stated that the failure of a secured creditor to file a proof of claim invalidated the secured creditor's lien. The secured creditor in this case failed not only to object to the plan, but also to file a proof of claim. The Fourth Circuit found that the application of § 1327(c) did not affect the validity of the liens. Moreover, the Fourth Circuit noted that a Chapter 13 plan could not discharge an \textit{in rem} claim against the debtor's property, a notion not discussed by the Penrod Court. More important, the Fourth Circuit held that the debtor must file some affirmative pleading to invalidate a lien, such as an adversary proceeding. \textit{Id.} at 92.\textsuperscript{115} The court


\textit{See also} \textit{City of Richmond v. Birch}, 249 U.S. 174, 177 (1919) ("Liens given or accepted in good faith and not in contemplation of or in fraud upon this act, shall not be affected by it").

\textit{See also} \textit{In re Be-Mac Transport Co., Inc.}, 83 F.3d 1020, 1024-26 (8th Cir. 1996) (court agreed with Penrod in finding that a lien could be invalidated if not retained in a confirmed plan).

\textit{See also} \textit{In re Wolf}, 162 B.R. 98 107 n. 14 (Bankr. D.N.J. 1993); \textit{In re Glow}, 111 B.R. 209, 221 (Bankr. N.D. Ind. 1990); \textit{cf.} \textit{Green Tree Fin. Corp. v. Garrett (In re Garrett)}, 185 B.R. 620 (continued...
also noted that a debtor should not be vested with a greater interest than it had prior to bankruptcy. *Id.* Finally, the Fourth Circuit adopted the Fifth Circuit's reasoning in *In re Simmons*, 756 F.2d 547 (1985), holding that a secured creditor does not need to file a proof of claim in order to retain its lien.116

Penrod and Hanson represent divergent views regarding the treatment of secured claims by a confirmed plan. We submit that the Bankruptcy Code should be amended to clarify the effect of a confirmed plan on secured claims. In our view, property should vest in the debtor under a confirmed plan subject to all existing liens and encumbrances, absent an adversary proceeding filed under Fed.R.Bankr.P. 7001(2) to invalidate the lien. This approach should apply at the least in Chapter 13 proceedings, where the volume of cases and speed of confirmation might otherwise tempt debtors to include provisions invalidating liens in their plans in the hope that such provisions would go unnoticed.

H. Clarify Post-petition Wages/Refunds as Property: Resolve the Conflict Between Sections 1306 and 1327.

The interaction of Sections 1306 and 1327(b), which govern the scope, possession and vesting of property of the Chapter 13 estate, remains the subject of frequent litigation. Interpreting these provisions, the courts have held variably that the Chapter 13 estate generally ceases to exist when the debt adjustment plan is confirmed,117 that upon confirmation all property of the estate becomes property of the debtor except for that property needed to fund the plan,118 and that property of the estate remains in the estate until the case is closed or dismissed.119 None of these lines of analysis can be fully squared with the terms of the statutory provisions. The uncertainty in this area disadvantages both debtors and creditors. Debtors cannot be sure whether they are free to deal with property as owners; whether, for example, they must seek court

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(continued)

(Bankr. N.D. Ala. 1995) (confirmed plan *res judicata* as to all issues that could be raised at confirmation).

*Id.* Neither Penrod nor Hanson considers §§ 1129(b)(2)(A)(i)(I) or 1325(a)(5)(B)(i), both of which require that a confirmed plan should provide for the retention of a secured creditor's lien.


approval before selling property or encumbering it to obtain postpetition financing. Postpetition creditors cannot be sure whether they are free to take collection action against property in the debtor's possession. In re Ziegler, supra. The provisions should be amended to resolve this confusion, bearing in mind the purposes of Chapter 13.

Chapter 13 provides an alternative for individual debtors to liquidation under Chapter 7. Instead of surrendering all nonexempt assets to a trustee for liquidation, see 11 U.S.C. §§ 542, 363, 522, 541, a debtor in Chapter 13 generally retains his property and pays creditors under a debt adjustment plan using future earnings. Section 1306 reflects this basic premise. First, it augments the scope of the estate defined in Section 541, which governs cases under all chapters and generally includes only the debtor's prepetition assets. Section 1306(a) adds to the estate all property that the debtor acquires "after the commencement of the case but before the case is closed, dismissed or converted," and, specifically, "earnings from services performed by the debtor" during the same period. Second, it generally relieves the debtor of the obligation to surrender estate property to the trustee. In that regard, Section 1306(b) provides that the debtor "shall remain in possession of all property of the estate."

Confirmation of the debt adjustment plan effects a change in the debtor's relation to the estate property. Section 1327(b) provides that "[e]xcept as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor." As in Chapter 11, which contains an identical provision, 11 U.S.C. § 1141(b), after confirmation, the debtor is no longer merely in possession of estate property, but vested with it. Although a few courts have held that vesting gives the Chapter 13 debtor something short of full ownership rights, that conclusion contradicts the accepted interpretation of the same provision in Chapter 11, in which confirmation is said to terminate the estate and place ownership in the debtor. Recognition of the post-confirmation debtor as the owner of the property in his

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See, e.g., Hillis Motors, Inc. v. Hawaii Auto Dealers Ass'n, 997 F.2d 581, 587 (9th Cir. 1993); United States v. Unger, 949 F.2d 231, 233 (8th Cir. 1991).
possession, is also consistent with the voluntary nature of Chapter 13 and the degree of freedom that its other provisions afford a debtor.\textsuperscript{124}

In proposing a debt adjustment plan in Chapter 13, the debtor spells out those assets that he will commit to the payment of his creditors. "The plan shall . . . provide for all or such portion of future earnings or other future income of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan." 11 U.S.C. § 1322(a)(1). In addition, "the plan may . . . provide for all or part of a claim against the debtor from property of the estate or property of the debtor." 11 U.S.C. § 1322(b)(8). Finally, "the plan may . . . provide for the vesting of property of the estate, on confirmation of the plan or at a later time, in the debtor or in any other entity." 11 U.S.C. § 1322(b)(9) (emphasis added). When, as in the typical Chapter 13 case, the debtor proposes to commit only his future earnings to the plan and does not propose to delay revesting of other property in himself, no reason exists to impair the debtor's ability to use his uncommitted property or to shield that property from his postpetition creditors.

Section 1306(a), as currently enacted, cannot be reconciled with Section 1327(b) in a way that leaves the debtor fully vested with uncommitted property after confirmation, without doing violence to the terms of one provision or the other.\textsuperscript{125} Accordingly, Section 1306(a) should be amended to provide that property of the estate includes, in addition to property specified in Section 541, property that the debtor acquires after the commencement of the case but before the earlier of the date a plan is confirmed or the case dismissed, except as provided in the plan or order of confirmation.

I. Educational Loan Issues

\textit{See} H.R. Rep. No. 595, \textit{supra}, at 118 (Chapter 13 "gives the debtor more flexibility in the formulation of a plan").

The provisions' literal terms may be reconciled, but the result is not in keeping with the notion that the debtor and his post-confirmation creditors should be able to deal with property that is not committed to performance of the plan unimpeded by the bankruptcy court. By their terms, the provisions would appear to operate in the following manner:
(i) because Section 1306(a) provides that the estate includes all property acquired by the debtor until the case is closed, dismissed or converted, property the debtor acquires both before and after plan confirmation must be property of the estate when it is acquired; 
(ii) because Section 1327(b) provides that all property of the estate vests in the debtor upon confirmation, property acquired by the debtor (and therefore by the estate) before confirmation ceases to be estate property on that date (except as otherwise provided in the plan); and 
(iii) new property (including future earnings) that the debtor acquires after confirmation but before the case is closed, dismissed or converted becomes property of the estate (consistent with Section 1306(a)).
1. Clarify the Tolling of the Statute of Limitations
During a Case for Nondischargeable Student Loan Debts

Section 523(a)(8)(A) of the Code provides that a student loan will not be discharged unless it "became due more than seven years (exclusive of any applicable suspension of the repayment period) before the date of the filing of the petition." The phrase "applicable suspension of the repayment period" has been the subject of a number of cases, with sometimes differing results.

For example, in Gibson v. Virginia State Education Assistance Authority, the bankruptcy court ruled that the term "applicable" modified the term "suspension" in a way that prevented the use of a prior bankruptcy to toll the seven year limit. The court thus limited "applicable suspension" not to include applications of the automatic stay in prior bankruptcies, and to include only suspensions of repayment that the lender granted in the ordinary course of business. The district court reversed, holding that the automatic stay was an "applicable suspension of the repayment period" that tolled the seven year nondischargeability period. 184 B.R. 716 (E.D. Va. 1995). The district court relied, inter alia, on In re Saburah, 136 B.R. 46 (Bankr. C.D. Cal. 1992), in which the court held that the "length of time that the stay was in effect in the prior Chapter 7 is includable when calculating the applicable suspension period under Section 523(a)(8)(A)." Id. at 254.

While the majority of decisions are in accord with the Saburah decision in broadly construing Section 523(a)(8)(A), at least one other bankruptcy court has narrowly construed the "applicable suspension" language, holding that it did not encompass a forbearance agreement which reduced, but did not suspend, student loan payments. In re Eckles, Slip Op., Bankr. No. 81-02586, Adv. No. 82-1295 (Bankr. E.D. Wisc. May 22, 1984). Although that decision was also reversed, In Re Eckles, 52 B.R. 433 (E.D. Wis. 1985), we believe that substantial litigation could be avoided if Section 523 were amended to make clear that any action taken by the debtor, including the filing of a prior bankruptcy petition, which defers or reduces student loan payments, constitutes an "applicable suspension of the repayment period.

2. Clarify the Nondischargeability of Health Education Assistance Loans and Medical Professional Scholarships

The discharge of loans issued under the Health Education Assistance Loan (HEAL) program is governed by 42 U.S.C. 292(f)(g). Under that section, HEAL loans may be discharged only: (i) after the expiration of the seven-year period beginning on the first date when repayment of the loan is required; (ii) upon a finding by the Bankruptcy Court that the nondischarge of such debt would be "unconscionable," and (iii) upon the condition that the Secretary of Health and Human Services has not waived certain statutorily enumerated rights. In particular, the use of the term "unconscionable" was intended to restrict severely the circumstances under which a HEAL loan could be discharged.

Although the term "unconscionable" is not defined in the statute, the courts have concluded that in employing this term the Congress intended its normal usage as "excessive, exorbitant," lying outside the limits of what is reasonably acceptable, shockingly unfair, harsh, or unjust," or "outrageous." See, e.g., In re Rice, 78 F.3d 1144, 1149 (6th Cir. 1996); see also Matthews v. Pineo, 19 F.3d 121, 124 (3d Cir. 1994) (construing the term "unconscionable" as employed in the discharge provision for National Health Service Corps scholarship obligations). They have also held that the definition of "unconscionability" is significantly more stringent than the "undue hardship" standard established for the discharge of other educational loans under Section 523(a)(8)(B). See In re Rice, supra; In re Malloy, 155 B.R. 940, 945 (E.D. Va. 1993), aff'd, 23 F.3d 402 (4th Cir. 1994). See also In re Hines, 63 B.R. 731, 736 (Bankr. D.S.D. 1986).

Section 523(b) of the Code states that a determination of dischargeability under HEAL is not permanent, but can be reexamined in a second case in accord with the dischargeability standard in Section 523(a). This provision, however, was enacted in 1978, prior to the enactment of the HEAL unconscionability standard, and was originally intended only to clarify that a debtor could file for discharge of the same debt under bankruptcy more than once. This intended purpose was altered in 1982, when the HEAL bankruptcy provisions were amended to add the unconscionability test. Now, Section 523(b) could be read to allow a debtor to seek the discharge of a HEAL loan in a second case under the less stringent standard of Section 523(a), rather than the unconscionability standard of the HEAL statute.

The Department has argued that the HEAL provision should take precedence over Section 523(b) as the later-enacted and more specific statute. But, in the recent case of United States v. Tanski, 195 B.R. 408, 412 (E.D. Wis. 1996), a district court rejected this argument and discharged a HEAL loan under Section 523(b) in a second bankruptcy. The court held that this result was compelled by the "plain wording" of Section 523(b) and concluded that "[i]f the dischargeability of HEAL loans is to be exclusively controlled by 42 U.S.C. 292f(g) in the first and all subsequent bankruptcy filings, this change in law must emanate from Congress, not from this court." 195 B.R. at 412.

Applying Section 523(b) to HEAL loans essentially renders Section 292f(g) meaningless as it allows a HEAL debtor to discharge his loan anytime the loan is beyond seven years from the beginning of the repayment period without any other showing, let alone a showing of
unconscionability. This is not what Congress intended and Section 523(b) should be amended to make clear that a HEAL debtor must meet the unconscionability standard, regardless of the number of times he or she files bankruptcy.

J. Create an Express Exception to the Automatic Stay for Condemnation Cases

Section 362(a) of the Code prohibits the commencement or continuation of a judicial, administrative proceeding against the debtor that was or could have been commenced before petition was filed, as well as any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate. None of the exceptions to operation of the automatic stay found in Section 362(b) expressly permit the United States to exercise its power of eminent domain. There are no reported case decisions on the application of the automatic stay under the Bankruptcy Code to eminent domain proceedings with the result the issue must continually be litigated. Pursuit of eminent domain proceedings against bankrupts was not impeded under the Bankruptcy Act because the Act did not contain an automatic stay provision. Further, United States v. New York, New Haven and Hartford R. Co., 348 F.2d 151 (1st Cir. 1965), provided that in a conflict with the Bankruptcy Act, "the [federal] eminent domain statute must prevail."

The federal power of eminent domain -- the power to take private property for public use upon payment of just compensation -- is a fundamental attribute of sovereignty. The Supreme Court has called the right of eminent domain "essential to [the] independent existence and perpetuity" of the United States. Kohl v. United States, 91 U.S. 367, 371 (1876). A corollary of its status as a core sovereign function is that the federal power of eminent domain is superior to private property rights. United States v. Lynah, 188 U.S. 445, 465 (1903), overruled in part on other grounds, 312 U.S. 592 (1941). In contrast, the Bankruptcy Code has as its object the orderly arrangement and distribution of property between individuals. The purpose of the automatic stay provision is to "protect the bankrupt's estate from being eaten away by creditors' lawsuits and seizures of property before the trustee has had a chance to marshal the estate's assets and distribute them equitably among the creditors." 

See also Georgia v. Chattanooga, 264 U.S. 472, 480 (1924). As the Supreme Court stated in United States v. Lynah, 188 U.S. 445 (1903), overruled in part on other grounds, 312 U.S. 592 (1941) ("All private property is held subject to the necessities of government. The right of eminent domain underlies all such rights of property. The government may take personal or real property whenever its necessities or the exigencies of the occasion demand.")

The taking by eminent domain of real property owned by a debtor does not diminish the
debtor's estate, but rather, substitutes money for the property taken. Title to the property does
not pass until the government pays just compensation for the property or, in a case brought under
the Declaration of Taking Act, 40 U.S.C. § 258a, the United States deposits into the registry of
the court a sum of money as estimated compensation for the property taken. Under the
provisions of the Declaration of Taking Act, the sum so deposited is available to the persons
entitled to it. If the deposit is less than the sum ultimately awarded as just compensation,
judgment will be entered for this difference plus interest from the date of taking.

The just compensation to be paid in the condemnation case must be the "full and perfect
equivalent for the property taken." The usual measure of such compensation is the fair market
value of the property taken, which is the price that could have been obtained for the property if
sold on the open market. The deposit paid into the registry of the court as estimated just
compensation, as well as the final amount of compensation, will be distributed to the bankruptcy
court. The protection of creditors in a manner consistent with the Bankruptcy Code will be
achieved by permitting the eminent domain action to proceed unhindered in the district court
while the bankruptcy matter is pending, and the creditors will receive the benefit of all payments
of just compensation. Accordingly, the Department recommends that an exception be added to
Section 362(b) authorizing the commencement or continuation of an action or proceeding to
acquire property by the exercise of the power of eminent domain and of the enforcement of any
orders and judgments entered in such a proceeding.

Seaboard Air Line Railway Co. v. United States, 261 U.S. 299, 304 (1923) (noting that just
compensation means that "the owner shall be put in as good a position pecuniarily as he would
have been if his property had not been taken").

United States v. Miller, 317 U.S. 369, 374-375 (1943); United States v. 564.54 Acres of
Land, 441 U.S. 506 (1979). It must be noted, however, that just compensation does not include
the value of a business conducted on the property, unless the business is also taken.
IV. ENVIRONMENTAL ISSUES

A. Provide a Fair Opportunity For Environmental Agencies To Participate in Bankruptcy Cases

Section 102(1) of the Code and Bankruptcy Rule 2002 generally require that notice of a bankruptcy proceeding be given to all creditors so that they have an equal opportunity to assert their claims against the debtor's estate. Yet, in bankruptcy proceedings, environmental agencies frequently do not receive adequate notice, preventing them from having a fair and reasonable opportunity to protect the public's interest. Some debtors with potential environmental liabilities fail to provide Environmental Protection Agency (EPA) and state agencies with any notice of their bankruptcy case. Other debtors send their bankruptcy notices to the wrong EPA office, instead of the one that would know about environmental liabilities for some of their operations. Attorneys for other debtors routinely provide EPA with notice of every bankruptcy case in which they participate, regardless whether a potential environmental liability is known. And when debtors do provide notice to environmental agencies, they frequently fail to provide any information about the location of facilities with potential liabilities or other basic identifying information about the nature of its potential environmental liabilities that would enable the agencies to determine whether to participate in the bankruptcy case. Bankruptcy schedules routinely provide no more information than that the Government has a disputed, contingent claim.

The result of these practices is that EPA and state environmental agencies receive a significant volume of bankruptcy notices that do not serve the function for which notices and bankruptcy schedules are intended -- to enable the creditor to determine whether participation in a bankruptcy case is necessary. Too often, when EPA or a state agency receives a notice it does not mean that there is a potential environmental liability, and even if there is, the effort to ascertain whether there is reason to participate in the bankruptcy imposes enormous investigative burdens on underfunded government agencies that might not even have any information about environmental problems at a debtor's operations. Particularly in large Chapter 11 cases, on the other hand, debtors typically have environmental affairs officers or departments that could easily provide basic identifying information.

132 See City of New York v. New York, New Hamp. & H.R. Co., 344 U.S. 293, 297 (1953) ("The statutory command for notice embodies a basic principle of justice ... that a reasonable opportunity to be heard must precede judicial denial of a party's claimed rights"); In re Savage Industries, Inc., 43 F. 3d 714, 720 (1st Cir. 1994) ("Notice is the cornerstone underpinning Bankruptcy Code procedure"); In Re Fairchild Aircraft Corp., 184 B.R. 910, 924-31 (Bankr. W.D. Tex. 1995); see also Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306 (1950) ("An elementary and fundamental requirement of due process in any proceeding which is to be accorded finality is notice reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections"); S. Rep. No. 989, 95th Cong., 2d Sess. 42 (1978) ("Due process will certainly require notice to all creditors and security holders.")
To rectify these intractable problems, we urge that debtors be required to file a special schedule listing all potential environmental liabilities, including any notices or complaints under environmental statutes, any administrative or judicial orders or settlements, any environmental permits, and any possible releases of hazardous substances into the environment relating to the debtor. We also support clarification of the law so that debtors are required to send copies of their environmental schedule, bar date notice, and other relevant bankruptcy papers to EPA and relevant state environmental authorities if their environmental schedule discloses any possible environmental liabilities. The law should be clear regarding the precise EPA and state agency offices that need to be notified on account of potential environmental liabilities.

B. Clarify the Point When Environmental Claims Arise

Environmental contamination occurring prepetition, for which a judgment of cleanup costs has been entered, clearly gives rise to a claim. However, it is less settled whether a claim arises where contamination has occurred but no enforcement action has begun (as where the debtor is the only one who knows about the contamination). Resolution of when a claim arises is important because claims arising post-bankruptcy are not dischargeable. See, e.g., 11 U.S.C. § 1141.

Some reorganizing companies have argued that the government's claim should include all liability relating to pre-petition contamination of a site and that they should get a discharge and fresh start from all such liability. But, from the Government's perspective and the public interest in fulfilling the important purposes of the environmental laws, some future cost recovery claims under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) should be found not to have yet arisen because, otherwise, the Government may not ever have a fair opportunity to participate in the bankruptcy proceeding or obtain any recourse from a polluter with respect to its polluting activities. For example, the Government may not be aware of a contaminated site or the debtor's connection to the site or may have insufficient information about the contamination to participate meaningfully in the bankruptcy. Environmental problems often become known to regulatory agencies years after the conduct that created or contributed to the hazard. And, even if a debtor can be connected to a site, estimating future response costs may be purely speculative during the early stages of the response process before site testing and investigation.

Environmental law has the goal of making responsible parties contribute towards the cleanup of environmental problems they have caused. This purpose and its intended deterrent effect on polluting activities of companies is seriously undermined if the Government has no effective recourse against a debtor because a site is not within its fair contemplation so as to enable it to participate in the bankruptcy case by filing a non-speculative claim. In attempting to harmonize the sometimes conflicting goals of the bankruptcy and environmental laws, courts in different circuits have formulated several sometimes differing standards as to when environmental claims arise and become dischargeable. The law needs clarification.
The emerging test in the courts for when environmental claims arise is some variation on the "fair contemplation test," first articulated in In re National Gypsum, Co., 139 B.R. 397, 407-09 (N.D. Tex. 1992). In National Gypsum, Judge Sanders identified specific milestones in the environmental investigation and cleanup process that could, depending on the facts of a particular case, constitute "fair contemplation:" the regulator's knowledge of a site to which a debtor is connected; listing of such site on the National Priorities List established pursuant to CERCLA, 42 U.S.C. §§ 9601, et seq.; notification to the debtor that EPA considers it potentially liable at a contaminated site; commencement of investigation or cleanup activities; or the incurrence of response costs subject to cost recovery. Subsequently, in In re Chicago, Milwaukee, St. Paul & Pacific R.R., 3 F.3d 200 (7th Cir. 1993), the Seventh Circuit held that a CERCLA cost recovery claim arises when the CERCLA claimant can tie the bankruptcy debtor to a known release of a hazardous substance which the claimant knows will lead to CERCLA response costs, and when the claimant has conducted tests with regard to the contamination problem. See also In re Chicago, Milwaukee, St. Paul & Pacific R.R., 974 F.2d 775 (7th Cir. 1992). In In re Jensen, 995 F.2d 925 (9th Cir. 1993), the Ninth Circuit similarly held that under the California Hazardous Substance Account Act, a claim for recovery of costs arises only when the State has sufficient knowledge of the debtor's potential liability based on site testing and inspections.133

We recommend that the law be clarified to codify the holdings of the Seventh and Ninth Circuits. The fair contemplation test best harmonizes the various purposes of the bankruptcy and environmental laws.134 Other tests may lead to the discharge of unknown claims, thereby encouraging debtors to file for bankruptcy before the EPA becomes aware of CERCLA violations to avoid allocating resources to clean up hazardous materials. Such a bankruptcy loophole in the environmental protection laws should not be sanctioned.

Courts adopting alternative tests to the fair contemplation test include In re Chateaugay Corp. (LTV), 944 F.2d 997 (2d Cir. 1991) (cost recovery claim arises upon release or threatened release of hazardous substances into the environment); United States v. Union Scrap Iron & Metal, 123 B.R. 831, 838 (D. Minn. 1990) (each separate element of a CERCLA claim must be established before a CERCLA claim arises, including the incurrence of response costs).

C. Confirm the Availability of Equitable Remedies Under The Environmental Laws

Bankruptcy courts should not become havens for polluters by enabling reorganizing debtors to avoid their regulatory responsibility to protect public health and the environment by complying with cleanup injunctions. Otherwise many businesses would file for reorganization to obtain a competitive advantage over other businesses that must comply with the environmental laws. In In re Torwico Electronics, Inc., 8 F.3d 146 (3d Cir. 1993), cert. denied, 114 S. Ct. 1576 (1994), the Third Circuit agreed and held that the State of New Jersey could enforce a cleanup order, under the New Jersey Environmental Cleanup Responsibility Act, against a debtor that no longer owned or operated contaminated real property. The Court held that the State's equitable remedy for dealing with ongoing pollution was not a dischargeable claim in bankruptcy and that such injunctive obligations survive because the debtor still owns the hazardous waste left behind. The Court based its ruling in part on the Code's definition of "claim" which includes "equitable remedies" only if there is an alternative right to payment in lieu of specific performance of the equitable obligation. 11 U.S.C. § 101(5). The ruling was warranted, the court reasoned, because the debtor's liability for clean up of formerly leased property was an ongoing regulatory obligation, which did not run with the land, but rather "run[s] with the waste." Id. at 11.

Torwico is consistent with holdings in other courts of appeal. See In re CMC Heartland Partners, 966 F.2d 1143 (7th Cir. 1992); In re Chateaugay Corp. (LTV), 944 F.2d 997 (2d Cir. 1991). It is also consistent with other non-environmental cases which hold that where non-bankruptcy law does not provide the debtor with an option to make a payment in lieu of providing specific performance, the obligation to perform is not a bankruptcy claim. See, e.g., In re Udell, 18 F.3d 403 (7th Cir. 1994). However, at least two lower courts have not agreed.135

To avoid unnecessary litigation, we recommend that the exception in the definition of "claim" in the Code for certain equitable remedies be further clarified to confirm that it applies to environmental statutes that do not provide an alternative right of payment in lieu of dealing with ongoing pollution. Bankruptcy should not be used by reorganizing polluting companies to provide a substantive right that does not exist under non-bankruptcy law. A mandatory environmental injunction is not normally equivalent to a claim for money damages, but rather is a legitimate independent obligation under laws that protect human health and the environment. If non-bankruptcy law requires reorganizing companies to remedy their pollution problems, bankruptcy law should not provide a haven for polluters to avoid these responsibilities.

D. Limit the Ability of Bankruptcy Courts to

Consider Future Environmental Claims

The Commission is considering various suggestions for handling certain claims that may arise post-bankruptcy, including in the area of mass torts. Most of the proposals are ill-suited to future environmental claims.

Future environmental claims by governmental agencies differ significantly from future mass tort claims. One justification for special provisions regarding future mass tort claims is that both debtors and potential claimants benefit from a fair provision for future claims. Since the future claimants' identities are not yet known, they cannot protect themselves. By comparison, the identity of environmental agencies is easily ascertainable. If it is in their mutual interest, the debtor and the government are therefore perfectly capable of working out their own compromise agreements with respect to the handling of future environmental claims. Indeed, the United States has entered into numerous such settlements with debtors. See, e.g., Notice: Lodging of Consent Decree, 58 Fed. Reg. 11421-02 (February 25, 1993)(providing public notice of settlement in the LTV bankruptcy providing, inter alia, for the disposition of claims arising from prepetition conduct as those claims arise in the future).

Environmental claims that have not yet arisen are especially speculative and inherently more difficult to predict or estimate than even mass tort claims. At least with respect to mass tort claims, a universe of existing claims sometimes exists that can provide a basis for predicting the number and amount of future claims and for setting aside money for such claims. Predicting a debtor's future and unknown environmental liabilities would be sheer guesswork.

Furthermore, under the emerging definition of environmental "claim" set forth above, environmental liabilities within the fair contemplation of the parties are present claims, and are therefore dealt with in the context of bankruptcy. However, the fair contemplation test excludes from the definition of claim those future liabilities that are as yet so inchoate that it would not be fair or feasible to deal with them in the context of a bankruptcy, even when such liabilities are based on a debtor's prepetition conduct.136 Any proposal that would require future environmental claims to be dealt with in the context of bankruptcy would be unfair, and would dramatically expand the scope of environmental liabilities within the jurisdiction of the bankruptcy courts.

Because the definition of claim encompasses all environmental liabilities that can be fairly dealt with in bankruptcy, attempting to deal with future environmental claims in bankruptcy

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See In re National Gypsum Corp., 139 B.R. 397, 407-09, (N.D. Tex. 1992); (In re Fairchild Aircraft Corp., 184 B.R. 910, 927, 931 (Bankr. W.D. Tex.)("Not every conceivable obligation finding its source in the debtor's prebankruptcy past is necessarily an obligation that can be fairly handled by the bankruptcy process... [T]he definition of claim is "restricted to those claims to which it is also possible to accord fair representation of their interests in the course of the case."

(footnote omitted)).
would, by definition, be beyond the realistic and fair limits of the bankruptcy process. Any Commission recommendation regarding future claims should explicitly except from its purview future environmental claims of governmental agencies. A contrary result would provide a strong incentive for companies to file for reorganization to cap their future environmental liabilities. The result would be a large increase in corporate filings to avoid environmental liability by polluters. Applying such provisions to the government's environmental claims would be tantamount to a rollback or repeal of the environmental laws to benefit polluters. Such a change would be unfair to companies that spend their resources to comply with the law and avoid pollution and would seriously undermine public health and safety. Under existing law, the Government has entered, and can continue to enter, into settlements with debtors that provide for appropriate mechanisms for most debtors to continue operations and maintain compliance with environmental laws. A change in the law in this area would undermine such settlements and provide an unhealthy and unwise incentive for polluters.

E. Ensure that Buyers of Contaminated Property From the Debtor Comply with Environmental Laws

Some debtors and buyers have improperly contended that Section 363 of the Code permits buyers of contaminated property to immunize themselves from environmental liability that arises from the operation and ownership of regulated facilities that were previously contaminated. Sometimes debtors and buyers do not even notify governmental agencies of this claimed immunity or they provide notices that are unclear.

Numerous environmental statutes are designed to ensure that the owners and operators of industrial facilities preserve human health and the environment. A party that purchases a facility in bankruptcy takes that facility with the same obligations as a party that acquires assets in any other way. As the Supreme Court observed in Ohio v. Kovacs, 469 U.S. 274, 285 (1985):

We do not question that anyone in possession of the site -- whether it is Kovacs or another . . . must comply with the environmental laws of the State of Ohio. Plainly, that person or firm may not maintain a nuisance, pollute the waters of the State, or refuse to remove the source of such conditions.

Other courts have continually upheld the principle that the purchaser or operator of a debtor's property is not entitled to obtain the property "free and clear" of environmental liabilities that exist after the purchase. Thus, in In re CMC Heartland Partners, 966 F.2d 1143, 1146-47 (7th Cir. 1992), the Seventh Circuit held that environmental obligations based on current ownership and operation were not affected by a prior bankruptcy even where there was pre-bankruptcy contamination. The cleanup obligation runs with the land to the new owner and operator.137

See also In re Fairchild Aircraft Corp., 184 B.R. 910, 917-19 (Bankr. W.D. Tex. 1995) (continued...
In order to avoid the Government having to respond to continued attempts by debtors and buyers to immunize themselves from environmental liability under Section 363, we recommend the statute be amended explicitly to preclude such requests for immunity. No one should be permitted to own and operate property in a manner that constitutes a nuisance or threatens the public’s well being or the environment.

F. Limit the Circumstances Under Which Debtors May Abandon Contaminated Property

Section 554(b) of the Code authorizes a trustee in bankruptcy to abandon property of an estate "after notice and a hearing" if such property is "burdensome to the estate or ... is of inconsequential value and benefit to the estate." In Midlantic National Bank v. New Jersey Department of Environmental Protection, 474 U.S. 494 (1986), the Supreme Court sharply curtailed a debtor’s ability to rely on abandonment to escape liability for the costs of environmental cleanup. The Court held that applying Section 554(b) was inappropriate when the abandonment of contaminated property would contravene "a state statute or regulation that [was] reasonably designed to protect the public health or safety from identifiable hazards." Id. at 507. In a footnote, however, the Court further stated that the "abandonment power is not to be fettered by laws or regulations not reasonably calculated to protect the public health or safety from imminent and identifiable harm." Id. at 507 n.9.

Post-Midlantic courts have struggled with its application, reaching different conclusions, particularly in cases where the debtor has limited assets. Some courts have strictly construed Midlantic and allowed abandonment if there is no imminent harm to the public health or where the trustee took minimal precautions short of remediating the hazard. Other courts have prohibited abandonment unless, inter alia, compliance with the environmental law is so onerous as to interfere with the bankruptcy reorganization process and the violation would be merely speculative or indeterminate. Once a contaminated facility is abandoned to the corporate shell,

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(Section 363 of the Code is limited to secured interests in property and may not be used to extinguish future claims that may arise based on a purchaser's post-acquisition ownership or operation of property); Zerand-Bernal Group, Inc. v. Cox, 23 F.3d 159, 163 (7th Cir. 1994); United States v. Wheeling-Pittsburgh Steel Corp., 818 F.2d 1077, 1081 (3d Cir. 1987) (reversing a lower court order that had relieved a debtor of its obligation to comply with the Clean Air Act).

See, e.g., In re In re L.F. Jennings Oil Co., 4 F.3d 887 (10th Cir. 1993); In re Smith-Douglass, Inc., 856 F. 2d 12, 16-17 (4th Cir. 1988); In re Better-Brite Plating, Inc., 105 B.R. 912, 919 (Bankr. E.D. Wis. 1989).

See, e.g., Lamcaster v. Tennessee, 831 F.2d 118 (6th Cir. 1987); In re Environmental (continued...)
environmental authorities may have difficulty finding any official to authorize access to the abandoned facility to conduct further cleanup actions.

We recommend that the law make clear that debtors may not abandon contaminated property without conditioning the abandonment on the use of unencumbered assets to address any threats to public health or the environment posed by property of the estate. We further recommend that the law clearly provide environmental authorities with a statutory right of access to any abandoned property for the purpose of addressing any threats to public health or the environment. See In re Mowbray Engineering Co., 67 B.R. 34 (Bankr. N.D. Ala. 1986) (providing EPA with a right of access to abandoned property).

G. Allow Holder of Contingent Claims For Contribution to Participate in Bankruptcy

An important issue in bankruptcy involves the treatment of claims for contribution filed by private parties. We recommend that the Commission consider clarifying the law to provide a fair opportunity for holders of such contingent environmental claims to participate in bankruptcy cases. Many courts have disallowed contingent environmental claims for contribution under Section 502(e)(1)(B) of the Code and other statutory provisions that were meant to deal with claims of co-guarantors.

As a matter of fairness, such claimants should have an opportunity to participate in bankruptcy cases as long as there are protections against the debtor having to pay twice: once to the contingent claimant and once to the Government. In addition, without a change permitting contingent contribution claimants to file claims, there is an undue burden upon the United States to file a claim. Unless the United States files a claim, the debtor may completely avoid making any payment on account of its environmental wrongdoing.

We therefore recommend some mechanism to allow contingent environmental contribution claimants to protect their interests. One solution could be to provide for an escrow.

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mechanism in appropriate cases which would protect the interests of other creditors and contribution claimants as well as the debtor. See In re Allegheny International, Inc., 126 B.R. 919 (W.D. Pa. 1991), aff’d, 950 F.2d 721 (3d Cir. 1992). The priority of direct claimants versus contribution claimants should continue to be governed by applicable non-bankruptcy law.
V. GOVERNMENT ISSUES

A. Ensure Adequate Notice is Provided to the Government

In a large Chapter 11 bankruptcy case involving a publicly-traded corporation in a regulated industry, e.g., an airline, the United States can have numerous interested client agencies: GSA (with ticket and transit claims), the FAA (with regulatory interests and fine and penalty claims), the DOT (with regulatory interests and fine and penalty claims), the INS (with fee and fine and penalty claims), the Customs Service (with fee and fine and penalty claims), the EEOC (with regulatory interests and damages, fines and penalty claims), various DOD components (with transit claims and contract disputes under the Civilian Reserve Aircraft Fleet program), the IRS (with various tax claims), the PBGC (with pension related issues and claims), the EPA (with environmental interests), the SEC (with securities related claims), and other agencies (e.g., Antitrust Division of the DOJ or the FTC with regulatory interests).

In a less extreme but very typical chapter 11, the United States has at least IRS and several other federal interests (including some of the agencies noted above, as well as the SBA, the Economic Development Administration of the Department of Commerce or HUD, with their insured loan programs). The same is true in chapter 12 family farmer cases where the IRS and a panoply of Department of Agriculture agencies (Consolidated Farm Service Administration, Rural Housing Administration, Federal Crop Insurance Corporation) can be involved. And even in individual Chapter 7 and 13 proceedings, numerous federal interests (HUD or VA insured home mortgages and Department of Education student loan claims) in addition to those of the IRS are routinely involved. Yet, in most instances, the notice received by the United States Attorney or the Attorney General is simply addressed to the United States with no indication of the affected federal agencies.\textsuperscript{141} With hundreds of federal agencies and thousands of field offices, this notice is tantamount to no notice at all.\textsuperscript{142}

Rule 2002(j)(4) also requires notice be sent to the department, agency, or instrumentality of the United States through which the debtor became indebted. But this has proved ineffectual. Notices routinely are sent (innocently or by design) to agency offices having no responsibility for asserting claims.\textsuperscript{143} For example, an agency may have one central lock box facility for processing

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\textsuperscript{141} A smaller United States Attorney's office can received ten to twenty such notices a day. In large, metropolitan offices, over a hundred notices a day can be received. Courts have differing views regarding the extent of notice that must be given to the United States.

\textsuperscript{142} We recognize and appreciate Congress's 1994 amendment of Section 502(b)(9) which enlarged to 180 days the time period within which governmental units may file claims. This change helps to ameliorate the harmful consequences caused by inadequate notice but does not address the core problems causing the harm.

\textsuperscript{143} See, e.g., \textit{In re Faust}, 180 B.R. 432, 436-38 (Bankr. D.S.C. 1994) (The court allowed a (continued...)}
the payment of invoices or loan installments that is neither responsible for, nor equipped to respond expeditiously to, notices which notify of the automatic stay and trigger numerous deadlines under the bankruptcy laws. Those responsibilities typically lie with the local office which administers the loan, grant, subsidy or other program, or, in the case of the IRS, with a special office created specifically to handle bankruptcy cases.

These notice difficulties lead to significant inefficiencies not only for the United States but for the bankruptcy system as well. For the United States, scarce resources are diverted, tax dollars that otherwise would go to the federal treasury are not recovered and program enforcement can be jeopardized. For the bankruptcy system, (often substantial or priority) claims are filed late (or not filed at all), inadvertent violations of the automatic stay (or even the discharge injunction) occur, challenges to dischargeability are delayed and, generally, uncertainty occurs.

Two changes would help to avoid these problems. First, debtors should be required to identify in the listing for the United States Attorney and the Attorney General in their address matrixes the names of the affected federal agency. Second, United States Attorneys should be permitted to publish a list in the local clerk's office indicating the appropriate address for service on creditor agencies frequently involved in bankruptcy cases there. This process has been utilized in some courts with considerable success. Utilizing these simple administrative improvements could enhance and simplify significantly the government's participation in the bankruptcy process, thereby benefitting not only the United States but debtors, creditors and the overall bankruptcy system.

B. Improve the United States Trustee Program

For almost fifty years prior to the enactment of the Code, studies of bankruptcy reform contained three themes. First, the bankruptcy system was ineffective and corrupt because administration of bankruptcy cases was largely unsupervised. Second, creditor involvement in

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later filed IRS proof of claim on equitable grounds because the debtors sent their tax return to the wrong IRS office. The court rejected the debtor's argument that sending the return to any office was sufficient, noting that permitting this would "allow a debtor to essentially 'play hide and seek' with the government.

144 Notices are prepared in many districts by the clerk's office. We do not propose that clerks be required to search the debtor's schedules (which frequently have not yet been filed when the first notices are sent) to locate federal agency claim. Instead, by requiring that identification be made in the address matrix, we seek to place the burden on the debtor.

145 For additional discussion of notice issues see Part I F. and Part IV A., supra.
most cases was inadequate to monitor the administration of cases. Third, the remedy for these problems was the creation of a federal agency to monitor and administer bankruptcy cases.  

The United States Trustee Program (the "USTP") was created in response to these abuses, filling the need for an independent "watchdog" to oversee bankruptcy administration. Originally created as a pilot project in 1978, it was expanded to a nationwide program in 1986. Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3088, 3119 ("BAFJA"). The USTP has largely eliminated the abuses it was designed to address. In the current discussions of bankruptcy reform and in the deliberations of the Bankruptcy Review Commission to date, the alleged "rings" and "cronyism" that dominated earlier reform studies are absent.

To strengthen the USTP and enhance its effectiveness in bankruptcy administration, we suggest four changes, as follows:

- Extend the USTP to Alabama and North Carolina.
- Grant the United States Trustees administrative subpoena power.
- Enhance the United States Trustee's administrative powers in Chapter 11 cases.
- Reduce the number of United States Trustee Regions from 21 to 11.

These proposals are discussed seriatim.

1. **Extend the USTP to Alabama and North Carolina.**

When Congress made the USTP a nationwide program in 1986, the commencement date of the program in different judicial districts varied. Six federal judicial districts in the States of North Carolina and Alabama remain outside the program, and the date for the inclusion of these districts has been postponed until October 1, 2002 -- sixteen years after the USTP's nationwide expansion. Pub. L. No. 101-650, 317(a), (c), 104 Stat. 5115, 5116 (1992). In these six judicial districts, "Bankruptcy Administrators" and court clerks employed by the judicial branch perform many of the functions that are performed by United States Trustees in USTP districts.

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This arrangement may not comply with Article I's mandate to "establish...uniform Laws on the subject of Bankruptcies throughout the United States." U.S. Const. art I, §8, cl.4. Supreme Court precedent on what "uniformity" means in this context is ambiguous. The leading case on the issue is *Hanover National Bank v. Moyses*, 186 U.S. 181 (1902) where the court rejected a challenge to the Bankruptcy Act of 1898, which recognized state exemptions instead of establishing a system of uniform federal exemptions. The opinion suggests that Congress can account for differences in state law in the bankruptcy laws without violating the requirement of uniformity. More recently, in *Railway Labor Executives' Ass'n v. Gibbons*, 455 U.S. 457 (1982), the Supreme Court struck down, as violative of Article I's uniformity requirement, a statute requiring employees of the bankrupt Rock Island and Pacific Railroad Co. estate to receive certain benefits if not rehired by other carriers. According to the Court, "to survive scrutiny under the Bankruptcy Clause, a law must at least apply uniformly to a defined class of creditors." *Gibbons*, 455 U.S. at 473.\(^{147}\)

Given the lack of clarity on Article I's uniformity requirement and the doubts raised about the justification for maintaining both the USTP and the Bankruptcy Administrator programs, additional challenges to the constitutionality of this dual system seems likely. In any event, maintaining a special system of bankruptcy administration for just six of the nation's 94 judicial districts is imprudent. No articulated policy justifies maintaining the Bankruptcy Administrator program, and its continued existence threatens only to inspire additional constitutional challenge.

### 2. Grant the United States Trustees Administrative Subpoena Power.

Title 28, § 586 requires the United States Trustee to monitor trustees. And the Attorney General has made rooting out bankruptcy fraud a Departmental priority. However, the Trustee's ability to guard against fraud and abuse by case and standing trustees is frustrated by its lack of a key regulatory tool -- the administrative subpoena.

Currently, the United States Trustee must rely on reports prepared and filed by the private trustees to detect fraud and embezzlement or obtain information informally from third parties. Unlike other private agencies that monitor and regulate professionals and fiduciaries in the private sector, such as the Securities Exchange Commission and the Federal Deposit Insurance

\(^{147}\) Some commentators suggest that, since the USTP and Bankruptcy Administrator systems deal with the administrative rather than substantive aspect of bankruptcy, the differences do not violate Article I. See Dan J. Schulman, *The Constitution, Interest Groups, and the Requirements of Uniformity: The United States Trustee and the Bankruptcy Administrator Programs*, 74 Neb. L. Rev. 91, 129 (1995). However, this distinction was flatly rejected by the Ninth Circuit in *St. Angelo v. Victoria Farms, Inc.*, 38 F.3d 1525 (9th Cir. 1994), on the grounds that the actions of the United States Trustee can affect substantive rights through their powers to appoint trustees, monitor proceedings, seek dismissal of cases, and determine fees that can be paid out of the estate. *Victoria Farms*, 38 F.3d at 1531.
Corporation, the United States Trustee may not compel the turnover of the private trustee's books and records without commencing litigation against the trustee.

With the power to issue administrative subpoenas, the United States Trustee could avoid unnecessary delay in obtaining information necessary to determine if a private trustee is engaging in misconduct. Crafting such a power could be modeled upon the powers possessed by the SEC and the FDIC and should contain the following elements:

- authority for the United States Trustee to issue an administrative subpoena for a private trustee's books and records;
- an opportunity for the party served with the subpoena to file a motion to quash or application to enjoin enforcement in the United States District for the district where the party resides;
- a standard that requires enforcement of the subpoena unless the United States Trustee had no reason to believe that the private trustee was engaged in fraud, embezzlement or other breach of its fiduciary duties.


3. **Enhance the United States Trustee's Administrative Powers in Chapter 11 Cases.**

The "small case" presents one of the most difficult and controversial issues in the discussions of Chapter 11 reform. While in large cases, there normally are active committees and sophisticated counsel to prevent the case from languishing, such stimuli are missing in small cases, leaving the debtor largely unsupervised and unmotivated to speed the case along. As a result, small cases languish -- they spend more time in bankruptcy and achieve confirmation less often than large cases with active creditor constituencies. See, e.g., Lynn M. Lopucki, "The Trouble with Chapter 11," 1993 *Wis. L. Rev.* 729.

One of the primary functions of the United States Trustees is to monitor the progress of Chapter 11 cases and frequently file motions to convert or dismiss if a case is not progressing toward confirmation. Unfortunately these efforts are infrequently successful. Judges are reluctant to dismiss a case unless a private party is seeking the relief, and many are inclined to permit debtors every available opportunity to reorganize. The Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 217, 108 Stat. 4106, and other recent calls for reform attempt to deal with the problem of languishing small cases by enacting special provisions dealing with small business and single asset cases.

This approach suffers from at least two major pitfalls. First, statutory change is a blunt instrument to deal with a complicated and multifaceted problem. No matter how carefully the
statutory reforms are drawn, some cases will be included improperly, while others that should be included are missed. Second, increasing the modes of reorganization relief will lead to litigation over whether a debtor has sought the appropriate remedy. The more Chapter 11 is “fine tuned” to deal with different categories of cases, the more this litigation will increase.

As an alternative, we urge the Commission to consider small cases as a problem of administration, and augment the powers of the United States Trustee to address the problems posed by these cases. Specifically, 28 U.S.C. § 586 should be amended to permit the United States Trustee to file reports on the progress of Chapter 11 cases, with financial analysis of the debtor and, where possible, an estimate of the likelihood of the debtor reaching confirmation. The need for these reports should be discretionary with the United States Trustee, to permit resources to be concentrated where needed. This proposal would significantly enhance the ability of the United States Trustee to move cases through the bankruptcy system.

4. Reduce the Number of United States Trustee Regions from 21 to 11.

The USTP’s FY 1997 budget proposes to reduce the number of United States Trustee regions from 21 to 11, but recommends that this change be delayed until the recommendation can be considered by the National Bankruptcy Review Commission. This proposal has been formerly referred to the Commission. The restructured United States Trustee Regions would generally be the same as the federal judicial circuits (with the exception of the DC circuit, which would be aligned with the proposed Region 4). The Program’s current configuration generally follows circuit lines on the east coast, but the merger of regions in other parts of the country would be necessary to comport with the circuit alignment. A gradual transition is proposed under which existing United States Trustees would be allowed to complete their appointments before their regions are reconfigured.

The Program’s current structure places a United States Trustee in charge of a defined geographic or judicial area. That structure allows the Program to operate successfully with very small offices, many with less than five staff members, thereby providing broad service to the bankruptcy courts which sit in more than 300 location nationwide. Bankruptcy courts closely reflect the local legal culture. Likewise, the United States Trustee’s discretion, judgment, and capacity to adapt policies to local conditions underpin the Program’s independence.

Unlike the United States Attorney model which places a single senior policy level policy position (the United States Attorney) in every judicial district, the USTP model recognizes that bankruptcy administration can be carried out successfully with a smaller number of senior level positions. The Program has now progressed to the point where it can now operate with as many United States Trustee positions as there are judicial circuits.

The circuit based model has a number of advantages. It is a rational and easily understood concept, likely to gain acceptance from the bench, the bankruptcy bar, and possibly the Congress.
As a variant of the current structure, it provides stability by permitting many of the current management practices and activities to continue. The proposal maintains a strong executive level presence in the field, dedicated to ensuring that the offices are well managed and take appropriate positions in litigation and in regulating private trustees. Increasing the geographic and judicial areas served by each of the United States Trustees will provide them increased flexibility to use staff to meet existing crises or sudden swings in case filing patterns within their respective areas.

C. Governmental Units Should be Eligible to Serve on Creditors' Committees

As noted by one commentator, "[t]he committee of creditors ... is an increasingly important component of the reorganization process." Kenneth N. Klee, "Creditors Committees Under Chapter 11 of the Bankruptcy Code," 44 S.C.L. Rev. 995, 996 (1993). Section 1102(a)(1) of the Code provides that "[a]s soon as practicable after the order for relief under Chapter 11 of this title, the United States trustee shall appoint a committee of creditors holding unsecured claims." That section further instructs that "[o]rdinarily [the committee shall] consist of the persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee." According to the legislative history of this provision, creditors' committees are intended to be the "primary negotiating bodies for the formulation of the plan of reorganization." H.Rep. No. 595, 95th Cong., 1st Sess. 401-02 (1977). In performing this role, a creditor's committee may, inter alia, consult with the trustee or debtor concerning the administration of the case and investigate the financial condition of the debtor, including the state of the debtor's business and the amount and nature of its assets and liabilities. 11 U.S.C. §1103(c). See also Daniel J. Bussel, "Coalition-Building Through Bankruptcy Creditors' Committees," 43 UCLA Law Review 1547, 1559-60 (1996).

As a consequence of the exclusion of governmental units from the definition of "person," 11 U.S.C. § 101(41), governmental units are generally not eligible for membership on creditors' committees under Section 1102 of the Code. The Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 106, amended Section 101(41) of the Code, to authorize the Pension Benefit

148 Because this section uses the word "ordinarily," it has been construed to allow creditors other than the several largest creditors to be appointed to the committee. See, e.g., In re Altair Airlines, 727 F.2d 88 (3d Cir. 1984). See also, H.Rep. No. 595, 95th Cong., 1st Sess. 401-02 (1977).

149 In re Gates Eng'g, 104 B.R. 653, 654 (Bankr. D. Del. 1989) (state agency not "person" eligible to serve on committee); In re VTN, 65 B.R. 278, 279-80 (Bankr. S.D. Fla. 1986) (same); In re Baldwin-United Corp., 38 B.R. 802, 806 (Bankr. S.D. Ohio 1984) (Federal Deposit Insurance Corporation not eligible to serve on committee); see also H.Rep. No. 595, 95th Cong, 1st Sess. 401 (1978) ("The court is restricted to the appointment of persons in order to exclude governmental holders of claims or interests.").
Guarantee Corporation and state pension plans to serve on creditors' committees in appropriate cases. Governmental units, such as the FDIC, are also eligible to serve on creditors' committees after acquiring assets through a loan guarantee agreement or as a receiver or liquidating agent. 11 U.S.C. §101(41). The exceptions for the PBGC and the FDIC reflect the desirability, and sometimes necessity, for government creditors with a large financial stake in a Chapter 11 proceeding to have access to essential information needed to make informed decisions regarding potential reorganization and to be active players in negotiating a plan of reorganization. In some cases, Department representatives have served on "unofficial" creditors' committees or as nonvoting members of a committee and have found their participation invaluable, albeit restricted.

We believe that all governmental creditors should have the right to serve on creditors' committees. Without access to information provided to creditors' committee members, the United States is handicapped in its ability to provide adequate and effective representation of its interests. Although, at times, the interests of a government creditor may conflict with the larger body of creditors, the same is true of non-government creditors who are allowed to sit on committees under current law. To the extent that a particular government creditor may have a conflict, the problem may be dealt with on a case-by-case basis as is currently done with non-government creditors. See In re Grant Broadcasting of Philadelphia, Inc., 71 B.R. 655, 664-65 (Bankr. E.D. Pa. 1987); In re Enduro Stainless, Inc., 59 B.R. 603, 605 (Bankr. N.D. Ohio 1986). With respect to the fiduciary responsibilities of members of creditors' committees, we do not believe that those responsibilities will be any greater burden for representatives of government than for representatives of private creditors.

D. Clarify that Restitution Orders Are Nondischargeable

Little systematic consideration has been given to the effect the Bankruptcy Code has on the enforcement of criminal sentences, particularly those that require offenders to pay restitution to victims of crime. Rather, the relationship between the Bankruptcy Code and the enforcement of criminal sentences has been addressed in a piecemeal fashion since the issue first gained prominence ten years ago. Interference with a government's ability to enforce restitution orders breeds disrespect for the law, reduces the likelihood of the offender's rehabilitation, limits the deterrent effect of the sentence and denies victims the opportunity to lessen the impact of the crime on their lives.

In Kelly v. Robinson, 479 U.S. 36, 47 (1986), the Supreme Court found a restitution order imposed under State law nondischargeable observing "[t]he right to formulate and enforce penal sanctions is an important aspect of the sovereignty retained by the States." Many believed that this ruling would fully protect restitution and other criminal financial penalties from discharge. However, in reaching this conclusion, the Court relied upon Section 523(a)(7) of the

The legislation provides that "[t]he amendments made by this subtitle shall, to the extent constitutionally permissible, be effective for sentencing proceedings in cases in which the defendant is convicted on or after the date of enactment of this Act [April 24, 1996]." Public Law 104-132 at § 211.

However, many ambiguities remain at the intersection of the criminal restitution law and bankruptcy. Recent Congressional action may set law enforcement and the Bankruptcy Code yet again on a collision course. In 1996, the Congress passed the Antiterrorism and Effective Death Penalty Act, Pub. L. No. 104-132 (1996), which makes the imposition of restitution mandatory for a broad variety of offenses, 18 U.S.C. § 3663A, and specifically directs the courts to order restitution to each victim "in the full amount of each victim's losses and without consideration of the economic circumstances of the defendant." 18 U.S.C. § 3664(f)(1)(A). As the quoted language suggests, the Congress clearly contemplated that court would impose restitution that is not payable at the time of the imposition, and that may never be paid by the offender. See 18 U.S.C. § 3664(f)(3)(B). At the same time, Congress extended the duration of liability for both fines and restitution. See 18 U.S.C. § 3613(b).

We believe that these new restitution orders should be nondischargeable, as would be the case under Chapter 13. Section 1328(a)(3) unambiguously prohibits the discharge of any debt "for restitution, or a criminal fine, included in a sentence on the debtor's conviction of a crime." It is less clear that these restitution orders will be nondischargeable under Chapters 7, 11 or 12. For example, Section 523(a)(7), relied upon by the Supreme Court in Kelly, renders nondischargeable debts "payable to and for the benefit of a government unit" and provides that the debt cannot be "compensation for actual pecuniary loss." By comparison, restitution orders under the Antiterrorism Act are payable to the individual harmed and are geared toward the victim's actual losses, thereby making it at least arguable that such orders are not covered by Section 523(a)(7). Moreover, Section 523(a)(7) also applies only to "individual debtors," thereby raising the specter that restitution orders against corporate debtors could be discharged under Chapters 7, 11 and 12.

The potential for discharging restitution orders likely will receive scrutiny as offenders are sentenced under the new Federal legislation. Accordingly, we believe Section 523(a)(7) should be amended to incorporate discharge language similar to that contained in Section 1328(a)(3). While there are clearly some competing interests between the law enforcement objectives of a criminal sentence and the bankruptcy objective of providing the debtor with a fresh start, we believe that the time is ripe to look at the relationship between criminal enforcement and the

151 The legislation provides that "[t]he amendments made by this subtitle shall, to the extent constitutionally permissible, be effective for sentencing proceedings in cases in which the defendant is convicted on or after the date of enactment of this Act [April 24, 1996]." Public Law 104-132 at § 211.
We would also like to explore with the Commission potential solutions to other difficulties imposed by the Bankruptcy Code on the enforcement of criminal sentences. For example, criminal financial penalties that are not subject to discharge are nonetheless subject to the automatic stay. Compare 11 U.S.C. §§ 362(a)(1) and 362(b)(4). Probation periods and periods of liability for criminal financial penalties can be brief enough to frustrate the criminal enforcement process once a bankruptcy is filed and further enforcement is stayed. See, e.g., 18 U.S.C. §§ 3013 and 3561(c).
VI. TAX ISSUES

A. Problems Relating to Proofs of Claim for Taxes

1. Retain Special Rules Regarding the Time for Filing Government Proofs of Claim

Under the Bankruptcy Act, Bankruptcy Rule 302(e) provided that the time for filing a proof of claim was six months after the first date set for the meeting of creditors. Rule 3002 of the Federal Rules of Bankruptcy Procedure shrunk the filing period to three months after the date first set for the creditors’ meeting. As with the earlier rule, Rule 3002 provided that government agencies could be granted an extension of time within which to file a proof of claim upon the filing of a timely motion. The general practice of government agencies, however, is to file an estimated claim rather than to seek an extension of time to file.

One consequence of the reduction of time in which to file proofs of claim was the disallowance of late claims in numerous cases and significant litigation over whether a claim filed after the bar date was timely as an amendment to a previously filed claim and significant revenue losses. For example, prior to the 1994 Amendments, there had been a split of authority concerning whether tardily filed claims should be allowed. Compare In re Hausladen, 146 B.R. 557, 560-61 (Bankr. D. Minn. 1992) (en banc) (claims not disallowed); In re Stoecker, 172 B.R. 579 (N.D. Ill. 1994) (same) with In re Glow, 111 B.R. 209, 217 (Bankr. N.D. Ind. 1990) (claims disallowed); In re Tucker, 174 B.R. 732 (Bankr. N.D. Ill. 1994) (same).

Congress resolved this dispute in 1994, by amending Section 502 of the Code to provide expressly for the disallowance of a claim if a proof of such claim is not timely filed. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 213(a), 108 Stat. 4106, 4125-26. Provision was made, however, for allowing tardy claims to the extent that Section 726(a)(1)-(3) provides for distribution on their account. Section 502(b)(9) also treats as timely a claim filed by a government unit within 180 days after the order for relief or within such later time as the bankruptcy rules provide. Thus, in order to receive payment in a bankruptcy case, a governmental unit’s claim must be allowed, although it will be allowed pursuant to somewhat different filing requirements than applicable to other creditors. See generally 14 Jacob Mertens, Jr., Mertens' Law of Fed. Income Tax'n §54.130 (1996).

These provisions are very beneficial to government agencies and should be retained. They recognize the special difficulties encountered by government in bankruptcy and the involuntary nature of its status as a creditor in some contexts, including as a tax collector.\textsuperscript{153} While problems with filing timely are by no means limited to government agencies or taxing authorities, staffing

\textsuperscript{153} See H. Rep. No. 595, 95th Cong., 1st Sess. 190 (1978) ("A taxing authority is given preferential treatment because it is an involuntary creditor of the debtor. It cannot choose its debtors, nor can it take security in advance of the time that taxes become due.")
restrictions and information systems limitations have a disproportionate effect on government agencies. Furthermore, tax returns with filing dates that fall after the commencement of bankruptcy, amended returns, late filed returns, and unfiled returns present special and relatively unique challenges to taxing authorities.

2. Taxing Authorities Should Be Excepted From Proof of Claim Requirement for Scheduled Taxes

In a Chapter 11 proceeding, debts scheduled by the debtor are deemed filed and a creditor need not file a proof of claim for such debts unless it contests the amount scheduled. 11 U.S.C. §1111(a). In other words, in Chapter 11, a creditor is not required to file a proof of claim agreeing with the amount scheduled by the debtor. In Chapters 7, 12, and 13, the rule is the opposite, and upon the failure to file a timely proof of claim for scheduled debts, a creditor is not entitled to distribution and, in most instances, its claim will be discharged. Even more confusing is a case converted to Chapter 7 from Chapter 11 -- a creditor is entitled to distribution on the basis of the schedules in a Chapter 11 case, but is not entitled to a distribution once the case converts to Chapter 7 unless a proof of claim is filed. See Fed. R. Bank. P. 1019(3); In re Cole, 189 B.R. 40, 50 (Bankr. S.D. N.Y. 1995).

Putting aside the question of whether these distinctions make any sense for creditors as a whole, they certainly make no sense in a tax context. When a taxpayer accurately lists on the schedules filed in a Chapter 7, 12, or 13 case the amount and nature of any tax debts owing, the amount determined by the debtor to be due should not be disallowed and denied distribution if the taxing authority, for whatever reason, does not file a claim. Nor should the debtor have to file a proof of claim on behalf of a tax listed on a schedule to ensure that a distribution is made with respect to a nondischargeable tax. Just as all scheduled claims are deemed filed in Chapter 11, all tax claims (or all government claims or all claims) should be deemed filed in other chapters. A taxing authority (or other creditor) should not in effect have to file a paper saying that it "really" wants to be paid. And a debtor should not receive a windfall when, for whatever reason, a taxing authority fails to affirm that it wants to be paid the scheduled debt. This is particularly true in Chapter 13, where it smacks of unseemly gamesmanship for debtors who schedule priority taxes in a Chapter 13 plan and begin to make payment to the trustee, to move to amend the plan after expiration of the bar date if the taxing authority fails to file.

The current claim filing rules unnecessarily contribute to the mountain of paper generated by bankruptcy proceedings, can be a trap for the unwary, and should be modified.
B. Serial Filings

1. Clarify Tolling of Priority and Discharge Periods

During the pendency of a case, the automatic stay generally enjoins the IRS and other creditors from collecting prepetition taxes or other debts. Taxes entitled to priority under Section 507(a)(8) of the Code include taxes for which returns were due within three years of bankruptcy and taxes assessed within 240 days of bankruptcy. Taxes entitled to priority and taxes attributable to delinquent returns filed within two years of bankruptcy are also excepted from discharge under Section 523(a)(1). Debtors often attempt to manipulate the timing requirements of these provisions through serial filings. After filing serial petitions, debtors contend that during the pendency of the earlier case or cases, the periods of time specified in Sections 507(a)(8) and 523(a)(1) continued to run and have lapsed with the result that such taxes are no longer subject to priority in the second or third case and have been discharged. For the most part, the courts have rejected this argument, holding, on various theories, that these time frames are suspended during the pendency of the earlier proceedings.

A debtor should not be permitted to stay the collection of a tax by filing a bankruptcy petition and then benefit from the pendency of the abortive case by reducing or eliminating the priority to which the government's tax claims would otherwise have been entitled or altering the dischargeability of a tax that would not have been otherwise dischargeable. While the courts have generally reached the correct result in these cases, the theories underlying the decisions are not consistent. To avoid unnecessary litigation, the Bankruptcy Code should be clarified to provide explicitly for the suspension of the periods set out in Sections 507(a)(8) and 523(a)(1) during the pendency of an earlier proceeding. Furthermore, in light of the disruption caused by serial filings, it would be appropriate for

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154 See discussion infra at Part III. B. urging that serial or sequential filings should not be permitted or should be severely curtailed.

155 See In re Richards, 994 F.2d 763 (10th Cir. 1993); In re West, 5 F.3d 423 (9th Cir. 1993), cert. denied, 114 S.Ct. 1830 (1994); In re Montoya, 965 F.2d 554 (7th Cir. 1992); contra, In re Quenzer, 19 F.3d 163 (5th Cir. 1993). The statutory provisions on which the courts have based their decisions include 11 U.S.C. §§ 105 and 108 and 26 U.S.C. § 6503.

156 For example, the Richards court suspended the Section 507(a)(8) priority time periods on the basis of 11 U.S.C. § 105. The courts in West and Montoya cited 11 U.S.C. § 108 and 26 U.S.C. § 6503 as their authority for suspending the priority time frames.
Recognizing that the disruption of the collection process extends beyond the period in which the automatic stay is in effect, Section 6503(h)(2) of the Internal Revenue Code suspends the period in the Internal Revenue Code for the collection of taxes after bankruptcy to include not only the period in which the automatic stay is in effect, but also an additional six months. See 15 Jacob Mertens, Jr., Merten's Law of Federal Income Taxation §57.72 (1996).

2. **A Subsequent Filing or a Default Under a Confirmed Chapter 11 Plan Should Not Change the Status or Priority of Taxes Payable under the Plan**

When a confirmed Chapter 11 plan provides for payment of tax claims over six years as authorized by Section 1129(a)(9) of the Code and the debtor subsequently defaults or files another Chapter 11 petition, the debtor often contends that the confirmation of a reorganization plan transformed the tax claims into contract claims and the unpaid tax claims from the original Chapter 11 proceeding have lost their character as priority tax claims. If this approach were permissible, the debtor could manipulate the priority and status of tax claims by defaulting on its tax-related obligations in order to transform those claims into general unsecured claims. However, the courts have generally not been receptive to this approach. For example, in *In the Matter of Official Committee of Unsecured Creditors of White Farm Equipment Co.*, 943 F.2d 752 (7th Cir. 1991), *cert. denied*, 503 U.S. 919 (1992), the court rejected the debtor's contention that the confirmation of a plan in the first case had transformed a claim for trust fund taxes into a general unsecured claim. *See also In re Townsend*, 187 B.R. 230 (Bankr. W.D. Tenn. 1995); *In re Sprouse-Ritz Stores, Inc.*, 177 B.R. 679 (Bankr. D. Or. 1994).

The Bankruptcy Code should encourage debtors to comply with the terms of a confirmed plan of reorganization rather than encourage them to default on their tax obligations under the plan. Thus, when a debtor either defaults on a plan or files another proceeding before completing payments under a confirmed plan, tax claims should retain their original status and should continue to have priority in recognition of the fact that absent bankruptcy the IRS could have collected the tax by levy or other enforcement actions.

C. **Require Debtors to File Tax Returns**

One of the most vexing problems for the administration of the bankruptcy system in general, and for taxing authorities in particular, is the number of individual debtors who file for bankruptcy, but do not file their tax returns. It is troubling and ironic that debtors who invoke the protections of government against their creditors, defy that same government in failing to do so.

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157 Recognizing that the disruption of the collection process extends beyond the period in which the automatic stay is in effect, Section 6503(h)(2) of the Internal Revenue Code suspends the period in the Internal Revenue Code for the collection of taxes after bankruptcy to include not only the period in which the automatic stay is in effect, but also an additional six months. See 15 Jacob Mertens, Jr., *Merten's Law of Federal Income Taxation* §57.72 (1996).
discharge their responsibilities as taxpayers. Indeed, with increasing frequency, tax protestors are attempting to use the bankruptcy laws to frustrate tax compliance efforts on the part of the IRS. Without a tax return, a taxing authority is hard pressed to determine whether taxes are owing and, if so, the amount of the claim, so that a proof of claim can be filed. The tax laws generally place the burden on taxpayers to file returns and determine the amount of their tax liability. No legitimate bankruptcy purpose is served by shifting those burdens to the taxing authorities.

The courts have dealt with this problem in a variety of ways. Some courts enter an order at the time a Chapter 13 petition is filed directing the debtor to file delinquent tax returns within 30 days. Other courts require the IRS to file a motion to compel the debtor to file tax returns. Still other courts believe that they have no authority to require a debtor to file a tax return. In some districts, the practice is for the IRS to file an objection to confirmation when tax returns have not been filed. The procedure in some courts is for the Chapter 13 trustee not to schedule a plan for confirmation and to file a motion to dismiss when tax returns have not been filed.

Comprehensive statistics documenting the number of pleadings filed in Chapter 13 cases to address this issue are not available, but information supplied by the Office of the United States Attorney for the Western District of Tennessee suggests its scope. In 1994, that office filed 756 motions or objections in chapter 13 cases, followed by 554 orders to file returns. Service of those motions and objections required an estimated 23,500 mailings.

The large number of tax debtors availing themselves of the protections of the bankruptcy laws without filing tax returns is a serious and pervasive problem for which a uniform statutory solution is needed. The filing of motions or objections for which the debtor can have no legitimate response and that are granted as a matter of course should not be necessary. Many of the current local practices waste the scarce resources of the IRS, the Justice Department, and the courts. Instead, we believe that if a Chapter 13 debtor does not file federal tax returns by the date first set for the meeting of creditors (or within 30 days subsequent to that date if the debtor

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158 See In re Hahn, 77 A.F.T.R. 2d (RIA) 1938 (Bankr. M.D. Fla. 1996) (two days after a Chapter 13 petition was filed, the court entered a "Duties Order" requiring the debtor to file tax returns within 30 days and subsequently granted a motion to dismiss for failure to comply with the order).

159 See In re Anderson, 165 B.R. 445 (S.D. Ind. 1994) (on motion of the IRS, the bankruptcy court entered an order to compel the Chapter 13 debtor to file tax returns within 30 days and dismissed the case for failure to comply with the order).

160 See In re Bradford, 74 A.F.T.R. 2d (RIA) 5942 (Bankr. E.D. Va. 1994) (case dismissed after objections to confirmation were filed by IRS and the Chapter 13 trustee for debtor's failure to file tax returns).
obtains an extension from the court), the Bankruptcy Code should provide that the case will be
dismissed or converted to a Chapter 7 proceeding automatically.161

In addition, debtors in possession and Chapter 13 debtors frequently fail to file
postpetition tax returns. Some courts are slow to act on motions to dismiss or convert filed as
result of a debtor's failure to file postpetition returns. It would be helpful for 11 U.S.C.
§§ 1112, 1208, and 1307 to list failure to file postpetition tax returns or to pay postpetition taxes
as specific grounds for dismissal or conversion.

D. Section 505 Issues

Section 505 of the Code, the successor to Section 2A(2a) of the Bankruptcy Act, is a
waiver of sovereign immunity authorizing the bankruptcy courts to hear and determine tax claims,
even when a proof of claim is not filed. Section 2A(2a) was enacted by Congress in 1970
specifically to give the bankruptcy courts authority to determine tax issues and to put to rest
litigation over this issue. In recent years, Section 505 has grown in importance as the bankruptcy
courts have become the forum of choice for the determination of tax issues. See Robert A.
Jacobs, "The Bankruptcy Court's Emergence as Tax Dispute Arbiter of Choice," 45 Tax Law.
971 (1992); Francis M. Allegra, "Bankruptcy Courts: The Tax Forum for the '90s.,” 38 Fed. Bar
New & J. 338 (1991). Yet, several basic issues regarding the scope and operation of this section
remain unresolved.

1. Clarify That the Burden of
Proof is on the Debtor in Tax Matters

In bankruptcy, a party objecting to a claim generally "carries the burden of going forward
to meet, overcome, or at least equalize, what operates in favor of the creditor by the force of
ultimate persuasion," however, "is always on the claimant." Id. at ¶ 502.01[3]. The underlying rationale for this rule is that a claimant in bankruptcy is in the same
legal position as a plaintiff in a non-bankruptcy proceeding, who generally bears the burden of
proof. See In re Lewis, 80 B.R. 39, 40 (Bankr. E.D. Pa. 1987); In re KDI Corp, 22 B.R. 503,
504 (Bankr. S.D. Ohio 1980).

161 The problem is most pervasive in Chapter 13 cases because of the volume of Chapter 13
petitions, but also arises in Chapter 11 and 12 cases filed by individuals. The failure to file
prepetition tax returns should also be listed as grounds for dismissal or conversion in Sections
1112 and 1208 for Chapter 11 and 12 cases filed by individuals and in Section 1307 for Chapter
13 cases.
Nonetheless, the courts are divided concerning the placement of the burden of proof regarding tax claims in bankruptcy cases, with some courts going so far as to draw a distinction between assessed and unassessed taxes. In tax litigation outside of the bankruptcy court, there is no such uncertainty -- the burden of proof is generally on the taxpayer rather than on the taxing authority. This is appropriate because the taxpayer has or should have information underlying entries on the tax return including information relating to the income and deductions. Moreover, a fundamental precept of tax law is that deductions are matters of legislative grace and should not be allowed except to the extent substantiated by the taxpayer. A taxing authority would be at a serious disadvantage if all of a taxpayer's unsubstantiated deductions had to be allowed, absent proof that such deductions were inappropriate.

The same considerations that underlie the allocation of the burden of proof in nonbankruptcy tax cases apply in the bankruptcy context. The Government's "imperious need" of taxes -- the "life-blood of government" -- which warrants assignment of the burden to the taxpayers generally, Bull v. United States, 295 U.S. at 260, is hardly diminished when the taxpayer enters into bankruptcy. Except in the rarest of circumstances, the Government is a stranger to the transactions that are the subject of a tax dispute. In addition, as is the case outside of bankruptcy, casting the burden of proof on the taxpayer or the estate buttresses, rather than undermines, the record-keeping requirements of Section 6001 of the Internal Revenue Code, which requires every person liable for any tax or its collection to keep the necessary records. See also 11 U.S.C. §521(4) (debtor shall surrender to trustee all recorded information relating to

162 The Third and Fourth Circuits have concluded that the burden of proof is on the taxpayer/debtor. In re Landbank Equity Corp., 973 F.2d 265 (4th Cir. 1992); Resyn Corp. v. United States, 851 F.2d 660, 663 (3d Cir. 1988). The Fifth, Ninth and Tenth Circuits have reached the opposite conclusion. Franchise Tax Board of the State of Calif. v. Macfarlane, 83 F.3d 1041 (9th Cir. 1996); In re Placid Oil Co., 988 F.2d 554 (5th Cir. 1993); In re Fullmer, 962 F.2d 1463, 1466 (10th Cir. 1992). The Eighth Circuit has decisions that appear on both sides of the ledger. Compare In re Gran, 964 F.2d 822, 827-28 (8th Cir. 1992) (placing burden on the government) with In re Uneco, Inc., 532 F.2d 1204, 1207 (8th Cir. 1976) (placing burden on the taxpayer). See also Elmer Dean Martin III, "Burden of Persuasion: The Overlooked Defense to Tax Claims," 21 Cal. Bankr. J. 117 (1993).


property of the estate). And as is true outside bankruptcy, this allocation is also consistent with the presumption of administrative regularity. United States v. Rexach, 482 F.2d 10, 15-18 (1st Cir.), cert. denied, 414 U.S. 1039 (1973).

The bankruptcy laws generally do not -- and should not -- endeavor to supplant the substantive law under which a claim against the estate arises. See generally, Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 137 (Pt. I), 93d Cong., 1st Sess 68-71, 76-78 (1973). Matters of proof in tax cases are part of the substantive tax law, and should not be altered in bankruptcy to allow certain taxpayers to avoid improperly their tax debts. Indeed, the concerns which underlie the allocation of the burden of proof are, if anything, elevated in bankruptcy, where time constraints limit the Government's ability to conduct extensive investigations and records are more likely to be in disarray. See L. King, Collier on Bankruptcy, ¶ 12.03 (15th ed. 1996) ("The common law rule placing the burden on the party with access to the facts seems particularly applicable in a self-assessment system which provides for the taxpayer to make the initial determination of liability").

Furthermore, with respect to federal tax issues, the burden of proof should be on the taxpayer even if the tax has not been assessed. In this respect, litigation in the bankruptcy court would be no different than litigation in the Tax Court where cases are litigated before assessments are made. The burden of proof should also be the same for objections to claim for taxes and for actions under Section 505 to determine dischargeability. The same kind of tax issues can arise under either procedure and the result should not depend on whether an issue arises in the context of an objection to claim or of a proceeding under Section 505.


167 In making this assertion, we are mindful of the legislative history of the Bankruptcy Code, wherein it was stated:

Since tax authorities are creditors of practically every taxpayer, another important element is that tax collection rules for bankruptcy cases have a direct impact on the integrity of Federal, State and local tax systems. These tax systems, generally based on voluntary assessment, work to the extent that the majority of taxpayers think they are fair. This presumption of fairness is an asset which should be protected and not jeopardized by permitting taxpayers to use bankruptcy as a means of improperly avoiding their tax debts. To the extent that debtors in a bankruptcy are freed from paying their tax liabilities, the burden of making up the revenues thus lost must be shifted to other taxpayers.

2. Limit the Authority of the Court to Determine Tax Liability of Nondebtor.

Whether there is jurisdiction in bankruptcy to determine tax claims of third parties is another area that has produced a bountiful harvest of cases. Section 505 does not explicitly say that its waiver of sovereign immunity is limited to a determination of the tax liability of the debtor or of the trustee. Three courts of appeals have concluded that Section 505 determinations are appropriate only to determine the liability of the debtor or trustee and are inappropriate for determining the liability of third-parties, such as the debtor's corporate officers subject to "responsible officer" penalties under 26 U.S.C. §6672. See American Principals Leasing Corp. v. United States, 904 F.2d 477 (9th Cir. 1990); In re Brandt Airflex Corp., 843 F.2d 90 (2d Cir. 1988); and United States v. Huckabee Auto Co., 783 F.2d 1546 (11th Cir. 1986) (no jurisdiction). Two other courts of appeal, however, have decided that the authority of the bankruptcy court under Section 505 extends to determinations of liability of the responsible persons of the debtor. See In re Wolverine Radio Co., 930 F.2d 1132 (6th Cir. 1991), cert. denied, 503 U.S. 978 (1992); and In re Quattrone Accountants, Inc., 895 F.2d 921 (3d Cir. 1990).

Bankruptcy judges should not make determinations of the tax liability of responsible persons or other third parties except as part of a separate, personal bankruptcy proceeding filed by the responsible person. The function of the court in a particular bankruptcy proceeding is -- or should be -- to facilitate the liquidation or reorganization of the debtor and not to protect individuals who themselves have chosen not to file for bankruptcy. The responsible persons, having made the business judgments or misjudgments that resulted in the bankruptcy, should not be able to disadvantage the IRS by using their positions as insiders to escape their derivative liability for trust fund taxes. Allowing responsible persons to use their fiduciary positions to personal advantage is an unconscionable abuse. Accordingly, Section 505 should be modified to clarify that the jurisdiction of the bankruptcy court extends only to determination of tax liability of the debtor and the estate. See Stephen. W. Sather, et al., "Borrowing from the Taxpayer: State and Local Tax Claims in Bankruptcy," 4 Am. Bankr. L. Rev. 201, 234 (1996) ("Allowing protection of third parties is a departure from the general principles of the Code").

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168 "Responsible person" liability is imposed upon "[a]ny person required to collect, truthfully account for and pay over any tax imposed... who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof." 26 U.S.C. §6672.
3. Clarify That Courts May Not Enjoin Collection Against Responsible Persons

The suggestion has been made by some bankruptcy practitioners that Section 505 should be amended to authorize the bankruptcy court to enjoin the collection of taxes from responsible persons. Most of the courts that have considered the issue have concluded that the Anti-Injunction Act, 26 U.S.C. § 7421, would not permit the entry of such an injunction so that bankruptcy courts currently do not have jurisdiction to enjoin the collection of taxes from responsible persons. We submit that as a matter of policy such jurisdiction should not be extended to the bankruptcy courts.

Responsible person liability is an alternative collection device intended to assure that "trust fund" taxes are accounted for and paid over to the government. It is imposed on those responsible for complying with the law who intentionally (willfully) fail to do so. Having mismanaged their company into bankruptcy, the objective of responsible persons then becomes to avoid the day of reckoning as long as possible, sometimes in the belief that a change of luck is imminent and sometimes just for the sake of delay. The longer collection against the responsible person is delayed, however, the greater the opportunity for assets to be transferred or to

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169 See Reforming the Bankruptcy Code: The National Bankruptcy Conference's Code Review Project at 76-77 (1994.) The National Bankruptcy Conference's rationale for this amendment is that (Id. at 77):

Permitting the IRS to pursue responsible persons while the debtor is in bankruptcy may impair the debtor's ability to reorganize because of several possible variables, including: (1) the responsible person no longer wishes to be associated with the debtor for fear that future Trust Fund Taxes will be unpaid; (2) the responsible person spends time defending himself against the IRS levy and is less committed to managing the debtor’s corporate affairs; or (3) the responsible person loses the ability to obtain personal credit to infuse additional funds into the debtor. In short, the IRS action does have the potential to seriously undermine a successful reorganization effort by imposing a personal burden on those corporate personnel required to successfully implement the reorganization plan.

A representative of the National Bankruptcy Conference, Myron Sheinfeld spoke in favor of such an amendment at the meeting of the Government Issue Task Force of the Bankruptcy Review Commission at its June meeting in Washington.

disappear. Witnesses and documents relevant to the issues of responsibility also disappear. Moreover, if an assessment against a responsible person is not made within three years of the filing of the corporate employment returns, the assessment will be time-barred. For these reasons, we are opposed to allowing the bankruptcy courts to enjoin the collection of taxes from responsible persons. See Steven C. Bennett, "The Bankruptcy Code and the Anti-Injunction Act: Collectibility of Employment Tax Liabilities from Nondebtor 'Responsible Persons'," 48 Tax. Law. 349, 373 (1994) ("Although attainment of the elusive goal of successful reorganization of a debtor in bankruptcy may be desirable, creation of an exception to the Anti-Injunction Act to permit additional protection of nondebtor responsible officers in furtherance of that goal is not warranted").

E. Prepetition Tax Claims and Penalties

Some prepetition tax claims of federal, state, and local governments are given priority in recognition that, as tax collector, governments are involuntary creditors that cannot evaluate the credit risk of their customers in advance, provide services on a C.O.D. basis, extend credit only with collateral as security, or deny credit when a customer is overextended. See H. Rep. 95-595, 95th Cong. 1st Sess. at 190. For the most part, taxing authorities have no way to determine the amount of credit extended to their "customers" until such time as a tax return is filed. Even then, of course, the self-assessed liability on a filed return may be incorrect. Others ignore their responsibility to file tax returns at all. Even when a taxing authority knows of an unpaid liability, it needs time to locate and pursue collection action against the delinquent taxpayer. Priority is given to tax claims, in part, in recognition of the collection problems as well. Id.

Prior to enactment of the Bankruptcy Code in 1978, the priority and discharge provisions of the bankruptcy laws were congruent. Thus, all taxes excepted from discharge under Section 17 of the Bankruptcy Act, including taxes attributable to fraud and taxes for which a return had never been filed, were entitled to priority by the terms of Section 64 of the Bankruptcy Act. The Bankruptcy Code departed from this pattern by denying priority for certain taxes attributable to fraud and taxes attributable to seriously delinquent tax returns, but continuing to provide that the debtor would not receive a discharge from such taxes. See 11 U.S.C. §§ 507(a)(8) and 523(a)(1). The rationale for changing the priority and discharge of tax claims in this respect was explained as follows by the Senate Finance Committee (S. Rep. No. 1106, 95th Cong., 2d Sess. 22, n.19 (1978)):

The bankruptcy policy for this treatment is that it is not fair to penalize private creditors of the debtor by paying out the "pot" of assets in the estate tax liabilities arising from the debtor's deliberate misconduct. On the other hand, the debtor should not be able to use bankruptcy to escape these kinds of taxes. Therefore, these taxes have no priority in payment of taxes from the estate but would survive as continuing debts after the case.

1. Conform the Chapter 13 Discharge to the Discharge Available in Chapters 7, 11, or 12

Earlier in this document, we have urged that the discharge under Chapter 13 should be conformed with the discharges available in Chapters 7, 11, or 12. The impact of Chapter 13’s superdischarge in cases involving tax debts is particular disturbing.

This is especially so where the taxpayer-debtor was prosecuted for tax violations. Criminal tax cases are difficult and time-consuming to investigate and prosecute, but a tax enforcement program is essential to the health of our tax system. In recognition of the special problems these cases present, the statute of limitations on prosecution is six years. 26 U.S.C. § 6531. Moreover, additional time is consumed after the investigation in determining the civil liability. Yet, the effect of the superdischarge is that after conviction much of the tax liability can be discharged by filing a Chapter 13 case. See In re Zieg, 194 B.R. 469, 472 (Bankr. D. Neb. 1996); In re Verdunn, 160 B.R. 682, 685 (Bankr. M.D. Fla. 1993), aff’d, 187 B.R. 996 (M.D. Fla. 1995), rev’d on other grounds, 89 F.3d 799 (11th Cir. 1996); In re Dwyer, 1993 WL 596259 (Bankr. M.D. Fla. 1993).

The superdischarge also has the effect of allowing debtors to discharge priority taxes, even though priority taxes are supposed to be paid in full under the plan and cannot be discharged in Chapter 7, 11, or 12 proceedings. The courts have held that the payment in full requirement of Section 1322(a)(2) applies only to "allowed" claims, since Section 507(a) gives priority only to "allowed" claims. See In re Tomlan, 102 B.R. 790 (E.D. Wash. 1989), aff’d, 907 F.2d 114 (9th Cir. 1990); In re Lee, 95-1 U.S.T.C. ¶ 50,017 (Bankr. W.D. Va. 1994), aff’d, 184 B.R. 257 (W.D. Va. 1995). A claim is allowed only if a proof of claim is filed. Thus, the courts have held that if a timely proof of claim is not filed, a claim that would otherwise be entitled to payment in full under Section 1322(a)(2) is not required to be paid and will be discharged. As a consequence of this reasoning, millions of dollars of tax claims have been discharged, including claims for Section 6672 liability that were still in the investigative stage.

We submit that the Chapter 13 discharge should be identical to the discharge available in a Chapter 7, 11, or 12 proceeding, perhaps with some allowance for interest and penalties. If bankruptcy policy favors a discharge for tax offenders who evade taxes or never file returns, that policy should apply to Chapter 7 debtors, as well as Chapter 13 debtors. We believe that the appropriate approach, however, is for the provisions of Section 523(a)(1) to apply in all chapters. Permitting taxes that have been evaded, or for which returns have never been filed, to be

171 See Part III D.1., infra.
discharged on the basis of a tax evader's commitment to make his or her "disposable income" available to creditors for three or five years makes bankruptcy a haven.

In considering the bill that ultimately resulted in enactment of the Bankruptcy Code, the House Judiciary Committee stated: "An open-ended dischargeability policy would provide an opportunity for tax evasion, through bankruptcy, by permitting discharge of tax debts before a taxing authority has an opportunity to collect any taxes due." H. Rep. 595, 95th Cong., 1st Sess. at 190 (1977). Tax policy and bankruptcy policy are frequently in conflict. In this instance, the tax policies of discouraging evasion of tax and encouraging the filing of tax returns should outweigh the bankruptcy policy of encouraging debtors to file Chapter 13 petitions. These policy concerns are especially important in view of the recent increase in Chapter 13 eligibility limits, making debtors with tax obligations of up to $250,000 of unsecured taxes and $750,000 of secured taxes eligible for Chapter 13.

At the least, all taxes excepted from discharge by Section 523(a)(1) should be treated as priority taxes and be payable in full as part of a Chapter 13 plan. The rationale for no longer providing parallel treatment of priority taxes and taxes excepted from discharge was to benefit creditors, but was not intended to let the tax debtor benefit from his or her misdeeds. Taxes that have been evaded or for which the debtor has never filed returns do not deserve special, lenient treatment. It is unfair to honest taxpayers to allow such debtors to escape their tax.

The superdischarge also underlies the holding of Tomlan and its progeny that priority taxes are "provided for" in a plan when a plan provides for such taxes only if a proof of claim is filed and in the absence of a proof of claim, such taxes are discharged. We submit that in the same manner as the tax law places on a taxpayer an obligation to determine the amount of his or her liability, the bankruptcy law should require a Chapter 13 debtor to include all tax obligations in the plan and to pay those claims, whether or not a proof of claim is filed. To the extent that tax claims are omitted, the debtor should remain liable for those taxes.

2. Priority for Income Taxes Assessed Within 240 Days Before Bankruptcy

Under the Bankruptcy Act, when the "prohibition" on assessment expired, a tax was no longer excepted from discharge or entitled to priority. As a consequence, the day after the Tax Court entered a decision, a taxpayer could file a bankruptcy petition and be relieved of the liability even though the IRS never had any opportunity to attempt to effect collection. The 240-day period found in 11 U.S.C. § 507(a)(8)(A)(ii) was enacted to give the IRS a minimum period of time to effectuate collection after assessment of an income tax before priority could be denied to a tax liability in bankruptcy and the liability would become eligible for discharge. Well advised tax debtors who lose a Tax Court case must now wait 240 days before filing a bankruptcy petition instead of filing the day after the decision as under the Bankruptcy Act. The 240-day period is
obviously preferable to the situation that existed under the Bankruptcy Act. Nonetheless, the 240-day period is not adequate for collection efforts to be made and ideally the period should be changed to one year.

Section 507(a)(8)(A) grants priority to income taxes assessed within 240 days of bankruptcy and to income taxes still assessable on the petition date. These provisions were enacted in recognition that taxing authorities are involuntary creditors and should have at least some minimal period before bankruptcy in which to attempt collection. See H. Rep. No. 595, 95th Cong. 1st Sess. (1978). Although similar problems arise in connection with determining employment and excise taxes, especially in audits of some of the larger companies, the Bankruptcy Code does not include similar treatment of employment tax and excise tax claims. It would be helpful if the treatment of employment and excise taxes could be conformed to the treatment of income taxes in this respect.

3. Priority Taxes in Chapter 11 Cases Should Be Paid in Equal Installments with Interest at the Statutory Rate

In a Chapter 11 case, priority taxes are payable over six years from the date of assessment. Some Chapter 11 plans provide for balloon payments of priority taxes rather than paying such taxes in equal monthly or quarterly payments. Any plan that back-end loads the payment of priority taxes raises serious fairness and feasibility questions. Such plans place the risk of loss on the taxing authority by failing to amortize the payments over the appropriate period. The risk of loss is not insubstantial, especially in small Chapter 11 cases, because confirmation is no guaranty of success and defaults are commonplace. In any event, the Bankruptcy Code departed from prior law in allowing installment payments of priority taxes. It should be clarified to provide expressly for equal installments and to prohibit balloon payments.172

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Cases where the court required immediate installments payments include In re Mason and Dixon Lines, Inc., 71 B.R. 300 (Bankr. M.D. N.C. 1987) (disapproving plan providing monthly payments of interest with the principal amount payable in a lump sum in six years); In re Mahoney, 80 B.R. 197 (Bankr. S.D. Cal. 1987) (disapproving plan providing for payment of tax in a lump sum in last month of a five-year plan); and In re Inventive Packaging Corp., 81 B.R. 74
The interest rate on deferred payments of federal taxes in Chapter 11 cases should be the 26 U.S.C. § 6621 fluctuating rate (or at least the Section 6621 rate on the date of confirmation). There has been much litigation over the appropriate "market rate" of interest on tax claims. The Bankruptcy Code should be modified to provide that the applicable rate of interest on a tax claim is the rate of interest applicable to such a claim outside of bankruptcy (perhaps excluding penalty interest). At the federal level, the rate changes every three months and, accordingly, is relatively current. Litigation over the appropriate interest rate is not productive for the litigants or the courts and should be fixed by legislation at least for tax claims.

F. Discharge of Tax Claims

1. Clarify Treatment of Tax Penalties

Legislation is needed to clarify Section 523(a)(7)(B) of the Code, relating to the discharge of tax penalties. As a general rule, all fines and penalties are excepted from discharge under Section 523(a)(7); certain tax penalties, however, are discharged under Section 523(a)(7)(A) and (B).

Under the Bankruptcy Act, the IRS took the position that if a tax was discharged any penalty relating to such tax was also discharged. Rev. Rul. 68-574, 1968-2 C.B. 595. The effect of this position was that if a tax could be written off by the IRS as discharged, any related penalty could be written off as well. This approach was adopted by Congress in Section 523(a)(7)(A). Thus, for example, if a debtor incurs a late filing penalty as a result of filing a delinquent tax return, but the tax attributable to the return was ultimately discharged, the penalty will be discharged. The Congress, however, also included a second tax penalty discharge provision in the Bankruptcy Code, Section 523(a)(7)(B), which provides for a discharge of a tax penalty "imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition."

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See also discussion of priority and discharge of tax claims in Chapter 13 cases, supra.
The floor statements of Representative Edwards and Senator DeConcini described the treatment of tax penalties in the following terms (124 Cong. Rec. 32350, 32417 (1978) (statement of Cong. Edwards), and 124 Cong Rec. 33989, 34016 (1978) (statement of Sen. DeConcini)):

The House amendment also adopts the Senate amendment provision limiting the nondischargeability of punitive tax penalties, that is, penalties other than those which represent collection of a principal amount of tax liability through the form of a "penalty." Under the House amendment, tax penalties which are basically punitive in nature are to be nondischargeable only if the penalty is computed by reference to a related tax liability which is nondischargeable or, if the amount of the penalty is not computed by reference to a tax liability, the transaction or event giving rise to the penalty occurred during the 3-year period ending on the date of the petition.

Notwithstanding this legislative history, the courts have held that the language of Section 523(a)(7)(B) literally applies to a penalty attributable to the filing of a tax return as well as to transactions or events other than the filing of a return. McKay v. United States, 957 F.2d 689 (9th. Cir 1992); In re Roberts, 906 F.2d 1440 (10th Cir. 1990); In re Burns, 887 F.2d 1541 (11th Cir. 1989). As a result of these decisions, filing penalties including the fraud penalty may be discharged even before the liability for tax is determined. The court in McKay acknowledged (957 F.2d at 693-94): "There is some evidence in the legislative history that Congress did not intend this result." Section 523(a)(7)(B) should be clarified to provide that it is not triggered by the filing of a return. An amendment along these lines is consistent with bankruptcy policy which generally excepts penalties from discharge. See generally, Kelly v. Robinson, 479 U.S. 36, 48 (1986).

2. Endorse Administrative Discharge

Many taxpayers are entitled to a discharge of "old and cold" taxes by the clear terms of Section 523(a), but for a variety of reasons want the certainty of a court order acknowledging the discharge of those taxes. The formal procedure for getting such an order is to commence an adversary proceeding. That process is expensive for the debtor and costly for the court and the government. In a number of districts, the IRS and the Justice Department have created an

175 For example, the statute of limitations on prosecution of the crime of tax evasion is six years. 26 U.S.C. § 6531. Fraud penalties imposed after a criminal prosecution for tax evasion would inevitably be discharged under these decisions even though the related tax is excepted from discharge by reason of 11 U.S.C. § 523(a)(1)(C).

176 The McKay opinion further indicates that logically "a penalty with respect to a nondischargeable tax should itself not be dischargeable. Intuitively, that makes sense. While some may have intended the statute to have this meaning, it does not say that." 957 F.2d at 693.
administrative procedure for determining whether a tax is excepted from discharge by 11 U.S.C. § 523(a)(1). Debtors' attorneys are encouraged to send a letter to the IRS to determine whether the IRS agrees that the taxes are dischargeable. If IRS is in agreement, a simple joint stipulation is then filed with the court acknowledging the discharge of the taxes and requesting that the court order the taxes discharged. This process saves the court, the debtor, and the IRS much time and expense. It would be helpful for the Commission to endorse this practice, although we do not believe this practice requires any statutory change.

G. Secured Tax Claims

1. Chapter 11

In a Chapter 11 case, an unsecured priority tax claim must be paid under the plan within six years of the assessment date pursuant to Section 1129(a)(9) of the Code. In contrast, the Bankruptcy Code does not impose any time limit on the payment of a secured claim, including a secured tax claim. See 11 U.S.C. § 1129(b). In one extreme case a bankruptcy court approved a plan extending payment of secured tax claims for 30 years in a Chapter 11 proceeding commenced by a 68-year old lawyer. In re Haas, 195 B.R. 933 (Bankr. S.D. Ala. 1996).\(^{177}\)

The extended payment period for secured tax claims in Chapter 11 cases should be limited to six years, as is the case for priority tax claims. In deciding to allow a Chapter 11 debt to pay priority taxes over six years, rather than requiring their payment in full and in cash at the time of confirmation, the Congress placed collection of those taxes at risk and granted a valuable right to debtors. We submit that payment of secured tax claims should be required over the same period of time. Six years from the date of assessment should be an adequate period for allowing a Chapter 11 business to right itself, and if secured or unsecured tax debts cannot be paid within that period, the debtor should liquidate.

2. Chapter 13

In a Chapter 13 case, a tax lien should be released only upon completion of all payments under the plan. In In re Campbell, 160 B.R. 168 (Bankr. M.D. Fla. 1993), aff’d 180 B.R. 686 (M.D. Fla. 1995), the bankruptcy court required the IRS to release a federal tax lien after the debtor paid the allowed amount of the IRS claim, but before all payments under the plan were completed. Unlike most other liens, a federal tax lien attaches to all property and rights to property of a tax debtor and must be released only when paid in full or discharged. See 26 U.S.C. \(^{\text{---}}\)

\(^{177}\) Other cases involving stretched out payments of secured taxes include In re Rotella, 73 A.F.T.R. 2d 94-1866 (Bankr. N.D. N.Y. 1994) (deferred cash payments over 30 years); and In re Reichert, 138 B.R. 522 (Bankr. W.D. Mich. 1992) (length of deferral to be determined in subsequent proceedings).
§ 6325(a). By requiring release of a federal tax lien upon payment of the allowed amount of the secured claim, the effect of the Campbell decision is to prevent enforcement of the lien against exempt, abandoned or excluded property and would effectively alter the rights of the IRS as they existed at the time of commencement of the case. Moreover, release of the lien eliminates an incentive on the part of the debtor to complete payments required by the plan. We submit that as a matter of both tax policy and bankruptcy policy, a tax lien on property of the estate should not be released in a Chapter 13 proceeding until discharge.

3. **Subordination of Tax Liens.**

A Federal tax lien for which notice is duly filed cannot be avoided by a trustee under Section 544 of the Code in his capacity as a hypothetical bona fide purchaser of real property. Such a lien is also valid under the bona fide purchaser test of Section 545(2). The fixing of notice of a federal tax lien within 90 days of the petition date cannot be avoided as a preference. See 11 U.S.C. § 547(c)(6). Once notice is filed, a federal tax lien is even valid against exempt property. See 11 U.S.C. § 522(c)(2). Thus, with one exception, the rights of the IRS as a secured creditor by reason of filing a notice of tax lien are recognized in bankruptcy.

The exception is found in Section 724(b), a provision that applies only in Chapter 7 and subordinates tax liens, including federal tax liens, to administrative expenses and to other creditors whose claims would be primed by the tax lien outside of bankruptcy. In effect, Section 724(b) treats a secured tax claim as if it were an unsecured priority claim. Thus, while Section 506(c) allows the trustee to recover from secured property the selling costs of the property and the costs of caring for the property, Section 724(b) allows such costs to be shifted to a taxing authority if the property is subject to a tax lien.

Absent some significant bankruptcy policy to the contrary, the Bankruptcy Code should not alter a party's interest in property or the expectations of the parties under nonbankruptcy laws. No justification exists for discriminating against tax liens as provided in 11 U.S.C. § 724(b), especially with respect to liens on real estate. Secured creditors should bear the costs of preservation and sale of secured property rather than gain a windfall by having those costs shifted to taxing authorities under Section 724(b). Accordingly, Section 724(b) should be repealed.

4. **Clarify Application of Section 545(2) to the Superpriority Provisions Governing Federal Tax Liens**

Legislation is needed to clarify that 11 U.S.C. § 545(2) does not apply to duly noticed federal tax liens. Section 6323 of the Internal Revenue Code (26 U.S.C.) provides protection to a purchaser of property against a federal tax lien up until notice of that lien has been duly filed. A "purchaser" is defined at Section 6323(h)(6) as a person who, for adequate and full consideration in money or money's worth, acquires an interest (other than a lien or security interest) in property,
which is valid under local law against subsequent purchasers without notice. But, Section 6323(b) provides an exception to this general rule, by providing that a duly filed tax lien is not valid as to a purchaser of certain types of property, that is, securities (defined to include money), motor vehicles, personal property purchased at retail, and personal property purchased at casual sales. This superpriority is intended to allow the free movement of personal property in commerce. A retail purchaser of a television at a local department store should not be expected to check lien filings to make certain that there are no tax liens outstanding against the store.

Section 545(2) of the Bankruptcy Code permits a trustee to avoid a federal tax lien that is not perfected or enforceable at the time of the petition against a bona fide purchaser, "whether or not such a purchaser exists." This "hypothetical purchaser" power of the trustee is derived from Section 67c(1)(B) of the Bankruptcy Act, and was added by the Chandler Act in 1938 to reduce the ability of creditors to use various lien rights to thwart the priority provisions of the bankruptcy law. Instead, trustees and/or debtors in Chapter 11 and Chapter 13 cases have attempted to use the powers under Section 545(2) to avoid federal tax liens on estate assets listed in 26 U.S.C. § 6323(b)(1)-(4), on the basis that the trustee (including a Chapter 11 debtor in possession) steps into the shoes of the hypothetical bona fide purchaser entitled to superpriority protection under 26 U.S.C. § 6323(b).

Some courts have focussed on whether the debtor has standing to raise the issue, see In re Coan, 134 B.R. 670 (Bankr. M.D. Fla. 1991); In re Robinson, 166 B.R. 812 (Bankr. D. Vt. 1994); and In re O'Neil, 177 B.R. 809 (Bankr. S.D.N.Y. 1995); others on whether the trustee's statutory powers were coterminous with the definition and limitations placed upon a purchaser by § 6323. Compare In re Walter, 45 F.3d 1023 (6th Cir. 1995), with Christison v. United States, 960 F.2d 613 (7th Cir. 1992), and United States v. Sierer, 139 B.R. 752 (N.D. Fla. 1991); see also In re Berg, 188 B.R. 615 (Bankr. 9th Cir. 1995), and In re Guyana Dev. Corp., 189 B.R. 393 (Bankr. S.D. Tex. 1995).

The characteristics of a purchaser protected by the superpriority provisions of Section 6323(b) of the Internal Revenue Code are shared neither by the trustee nor the unsecured creditors that the trustee represents. The purpose of free movement of personal goods in general commerce has no application to the powers or status of a trustee. As under Section 70c of the Bankruptcy Act, notice of a federal tax lien must be filed for the lien to be valid against the trustee under Section 544 and, under current law, a tax lien is subordinated in Chapter 7 pursuant to Section 724(b). If Section 545(2) applied to federal tax liens, it would create a windfall for the debtor. The Bankruptcy Code should be amended to remove this potential loophole.

H. Postpetition Taxes

1. Payment in the Ordinary Course of Business
Taxes incurred postpetition have priority as administrative expense. See In re Goffena, 175 B.R. 386 (Bankr. D. Mont. 1994); In re Hillsborough Holdings Corp., 156 B.R. 318 (Bankr. M.D. Fla. 1993). Title 28, Section 960, provides that anyone conducting a business under the authority of a federal court is subject to federal, state, and local taxes as if the business were conducted by an individual or corporation. Section 503(b) of the Code suggests, however, that such taxes can be paid only pursuant to a request for payment and notice and hearing. These provisions should be reconciled. The trustees should pay taxes in the ordinary course of business without any need for a request from the taxing authority.

2. Corporate Tax Liability for the Year in which the Petition is Filed Should not be Split into Prepetition and Postpetition Segments

Some courts have recently held that the tax return of a corporate debtor for a tax year that straddles the filing of a Chapter 7 or 11 petition must be split into prepetition and postpetition segments, and only the later will be treated as an administrative claim. In re Pacific-Atlantic Trading Co., 64 F.3d 1292 (9th Cir. 1995); In re L.J. O’Neill Shoe Co., 64 F.3d 1146 (8th Cir. 1995); and In re Hillsborough Holding Corp., 76 A.F.T.R. 2d (RIA) 7843 (M.D. Fla. 1995).

These decisions may create considerable mischief because in virtually every case the tax year of the corporation will straddle the petition date and, depending on the petition date and the corporate tax year, the return may not be filed for many months after the petition date, especially if the corporation avails itself of the automatic extension of time to file its income tax return. Thus, this approach will put the IRS and other taxing authorities at a serious disadvantage in attempting to determine whether they have a claim and in determining the amount of prepetition tax for purposes of preparing a proof of claim. On a theoretical level, it sounds simple to allocate tax liability between prepetition and postpetition periods through some formula or another. Such allocations are impossible to do without having a tax return on file and, in the absence of a uniform system of allocations, the taxing authority will inevitably be whipsawed.

We strongly urge the Commission to examine this issue and to propose legislation clarifying that a corporate income tax liability for a tax year that straddles the petition date is incurred for purposes of Section 503(b) of the Code on the date when that liability can be calculated—the last day of the tax year. Any other result would create an administrative nightmare for taxing agencies.

3. Clarify the Rules Governing and Treatment of Postpetition Taxes of Chapter 13 Debtors

Many Chapter 13 debtors do not pay their postpetition tax debts while making payments pursuant to a confirmed plan. Such taxes are not incurred by the estate and are not administrative expenses. Section 1305 of the Code authorizes a taxing authority to file a proof of claim for a
debtor's postpetition taxes in order to collect such taxes pursuant to the plan. However, some confusion exists about the status of such a claim since Section 1305 merely says that a proof of claim can be filed by a taxing authority for postpetition taxes. Section 1305 is potentially a valuable procedure for both taxing authorities and for debtors. Debtors would benefit from its use because otherwise the IRS would simply issue a levy causing the debtor to default on the plan. The IRS would benefit if the filing of a Section 1305 claim resulted in payment by the debtor of both prepetition and postpetition taxes.

Section 1305 should be clarified to provide that tax claims filed pursuant to its provisions are to be paid in full over the period of the plan, interest will continue to run on such claims and will be paid under the plan, and in the event of a default, such claims will not be discharged.

I. Except Setoff of Tax Refunds from the Automatic Stay

The Commission has estimated that nearly 1 million consumer bankruptcies will be filed in 1996. A large number of those debtors will be entitled to claim a tax refund on their individual federal income tax returns--historically more than 70 percent of individual filers receive a refund from the IRS. If the debtor owes taxes, the IRS' right to setoff its claim against the refund is preserved by Section 553. While the act of setoff is subject to the automatic stay, Section 362(a)(7), freezing an account to preserve a right of setoff is not a violation of the automatic stay. See Citizens Bank of Maryland v. Strumpf, 116 S.Ct. 286 (1995). We believe that the effect of the decision in Strumpf is that the debtor has the burden of seeking a turnover order from the court in order to get access to a frozen tax refund. Debtors will likely interpret the decision narrowly and will contend that the IRS must promptly file a motion to lift the stay and cannot indefinitely retain a frozen tax refund. See In re Glenn, 78 A.F.T.R. 2d (RIA) 5851 (Bankr. E.D. Pa. 1996).

The filing of motions on a routine basis to lift stays in order to setoff a tax refund against a tax claim would be extremely burdensome to the IRS and the courts. In a number of districts, a local rule or standing order authorizes the setoff of tax refunds against tax claims in all bankruptcy cases, under particular chapters, or under specific provisions, without filing a lift stay motion on a case by case basis.178 We submit that the issuance of tax refund is so commonplace and the

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178 See, e.g., Bankr. Ct. D. Ariz. General Order No. 8 (IRS can make setoffs against tax refunds in the ordinary course of business); Bankr. Ct. S.D. Ind. L.R. B-6011 (IRS can setoff prepetition tax claims against a prepetition tax refunds, subject to review on motion of a party in interest); Bankr. Ct D. Minn. L.R. 1210 (refunds can be setoff against assessed taxes in the ordinary course of business); Bankr. Ct. E.D.N.C. L.R. 4001.1 (in Chapter 7 and 13 cases refunds can be setoff against taxes due the United States); Bankr. Ct. M.D.N.C. L.R. 4001 (in Chapter 7 and 13 refunds can be setoff against taxes due); Bankr. Ct. D. Md. L.R. 25 (IRS can make setoffs against tax refunds owed to individual debtors provided the claim is filed and the claim is not disputed or has not been disallowed by another court).
incidence of tax refund offset so common that such setoffs should be specifically authorized as an exception to the automatic stay. The dollar amount of the refunds is small on average. Dealing with this issue on a case by case basis is unproductive for the courts, bankruptcy trustees, and the IRS. Thus, unless otherwise ordered by the court, tax refunds should be subject to setoff in the ordinary course.

J. Return and Augment Special Tax Provisions, such as Declaratory Judgments on the Tax Effect of a Reorganization

The "special tax provisions" found in Sections 346, 728, 1146 and 1231 of the Code apply only to state and local taxes and expressly do not apply for federal tax purposes. The state or local limitation was adopted as a result of a compromise between the House Judiciary Committee and the House Ways and Means Committee during consideration of the Bankruptcy Reform Act by the Congress. In the course of its deliberations on the Bankruptcy Reform, the Senate stripped out the special tax provisions. The provisions were restored in the "informal" conference so they could be "studied" by the bench and bar and in the expectation that the special tax provisions would be conformed with bankruptcy-tax legislation to be considered by the tax writing committees. While the tax writing committees did consider and pass the Bankruptcy Tax Act of 1980, conforming changes to the special tax provisions were not made. As a consequence, the special tax provisions impose different rules for state and local tax purposes than for federal tax purposes. The Commission should review these provisions and determine whether these differences are appropriate.

We are particularly concerned with removal of the state or local limitation on one special tax provision. Section 1146(d) contains a procedure for obtaining a declaratory judgment from the bankruptcy court concerning the tax effects of a proposed plan of reorganization. Under current law, such declaratory judgments are limited to state and local tax issues. Some members of the bankruptcy community contend that the jurisdiction of a bankruptcy court should be expanded to include declaratory judgments of the federal tax consequences of a Chapter 11 plan of reorganization. Reforming the Bankruptcy Code: The National Bankruptcy Conference's Code Review Project 68-71 (1994); Donald D. Haber, "The Declaratory Powers of Bankruptcy Courts to Determine the Federal Tax Consequences of Chapter 11 Plans," 2 Am. Bankr. Inst. L. Rev. 407 (1995).

Congress has been extraordinarily wary about giving the courts jurisdiction to grant declaratory judgments with respect to the future tax consequences of a transaction. Thus, the Internal Revenue Code gives declaratory judgment jurisdiction to the courts only with respect to: (i) exemptions and revocations of exemptions of 26 U.S.C. §501(c)(3) organizations (26 U.S.C. § 7428); (ii) the qualification of certain retirement plans (26 U.S.C. § 7467); and (iii) the qualification of state and local bonds for purposes of the exemption of interest from income (26 U.S.C. § 7468). We are unaware of any provision of law outside the Internal Revenue Code that
grants the courts jurisdiction to enter declaratory judgments relating to prospective transactions. *Cf.* Holywell Corp. v. Smith, 503 U.S. 47 (1992) (Chapter 11 plan does not bind the United States with respect to post-confirmation tax issues).

Under current law, the disclosure statement should include representations concerning the tax effects of a proposed plan of reorganization based upon opinions of counsel. If the feasibility of the plan is dependent on the tax consequences, the court may have to decide whether the representations concerning the tax consequences are realistic or fanciful. Such feasibility hearings can and are held without considering the IRS an indispensable party. The government has neither the resources nor an interest in being drawn into every Chapter 11 proceeding for purposes of determining future tax effects of the plan. If the government is a party in interest, it can participate in the feasibility hearing at its election in the same manner as other parties in interest. Nothing further is required. Accordingly, we strongly oppose any suggestion that the bankruptcy courts be given jurisdiction that is generally denied to other courts to entertain declaratory judgment suits on tax matters.

**K. Overrule Energy Resources**

Section 505 should be amended to overrule United States v. Energy Resources Co., 495 U.S. 545 (1990). In *Energy Resources*, the Supreme Court held that when necessary to effectuate a successful reorganization, the bankruptcy court could direct that payments be allocated to the trust fund portion of any tax liability, rather than allowing the IRS to allocate payments to the non-trust fund portion. The situation generally arises when corporate officers liable under 26 U.S.C. § 6672 for unpaid trust fund taxes remain in control of the debtor in possession. Their personal financial interests are furthered if payments under a Chapter 11 are initially allocated to the trust fund taxes because such payments reduce their personal liability and the allocation shifts the risk of a default and of loss to the IRS. Some courts have even upheld such allocations in a liquidating Chapter 11 case. *See In re Deer Park*, 10 F.3d 1478 (9th Cir. 1993).

The *Energy Resources* decision encourages corporate officers to use their positions as fiduciaries for their personal benefit and to the disadvantage of taxing authorities. An appointed Chapter 11 trustee would not have a similar interest. The officers of a debtor in possession are supposed to perform the functions of an appointed trustee. 11 U.S.C. § 1106. Acting for one's personal financial benefit is completely inconsistent with the fiduciary responsibilities of a trustee to creditors of the corporation, including the IRS.

Corporate officers liable for trust fund taxes contend that the allocation of payments to trust fund liability is necessary for a successful reorganization because in the absence of an allocation they might not be interested in continuing to work for the debtor to assist in the reorganization. The *Energy Resources* decision creates a limited incentive for corporate officer --
an incentive to keep the business going until the trust fund tax is paid by the corporation. On the other hand, in the absence of an allocation, corporate officers would have an incentive to see that the business was sufficiently successful that all of the tax liability provided for in the plan is satisfied. Moreover, it is inappropriate and unfair to place the burden of encouraging an officer's cooperation on a single creditor (the IRS) for the good of the entire estate. Necessary costs and expenses of the estate are to be borne by all of the creditors. See 11 U.S.C. § 502(b)

Congress enacted 26 U.S.C. § 6672 to encourage payment of trust fund taxes by responsible persons in the ordinary course of business and to provide a mechanism for collecting those taxes if the responsible persons are derelict in performing their duties. Outside of bankruptcy, and except for Energy Resources in bankruptcy, the IRS would have the right to allocate involuntary payments to maximize its ability to collect taxes owed by the corporation. The intervention of bankruptcy does not justify a different result. Accordingly, we submit that the Energy Resources decision should be overturned.