BANKRUPTCY AMENDMENTS OF 1997; AND THE BANKRUPTCY LAW TECHNICAL CORRECTIONS ACT OF 1997

WEDNESDAY, APRIL 30, 1997
House of Representatives,
Subcommittee on Commercial and
Administrative Law,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2237, Rayburn House Office Building, Hon. George W. Gekas (chairman of the subcommittee) presiding.

Present: Representatives George W. Gekas, Ed Bryant, Jerrold Nadler, Sheila Jackson Lee, Martin T. Meehan and William D. Delahunt.

Also present: Raymond V. Smietanka, chief counsel; Charles E. Kern II, counsel; Peter J. Levinson, counsel; Susana Gutierrez, clerk/research assistant; and Perry Apelbaum, minority chief counsel.

OPENING STATEMENT OF CHAIRMAN GEKAS

Mr. **GEKAS.** The hour of 10 o'clock having arrived, the subcommittee will come to order.

Noting the absence of a quorum, we are constrained to recess until the appearance of same, and so we do so. We are recessed until the members appear to constitute a working quorum.

For the edification of the audience, ever since I assumed the chairmanship of this subcommittee 2 years ago, I have kept faith with the notion that we should begin our subcommittee meetings and hearings on time.

The subcommittee will come to order. The gentleman from Massachusetts having arrived and speedily taken his place on the dais, we now have a working quorum; and we will begin the proceedings.

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As everyone knows, bankruptcy looms large in the potential business of the Congress for this year and for next year, the giant peg of which will be the final report of the National Bankruptcy Review Commission that is due later this fall and will, of course, urge action by this subcommittee, by the Judiciary Committee as a whole, and by the Congress.

In the meantime, the lesser problems surrounding bankruptcy and the loopholes left over from past work are still the business of the Congress and must be dealt with pending the arrival of that final report. Thus, the hearing today. The technical corrections legislation now before us will help to bring us up to snuff and lay the groundwork for the work to be done following our receipt of the Commission report.

We have Members of Congress present who have a particular interest in the outcome of the technical corrections bills. We will hear from them first and then acknowledge their presence and invite the other witnesses, who are experts on various elements of this legislation, to the witness table.

The bills that you will be considering are H.R. 764 and H.R. 120 introduced by the chairman of the Judiciary Committee and the ranking member, respectively. They complement one another with respect to many of the purely technical corrections that we must make and then are a bit divergent on other salient features of the bankruptcy problems that we face.

[The opening statement of Mr. Gekas follows:]

OPENING STATEMENT OF HON. GEORGE W. GEKAS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA, AND CHAIRMAN, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

The purpose of this hearing is to make a record which will serve as the basis for our action on the two bills before us, the Bankruptcy Amendments of 1997, H.R. 764, introduced by Mr. Hyde, and the Bankruptcy Law Technical Corrections Act of 1997, H.R. 120, introduced by Mr. Conyers. These are highly technical bills, and to a considerable extent they are also technical in the legislative sense, that is, they do not make substantive changes in the law. But there are substantive provisions of some importance in both bills, and I anticipate that our witnesses will have much to say about them this morning.

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These bills are also a foretaste of the complex legislative agenda which will be before us after the National Bankruptcy Review Commission makes its report in October. Prior to that, we have this legislation to deal with, we have a new bankruptcy judgeships bill which will shortly be introduced, and I intend to have hearings to explore and familiarize our members with some of the issues in bankruptcy which have emerged from the Commission's work thus far.

[The bills, H.R. 764 and H.R. 120, follow:]

INSERT OFFSET RING FOLIOS 1 TO 24 **HERE**

Mr. **GEKAS.** Unless the gentleman from Massachusetts has an opening statement, we will begin by listening to the gentleman from Michigan.

Mr. **DELAHUNT.** I welcome the gentleman, whom I have great respect for, from Michigan.

Mr. **GEKAS.** With that, we will recognize the gentleman from Michigan for whatever testimony he wishes to offer. His written statement will be made part of the record and acknowledged as such.

However, we now acknowledge the presence of the gentleman from New York, Mr. Nadler, the ranking member of this subcommittee.

The gentleman from Michigan will proceed.

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STATEMENT OF HON. JOE KNOLLENBERG, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. **KNOLLENBERG.** Mr. Chairman, thank you very kindly; and I very much respect the opportunity to come before you today. I thank you for your comment.

I wanted to thank you personally, Mr. Chairman, for your leadership and your efforts in bringing this bill to its current state and, for example, to include that provision that I have authored.

I am here to address an injustice in title 11 of the U.S. Code regarding single asset bankruptcies. Incidentally, and as I think you mentioned, Chairman Hyde's bill, which we are discussing today--and I appreciate his help on this as well and his staff--all had a hand in this. That bill of Mr. Hyde's does include language that is similar to my one bill regarding single asset bankruptcy. I am encouraged to see that we share a common ground, and I hope we can work closely--that I can work closely with the subcommittee on this issue to bring it to closure.

Mr. **GEKAS.** Just as a point of reference, you agree with us that the Conyers bill does not address the single asset problem, specifically? Is that your understanding?

Mr. **KNOLLENBERG.** Not in the framework of what I would like to see. That is right.

The injustice within title 11 stems from the 103d Congress, when a $4 million ceiling was placed on single asset provisions of the bankruptcy reform bill. Investors are rendered helpless in foreclosures on single assets valued at over $4 million.

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Both my bill and Chairman Hyde's bill would rectify this problem by eliminating the arbitrary $4 million ceiling and allowing creditors to recover their losses. Under current law, chapter 11 of the Bankruptcy Code becomes a legal shield for the debtor. When the investor files to foreclose, the debtor can immediately file for chapter 11 protection, which postpones foreclosure indefinitely.

While in chapter 11, the debtor continues to collect the rents on the commercial asset, that is true. However, the commercial property typically is left to deteriorate, and the property taxes go unpaid. When the investor finally recovers the property through the delayed foreclosure, they owe an enormous amount in back taxes; their deteriorated property has a lower rent value and also a lower resale value; and, on top of that, the rents paid during the time they spent trying to retain the property went to the uncollectible debtor.

Neither my bill nor Chairman Hyde's bill leaves the debtor without protection. First, the investor brings a foreclosure against a debtor only as a last resort. This usually comes after all other efforts to reconcile delinquent mortgage payments have failed. Second, the debtor has up to 90 days to reorganize under chapter 11. However, single asset reorganizations are typically a false hope, since the owner of a single asset does not have other properties from which he can recapitalize his business.

I was glad to see that Al Sullivan, Director of Asset Management and Disposition, from the Department of Housing and Urban Development is scheduled to testify as well.

HUD, incidentally, is another loser under current single asset bankruptcy laws. Just last month--March 21, to be exact--Chris Greer, the Deputy Assistant Secretary for Multifamily Housing from HUD, issued a statement in response to a discussion at the Bankruptcy Commission on the effect of the Bankruptcy Code on HUD. Chris Greer stated that foreclosure is sought--and I am quoting--usually because the principals will not support the property and will not invest additional capital where necessary.

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He also points out that--and, again, I am quoting--in many cases where bankruptcy has stayed foreclosure, owners have bled their properties and deprived tenants of decent and safe housing.

There is no incentive to maintain the property if the owner knows they will lose the property in foreclosure.

My bill also helps all American families by making their investments more secure and more valuable. My bill protects the "little guy" from being tied up in years of litigation, while a few unscrupulous commercial property owners continue to collect the rent to line their own pockets. Hardworking American families who depend on their life insurance policies and who have paid for years into their pensions will save millions in reduced costs.

Again, Mr. Chairman, I thank you for giving me the opportunity to express these comments and to testify before the subcommittee; and I will be happy to answer any questions that you might have at this time.

Mr. **GEKAS.** We thank the gentleman for the statement. He has persevered in this arena for quite some time now, and I think that success is on the horizon in one form or another for the interest that you have in that particular issue.

[The prepared statement of Mr. Knollenberg follows:]

PREPARED STATEMENT OF HON. JOE KNOLLENBERG, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

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Thank you for extending me this time to testify today on a very important issue. I am here to address an injustice in Title 11 of the United States Code regarding single asset bankruptcies. Incidentally, Chairman Hyde's bill, which we are discussing today, includes language similar to my own bill regarding single asset bankruptcy. I'm encouraged to see that we share common ground and I hope to work closely with the Subcommittee on this issue.

The injustice within Title 11 stems from the 103rd Congress, when a $4 million ceiling was placed on single asset provisions of the bankruptcy reform bill. Investors are rendered helpless in foreclosures on single assets valued over $4 million.

Both my bill and Chairman Hyde's bill would rectify this problem, by eliminating the arbitrary $4 million ceiling and allowing creditors to recover their losses. Under current law, Chapter 11 of the Bankruptcy Code becomes a legal shield for the debtor. When the investor files to foreclose, the debtor can immediately file for Chapter 11 protection which postpones foreclosure indefinitely.

While in Chapter 11, the debtor continues to collect the rents on the commercial asset. However, the commercial property typically is left to deteriorate and the property taxes go unpaid. When the investor finally recovers the property through the delayed foreclosure, they owe an enormous amount in back taxes; their deteriorated property has a lower rent value and resale value; and the rents paid during the time they spent trying to retain the property went to the uncollectible debtor.

Neither my bill nor Chairman Hyde's bill leaves the debtor without protection. First, the investor brings a foreclosure against a debtor only as a last resort. This usually comes after all other efforts to reconcile delinquent mortgage payments have failed. Second, the debtor has up to ninety days to re-organize under Chapter 11. However, single asset reorganizations are typically a false hope since the owner of a single asset does not have other properties from which he can recapitalize his business.

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I was glad to see that Al Sullivan, Director of Asset Management and Disposition, from the Department of Housing and Urban Development is scheduled to testify as well. HUD is another loser under current single asset bankruptcy laws. Just last month (March 21, 1997) Chris Greer, the Deputy Assistant Secretary for Multifamily Housing from HUD, issued a statement in response to a discussion at the Bankruptcy Commission on the effect of the bankruptcy code on HUD. Chris Greer stated that "foreclosure is sought ... usually because the principals will not support the property and will not invest additional capital where necessary." He also points out that "in many cases where bankruptcy has stayed foreclosure, owners have bled their properties and deprived tenants of decent and safe housing." There is no incentive to maintain the property if the owner knows they will lose the property in foreclosure.

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Again, thanks for extending me this time to testify before the subcommittee. I would be happy to answer any questions you may have at this time.

Mr. **GEKAS.** I wanted to mention that both the gentleman from Illinois, Mr. Hyde, and the gentleman from Michigan, Mr. Conyers, wanted to testify. They have other commitments, but their written statements will be accepted for the record

We are also informed that the gentleman from New York, Mr. Nadler, has an opening statement, which he will relegate to a written statement, which will be accepted for the record without objection.

[The prepared statement of Mr. Nadler follows:]

PREPARED STATEMENT OF HON. JERROLD NADLER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Thank you, Mr. Chairman. I will keep my comments brief. I want to commend you for moving forward on this important legislation. While not necessarily the most high profile of the work the Congress does, it will nonetheless touch the lives of more than one million American families and thousands of businesses.

In addition to some clearly technical amendments and clarifications of Congressional intent, each of these bills contains a number of substantive changes to the Code. In addition to explaining why we should or should not make any of these changes, I hope the witnesses will address themselves to the question whether it is appropriate to make these changes in a technical corrections bill, or whether these changes would not be best left to legislation we will consider based on the recommendations of the National Bankruptcy Review Commission in October. Clearly, any change which affects the rights of any stakeholder affects, to some degree, the rights of all. For that reason, it is normally my belief that changes should not be made piecemeal.

Nonetheless, there are those changes to the Code which are so obviously appropriate, that there may be no need to await the more comprehensive rewrite we will receive from the Commission. The question, as I see it, is into which category do these proposed changes fall? I hope today's witnesses will address themselves to that question.

Thank you, Mr. Chairman.

Mr. **GEKAS.** Mr. Knollenberg is excused with the thanks of the subcommittee.

Mr. **NADLER.** Can I ask a question?

Mr. **GEKAS.** The gentleman from New York wishes to pose a question.

Mr. **NADLER.** Let me say two things in lieu of my opening statement.

One, I want to thank the chairman for moving forward on this important legislation and for calling this hearing today.

Secondly, I want to state, both as a general statement and for preparation for one of my questions to you, there is considerable material in these technical corrections bills that are in fact substantive in nature, such as this provision we are talking about today; and one of the things I will ask all the witnesses to mention is why, aside from the merits of the provision, is why we should deal with them now in a technical corrections bill, as opposed to dealing with them in the major bill which we will be undertaking after the report of the Bankruptcy Review Commission, which is due on October 20.

Since most provisions of the Bankruptcy Code interrelate with each other and there is a lot of interdependence of the provisions, why it is necessary or a good idea to do any of the substantive changes now as opposed to seeing how they fit into the major bill?

So I have two questions of you, sir. That is the first. Why should we deal with this single asset real estate problem now as opposed to waiting for the major bill?

Mr. **KNOLLENBERG.** We introduced, as you know, Mr. Nadler, in the 103d and 104th Congress; and it was originally going to be a stand-alone, in discussions with the Judiciary Committee; and I believe my staff has had interrelated conversations with this staff, and it was decided it would be appropriate to bring it in as part of a larger bill. That was part of the 104th. What we are merely doing is reentering or reintroducing it within the broader framework of the large bill.

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Mr. **NADLER.** But, in this instance, do you think there is any real reason we should do this now as opposed to in the major bill? And in connection with that, do you think that this provision interrelates with other provisions and other changes in such a way that it might be a good idea to wait for the more comprehensive rewrite?

Mr. **KNOLLENBERG.** From what I believe, from what I understand, this is the appropriate vehicle to bring it up under.

Mr. **NADLER.** You state at the bottom of page 1 of your testimony, single asset real estate reorganizations are typically a false hope, since the owner of single asset real estate does not have other properties from which he can recapitalize his business. Now that may very well--in many cases, that will not be true.

Because in many, maybe even most, certainly many single asset businesses are typically a property owner, let's say limited partnership, that organizes limited partnership to one multifamily building, an apartment building in New York, for example. The same group of people, the same limited partners, may in fact own lots of buildings, but organized as--they may own 200 buildings, organized as separate limited partnerships. They may very well have the ability, if they want to, to recapitalize, even though it is not the same limited partnership. So would you just comment on that?

Mr. **KNOLLENBERG.** Well, I think what I would say is in every case it isn't such that they couldn't in fact regroup, but in many instances we find that these individuals are--this is their asset. It is the only asset that they have. And, in that regard, and specifically to focus on the large numbers of people who are--they are small-type people who are engaged in the ownership of property. And it is those people, I think, in large number--and I can't say everyone will fall into that category, but a great many do, and I believe we have to----

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Mr. **NADLER.** But you think it is most.

Mr. **KNOLLENBERG.** I am sorry?

Mr. **NADLER.** You think it is most.

Mr. **KNOLLENBERG.** My belief from our study is it is certainly in the range of being most, yes.

Mr. **NADLER.** OK. Thank you.

Mr. **GEKAS.** We thank the gentleman. We excuse him.

Mr. **KNOLLENBERG.** Thank you.

Mr. **GEKAS.** We now call the gentleman from Michigan, Mr. Ehlers, to the witness table. He appeared before our subcommittee previously regarding a particular issue in the bankruptcy arena. And we now recognize him for his oral testimony noting that his written statement will be accepted as part of the record, without objection.

STATEMENT OF HON. VERNON J. EHLERS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. **EHLERS.** Thank you, Mr. Chairman.

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I appreciate you taking this up, and I want to thank you and the subcommittee for giving me the opportunity to testify today regarding section 10(2)(B) of H.R. 764, which would make nondischargable through bankruptcy a debt incurred as a result of the operation of a boat or airplane while under the influence of alcohol.

This section was taken from a bill I sponsored for several years and which the House passed unanimously last year. Unfortunately, the Senate did not act. My bill, and this section of H.R. 764, seeks to correct what I believe was a bill-drafting oversight involving our bankruptcy laws. Current law states that if an individual incurs a debt as a result of their operation of a motor vehicle under the influence of alcohol, they cannot have that debt discharged through a declaration of bankruptcy. Since this law was originally enacted, the courts have generally interpreted the statute's use of the term "motor vehicle" as meaning "automobile."

Mr. Chairman, as you know, my home State of Michigan has an extraordinarily robust boating industry. Over the years, we have worked hard on the State level--as have many other States--to make it perfectly clear we viewed drunk boating as a serious crime, as serious as drunk driving, and we have consistently written our drunk driving laws to explicitly include drunk boating.

The language in this section simply seeks to extend this notion of equal treatment of drunk driving and drunk boating to the Federal level, as it concerns our bankruptcy laws. Since the courts have ruled that the Bankruptcy Code, as it is currently written, may only refer to automobiles, we seek to specifically add watercraft to this section of the Bankruptcy Code.

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In addition, while this has nowhere near the public profile of drunk driving and drunk boating, the operation of aircraft under the influence of alcohol and drugs has also been a problem, with far higher potential for injury and death. I am well aware of this as a former pilot myself. The language in the bill recognizes this and includes the drunk operation of aircraft as well.

I wanted to note here it is not my intention nor do I believe it is the intention of this committee to include watercraft and aircraft in the definition of motor vehicle, but rather it is our intention to add watercraft and aircraft to this section of the Bankruptcy Code exclusive of motor vehicle, and I hope the committee record will reflect this. I believe that is a very important distinction, because the boating industry has for years tried to make clear that watercraft are not to be considered as motor vehicles.

Again, Mr. Chairman, I thank you and the subcommittee for the opportunity to testify today. While this issue may not garner a great deal of public attention, those who have been negatively impacted by the lack of clarity in this section of the Bankruptcy Code have suffered significantly and we ought to protect future victims of drunk boating and drunk flying, by making the simple fix called for in this bill.

Thank you very much, and I will be happy to answer any questions.

Mr. **GEKAS.** We thank the gentleman.

[The prepared statement of Mr. Ehlers follows:]

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PREPARED STATEMENT OF HON. VERNON J. EHLERS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. Chairman, first, I want to thank you and the Subcommittee for giving me the opportunity to testify today regarding Section 10(2)(B) of H.R. 764, which would make nondischargable through bankruptcy a debt incurred as a result of the operation of a boat or airplane while under the influence of alcohol.

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I want to note here that it is not my intention, nor do I believe that it is the intention of this committee, to include "watercraft" and "aircraft" in the definition of motor vehicle, but rather it is our intention to add "watercraft" and "aircraft" to this section of the bankruptcy code exclusive of "motor vehicle," and I hope that the committee record will reflect this.

Again, Mr. Chairman, I want to thank you and the Subcommittee for the opportunity to testify today. While this issue may not garner a great deal of public attention, those who have been negatively impacted by the lack of clarity in this section of the bankruptcy code have suffered significantly and we ought to protect future victims of drunk boating, and flying, by making the simple fix called for in this bill.

Mr. **GEKAS.** By the way, the bill passed at the last session by your urging and that went through this subcommittee was, as I recall, satisfactory to the boating industry in that it was distinct from the definition of motor vehicle, is that correct?

Mr. **EHLERS.** It was not satisfactory once it passed the House, and they sought to have it changed in the Senate. And, unfortunately, they informed the Senate it was not satisfactory so all action was suspended on it, and we were never really able to recover from that in the time left during the session.

I believe if we include the statement in the report language that should be adequate to clearly convey the intent of the legislation. Your attorneys and the bill drafters agreed with our position that it is clear we are not including watercraft in the definition of the motor vehicle. However, the associations involved wanted even greater clarity, and that is where the difficulty arose.

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Mr. **GEKAS.** I thank the gentleman.

I yield back the balance of the Chair's time and recognize the gentleman from New York.

Mr. **NADLER.** Thank you.

I certainly voted for this bill last year, it is obvious, since it passed the House unanimously. Let me just ask you one question. In the Hyde bill, it says, amend the paragraph by inserting watercraft or aircraft after motor vehicle. Now is it your intent to limit this to pleasure boats, et cetera, or do you also mean to include the *Queen Mary* or the *Exxon Valdez?*

Mr. **EHLERS.** I believe that anyone is included.

Now we are dealing here with the personal bankruptcy of the operator. When you want to discuss the owner, that may be a different issue in the case of a large vessel like that.

Mr. **NADLER.** So this only deals with the personal bankruptcy of the operator.

Mr. **EHLERS.** I would have to check with the experts on that. It may include the bankruptcy of the owner as well.

Mr. **GEKAS.** A broad interpretation would be any bankruptcy action on any owner of watercraft.

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Mr. **EHLERS.** Since it deals with the drunk driving or the drunk boating, it is the operator, who is the one that is being referred to here.

Mr. **NADLER.** Thank you.

Mr. **GEKAS.** The gentleman from Massachusetts wishes to have time?

Mr. **DELAHUNT.** I have no questions.

Mr. **GEKAS.** We thank the gentleman from Michigan. We hope he never has to appear before our committee again.

Mr. **EHLERS.** Well, I can only speak for myself, but it has been a great pleasure for me. But if you don't wish to have me back, I will be happy to honor that.

Mr. **GEKAS.** We thank the gentleman. You have been very persistent.

Now we turn to our panel of experts who will provide an overview of the two bills that we have before us. Each of these witnesses represents an organization which is qualified to provide a disinterested analysis of bankruptcy legislation, and each of these groups has been very helpful in the past and I trust will continue to be so in the future. They have been very helpful to this subcommittee in the development of this legislation.

Our first witness is Kenneth N. Klee, who graduated from Stanford with a degree in economics with great distinction and cum laude from Harvard Law School. To add luster, he is also an alumnus of our Judiciary Committee staff. He was a principal draftsman of the Bankruptcy Code enacted by the Congress in 1978.

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Since leaving us, his continuing service to bankruptcy education and constructive reform has paralleled his practice with Stutman, Treister & Glatt in Los Angeles. Mr. Klee represents the National Bankruptcy Conference.

Our next witness on this panel, Roger M. Whelan, is with the Washington firm of Shaw, Pittman, Potts & Trowbridge is the chairman of the Legislative Committee of the American Bankruptcy Institute.

Mr. Whelan served as U.S. bankruptcy judge for the District of Columbia from 1978 through 1983, which included the transition to the new Bankruptcy Code. He has taught bankruptcy and insolvency classes at the Catholic University

Law School for over 20 years and has written and lectured extensively in the bankruptcy field. He will represent ABI at this hearing.

The third witness is Frederick M. Luper, who appears on behalf of the Commercial Law League of America. Mr. Luper is cochair of the League's Legislative Committee and a partner in the firm of Luper, Sheriff & Neidenthal of Columbus, OH.

We will say in advance, the written statements of the witnesses will be accepted for the record without objection and that we request each witness to attempt to limit the remarks to 5 minutes, after which we hope they will submit questions from the members of the subcommittee.

We will begin with Mr. Klee.

STATEMENT OF KENNETH N. KLEE, CHAIRMAN, COMMITTEE ON LEGISLATION, NATIONAL BANKRUPTCY CONFERENCE

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Mr. **KLEE.** Thank you, Mr. Chairman.

Mr. Chairman, members of the subcommittee, it is an honor and a privilege for me to appear on behalf of the National Bankruptcy Conference to testify before this subcommittee on the provisions of H.R. 120 and H.R. 764. The National Bankruptcy Conference largely supports enactment of these bills. Certainly the technical provisions in these bills ought to be enacted to cure defects in the Bankruptcy Reform Act of 1994.

However, there are some substantive provisions in these bills that we believe should not be included in their present form, if at all. And to answer Congressman Nadler's questions to the previous witness, we believe that congressional action on substantive amendments ought to await the filing of the Commission's report and ought to be considered in the context of omnibus bankruptcy reform legislation.

I want to highlight for the subcommittee what I believe are the two most controversial, substantive provisions in this legislation. The first is the repeal of the $4 million cap in the definition of "single asset real estate."

You have heard it said and you will hear other witnesses subsequent to me say that this cap ought to be repealed. Mr. Chairman, this is a substantive amendment. It is in no way technical. It will vastly change the dynamics of bankruptcy cases involving single asset real estate.

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The National Bankruptcy Conference has problems with the amendment on the merits as well. Rockefeller Center could qualify as a single asset real estate project under this definition.

Those proponents of this legislation say the size of the real estate project shouldn't matter, that it is essentially a two-party dispute. Mr. Chairman, members of the subcommittee, that is simply not the case. When the single asset is a hotel, there are jobs at stake, there are interests of other creditors at stake.

It is important that the subcommittee understand the underlying economics of what is going on here and why repeal of the $4 million cap is being supported by the commercial credit industry. This legislation will cause debtors in complex business reorganization cases to start making interest payments to undersecured lenders 90 days after the date of the filing of the bankruptcy case. That is contrary to the Supreme Court's opinion in the *Timbers* case, and it is contrary to the principle that interest stops accruing as of the date of bankruptcy unless the creditor is oversecured.

This money comes out of the pocket of other unsecured creditors and employees. It is not something that would go to the limited partners and the owners. There are other creditors in many of these cases.

Now, to be sure, HUD can make the case in some of their projects that this is a two-party dispute and there aren't other creditors, and perhaps the $4 million limit is a limit that empirically doesn't work for HUD. This committee should gather evidence on that point before amending the law to repeal the cap altogether.

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Think of the prime commercial office building in the largest town in your district and the people who are in that building. It may not be that if the lender forecloses that they will continue to work there, and that is certainly true if a business is involved in connection with the property. A hotel, a marina, a casino could all constitute single asset real estate. So the conference is opposed to that substantive change in this legislation.

The second provision that the conference opposes is actually contained in both bills, and it is a testimony to the fine lobbying work of the equipment leasing industry. Both section 6(1) of H.R. 764 and section 11(1) of H.R. 120 contain amendments to section 365 of the Bankruptcy Code. But the amendments, while useful in some respect in clarifying that penalty provisions do not apply to nonmonetary defaults, do carve out personal property equipment leases from the general rule that a debtor need not cure a nonmonetary default in order to assume or assign a lease.

What this means, Mr. Chairman and members of the subcommittee, is that the equipment lessors will have a veto power where there is a prepetition or postpetition nonmonetary default that is incapable of being cured. They are requiring the estate to do the impossible by curing nonmonetary defaults that can't be cured.

Now they say in their testimony that this is inconsistent with the provisions they lobbied into section 365(d)(10) in 1994 that requires the estate to timely perform all obligations. What they overlook, Mr. Chairman, is that the nonmonetary default could have taken place prepetition. It might have been the fact that the equipment wasn't maintained because the debtor ran out of money, but now what they would do is prevent the estate from assuming the lease based on the default.

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Mr. Chairman, my time has expired. I stand ready to answer questions posed by members of the subcommittee. Thank you.

[The prepared statement of Mr. Klee follows:]

PREPARED STATEMENT OF KENNETH N. KLEE, CHAIRMAN, COMMITTEE ON LEGISLATION, NATIONAL BANKRUPTCY CONFERENCE

Mr. Chairman and Members of the Subcommittee on Commercial and Administrative Law, I am Kenneth N. Klee, a member of the National Bankruptcy Conference, which is a private organization of bankruptcy judges, practitioners, and law professors formed in 1932 to work on proposed revisions of the Bankruptcy Act of 1898. The Conference has functioned since 1932 to advise Congress with respect to issues regarding bankruptcy legislation and laws. Following my graduation from Harvard Law School in 1974, I served for three years as associate counsel to the House Judiciary Committee. Since 1977 I have practiced law in Los Angeles, California in the areas of bankruptcy, insolvency, and corporate reorganization law. I served as the Robert Braucher visiting professor of law from practice at Harvard Law School, teaching courses in bankruptcy law and chapter 11 business reorganization law during the Fall and Spring semesters, 1995—96. I have taught a reorganization seminar as a visiting lecturer at the University of California at Los Angeles Law School almost every year since 1979. I served periodically as a bankruptcy law consultant to the House Judiciary Committee from 1977 through 1982 and to the United States Department of Justice from 1983 through 1984. In accordance with House Rule XI, clause 2(g)(4), my complete curriculum vitae is attached as an exhibit. No federal grant, contract, or subcontract has been received by me or the National Bankruptcy Conference.

I appear today at the invitation of the Subcommittee on Commercial and Administrative Law of the House Committee on the Judiciary to present the National Bankruptcy Conference's position with respect to H.R. 764, the "Bankruptcy Amendments of 1997," and H.R. 120, the "Bankruptcy Law Technical Corrections Act of 1997." I appear in my capacity as the chair of the Committee on Legislation of the National Bankruptcy Conference.

Although the Conference has not considered H.R. 764 and H.R. 120 specifically, the Conference did debate S. 1559, as passed by the Senate during the 104th Congress, and the House version of that legislation that Chairman Hyde prepared to bring to the Floor last year under suspension of the Rules. The Conference urges Congress to enact legislation to correct flaws in the Bankruptcy Code caused by the Bankruptcy Reform Act of 1994 or otherwise. Both H.R. 764 and H.R. 120 move in the right direction. Each Bill contains numerous provisions that, for the most part, cure technical flaws in the Bankruptcy Code. Except as set forth below, the Conference supports both of these bills, including provisions contained in one bill but omitted from the other bill.

The bills contain different approaches with respect to their effective dates. Under section 24(a) of H.R. 764, technical amendments are effective retroactively to apply, as they should, in pending cases. Since the bills propose "technical" amendments, the prospective approach of section 35(b) of H.R. 120 is undesirable, except with respect to the substantive amendments made by each bill. Regrettably, each Bill contains a few substantive amendments that are unwise and should be severed from this technical legislation.

OBJECTIONABLE SUBSTANTIVE PROVISIONS

The Conference believes that controversial substantive amendments should be deleted from these technical Bills. Specifically, the Conference asks this Subcommittee to strike sections 2(2)(B), 6(1), and 10(2)(B) from H.R. 764, and section 11(1) from H.R. 120.

1. Section 2(2)(B) of H.R. 764--Single Asset Real Estate

Section 2(2)(B) of H.R. 764 amends the "single asset real estate" definition in section 101(51B) of the Bankruptcy Code by deleting the $4 million debt limitation enacted in 1994. This provision is based on H.R. 73, the "Single Asset Bankruptcy Reform Act," introduced by Representative Knollenberg on January 7, 1997. Under current law, real property ventures with $4 million or less in debt are defined as "single asset real estate." For these single asset projects, special provisions in section 362(d)(3) of the Bankruptcy Code enable lenders to get expedited relief from the automatic stay or other protections, but only where debt encumbering a single asset project is $4 million or less. The $4 million limitation was carefully negotiated as a compromise between the House and Senate positions during the 103rd Congress. Insurance companies, banks, and other lenders who are mortgagees of real property have urged Congress to repeal the $4 million limit so they can obtain special benefits on all single asset projects. Their efforts should be rebuked because the amendment is substantive, controversial, and unwise on the merits.

There can be no doubt that the amendment proposed in section 2(2)(B) is substantive. Single asset projects with more than $4 million in encumbrances will be subjected to different rules with respect to the automatic stay, filing a plan, and making postpetition payments to undersecured lenders. The prospective effective date of section 2(2)(B) in section 24(b) of H.R. 764 evidences the substantive nature of the amendment.

The amendment in section 2(2)(B) is controversial and unwise because is alters debtor-creditor relations in significant bankruptcy cases to unreasonably favor secured creditors at the expense of trade creditors, tort creditors, employees; and debtors. As a result of the amendment, large single asset projects with hundreds of millions of dollars in debt would be subjected to section 362(d)(3). Under that section, the secured creditor gets relief from the automatic stay and can foreclose on the real property unless (A) the debtor files a plan within 90 days after the order for relief (or such later date as the court may determine for cause by order entered within the 90 day period) or (B) the debtor commences making payments, measured by interest at a fair market rate, to every creditor secured by the real estate. Unless the debtor wants to allow the creditor to foreclose, the debtor must file a plan prematurely, convince the judge to extend the period, or start making payments that look like postpetition interest. The latter provision is the most pernicious, because it takes money that would otherwise go to pay unsecured creditors, employees, or administrative claimants, and instead requires that payments be made to secured creditors who may be undersecured or completely "underwater" (where the value of the collateral is less than senior liens). This provision would overturn the result mandated by the Supreme Court in *United Savings Ass'n* v. *Timbers of Inwood Forest Assocs., Ltd.,* 484 U.S. 365, 108 S.Ct. 626 (1988), which forbade payment or accrual of postpetition interest as adequate protection to an undersecured creditor. Moreover, with respect to the oversecured creditor, the amendment would overturn the result in *Orix Credit Alliance* v. *Delta Resources* (*In re Delta Resources*), 54 F.3d 722 (11th Cir.), *cert. denied*, 116 S.Ct. 488 (1995), which allowed the accrual, but not the payment, of postpetition interest to an oversecured creditor prior to the effective date of a confirmed plan. These decisions should not be overturned by "technical" legislation. It would be unwise for Congress to entertain substantive legislation on these issues at this time, particularly since Congress has established a National Bankruptcy Review Commission to study substantive reform and file its report this October.

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2. Section. 6(1) of H.R. 764 and 11(1) of H.R. 120--Nonmonetary Default Equipment Lease Exclusion

Sections 6(1) of H.R. 764 and 11(1) of H.R. 120 contain amendments to section 365(b)(2)(D) of the Bankruptcy Code. These amendments improve the law by splitting the concepts of penalty rates and nonmonetary obligations into separate subparagraphs of section 365(b)(2). The Conference applauds the effort to clarify that the reference to "penalty" was never intended to modify "nonmonetary" obligations.

Each amendment also amends the law to exclude unexpired leases of personal property from the provision that excuses the cure of nonmonetary obligations. The proposed exclusion means that in order to assume an unexpired personal property lease, the debtor in possession or trustee will be required to cure all nonmonetary obligations. If some of these obligations are incurable, the lease cannot be assumed and ultimately will be forfeited back to the lessor. The Conference opposes the exclusion of unexpired leases of personal property, because the exclusion is substantive and unwise. The substantive nature of the amendment is self-evident and evidenced by the prospective nature of the effective date in section 29(b) of H.R. 764 and section 35(b) of H.R. 120. The lack of wisdom of the amendment requires a more lengthy discussion.

As a result of compromises reached at the end of the 103rd Congress, personal property equipment lessors gained the adoption of sections 365(d)(10) and 363(e)(2d sent.) of the Bankruptcy Code; they gave up the amendment to section 365(b)(2)(D) for all executory contracts and unexpired leases. The 1994 amendment to section 365(b)(2)(D) is particularly important as applied to real property leases. Nonmonetary defaults occur frequently in the context of real property leases (such as violations of "going dark" or "going out of business" clauses). The Conference is concerned that if the personal property lessors achieve their proposed exclusions, the real property lessors will not be far behind. This alone is a basis to oppose the proposed amendment.

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Nonmonetary defaults also occur in personal property leases incident to franchise agreements and the like. *See In re Claremont Acquisition Corp.,* 186 B.R. 977 (C.D. Cal. 1995), *app. pending*, (9th Cir. 1997). The proposed amendment would give personal property lessors undue leverage by permitting them to contract around the antiforfeiture provisions of the Bankruptcy Code (see sections 541(c)(1), 363(1), and 365(e)(1), (f)(1)&(3)). By creating a contractual, incurable, nonmonetary default, the lessor could block assumption (and assignment) of the lease, thereby depriving the estate of a valuable asset.

Although the Conference urges this Subcommittee to strike the offensive part of section 6(1) of H.R. 764 and section 11(1) of H.R. 120 during mark-up of technical amendments legislation, the National Bankruptcy Conference offers to assist this Subcommittee and its staff if you desire to perfect this substantive amendment. Currently, the amendment would be beneficial if this Subcommittee would strike the language in proposed subparagraph (E) "other than an unexpired lease of personal property." A less desirable solution (but better than the proposed legislation) would require an assumption motion of the trustee or debtor in possession to propose a cure of those nonmonetary defaults capable of being cured. Thus the debtor's failure to maintain leased equipment might require current repair and maintenance from the date of assumption rather than constituting an absolute bar to assumption, but the estate would not be required to cure incurable defaults.

3. Section 10(2)(B) of H.R. 764--Drunk Boating Aircraft Nondischargeability

The National Bankruptcy Conference objects to the amendment proposed by section 10(2)(B) of H.R. 764 because the amendment is substantive and unwise. The Conference submitted extensive testimony during the 104th Congress in opposition to H.R. 234, as introduced by Congressman Ehlers. Congressman Ehlers reintroduced the legislation as H.R. 30 during the 105th Congress and its substance is incorporated in section 10(2)(B) of H.R. 764. The substantive nature of the amendment is evidenced by the prospective effective date in section 24(b) of H.R. 764.

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Section 10(2)(B) of H.R. 764 amends section 523(a)(9) of the Bankruptcy Code to make nondischargeable any debts of an individual debtor for death or personal injury incurred from operation of a watercraft or aircraft if such operation was unlawful because the debtor was intoxicated. Currently, the law applies to motor vehicles, and courts differ whether the exception to discharge is restricted to operation of automobiles or extends to include other vehicles. Although the National Bankruptcy Conference does not condone operation of any vehicle by a person while intoxicated, the Conference believes that state criminal laws should address these issues. Injuries caused by intentional torts are already nondischargeable in chapter 7 cases under section 523(a)(6) of the Bankruptcy Code, and the Conference favors repeal of section 523(a)(9) in its entirety rather than expanding the scope of the exception to discharge. If a debtor does not intend to cause injury, it is not in the interest of society as a whole to prevent a fresh start by leaving outstanding a substantial judgment for injury caused by negligence or recklessness. If financial redress for the injured party is of paramount concern, a state or federal program of tort insurance is more likely to provide a meaningful remedy than fettering the debtor's discharge.

AMENDMENTS THAT REQUIRE IMPROVEMENT

4. Section 14(a) of H.R. 764 and section 21(a) of H.R. 120--DePrizio Fix

Both H.R. 764 and H.R. 120 contain proposed amendments that are flawed or require improvement. Specifically, section 14(a) of H.R. 764 and section 21(a) of H.R. 120 amend section 550(c) of the Bankruptcy Code in a manner that is overbroad. In 1994, Congress amended section 550(c) of the Bankruptcy Code to fix the so-called *DePrizio* problem by precluding the trustee's ability to recover an avoidable preference made more than 90 days before bankruptcy from a non-insider transferee. But the 1994 amendment only limited the trustee's ability to recover an avoided transfer or its value under section 550(c). No amendment was made to section 547, which deals with the avoidance of preferences as an initial proposition. Therefore some commentators have speculated that the trustee could still use section 547 to avoid a preferential lien given to a non-insider bank, more than 90 days but less than one year before bankruptcy, where the transfer benefited an insider guarantor of the debtor's debt to the bank. The avoided lien would be preserved for the benefit of the bankruptcy estate automatically under section 551 of the Bankruptcy Code, and the trustee would never need to seek recovery from the bank under section 550(c).

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Section 14 of H.R. 764 and section 21 of H.R. 120 seek to remedy this problem by preventing the trustee's ability to avoid transfers made for the benefit of a transferee that was not an insider at the time of the transfer. Sections 14(b) of H.R. 764 and 21(b) of H.R. 120 correctly make section 547 of the Bankruptcy Code subject to section 550(c). But sections 14(a)(2) of H.R. 764 and 21(a)(2) of H.R. 120 go too far by amending section 550(c) of the Bankruptcy Code where the lien is given to the insider guarantor rather than to the bank. Even though the non-insider bank might benefit indirectly from the granting of a preferential lien to an insider guarantor, the trustee should be able to avoid the lien as an alternative remedy to recovering its value from the insider. Only when the lien is given directly to the bank should the avoiding power be limited in the manner proposed.

Based on the foregoing reasons, the National Bankruptcy Conference recommends that sections 14(a)(2) of H.R. 764 and 21(a)(2) of H.R. 120 be amended by striking out "for the benefit of" and inserting "to" in lieu thereof. This refinement will preclude the trustee from avoiding liens given to non-insider creditors more than 90 days before bankruptcy, but will permit the trustee to recover preferential liens given to insiders more than 90 days but within one year before bankruptcy.

5. Section 23(2) of H.R. 764 and section 10(1) of H.R. 120--McConville Fix

Section 23(2) of H.R. 764 and section 10(1) of H.R. 120 appear to be unnecessary because 1994 amendments to section 547(e)(2)(A) of the Bankruptcy Code already refer to section 547(c)(3), and section 362(b)(3) of the Bankruptcy Code refers to section 547(e)(2)(A).

To the extent these amendments were designed to overrule the numerous erroneous decisions of the Court of Appeals for the 9th Circuit in *McConville*, however, the amendments are insufficient to remedy the problem. *See In re McConville*, ------ F.3d ------ (9th Cir. 1997) (decided March 26, 1997) (withdrawing prior decisions reported at 84 F.3d 340 (9th Cir. 1996); and 97 F.3d 316 (9th Cir. 1996)). *McConville* involved a postpetition loan secured by real property; the loan was secured by property that was property of the debtor's bankruptcy estate, but the bank that made the loan did not know that the debtor was in bankruptcy Originally the Court of Appeals avoided the bank's lien on the basis that the postpetition transaction violated the automatic stay and was not protected by section 549(c) of the Bankruptcy Code. Ultimately, the Court of Appeals held the borrowing was unauthorized under section 364 of the Bankruptcy Code, but the bank was awarded an equitable lien based on the facts of the case.

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Mr. Chairman, as a preliminary matter, let me disclose that my law firm, Stutman, Treister & Glatt Professional Corporation, represented a title insurance company in devising the *McConville* appellate strategy. I and my firm are not being compensated by any client for my testimony here today. To eliminate any appearance of impropriety, however, other members of the National Bankruptcy Conference prepared the essence of the following portion of this prepared testimony without editorial review.

The *McConville* case has gone through several appellate iterations, with the latest opinion of the 9th Circuit dated March 26, 1997 attached to this statement for your reference. As you will observe, the panel is trapped by two previous decisions of the 9th Circuit that misconstrue the intent of section 549 of the Bankruptcy Code.

Section 23(2) of H.R. 764 and section 10(1) of H.R. 120 attempt to cure the defects in the earlier *McConville* opinions by amending section 362(b)(3) of the Bankruptcy Code to establish that the automatic stay of section 362(a) does not apply to any act to perfect a security interest in real property to which section 547(c)(3) applies. The Conference assumes that this rightly permits and thus establishes perfection of an enabling loan within 20 days after the debtor acquires possession of the real property. Our problem with the proposed amendment is its reference to section 547(c)(3). Section 547(c)(3) deals with a preference defense to avoidable transfers. Section 547(b)(4) tells us that a preferential transfer must occur before the date of the filing of the bankruptcy petition. Because of this, the Conference is concerned that courts would be prone to read the exception in section 23(2) of H.R. 764 and section 10(1) of H.R. 120 to apply only to security interests granted prepetition. As noted, *McConville* involved a postpetition transfer.

The National Bankruptcy Conference suggests that Congress remedy the *McConville* problem by adding a new paragraph (19) to section 362(b) of the Bankruptcy Code that would read: "(19) under subsection (a) of this section of any transfer that is not avoidable under section 549." This would make clear that postpetition transfers immune from attack under section 549 of the Bankruptcy Code would not be void or voidable as made in violation of the automatic stay.

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The basic problem is the Ninth Circuit's view of the meaning of section 549(c) of the Bankruptcy Code. The Court of Appeals would apply section 549(c) to sales of real property but not to encumbrances. It is therefore essential to clarify section 549. The National Bankruptcy Conference suggests that section 549(c) be amended by inserting after "property" the first time it appears, the following: ", including a security interest in real property,". This would construe real property to include interests in real property and is preferable to the amendment to the definition of "transfer" in section 2(6) of H.R. 120.

The Conference would also, however, go so far as to cover other types of interests in real property where grantees rely on the recording acts, such as easements, etc. Thus the Conference urges this Subcommittee to also insert the words "an interest in" before "real" the first time it appears in section 549(c). The phrase would then read "a transfer of an interest in real property, including a security interest in real property, to a good faith purchaser...."

The final suggestion of the Conference is to clarify that section 549(c) applies to an encumbrances. Congress should amend the definition of "purchaser" in section 101(43) of the Bankruptcy Code by inserting "security interest or" immediately before "voluntary." The legislative history would show that the granting of a security interest is a voluntary transfer, that the creation of postpetition liens is governed by section 549, and that Congressional intent is to overrule *In re McConville*, ------ F.3d ------ (9th Cir. 1997) and the-cases cited therein that hold that the creation of a lien does not transfer property for purposes of section 549(c) of the Bankruptcy Code.
ADDITIONAL TECHNICAL CORRECTION
6. Postconfirmation U.S. Trustee's Chapter 11 Fees

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The National Bankruptcy Conference urges this Subcommittee to make an additional technical correction not contained in either H.R. 764 or H.R. 120. Recently, Congress amended section 1930(a)(6) of the Judicial Code to extend the time for collecting U.S. Trustee fees in chapter 11 cases. The legislation is flawed technically in several respects and is consuming unnecessary judicial resources to resolve ambiguities. First, paragraph (6) should be made a separate subsection of section 1930 of title 28, because Congress did not intend to impose these fees against the parties commencing the case, but rather against the bankruptcy estate. Currently, the preamble to section 1930(a) of title 28 imposes all of the fees on the parties commencing the case. While this would apply to the debtor in most cases, it would literally apply to the petitioning creditors in an involuntary case. Second, if the estate is responsible for these fees, they should be estimated and paid on the effective date of the plan as required by section 1129(a)(12) of the Bankruptcy Code, rather than at some later date when the estate may have no assets to pay the fees. Typically, all assets of the estate revest in the reorganized debtor or are transferred to a third party on the effective date of the plan. See 11 U.S.C. 1141(b). Thus typically there will be no assets in the estate to pay these fees postconfirmation. Third, the period over which fees should be imposed should continue (or be estimated) until the earliest of when the case is converted, dismissed or closed. The current statute fails to reference the closing of the case. Most successful chapter 11 cases are closed rather than converted or dismissed. See 11 U.S.C. 350. The current statute assesses the U.S. Trustee fee in perpetuity in these cases. The Conference is prepared to assist your staff in drafting corrective legislation should the Subcommittee desire to remedy these deficiencies or otherwise deal with bankruptcy law reform.

EXHIBIT TO TESTIMONY OF KENNETH N. KLEE ON H.R. *764 and H.R.* 120
MC CONVILLE OPINION

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Mr. **GEKAS.** Yes, at the request of the gentleman from New York, we will address the questions after each witness so that we can keep fresh with the ideas presented by the witness.

The gentleman from New York has a question of Mr. Klee.

Mr. **NADLER.** Yes, thank you.

Mr. **GEKAS.** I yield 5 minutes to the gentleman.

Mr. **NADLER.** Thank you.

Mr. Klee, if I understand what you are saying on this second point, you are saying this amendment would give the lessors a veto power over the reorganization by enabling them to require cures of nonmonetary defaults that occurred before the petition was filed which are, therefore, impossible to cure.

Mr. **KLEE.** There are nonmonetary defaults that could have occurred prepetition or postpetition, some of which could be cured, but some of which can't be. The requirement to maintain a piece of equipment at a specific time, if that is not done, the maintenance can be performed later, but the fact that it wasn't performed on time----

Mr. **NADLER.** Would your objection be eliminated or ameliorated if the provisions said that nonmonetary defaults only, postpetition, in other words, if it required the debtor to cure nonmonetary defaults, but not retroactively?

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Mr. **KLEE.** That would be an improvement, Congressman Nadler; but it still wouldn't be sufficient.

While it is the impetus of 365(d)(10) to require the debtor to timely perform obligations, the debtor in possession and trustee are excused from doing that during the first 60 days of the case.

And even though they are encouraged to perform these obligations, if, because of insufficient funds or circumstances, they fail to do so, such as in the real estate context, holding a going-out-of-business sale or going dark and not operating, the estate shouldn't forfeit this valuable asset. Rather, there should be an administrative claim for damages, which is the same thing that every other creditor gets in a bankruptcy case when the debtor in possession of trustee commits a tort or is unjustly enriched. The forfeiture of the valuable equipment lease can be too great a price to pay to the entire business.

Mr. **NADLER.** Thank you.

Mr. **GEKAS.** Yes. The Chair will yield itself 5 minutes for purposes of questioning Mr. Klee.

Mr. Klee, do you have a signal from the pending report by the Commission that the single asset will be treated in the final report?

Mr. **KLEE.** Mr. Chairman, I would not venture or speculate what the Commission will do in its final report on this issue. They have a small business committee or project working group that is considering several different proposals, and it would be premature for me to speculate how they are going to come out on this.

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Mr. **GEKAS.** Have you rendered input to the Commission on your thoughts on the single asset issue?

Mr. **KLEE.** I have given my personal views to the Commission staff, yes. I have not given views on behalf of the National Bankruptcy Conference to the Commission, however.

Mr. **GEKAS.** Are you free to tell us what that recommendation is or what you urged might be considered?

Mr. **KLEE.** Yes. I believe that there are substantial abuses in the single asset real estate area, and I believe steps need to be put in place to expedite the single asset cases.

But I believe defining "single asset real estate" to accomplish the objectives that the legislation in 1994 was intended to address is the preferable course of action. I think this subcommittee and the Commission has the talent to carve out those projects, such as the HUD multifamily projects, where there really are going to be two-party disputes, but, at the same time, preserve as mainstream chapter 11 cases the hotels and shopping centers and large commercial office buildings where more complex reorganization might be involved. I see that as the preferable solution.

Mr. **GEKAS.** Do you believe that one of the possible solutions we have to accommodate the HUD syndrome would be to raise the cap from--not eliminate it but to raise it to *x* from $4 million? Do you have any figure in mind there?

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Mr. **KLEE.** Congressman, I think that this group, this subcommittee is particularly well-qualified to make those kinds of----

Mr. **GEKAS.** You came from this committee. You understand that.

Mr. **KLEE.** I understand that, and the number of $10 million is the number that I read in the testimony on behalf of the bankers as the average. I would like to see what the median is as well as the mean, before I can recommend a number on this; but I would have to think a $10 million limit would bring in the lion's share of the projects that the banks are concerned about and probably should address HUD's concerns as well, although I think that question should be addressed to them when they testify.

Mr. **GEKAS.** We thank the gentleman.

The Chair recognizes the attendance of the gentleman from Tennessee, Mr. Bryant, and now recognizes Mr. Bryant.

Mr. **BRYANT.** Thank you, Mr. Chairman.

Mr. Klee, I apologize for missing your actual opening remarks, but I did review your statement. I have two other subcommittees going on in addition to this one.

In your statement, you make several technical suggestions to perfect the recent amendment to 28 U.S.C. 1930(a)(6) to extend the time for collecting U.S. Trustee's fees in chapter 11's. However, the suggestion has been made this morning by Congressman Bob Goodlatte that the U.S. Trustee's office no longer be empowered to collect post-confirmation quarterly fees, since it performs functions beyond that point.

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As you know, the U.S. Trustee system is funded entirely from fees; and I am advised at the present time, $12 million of the $70 million it collects in chapter 11 cases comes from post-confirmation fees. Since the overall budget of the U.S. Trustee system comes to over $100 million, the loss of $12 million would have a drastic effect.

What is your position on Bob Goodlatte's proposal and where would we make up this loss of revenue?

Mr. **KLEE.** Congressman Bryant, I agree with Congressman Goodlatte that the post-confirmation U.S. Trustee fee provisions are ill-considered and unwise. Certainly, the proposal was not run through the Judiciary Committee. The Judiciary Committee and this subcommittee never looked at that legislation.

It is my recollection that the Appropriations Committee was the genesis of that as a revenue raiser to try to find a way to get more money into the U.S. Trustee system. This has caused innumerable problems in the day-to-day functioning of the bankruptcy courts, particularly as this provision applies retroactively to pending cases; and in my prepared testimony I have suggested several specific amendments that can be made to perfect the language, in 28 U.S.C. 1930(a)(6). The National Bankruptcy Conference would support, however, its entire repeal.

With respect to the revenue gap, I believe that this subcommittee should conduct oversight hearings to determine how the U.S. Trustee system has been funded over the years and how its monies relate to the Department of Justice. It is my recollection that, during some years, the U.S. Trustee system has run a surplus and that funds in the U.S. Trustee system were actually used to subsidize immigration and naturalization or drug enforcement functions in the

Department of Justice.

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Now the Department of Justice can't have it both ways, Congressman. If they are going to take money from the bankruptcy system when it is flush to fund other areas that don't have enough revenue, maybe money should be taken from other programs to run the U.S. Trustee system at times when it requires more funds. So I think a study of the system is required before the question can be answered, how you make up the $12 million shortfall.

The second thing to be studied is whether the U.S. Trustee system is overstaffed and how it is using its money. $100 million is a lot of money, Congressman; and in this day where everyone is getting by with less, I think the question has to be asked whether the U.S. Trustee can get by with less.

Having said all that, if at the end of the day $12 million has to be raised, it should be raised in the chapter 11 cases in chief by raising the payments that are required during the maintenance of the case pre-confirmation, not by imposing post-confirmation fees. It would be unconscionable to impose the fees on the individual creditors in chapter 7 and chapter 13 cases by raising the filing fee or putting it on their backs. It should be borne by the chapter 11 estates.

Mr. **BRYANT.** Mr. Chairman, we are going to question each one individually?

Mr. **GEKAS.** That is correct.

Mr. **BRYANT.** OK. Mr. Klee, in regard to the chapter 7 intent of trying to give debtors a fresh start, I understand there are some 17 exceptions to discharge.

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Mr. **KLEE.** Eighteen, Congressman; and that is just in the Bankruptcy Code. There are actually other committees of Congress that have made exceptions to discharge to circumvent your jurisdiction.

Mr. **BRYANT.** Well, my question is, do we need to look at that number, 18, and perhaps some of these others that have been established and review those in terms of possibly eliminating some of these, in your opinion?

Mr. **KLEE.** I think you do, Congressman, for this reason: The purpose of bankruptcy is to give the poor but honest debtor a fresh start. Having yielded to every particularized interest that has come to Congress and said "let bankruptcy get rid of everybody else's debt except for mine," Congress has undermined the bankruptcy system.

The purpose of the bankruptcy system is not to undermine the criminal laws. The purpose of this system is to enable a debtor to reintegrate into society, to start earning a wage again, and to become contributing member of society, as an alternative to having the debtor labor under burdensome, crushing debt.

Eighteen exceptions to discharge is simply too many; but this reform should be done after the Commission files its report as part of the omnibus bankruptcy reform bill, not as part of the pending technical bills.

Mr. **BRYANT.** Mr. Chairman, I think my time has been exhausted.

Mr. **GEKAS.** The gentleman's time is expired.

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We will turn to the next witness and ask Mr. Whelan to testify.

Mr. **KLEE.** Mr. Chairman, may I be excused?

Mr. **GEKAS.** Yes, the gentleman is excused.

Mr. **KLEE.** Thank you.

Mr. **GEKAS.** Mr. Whelan.

STATEMENT OF ROGER M. WHELAN, CHAIRMAN, LEGISLATIVE COMMITTEE, AMERICAN BANKRUPTCY INSTITUTE

Mr. **WHELAN.** Good morning, Mr. Chairman and members of this committee.

I appreciate the opportunity to appear here this morning on behalf of the American Bankruptcy Institute, one of the Nation's largest group of bankruptcy and insolvency professionals. However, many of the views that I will be stating, of course, are not necessarily reflective of the membership of the American Bankruptcy Institute.

In view of the increasing number of bankruptcies--as this committee is well aware, in 1996 bankruptcy filings have now soared past the one million mark, with perhaps no end in sight--it is certainly critical, therefore, that the committee address the number of issues that have arisen since the passage of the 1994 Bankruptcy Reform Act.

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I certainly commend this committee for the efforts that it has already taken in connection with the proposed legislation, which addresses a number of critical issues. Many of these, such as the right of debtor's counsel in a chapter 7 case to receive compensation, the amendments which would further clarify the overruling of *Deprizio*--with respect to the creation of liens and provisions such as those dealing with the appointment of a trustee, will certainly go a long way to providing the necessary clarification that we need for our Nation's bankruptcy laws.

My written statement, of course, has covered a number of various issues. In view of the limited time, I will address the issue concerning the single asset real estate cases simply because this is, as acknowledged I think by most here today, a very serious and critical issue in connection with bankruptcy litigation and the delay and cost that ensues in many of these cases.

The more substantive provisions are covered in an article which has been attached to my written statement and published by the ABI and the American Bar Association.

However, with respect to the $4 million cap, this committee is aware there certainly does not appear to be any background for how the $4 million cap was arrived at. Originally, it was $2 million, and then it was $4 million.

Certainly, in my experience both as a former judge and now as a practitioner, I find that in most commercial real estate cases that are embraced within a single asset umbrella, most of these, if not all, are far in excess of the $4 million cap. Many of these loans are in the $20 million to $30 million range; and there will be testimony concerning, perhaps, the somewhat average figure of at least $10 million.

Congress has addressed the single asset provision, but it certainly seems proper at this time to remove the $4 million cap. I say this because there already have been problems with respect to what is even meant by the $4 million cap.

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You can imagine debtors' lawyers are most imaginative; and there is a difference of opinion, for example, as to how the $4 million is to be calculated. Does the $4 million refer to the aggregate dollar amount of the secured debt? Or does it, rather, mean that the $4 million cap refers to secured claims?

If the latter approach is taken--and it is the approach that most often will be advocated by debtors' counsel--it may very well require a valuation hearing, simply because, as this committee is aware, secured claims are measured and determined by the underlying value of the collateral pursuant to section 506 of the Bankruptcy Code. This illustrates some of the problems that have already developed with respect to the $4 million cap. It would be my opinion that it would be proper and advisable at this stage to address solely, at least, the $4 million cap. The far more substantive issues will be more properly addressed by the National Bankruptcy Review Commission.

I appreciate the opportunity to make this statement on behalf of the ABI; and if the committee has any questions, I will attempt to answer them.

Mr. **GEKAS.** We thank the gentleman.

[The prepared statement of Mr. Whelan follows:]

PREPARED STATEMENT OF ROGER M. WHELAN, CHAIRMAN, LEGISLATIVE COMMITTEE, AMERICAN BANKRUPTCY INSTITUTE

Mr. Chairman and Members of the Subcommittee, I am Roger M. Whelan, a practicing bankruptcy and insolvency attorney with the Washington law firm of Shaw Pittman Potts & Trowbridge. Prior to my involvement in the private practice of law, I served as United States Bankruptcy Judge for the District of Columbia from 1972 through 1983. I was on the bench when new bankruptcy rules were enacted in 1973 and continued to serve when the new Bankruptcy code was enacted in 1978, and first became effective in October 1979. I also served on the United States Bankruptcy Court for the District of Maryland from August 1981 through December 1982. I have written and lectured extensively on numerous consumer and business bankruptcy matters and have been a Distinguished Lecturer at the Columbus School of Law (Catholic University of America) where I have taught bankruptcy and insolvency classes continuously since 1975.

I am appearing here today on behalf of the American Bankruptcy Institute (ABI) a 5,500 person professional association of academicians, judges, practitioners and public policy makers who have a professional interest in the field of bankruptcy law and practice, and particularly in the organization and efficiency of the nation's bankruptcy courts. The ABI is a bipartisan, non-profit educational institute. I am a Director of the Institute and am presently serving as Chairman of its Legislative Committee. Because the ABI is not an advocacy organization, some of the views expressed here are solely those of the author and not necessarily those of the ABI or its other Directors.

I shall discuss certain provisions of the Bankruptcy Law Technical Corrections Act of 1997,(see footnote 1) which generally seeks to correct errors that arose when Congress passed the Bankruptcy Reform Act of 1994,(see footnote 2) which became effective October 22, 1994. Thus, the Technical Corrections Act would insert proper punctuation that was inadvertently omitted, correct inaccurate references to other Bankruptcy Code sections and correct the numbering/lettering of Bankruptcy Code subsections. The American Bankruptcy Institute supports these changes, which will alleviate confusion that resulted from what appear to be typographical errors.

The American Bankruptcy Institute also supports certain minor changes that will clarify Congress' intent. For example, the Technical Corrections Act modifies Bankruptcy Code Section 101(51B) to clarify that the definition of single asset real estate cases (*i.e.,* cases where the debtor's main asset is a single development, such as an apartment building or office complex) does not include family farms. The Technical Corrections Act also clarifies that in 1994, when Congress overruled the *Deprezio* line of cases, it intended the new law to apply to transfers of liens in property.(see footnote 3) Moreover, the Technical Corrections Act also expands the ability of a trustee to assist the estate by modifying Section 327(d) to allow a trustee to act as an attorney, accountant, appraiser, auctioneer or other professional person rather than as just the "attorney or accountant for the estate." In particular, the American Bankruptcy Institute supports the proposed revision that would allow bankruptcy professionals to receive fixed and contingent fees, rather than requiring that such professionals charge hourly rates,(see footnote 4) as well as the provision that clarifies that debtor corporations may recover punitive damages for willful violations of the automatic stay.(see footnote 5) The American Bankruptcy Institute also supports Congress' efforts to clarify that the 1994 amendments to Bankruptcy Code Section 525(c) apply only to bar discrimination concerning student loans and grants because of prior bankruptcies, and not all loans.

However, I believe that certain "technical" amendments are erroneous or misleading and, before addressing the more substantive issues, I would like to draw your attention to these errors.—First, the Technical Corrections Act proposes to replace language in Bankruptcy Code Section 108(c)(2) with identical language--"922, 1201 or" would be replaced with "922, 1201 or...."

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Second, the Technical Corrections Act proposes to change Bankruptcy Code section 327(c) by replacing "In a case under chapter 7, 11 or 12 of this title" to "In a case under chapter 7, 12, or 12 of this title." Moreover, the Technical Corrections Act proposes to delete the word "section" in Section 327(b), such that Section 327(b) would read, "If the trustee is authorized to operate the business under 721, 1202 or 1108 of this title...." These changes will only create confusion.

Third, the Technical Corrections Act proposes to amend Section 423(a) with several corrections and modifications. However, the Act is somewhat confusing in proposing to move subsection (a)(15) to follow subsection (a)(14), which it already does.

Fourth, the Technical Corrections Act proposes to replace language in Bankruptcy Code Section 524(aX3) with identical language--"523, 1228(a)(1), or 1328(a)(l) of this title, or that ..." would be replaced with "523, 1228(a)(1), or 1328(a)(1) of this title, or that...."

Now, I would like to briefly address my main substantive comment regarding an important proposed amendment. The Bankruptcy Code allows the trustee to assume or reject the debtor's contracts with third parties. However, there are certain exceptions to protect the third parties. Thus, in order to assume a contract, the trustee must first "cure," which requires the trustee to bring all outstanding arrearages current and otherwise be in compliance with the debtor's contractual obligations under the contract. However, to prevent third parties from creating artificial contractual obligations to prevent a debtor from assuming a contract, Congress relieved the trustee of curing certain obligations, including those conditioned on the debtor's remaining solvent. Furthermore, the Bankruptcy Reform Act of 1994 amended Bankruptcy Code Section 365(b) to provide that a trustee need not cure "a penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease." The amendment was intended to allow a trustee to assume a contract without curing penalty rates or penalty provisions.

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Certain case law interpreted the word "penalty" in the 1994 amendments to modify only "rate" and not "provision." Thus, at least one court allowed a trustee to assume contracts without curing certain nonmonetary defaults that it would previously have been required to cure, notwithstanding that the provisions were not penalty provisions. See *In re Claremont Acquisition Corp.*, 186 B.R. 977, 989—90 (C.D. Cal. 1995), *appeal granted.* This inaccurate interpretation could wreak havoc for creditors that enter into contract provisions that require that the debtor do more than pay a fee (*e.g.,* maintain insurance).

The Technical Corrections Act seeks to clarify that in passing the Bankruptcy Reform Act of 1994, Congress intended "penalty" to modify both "rates" and "provisions." However, the proposed modifications in the Technical Corrections Act do not accomplish Congress' goal. In fact, the proposed change may have the opposite result of the one Congress intends. Currently, the Technical Corrections Act would replace Section 365(b)(2)(D) with the following two provisions:

(D) the satisfaction of any penalty rate in any contract or unexpired lease; or

(E) the satisfaction of any provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under any executory contract or unexpired lease other that an unexpired lease of personal property.

Subsection (E) does not artfully accomplish the House's expressed intent of allowing a trustee to assume a contract without curing penalty provisions.

I would propose that correcting the interpretation of Bankruptcy Code Section 365(b)(2)(D) is more readily accomplished by simply modifying Bankruptcy Code Section 365(b)(2)(D) to read:

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the satisfaction of any *penalty* rate or *penalty* provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease. (Emphasis added.)

Because Congress has already chosen to address the problem area of Single Asset Real Estate cases in the Bankruptcy Reform Act of 1994, and because there is also an amendment that would remove the statutory $4 million cap in Bankruptcy Code Section 101(51B), I would refer the Committee to my chapter in the American Bankruptcy Institute's recently published work "Single Asset Real Estate Bankruptcies--Current Developments and Legislative Issues," published by the American Bar Association in 1997 (Chapter 12 is referenced and attached to this testimony). Because single asset cases lack economic substance in that the only significant creditor is the secured lender, legislation is sorely needed to address this significant issue.

Finally, I commend Congress for its efforts to pass the Boating and Aviation Operation Act of 1997 (the "Safety Act"), introduced on January 7, 1997 by Rep. Ehlers. The Safety Act would bar discharge in bankruptcy of a debt for death or personal injury caused by the debtor's operation of watercraft or aircraft while intoxicated. This amendment is urgently needed to overrule cases like *In re Greenway (Boyce* v. *Greenway*), 71 F.3d 1177 (5th Cir.), *cert. denied,* where the court determined that provisions of the Bankruptcy Code that prohibit discharge for debts incurred while intoxicated from the operation of a motor vehicle do not apply to debts from operating a boat. Thus, in *Greenway*, the court allowed discharge of claims against the debtor who, while intoxicated, crashed his boat into the claimants' vessel, killing one person and injuring several more.

I thank you for the opportunity of appearing before this subcommittee and hope that these remarks will be of some assistance to you in this important work. If I can be of further assistance to you or the subcommittee, please do not hesitate to call upon me or the American Bankruptcy Institute.

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Mr. **GEKAS.** The Chair yields itself the customary 5 minutes.

I am mildly shocked that there is a controversy, even within the $4 million cap. I didn't realize that that is subject to interpretation as to whether it is just for secured or unsecured or a mix or whatever. Are you saying that it is not well settled at all on the----

Mr. **WHELAN.** Well, we have not had time, Mr. Chairman, to see all of how the case law will come out on this. It has been my opinion that the intention of Congress was to address it by way of aggregate dollar amount; namely, $4 million based on the then outstanding obligation of the secured creditor or creditors, as the case might be. However, debtors' counsel will often take the position that the $4 million refers to secured claims. As I stated, secured claims will be based on the underlying value of the collateral, which, in most cases, will necessitate a separate court hearing.

Mr. **GEKAS.** I yield back the balance of my time.

I want to recognize the attendance of the gentleman from South Carolina and the gentleman from Massachusetts, and

I will yield 5 minutes to the gentleman from New York.

Mr. **NADLER.** Thank you.

Mr. Whelan, first of all, just let me ask you a very simple question. Given that that is unsettled and apparently we are wasting a lot of time in lawsuits to settle that, should Congress clarify that? And, if so, which way?

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Mr. **WHELAN.** Well, it certainly would be a step in the right direction.

Mr. **NADLER.** But which way should we clarify it?

Mr. **WHELAN.** I think the better approach is to be sure that it is $4 million in aggregate indebtedness and does not refer to the secured claims.

Mr. **NADLER.** And why do you think it should be aggregate, rather than secured?

Mr. **WHELAN.** Simply because what happens is that if it is based on the secured claim, that means that we have to look to the value of the underlying collateral. That, as I said, would more than likely require a valuation hearing, which, in turn, produces delay and which is, in turn----

Mr. **NADLER.** In other words, to simply avoid the necessity of that hearing.

Mr. **WHELAN.** Pardon me?

Mr. **NADLER.** To have certainty in measurement and avoid the hearing.

Mr. **WHELAN.** That is correct.

Mr. **NADLER.** OK. Secondly, I haven't had a chance to read your article here in the last few minutes; but you said in your testimony, the $4 million figure is too low. Are you advocating it be raised or eliminated entirely and why?

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Mr. **WHELAN.** I think at this time, in view of the fact Congress has chosen to address this as a serious issue, that removal of the cap would be appropriate at this time because many of the substantive problems will presumably be addressed by the review commission.

Mr. **NADLER.** Which brings me to my next question, which is, do you think, in view of what you just said, that there are a lot of questions involved in this, that this question should be addressed in this bill now? Or should it be addressed, as Mr. Klee implied, that the Bankruptcy Commission has a working group of small business people looking into this, at various approaches that they may recommend, and should we deal with this now or should we wait for the Bankruptcy Commission report, take a look at their recommendations and their reasons and deal with this in the overall legislation that we will be doing probably next year?

Mr. **WHELAN.** In my view, it would be appropriate at this time to address the $4 million cap as stated in the present legislation.

Mr. **NADLER.** Why?

Mr. **WHELAN.** Because I don't think there is any rationale, as seen by practice, as to why there should be a $4 million cap or a $6 million cap or a $10 million cap. Rather, since Congress has addressed the issue by putting very tight time requirements and substantive requirements on the debtor, it should apply to all single asset real estate cases.

Mr. **NADLER.** Let me ask you the following question: If we were going to eliminate this entirely, as you are suggesting now, how would this change affect a large complex, say, Rockefeller Center, across the street, literally, from my district, which employs many people and many businesses, enough to fill a small town? So it is not simply a question between two creditors. The implications are pretty wide for a lot of different people, including, perhaps, union contracts, collective bargaining contracts. How would this affect it?

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Mr. **WHELAN.** Assuming there is removal of the cap, that type of single asset case would be subject to the existing provisions set forth under 362(b). There would be a requirement that the debtor file a plan with reasonable prospects of confirmation within 90 days or begin paying interest to the secured creditors.

Mr. **NADLER.** Do you think in a large complex case, such as, for example, Rockefeller Center, it is reasonable to expect that a creditor--that a debtor, rather, could take into account everything that has to be taken into account and file a reasonable plan within 90 days?

Mr. **WHELAN.** That may very well not be the case, but the existing legislation does provide for extensions; and based on the language of the existing statute, the debtor in a complex case could seek an extension of time within which to file a required plan.

Mr. **NADLER.** That being the case, why do you think it preferable to give the discretion to a judge, instead of saying, in a complex case like this or in a big case, set some sort of limit where the debtor would have a more appropriate time as a right?

Mr. **WHELAN.** Well, I think in complex cases, it is always best to leave it to the discretion of the judge. Perhaps I am saying that based on my past experience; but, nonetheless, I think it is incumbent on the judge; and he is in the position best to understand the complexities of that situation and, in turn, to determine whether or not it would be appropriate to grant such an extension.

Mr. **NADLER.** Thank you, Mr. Whelan.

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Mr. **GEKAS.** The Chair yields 5 minutes to the gentleman from Tennessee.

Mr. **BRYANT.** Thank you.

Mr. Whelan, as I understand, you are a former bankruptcy judge.

Mr. **WHELAN.** That is correct.

Mr. **BRYANT.** Let me call you Judge Whelan then.

Judge, my question tracks along my colleague from New York's idea in terms of this apparently compromised number that was achieved, why it is $4 million versus 2 or 6 or whatever. But, as I view this, it is an effort to balance the various rights involved in bankruptcy between the debtor, who is entitled to a fair effort and time to reorganize, and, on the other hand, the creditor. We must not allow misuse of the system to the detriment of the creditors, who are obviously entitled to some relief on getting their money.

If I understand what you are saying, your preference would be to simply abolish this artificial $4 million figure and allow expedited treatment for all single asset real estate, regardless of the amount of debt. Is that correct, so far?

Mr. **WHELAN.** That is correct, Congressman. I think it would be fair. Simply because, since Congress has initially addressed the issue, it would be far more realistic to see how the provisions are going to work across the board, bearing in mind--and particularly with reference to my response to Congressman Nadler's question, as to how do you deal with the mega chapter 11 case.

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Clearly, the existing statute does provide discretion to the judge, who is in the best position, usually, initially, to understand the complexities of the case and determine whether or not an extension would be warranted.

Mr. **BRYANT.** And during the time, if the judge--and it has been a long time since I practiced, but I do recall the extensions are fairly liberally granted.

Mr. **WHELAN.** That is correct.

Mr. **BRYANT.** And during that time, there are no interest payments being made.

Mr. **WHELAN.** Well, the statute provides that after 90 days the interest would have to be paid, unless an extension is granted. Keep in mind that the Supreme Court in the *Timbers* case ruled that undersecured creditors, creditors who are owed more money than the underlying amount of their collateral, are not entitled to interest payments because of their undersecured position.

Mr. **NADLER.** Would the gentleman from Tennessee yield for a moment?

Mr. **BRYANT.** Yes.

Mr. **NADLER.** I am a little confused about an answer you gave, sir, to Mr. Bryant a moment ago.

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I thought that when you said the judge could grant an extension of the 90 days that that meant that you wouldn't have to pay interest during the extension. I think I heard you say you would pay interest during the extension.

Mr. **WHELAN.** The statute draft provides there be interest payments.

Mr. **NADLER.** In which case, what is the point of the extension?

Mr. **WHELAN.** Well, because, at least in the case you have posited, that is highly income producing; and I am sure that arrangement could be made to determine what the proper rate of interest is that would be paid.

Mr. **NADLER.** Under the current statute in that kind of a case, Rockefeller Center or some other megacomplicated case, under the current statute with the $4 million limitation, they would not be paying interest.

Mr. **WHELAN.** That is correct.

Mr. **NADLER.** So what you are saying then is, if we were to remove the $4 million cap, such a complicated case where you could not reasonably expect them to have a filing and so forth within 90 days, they should nevertheless pay interest, even if they got the extension from the judge.

Mr. **WHELAN.** What I am attempting to state is, by removal of the $4 million cap, you enable the courts to apply the law as it was originally drafted to all of these cases.

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Mr. **NADLER.** But you don't enable the Court to waive the interest payments or do you?

Mr. **WHELAN.** That may be done, in the discretion of the judge.

Mr. **NADLER.** So there is a major substantive change here then in terms of payment of interest payments, even if the judge thinks an extension is in order.

Mr. **WHELAN.** Yes. As I said, that would be the discretion of the judge.

Mr. **NADLER.** Thank you.

I yield back the time. Thank you for yielding to me.

Mr. **GEKAS.** The Chair will yield an additional 1 1/2 minutes to the gentleman from Tennessee.

Mr. **BRYANT.** Is there some magic to this 90-day number in that the debtor has the exclusive right to file the plan within that period? Is there some exclusivity provision on behalf of the 90 days?

Mr. **WHELAN.** Well, once the extension is granted, that would provide the debtor with a right to file its plan.

There may be a question, as I have pointed out in my article, as to what rights exist on the part of the secured lender during that 90-day period. For example, there might be a situation, particularly in the--in almost any type of case there is an issue of waste or serious depreciation. And it certainly would be my view, although it is not entirely clear, that the secured lender would be entitled, even during that initial 90-day period, to seek relief from the automatic stay.

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Mr. **BRYANT.** Thank you, Mr. Chairman.

Mr. **GEKAS.** We thank the gentleman.

The Chair yields 5 minutes to the gentleman from Massachusetts.

Mr. **MEEHAN.** Thank you, Mr. Chairman; and I appreciate the opportunity to ask questions on this, particularly, as a new member of the subcommittee. I have to confess that when I a requested a seat on the Judiciary Committee, the first or second reason wasn't to be involved in a technical corrections to the Bankruptcy Code bill.

But, in any event, I do appreciate the opportunity to ask questions of witnesses who have dealt extensively with the Bankruptcy Code, mainly on a day-to-day basis. Especially in light of the fact that the Hyde and Conyers bills overlap in significant respects, I am hopeful we can arrive at some sort of consensus on what sort of changes ought to be made immediately to the Bankruptcy Code.

Mr. Whelan, getting back to this issue of single asset real estate, many of those who support this proposal suggest that single asset real estate debtors typically have little chance of successfully reorganizing their assets in a viable manner. Thus, they claim that creditor foreclosure will actually save jobs in businesses that have leased based on single asset real estate, because the property will be restored to the proper management.

I am wondering, what has been the track record of creditors who have foreclosed on single asset real estate? And have they been able to save those jobs linked to these properties?

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And I am wondering with respect to those who say part of the reason why they support doing away with the $4 million cap is potentially saving jobs, what has been your experience?

Mr. **WHELAN.** Well, my experience, Congressman, has been in the overwhelmingly number of single asset real estate cases you have one piece of property, you have one owner, usually a partnership or perhaps a corporation; and there are very few employees involved. There is almost no unsecured trade debt.

The battle, essentially, boils down to the rights of the secured lender versus the debtor; and the ultimate issue of recapture, which is critical, of course, to the debtor because of the tax implications. Remove reissue of recapture and you probably would not have many of these chapter 11 cases. But, nonetheless, the ultimate reality is that there is very little substance involved other than who is going to ultimately control the property.

Mr. **MEEHAN.** So with respect to the ability to reorganize and to sell its jobs, there really isn't a link.

Mr. **WHELAN.** No. Because, in many of the cases, you have to look at the existing definition of what qualifies for a single asset case. And in those instances where there is the business that is being conducted, other than the ownership of the single asset, you might not even have application of the single asset case; and I think that may very well apply to even the Rockefeller Center, because there are other businesses, obviously, that are critically involved there.

Most of the cases that are being addressed by the courts today are those involving substantial secured debt and a limited partnership that is attempting to avoid recapture, almost no unsecured debt, other, perhaps, than some insider, this is usually where the issue is fought.

Mr. **MEEHAN.** Let me ask a question about equipment leases.

In certain cases, a debtor may default on a personal property lease by failing to comply with nonmonetary terms of the lease. For example, a party that leases equipment might fail to keep the equipment in good repair or insure it properly. If a debtor goes bankrupt, an unexpired personal property lease could be a valuable part of the bankrupt estate.

However, both H.R. 764 and H.R. 120 would require any nonmonetary defaults first be cured before a trustee or a debtor could--in possession--could assume such a lease.

Now there has been some concern that this sets a precedent for a similar rule in the case of real estate leases. Are there differences between personal property and real estate leases which would make this rule relevant--less relevant, rather, to real estate leases? And do you believe that the rule should be extended to real estate leases?

Mr. **WHELAN.** Well, I don't have an opinion with regard to whether or not it should be extended to real estate leases, because there may very well be underlying differences. This legislation, however, proposes to carve out a specific exception for the equipment lessor. And the substantive issues are very serious in this area, because, traditionally, it would seem that what was to be addressed was the debtor was to be protected against penalty provisions, as pointed out in the written portion of my testimony.

Of course, one way of addressing that would be to again say it is a penalty rate or penalty provisions; and the courts then would address the issue as to what would constitute a penalty under the particular facts and circumstances of the case. But, clearly, it is a serious issue, because it has to do with the debtor's right to assume a contract, which is a vital issue in many chapter 11 cases.

Mr. **MEEHAN.** Thank you, Judge.

Mr. **GEKAS.** The Chair recognizes the attendance of the lady from Texas, Ms. Jackson Lee, and the gentleman from Michigan, Mr. Conyers, the Ranking Member of the full Judiciary Committee.

Does the lady from Texas have any questions to pose?

Ms. **JACKSON LEE.** I do, Mr. Chairman.

Mr. **GEKAS.** The lady is entitled to 5 minutes.

Ms. **JACKSON LEE.** I would ask unanimous consent to have my opening statement submitted in the record.

Mr. **GEKAS.** Without objection.

Ms. **JACKSON LEE.** Thank you.

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[The prepared statement of Ms. Jackson Lee follows:]

PREPARED STATEMENT OF SHEILA JACKSON LEE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. Chairman, I would like to thank Chairman Gekas for holding this hearing on the two bills sponsored by the chairman of the Judiciary Committee and the ranking member respectively. I am a friend of both these bills as they both seek to make necessary and worthwhile technical corrections and clarifications to the provisions of the Bankruptcy Reform Act of 1994. I am particularly gratified that both bills clarify that student loans and grants cannot be denied on the basis of a prior bankruptcy by an institution making government guaranteed or ensured student loans. Just recently, it was reported by the Administrative Office of the U.S. Courts on March 18th of this year, that the total filings for the year were over 1.17 million. These filings represent an all time high which is an increase by 27.7% since the same period last year. In 1996, there were over 13,000 reported filings in the Southern Judicial District, which sits in my congressional district of Houston, Texas, and that figure saw a jump last year from over 14,000 to over 17,000 in that judicial district alone. While these figures are indeed staggering, what is most important however, is what are the causes of these many filings?

On a survey taken recently by the National Bankruptcy Review Commission which polled both creditor and debtor representatives, five primary causes were cited by two-thirds of the respondents. They were the ease of obtaining personal credit cards, loss of a job, financial mismanagement, medical problems, and marital family problems. In the ten largest cities, the leading causes were job loss, business/employer failure, and catastrophic events. While I understand that many in the creditors' community believe that there are abuses in the bankruptcy system, the survey results conducted by the Commission point out that although abuse is a problem in our current bankruptcy system, it is not rampant. I represent a congressional district in which the make-up of the population includes low to middle income families. While the majority of the population might not be homeowners, those who do own homes, have worked awfully hard to obtain this American dream. While the bankruptcy system might need some "reform," I want to insure that reform is equitable and fair and that it does not leave the homeowner who may have come under sudden financial strain due to job loss without his home, or make it harder for someone to liquidate one's assets, or almost impossible for the small businessowner to reorganize his debt through chapter 11 of the Bankruptcy Code. It is imperative, Mr. Chairman, that true "Bankruptcy reform," be both fair and equitable for all Americans.

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Ms. **JACKSON LEE.** Let me raise a general question that I would appreciate both Mr. Luper and Mr. Whelan responding to.

Having not been able to be present for your testimony, with other matters that I was responding to, I wanted to just get your sense of what do you think a creditor should be able to do in business after filing a bankruptcy, meaning that, after they have filed a bankruptcy, under whatever we wind up adopting, what latitude and leeway should they have in entering the business community again, engaging in secured loans and various other tools that are needed to establish a business. Mr. Luper.

Mr. **LUPER.** I think the market pretty much directs that when a person can get credit again, when a person can comfortably employ people and be able to support them. I know there is nothing within the Bankruptcy Code that would prohibit a debtor from going into business immediately.

In the commercial area, we see it frequently. Without the intervention of bankruptcy, that debtors are forming a new corporation every year, when the creditors stop shipping to the old corporation.

So I think it is a marketplace consideration. And as far as I can think, as I sit here, there is nothing within the Bankruptcy Code to inhibit debtors who have bankruptcy discharges from going right back and doing them, as long as someone will extend them credit and someone will lease them space and so on.

Ms. **JACKSON LEE.** Mr. Whelan.

Mr. **WHELAN.** Congresswoman, I think an important thing to understand is the requirement in chapter 11 that the bankruptcy judge make a specific finding that whatever plan is proposed by the debtor is feasible. And by feasible, the case law has construed that to mean that the debtor has reasonable--not absolute certainty by any means--but reasonable prospects of succeeding and fulfilling the obligations that have been set forth in the plan.

It has been my experience that the goal of chapter 11 is primarily one of rehabilitation, and that is to send a debtor back into the community. And I think that the regular economic circumstances that lenders and other unsecured creditors deal with, they then confront that based on the reorganized debtors status.

Ms. **JACKSON LEE.** That is the direction I am going. The difficulty I have seen, constituents of my area--I come from the Southern District of Texas, which had in the 1980's and into the early 1990's certainly its share of extensive bankruptcy filings.

The community is a business-directed small--small-business-directed community. At least that was seemingly their choice in the boom time of the shadow of the oil industry. And my concern is whether or not that order or that plan is effectively used or respected by the marketplace that Mr. Luper has noted. From your experience, is that plan respected as the debtor goes out--back into the community?

Mr. **WHELAN.** Well, first of all, I think we have to look at the unfortunate statistics with respect to most chapter 11 cases. The overwhelming number in any given year, in excess of 80 percent of all filed chapter 11's never even make it to confirmation. And there are a number of very sound reasons as to why that figure is so high.

Many of them are businesses that are undercapitalized, and many of them represent instances where the attorneys or the debtor is filing solely for the cause of delay, because of tax obligations, perhaps.

But in those instances where the case does reach confirmation, in most instances, the judges are very careful to be sure--and even if all the creditors consent to a plan, there is still a requirement that the debtor set forth evidence on the record as to--and particularly with regards to the issue of feasibility that I addressed earlier, this I think is very important; and the judges, I think, take that responsibility very seriously.

Ms. **JACKSON LEE.** I would want to explore that with you further.

Let me move to two other questions. I think your point about the statistics on getting to confirmation is an issue that certainly needs to be addressed. Let me pursue my colleague--Mr. Meehan raised the question regarding the $4 million provision, and----

Mr. **GEKAS.** The time of the lady has expired.

We have not yet heard from Mr. Luper, so we will move to the testimony of Mr. Luper. Then we will yield to the lady, as the first member of the committee, to address questions.

Ms. **JACKSON LEE.** And if I am not here, Mr. Chairman, I will put them in writing in the record.

Mr. **GEKAS.** Thank you. Without objection.

Mr. Luper is now recognized.

STATEMENT OF FREDERICK M. LUPER, COCHAIR, LEGISLATIVE COMMITTEE, COMMERCIAL LAW LEAGUE OF AMERICA

Mr. **LUPER.** Thank you, Mr. Chairman, members of the committee. I am honored to appear here as a representative of the Commercial Law League of America, which is North America's oldest credit rights organization.

The written testimony covers a lot of detail, but I am going to go into a couple things that haven't been brought up yet.

The first one is section 6 in H.R. 120, which eliminates the residency requirement for trustees. We oppose this, because what will inevitably happen is the two or three national companies will wind up with all the substantial asset cases.

The problem with this, for the system, is those members of the panel of trustees, under the U.S. Trustee, typically stay on that panel and handle 90 to 95 percent of the no-asset cases for the opportunity of getting an asset case. This would prevent them from doing that and probably degrade the quality of the panel trustees.

The so-called McConville fix is perhaps now mooted by the fact that the McConville court withdrew the opinion that generated the legislation before you and substituted a new opinion on March 26th of this year that really treats the creditor more equitably than did they treated this lender in their former opinion.

The 365 issues are what I would call the Claremont fix. The Claremont acquisition was a 1995 case out of the district of California. It involved not an equipment lease, but it involved car franchises. And the default, which was a nonmonetary default, was a continuous operation clause.

If Claremont was closed for 7 consecutive business days, then the franchise agreement was avoided. Well, Claremont was closed for more than 7 days--about 2 weeks, in fact--before they filed their bankruptcy. Obviously, an incurable default, because you couldn't go back and reopen it.

So the court found that, equitably, the franchise agreements could be assumed and assigned without curing that default. The language in that case, which makes the tension between the equipment lessors and the landlords, the real estate landlords, is that, by inclusion of the "no need to cure nonmonetary defaults" for the personal property lessors, inferentially means the real estate lessors have the benefit and the right to require the curing of incurable nonmonetary defaults.

I would like to make a couple of comments with respect the $4 million cap which has been very thoroughly gone over. Our association favors the repeal of that. It is an experiment that was put in and just doesn't work.

My experience with single asset cases, like Judge Whelan, is that the debtor and the lender have to make peace or there will never be a confirmed bankruptcy. And the stall, stall and delay, if you are the lender, or the cooling-off period if you are the debtor, doesn't really accomplish very much, in my opinion. So I think the $4 million should go.

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There is something that is not in either bill that I wanted to comment on. It was within Senate bill 1559 of the last Congress, with reference to due process for chapter 13 standing trustees and chapter 7 panel trustees. I understand that the Association of Bankruptcy Professionals will be recommending the inclusion of that due process material in this bill, and the league supports the notion that there should be some administrative review as a result of the action taken by the office of the U.S. Trustee.

I see my time has expired, and I am happy to answer any questions.

Mr. **GEKAS.** I will yield, to the gentleman, Mr. Luper, an additional 5 minutes to conclude his statement.

Mr. **LUPER.** Thank you.

With respect to the administrative process, it is not unlike Federal employees who may have some civil service protection, that there is an administrative process and some opportunity for judicial review. It is simply not that every U.S. Trustee manager of an office is high-handed, but the risk is there that they can be. And it does chill panel trustees who can be cut out of the draw for new cases, who can be terminated, who can fail to be reappointed.

There is one other thing that was in Senate bill 1559 that I would like to encourage, and that is the $500,000 limitation exemption on homesteads, which is the sort of Florida and Texas under limited homestead exemption issue. In Ohio, it is $5,000; in Florida, it is unlimited. So folks can buy multimillion-dollar mansions and retain them in a bankruptcy. The $500,000 is a good idea, in our view.

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Mr. **GEKAS.** To retain it.

Mr. **LUPER.** Well, there is no limitation on homestead exemptions; and now States can opt out of the Federal exemption system and enact their own. In Florida--in Texas, with some minor limitations, there is virtually an unlimited homestead exemption. So some former--baseball commissioners and other folks have these multi-million-dollar homes in Florida which they were able to keep by being Florida residents, despite being able to go bankrupt.

Mr. **GEKAS.** I thank the gentleman.

[The prepared statement of Mr. Luper follows:]

PREPARED STATEMENT OF FREDERICK M. LUPER, COCHAIR, LEGISLATIVE COMMITTEE, COMMERCIAL LAW LEAGUE OF AMERICA

Dear Congressman Gekas, thank you for the opportunity to appear before the Commercial and Administrative Law Subcommittee and discuss the pending legislation to make technical corrections to the bankruptcy code of the United

States.
The CLLA, founded in 1895 is the nation's oldest organization of attorneys and other experts in credit and finance actively engaged in the field of commercial law, bankruptcy and reorganization. Its membership exceeds 4,600 individuals. The CLLA has long been associated with the representation of creditor interests, while at the same time seeking fair, equitable and efficient administration of bankruptcy cases for all parties in interest. Its Bankruptcy and Insolvency Section is made up of approximately 1,800 bankruptcy lawyers and bankruptcy judges from virtually every state in the United States. Its members include practitioners with both small and large practices who represent divergent interests in bankruptcy cases.

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The CLLA has testified before Congress on numerous occasions as experts in the bankruptcy and reorganization field as well as in the areas of credit and collections. In addition, the CLLA has appeared several times before the National Bankruptcy Review Commission over the past year.
This presentation will focus specifically on two bills currently pending before the Subcommittee--H.R. 120 and H.R. 764 introduced by Congressmen John Conyers, Jr. and Henry Hyde, respectively. It will highlight those provisions of the bills that are not technical in nature and where appropriate will provide a recommendation from the Commercial Law League of America. Further, it will indicate in which bill the provision can be located, the differences, if any between the versions in each bill and if there isn't a similar provision in the other bill.
H.R. 120: SECTION 6. ELIGIBILITY TO SERVE AS TRUSTEE
This section would amend Section 321 of the Bankruptcy Code to eliminate the requirement that a Chapter 7 trustee reside or have an office in the judicial district in which the bankruptcy case is pending or in an adjacent district. This would apply to either individuals or corporations.
This is not a technical amendment. The residency requirement existed prior to the enactment of the Bankruptcy Reform Act of 1978.
Presumably this amendment recognizes the fact that bankruptcy practice has expanded to include national firms providing a wide variety of services, including trustee work.
However, it potentially undermines what is inherent about the trustee system that make it economically feasible. In most jurisdictions, the vast majority (upwards of 90—95%) of all cases assigned to panel trustees are no asset cases for which trustees receive a flat fee. Generally, there aren't enough no asset cases assigned to any one trustee to provide sufficient revenue to cover overhead. In most jurisdictions, accepting no asset cases is the "loss leader" in anticipation of receiving the case with some assets in order to generate sufficient revenue to provide some profit.

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It is very likely that the elimination of the residency requirement may allow for the large national firms that seek trustee work to effectively "cherry pick" the good cases to the detriment of the local panel trustees. This might very well result in the inability to find local persons willing to serve as trustees.
There is no similar provision in H.R. 764.
The Commercial Law League would recommend that this provision not be enacted into law.

H.R. 120: SECTION 7. EMPLOYMENT OF PROFESSIONAL PERSONS
A proposed change to subsection (c) of Section 327 is exceptionally confusing.
Part of the confusion arises from how subsection (c) has been published in various versions of the Bankruptcy Code.

Depending upon the version of the code one reads, the current language could be either "Chapter 7, 12, or 11" or "chapter 7, 11, or 12".
The provision in H.R. 120 calls for 'striking "chapter 7" and all that follows through 'or' the first place is [sic] appears, and inserting 'chapter 7, 12, or', ..."
If the current code provision reads "chapter 7, 12, or 11" then the proposal in H.R. 120 does nothing. If the current code reads "chapter 7, 11, or 12", then the new law would change it to read "chapter 7, 12, or 12".
Clearly this is redundant if not totally confusing.
Intended or not, the latter reading would eliminate chapter 11 from the subsection and thus presumably preclude employment of a professional in a Chapter 11 case because of his or her employment by or representation of a creditor.
If this is the case, the Commercial Law League would strenuously oppose any such change. There has been no

indication that there are problems that have resulted from current law. There are provisions whereby those who believe that there exists an actual conflict of interest may bring their objection to the attention of the bankruptcy court for review and a determination. There are adequate protections to the system, the estate and the parties and no need to tamper with this provision in this manner.

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H.R. 764 does not contain a similar provision.

Another portion of H.R. 120 would amend subsection (d) of Section 327 to allow the trustee to act as his or her own appraiser, auctioneer or other professional person in addition to current authority to act as attorney or accountant.

Presumably this is intended to encourage the increased use of non-attorney/non-accountants as trustees. Clearly this makes it more beneficial to those seeking to act as trustee if he or she may act in another capacity.

The CLLA believes that it would be inappropriate for trustees to be authorized to retain themselves in a capacity as outlined in H.R. 120. The role played by appraisers, for example, is that of an independent outside expert who is called upon to provide valuation information and might ultimately be called upon to testify in court on the basis for his or her conclusions. This is distinguished from the attorney for the trustee whose role is more that of an advocate.

Auctioneers and the auction process is public and visible. Often it is a primary means used by the bankruptcy estate for converting property to cash. The integrity of the process must be maintained at the highest level so that the public does not have even the hint of possible self-dealing.

The CLLA would oppose the change to Section 327(d).

Other provisions in H.R. 120 (see changes contained in Section 6. Limitation on Compensation of Professional Persons impacting 11 USC 328(a)) contain amendments to bring 11 USC 328(a) in line with the suggested changes above. Further, it recognizes and specifically authorizes additional forms of compensation other than retainer, hourly basis or contingent fee basis by adding on a fixed or percentage fee basis. As these changes merely recognize the latest trends in compensation, and are not solely the purview of appraisers, auctioneers and other professionals, the CLLA endorses these proposals despite its opposition to the proposed amendment to Section 327(d) discussed above.

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H.R. 120: SECTION 10. AUTOMATIC STAY

This provision would amend Section 362(b)(3) to provide that the automatic stay does not operate as a stay "with respect to a security interest that is created by a transfer to which section 547(c)(3) of this title applies."

H.R. 764, in Section 23, also addresses this issue by adding "a security interest in real property to which section 547(c)(3) applies".

The purpose of this provision is to address the decision in the 9th Circuit Court of Appeals decision in *Thompson* v. *David Margen and Lawton Associates (In re McConville)* 1997 WL 136529 (9th Cir.(Cal)).

In that case, a lender provided credit (secured by an unencumbered piece of real property) to borrower who was in bankruptcy. Unfortunately, the fact of the borrower's bankruptcy was not known to the lender. Even more unfortunate for the lender, was their failure to require a loan statement from the borrower or any representation of the borrower's assets and liabilities.

One month after the loan was made, the borrower's previously filed Chapter 11 converted to a Chapter 7 proceeding. The lenders sought relief from the automatic stay to foreclose the deed of trust. The bankruptcy court denied the relief. The trustee then filed a complaint to void the lien created by the deed of trust as an unauthorized, post petition transfer, voidable under Section 549(a). The bankruptcy court entered judgment for the Trustee. The District Court affirmed the judgment of the bankruptcy court.

An appeal was taken to the 9th Circuit which issued an opinion on May 21, 1996. That original opinion was subsequently amended on September 26, 1996 and ultimately withdrawn and replaced by the March 26, 1997 decision cited above.

The September 26, 1996 amended opinion noted that under Section 549(c) a trustee may not avoid a transfer of real property to a good faith purchaser without knowledge of the bankruptcy. However, the Court ruled that no transfer of property occurred in this case because, under California law, all the execution of a deed of trust accomplishes is the creation of a lien in favor of the creditor.

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There is no specific exception to the automatic stay as enumerated under Section 362(b)(1) through (18) for the creation, perfection or enforcing of a lien obtained by a simple lender to the estate. Thus the creation of the lien falls neither under an exception nor is it considered a transfer of property such that the trustee may not avoid the transfer.

A final attempt by the Lender fell short as well. It argued that Section 549(c) further provides that the trustee cannot avoid a "lien on the property transferred to the extent of any present value given." However, the Court rejected this argument based upon the holdings in *In re Shamblin* 890 F.2d 123 (9th Cir. 1989) and *In re Schwartz* 954 F.2d at 569 (9th Cir. 1992) stating that no real property was transferred and thus there was no property on which the lien referred to in Section 549(c) may operate, thus no transfer was made.

In its most recent permutation, the 9th Circuit noted that to change the rulings *In re Shamblin* and *In re Schwartz* an en banc court would be needed and the Court decided that was not necessary in order to now resolve the case.

The Court looked at Section 364(c) and (c)(2) and determined that the borrower violated those provisions of the Bankruptcy Code because it failed to gain approval from the court prior to obtaining the new secured credit and it is within the power of the bankruptcy court to rescind the contract.

However, the Court further stated that the equities in the case should not be disregarded. Among other items, the Court noted that the "lenders' failure to ask for any representation of the Debtors' financial condition amounted to pretty much willful blindness. The Lenders' lack of knowledge of the Debtors' bankruptcy was not unavoidable."

The Court then ruled that the Lenders be entitled to a lien on the amount they lent less what they have already been paid, but that they should get no benefit from their loan.

It is against this set of facts that Congress is being asked to amend the bankruptcy code to address the issues as framed by the American Land Title Association (ALTA).

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The ALTA recommendations were significantly more extensive that either of those contained in H.R. 120 or H.R. 764.

However, the amendments currently before this Subcommittee are an attempt to as narrowly as possible address the void created by the now withdrawn September 26, 1996 opinion in *In re McConville*.

It accomplishes that by specifically including as one of the exceptions to the automatic stay a security interest in property described under the "new value" exception to the preferences provisions of the code (i.e. Section 547(c)(3)).

There are several questions that should be addressed:

1. Does the withdrawal of the September 26, 1996 opinion in *In re McConville* and the subsequent March 27, 1997 decision render the need for corrective legislation moot? If so, then Congress need not invest any more resources on this issue.

2. If not, does the attempted fix outlined in H.R. 120 and H.R. 764 solve the problem narrowly enough so as to avoid creating other problems. It appears that the approach taken in H.R. 764 is more narrowly drafted and specifically notes that it would only apply to real property situations. However, the language in H.R. 120 merely makes reference to the key provisions under Section 547(c)(3) without making a distinction between real property and personal property. As the specific concerns raised by the ALTA relate to real property title insurance issues, the more specific language contained in H.R. 764 should survive, if in fact there should even be an amendment.

3. Were the facts in the *McConville* case so unique and the efforts (or lack thereof) by the lender to perform any due diligence so minimal as to place this case into the "bad facts make bad law" situation, such that Congress need not address this legislatively. Is it also possible that the treatment of the effect of the execution of a deed of trust under California law may be unique in and of itself. The proponents of this amendment would presumably argue that this is not a unique situation but rather the *McConville* decision raises the spectre of a virtual inability by the land title insurers to obtain any comfort level because of undisclosed bankruptcies particularly in light of the current unavailability of a national bankruptcy filing database. An exception for undisclosed bankruptcies might be needed in title insurance policies thus potentially leading to a chilling impact on the lending industry's willingness to extend credit. It appears that this case involved a debtor that was not as forthcoming as it should have been and a lender that was more trusting that it should have been. That situation is probably not all that unique. However, should the bankruptcy code be used to remedy stupidity, greed and slights of hand that go awry? The CLLA believes that is not an appropriate purpose for amending the Bankruptcy Code.

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4. Section 1 of H.R. 120 does contain a proposed change to paragraph 54 of Section 101 of the Bankruptcy Code by adding "creation of a lien," after the term "security interest" in the definition of transfer. Our concern is that definitional changes often have unintended results. Therefore this is not an appropriate approach.

5. It appears that the appropriate way to fix the problem is through a very specific change to Section 549 which was the subject of the *McConville* case. Unfortunately, neither H.R. 120 nor H.R. 764 contains any amendments. Should one be drafted succinctly enough to address only the narrow issue raised in the *McConville* case, the CLLA would be favorably inclined to consider such a narrow, specific fix.

However, the CLLA opposes adoption of the provisions currently contained in H.R. 120 and H.R. 724 as detailed above.

H.R. 120: SECTION 11. EXECUTORY CONTRACTS AND UNEXPIRED LEASES

This provision is intended to address the result in the 1995 decision *In re Claremont Acquisition Corp.*, 186 B.R. 977 (C.D. Cal. 1995). That decision relates to an amendment adding Section 365(b)(2)(D) to the Bankruptcy Reform Act of 1994.

However, the court in the *Claremont* decision determined that the word "penalty" modified on "rate" and not the phrase "provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations...."

Thus the trustee could assume these contracts or leases without being first required to cure these non-monetary penalties.

The facts of the *Claremont* case involve automobile dealer franchises where one requirement of the agreement was continuous operation. The stores were closed for a few days prior to filing Chapter 11 and thus the non-monetary provision was impossible to cure.

The proposed new language would presumably address these non-monetary provisions but effectively carves out an exception for leases of personal property. The trustee would still be required to cure non-monetary penalty obligations under any executory contract or unexpired lease other than an unexpired lease of personal property.

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Section 6 of H.R. 764 contains identical language.

It is the position of the Commercial Law League of America that the *Claremont* decision does not carry out the specific legislative intent of Congress when it enacted the Bankruptcy Reform Act of 1994. It is also special interest legislation that is intended to favor one party in interest in the bankruptcy process. The Commercial Law League of America has long taken the stance that such special interest legislation should not be a part of the bankruptcy code. The CLLA would oppose enactment of this provision as written.

Further, the CLLA suggests that the issue that Congress should address legislatively is to:

a. make the statute specific enough to carry out its original intent
b. address those situation where there is a requirement that is impossible to cure

H.R. 120: SECTION 21. LIABILITY OF TRANSFEREE OF AVOIDED TRANSFER

This provision would amend Section 550(c) by replacing the language "recover under subsection (a) from a transferee that is not an insider." With "avoid under section 547 such transfer, to the extent that such transfer was made for the benefit of a transferee that was not an insider at the time of such transfer, or recover under subsection (a) from a transferee that was not an insider at the time of such transfer."

Section 14 of H.R. 764 contains identical language.

It appears that this is intended to address the situation where the transferee simply acts as a conduit for funds intended for the ultimate recipient. For example, an insurance broker may accept a check on behalf of the insurance company but is entitled only to a commission rather than the entire premium. Another example is a collection agency that receives payment from a debtor on behalf of a creditor and remits the funds, less a commission, to the creditor.

The CLLA supports this amendment.

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H.R. 120: SECTION 25. APPOINTMENT OF ELECTED TRUSTEE

This provision is intended to address a void created by the Bankruptcy Reform Act of 1994 which allowed for the election of trustees by creditors in Chapter 11 cases. There was no specific provision for the termination of the appointment of the interim appointed trustee nor any provision for resolve disputes arising under the election.

The bill would address both questions by specifically providing that the service of the interim trustee ceases upon submission of a report by the U.S. Trustee of the election of the new trustee. The bankruptcy court is specifically granted authority to resolve disputes arising under the election.

Identical language is found in Section 20 of H.R. 764.

The Commercial Law League supports this amendment.

H.R. 764: SECTION 2. DEFINITIONS

One of the provisions in this section of the bill would amend Section 101(51B) of the Bankruptcy Code by eliminating the dollar limitation on the definition of single asset real estate cases.

There is no similar provision in H.R. 120.

The National Bankruptcy Review Commission has a proposal before it to accomplish the same result. The Commercial Law League has appeared before the Commission and has endorsed the elimination of the dollar limitation on the definition of single asset real estate.

These cases, which are essentially two party disputes, clutter the bankruptcy system. The clear intent of Congress when enacting a definition of single asset real estate cases under the Bankruptcy Reform Act of 1994 was to expedite the handling of these two-party disputes. Elimination of the $4 million cap will help accomplish that goal. Moreover, there is no logic behind the limination and it has simply resulted in needless litigation over the issue of the how the $4 million cap should be calculated.

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The Commercial Law League of America supports this provision.

OTHER BANKRUPTCY MATTERS

A. Expenses for Chapter 13 Standing Trustees

The 1996 version of the Technical Amendments bill (S. 1559) contained provisions relating to due process when there is a reduction of case load for panel trustees by the U.S. Trustee and when there is a dispute relating to reimbursable expenses for Chapter 13 Standing Trustees with the U.S. Trustee.

It is the CLLA's understanding that provisions will be recommended for inclusion in the current Bankruptcy Technical Amendments bills that will again address the above enumerated problems.

Congress has not defined the term "actual, necessary" as it relates to reimbursable expenses for Chapter 13 Standing Trustees. Thus, when there is a dispute over the application of those terms of art to specific items of expenditure, there is no mechanism for resolving those honest disagreements. An amendment to 11 USC 330 would afford the Chapter 13 Standing Trustee the opportunity, once he or she has exhausted all administrative remedies, to have the bankruptcy court resolve--with appropriate criteria--the dispute with the U.S. Trustee.

The following language has been suggested by the Association of Bankruptcy Professionals, Inc.

Section 330 of Title 11 of the United States Code is amended by adding to the end thereof the following:

"(e) Upon the motion of a trustee appointed under Section 586(b) of Title 28, and after all available administrative remedies have been exhausted, the court shall have the authority, notwithstanding Section 326(b) of this title, to determine the actual, necessary expenses of the standing trustee. In determining actual, necessary expenses, the court shall consider all relevant factors, including:

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"(1) whether the expense will benefit the administration of cases by the trustee; and

"(2) whether the expense is reasonable, based upon the customary and usual expenses incurred by fiduciaries providing services of comparable nature in matters other than cases under this title."

The CLLA supports the change proposed by the Association of Bankruptcy Professionals.

B. Reduction in Caseload for Private Panel Trustee

The position of trustee has become a rather important one in the bankruptcy system with hundreds if not thousands of Chapter 7 bankruptcy cases assigned annually to trustees appointed by the U.S. Trustees. At times, the interests of the private trustee and that of the U.S. Trustee relative to a particular case may differ. Periodically personality conflicts may exist.

While infrequent, the reduction in caseload assigned by the U.S. Trustee to panel trustees has been used as a weapon to resolve differences between the U.S. Trustee and some private trustees. Under current law, there is no redress for the private trustee despite the immediate and irreparable harm such a reduction in caseload can cause the trustee and the debtors and creditors of bankruptcy estates.

The CLLA supports due process for such trustees so aggrieved after all administrative remedies have been exhausted.
The Association of Bankruptcy Professionals, Inc. plans to proffer the following language:
Section 324 of Title 11, United States Code, is amended by adding to the end thereof the following:

(c)(1) Notwithstanding any provision of Section 586 of Title 28, in the event the Attorney General ceases assigning cases to a trustee appointed under Section 586(a) or (b) of Title 28, the trustee, after exhausting all available administrative remedies, may seek judicial review of the Attorney General's determination. upon review, the court may reverse the Attorney General's determination only if the Attorney General has acted unreasonably or without cause. The failure of the Attorney General to make a final administrative disposition of a trustee's request to reconsider the decision to cease assigning cases within thirty days of such request shall be deemed an exhaustion of all administrative remedies for the purposes of this subsection.

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(2) Notwithstanding any other provision of law, and pending the exhaustion of available administrative remedies or a judicial determination on the merits, the court may order injunctive relief in favor of the trustee.
The CLLA supports the change proposed by the Association of Bankruptcy Professionals.
C. Homestead Exemptions
Senate Bill 1559 from the 104th Congress contained provisions to provide for a $500,000 cap on homestead exemptions. This was primarily intended to address the so called bankruptcy havens of Texas and Florida that have significantly higher exemptions. The CLLA would support such a limitation for enactment in this Congress as well.
The Commercial Law League of America appreciates the opportunity to provide input to the Subcommittee and offers its assistance on an ongoing basis.

Mr. **GEKAS.** The Chair has no further questions for Mr. Luper and will yield back its time.

The gentleman from New York--oh, yes, Ms. Jackson Lee has first opportunity.

Ms. **JACKSON LEE.** Thank you very much.

I think I was on the question dealing with the $4 million; and I guess, Mr. Luper, I am going to raise it with you and Mr. Whelan, if you might comment briefly. And maybe it is Mr. Whelan, but I will ask Mr. Luper your position on the $4 million provision that is in the legislation. Will this help or hurt activities that our constituents engage in regarding real estate?

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Mr. **LUPER.** Well, you are dealing with a complex issue in any event.

Congressman Nadler brings up the proverbial Rockefeller Center bankruptcy. There are many provisions in the law to protect businesses which operate in one of these places, which protect the right to stay in the space, if you are a tenant; and those things can be sorted out, mostly outside the Bankruptcy Court and, to some extent, in a limited way, within the Bankruptcy Court. If, for example, the debtor wants to evict you, notwithstanding the fact you may have a lease, there are ways that the tenant can stay in possession.

So at the bottom of even a megacase, you are going to have the one secured creditor who has a security interest and most of the assets; and the debtor--and my experience and my view has been, they have to come to an agreement. The courts can't really assist them very much in an agreement because the secured lender is going to say, unless you do X, Y, Z, I am not signing on to this case; and there isn't really much the courts can do.

Ms. **JACKSON LEE.** Mr. Whelan.

Mr. **WHELAN.** I think, based on my prior testimony, Congresswoman, it is important to remove the $4 million cap, because it does not seem to have any real justification in the overall structure of the existing legislation. Congress has chosen to address what has been perceived and what is a very serious issue for many of the Nation's lenders; and I think that the more substantive issues which have been raised--of course, will more than likely be addressed by the National Bankruptcy Review Commission.

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But in connection with the $4 million cap, as they pointed out earlier, one of the problems has been that--how do you even apply or how do you interpret what is meant by the $4 million cap? Does that refer to $4 million of aggregate indebtedness or does it refer to the secured claim of the secured lender, which would mean a valuation hearing? Because you would have to, in turn, determine the value of the collateral.

Ms. **JACKSON LEE.** Thank you.

Let me ask my last question, and I thank the chairman for his graciousness and the ranking member as well.

I found an interesting provision, a protection on those who have filed bankruptcy and not denying them student loans. What is your view on that provision, in not denying potential student loan applicants the ability to apply and receive a government guaranteed loan if they have previously filed a bankruptcy?

Mr. **LUPER.** I don't think there should be any discrimination against someone who has filed a bankruptcy and received a discharge. I think the economics should work; and if there are policy considerations, such as there would be a in a student loan, the policy should work.

Ms. **JACKSON LEE.** So you would support that person not being discriminated against?

Mr. **LUPER.** Yes.

Ms. **JACKSON LEE.** Mr. Whelan.

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Mr. **WHELAN.** Likewise, I think it is important to understand that, in connection with the overall philosophy to compell students to honor their obligations once they have secured their education, they can still receive a discharge if there is an established cause for undue hardship.

In fact, I think one of the cases that I well remember involved a dentist who, having received his education and when I asked him from the bench what he considered to be his hardship, he said he was having trouble making payments on his Rolls Royce automobile. This was very difficult for me to understand since I was driving a 10-year-old Plymouth Duster at the time.

Ms. **JACKSON LEE.** He didn't live in Texas, I am sure.

But I thank you for that, and I certainly adhere to your responsibility to one's debts.

I yield back, Mr. Chairman.

Mr. **GEKAS.** We thank the lady; and now I transfer 5 minutes to the gentleman from New York, Mr. Nadler.

Mr. **NADLER.** Thank you, Mr. Chairman.

Mr. Luper, you oppose the elimination of residency requirements for appointment of trustees since you say three large companies would end up doing the bulk of the work and local people who now sign on as trustees nonasset cases in the expectations, eventually they will get an asset case, also make some money, wouldn't do so. So I assume you think it is unhelpful, generally, for three companies to do all the work in the country.

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But, No. 2, you are saying the system would suffer the loss of local trustees to do nonasset cases.

Mr. **LUPER.** In our region, there is a random draw for cases; and I think that is mandated in the Department of Justice rules. So any panel trustee has the same opportunity for an asset case as for a nonasset case. Ninety to ninety-five percent of the cases are no-asset cases anyway, in chapter 7. I am talking about chapter 7's now.

Mr. **NADLER.** What are the reasons for this recommendation? Do you know?

Mr. **LUPER.** To keep the bankruptcy panel trustee system strong. To prevent people who say I am waiting around here for a year to get the opportunity to get a case and, suddenly, the case comes out and, lo and behold, somebody from Chicago or someplace----

Mr. **NADLER.** That is why you might want to oppose this recommendation. I am asking what are the reasons for the recommendations in the first place.

Mr. **LUPER.** I can't answer that question. I don't know.

Mr. **NADLER.** Let me ask you one other question on this.

If this recommendation were to pass and if three large companies or four or whatever ended up doing the bulk of this work, do you think the quality of the work would in general go up, go down or remain the same?

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Mr. **LUPER.** These companies have lots of resources to work on the megacases. In the average-sized case or even the large case, they are very expensive; and my postulate is that it can be done as effectively with very few limitations by local trustees. These companies that are work-out companies and so forth can be employed as professional persons without being appointed the trustee, should the need arise.

Mr. **GEKAS.** Would the gentleman yield for a moment?

Mr. **NADLER.** Certainly.

Mr. **GEKAS.** It occurred to us--staff informed me--Mr. Conyers has that in his bill. We might want to ask him the rationale for his inclusion of that provision.

Mr. **NADLER.** I will certainly ask him in private on that.

Let me ask you one other question. Two others of your recommendations intrigued me.

One, you oppose an amendment in the bill that would allow the trustee to act as his own appraiser or other professional person, because the services provided by appraisers are used typically more as independent experts and presumably you should have an independent as an independent expert; and, second of all, you endorse provisions contained in the Senate bill from last year that would set a cap of $500,000 of State homestead exemptions. The reason for that last is obvious.

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My question is twofold. One, why shouldn't we let the States do this? Why should we preempt the States, even if we don't agree with what, say, Florida does?

And, two, in both of the cases, given the fact there are arguments--and there may be arguments we are not aware of right now--why should we enact this in a technical bill now and not wait for the overall rewrite after we have the benefit of the recommendations after we have the Bankruptcy Commissions?

Mr. **LUPER.** Is that to me?

Mr. **NADLER.** Yes.

Mr. **LUPER.** Going backwards, I believe and the Commercial Law League believes piecemeal fixes of substantive provisions should abide the support of the National Bankruptcy Review Commission, which is due out in mid-October.

Mr. **NADLER.** You are saying we should wait.

Mr. **LUPER.** You should wait. If Mr. Klee were still here, he could talk about why the 1978 act was needed. And the reason it was needed was because during the 20 years before that we did piecemeal fixes; and we got a Rube Goldberg kind of a thing, instead of something that has continuity and consistency. So I think those items which are clearly technical should be enacted, and those items which are substantive should wait.

Mr. **NADLER.** But that doesn't apply to the $4 million.

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Mr. **LUPER.** Well, I didn't say it should be enacted or not. I said that it should be repealed. Now maybe it should be repealed after the National Bankruptcy Review Commission's report comes out. This is my own crack at you people.

Mr. **NADLER.** Thank you, sir.

Mr. **GEKAS.** The Chair now recognizes the gentleman from Massachusetts for 5 minutes.

Mr. **MEEHAN.** Thank you, Mr. Chairman.

I have a brief question for both witnesses. H.R. 764 would make nondischargable any debts for death or personal injury caused by an individual debtor's operation of watercraft or aircraft while intoxicated. A similar exclusion from discharge already applies to debts for death of personal injury related to the drunken operation of a motor vehicle.

This addition to the list of nondischargable debts might reflect a trend towards making debt stemming from negligent conduct nondischargable. Do you think any such trend is a good one? I wonder if both of you could comment on that.

Mr. **WHELAN.** Let me address the fact that I think what Mr. Klee stated earlier makes a lot of sense. We have to concentrate on not expanding the list of nondischargable debts, because it seems to go on and on; and, in many cases, it seems to favor certain interest groups.

With respect to the proposal of dealing with watercraft and aviation and their application of nondischargability, I think it really is designed to overcome the results of the fifth circuit case which had to do with a death and serious injuries to individuals that resulted from an intoxicated driver of a motorboat.

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Of course, the question that might arise is, does the legislation apply to snowmobiles and to ATV's? Because there are already serious injuries resulting from intoxicated drivers. My view is I think the bankruptcy judges can deal with those and more than likely will state those come within the definition of motor vehicle.

But, clearly, there is a need--having addressed the issue initially as to intoxication and the responsibility that these individuals should bear for their actions, clearly, the bill introduced by Congressman Ehlers is sorely overdue.

Mr. **LUPER.** There is a trend nationally to harden penalties, both civil and criminal, for drunk drivers.

Ohio in January enacted a provision in their tort reform law which says the presence of alcohol and the required quantity in the blood of either party creates a presumption of negligence against that party.

When Congressman Knollenberg--appeared here earlier, he simply wanted to make sure that drunk driving would carry over into boating in his State of Michigan. I think the egregiousness of the conduct in not picking out little things is the thing that needs to be dealt with, and I think the courts are perfectly capable of dealing with--you know, there is a difference between running a stop sign and going 90 miles an hour through a school zone. They are both negligent, but there is a different outcome in a dischargeability case.

Mr. **MEEHAN.** So would you support this particular provision in this bill.

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Mr. **LUPER.** The league has taken no position on it. I see no reason we would oppose it.

Mr. **MEEHAN.** You are concerned about the trend because judges have the discretion to make those decisions.

Mr. **LUPER.** I think they do.

Mr. **MEEHAN.** Thank you, Mr. Chairman. I yield back the balance of my time.

Mr. **GEKAS.** We thank both of the witnesses, and we discharge them with the gratitude of the subcommittee.

We now invite and welcome the final panel. Testifying on the single will assets issue will be Albert Sullivan, Office of Asset Management and Discharge at the Department of Housing and Urban Development; and Donald Ennis, St. Paul Federal Bank for Savings, Chicago, IL. Mr. Ennis will be representing both the American Council of Life Insurance and the Mortgage Bankers Association.

Testifying on the *McConville* case, which involves exception to the automatic stay for any act to take an interest in property, is Joseph C. Bonita, senior vice president of Chicago Title Insurance Co. He represents the American Land Title Association and is chairman of the Title Insurance Forms Committee of that organization.

Mr. Richard Gerken, who is chairman of the Legal Committee of the Equipment Leasing Association, will testify on behalf of that organization with respect to the equipment leasing provision contained in both bills before us.

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And, finally, for the American Bankers Association is Jill M. Sturtevant, assistant general counsel to the Bank of America in Los Angeles, who will testify on student loans and several other bank-related issues.

At the outset, we will follow our custom in asking that each witness limit himself or herself to 5 minutes but with the understanding their written statements will be accepted for the record without objection. This time we will have each witness complete his or her testimony, at the conclusion of which the members will have 5 minutes to examine a witness of one's choice.

We will start now with Mr. Sullivan, the first one announced.

STATEMENT OF ALBERT B. SULLIVAN, DIRECTOR, OFFICE OF ASSET MANAGEMENT AND

DISPOSITION, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. **SULLIVAN.** Thank you, Mr. Chairman, for the opportunity to present the views of the Department of Housing and Urban Development on the proposal to amend the Bankruptcy Code to remove the monetary limitation for single asset debtors, which the subcommittee is considering today.

I have the responsibility for the operation of HUD's Multifamily Asset Management and Disposition Office. We have quite a number of multifamily loans we deal with in various degrees. In that capacity, I have gained considerable experience working with owners of HUD-insured and HUD-held multifamily projects.

I have experienced the negative impact upon the Department when owners seek delay of foreclosure on defaulted loans under the protection of the Bankruptcy Code. I have seen the impact that these delays cause upon not only the Federal taxpayers but on the families living in the properties.

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While HUD endorses the removing of the cap in the definition of single asset real estate, it is important to note that this is a small step in addressing the more fundamental problem. Most if not all bankruptcies involving HUD or FHA programs are filed when HUD attempts to assert its regulatory and contractual rights to foreclose or gain compliance with an owner's obligation to provide decent, safe and sanitary housing.

The bankruptcy petition is a harmful shield for owners hiding from their contractual obligations. Not only is HUD delayed in gaining control over the real estate that may offer unconscionable living conditions, but HUD is also compelled to continue to pay scarce rental subsidy assistance into a project which does not meet Congress' goal of meeting a decent and safe living environment.

The project continues to deteriorate while the owner enjoys the benefits of a lengthy delay, while having no intention to provide the financing necessary that will bring the project into repair. The owner is delaying to avoid the adverse consequences of foreclosure causing a taxable event.

An example is a property located in New Jersey, in Newark, that is a 420 unit multifamily property. Over the years, the Department has worked with two different sets of owners to address the severe physical deficiencies in the building. HUD approved the most recent owner in 1994, who proposed to restore this property. The owner intended to use low income housing tax credits to accomplish that.

HUD finally initiated foreclosure proceedings in 1996. We intended to deed the property to the local housing authority and provide a grant for demolition of the building so they could reconstruct other affordable housing on the site.

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On the eve of foreclosure, the owner sought a temporary restraining order against HUD's foreclosure sale, but the court ruled in our favor. The court found HUD negotiated long and hard, to no fruition, and HUD was entitled to foreclose.

One day before the foreclosure sale, the owner filed a chapter 11 petition. The owner refused to give HUD mortgagee-in-possession status, thus thwarting HUD's attempts to relieve the tenants from the deplorable living conditions. HUD was compelled to make section 8 rental assistance payments, despite the fact the project was by no means decent, safe and sanitary, as required by the statute and the contract.

When the management agent abandoned the property, the court did grant HUD's motion to become mortgagee-in-possession. On March 24, 1997, HUD filed a motion from relief for the automatic stay. The total outstanding debt is over $21 million. Now this includes a lot of money we have had to advance in order to maintain minimal living conditions there, on a property that is probably worth somewhere in the neighborhood of $4 million.

On the last day of the 120-day exclusivity period, the owner filed a reorganization plan as an attempt to further delay HUD's enforcement efforts. The plan proposed no additional financing to repair the property but was designed solely to retain the benefits of the low income housing tax credits which would require the building to remain standing. HUD's hands are needlessly tied in this hopeless bankruptcy delay.

Other owners perfected the use of the Bankruptcy Code to delay HUD's enforcement actions. In the mid-1990's, George Marshall filed seven bankruptcy petitions. Five were filed on the eve of the foreclosure sale. Two other bankruptcies were filed to shield the owner from his obligation to provide habitable housing, in exchange for receipt of the section 8 rental assistance payments.

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Such bankruptcy filings are harmful to the lives of the tenants. They delay either the removal of the owner in favor of one who has the ability in fuse new cash or to make repairs or the relocation of the tenants.

I see my time is expired, and I stand ready to answer any questions the committee may have.

Mr. **GEKAS.** We thank the witness.

[The prepared statement of Mr. Sullivan follows:]

PREPARED STATEMENT OF ALBERT B. SULLIVAN, DIRECTOR, OFFICE OF ASSET MANAGEMENT AND DISPOSITION, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Thank you, Mr. Chairman, for the opportunity to present the views of the Department of Housing and Urban Development on the proposals to amend the Bankruptcy Code that the Subcommittee is considering today.

I am Albert Sullivan; I have primary responsibility for the day-to-day operations of HUD's Multifamily Asset Management and Disposition Office. In that capacity I have gained considerable experience working with the owners of properties whose loans, for one reason or another, go into default and become candidates for foreclosure. There are approximately 16,000 properties in HUD's multifamily housing portfolio, including hospital and other health care facilities; nearly 1,200 represent HUD loans.

HUD is seeking certain substantive changes to the Bankruptcy Code, foremost among which are amendments that would exempt HUD's multifamily foreclosure actions from the stay provisions of the Code. We have submitted our proposals to the National Bankruptcy Review Commission and have attached them to our testimony today.

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In the interim--and by interim I mean the period that will end after Congress considers the Commission's recommendations and enacts amendments that will reform the Bankruptcy Code--we are pleased to be here today to support section 2 of H.R. 764, which would remove the $4 million cap from the definition of Single Asset Real Estate.

Frankly, removing the cap in the definition of Single Asset Real Estate is but a single step in addressing a more fundamental problem: delay in the foreclosure process. The current Code provisions usually will result in a debtor's making monthly payments as prescribed in 362(d)(3) to avoid stay relief, but the quid pro quo is inadequate. The debtor must pay only interest on the value of the property. For a lender whose collateral in bankruptcy is usually valued substantially below the amount of debt, the inequity is clear. In some cases debtors file Plans of Reorganization. Although filing those Plans will avoid stay relief, their feasibility is questionable. If they were subject to a mandated early evaluation, perhaps they would be meaningful. As it is, they create just another opportunity for case-prolonging arguments.

The best HUD, or any lender in a similar situation, may hope to achieve is reasonable assurance that a debtor will start paying something a bit earlier those otherwise would be the case. The incentive to file feasible Plans has not been realized in our cases. We have had better experiences with cash collateral orders than with the interest payments that 362(d)(3) allows as an exception to filing a Plan.

The real problem in a Single Asset case is not the amount of debt but that Single Asset cases are not truly suited to the bankruptcy process.

Single asset cases are essentially two-party disputes. This is particularly true of HUD projects, since HUD nearly always is a sole lender. Usually, the borrower has little or no equity in the property, trade debt is nil, and reorganization is not a realistic option. The only reason for filing a petition is to stall enforcement of the rights of the secured lender who holds the overwhelming bulk of all claims. Stalling enforcement, in turn, allows the debtor to defer the recognition of taxable income, which is a motivating factor in many of our cases.

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Although there may be situations in which there are more than one substantial lender, the circumstances of this type of case normally are the same: a borrower whose last gasp is a Chapter 11 petition and a single secured lender who, by virtue of being undersecured, holds the voting control of unsecured claims. Add to these factors the fact that the business has been struggling and is not truly a going concern, and the result is that a reorganization can be achieved only with the lender's consent, or in a rare case, through a cramdown. In other words, these two party disputes, regardless of the amount of the debt, can and should be resolved in a non-bankruptcy forum. No doubt you have heard this position expressed by others, but it bears repeating.

Perhaps what you have not heard from other sources is what distinguishes HUD from most other lenders. First, HUD multifamily loans are non-recourse. More importantly, HUD provides subsidies to many property owners on behalf of tenants with low incomes. Once the owner has filed a bankruptcy petition, HUD is obligated to continue making subsidy payments even though the owner may not be complying with the federal regulatory scheme that is a predicate for those payments. As a practical matter, HUD loses control over those funds because they are treated the same as any other estate income. Relief from the bankruptcy court is difficult to obtain. Thus, HUD is placed in the anomalous position of having to fund a debtor post petition without a concomitant enhancement of its position. As an ironic capstone, debtors--until stopped by HUD--often use project revenues, including subsidies, to pay legal fees. Payment of legal fees for the bankruptcy not only violates the loan documents, but also 330 of the Code because in most cases the benefits of the legal services flow to the principals, not to the debtor's estate.

We believe that HUD's unique role as a housing provider sets it apart from most creditors in other ways as well: not only are the financial resources at risk taxpayers' dollars, but HUD has a statutory obligation to preserve the property and protect the living conditions of the tenants. As the case profiles attached to this statement make clear, delays in foreclosure caused by bankruptcy filings often result in significant harm to the safety and security of the families who benefit from HUD's federal housing programs. In the end, the real losers in this scenario are the taxpayers and the low and moderate income tenants, many of whom are the elderly and persons with disabilities.

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In sum, Mr. Chairman and members of the subcommittee, HUD supports elimination of the dollar cap in the definition of Single Asset Real Estate as proposed in H. R. 764. In addition, we emphasize that substantial reform of the Code is needed and urge that the subcommittee continue to examine the issue of bankruptcy protection for Single Asset cases.

Thank you again for giving us the opportunity to present our views here today. I would be happy to answer any questions you might have.

U.S. Department of Housing
and Urban Development,
Washington, DC, March 21, 1997.
Mr. **BRADY C. WILLIAMSON,**
Chair, National Bankruptcy Review Commission,
Washington, DC.

DEAR MR. WILLIAMSON: Representatives from the Department's Office of General Counsel, Office of Legislation and Office of Multifamily Housing Programs participated in the discussions of the Small Business Working Group during the Commission's January meeting here in Washington. During the course of the discussion, the Department expressed its concerns about the effect of the bankruptcy code on HUD's ability to preserve and manage its multifamily housing portfolio.

At that time, the Department was invited to submit a formal statement to the Commission describing our recommendations for changes in the bankruptcy code. That statement is enclosed. We believe these changes will better enable the Department to fulfill its mission and protect the public fisc. We are seeking the Commission's support for these changes and hope they will be among the recommendations in your final report to Congress.

On behalf of the Department, I want to thank the Commission for inviting us to present our views and for the opportunity to meet with the members of the Small Business Working Group and the Commission's staff. If you have any questions, please do not hesitate to call on me.

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Sincerely,
CHRIS GREER,
Deputy Assistant Secretary,
Office of Multifamily Housing Programs.

Enclosure (1).
cc: John A. Gose.
Susan Jensen-Conklin.
Jennifer Frasier.

STATEMENT OF CHRIS GREER, DEPUTY ASSISTANT SECRETARY FOR MULTIFAMILY HOUSING, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, MARCH 21, 1997

I am Chris Greer, Deputy Assistant Secretary for Multifamily Housing of the Department of Housing and Urban Development (HUD) Thank you for giving us the opportunity to present our views to the Commission and for the opportunity to meet with Commission members and staff.

Beginning with the enactment of the National Housing Act in 1934, HUD and its predecessor agencies have had a congressionally mandated responsibility to provide and encourage the development of affordable and decent housing for low and moderate income Americans. HUD accomplishes this mission, in part, both as a direct lender and, through the FHA, as a major insurer of residential real estate loans.

The HUD multifamily housing portfolio consists of approximately 16,000 projects for which HUD has insured the mortgages (including 1,000 loans for hospitals and other health care facilities) and 1200 direct loans. Of these projects, 55% receive additional subsidies. As with any large portfolio, at any time there are a significant number of nonperforming assets. I have the overall responsibility for these properties from the development phase through foreclosure and disposition.

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HUD seeks the Commission's support for changes in the bankruptcy code that will better enable the Department to fulfill its housing mission and to protect the public fisc. We believe the Department's unique role as a housing provider sets it apart from most creditors: not only are the financial resources at risk taxpayers dollars, but HUD has a direct statutory obligation to preserve the property and protect the living conditions of the tenants. Accordingly, HUD urges the Commission to recommend changes in the bankruptcy code to exempt HUD from stays against foreclosure on both FHA insured loans and direct loans for multifamily housing and health care facilities so that the Department can better fulfill its mission.

Unfortunately, the bankruptcy code is often used by defaulting owners of multi-family properties, not to afford the debtor a fresh start, but to defer the recognition of taxable income, thus interfering with HUD's efforts to effectively support affordable housing for low and moderate income tenants. In the case of insured loans, FHA insures mortgages made by private lending institutions to finance the construction of multifamily housing by private developers. Nearly all of the multifamily properties are held by single asset partnerships. Most were organized as tax shelters which by now have tax bases near or at zero. If the owner defaults, FHA pays the private lender for its claim and takes over the mortgage.(see footnote 6) In order to protect the property, the residents, and the governments financial interest, HUD often must act quickly to foreclose. In response, however, owners often file for bankruptcy, automatically staying the foreclosure. A similar scenario often unfolds where HUD as the direct lender acts to foreclose on properties in default.(see footnote 7) While the bankruptcy code currently permits HUD to at least commence foreclosure, it does not permit HUD to complete the process during the stay.

Adding to the complexity of the relationship with the mortgagor, several HUD multifamily programs provide subsidies to project owners on behalf of tenants with low incomes. Most prominent are section 8 rent subsidies. These subsidies make up the difference between 30% of a qualifying tenant's income and the contract rent. They are either tenant based--the subsidy is for the individual and paid to the owner of the property where the tenant chooses to live, or project based--the subsidies are paid directly to the owner for a particular apartment unit where qualifying tenants live. If the owner of a subsidized property has filed a bankruptcy petition before HUD acts to suspend subsidies, HUD is obligated to continue making subsidy payments even if the owner is not complying with other federal regulatory requirements that are a predicate for those payments. As a practical matter, HUD loses control over those funds because they are treated the same as any other estate income.(see footnote 8)

Typically, HUD mortgaged properties are held by investment limited partnerships that have a single real estate asset. There is a general partner who often provides the management services, but who may have little investment in the property. Nearly all of the loans are non-recourse. Most of these properties have little or no depreciable tax basis remaining. Generally there is little or no equity in the property because the outstanding debt exceeds any market value the property might have. Should there be a change of ownership or foreclosure, there will be considerable taxable recognition of depreciation recapture, but very little or no cash in the transaction to pay the taxes. Thus, it is very clear that the mortgagors in nearly all cases are affording themselves of the protection of the bankruptcy code not to reorganize and move forward, but to delay recognition of the tax liability for the recapture of depreciation resulting from foreclosure.

When foreclosure is sought, it is usually because the principals will not support the property and will not invest additional capital where necessary. The project can no longer succeed. HUD's only recourse is to move to foreclose on the defaulted mortgage. Foreclosure is necessary to recover the government's investment, to preserve the property, and to protect the living conditions of the tenants.

Unfortunately, in many cases where bankruptcy has stayed foreclosure, owners have bled their properties and deprived their tenants of decent and safe housing. If an owner knows that the property will ultimately be lost to foreclosure, what incentive is there to maintain the property? Besides the FHA and the taxpayers, the losers here are the low and moderate income tenants, many of whom are the elderly and persons with disabilities.

It is well recognized that single asset real estate bankruptcy cases are essentially two-party disputes. This is particularly true of HUD projects, since HUD nearly always is the sole lender. Usually, the borrower has little or no equity in the property, trade debt is nil, and reorganization is not a realistic option. The only reason for filing a petition is to defer the recognition of taxable income by stalling enforcement of the rights of the secured lender who holds the overwhelming bulk of all claims. The bankruptcy process was not designed for disputes of this nature; they can and should be resolved in a non-bankruptcy forum.

Substantial governmental assets from both HUD and the Department of Justice must be expended on these cases, often when there is no legitimate expectation by the debtors that a successful reorganization plan can be developed. In an era of smaller government, reforming bankruptcy protection for single asset real estate owners could enable HUD to operate more efficiently with fewer employees and free up Justice Department resources for other law enforcement purposes.

HUD urges that the Commission recommend amending sections 105 and 362 of the Bankruptcy Code (title 11 of the United States Code, as recodified by the Bankruptcy Reform Act of 1978 (Pub. L. 95—598; 92 Stat. 2549)). The changes to section 362 would exempt from the automatic stay provisions of the Bankruptcy Code those acts taken by the Secretary of HUD toward foreclosure (including acts to obtain possession or for the appointment of a receiver) on multifamily projects with liens that are insured or held by the Secretary of HUD pursuant to title V of the Housing Act of 1949. Other acts to protect the financial position or interest of the Secretary in bankruptcy situations relating to these projects would also be excluded from the automatic stay where a right (for example, to offset funding otherwise due to a debtor) is provided for under contract, regulatory agreement, regulation, or statute. The amendments to section 105 would make clear that the acts covered by these changes to section 362 are not subject to a bankruptcy court's discretion to issue stay orders.

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The proposal would expand the existing exception to the automatic stay provisions in two respects. First, since the existing exception applies only to the *commencement* of a foreclosure action, the automatic stay still applies to any other step in the prosecution of a foreclosure, once commenced, and owners and their investors continue to enjoy the tax advantages until the automatic stay is lifted and the government's foreclosure action is completed. Therefore, the proposal would permit prosecution of further steps, through the completion of foreclosure.

Second, because only the commencement of *foreclosure* actions is now exempt from the automatic stay provisions, actions to obtain possession as a mortgagee in possession or for the appointment of a receiver, or otherwise to protect the Federal financial interest, cannot usually be obtained on a timely basis. Pending a determination of whether foreclosure is necessary, it is highly desirable for the HUD Secretary to have these options, both for the protection of the FHA insurance funds and to protect tenants by assuring continued, satisfactory management and operation of multifamily housing projects in default. In this regard, *the longer a property is tied up in bankruptcy the more physical deterioration is likely and the greater is the need for intermediate remedies*, such as receivership. Moreover, the longer the bankruptcy proceedings last, the more sharply reduced the proceeds of sale are likely to be, when finally permitted after foreclosure.

In addition, the proposal would amend section 105 of the Bankruptcy Code, to prevent a bankruptcy court from invoking its other *discretionary* powers in a way that would frustrate the purposes of expanding the exemption from the automatic stay in section 362. The central concern is that unless section 105 is amended, section 362(b)(8) (even as amended under the proposal) would not necessarily protect HUD, since a bankruptcy court could make injunctive or other equitable relief available to mortgagors in the exercise of its discretion under section 105. The benefits of the proposed exception to the automatic stay in section 362(b)(8) could thus be negated, if the bankruptcy court is free to exercise its power under section 105. Accordingly, the amendment to section 105 would prevent imposition of a *discretionary* stay on HUD in situations where, under the amendments proposed to section 362(b)(8), an automatic stay may not be imposed.

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If the Commission should conclude that single asset real estate owners should remain eligible for bankruptcy protection, and a complete exemption from the stay is not appropriate, HUD offers the following suggestions.

One alternative to a complete exemption from the stay would be to authorize exemption for HUD only from the automatic stay. Such an amendment would place HUD in the position it was in prior to enactment of the Bankruptcy Reform Act in 1978. Under the earlier Bankruptcy Act provisions, HUD-insured mortgagees were not subject to an automatic stay and by judicial opinion that status was extended to HUD as a mortgagee.

Another alternative could be to expand the grounds for automatic stay relief. HUD should be entitled to relief from a stay if the debtor has no equity in the property and any of the following conditions are present: 1) the debtor has been in default for more than 180 days prior to entry of the Order for Relief; 2) there is rental assistance for more than a specified percentage of the units in the property; or, 3) the property has not been substantially in compliance with applicable health and safety standards, including compliance with HUD's section 8 housing assistance payments contract for more than 30 days prior to entry of the Order for Relief.

HUD supports shifting the burden to remain in Chapter 11 to the debtor and expanding the bases for conversion or dismissal. Additional oversight by the Trustee, including the use of analysts, would be most welcome, especially where in a busy judicial district analysts often have a better grasp of a debtor's day-today operations than the Trustee's attorney.

HUD strongly favors retention of the absolute priority rule and endorses statutory abolition of the new value exception as to Single Asset cases. The quantum of value proffered in HUD related cases tends to be inadequate, particularly because it is proposed by the persons who were responsible for the debtor's need for bankruptcy protection.

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The $4 million cap should be repealed. There is no rational basis for it. The size of the debt is not the determining factor as to whether foreclosure will unfairly prevent the debtor from continuing an enterprise. Other, more important factors include the presence of an associated ongoing business, such as a hotel. Moreover, if expedited proceedings are the objective, the cap has not achieved its goal. The threat of stay relief within 90 days rings hollow since debtors do make monthly payments, usually after HUD, undersecured in most cases, seeks a cash collateral order.

Section 365 should include a definition of "executory contract" and should recite certain categories of contracts that are excluded from 365. For HUD purposes, these include contracts to which the government is a party and the objective of the contract is for defined public purposes as part of the federal housing regulatory scheme.

Although the appointment of a Trustee should not be automatic in Single Asset cases, the burden of showing the need for one should be eased. For example, a prima facie showing of the debtor's illegal conduct, such as breach of the federal regulatory scheme, should justify the appointment or at least shift the burden to the debtor to show why a Trustee should not be appointed.

In conclusion, I cannot emphasize too strongly that the Department believes that the overwhelming majority of the bankruptcies of single asset partnerships with HUD insured or HUD held mortgages are to defer recognition of taxable income and not to provide for a fresh start. An owner of a property covered by a mortgage insured or held by HUD has ample opportunity to challenge regulatory enforcement actions in a U.S. District Court. An owner should not then be permitted to use the Bankruptcy Code which, in too many cases, has provided an unnecessary shield of delays and has resulted in significant harm to the quality of life for families who benefit from HUD's Federal housing programs. HUD urges the Commission to recommend that the Bankruptcy Code be amended to allow HUD to prosecute foreclosures even in the face of bankruptcy filings by single asset real estate partnerships holding properties whose mortgages have been insured or held by HUD.

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I have attached some case profiles from HUD's portfolio which illustrate the problems I have described in my statement. Again, thank you for giving the Department the opportunity to present its views on this important matter.

Case profiles where HUD's ability to protect patients, and the taxpayers have been significantly creditors filing for bankruptcy protection.

1) The owner and management agent of three projects in Tennessee diverted millions of dollars of project income. Within a week of HUD's filing a complaint for double damages in District Court in 1991, the owner filed Chapter 11 petitions. No reorganization plans were ever filed. After four years in Bankruptcy Court, District Court and U.S. Court of Appeals for the 6th Circuit, HUD was granted summary judgment.

2) In 1995, HUD filed a complaint in the U.S. District Court in Connecticut against the owner and management agent for diversion of over $300,000. The owner immediately filed a Chapter 11 petition, which stayed the District Court action on grounds that the general partner of the owner and the management agent were integral parties to any potential reorganization plan. No reorganization plan was filed. The owner's diversion of project income has limited the ability of the debtor to maintain the property. The debtor has admitted that the sole reason for having filed the petition was to stop HUD's enforcement action filed in the District Court for recovery of the misused project income. The court has invited HUD to file a motion to dismiss the bankruptcy.

3) In 1995, HUD declared the owner of a project in Washington, DC to be in default for failing to provide decent, safe, and sanitary housing as required by Deed of Trust, Regulatory Agreement, and Section 8 Housing Assistance Payments Contract. Before HUD could enforce its regulatory remedies, the owner filed a Chapter 11 petition, and HUD's efforts to pursue contract remedies and foreclosure were stayed pending the expiration of the owner's exclusivity period. The owner filed a futile plan of reorganization. During this time, the residents were forced to continue to live under substandard conditions.

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4) In 1969, HUD insured a mortgage of $9 million for a project in New Jersey. In 1981, HUD restructured the loan and took a second mortgage of $1.6 million and provided Section 8 payments. In 1994, HUD insured an additional loan of $4 million secured by a third mortgage. HUD and the owner had negotiated for several years to restructure the first mortgage on project. The owner failed to find an equity partner and the project continued to deteriorate. Rehabilitation costs are estimated to be $14 million. In 1996, HUD began foreclosure proceedings, but the owner filed a Chapter 11 one day before the sale. No reorganization plan has been filed. The owner states that it will "walk away" from the project if HUD gives it $3 million.
5) The owner had a dispute with the general contractor and filed a Chapter 11 petition in Oklahoma. During the litigation, the project was not repaired or winterized. The project suffered serious structural deterioration, and the tenants health and safety were compromised. HUD had to file a motion with the court to obtain management rights and a super priority lien for advances to run the project. No reorganization plan was filed by the debtor. There is no likelihood that HUD will recover $535,000 in advances.
6) In January 1994, the owner filed a Chapter 11 petition and sought to enjoin the assignment of the mortgage to HUD. This Louisiana project was uninhabitable and was condemned by the municipality. The Bankruptcy Court granted HUD's motion for possession, and HUD advanced $3.5 million to stabilize the project during the bankruptcy proceeding. No reorganization plan was filed by debtor.
7) The owner of a project in Massachusetts filed a Chapter 11 petition in the summer of 1986, and HUD filed a motion seeking possession because of the project's deplorable condition and inadequate income to meet the costs of emergency repairs. The court rejected HUD's motion and appointed an inexperienced trustee, who tried to sell part of the project for middle income rental or convert it to condominiums, notwithstanding that the project was built for families with low and moderate incomes. When cold weather approached, the trustee realized that he lacked sufficient income to repair the heating system, and he entered into a settlement whereby HUD was granted possession to protect the health and safety of the tenants.

Mr. **GEKAS.** We will turn to Mr. Ennis.

STATEMENT OF DONALD R. ENNIS, ON BEHALF OF THE MORTGAGE BANKERS ASSOCIATION OF AMERICA AND THE AMERICAN COUNCIL OF LIFE INSURANCE

Mr. **ENNIS.** Thank you, Mr. Chairman.

Mr. Chairman and members of the subcommittee, I appreciate the opportunity to appear here today for this subcommittee; and I appear on behalf of the Mortgage Bankers Association, the MBA, and the American Council of Life Insurance, ACLI.

MBA and ACLI appreciate the opportunity to appear on the bankruptcy technical correction bill, H.R. 764, the Bankruptcy Amendments of 1997. The purpose of my being here today is to address one specific issue that is contained in H.R. 764, the bill introduced by Chairman Hyde. The bill would delete the $4 million cap from the definition of single asset real estate. This $4 million cap was inserted into the definition of single asset real estate in the House during the final hours leading to passage of the Bankruptcy Amendments of 1994. Its appearance was unexplained and is inconsistent with the treatment of single asset real estate intended by the amendments. The $4 million cap should be deleted to permit the efficient operation of the single asset provisions and the fulfillment of their purpose.

The concept of single asset real estate is simple. Over the years, commercial real estate lenders and borrowers have developed a financing and ownership arrangement in which the owner of commercial real property can borrow funds using the real property as collateral. Normally, the owner of the property is not a real person but, rather, a legal entity such as a corporation or a limited partnership. Key to the arrangement is that the legal entity, which is the borrower, has a single purpose and that is to own the property, rather than to conduct other business on the property.

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There is nothing in this description of single asset real estate which changes with the dollar amount of the loan secured by the mortgage. There is no threshold which is reached at $4 million or any other dollar figure. And therefore, no dollar cap makes any sense in the definition. The cap should be deleted.

It could have been inserted in the legislation in the belief that, while $4 million is not a threshold, it is sufficiently large to encompass the universe of mortgage loans on commercial real estate. That is, the $4 million may have no theoretical purpose or basis for being in the definition, but it does no harm because commercial mortgages do not exceed $4 million.

Such is not the case. The $4 million cap does indeed derive a substantial portion of the commercial mortgage market universe from the efficient and appropriate single asset treatment in bankruptcy.

Each year, the American Council of Life Insurance surveys life insurance companies for data about their commitments for loans secured by commercial real estate, almost all of which is done in the single asset structure. The average loan amount has consistently been around $10 million since as far back as 1993.

As this illustrates, the commercial real estate market does not stop at $4 million. It averages over $10 million, and that is the average, not the upper limit.

For these reasons, we strongly support H.R. 764 and, specifically, the provision in the bill that would delete the $4 million cap from the definition of single asset real estate.

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I want to thank you, Mr. Chairman, on behalf of the MBA and the ACLI, and I would be happy to answer questions.

Mr. **GEKAS.** We thank the gentleman.

[The prepared statement of Mr. Ennis follows:]

PREPARED STATEMENT OF DONALD R. ENNIS, ON BEHALF OF THE MORTGAGE BANKERS ASSOCIATION OF AMERICA AND THE AMERICAN COUNCIL OF LIFE INSURANCE

Mr. Chairman and Members of the Subcommittee, I am Donald R. Ennis, First Vice President of St. Paul Federal Bank for Savings, headquartered in Chicago, Illinois. I appear today on behalf of the Mortgage Bankers Association of America (MBA) and the American Council of Life Insurance (ACLI). I am a member of the Bankruptcy Working Group of the Mortgage Bankers Association. With me, today, are Michael J. Ferrell, Senior Staff Vice President and Legislative Counsel, William E. Cumberland, Senior Staff Vice President and General Counsel, James T. Freeman, Associate Director, Legislation, MBA and Margaret Durbin, Director of Federal Relations, ACLI.

MBA and ACLI appreciate the opportunity to appear before the Subcommittee today on the bankruptcy technical correction bill, H.R. 764, the "Bankruptcy Amendments of 1997." We commend you, Mr. Chairman, for holding this hearing and for your continued leadership in bankruptcy reform. We are committed to continuing to work with you and the Subcommittee to address needed and comprehensive reform of the Bankruptcy Code.

The American Council of Life Insurance is the principal trade association for life insurance companies. Its 557 members account for approximately 90% of the life insurance and pension business in force in the United States.

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MBA is the national association representing exclusively the real estate finance industry. Headquartered in Washington, D.C., the association works to ensure the continued strength of the Nation's residential and commercial real estate markets; to expand homeownership prospects through increased affordability; and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate finance professionals through a wide range of educational programs and technical publications. Its membership of over 2,700 companies includes all elements of real estate finance: mortgage companies; life insurance companies; savings and loan associations; commercial banks; savings banks; state housing finance agencies; and others in the mortgage lending field.

Included in MBA's membership are 467 commercial mortgage banking companies. A commercial mortgage banker serves as a financial intermediary between the owners of commercial real estate and institutions that lend on mortgages on commercial real estate. In 1996, commercial mortgage bankers generated in excess of $30.1 billion in mortgage loans on commercial real estate within the United States.

The purpose of my being here today is to address one specific point that is contained in H.R. 764, the technical corrections bill introduced by Chairman Hyde. The bill would delete the $4 million cap from the definition of single asset real estate. This $4 million cap was inserted into the definition of single asset real estate in the House during the final hours leading to passage of the Bankruptcy Amendments of 1994 (P.L. 103—394). Its appearance was unexplained and is inconsistent with the treatment of single asset real estate intended by the Amendments. The $4 million cap should be deleted to permit the efficient operation of the single asset provisions and the fulfillment of their purpose.

The concept of single asset real estate is simple. Over the years commercial real estate lenders and borrowers have developed a financing and ownership arrangement in which the owner of commercial real property can borrow funds using the real property as collateral. Normally, the owner of the property is not a real person; but rather a legal entity, such as a corporation or a limited partnership. Key to the arrangement is that the legal entity which is the borrower, the mortgagor, has a single purpose. that is, to own the property, rather than to conduct other business on the property. The significance of this with regard to bankruptcy reorganization is that they do not provide, as they do for more complex businesses, new or different opportunities for a single asset real estate debtor to resolve its financial problems. Such financial problems for a single asset real estate debtor exits only with its secured lender, and thus there are no new opportunities for resolutions which were not explored with the lender prior to the bankruptcy proceedings. The single asset provisions in the Bankruptcy Code operate to require a debtor to provide timely justification for reorganization.

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There is nothing is this description of single asset real estate which changes with the dollar amount of the loan secured by the mortgage. There is no threshold which is reached at $4 million or any other dollar figure. And therefore, no dollar cap makes any sense in the definition. The cap should be deleted.

It could have been inserted in the legislation in the belief that, while $4 million is not a threshold, it is sufficiently large to encompass the universe of mortgage loans on commercial real estate. That is, the $4 million may have no theoretical basis for being in the definition, but it does no harm because no commercial loans exceed the $4 million figure.

Such is not the case. The $4 million cap does indeed deprive a substantial portion of the commercial mortgage market universe from the efficient and appropriate single asset treatment in bankruptcy.

Each year, the American Council of Life Insurance surveys life insurance companies for data about their commitments for loans secured by commercial real estate, almost all of which is done in the single asset structure. The AVERAGE loan amount has consistently been around $10 million since at least as far back as 1993. The two most recent years show as follows:

1996 Commitments. Commercial Real Estate Mortgages: Number of loans 1,864; amount committed $19,032,760,000; average $10,211,000.

1995 Commitments. Commercial Real Estate Mortgages: Number of loans 1,974; amount committed $21,399,555,000; average $10,841,000.

As this data demonstrates, the commercial real estate market does not stop at $4 million. It averages over $10 million, and that is the average, not the upper limit.

For these reasons, we strongly support H.R. 764, and specifically, the provision in the bill that would delete the $4 million cap from the definition of single asset real estate.

Mr. Chairman, on behalf of the MBA and ACLI, I want to thank you for the opportunity to appear here today and to offer our perspective on this important issue. We are committed to working with you and the Members of the Subcommittee. We would be pleased to answer any questions you may have to provide further information, as necessary, for the record.

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Thank you for allowing us to appear today.

Mr. **GEKAS.** We will turn to Mr. Bonita.

STATEMENT OF JOSEPH C. BONITA, CHAIR, TITLE INSURANCE FORMS COMMITTEE, AMERICAN LAND TITLE ASSOCIATION

Mr. **BONITA.** Thank you, Mr. Chairman. Members of the subcommittee, I thank you.

I appreciate the chance to present this testimony. My name is Joseph Bonita. I am senior vice president of Chicago Title Insurance Co. and chair of the American Land Title Association's Title Insurance Forms Committee. I am presenting the ALTA members' concern regarding necessary legislative clarifications to the Bankruptcy Code with relation to *McConville.*

Our membership, by the way, is composed of about 2,000 title insurance companies, their agents and attorneys who search, examine and insure land titles to protect owners and mortgage lenders against losses from defects in title. You may be familiar with the names of some of our other large underwriter members, such as Commonwealth Land Title Insurance Co. based in Pennsylvania and First American Title Insurance Co. based in California.

We thank the chairman and the ranking member of the full committee for including provisions to address the ninth circuit *McConville* decision in their bills. We hope the committee will include changes our industry believes are warranted within the reported bill.

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ALTA recommends amendments to clarify the law as it was enacted in 1978. Our industry believes these changes are not changes from what was intended either under the existing Bankruptcy Code or under the former Bankruptcy Act. Clarification, however, is necessary because of the issues raised by *McConville.*

In that case, the ninth circuit's narrow reading of the code in *McConville,* in three successive, controversial opinions, potentially puts at risk real property transactions other than mortgages.

McConville raises questions of what will happen where the debtor has filed an undisclosed bankruptcy case, potentially in remote jurisdictions. It is impractical for the title insurance industry, or anyone else, to search bankruptcy filings in every bankruptcy court in all 50 States at the time of a real estate closing. Now each individual title insurance underwriter makes its own underwriting decision, but if the decision in *McConville* is allowed to stand, each of the members is probably going to have to consider whether or not to exclude insurance from its title insurance coverage for the existence of these undisclosed--potentially undisclosed bankruptcies.

We disagree with the notion the latest *McConville* opinion solves the problem. However, we also note that the CLL's written statement favors some kind of a fix to this problem; and we agree.

The risk of loss in these cases will be placed on the lending, leasing and development industries and potentially chill the availability of credit. This would be similar to the developments which occurred in response to the decision in *Durrette* v. *Washington National Insurance Company* which, I might add, has been subsequently overruled.

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In contrast, we believe that, from its inception, Bankruptcy Code section 549(c), dealing with postpetition transactions, was specifically intended to protect bona fide purchasers and bona fide encumbrances from undisclosed bankruptcy filings.

ALTA proposes that the clarifying amendments be structured as follows:

First, a statement is needed, we believe, that section 549(c) protects security interests as well as cash purchases.

Second, it should be clear that the automatic stay of section 362 does not prevent security interests from being protected by the proposed clarification of 549(c).

Third, for consistency, it should be clear that the term "purchaser" includes the transferee of a security interest.

We note that support for clarification is widespread throughout the real estate and bankruptcy bar. A legislative solution addressing *McConville* is supported by the National Bankruptcy Conference, the National Bankruptcy Review Commission and the Subcommittee on Use and Disposition of Property of the American Bar Association's Committee on Business Bankruptcy.

We thank the committee for its consideration, and we will be happy to answer questions. Thank you.

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Mr. **GEKAS.** We thank you, Mr. Bonita.

[The prepared statement of Mr. Bonita follows:]

PREPARED STATEMENT OF JOSEPH C. BONITA, CHAIR, TITLE INSURANCE FORMS COMMITTEE, AMERICAN LAND TITLE ASSOCIATION

Mr. Chairman, Members of the Committee, I appreciate the opportunity to present this testimony before this distinguished Committee. My name is Joseph Bonita. I am Senior Vice President of Chicago Title Insurance Company and Chair of the Title Insurance Forms Committee of the American Land Title Association.(see footnote 9) I am accompanied by Ann vom Eigen, Legislative Counsel of ALTA. I am presenting our ALTA members' concern regarding necessary legislative changes to the bankruptcy code.

Our membership is composed of 2,000 title insurance companies, their agents, independent abstracters, and attorneys who search, examine, and insure land titles to protect owners and mortgage lenders against losses from defects in titles. You may be familiar with the names of some of our other large underwriter members such as Commonwealth Land Title Insurance Company based in Philadelphia, Pennsylvania and First American Title Insurance Company based in Santa Ana, California.

We appreciate the efforts made to date by the Chairman and the Ranking Member to address the serious issues raised by the Ninth Circuit Decision in *McConville* by including provisions in H.R. 764 and H.R. 120 to address this case. We hope that the Committee will include the changes the industry believes are warranted within the reported bill.

ALTA recommends amendments to clarify the law as it was enacted in 1978. Our industry believes that these changes do not represent a change in the law either under the Bankruptcy Code or under the former Bankruptcy Act. This clarification is necessary, however, to address the issues raised by the United States Court of Appeals for the Ninth Circuit in *Thompson* v. *David Margen and Lawton associates (In Re McConville)* (Attached).

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The Ninth Circuit's decision in *In re McConville*, 1997 W.L. 136529 (9th Cir. 1997) (decided March 26,1997 and withdrawing its prior decisions reported at 84 F.3d 340 (9th Cir. 1996) and at 97 F.3d 316 (9th Cir. 1996)) puts at risk every real property lessee, easement grantee and lender who provides consideration or extends credit in reliance upon the state real property recording acts under circumstances where the debtor has filed an undisclosed bankruptcy case, potentially in a remote jurisdiction. It is a practicable impossibility for the title insurance industry to search contemporaneously bankruptcy filings in every bankruptcy court in all 50 states at the time of closing. Consequently, were the decision in *McConville* allowed to stand, while each individual title insurance underwriter makes its own underwriting decision, the title industry would necessarily be required to consider exceptions from its title coverage for the existence of an undisclosed bankruptcy case. This would place the risk of loss on the lending, leasing and development industries, and potentially chill the availability of credit. This would be similar to the developments which occurred in response the decision in *Durrett* v. *Washington Nat'l Ins. Co.*, 621 F.2d 201 (5th Cir. 1980), where a properly conducted foreclosure sale was subject to attack as fraudulent conveyance.

In contrast, we believe that from its inception, Bankruptcy Code section 549(c), dealing with postpetition transactions was specifically intended to protect bona fide purchasers and bona fide encumbrancers from undisclosed bankruptcy filings. It thereby preserves the integrity of the state real property recording acts and protecting lenders, lessees and other parties who advance new funds in good faith without knowledge of a bankruptcy filing, but in reliance upon the state of title of real property as described in the local real property recordings.

The local real property recording acts provide all parties with a single, comprehensive method to ascertain the existence of interests in real property. Prior to 1984, section 549(c) of the Bankruptcy Code slightly disrupted this "single source" system for ascertaining interests in real property. There was a general duty of the representative of the bankruptcy estate to record a copy of the bankruptcy petition in the real property records of each county where the bankruptcy estate owned real property. However, Section 549(c) provided an exemption from recording in the county where the bankruptcy case was pending. This exception thus required parties to search both the local real property records and the bankruptcy court filings in the county where the bankruptcy was pending to ascertain the current state of title. By amendments to the Code enacted in 1984, the recording exception for counties in which the bankruptcy was pending in section 549(c) was eliminated, evidencing Congressional intent to protect the integrity of the state real property recording system. It thereby established the state real property recording acts as the single source for information as to the status of title to real property.

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Bankruptcy Code section 549(c) establishes a "race/notice" test with respect to the enforceability of a post-petition transfer as against the bankruptcy estate. Under section 549(c), the transferee who seeks to validate a debtor's postpetition transfer which was not approved by the Bankruptcy Court must establish that it has provided present fair equivalent value and must both (a) be "without knowledge of the commencement of the case" and (b) perfect its interest prior to the recordation of the bankruptcy petition, such that "a bona fide purchaser of such property, could not acquire an interest that is superior to the interest of such good faith purchaser."

ALTA believes section 549(c) is intended to protect not only buyers of real property, but all parties acquiring interests in real property, including purchasers, lenders, lessees and grantees of easements, who provide present fair equivalent value to the debtor without knowledge of the commencement of the bankruptcy case and perfect their interests prior to the recordation of the petition. Thus, when section 549(c) describes a "transfer of real property," the definition of "transfer" under Bankruptcy Code section 101(54) includes "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property." Accordingly, the term a "transfer of real property" in section 549(c) clearly was intended to include a transfer of an interest in real property. Such an interest includes a lien arising under a mortgage or deed of trust because the term "lien" is defined in Bankruptcy Code section 101(37) to mean a "charge against or interest in property to secure payment of a debt or performance of an obligation." Accordingly, the clear intent of the Bankruptcy Code is that the creation of a "lien" against the debtor's property is a "transfer of real property," for it is the conveyance of "an interest in property" for a particular purpose; i.e., "to secure payment of a debt or performance of an obligation." Finally, when such a lien is voluntarily granted by the debtor, the secured creditor is accorded the status of a "purchaser," which Bankruptcy Code section 101(43) defines as the "transferee of a voluntary transfer." Thus the term "purchaser" encompasses all voluntary transfers by the debtor, in contrast to involuntary transfers of interests in real property such as judgment liens or foreclosure sales.

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Unfortunately, the recent *McConville* decision by the Ninth Circuit threatens to interfere with the statutory scheme we believe was intended by Congress and will create significant insecurity in the real property leasing, development and lending industries. In *McConville*, a purchase-money lender, without knowledge that the debtor had recently filed an undisclosed chapter 11 case, funded the debtor's acquisition of an apartment complex, and simultaneously recorded its purchase-money deed of trust. Under the definitions set forth in Bankruptcy Code section 101 and, we believe, the intended scheme of section 549(c), the voluntary transfer of the purchase-money deed of trust by the debtor to the lender in return for the purchase-money loan proceeds was clearly a "transfer of real property," and because the lien was voluntary, the lender should have been accorded the status of a "purchaser." As a result, the transfer of the purchase money deed of trust should have been protected under section 549(c).

However, in addressing these facts, the Ninth Circuit in *McConville* failed to properly interpret section 549(c). Based upon its prior decisions in *In re Shamblin,* 890 F.2d 123 (9th Cir. 1989) and *In re Schwartz,* 954 F.2d 569 (9th Cir. 1992), the Ninth Circuit held that the granting of a lien, such as a mortgage or deed of trust, was not a "transfer of real property" under section 549(c), thereby limiting the applicability of section 549(c) to transfers of fee interests only. In addition, in the previous *McConville* opinion appearing at 97 F.3d 316 (withdrawn March 26, 1997), the Ninth Circuit had also held that, notwithstanding the "race/notice" requirement of section 549(c) (i.e., that a party has to both take the interest in real property without notice of the pendancy of the bankruptcy case and record notice of that interest before the bankruptcy petition is recorded), the automatic stay of section 362(a) prohibited the recordation and perfection of the interest.

The court applied Section 364 of the Code in an attempt to achieve "equity" but found that the Debtors nevertheless breached Section 364 and incurred secured debt without prior court authorization. The Court modified the judgment to give the lender the amount lent less what they had already been paid. The case was remanded to the district court with direction to modify the decree of the bankruptcy court so that the lenders have a lien of a limited dollar amount on the estate. The trustee is now challenging the decision.

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The amendments proposed are intended to overrule the *McConville* decisions on the issues raised concerning Section 549, thereby rectifying the problem of imposing on a lienholder, lessee or grantee of an easement the duty to search the records of every bankruptcy court in the nation to ascertain if the owner of the property has filed an undisclosed bankruptcy case. The problems created by the *McConville* decision are solved by a series of simple amendments which merely clarify the law as it was enacted in 1978 and do not represent a change in the law under the Bankruptcy Code.

First, with respect to the automatic stay section 362(b) of the Bankruptcy Code is amended to add a new subsection (19) that would read as follows:

(19) under subsection (a) of this section, of any transfer that is not avoidable under section 549.

This amendment would clarify that postpetition transfers required to be perfected under section 549(c), and which are otherwise immune from attack under section 549, would not be void or violable as made in violation of the automatic stay.

Second, to overrule the *McConville* Court's treatment of transfers of non-fee interests in real property under section 549(c), section 549(c) would be amended: Insert "an interest in" before "real" the first time it appears, and insert after "property the first time it appears the following: ", including a security interest in real property,".

By this amendment, section 549(c) would be clarified to apply to "transfers of interests in real property, including a security interest in real property" where the purchaser has given fair equivalent value without notice of the pendancy of the bankruptcy case- and has perfected that interest timely.

Finally, to clarify that section 549(c) of the Bankruptcy Code applies to encumbrancers, the definition of "purchasers in section 101(43) would be amended as follows: Insert "security interest or" immediately before "voluntary".

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We appreciate the Chairman and Ranking Member's efforts to address the *McConville* decision in H.R. 120 and H.R. 764, and note that support for a clarification is widespread throughout the real estate and bankruptcy bar. The National Bankruptcy Conference, through its chairman, Bernard Shapiro, has indicated to the Committee in a letter of April 1997, its support for clarification. ALTA also testified before the National Bankruptcy Review Commission in December 1996. The Commission expressed concern regarding the Ninth Circuit decision, and concurred with our Association's recommendation that clarifications to *McConville* be included in the Code.

In addition, the Subcommittee on Use and Disposition of Property of the American Bar Association's Committee on Business Bankruptcy discussed the revised March 26, 1997 *McConville* decision on April 5, 1997. There was general assent among the lawyers at the meeting that section 549(c) should have given protection to the lender in *McConville.* The Subcommittee members present felt comfortable with a legislative "fix" that is relatively narrow and focused on that problem, and, given the potential for unintended effects elsewhere in the Code, did not involve wholesale changes to the definitions as originally suggested in our December 1996 statement to the National Bankruptcy Review Commission. The amendments set forth above achieve this mandate. While no votes were taken, and there may have been other viewpoints that were not expressed, there was consensus that a solution to the problems presented by the *McConville* decision was desirable.

We appreciate the Committee's attention to this important issue, and would be happy to respond to questions.

Mr. **GEKAS.** We turn to Mr. Gerken.

STATEMENT OF RICHARD R. GERKEN, VICE PRESIDENT AND ASSOCIATE GENERAL COUNSEL, COMDISCO, INC., ON BEHALF OF THE EQUIPMENT LEASING ASSOCIATION

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Mr. **GERKEN.** Thank you, Mr. Chairman and members of the subcommittee. I am appearing before you today in my capacity as chairman of the Legal Committee of the Equipment Leasing Association, which I will refer to as the ELA.

The ELA is a 700-member company trade association. The equipment leasing industry is the second largest source of capital for equipment acquisition in the United States, totaling almost $170 billion in 1996. In 1997, it will be somewhere around $176 billion by Commerce Department estimates.

Because of the large role leasing plays in equipment acquisition, inconsistent Bankruptcy Code provisions can restrict the availability of capital and increase the cost of lease financing. Thus, the ELA supports the provisions of H.R. 764 and H.R. 120, which make a technical correction to section 365 of the code; and we appreciate the bipartisan support of Judiciary Committee Chairman Hyde and Ranking Committee Member Conyers.

The Hyde-Conyers technical amendments to 365 of the Bankruptcy Code fulfill congressional intent by clarifying that a trustee does not have to satisfy a penalty rate or penalty provisions prior to assuming an unexpired lease of personal property, but does have to cure a default of nonmonetary obligations before it may assume.

This is clear from the history of the legislation in 1994, especially the compromise that was reached between several organizations, including the National Bankruptcy Council, which Mr. Klee appeared for, then and now, and we submit that, contrary to that assertion, this is not a special interest or substantive change. Rather, it is reflective of what has transpired and recognizes differences throughout the code between different types of industries.

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One of those situations that I would like to point out to your attention is the difference between personal property leasing and the leasing of real property and lending.

Personal property leases are of shorter duration and involve rapid depreciation versus real estate leases. Often, personal property lessons do not achieve a profit on the equipment and the transaction until after the initial lease is expired and the equipment is remarketed. Any delay or reduction in payments increases the lessor's risk that it will not achieve its purposes under which it entered into the original transaction.

The personal property lessor does not achieve a profit, as I mentioned, until it is remarketed. Lenders are paid out and receive their profits during the course of the loan. So there are the differences, and those have been codified by the 1994 amendments.

Now let me turn to the fact that those who oppose Hyde-Conyers are the ones that opposed the original changes that were made in 1994, and I think, want to preserve the erroneous *Claremont* interpretation of a lessor's rights.

In personal property leases, there are a lot of nonmonetary defaults, which are a significant matter to a lessor. Those include not only maintenance and repair but they include property insurance, they include liability insurance, they include safety, legal and regulatory compliance and compliance with regard to the appropriate usage and location of equipment.

My company, Comdisco, is involved in medical equipment leasing; and I shudder to think how a person could be able to use MRI's and cat scanners in an improper fashion and be allowed to assume a lease under those circumstances.

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The technical corrections are needed now because the *Claremont* decision, which was a real estate matter, may be applied to personal property leases, which we think is wrong; and we think the *Claremont* interpretation is wrong. It is wrong for several reasons:

It is wrong because it is in direct conflict with the primary statutory language of section 365(d)(10), which requires a cure of all obligations, monetary and nonmonetary.

It misconstrues the legislation which requires a cure by paying nondefault rates but not penalty rates.

It is inconsistent with the plain language of 365(b)(1), which is the primary section governing a trustee's assumption and cure duties, and conflicts with general bankruptcy policy and years of common law interpreting the code prior to the 1994 provisions, requiring both the cure of monetary and nonmonetary defaults.

There is no statutory language or legislative history--I will be finished in a second, if I may--which requires that nonmonetary defaults need not be cured. If that significant issue was present, it would have been discussed as part of the legislation.

Lastly, the plain English interpretation of section 365(j)(2)(D) would yield the fact that the word penalty is an adjective that modifies both the nouns rate and provision, and you have to insert the word any before the word provision to achieve the *Claremont* court's result.

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So I thank you for the opportunity to appear. We appreciate the bipartisan support. We also support Senator Grassley's proposal on the Senate side in the last Congress. I will entertain any questions you may have.

[The prepared statement of Mr. Gerken follows:]

PREPARED STATEMENT OF RICHARD R. GERKEN, VICE PRESIDENT AND ASSOCIATE GENERAL COUNSEL, COMDISCO, INC., ON BEHALF OF THE EQUIPMENT LEASING ASSOCIATION

Good morning Mr. Chairman and members of the subcommittee. I am Richard Gerken, Vice President and Associate General Counsel, Comdisco, Inc. I am appearing here this morning in my capacity as Chairman of the Equipment Leasing Association's Legal Committee to testify in support of the provisions in Chairman Hyde's bill, H.R. 764, and Representative Conyers' Bill, H.R. 120, which will restore Congressional intent by making a technical correction to Section 365 of the Code. (Neither I nor the Equipment Leasing Association have been the recipient of any federal grant, contract or subcontract in the current or preceding two fiscal years.) The Hyde and Conyers amendments to Section 365 supported by the Equipment Leasing Association (ELA) will clarify that in order to assume an unexpired lease of personal property, a trustee does not have to satisfy any default of a penalty rate or penalty provision in the contract [subsection 365(b)(2)(D)]. Further, the amendments clarify that a trustee does have to cure a default of a nonmonetary obligation before it may assume an unexpired lease of personal property. By resolving a grammatical question raised about subsection 365(b)(2)(D), the Hyde and Conyers amendments fulfill Congressional intent by making 365(b)(2(D) consistent with other relevant provisions of the Code, including 365(d)(10).

On behalf of the members of ELA, I would like to express how pleased we are that both the Chairman of the House Judiciary Committee and the Committee's Ranking Member have included provisions in their respective technical corrections bills to address the problems caused by the *Claremont* court's interpretation of subsection 365(b)(2)(D). This strong bipartisan support is further evidenced by the fact that the language in Chairman Hyde's bill and the language in Representative Conyers' bill are identical.

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Those who allege that the Hyde-Conyers amendment is "special interest" legislation are wrong. In 1994, Congress acknowledged that owners/lessors of personal property were treated unfairly under the Code, and after reviewing the entire record, struck a reasonable balance by adopting subsections 365(d)(10), 365(e) and 365(b)(2)(D). Today, some organizations are opposing the Hyde-Conyers amendment, not because they disagree with ELA that the *Claremont* court incorrectly interpreted 365(b)(2)(D), but because they prefer a different solution. Others opposing Hyde-Conyers are essentially the same groups who opposed bipartisan Congressional reform in 1994 authorizing lessors to enforce both monetary and nonmonetary obligations in lease agreements. By killing the Hyde-Conyers amendment, these groups hope to preserve and extend the erroneous *Claremont* interpretation and restrict lessors rights, thereby accomplishing through the judiciary that which they did not accomplish in Congress.

Those who oppose Hyde-Conyers primarily represent the interests of secured and unsecured creditors (as opposed to lessors). However, we would advise the Subcommittee that organizations representing thousands of secured and unsecured creditors supported ELA's efforts in 1994 to receive contract rent and enforce nonmonetary obligations such as maintenance and repair pending the trustee's decision to assume or reject an unexpired lease of personal property (See Senator Herb Kohl's Dear Colleague letter of September 28, 1994--attached.)

By way of background, ELA has over 700 member companies and the equipment leasing industry represents the second largest source of capital for equipment acquisition in the United States. In 1996, the Department of Commerce estimates that the volume of equipment leasing in the U.S. was $168.9 billion. It is projected that in 1997, equipment lessors will finance over $176 billion in equipment acquisition for businesses of all sizes. Because of the large role leasing plays in the acquisition of equipment, provisions in the Bankruptcy Code which are unclear or inconsistent can restrict the availability of capital and/or needlessly increase the cost of lease financing. In addition to fulfilling Congressional intent, the Hyde-Conyers amendment will also remove an inconsistent interpretation of a provision of the Code.

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Section 365(b)(2)(D) was included in the Bankruptcy Reform Act of 1994 as part of a compromise package of three amendments--new subsections 365(d)(10), 365(e) and 365(b)(2)(D). The reason subsection 365(b)(2)(D) was included in the package is directly related to the adoption of subsection 365(d)(10).

In adopting subsection 365(d)(10), Congress intended to cure the problem experienced by equipment lessors regarding their inability to collect rent and assure compliance with other material provisions of their lease agreements, pending the lessee's decision to assume or reject a lease. As the compromise was explained to ELA by Committee staff, subsection 365(b)(2)(D) was limited solely to penalty rates and penalty provisions, and the inclusion of 365(b)(2)(D) was essentially the "quid pro quo" for the adoption of 365(d)(10). That is, since under 365(d)(10) Congress was requiring lessees to pay rent and fulfill all obligations in the lease agreement (60 days after the filing), it was concerned that if lessors could require the cure of defaults of penalty rates and provisions at the time of assumption, trustees might be disincented from assuming unexpired leases. The intent of subsection 365(b)(2)(D) was to prevent lessors from requiring lessees to cure prior defaults of penalty provisions in order to assume a lease. Thus, since lessors were being authorized to enforce all contractual obligations under 365(d)(10), in the spirit of compromise, ELA agreed to give up the right to require debtors to cure all prior defaults prior to assumption by waiving the right to enforce the cure of defaults of penalty rates and provisions.

To fully understand the problems associated with the *Claremont* construction of 365(b)(2)(D), one must look at subsection 365(d)(10), which was the primary amendment in the compromise package. Under subsection 365(d)(10), until a lease is assumed or rejected, the trustee in bankruptcy is required to "timely perform *all* obligations of the debtor ... first arising from or after 60 days" after the issuance of the court's order for relief, "unless the court orders otherwise."

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Subsection 365(b)(2)(D) provides that the trustee's assumption of a defaulted lease is not conditioned upon the trustee curing or providing compensation with respect to a default relating to "the satisfaction of any *penalty rate or provision* relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the ... unexpired lease." Consequently, to assume a lease, bankrupt lessees need not pay any late charges on past due rent installments or any other amounts that constitute payment of a penalty rate or provision. This pro-debtor amendment, which ELA agreed to as part of the compromise package, was intended to remove a potential deterrent to assuming an unexpired lease of personal property. ELA supported the amendment in light of the obligations imposed on debtors under new subsection 365(d)(10), requiring debtors to fulfill "*all*" obligations (*monetary and non-monetary*) in the contract starting 60 days after the filing. Accordingly, where the lease agreement provided that the lessee would maintain and repair the leased equipment, it was clear that 365(d)(10) was intended to, and did, require the lessee to fulfill this critical nonmonetary obligation.

The Hyde-Conyers technical amendment is necessary because a federal district court has incorrectly interpreted subsection 365(b)(2)(D) as providing a broad exemption from curing nonmonetary obligation defaults [*In re Claremont Acquisition Corp.*, 186 B.R. 977, 990 (C.D. Cal. 1995)]. If applied to personal property leasing, the *Claremont* decision is inconsistent with the stated legislative intent and violates the spirit of the compromise package developed by former Judiciary Committee Chairman, Jack Brooks and Ranking Member Hamilton Fish, and agreed to by ELA. The *Claremont* interpretation is wrong for the following reasons:

1) It is in direct conflict with the primary amendment, subsection 365(d)(10), which requires that *all obligations, monetary and nonmonetary*, arising on or after day 60 in a Chapter 11 proceeding be performed by the debtor, unless the bankruptcy court orders otherwise under an "equities of the case" exception.

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2) It misconstrues the legislative history--see H.R. Rep. Non. 835, 103d Cong., 2d Sess. 10 (1994), *reprinted* in 1994 U.S.C.C.A.N. 3359 ("[S]ection 365(b) is clarified to provide that when sought by a debtor, a lease can be cured at the nondefault rate (i.e., it would not need to pay penalty rates)."; (see also 140 *Cong. Rec.* 10,769 (1994)).
3) Elimination of nonmonetary cure is not only inconsistent with the plain language of 365(b)(1), the primary section governing a trustee's assumption and cure duties, but it is also inconsistent with bankruptcy policy as expressed in the legislative history of the Code, and years of common law interpreting the Code requiring the cure of monetary and nonmonetary defaults.

4) There is no statutory language or history which states or even suggests that nonmonetary defaults need not be cured. Surely, had Congress intended such a result, it would have clearly stated it, particularly in light of the requirement in subsection 365(d)(10) to fulfill *all* obligations. The section-by-section analysis of the 1994 reform act by the House Judiciary Committee supports this conclusion: "Section 219. Leases of personal property.... The section amends section 365(d) to specify that 60 days after the order for relief the debtor must perform all obligations under an equipment lease...". (see *Cong. Rec.* of October 4, 1994 at H10758).
5) To suggest that 365(b)(2)(D) eliminates the cure for all nonmonetary defaults assumes that "penalty" in "any penalty rate or provision relating to ... nonmonetary obligations" is used as an adjective that solely modifies the noun "rate," and not both the nouns "rate" and "provision." Such an interpretation erroneously extracts the phrase "provision relating to a default arising from any failure by the debtor to perform obligations" from its "penalty" antecedent. The term "penalty" is an adjective modifying both "rate" and "provision."
6) Any interpretation of subsection 365(b)(2)(D) that would apply it to cover all nonmonetary defaults requires the addition of language not found in subsection 365(b)(2)(D). The *Claremont* court's analysis requires the addition of the word "any" not found in the statute: "the satisfaction of any penalty rate or [*any*] provision relating to a default arising from the failure by the debtor to perform nonmonetary obligations...." Only with the word "*any*" superimposed on the statute could it reasonably be read to provide broad relief from cure of nonmonetary obligations.

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The proper performance of, and the cure of defaults in, nonmonetary obligations is important for equipment leasing companies. Congress itself has recognized that leases of personal property differ in material respects from leases of real property and lending. Where real property leases generally are of longer duration covering an asset which tends to appreciate in value, personal property leases often are shorter in duration involving high technology and other types of assets which rapidly depreciate in value. Generally, personal property lessors, unlike lenders, do not make a profit until the property is remarketed after the initial lease. In a bankruptcy context, these factors when coupled with any actions that delay or reduce rental payments dramatically increase the risks and potential loss to a personal property lessor. Thus, Congress intended in the 1994 Code revisions to end the trustee's "free ride" usage of a lessor's property by requiring timely performance of all of the lessee's obligations pending assumption or rejection of a lease while encouraging lease assumption by precluding the need to cure penalty rates or penalty provisions.

As stated above, equipment leasing differs greatly from lending and real estate leasing. This was acknowledged by Senator Herb Kohl, the sponsor of the Senate measure which ultimately became the companion to subsection 365(d)(10). Upon the introduction of his bill (S.540), Senator Kohl noted the uniqueness of equipment leasing when he stated:

Some may suggest that the different treatment real property leases and equipment leases receive [*under the Code*] is justified. If so, perhaps equipment leases should receive preferential treatment. Equipment leasing differs from lending and real estate leasing in that equipment leases generally involve depreciating assets which decline in value during the term of a lease. Depreciation of an asset makes maintenance and repair [*nonmonetary obligations*] of the asset a key factor in ensuring the value of the equipment at the end of the lease. Without a change in the Code, debtors will continue to use and abuse leased equipment. Amending section 365(d)(3), as this bill does, requires equipment lessees to perform all obligations of a lease-including repair and maintenance vital to the long-term value of equipment--during the time taken to decide to reject or accept the lease. (*See Cong. Rec. of March 10, 1993 at S2643.*)

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There are several other important nonmonetary obligations which could be negatively affected under the *Claremont* interpretation, including provisions requiring the lessee to purchase insurance against risk of loss and liability insurance. Other material nonmonetary provisions such as requiring the equipment to be kept at a designated location, compliance with legal and regulatory requirements, and using the equipment in the appropriate manner stand to be negatively impacted without the adoption of the Hyde-Conyers amendment.

To fulfill Congressional intent, to execute the spirit of the 1994 package of amendments and to produce a reliable, proper and consistent view of subsection 365(b)(2)(D) in the administration of bankruptcy cases, ELA urges the adoption of the Hyde-Conyers technical amendment to subsection 365(b)(2).

In concluding, I would respectfully note for the record that ELA also supports the approach taken by Senator Charles Grassley in S. 2059 in the 104th Congress. Instead of redrafting subsection 365(b)(2)(D) and creating a new subsection 365(b)(2)(E), Senator Grassley opted to clarify the language by inserting the word "*penalty*" before provision in subsection 365(b)(2)(D). Just as the effort to clarify 365(b)(2)(D) enjoys bipartisan support in the House, original cosponsors of Senator Grassley's bill included Senate Judiciary Committee Chairman, Orrin Hatch, and Ranking Member, Howell Heflin. We anticipate similar bipartisan support for a technical amendment in the Senate this year.

Thank you for the opportunity to appear here today to present the views of the Equipment Leasing Association. If there are any questions, I would be pleased to answer them.

U.S. Senate,

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Washington, DC, September 28, 1994.

DEAR COLLEAGUE: In the 102nd Congress and again in the 103rd Congress, I have sponsored an amendment to Section 365(d)(3) of the Bankruptcy Code which would put an end to "free rides" on leased equipment by requiring a lessee who has filed a bankruptcy petition under Chapter 11 to pay the contract rate and maintain leased equipment pending the decision to assume or reject the lease.

This amendment has enjoyed strong bi-partisan support in the Senate and is currently contained in Section 204 of S. 540, "The Bankruptcy Amendments Act of 1993." During the *House Judiciary Committee* markup of *bankruptcy code reform legislation* this week, Representative Barney Frank will introduce a similar amendment, and I am writing to encourage you to *support* and vote in favor of his amendment at the markup.

This provision is also supported by the following organizations, which represent thousands of secured and unsecured creditors: American Bankers Association; American Financial Services Association; Community Bankers Association of New York State; Consumer Bankers Association; Credit Union National Association; Equipment Leasing Association of America; MasterCard International; National Association of Federal Credit Unions; Savings & Community Bankers of America; Texas Savings & Community Bankers Association; Advanta Corporation; AT&T, Beneficial Management Corporation; The Chase Manhattan Bank, N.A.; Citicorp; Dean Whitter, Discover & Co.; Household International; ITT Corporation; MBNA; and VISA USA.

Sincerely,

HERB KOHL,
Member, U.S. Senate.

Mr. **BRYANT** [presiding]. Ms. Sturtevant.

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STATEMENT OF JILL M. STURTEVANT, ASSISTANT GENERAL COUNSEL, BANK OF AMERICA, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Ms. **STURTEVANT.** Thank you for the opportunity to appear before you today on behalf of the American Bankers Association.

We commend the subcommittee for its continuing attention to bankruptcy matters. In particular, we urge the subcommittee to inquire into the causes and potential solutions of the current explosion of consumer bankruptcies in advance of receipt of the report and recommendations of the National Bankruptcy Review Commission to provide a realistic opportunity for enactment of remedial legislation in the Congress.

ABA generally supports the enactment of those provisions of H.R. 764 and H.R. 120 which make necessary and desirable technical corrections to and worthwhile clarifications of provisions of the Bankruptcy Reform Act of 1994. We are particularly gratified that these bills clarify that lenders involved in the making of student loans have discretion to deny applications for other types of loans on an applicant's prior bankruptcy.

The ABA also strongly supports enactment of the provisions striking the $4 million debt cap applicable to single asset real estate cases. Enactment of this provision will halt abusive chapter 11 filings involving such realty developments.

Contrary to some statements made earlier, this action will not cause job loss of those employed by companies leasing space in these troubled properties. The only jobs at risk are those of the bankrupt owner-managers.

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ABA has no objection to the provisions in both bills which would clarify the treatment of defaults on equipment leases. However, we would strongly oppose any expansion.

Mr. **BRYANT.** Can we take the unprecedented action of interrupting you just a minute so Mr. Nadler can ask you a question?

Mr. **NADLER.** Thank you very much, Mr. Chairman.

You made a statement--I will just ask you why you say that. You said, in a big complicated case, removing the $4 million cap would not affect the jobs, let's say, of tenants or employees of tenants in the property. It would only affect the jobs of the debtors. Why do you say that?

Ms. **STURTEVANT.** Because it is well in the interest of the secured lender to maintain the tenancies in the building. Creditors are not about to lose the tenants. The property would lose its value. Naturally, what would go on to the property would be a receiver or new property manager, and it would be to the creditor's benefit to keep the value of the property up.

Mr. **NADLER.** That doesn't necessarily follow.

Let's say there is a commercial lease for 10 years at a given rental, and it is 5 years into the lease. Property or rental values have appreciated more than the people assumed was the case 5 years ago or the tenant got a good deal 5 years ago; and it might very well, if they could break that lease, pay for the creditors to kick out that tenant and the employees of that tenant and put in someone with higher rental.

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Ms. **STURTEVANT.** Why would that not also apply to the debtor? The debtor would have the same----

Mr. **NADLER.** Excuse me. The debtor is bound by the 10-year lease.

Ms. **STURTEVANT.** And you are assuming the lender's lease is going to be prior in right to the tenants leases, which is often not the case. Very often, we are subordinated.

Mr. **NADLER.** But it could be.

Ms. **STURTEVANT.** It could be.

Mr. **NADLER.** So, in other words, you shouldn't say with such assurance that those jobs would be affected. You might say you don't think it would be, too often; but some people's jobs could be affected.

Ms. **STURTEVANT.** I am not certain losing a lease means a job is lost either. That makes an assumption jump that if you lose your lease, you lose your job.

Mr. **NADLER.** If you lose your lease, your employees lose their jobs.

Ms. **STURTEVANT.** Pardon me?

Mr. **NADLER.** If the factory or the store loses its lease, the salespeople or the employees lose their jobs. I wasn't talking about the owner.

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Ms. **STURTEVANT.** That may happen on occasion.

Mr. **NADLER.** OK, thank you.

Mr. **BRYANT.** Thank you for your courtesy in responding, but could you finish your statement now?

Ms. **STURTEVANT.** Certainly.

However, we would strongly oppose any expansion of this provision to include real estate leases and thereby permit landlords to seize valuable tenant leases due to inherently incurable nonmonetary defaults. Enactment of such a provision would be extremely unfair to troubled retailers and other creditors. ABA would be unable to support passage of these otherwise acceptable bills if this offensive provision was added.

ABA urges the subcommittee to consider inclusion of a number of other technical and clarifying amendments to the bill. In particular, we urge you to clarify that debt incurred to pay State and local tax obligations, as well as private sector, higher education loans, cannot be discharged in bankruptcy.

Thank you, Mr. Chairman, for this opportunity, and I am prepared to answer further questions.

Mr. **BRYANT.** Thank you, Miss Sturtevant. We didn't mean to ambush you on that one.

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[The prepared statement of Ms. Sturtevant follows:]

PREPARED STATEMENT OF JILL M. STURTEVANT, ASSISTANT GENERAL COUNSEL, BANK OF AMERICA, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. Chairman and Members of the Subcommittee, my name is Jill M. Sturtevant. I am Assistant General Counsel to the Bank of America. In that position I manage most of the Bank's problem loans and bankruptcies, including litigation in both consumer and commercial cases, from my office in Los Angeles, California. I am pleased to appear before you today on behalf of the American Bankers Association (ABA).

I was one of a number of bankruptcy attorneys who assisted the ABA during Congressional consideration of the legislation which was ultimately enacted as the Bankruptcy Reform Act of 1994. In that role I had the opportunity to work closely with many of the staff of the House and Senate Judiciary Committees in crafting the final bill. Appearing today to comment on H.R. 764 and H.R. 120--bills which primarily correct drafting errors, make necessary clarifications, and effect other technical changes to that major bankruptcy bill--brings to mind memories of the hectic and ultimately successful efforts to enact that important legislation in the waning days of the 103rd Congress.

Given the critical role of commercial banks in the Nation's economy, and their involvement in all aspects of bankruptcy due to their multifaceted lending activities, any bankruptcy legislation is of keen interest to ABA's members. The ABA brings together all elements of the banking community to best represent the interests of our rapidly changing industry. Its membership--which includes community, regional and money center banks and bank holding companies, as well as savings associations, trust companies, and savings banks--makes ABA the largest banking trade association in the country.

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ABA commends this Subcommittee for its recent inquiry into conditions in the bankruptcy system and the ongoing work of the National Bankruptcy Review Commission. ABA has monitored every aspect of the Commission's important work, and has participated in numerous Commission activities focusing on consumer, commercial, farm, realty, and small business bankruptcies. On April 17 I participated, at its invitation, in the Commission's continuing examination of possible consumer bankruptcy reforms at its most recent hearing in Seattle, Washington. The banking industry has enjoyed excellent access to Commission proceedings, members and staff, and we have already endorsed many of its preliminary recommendations regarding commercial bankruptcy issues.

Nonetheless, the ABA urges this Subcommittee to continue its inquiry into current bankruptcy issues--and most particularly with the causes of and problems associated with escalating consumer bankruptcy filings--so that you can "hit the ground running" when the Commission issues its report and recommendations this coming October. Only continued inquiry into these matters in advance of receiving that report can provide a realistic chance of enacting necessary bankruptcy reforms in this Congress. There is a crisis in the consumer bankruptcy system, and we look to the members of this Subcommittee as being in the front lines of addressing it. ABA will lend its full support and whatever assistance you find useful to that critically important effort.

SUPPORT FOR TECHNICAL CORRECTIONS

The majority of the provisions of both H.R. 764 and H.R. 120 are identical, or nearly identical, provisions which effect non-controversial, non-substantive, truly technical changes to the 1994 Bankruptcy Act. These amendments were prepared by the National Bankruptcy Conference (NBC) and forwarded for Congressional consideration in mid-1995. ABA's ad hoc bankruptcy advisory group, made up of both in-house and outside counsel, and of which I am a member, reviewed these proposals in the fall of 1995 and concluded that they were constructive improvements to and clarifications of the 1994 Act and worthy of enactment. The NBC package was introduced in the Senate as S.1559 on February 6, 1996 by Senators Grassley and Heflin. S. 1559 was ultimately passed by the Senate, with amendments, later that year. But, as you are aware, both time constraints and policy disagreements regarding certain provisions thwarted House passage in the closing days of the 104th Congress. ABA supports enactment of the package of technical amendments prepared by the NBC.

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In particular, the bills before you contain language regarding two key items which incorporate suggestions made by the ABA during the last Congress.

The first corrects an inadvertent drafting error in Section 525(c) which could be read as stating that a lender engaged in making student loans cannot deny any type of loan to an individual who has declared bankruptcy. This would be clarified by the bills, consistent with this provision's legislative history, so that this nondiscrimination treatment extends solely to student loans. We would also suggest that this provision be further perfected by making it clear that while a lender cannot deny a guaranteed student loan to an individual solely on the basis of a prior bankruptcy filing, a prior bankruptcy could be one of the material factors considered in such a denial.

The other amendment ensures that the resolution of the *Deprizio* matter covers transfers of liens in property. This is consistent with Congress' clear intent to overrule that decision in its entirety.

My statement later describes a number of additional technical improvements which we believe are worthy of this Subcommittee's consideration prior to mark-up.

SINGLE ASSET REAL ESTATE

ABA supports the provision, contained in Sections 2 of both bills, which removes family farms from the definition of "single asset real estate" found at Section 101(51B) of the Bankruptcy Code. There is broad agreement that family farms, given their extensive separate treatment in Chapter 12 of the Code, were not intended to be encompassed by this definition.

ABA also strongly supports the additional provision contained in H.R. 764 which strikes the $4 million debt cap now contained in the definition "single asset real estate." That debt cap is simply far too low. It permits realty developers in control of major troubled projects to stall foreclosure efforts when they have no realistic prospects of reorganizing that single asset in a viable manner. It thwarts Congressional intent, expressed in 1994, to halt abusive Chapter 11 filings by those in control of realty assets.

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We understand that there is legitimate concern that striking the debt cap can jeopardize the jobs of employees of the offices, hotels, and retailers that lease these properties. Precisely the opposite is true. It is not uncommon for those in control of troubled commercial realty to defer maintenance, upkeep, and security, to let insurance coverage lapse and taxes go unpaid, and to utilize rental and lease payments for purposes other than keeping the realty asset in a condition which is conducive to carrying on business. Under these deteriorating conditions, the tenants and lessees of the property owner are disadvantaged both personally and in terms of carrying on their own enterprises.

The amendment made to Section 362 of the Code by the 1994 Act recognized these unpleasant realities by putting in place modest requirements which can be met by any property owner who has a realistic chance of reorganizing his realty asset. Stays against actions initiated by creditors secured by the realty asset will be lifted unless, within 90 days after entry of the order for relief, the debtor either files a plan of reorganization which has a reasonable chance of being confirmed within a reasonable time, or the debtor has commenced monthly payments to creditors in an amount equal to interest at a fair market rate on the value of the creditor's interest in the real estate. Debtors who are unable to take one of these alternative actions are most unlikely to carry out a successful reorganization. They should not be permitted to continue to drain income from a mismanaged property while letting it fall into disrepair.

Creditor foreclosures on such properties will only jeopardize the job of the property owner--a job which has obviously not been done well. The jobs of those employed by enterprises leasing space within the realty will be more secure when mismanagement is removed and the property is again maintained in proper fashion. It would not be in the economic self-interest of creditors to shut down lessee enterprises, and jeopardize those jobs, because the value of the real estate is the income stream produced by lease payments.

We urge those Members who opposed this provision at the end of the last Congress to reexamine their position.

Workers and local governments will benefit from the transfer of a troubled property from mismanagement to sound management. There can be no policy rationale for prohibiting small abuses but permitting large ones. Whether a property is large or small in terms of debt, it is by definition a single asset--there are no other assets to sell off or reorganize to get the enterprise back on its feet. We urge the Subcommittee to retain this important provision of H.R. 764 and thereby stop abusive Chapter 11 real estate filings.

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EXECUTORY CONTRACTS AND UNEXPIRED LEASES

Both H.R. 764 (Sec. 6) and H.R. 120 (Sec. 11) contain identical provisions relating to executory contracts and unexpired leases. These provisions effect significant changes to Section 365(b)(2)(D) of the Code.

These changes, to which ABA has no objection, would clarify that the penalty provisions of executory contracts or unexpired leases fall within the provision's exception to the general rule that all defaults must be cured before the debtor can assume the contract or lease. This clarification is consistent with the Congressional intent underlying enactment of this Section in 1994. They would also reverse erroneous subsequent court rulings that the section relieves debtors from curing all nonmonetary defaults in the assumption and assignment of executory contracts and leases. It would also clarify that nonmonetary defaults arising under an unexpired lease of personal property would have to be cured prior to such lease's assumption.

However, ABA would strongly oppose any attempt by real estate interests to add to these provisions language enabling them to seize reality leases for incurable nonmonetary defaults. Our concern is so serious that we would be unable to support either H.R. 764 or H.R. 120 were they to contain such a provision. Such a provision would narrow the coverage of Section 365(b)(2)(D) solely to unexpired leases and executory contracts of personal property, thereby removing real property from its coverage. It constitutes a highly transparent attempt by realty developers--primarily shopping center operators--to remove themselves from the bankruptcy process involving a lessee retail establishment. This very substantive provision would fundamentally alter the balance between lessors and other parties in interest to a retailer's bankruptcy. It would be most unfair to the retailer's creditors and completely antithetical to any prospects of the retailer completing a successful Chapter 11 reorganization and thereby maintaining the jobs associated with its enterprise.

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Current bankruptcy law requires retail establishments to cure all monetary defaults prior to assumption or assignment of a lease. But Section 365 exempts them from satisfying penalty rates or provisions arising from failures to perform nonmonetary obligations. If realty leases were removed from the Section's coverage it would become impossible for the debtor retailer to retain or assign its lease. The lease would then revert to the landlord, taking it outside the bankrupt retailer's estate. As the leases of bankrupt retailers often have substantially more value than their inventory, stripping the retailer of its leases due to nonmonetary defaults would be highly detrimental to its chances of reorganization, and unfair to all its other creditors. If this provision became law retailers in general, and financially troubled retailers in particular, would find it considerably more difficult and expensive to obtain financing prior to any bankruptcy filing. They would also find significantly reduced prospects for obtaining debtor-in-possession financing once they had entered into Chapter 11.

We urge the Subcommittee to reject any attempt to add this unsound provision to the bills before you. This very substantive provision would be highly adverse to retailers and to the banks and other creditors which provide them with working capital, and has no place in a technical corrections bill.

TECHNICAL AMENDMENT PERFECTION

Both H.R. 764 (Sec. 7) and H.R. 120 (Sec. 13) contain provisions which disallow attorney and accounting fees as administrative expenses when they are incurred on behalf of a member of a creditors' committee, rather than for the committee as a whole. We support this clarification. In addition, we would suggest an additional, complementary perfecting amendment to Section 504(b)(3), by striking the words specified in paragraph (4) of this subsection and inserting in lieu thereof "for professional services and related expenses" after the word "reimbursement".

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ADDITIONAL RECOMMENDED TECHNICAL AMENDMENTS

We would like to suggest a number of additional, modest technical amendments for the Subcommittee's consideration as possible additions to any legislation reported for full Committee consideration. ABA would be pleased to work with staff in crafting the language to carry out any of these proposals.

Nondischargeability of tax debt--The 1994 Act added a new paragraph 14 to Section 523 of the Code to bar the discharge of a debt incurred to pay a United States tax which would itself be nondischargeable. This addition reflected Congressional policy that, in an era when government seeks to provide the convenience of permitting taxpayers to satisfy their tax obligations through the use of charge or credit cards, debtors should not be permitted to effectively defeat the bar to discharge of tax obligations through the use of such a payment mechanism. That is what would occur if debtors could use such a payments mechanism to satisfy their tax obligations and then file for bankruptcy shortly thereafter, leaving the unsecured creditor stuck with paying debtor's bill. The 1994 amendment bars that abuse in regard to federal taxes but is silent in regard to state and local taxes.

We urge you to amend paragraph 14 of Section 523 to include state and local tax obligations. We believe that the omission of these obligations was unintentionally made in the 103rd Congress' haste to enact the 1994 Act before final adjournment. Given that all levels of government are moving to accept modem payments mechanisms for the satisfaction of tax obligations, it makes no policy sense to prevent abuse in regard to federal taxes but to permit it in regard to state and local tax obligations.

In a related amendment, we suggest that Section 1328(a)(2) of the Code be amended to include a cross-reference to paragraph 14 of Section 523. This would remove debts incurred to pay nondischargeable taxes from the scope of the Chapter 13 superdischarge. We believe that the omission of Chapter 13 from the 1994 Act was an inadvertent error and that there is no compelling policy reason to permit debtors to discharge such debts in Chapter 13 when they would be unable to do so in Chapter 7.

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Chapter 13 Schedules--We urge the Subcommittee to amend the Code provisions relating to a debtor's duties to require that a debtor distribute complete schedules of assets, liabilities, income and expenditures to all creditors listed in a Chapter 13 proceeding. This administrative requirement would resolve the difficulties which creditors sometimes experience in keeping track of a Chapter 13 debtor's financial status.

Communications With Creditors--We urge the Subcommittee to require that, in all communications with creditors, debtors be required to list credit account numbers on all filings, schedules, and similar communications. This modest provision would impose no meaningful burden on the debtor but would greatly assist creditors in correctly identifying affected lines of credit.

Address of Notification--We urge the Subcommittee to permit creditors to designate the address of notification at which they are to receive communications from debtors. This will help to assure a creditor's meaningful participation in a case. It will curb the practice by which some debtors dispatch communications to a creditor's outlying offices in an attempt to create delay and confusion in bringing matters to the attention of a creditor's appropriate officer.

Nondischargeability of Private Sector Student Loans--We urge the Subcommittee to expand the scope of Section 523(a)(8) of the Code to encompass all education loans, including those which are not made, insured or guaranteed by a governmental unit.

At the time the Section was enacted, virtually all loans for college and graduate education were made or guaranteed under government assistance programs. That situation has changed considerably in recent years. Rising college costs and restrictions on guaranteed lending programs have compelled students to increasingly look to private credit sources for educational financing funds. The current private education loan volume is $1.25 billion annually, and this level is expected to grow considerably in the future.

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The great majority of education loans are made to individuals who have no or little employment or credit history, no collateral, and no ability to begin repayment until after graduation. These loans are made on the expectation that they will be repaid from a future income enhanced by the education being financed. A large percentage of graduates of institutions of higher learning are technically insolvent, with debts considerably exceeding their assets. Section 523(a)(8) was enacted to prevent these individuals from discharging their obligation to repay guaranteed student loans in a bankruptcy proceeding.

In the absence of the addition of all educational loans to this Code section, the cost of private borrowing for education will grow as a result of bankruptcy abuses by a small but nonetheless significant minority of borrowers. In a worse case scenario, private lending could become unavailable in response to excessive levels of educational debt discharged in bankruptcy. This would be contrary to national goals of encouraging higher education. That undesirable result can be forestalled by taking action now to prevent the discharge of any education loan in bankruptcy.

CONCLUSION

Mr. Chairman and Members of the Subcommittee, I want to again express the ABA's appreciation for the opportunity to testify in regard to these pending technical correction bills. By and large, they accomplish modest but necessary clarifications and improvements to the 1994 Bankruptcy Reform Act.

In particular, we urge the Subcommittee to retain H.R. 764's striking of the debt dollar limit in regard to the requirement that debtors in single asset real estate cases provide evidence of some realistic probability of successful reorganization, after a decent interval from the filing date, in order to maintain their possession of the property at issue.

While we support these bills' provisions clarifying the treatment of equipment leases, we would be unable to support enactment of these bills if any provision were added permitting landlords to seize tenants' valuable leases for nonmonetary defaults which are incapable of cure. This extremely substantive provision has no place in a technical corrections bill. Its enactment would be particularly detrimental to financially troubled retailers and all of their other creditors. ABA urges the Subcommittee to reject any attempt to add such a provision to these technical bills.

Finally, we urge the Subcommittee to give consideration to the modest additional perfecting and technical amendments recommended in our testimony.

I would be pleased to answer any questions.

Mr. **BRYANT.** Before I yield time to the distinguished gentleman from New York, let me be clear that we will be following the 5-minute rule in terms of the entire panel; during one of the earlier panels we applied that to various members.

At this time, I would yield the customary 5 minutes to the distinguished gentleman from New York, Mr. Nadler.

Mr. **NADLER.** Thank you.

Let me thank the chairman for allowing me to ask that question out of turn because when I heard a statement that said this wouldn't happen, I wanted to know why.

I have no further questions for Ms. Sturtevant, and I do have questions for Mr. Sullivan from HUD.

Mr. Sullivan, you testified eloquently that HUD is in a special position. HUD is a mortgage guarantor or lender, but usually the guarantor for the purpose of providing housing for low income people who couldn't get in on the open market and that what often happens is, when these cases are stayed it simply means that the foreclosure is stopped and the mortgagee or the owner simply allows the property to deteriorate while the proceeding is going on or doesn't provide services to tenants and whatnot. And, therefore, the purpose of HUD to provide decent housing for these people is gravely injured.

And I accept all that, and I think you are quite right, and I think we ought to do something about it, whether carving out an exception for government lenders or repealing the whole thing separately is a different question, but we certainly ought to solve that problem.

Let me ask you a different question. You have to be very careful, obviously, about where you lend money so you don't get into these bankruptcy situations.

Now Donald Trump, who has already defaulted so that Chase Manhattan Bank had to eat $130 million on one project in my district, has applied to HUD for $356 million. He just reduced it to--for a mortgage guarantee of $178 million. The Inspector General of HUD has said it is imprudent. This loan would be imprudent. There wouldn't be proper security for it.

The community is all up in arms and doesn't want this project to start with. The asserted reason is you get 20 percent of low income units out of it. That would come to $1 million per low income unit. Assuming that Mr. Trump were to default again, as he already has once on this project, and since the Inspector General has already said it wouldn't be totally secured, why is HUD even considering it at this point?

Mr. **SULLIVAN.** This is an area that is really not my program jurisdiction; but, nevertheless, the Department received an application for mortgage insurance, and it is being evaluated. The Department hasn't ruled one way or another on it. It is being evaluated, and all the considerations are being taken and looked at.

Mr. **NADLER.** Why is it even still at the consideration stage when the Inspector General has already said don't do it?

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Mr. **SULLIVAN.** I honestly don't know the status of that particular loan application. But it is an application, and it is being reviewed, and everyone's comments are being considered.

Mr. **NADLER.** How seriously does HUD generally take the reports submitted by its own Inspector General where he says, for example, HUD should not, quote, "bear the risk of the mortgage guarantee," unquote?

Mr. **SULLIVAN.** We take all the reports from the Inspector General very seriously.

Mr. **NADLER.** Let me ask one further question on this.

When there are various statutory requirements for a HUD mortgage guarantee, such as various things to be done by a local government over the years no if a local government certifies that these requirements have been met, does HUD ever look beyond the statement by the local government or does it take it at face value all the time?

Mr. **SULLIVAN.** The Department makes an underwriting decision where it takes a lot of different factors into valuation before it agrees to insure the loan.

Mr. **NADLER.** No, but I am not asking that. If a local government makes statements of fact, do you always assume they are telling the truth when other people come to you and tell you they are not? Or do you see your responsibility to ensure that the statute is upheld. Does HUD take the position that you have no responsibility to see that their assurances that the statutory requirements have been met are true?

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Mr. **SULLIVAN.** I am not sure I understand the complete impact of your statement, but the Department endeavors to understand the truth and to evaluate the application fairly.

Mr. **NADLER.** And if it were brought to your attention that the assurances of the local government as to how the local statutory requirements are met were not in fact written by the signatory of the letter for the local government but were written by Mr. Trump's agents and signed by the local government official, would that affect your judgment?

Mr. **SULLIVAN.** Yes, we would have to look into that--seriously.

Mr. **NADLER.** Thank you very much.

Mr. **GEKAS** [presiding]. The time of the gentleman has expired.

We thank the panel for their input. We are faced with consideration of these bills and then the imminent final conclusions of the Bankruptcy Commission in its report. I personally am worried about what should we include in this technical amendments forum and what we should not. But that is my problem.

Thank you very much.

This hearing is adjourned.

[Whereupon, at 12:08 p.m., the subcommittee adjourned.]

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A P P E N D I X

Material Submitted for the Hearing

PREPARED STATEMENT OF HON. HENRY J. HYDE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS, AND CHAIRMAN, COMMITTEE ON THE JUDICIARY

I appreciate Chairman Gekas scheduling this hearing on H.R. 764 [the "Bankruptcy Amendments of 1997"], legislation I introduced, and H.R. 120 [the "Bankruptcy Law Technical Corrections Act of 1997"], legislation introduced by the Ranking Member of our full committee. Both these bills incorporate a number of provisions from S. 1559, which passed the Senate in the 104th Congress.

This morning I welcome the opportunity to offer comments in support of H.R. 764. Although the primary focus of my bill is to make needed technical and conforming changes in the Bankruptcy Code and correct drafting problems relating to provisions of Public Law 103—394, the Bankruptcy Reform Act of 1994, the legislation also includes some substantive provisions--limited in scope--that are designed to rectify shortcomings in current law.

I am confident that the very knowledgeable witnesses at this hearing will help to build a record justifying Committee action in the near future. At this point, I am pleased to highlight some of the Bankruptcy Code amendments that are incorporated in H.R. 764.

P.L. 103—394 included a provision designed to deter abuses of the reorganization process by single asset real estate debtors. The new statutory remedy of facilitating more expeditious terminations of the automated stay, however, was undercut by making it unavailable when debt exceeded $4 million. Because of the potential for dissipation of assets in large cases--as well as in small cases--my bill deletes this inappropriate debt ceiling. Congressman Knollenberg, who will testify today, is the author of separate legislation on this subject.

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H.R. 764 also improves a provision of P.L. 103—394 limiting liability of non-insider transferees. In 1994, we concluded that lending institutions were being penalized unfairly for obtaining loan guarantees by being subjected to a longer recapture period--during which transfers to lenders are subject to potential recovery by a trustee in a bankruptcy case. Further clarification at this time is needed to effectuate Congress' intent.

My bill also attempts to respond in a focused manner to a major problem confronting equipment lessors in bankruptcy cases. An equipment lessee who fails to perform nonmonetary obligations can do great damage to a lessor's interests. An example is breach of maintenance requirements. Equipment that is not properly maintained quickly loses its value. We need to clarify that there is no broad exemption--in the context of a bankruptcy trustee's assumption of an equipment lease--from curing nonmonetary defaults.

Another provision of H.R. 764 prevents individuals whose operation of watercraft or aircraft is unlawful because of intoxication from avoiding obligations to victims by relying on discharges in bankruptcy. Congressman Ehlers deserves credit for introducing separate legislation on this subject. His bill in the 104th Congress passed the House.

H.R. 764 is designed to accomplish a number of other objectives:

It attempts to provide assurance that criminal enforcement of a court order requiring payment of child support will not be subject to the automatic stay in bankruptcy--thus preventing a bankruptcy filing from shielding parents with support

obligations.
It clarifies that a student loan related amendment to the Bankruptcy Code, enacted in 1994, does not effectuate a broader limitation on lender discretion to consider a prospective borrower's bankruptcy history in making loans.
It seeks to protect certain security interests in real property in recognition of the potential for undisclosed bankruptcy filings to compromise important rights.
It safeguards estate assets by clarifying that expenses incurred by individual members of creditors' and equity security holders' committees for attorneys or accountants do not qualify as allowable expenses in the administration of an estate in bankruptcy.

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It elaborates on existing law--enacted in 1994--relating to the election of a trustee by creditors in a reorganization case.
I commend this subcommittee for its efforts to improve the bankruptcy process and look forward to full committee consideration of your work product.

PREPARED STATEMENT OF JOHN CONYERS, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

I want to begin by thanking you, Chairman Gekas and Ranking Member Nadler, for inviting me to testify today. I think it is truly within the bipartisan "spirit of Hershey" to begin this process by permitting both myself and Chairman Hyde to testify on our respective bills.
There are few matters which are more complex, or more important to this country, than the bankruptcy laws. However, in recent years, the bankruptcy laws have become so complex that when we make significant substantive changes--as we did in 1978, 1984 and 1994--we often make inadvertent errors which require periodic fixing through technical corrections bills.
This is why I introduced a technical corrections bill on the very first day of the Congress. My bill was based on proposals made last Congress by numerous parties interested in the bankruptcy process as well as the well respected National Bankruptcy Conference. A similar bill was unanimously adopted by the Senate last year (S. 1559), but we ran out of time to deal with it in the rush of business at the end of the Congress.
Both my bill and Chairman Hyde's bill are by and large limited to technical and noncontroversial changes. For the most part, the bills are very similar and I am hopeful that we will be able to resolve the differences before moving to any markup.
While both bills are technical, I would also note that if enacted into law, they will provide genuinely needed clarity to the Bankruptcy Code, helping both debtors and creditors alike. For example, by clarifying the operation of the manner in which the preference provisions of the Code apply to non-insider creditors (overruling *DePrizio*) we will be able to offer much needed certainty to commercial lenders and encourage the continued flow of credit to businesses.

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And by clarifying that non-monetary equipment lease obligations need not be cured (in response to the *Claremont Acquisition* case), the legislation would eliminate a potential cloud over thousands of equipment leasing transactions.

Also, by clarifying that "production payments" are not subject to bankruptcy, we will be helping many persons in the oil and gas business who rely on these sales to operate their business.
I am also attaching hereto a comprehensive summary of my bill, and ask that it be made part of the record as well.
Since I have introduced H.R. 120 an additional technical correction has come to my attention. Section 305 of the 1994 Reform Act overruled *Rake* v. *Wade*(see footnote 10) to make it clear that the Bankruptcy Code did not require debtors to pay interest on their arrearages in order to cure their mortgages. It is my understanding that some lenders have nonetheless sought to require that debtors pay special high penalty rates in order to cure their mortgage, which was certainly not intended. I hope we can end this practice through a further technical amendment to the Code.(see footnote 11)

Also, I would note that the Judicial Conference has requested 18 additional bankruptcy judgeships. These are needed to deal with the tremendous increase in bankruptcy filings we are experiencing (up 27% nationally to over 1.1 million filings, and up 26% in Michigan). I would suggest that Chairman Gekas and Ranking Member Nadler considering combining the final technical corrections bill that emerges from the Subcommittee with the new judgeship bill. This will eliminate the need to obtain two unanimous consent requests in the Senate on these two measures.

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Finally, I would remind you that the *In Forma Pauperis* pilot program Congress created several years ago(see footnote 12) is scheduled to expire on September 30, 1997. This very limited program has operated extremely well in practice at very minimal cost. The issue of *In Forma Pauperis*--allowing for a waiver of bankruptcy filings fees by indigent individual debtors--is being considered by the Bankruptcy Commission and a report on the issue is due from the Federal Judicial Center next spring. However, it would be extremely disruptive to the few districts where the pilot program now operates if it was prematurely terminated. I would therefore strongly urge that the Members recommend that the Appropriations Committee continue to allow appropriations for this salutary program.

Thank you once again for allowing me to testify.

SUMMARY OF CONYERS TECHNICAL BILL (H.R. 120)
SECTION 1. SHORT TITLE
SECTION 2. DEFINITIONS

This section makes a number of changes in the definitions section of the Bankruptcy Code. First, it would amend the definition of "single asset real estate" to expressly exclude family farms. While I believe this was the intent of the 1994 legislation we need to make sure that family farms are not otherwise treated as single asset real estate.
This section would also amend the definition of "transfer" to clarify that it includes the creation of liens. This change is needed to avoid confusion created by the Ninth Circuit in *Thompson* v. *David Margen and Lawton Associates (In re McConville)*.(see footnote 13) Under that Ninth Circuit case there is a risk that lenders who extend credit to parties who fail to disclose the fact of their bankruptcy will have their liens voided. Prior to the *In re McConville* decision it was generally understood that a lender who extended such credit would be treated as a "purchaser" under the Bankruptcy Code, and would thereby be protected from having its mortgage invalidated as an unauthorized post-petition transfer or a violation of the automatic stay.

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If the *McConville* case is allowed to stand, it would be impossible for any title insurer to be able to promise to a lender that it had good title to the property without checking for the existence of a bankruptcy filing in all 50 states. In practice, this would force the title insurer to take an exception to such eventuality in their insurance, shifting the risk of loss to the lender, and ultimately diminishing the availability of credit. The *McConville* case has been amended and republished on two separate occasions, and the Subcommittee may want to consider further changes to the Bankruptcy Code to deal with these developments.
Notably, the bill does not eliminate the current requirement in single asset real estate cases that such property have aggregate, noncontingent, liquidated secured debt in the amount of no more than $4 million. I am concerned that subjecting all single asset real estate to the requirement that they file a plan of reorganization which can be confirmed or commence monthly loan payments within a 90 day period, or face immediate foreclosure, could cause significant economic disruption and the loss of jobs. For example, if the $4 million cap were eliminated, complex cases such as the bankruptcy of Rockefeller Center would be subject to this preemptory proceeding. This is certainly not a technical change, and in my view warrants serious consideration by the Bankruptcy Commission and Congress before further action is taken.

SECTION 3. ADJUSTMENT OF DOLLAR AMOUNTS
This section would amend Section 104 of the Bankruptcy Code to provide that the dollar amount of those professional tools, crops, etc. for which liens may be avoided by a debtor (currently $5,000) is subject to adjustment every three

years to reflect changes in the Consumer Price Index. This item was inadvertently omitted from the 1994 changes.

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SECTION 4. EXTENSION OF TIME

This section makes a technical and conforming change (eliminating an inconsistency between the bankruptcy language adopted by Congress as section 108 of the Code and the version ultimately prepared by Law Revision Counsel).

SECTION 5. PENALTY FOR PERSONS WHO NEGLIGENTLY OR FRAUDULENTLY PREPARE BANKRUPTCY PETITIONS

This section makes a technical and conforming change.

SECTION 6. ELIGIBILITY TO SERVE AS TRUSTEE

This Action amends Section 321(a) of the Bankruptcy Code to delete chanter 7 trustees from the requirement of residing or having an of lice in the judicial district within which the bankruptcy case is pending. At a time when many trustees operate on a regional or national basis, the residency requirement is an outmoded and needless obstacle to efficient bankruptcy administration.

SECTION 7. EMPLOYMENT OF PROFESSIONAL PERSONS

This section specifies that a trustee may offer professional services generally to the estate, rather than merely acting as an attorney or accountant. The limitation on services by trustees is an outmoded requirement based on the assumption that they would only offer legal or accounting services.

The section also makes a number of technical and conforming changes.

SECTION 6.(see footnote 14) Limitation on Compensation of Professional Services

This section amends section 328(a) to allow professionals to be compensated on a fixed or percentage basis, in addition to the other types of delineated payment schemes. This will provide the estate with the needed flexibility to take advantage of a number of types of incentive compensation proposals.

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SECTION 7. COMPENSATION TO OFFICERS

This section makes a technical change to clarify that the debtor's attorney is entitled to court-awarded compensation in appropriate circumstances, correcting an inadvertent omission in the 1994 Act..

SECTION 8. SPECIAL TAX PROVISIONS

This section makes a technical and conforming change (eliminating a now obsolete cross-reference to section 371 of the Internal Revenue Code).

SECTION 9. EFFECT OF CONVERSION

This section clarifies that in cases where a debtor converts a case under chapter 13 in bad faith to another chapter, the property of the estate shall include the property as of the date of the conversion (e.g. it would include property acquired subsequent to the initial filing, potentially benefiting the estate's creditors).

SECTION 10. AUTOMATIC STAY

This section amends section 362(b)(3) to clarify that a creditor may perfect a security interest within twenty days of a bankruptcy filing without violating the automatic stay, rather than just 10 days. This is necessary to conform to changes made in the 1994 amendments allowing for 20 days for perfection under section 547(c)(3).

The section also amends section 362(h) to specify that violations of the automatic stay should apply to any "entity," not just individuals. This will insure that there is more equitable and even-handed enforcement of the automatic stay provisions.

SECTION 11. EXECUTORY CONTRACTS AND UNEXPIRED LEASES

This section modifies section 365 to clarify that subsection (b)(2)(D), providing for an exception to the obligations which must be cured in order for the trustee to assume a lease, covers "penalty rates" as well as "penalty provisions." The section also adds a new subparagraph (e) clarifying that non-monetary lease obligations need not be cured whether or not they involve penalties, thereby codifying *In re Claremont Acquisition Corp*.,(see footnote 15) except with respect unexpired leases of personal property.

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The intent of this clause is to insure that a steady steam of capital remains available for business equipment lessors. (I did not intend that subsection (e) apply to consumer leases, and may be necessary to clarify this through an additional technical correction.)

SECTION 12. AMENDMENT TO TABLE OF SECTIONS
This section makes a number of technical and conforming changes.

SECTION 13. ALLOWANCE OF ADMINISTRATIVE EXPENSES
This section amends section 503(b)(4) to clarify the types of professional services by attorneys or accountants eligible for administrative expense status.
SECTION 14. PRIORITIES
This section makes a number of grammatical and conforming corrections.
SECTION 15. EXEMPTIONS
This section makes a number of grammatical and conforming corrections.(see footnote 16)

SECTION 16. EXCEPTIONS TO DISCHARGE
This section amends section 523 (a)(15) to make it clear that changes in the 1994 Act which made it more difficult for debtors to use bankruptcy to avoid property settlement obligations made for the benefit of former spouses and children only applies to benefit such persons (*e.g.* it does not also serve to benefit other parties, where for example, the debtor had promised to make payments to a creditor or other party as part of a property settlement).

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The section also clarifies that changes made in the 1996 Rescissions and Appropriations Act(see footnote 17) approved last Congress to limit the dischargeability of fees imposed upon prisoners by court is not construed to cover fines and fees imposed on non-prisoners.

The section also makes a number of additional grammatical and conforming corrections.

SECTION 17. EFFECT OF DISCHARGE

This section makes a technical and conforming correction.
SECTION 18. PROTECTION AGAINST DISCRIMINATORY TREATMENT
This section amends section 525c to clarify that the non-discrimination provisions governing student-loan lenders made in the '94 changes apply only to the granting of student loans, not all loans.
SECTION 19. PROPERTY OF THE ESTATE
This section amends section 541(b)(4) to clarify that so-called oil and gas "production payments" may not be recharacterized in bankruptcy. (A production payment is an interest in oil and gas reserves which has been transferred by the title holder to a purchaser which is not effected by production costs.) Under the 1994 changes to the Bankruptcy Code production payments were generally excluded from the debtor's bankruptcy estates. However, in doing so the term production payment was defined in an unnecessarily narrow manner. Namely it failed to specify that if a production payment in an oil and gas interest was otherwise subject to rejection as an executory contract under section 365 of the Code, it did not qualify for the new exclusion.
SECTION 20. LIMITATIONS ON AVOIDING POWERS

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This section makes a technical and conforming correction.
SECTION 21. LIABILITY OF TRANSFEREE TO AVOIDED TRANSFER
The 1994 Bankruptcy Reform Act included a provision intended to overturn *Levit* v. *Ingersoll Rand Financial Corp*

(In re V.N. DePrizio Construction Co.).(see footnote 18) Under the *DePrizio* decision, bankruptcy trustees were able to recapture payments made to non-insiders creditors a full year prior to bankruptcy (even though the law was designed to allow such recovery only against insiders) if an insider was found to somehow benefit from the transfer. (For example, the payment of a loan which relieved a corporate director from his guaranty could result in the trustee recovering the loan from the non-insider lender). However, in overturning the *DePrizio* decision in 1994 Congress unnecessarily limited the scope of the new exception to transfers voidable under section 547(b), whereas it should have more properly applied to any preference otherwise voidable under section 547. Under this broader construction, for example, a noninsider who benefits from the transfer of a lien, and not just the repayment of a loan was subject to preferential treatment.

SECTION 22. SETOFF

This section makes a technical and conforming correction.

SECTION 23. DISPOSITION OF PROPERTY OF THE ESTATE

This section makes a technical and conforming correction.

SECTION 24. GENERAL PROVISIONS

This section makes a technical and conforming correction.

SECTION 25. APPOINTMENT OF ELECTED TRUSTEE

This section amends section 1104(b) to specify the procedures which apply when a trustee is elected by the creditors in a chapter 11 case. Namely, the section provides that in the event of such an election, the U.S. Trustee is to file a report certifying the election and the services of a trustee previously appointed. The section also provides that any disputes regarding elections are to be resolved by the court.

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SECTION 26. ABANDONMENT OF RAILROAD LINE

This section makes a technical and conforming correction.

SECTION 27. CONTENTS OF PLAN

This section makes a technical and conforming correction.

SECTION 28. PAYMENTS

This section makes a technical and conforming correction.

SECTION 29. DISCHARGE

This section makes a technical and conforming correction.

SECTION 30. CONTENTS OF PLAN

This section makes a technical and conforming correction.

SECTION 31. DISCHARGE

This section makes a technical and conforming correction.

SECTION 32. BANKRUPTCY CASES AND PROCEEDINGS

This section makes a number of technical and conforming corrections.

SECTION 33. BANKRUPTCY REVIEW COMMISSION

This section clarifies the requirements for membership on the Bankruptcy Commission.

SECTION 34. KNOWING DISREGARD OF BANKRUPTCY RULE OR LAW

This section makes a number of technical and conforming corrections.

SECTION 35. EFFECTIVE DATE, APPLICATION OF AMENDMENTS

This section provides that the amendments made by this bill only apply to bankruptcy cases filed on or after the date of enactment.

PREPARED STATEMENT OF HON. BOB GOODLATTE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Mr. Chairman, I appreciate the opportunity to testify before the Subcommittee today on a perhaps minor yet important change to Chapter 11 bankruptcy law.

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The 1995 Balanced Budget Downpayment Act made a change to Chapter 11 bankruptcy law that is minor in scope, yet significant in terms of its cost to debtors. Prior to passage of the Act, during the reorganization phase, a debtor-in-possession was required to pay quarterly fees to the U.S. Trustee while the case was pending, but prior to confirmation of the reorganization plan. The fees ceased upon confirmation of the Plan, because the Trustee's involvement in the case ceased upon confirmation of the Plan.

The 1995 Budget Act changed the law to require that Trustee's quarterly fees continue to be paid until the entry of the Final Decree. This seemingly small change has very large implications. For example, it may take 6 to 9 months to reorganize a company in Chapter 11, but it may take several years to resolve claims, litigate pre-petition disputes, implement the Plan, and wrapup all outstanding issues prior to the entry of the Final Decree. As a result, debtors are now required to pay quarterly Trustee fees well beyond the period during which the Trustees are actually involved in their cases.

To add insult to injury, last year's Omnibus Appropriations bill applied the new requirement to all pending bankruptcy cases, effectively making the law retroactive. With bankruptcy filings having reached an all-time high at over 1 million last year, we are looking at an enormous burden on debtors who are simply struggling to survive.

When considering technical corrections to the bankruptcy law this year, I urge the Subcommittee to consider repealing this onerous law. Businesses struggling to stay alive in Chapter 11 reorganization efforts should not be burdened with additional taxes in the form of quarterly Trustee fees, for which the debtors receive nothing in return.

Quarterly Trustee fees are certainly appropriate during the time that a Trustee is involved in a case--in other words, until confirmation of a reorganization Plan. After the Trustee's involvement has ceased, however; it makes no sense to continue to require businesses to pay quarterly fees.

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Mr. Chairman, thank you for your consideration of my request, and I look forward to working with the Subcommittee to restore equity in our bankruptcy law. I would be happy to answer any questions you may have.

PREPARED STATEMENT OF THE ASSOCIATION OF FINANCIAL GUARANTY INSURORS

Mr. Chairman, the Association of Financial Guaranty Insurors (AFGI), a trade association of financial guaranty insurers,(see footnote 19) appreciates the opportunity to submit testimony to the Subcommittee on suggested revisions to the United States Bankruptcy Code related to asset-backed securities. The proposed amendment, a copy of which is attached to this testimony as Appendix A, would revise subsections (b) and (e) of section 541 as well as section 362(b). A draft commentary on the proposed amendment is attached as Appendix B.

PURPOSE OF PROPOSED BANKRUPTCY AMENDMENT

The proposed bankruptcy amendment eliminates uncertainty under the Bankruptcy Code as it applies to the almost $200 billion per year of asset-backed securities issued in the United States. By eliminating uncertainty, the proposed amendment will insure stability in our capital markets, facilitate asset-backed financings and eliminate risks which otherwise indirectly increase interest rates for millions of consumers. The proposed amendment is constructed to achieve these benefits without impairing any of the reorganization and fairness policies underlying the Bankruptcy Code.

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APPLICATION OF THE PROPOSED AMENDMENT

Currently, there are trillions of dollars of asset-backed securities outstanding in the United States. The typical asset-backed security is sponsored by a company that seeks to raise money through the issuance of securities collateralized by assets ("Securitized Assets") having an ascertainable cash flow or market value (such as mortgage loans, credit card receivables, automobile loans, bank loans, etc.). The company will typically transfer the Securitized Assets to a "bankruptcy remote entity." In turn, the bankruptcy remote entity will typically issue debt or other securities--the asset-backed securities--collateralized by the Securitized Assets. All or a portion of the proceeds from the sale of the asset-backed securities are used by the bankruptcy remote entity to pay the operating company for the Securitized Assets that were transferred to the entity. The bankruptcy remote entity is restricted to doing no business other than holding the Securitized Assets that collateralize the asset-backed securities and other activities ancillary to the asset backed securities.

Generally, the cash flow or other proceeds generated by the Securitized Assets are sufficient to pay the amounts due on the asset-backed securities. In certain instances, credit enhancement is provided by third parties, including members of AFGI, guaranteeing the timely payment of amounts due to the holders of the asset-backed securities.

Under current law, uncertainty can arise when the transfer of the Securitized Assets by the operating company to the bankruptcy remote entity is deemed to be something other than a sale. If the transfer is not a sale and if the operating company seeks relief under Chapter 11 of the Bankruptcy Code, the Securitized Assets purported to have been transferred to the bankruptcy remote entity may be included in the operating company's bankruptcy estate. In that event, the cash flow or other proceeds generated by the Securitized Assets (i) would be subject to the automatic stay provision of the Bankruptcy Code and would not be available to pay the holders of the asset-backed securities until relief was obtained from the automatic stay and (ii) may be subject to cramdown or collateral substitution that would further impair cash coverage on the asset-backed securities.

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Any interruption or impairment of the cash flow or proceeds resulting from the application of the automatic stay, cramdown or collateral substitution, impairs the market value of the asset-backed securities and, in the case of insured asset-backed securities, requires the insurer of these securities to pay the amounts due the holders thereof.

THE PROPOSED AMENDMENT

In order to address the situation in which the operating company commences a Chapter 11 case under the Bankruptcy Code, the proposed amendment prevents the Securitized Assets transferred to the bankruptcy remote entity from being included in the operating company's bankruptcy estate. This enables the bankruptcy remote entity to continue using the cash flow or other proceeds from the Securitized Assets to make payments to the holders of the asset-backed securities. To the extent, if any, that the bankruptcy remote entity owes any amount to the operating company, that obligation remains valid and the operating company can obtain payment of that amount in accordance with its original terms.

The proposed amendment is limited in its application to preventing the Securitized Assets transferred by the operating company to the bankruptcy remote entity from being included in the company's bankruptcy estate. Thus, the proposed amendment eliminates any possibility that it will impair the reorganization of an entity that operates a business. Furthermore, the proposed amendment is limited to transactions involving the issuance of investment-grade securities, since a primary purpose of the amendment is to protect the legitimate expectations of investors in asset-backed securities sold in the capital markets. In addition, as explained in greater detail in the draft commentary at Appendix B, limiting the application of the proposed amendment to investment grade securities substantially reduces, if not eliminates, the possibility that an operating company could transfer its Securitized Assets to a bankruptcy remote entity in an effort to defraud creditors of the company.

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AFGI and its member companies look forward to working with you, Mr. Chairman, and the Members of staff of your Subcommittee, in developing a solution that will provide certainty to the asset-backed securities market, a solution that will ensure stability in our capital markets and facilitate asset-backed financings, which will in turn enhance liquidity in the secondary market and provide an efficient funding source for mortgage loans, credit card accounts, automobile loans and other consumer loans.

APPENDIX A.--PROPOSED AMENDMENT TO 541 of the Bankruptcy Code

Add a new subparagraph (5) to 541(b) of the Bankruptcy Code as follows:

(5) any eligible asset (or proceeds thereof) to the extent that such eligible asset was transferred by the debtor, before the date of commencement of the case, to an eligible entity in connection with an asset-backed securitization.

Add a new paragraph (c) to 541 of the Bankruptcy Code as follows:

(e) For purposes of this section----
(1) "asset-backed securitization" means a transaction in which eligible assets transferred to an eligible entity are used to back securities, the most senior of which arc rated investment grade by a nationally recognized securities rating agency, issued by an issuer;
(2) "eligible assets" means (a) financial assets (including interests therein and proceeds thereof), either fixed or revolving, including, without limitation, loans, consumer receivables, trade receivables and lease receivables, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security-holders, (b) cash and (c) securities;

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(3) "eligible entity" means (a) an issuer or (b) a trust, corporation or other entity engaged exclusively in the business of acquiring and transferring eligible assets directly or indirectly to an issuer and taking actions ancillary thereto;
(4) "issuer" means a trust, corporation or other entity engaged exclusively in the business of acquiring and holding eligible assets, issuing securities backed by eligible assets and taking actions ancillary thereto; and
(5) "transferred" means the debtor, pursuant to a written agreement, represented and warranted that such eligible assets were sold, contributed or otherwise conveyed with the intention of removing them from the debtor's estate pursuant to section 541(b)(5) of this title, irrespective, without limitation, of (a) whether the debtor directly or indirectly obtained or held an interest in the issuer or in any securities issued by the issuer, (b) whether the debtor had an obligation to repurchase, or to service or supervise the servicing of, all or any portion of such eligible assets and (c) the characterization of such sale, contribution or other conveyance for tax or accounting purposes.
PROPOSED AMENDMENT TO 362(b) of the Bankruptcy Code

To conform 362 to the proposed amendment to 541 of the Bankruptcy Code, add a new subsection to 362(b) as follows:

(17) under subsection (a) of this section, of the enforcement of any rights or remedies with respect to any eligible asset excluded from property of the estate pursuant to section 541(b)(5) of this title.

APPENDIX B.--PROPOSED AMENDMENTS TO SECTIONS 541 and 362(b) of the Bankruptcy Code (Structured Finance Exemption)

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EXPLANATION
The purpose of the proposed amendments to the Bankruptcy Code is to provide certainty and uniformity of treatment for asset securitizations under the Bankruptcy Code.
Asset securitization involves the issuance of securities backed by pools of assets having an ascertainable cash flow or market value. Asset securitization started in the 1970's with the securitization of mortgages into mortgage-backed securities, and has expanded into various other asset types, including credit card receivables and car loans. In 1996, approximately $38.4 billion of private label (non-government sponsored) residential mortgage backed securities were offered in U.S. public and private markets and approximately $151.1 billion of other asset-backed securities, including transactions backed by credit card and auto receivables, were offered in U.S. public markets. The foregoing numbers exclude the multi-billion dollar markets in asset-backed commercial paper and in private non-mortgage-backed asset-backed securities. Securitization of consumer receivables, such as mortgages, car loans and credit card receivables, allows for the funding of consumer loans from capital market sources. The increased efficiency of such financings has historically resulted in lower consumer interest rates.
Asset-backed securities are typically issued by entities restricted by their organizational instruments and by contract from operating any business other than the acquisition of the underlying assets and the issuance of securities backed by such assets. The rating agencies rating the asset-backed securities, the underwriters of the securities and investors require opinions of law firms involved in the securitization confirming that the bankruptcy of the sponsor or seller will

not interfere with the ability of the issuer to make timely payments on the asset-backed securities. The lack of either clear judicial precedent or statutory provisions respecting the availability of cash-flows and proceeds from the underlying assets for payment of the asset-backed securities leave those arrangements open to challenge, with potentially disastrous consequences for the multi-billion dollar market. The proposed amendments are intended to protect outstanding asset-backed transactions from disruption and to allow for the further development of structured finance.

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The proposed amendments are also intended to eliminate legal opinion impediments to he completion of new asset-backed securitizations in the face of uncertainties of state law and differing treatments for tax or accounting purposes. Receipt of a "true sale" opinion, concluding that, in the event of the bankruptcy of the seller of the securitized assets, such assets would not be part of the seller's bankruptcy estate and the proceeds from such assets would continue to be available to pay the asset-backed securities without interruption, is required for the completion of the typical asset-backed securitization. The lack of judicial precedent and statutory provisions in this area have led to the refusal by some law firms to render true sale opinions for certain otherwise viable asset securitization transactions. In particular, securitizations of subprime (low quality) mortgage, auto and other consumer loans typically require high levels of subordination or other credit enhancement in order to obtain an investment grade rating. Some law firms have questioned whether retention of a large subordinated interest by the seller of the securitized assets constitutes "recourse" to the seller that is inconsistent with a true sale of assets. A few law firms have categorically concluded that retention of a subordinated interest in excess of 10% (regardless of asset quality or historical asset performance) is inconsistent with a true sale. By denying the outlet of securitization to low quality loans, such true sale analysis indirectly results in increased costs for consumer financing for those who can afford it least.

Developments in the law that would initially seem unrelated to asset securitization can, in the absence of specific legislation such as that proposed, damage the asset-backed securities market. For example, in 1993, the Tenth Circuit Court of Appeals in *Octagon Gas Systems, Inc.* v. *Rimmer* concluded that a seller of accounts receivable retained a property interest in the accounts that subjected them to the provisions of the automatic stay. For a period of time, this ruling created turmoil in the asset-backed securitization market,(see footnote 20) and Standard & Poor's rated such transactions in the Tenth Circuit (Colorado, Kansas, New Mexico, Oklahoma, Utah and Wyoming) only when the seller of the receivables was already investment grade. While subsequent events have substantially diminished the impact of the *Octagon* decision,(see footnote 21) it remains an example of the vulnerability of the multi-billion dollar securitization industry to legal uncertainties in this area.

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The proposed amendments resolve these uncertainties by excluding the securitized assets from the debtor's estate for purposes of the Bankruptcy Code rather than by declaring that the issuer "owns" such assets (i.e., that a "true sale" has occurred), since employing the Bankruptcy Code to determine ownership of assets might raise constitutional questions. The United States Supreme Court has ruled that state law ordinarily defines property rights in bankruptcy cases. *Butner* v. *U.S.*, 440 U.S. 48 (1979). Therefore, if section 541(b)(5) purported to override a state law determination that the operating company retained ownership of the securitized assets, the section might not withstand a constitutional challenge.

Section 541(b)(5) is not intended to override state law requirements, if any, regarding "perfection" of an asset sale. However, regardless of strict compliance with such state law requirements, section 541(b)(5) is intended to provide an absolute exclusion of the debtor's interest in eligible assets (and proceeds thereof) from the debtor's estate, upon compliance with section 541(b)(5). Thus, despite an eligible entity's failure to have properly perfected a sale for state law purposes, the eligible assets in question would remain excluded from the debtor's estate. In such event, however, a third party creditor with an interest in such eligible assets under state law would not be precluded from asserting, outside of the bankruptcy proceedings, such interest against the issuer or any other party purporting to have an interest in those assets. In other words, the amendments do not purport to extinguish any party's interest in the securitized assets other than the debtor's interest to the extent transferred by the debtor to the securitization vehicle. In order to provide certainty to participants in the asset-backed securities market (including both issuers and purchasers of such securities), it is noted that the "strong-arm" provisions of section 544 are not intended to override the general rule set forth in section 541(b)(5) so as to bring such assets back into the debtor's estate.

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The proposed amendments are designed to provide clear, uniform and fair standards for the securitization of assets, eliminating much of the current uncertainty and allowing for more efficient securitizations. The amendments' operation is restricted to assets typically involved in securitizations ("eligible assets")--essentially, financial assets that convert into cash within a finite time period--transferred in accordance with the clear-cut criteria established in the proposed amendments, which are designed to protect both the transferor's creditors and the purchasers of the asset-backed securities. Thus, the amendments would not affect the reorganization of operating companies, while they would provide significant benefits for the asset-backed securities market, and ultimately for consumers.

Section 541(b), as amended, operates as follows:

Section 541(b)(5) is the operative provision. It excludes from the property of a debtor's estate any eligible asset (and proceeds thereof) to the extent that such eligible asset was transferred by the debtor, before the date of commencement of the case, to an eligible entity in connection with an asset-backed securitization. The four key elements necessary to qualify for the exclusion are established in this provision, namely: (1) asset type ("eligible assets"), (2) manner of conveyance (the assets must be "transferred"), (3) nature of the transferee (an "eligible entity") and (4) purpose of the transfer (it must be in connection with an "asset-backed securitization"). The phrase "to the extent" makes clear that a portion of the eligible asset may remain part of the debtor's estate, for example, where the right to receive, for example, only interest payments or the first 10% of payments due on a receivable, is transferred to an eligible entity in connection with an asset-backed securitization.

Section 541(e) provides the definitions for each element necessary to qualify for the exclusion provided by section 541(b)(5).

Section 541(e)(1) defines "asset-backed securitization." The purpose of including the definition is to make clear that the eligible assets cannot simply be transferred to an eligible entity; they must be so transferred in connection with a transaction whereby the eligible assets are used to back securities issued by an issuer. The assets can be used either as collateral for such securities--which is the case in "pay-through" transactions--or as ownership interests represented by such securities--which is the case in "pass-through" transactions, where typically certificate-holders have an undivided ownership interest in such assets.

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Frequently, asset securitizations involve the issuance of more than one class of securities with differing payment speeds, subordination provisions and other characteristics. The definition of "asset-backed securitization" contained in Section 541(e)(1) requires that the most senior asset-backed securities backed by the eligible assets in question be investment grade, thereby requiring that each asset-backed securitization as to which eligible assets are excluded from the debtor's estate be a carefully reviewed transaction subjected to third party scrutiny by a recognized securities rating agency. In view of the cost, time and other burdens associated with obtaining an investment grade securities rating, this provision substantially eliminates potential use of the proposed amendment for sham transactions and ensures its application for its intended purpose, to preserve payments on securities issued in the public and private markets.

Section 541(e)(2) defines "eligible asset." This definition is based upon that provided in Rule 3a—7 under the Investment Company Act of 1940, which provides an exemption from registration under the Investment Company Act for issuers of asset-backed securities (*i.e.*, issuers in the business of purchasing, or otherwise acquiring, and holding eligible assets). The phrase "or other assets" is intended to cover assets often conveyed in connection with securitization transactions such as swaps, hedge agreements, etc., provided as additional credit support. The inclusion of cash and securities as eligible assets allows so-called market-value based securitizations of equity and other non-amortizing securities to fall within the purview of the amendment, although securitizations of such securities are not included under Rule 3a—7 and therefore would be subject to regulation under the Investment Company Act if another exemption therefrom were not available.

Sections 541(e)(3) and (4) define "eligible entity" and "issuer." The definitions exclude operating companies by encompassing only single purpose entities. Because securitization transactions often involve intermediary transferees, an eligible entity can be either an issuer or an entity engaged exclusively in the business of acquiring and transferring eligible assets directly or indirectly to an issuer.

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Section 541(e)(5) defines "transferred." In order for the eligible assets to be excluded from the debtor's estate under section 541(b)(5), the debtor must represent and warrant in a written agreement that such eligible assets were sold, contributed or otherwise conveyed with the intention of removing them from the debtor's estate pursuant to section 541(b)(5). The definition makes clear that the debtor's written intention as to the exclusion of the eligible assets will be honored, regardless of the state law characterization of the transfer as a sale, contribution or other conveyance, and regardless of any other aspect of the transaction (such as the debtor's holding an interest in the issuer or any securities issued by the issuer; the ongoing servicing obligation of the debtor; the tax and accounting characterization; or any recourse to the debtor, whether relating to a breach of a representation, warranty or covenant, or otherwise) which may affect a state law analysis as to the true sale.

Section 362(b)(17) makes clear that the automatic stay does not apply to the eligible assets underlying an asset-backed security that are not property of the estate due to the operation of the proposed amendment to section 541. Thus, the proceeds from such assets may continue to be used to service debt as intended, without interruption, even in the event of the bankruptcy of the seller of the assets, without attempting to preempt state law on issues of "true sale."

PREPARED STATEMENT OF THE CONSUMER MORTGAGE COALITION

Mr. Chairman, the Consumer Mortgage Coalition (CMC), a trade association representing national mortgage providers, appreciates the opportunity to submit testimony to the Subcommittee on possible revisions to the United States Bankruptcy Code (the "Bankruptcy Code") related to residential mortgage loans.

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THE BANKRUPTCY CRIB

The CMC believes it is imperative to reverse the acceleration in personal bankruptcy filings, which have exceeded one million in 1996, an all time high.

Attached to this testimony is a case history (Appendix A) which illustrates the reason mortgage lenders are so concerned about bankruptcy abuse. In this case, the borrower was able to delay foreclosure for more than a year through the simple technique of repeatedly conveying a partial interest in the mortgaged property to a third party, who then filed for bankruptcy under Chapter 7. The filing by the third party triggered the automatic stay, delaying foreclosure on the property by two to three months for each filing. When the judge dismissed each Chapter 7, the borrower simply found another transferee to whom a partial interest could be conveyed.

In this case example, the borrower was able to obtain nine separate delays of the foreclosure sale, using five different transferees. The lender was finally able to obtain relief from the automatic stay by presenting evidence demonstrating to the court that the addresses--and even the existence--of the transferee could not be verified. Even after the court granted the motion for relief, the borrower again attempted the same technique, transferring a fractional interest to yet another third party who immediately filed under Chapter 7. As discussed in more detail later, abuses of this type ultimately raise costs for the overwhelming majority of creditworthy borrowers.

The increase in bankruptcies is of particular concern because it is occurring during a time of economic growth. In the past, the bankruptcy rate reflected either a general deterioration in the economy, or problems in particular regional or economic sectors. For example, filings grew in the 1980's in response to the collapse of several major real estate markets, high unemployment in some regions, the decline in manufacturing, and instability in interest rates. By contrast, there is no identifiable economic cause of the current acceleration in filings. This suggests that the significant over-liberalization of the Bankruptcy Code in 1978 has contributed to a significant increase in the filing rate.

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CMC acknowledges the potential social benefit in providing relief for borrowers who are unable to pay their debts because of legitimate, unforeseen circumstances. At the same time, it must be recognized that the effect of bankruptcy on home mortgage lenders ("bankruptcy severity") ultimately affects the cost of mortgage loans, credit availability, or both. In making pricing and underwriting decisions, mortgage lenders consider the frequency of bankruptcy filings, the delays caused by such filings, the amount of debt recovered in bankruptcy, and the legal fees and other transaction costs involved. Delays are of particular concern to mortgage lenders because they lead to deterioration of the residence securing the mortgage loan, which is being maintained by borrowers with little or no stake in the condition of the property. While payment is delayed, the mortgage servicer must continue to make principal and interest payments to the ultimate investor/noteholder. Although the investor/noteholder may occasionally be reimbursed for some of these costs by a mortgage insurer, the insurer must recapture those expenses through higher mortgage insurance premiums--which must be paid by other consumers.

These concerns are particularly acute in the context of Chapter 13 of the Bankruptcy Code. The purpose of Chapter 13, reflected in its nickname, the "wage earned' bankruptcy, is to allow a debtor with a steady source of income to restructure his or her debts and move forward. Chapter 13 is designed to avoid the devastating effects of Chapter 7 liquidation on either the debtor or the lender. If this goal were fully realized debtors, lenders, and other borrowers would all benefit. Weaknesses in the Bankruptcy Code, however, have prevented Chapter 13 from realizing its potential as a less dramatic alternative to complete liquidation.

Any changes in the bankruptcy system that decrease bankruptcy severity will ultimately reduce the cost of home mortgages to the general public and will benefit creditworthy consumers who are seeking home mortgage financing. This testimony addresses areas where CMC believes that bankruptcy severity can be reduced in a way that is consistent with the goals of the bankruptcy system and the intent of Congress. We first discuss the "basic bankruptcy" concept raised by Professor Warren, the Reporter to the National Bankruptcy Review Commission (NBRC), and then address several issues that we believe must be resolved regardless of whether the basic bankruptcy concept is adopted.

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BASIC BANKRUPTCY

Professor Warren's basic bankruptcy proposal is based on four central concepts. First, all consumer debtors and creditors would be processed in a single, unified system. The distinction between Chapter 7 and Chapter 13 would be abolished. Second, options such as working out a delinquent home mortgage loan would no longer be linked to other features of the Bankruptcy Code, such as the automatic stay.

Third, a debtor would have single opportunity to file and receive a quick discharge if the debtor had not abused the system. The Bankruptcy Code would bar repeated filings simply to obtain an automatic stay, as in the case described earlier. Fourth, a sample of debtors would be audited, much as in the tax system.

CMC believes that bankruptcy should be standardized to reflect the increasingly nationwide scope of the consumer credit market. We also support efforts to reduce the overall number of filings, to ensure that consumers pay their debts through a restructuring where possible, and to prevent abuses such as repeated filings simply to take advantage of the automatic stay.

CMC is, however, concerned that the basic bankruptcy proposal would reopen issues that have been discussed and settled in past legislative reform efforts. Moreover, a radical change in the bankruptcy system, as envisioned by the basic bankruptcy concept, could have unintended and, potentially, negative effects on the mortgage loan market. For example, the "cramdown" or "lien-stripping" issue is of major consequence to mortgage lenders. As we will discuss in detail later, recent court decisions have called into question the effectiveness of the Bankruptcy Code's anti-cramdown provisions. Professor Warren's memorandum on basic bankruptcy suggests that a possible resolution would be to eliminate any restrictions on cramdowns, rather than to clarify the Congressional intent that standard residential mortgages are protected from cramdowns.

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Although the cramdown issue is of the greatest immediate concern to our industry, it appears that many other questions would also be reopened, such as the mechanism (if any) for reaffirming a debt and the treatment of taxes.

INCREASE INCENTIVES FOR CHAPTER 13 FILINGS AND FOR COMPLETION OF PLAN

The 1994 Reform Act attempted to increase debtors' use of Chapter 13 "wageearner" workouts, as opposed to Chapter 7 liquidations, by raising the dollar threshold for a Chapter 13 filing and requiring the Bankruptcy Judge to explain the consequences of a Chapter 7 bankruptcy to the debtor. Debtors still have, however, the option of filing for a Chapter 7, even when they have sufficient income to restructure their debts under a Chapter 13, and many find a Chapter 7 filing an attractive alternative--especially since it is often easier to get credit with a Chapter 7 on the debtor's record than with an ongoing Chapter 13. As we have noted, CMC believes that this situation defeats the purpose of Chapter 13.

To make Chapter 13 more attractive, credit reporting periods for Chapter 13 plans could be shortened from the present ten years (which also applies to other bankruptcies)--perhaps to a maximum of five years after filing or six months after completion of the plan. Chapter 13 trustees should be required to make interim disbursements if the plan is not confirmed within a specified period, perhaps three months. This would be consistent with the intent of the "wage earner" bankruptcy statute, and would decrease bankruptcy severity for lenders.

One of the advantages of Chapter 13 to both homeowners and mortgage lenders is that the lien on the residence is not affected by the plan. This not only protects the lender, it also allows the homeowner to keep the home.

As noted below, however, several recent court cases of held that a lien on a residence is subject to cramdown in certain circumstances. A cramdown can negatively impact the lender's secured claim. In a cramdown, the secured claim is reduced to the amount of the lien that does not exceed the market value of the property. The rest of the claim is considered unsecured, which reduces or eliminates its value.

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In addition, the lender's remaining security interest under a cramdown is subject to restructuring as a secured claim in the Chapter 13 plan, which can dramatically reduce its value. There have been cases, for example, in which a conventional mortgage loan with equal monthly payments to maturity was converted into one with small monthly payments and a large balloon payment--which the borrower could not realistically be expected to be able to pay.

The United States Supreme Court in *Nobleman* v. *American Savings Bank, 61 LW 4531 (SpCt 1993)* disallowed cramdowns on residential mortgage loans involving the debtor's principal residence under a Chapter 13 proceeding. However, courts, such as the Third Circuit Court of Appeals in *Hammond* v. *Commonwealth Mortgage Corporation of America, 27 F.3d 52 (3d Cir. 1994)* have subsequently narrowed the reach of the *Nobleman* case so that it does not apply to the standard Fannie Mae/Freddie Mac loan agreement--which is also widely used by non-conforming mortgage lenders. Those courts have held that because the mortgage lien on the residence contained language creating a security interest in fixtures, rents, escrow balances and the like, the mortgage lien was no longer entitled to protection from cramdowns and restructurings. The practical effect of these decisions has been to nullify the anti-modification provisions in the Bankruptcy Code as enacted by the Congress and interpreted by the U.S. Supreme Court in *Nobleman* for the overwhelming majority of mortgages.

The problem created by these court cases could be cured by revising the Bankruptcy Code to make it clear that mortgage loans, including the standard Fannie Mae/Freddie Mac loans, continue to obtain the benefit of the anti-cramdown provision, even though they take a security interest in fixtures, rents, escrow accounts, and other related items, as well as the principal residence. Other cramdown issues include clarifying that the anti-cramdown provisions of the Bankruptcy Code apply if the home was, or was intended to be, the debtor's primary residence either at filing or when the mortgage was granted, and applying the anti-cramdown rules to 1—4 family owneroccupied property. Currently, borrowers often successfully attempt to take advantage of a cramdown by temporarily moving out of their homes just before filing petition and claiming that the property is not their principal residence. Borrowers then move back in after the court determines that the property is not the their principal residence. This type of abuse imposes significant costs on home mortgage lenders, which may ultimately be passed on to consumers.

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There are a number of reasons for according home mortgage loans protection from the cramdown and restructuring provisions of Chapter 13.
Protecting home mortgages against modification encourages lenders to make higher loan-to-value loans and to lend to borrowers to whom they might otherwise not lend to at all. This in turn makes possible wider home ownership consistent with the national policy evidenced by tax benefits favoring home ownership and government-sponsored mortgage insurance.
The anti-modification provisions protect and support the secondary market in home mortgages. The existence of the secondary market in turn encourages mortgage origination by providing greater access to capital with which to fund mortgage loans. No other type of collateral supports a secondary market of comparable importance.

If a debtor is permitted to cramdown a mortgage loan to the current market value of a residence securing the loan, he will be able to take advantage of a temporary decline in the value of his home to reduce the mortgage lender's secured claim. If the residence later increases in value, the debtor rather than the lender will get the benefit of the appreciation. This problem is not particularly serious in the case of other consumer collateral (such as automobiles or appliances) since those types of collateral depreciate in value over time. It is a serious problem (and a temptation to the debtor) in the case of a home mortgage, since a home often fluctuates in value over the life of a mortgage loan.

Since the procedures provided by real estate law for foreclosing on a home mortgage are typically more formal, more cumbersome and provide greater protection to borrowers (e.g., through rights of redemption) than is the case with other types of consumer collateral, the debtor's need for the ability to cramdown a mortgage loan is less and the prejudice to the mortgage lender from taking away protection from cramdowns and restructurings, when combined with the greater limitations on the mortgage lender's ability to foreclose is greater.

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PENALIZE REPEATED, FRIVOLOUS FILINGS AND OTHER ABUSES

There are a number of abuses of the bankruptcy process that prevent lenders from foreclosing, even when the borrower is clearly unable to pay the mortgage debt. For example, the debtor may file a Chapter 13 petition, never make a single payment under any plan, voluntarily dismiss the case just before the hearing on the lender's motion to lift the automatic stay--and then file another petition within six months just before the next foreclosure sale. Alternatively, the case may be dismissed involuntarily because confirmation requirements cannot be met. Although these practices should subject the debtor to sanctions, the penalties in the current Bankruptcy Code are difficult to enforce.

Solutions to filing abuse include mandatory sanctions such as requiring the debtor to pay the lender's attorneys' fees, court costs, and lost opportunity costs, and dismissing the petition with prejudice. Once the petition is dismissed, whether voluntary or involuntary, the debtor should not be able to file a new petition without showing that such repetitive filing is justified by a significant change in circumstances and should have to meet a high standard for showing that he will be able to confirm and perform a plan. The burden should be on the debtor to make the required showing and overcome a presumption that repetitive filings are an abuse of the bankruptcy process. In general, the concept of dismissal for substantial abuse which today applies in narrow circumstances in Chapter 7 should not only be broadened but should apply to repetitive filings in Chapter 13. Any party-in-interest, including a secured lender, should be able to move to dismiss a petition for substantial abuse. Moreover, the automatic stay of legal actions, such as foreclosure, could be made inapplicable to subsequent filings. Also, Chapters 11 and 13 should be subject to the same 6-year rule.

The Bankruptcy Code should make it clear that a workout or forbearance agreement with a secured lender can include an effective waiver of the protection of the automatic stay in a future bankruptcy proceeding. Waivers should be given effect whether they are made by the debtor, the debtor-in-possession, or the trustee. This clarification should limit repetitive bankruptcies both by encouraging lenders to implement workout or forbearance arrangements as an alternative to bankruptcy and by discouraging the debtor from filing a bankruptcy simply in order to get the benefit of the automatic stay.

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OTHER ISSUES

While protection from cramdowns and the abuse of the filing system are the most significant bankruptcy issues faced by mortgage lenders, there are several other issues that should also be considered.

Under current Chapter 13, bankruptcy trustees often do not dismiss the case even when the borrower has completely stopped paying. The burden is then on the lender to move for dismissal, which causes delays and increases the lender's costs. The Bankruptcy Code should be amended to automatically reinstate the contract terms of a mortgage loan as of the petition date without further court approval if a borrower in a Chapter 13 plan misses a payment by more than a specified period (such as thirty days). In addition, the automatic stay should automatically lift at the end of the period to allow the lender to foreclose unless the debtor brings current the full amount due under the original contract. Any past due amounts should be assessed interest at the rate of the underlying mortgage loan, and should be due in a specified period such as two years.

Although it is designed for corporate liquidations, Chapter 11 is currently available to individuals as well. Many legislative attempts to correct problems in Chapter 13 have not affected Chapter 11, leading some debtors to view Chapter 11 as a more "debtor-friendly" alternative. Also, Chapter 11 does not impose a time limit on filing a plan, only an exclusivity period of four months during which the debtor has the exclusive right to file a plan, and this four month period is routinely extended by the courts.

This loophole could be closed by denying Chapter 11 eligibility to individuals, other than those who are engaged in business. Alternatively, a 3 to 4 month time limit could be placed on filing a plan in Chapter 11 cases for individuals not engaged in business. Again, if a plan is not filed, the automatic stay should automatically be lifted.

CONCLUSION

CMC is very appreciative of the opportunity to present our views on issues of critical importance to the home mortgage industry and to all American homeowners. We look forward to continuing to work with this Subcommittee and the full Committee as you work through the recommendations of the National Bankruptcy Review Commission and develop legislation to implement those recommendations.

APPENDIX

3/30/95--File referred for foreclosure department; foreclosure sale set for 8/10/95.
7/10/95--Quitclaim deed by Borrower granting 1/4 interest of the property to Transferee A.
7/12/95--Transferee A files Chapter 7; foreclosure sale postponed until 10/10/95.
9/10/95--Quitclaim deed by Borrower granting 1/10 interest to Transferee B.
9/12/95--Transferee A's bankruptcy dismissed.
9/18/95--Transferee B Files Chapter 7; foreclosure sale postponed until 12/12/95.
12/1/95--Quitclaim deed by Borrower granting 1/10 interest in property to Transferee C.
12/28/95--Stay terminated in Transferee B's bankruptcy; foreclosure postponed until 3/12/96.
2/23/96--Transferee C files Chapter 7; foreclosure sale postponed until 5/14/96.
5/2/96--Stay terminated in Transferee C's bankruptcy case.
5/4/96--Quitclaim deed by Borrower conveying 1/10 interest in property to Transferee D.
5/13/96--Foreclosure delayed until 5/21/96.

5/13/96--Transferee D files Chapter 7; foreclosure sale postponed until 7/23/96.
7/3/96--Transferee D's bankruptcy dismissed.
7/10/96--Transferee E files Chapter 7.
7/23/96--Quitclaim deed by Borrower conveying 1/10 interest to Transferee E; foreclosure sale set for 8/2/96.
8/1/96--Foreclosure sale postponed until 9/3/96.
8/8/96--Hearing held on motion for relief, court orders that "the stay against enforcement of the foreclosure and possessor rights is terminated so as to allow the foreclosure trustee to conduct the foreclosure." The judge granted this order because outside counsel researched the prior debtors and could not verify that they were real persons nor could he verify their addresses. Certain conditions must be met at the same and the sale has to be ratified by the bankruptcy court.
9/3/96--Quitclaim deed from Borrower conveying 1/10 interest to Transferee F.
9/3/96--Transferee F files Chapter 7; foreclosure sale postponed until 9/10/96.
9/6/96--Transferee E's bankruptcy dismissed.

National Multi Housing Council

and National Apartment Association,
Washington, DC, May 5, 1997.
Hon. **GEORGE GEKAS,**
Chairman, House Commercial and Administrative Law Subcommittee,
Washington, DC.

DEAR CHAIRMAN GEKAS: I am writing to you on behalf of the National Multi Housing Council (NMHC) and the National Apartment Association (NAA). On April 30, 1997 the Commercial and Administrative Law Subcommittee held a hearing to discuss two bankruptcy reform measures currently pending in the U.S. House of Representatives--H.R. 120 and H.R. 764. We ask that you include the enclosed testimony in the record for that hearing.

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The enclosed testimony was submitted by NMHC/NAA to the National Bankruptcy Review Commission (NBRC) on November 30, 1995. NMHC/NAA have been advocating that the NBRC recommend in its final report to Congress the closing of a loophole in the U.S. Bankruptcy Code which has allowed residents to simply file for bankruptcy in order to delay evictions and live in an apartment rent-free. Also enclosed is a list of organizations supporting this effort.

We believe mat many Commissioners of NBRC agree with us on the need to address this problem and we urge you to take the next step by seriously considering the enclosed preferred draft language amending the U.S. Bankruptcy Code for inclusion in both H.R. 120 and H.R. 764. This is a very important issue for bankruptcy courts who are already inundated with bankruptcy filings; housing providers who must bear the cost and time of pursuing "relief of stay" orders and lost rent; and residents who may be impacted by residents who are filing for bankruptcy with the sole intent of living in an apartment rent-free.

Thank you again for including the enclosed testimony in the record for the hearing and considering the enclosed preferred draft language for inclusion in H.R. 120 and H.R. 764. Please do not hesitate to contact me if you have any questions.

Sincerely,
CLARINE NARDI RIDDLE.

Enclosure.

PREPARED STATEMENT OF THE NATIONAL MULTI HOUSING COUNCIL AND THE NATIONAL APARTMENT ASSOCIATION BEFORE THE NATIONAL BANKRUPTCY REVIEW COMMISSION, NOVEMBER 30, 1995

Chairman Mike Synar and Members of the Commission: the National Multi Housing Council (NMHC) and the National Apartment Association (NAA) appreciate the opportunity to submit written testimony regarding your review of Title 11 of the United States Code, commonly known as the United States Bankruptcy Code.

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NMHC and NAA represent the preponderance of the nation's firms participating in the multifamily rental housing industry. Our combined memberships are engaged in all aspects of the development and operation of multifamily housing, including ownership, construction, finance, and management of rental properties. NMHC and NAA are dedicated to providing clean, safe, affordable living for millions of Americans.

NMHC represents the interests of the larger firms in the multifamily rental housing industry. NAA is the largest industry-wide, nonprofit trade association devoted solely to the needs of the apartment industry. NAA is a federation of local and state associations concerned with governmental decisions at the federal, state, and local levels.

There are approximately 15 million multifamily units, defined as part of a complex of five or more units, in the U.S. A study by Regis J. Sheehan & Associates for the U.S. Departments of Labor, Commerce, and Housing and Urban Development revealed that in 1993 the "rental housing industry's contribution to the Gross Domestic Product was about $153.2 billion dollars representing 2.3% of our economy." In normal economic times, rental housing is the fifth largest contributor to the U.S. economy.

BACKGROUND

As you well know, the U.S. Bankruptcy Code was enacted to provide relief for creditors and debtors in cases where a debtor is unable to pay his or her debts. The discharge of debts gives debtors a "fresh start," a goal properly sought by debtors who file bankruptcy in good faith. We believe that the U.S. Bankruptcy Code has worked reasonably well over the years in assuring that creditors and debtors are treated fairly and impartially. This is evident, in part, given that the U.S. Bankruptcy Code has undergone few major revisions since its enactment in 1898. We believe, however, that the fairness and impartiality fostered by the U.S. Bankruptcy Code is now being threatened and abused.

Under federal bankruptcy law, once a bankruptcy petition is filed all action against the debtor (tenant) or the debtor's estate (arguably the apartment) is "stayed" (held in abeyance) pending a bankruptcy court "relief from stay" order. This "stay" provision has allowed tenants, who are no longer legally entitled to possession of apartment premises, to delay actual physical evictions for months by simply filing a bankruptcy petition. All of this occurs notwithstanding the owner's possession of a state court judgment (the jurisdiction for determining property rights) declaring that the tenant has "no interest in the owner's property" (i.e. nothing to take to bankruptcy court to protect). The closing of this loophole could eliminate millions of dollars of recurring annual losses in time and money both by property owners and by the federal bankruptcy courts.

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Additionally, we have witnessed, in California in particular, the birth of a cottage industry of attorneys and paralegals who are blatantly abusing the bankruptcy court system for their own profit. Known collectively as "bankruptcy mills," these attorneys and paralegals are defrauding owners, tenants, and the judicial system of time and money by utilizing this loophole in the U.S. Bankruptcy Code to restrict an owner from regaining timely possession of premises that are wrongfully being held by a tenant who has no rights to possession.

Generally if a tenant fails to pay his or her rent, an owner will serve the tenant with a notice requesting the tenant to vacate the leased premises. If the resident fails to rectify the situation, the owner will usually go to state court to secure a "judgment of possession," which allows an owner to take legally authorized steps to have the tenant and his or her possessions removed from the premises. Under state law, the actual removal, however, is usually implemented by a local sheriff or marshal.

"Bankruptcy mills," however, have circumvented this process by soliciting tenants who are facing evictions with flyers, phone calls, and door-to-door canvassing and by promising them that for a fee, usually ranging from $20 to $200, these attorneys and paralegals can delay an eviction and allow the tenant to retain possession of a leased premises without paying rent. (See "Attachment A" for illustrative advertisements and solicitation forms for these services and relevant news articles.) A "bankruptcy mill" fulfills its promise by filing a "bare bones" bankruptcy petition on behalf of a tenant. These "bare bones" petitions are filed either before or during the pendency of a state court eviction proceeding or after a "judgment of possession" is granted to an owner. By the filing of the bankruptcy petition, the "stay" provision, as discussed above, is activated. Its effect is to restrain the owner from taking steps to regain rightful possession of the premises. The bankruptcy petition then requires an owner to incur additional costs and file papers in court objecting to the petition and asking that a "relief from stay" be granted. By the time a "relief from stay" is granted, however, the "stay" has already achieved its ulterior purpose: it has allowed a tenant with no lawful right to the premises to delay the eventual eviction and retain possession of a leased premises without paying rent.

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Tenants who are lured by "bankruptcy mills" are often not advised that the filing of a bankruptcy petition will have a deleterious effect on their credit records. In fact, many "bankruptcy mills" do not even disclose that they will be filing a bankruptcy petition on a tenant's behalf. Rather, tenants are led to believe that they are obtaining an appropriate form of legal relief. The result is that tenants often lose hundreds of dollars in fees that they cannot afford to pay or that could have been better used to pay off overdue rent or the costs of moving elsewhere.

Owners who are targeted by "bankruptcy mills" are often left to shoulder the financial burden of overdue rent, rent they could have received during the stay, and the cost of hiring attorneys to pursue evictions and seek "relief from stays." These unanticipated costs create a vicious cycle whereby an owner must increase the price of rent which makes it even more difficult for subsequent tenants to pay their rent.

Courts are being overwhelmed with these bankruptcy cases. Case statistics for the U.S. Bankruptcy Court for the Central District of California document that over 39,000 Chapter 7 bankruptcy cases are filed annually in which a significant number of them are filed to prevent an owner from evicting a tenant. (see footnote 22) "Relief from stays" in these cases are rarely ever contested and never lost. As a result, many courts have had to establish special procedures to expedite these numerous "open and shut" cases as quickly as possible. This abuse of the U.S. Bankruptcy Code has become a severe problem, particularly for many of the more highly populated states such as California, Florida, New Jersey and New York.

IN RE SMITH

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There is one bankruptcy court case that has specifically addressed these issues and gives us guidance as to how to look at the legal issues involved.

The case, *In re Smith*, 105 B.R. 50 (Bkrtcy. C.D. Cal. 1989), held that a "stay" does not prevent an owner from regaining possession of the premises from an evicted tenant as long as the owner seeks only to repossess the premises and not to enforce any other judgment against the tenant and the bankruptcy estate, such as collecting for monetary damages. The bankruptcy court, through Judge Vincent P. Zurzolo, discussed the proliferation of "unlawful detainer" case filings in bankruptcy court; the role of the "bankruptcy mills"; the effect on bankruptcy courts; and the scope of the "stay" provisions, in particular, sections 362 (a) and 541 (a) (1). (See "Attachment B" for a complete copy of *In re Smith*.)

He noted that section 362 (a) (3) of the U.S. Bankruptcy Code provides, in pertinent part, that, "a petition filed under section 301, 302, or 303 of this title ... operates as a stay, applicable to all entities of ... any act to obtain possession of property from the estate or of property of the estate or to exercise control over the estate." "Property of the estate" is defined in section 541 (a) (1) of the U.S. Bankruptcy Code to include, "all legal or equitable interests of the debtor in property as of the commencement of the case." He went on to note that state law determines what "legal or equitable interests" the debtor had at the beginning of a bankruptcy case. He noted that prior cases, including this one, recognized that under California law a tenant does not retain any property interest once a lease has been terminated except for the right to obtain relief from forfeiture, which no tenant had ever sought.

Judge Zurzolo then reviewed section 542 (a) of the U.S. Bankruptcy Code and in footnote 8 noted that, "if an entity has possession of property of the estate that is of inconsequential value or benefit to the estate, section 542 excuses that entity from turning it over to the trustee." He points out that it is arguable that these bankruptcy estates retain any property interest in the right to seek relief from forfeiture since such tenancies have absolutely no value to a bankruptcy estate and its creditors and that these cases rarely, if ever, have any assets that could be used in the administration of an estate or in the discharge of debt.

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NMHC/NAA RECOMMENDATIONS

It should be noted that, notwithstanding the holding of *In re Smith*, many state courts in California and all across the country are still requiring that owners receive "relief from stay" orders from bankruptcy court before those state courts will take any additional action in the state court case or allow the actual eviction to be carried out. Additionally, the states, California in particular, have enacted some state laws to require bonds for the "bankruptcy mills," the masking of the parties' names in the court files of eviction actions, and other related issues. The fundamental issue, though, regarding the proper use of the bankruptcy court system, still needs federal legislative clarification for the sake of the states, state courts, and the parties involved.

Based on all the above, the Commission could rectify this situation by recommending that Congress amend section 362(a)(3) of the U.S. Bankruptcy Code or create a new section 362(b)(17) in the U.S. Bankruptcy Code in the following manner:

Section 362(a)(3) 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, *except that possession of a residence by a tenant under a rental agreement shall not be deemed property of the estate, or 362(b)(17) under subsection (a)(3) of this section, except that possession of a residence by a tenant under a rental agreement shall not be deemed property of the estate.*

CONCLUSION

NMHC and NAA strongly support the adoption of either of these two amendments. Either of them would further the rightful purposes of the U.S. Bankruptcy Code in the handling of appropriate debtors and bankrupt estates and would address a serious abuse. We urge the Commission to rectify this situation by making this recommendation to Congress.

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Thank you.

41—948CC

1997
BANKRUPTCY AMENDMENTS OF 1997; AND BANKRUPTCY LAW TECHNICAL CORRECTIONS ACT OF 1997

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE
COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTH CONGRESS

FIRST SESSION

ON

H.R. 764

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BANKRUPTCY AMENDMENTS OF 1997

AND

H.R. 120

BANKRUPTCY LAW TECHNICAL CORRECTIONS ACT OF 1997

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C O N T E N T S

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Sturtevant, Jill M., assistant general counsel, Bank of American, on behalf of the American Bankers Association: Prepared statement

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Sullivan, Albert B., Director, Office of Asset Management and Disposition, U.S. Department of Housing and Urban Development: Prepared statement

Whelan, Roger M., chairman, Legislative Committee, American Bankruptcy Institute: Prepared statement

APPENDIX

Material submitted for the hearing

(Footnote 1 return)
For ease of reference, I shall refer to both H.R. 120 (introduced on January 7, 1997 by Rep. Conyers) and H.R. 764 (introduced on February 13, 1997 by Rep. Hyde) as the Technical Corrections Act because each bill is not identical with respect to each document. A comparison of both bills with respect to Sections set forth in one bill but not the other is attached for reference.

(Footnote 2 return)
Pub. L. No. 103—394, 108 Stat/ 4106.

(Footnote 3 return)
The Technical Corrections Act proposes to modify the definition of "transfers" in Section 101(54) to include the "creation of a lien," and further amends Sections 550(c) and 547(b).

(Footnote 4 return)
Revised Section 328(a) would provide that a professional may be employed on "any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, *on a fixed or percentage fee basis*, or a contingent fee basis."

(Footnote 5 return)
Section 362(h) replaces "individual" with "entity," thereby clarifying that a debtor that is an individual, corporation, partnership or other entities may recover punitive damages and shall recover actual damages for willful violations of the automatic stay. Thus, the Act eliminates the construction of Section 362(h) that prevents non-individual debtors from recovering for willful stay violations.

(Footnote 6 return)
FHA agrees to pay 99% of the unpaid principal balance (UPB) in the event of a default. The lender transfers the mortgage to FHA. FHA currently sells into the private sector most of the defaulted mortgages for properties that do not have other housing subsidies attached to them, such as the Section 8 subsidies described elsewhere in this statement.

(Footnote 7 return)
In addition, FHA has regulatory oversight for properties with FHA insurance and other federal subsidies. It can declare a property in regulatory default. Ordinarily, this happens when the owner has not kept the property in appropriate condition or there is some financial violation.

(Footnote 8 return)
In those cases, HUD often seeks a protective order from the court to assure that the subsidy is being properly used. HUD is placed in the anomalous position of having to fund a debtor post petition without a concomitant enhancement of its position. Ironically, debtors, until stopped by HUD, often use project revenues, including subsidies to pay legal

fees. Payment of legal fees for the bankruptcy not only violates the loan documents but also 330 of the Code because in most cases the benefits of the legal services flow to the principals, not to the debtor's estate.

(Footnote 9 return)
The American Land Title Association membership is composed of 2,000 title insurance companies, their agents, independent abstracters and attorneys who search, examine, and insure land titles to protect owners and mortgage lenders against losses from defects in titles. These firms and individuals also provide other real estate information services such as flood certification and tax services, employ nearly 100,000 individuals, and operate in every county in the country.

(Footnote 10 return)
113 S.Ct. 2187 (1993).

(Footnote 11 return)
I would suggest adding the clause "except the ratification of any penalty rate" at the end of sections 1123(d), 1222(d) and 1322(e).

(Footnote 12 return)
Sec. 111(d)(3) of the FY '94 Commerce, Justice, State Appropriations Bill (Pub. L. 103—121).

(Footnote 13 return)
84 F. 3d 340 (9th Cir. 1996), amended and republished, 97 F. 3d 316 (9th Cir. 1996), further amended and republished No. 95—15122 (March 26, 1997).

(Footnote 14 return)
The remaining sections of the bill were misnumbered in the legislation introduced.

(Footnote 15 return)
186 B.R. 977, 990 (C.D. Cal. 1995).

(Footnote 16 return)
I have reviewed similar changes made in Chairman Hyde's bill, and believe his proposed technical changes are preferable to those contained in sec. 15 of my bill.

(Footnote 17 return)
Pub. L. No. 104—134, Section 804(b).

(Footnote 18 return)
874 F.2d 1186 (7th Cir. 1989).

(Footnote 19 return)
The members of AFGI are AMBAC Indemnity Corporation, AXA Re Finance S.A., Capital Markets Assurance Corporation, Capital Reinsurance Company, Connie Lee Insurance Company, Enhance Reinsurance Company, Financial Guaranty Insurance Company, Financial Security Assurance Inc. and MBIA Insurance Corporation.

(Footnote 20 return)
See "*Octagon Gas' Ruling Creates Turmoil for Commercial and Asset-Based Finance*," by Steven L. Schwarcz, New York Law Journal, August 4, 1993 at page 1.

(Footnote 21 return)
Since the Octagon ruling, a number of experts, including the Permanent Editorial Board of the UCC, criticized the decision as a plain misreading of Article 9 of the Uniform Commercial Code, and the Third and Ninth Circuits rendered contrary decisions. Only recently has Standard & Poor's dropped its separate standards of review for securitizations in the Tenth Circuit, and the State of Oklahoma has purported to over-rule Octagon by amendments to

Article 9 as in effect in that State. See "The *Octagon* Decision_Interim Receivable-Backed Criteria Eliminated," *Standard & Poor's CreditWeek*, October 9, 1996. Also see "Oklahoma Law Voids 10th Circuit's Octagon Decision", *Asset-Backed Securities Week*, October 7, 1996.

(Footnote 22 return)
See footnote 1, *In re Smith*, 105 B.R. 50, 51 (Bkrtcy. C.D. Cal.1989), "The Federal Judicial Workload Statistics," Dec. 1988 edition, Administrative Office of the United States Courts, Statistical Analysis and Reports Division.