THE NATIONAL BANKRUPTCY CONFERENCE

SECTION-BY-SECTION ANALYSIS OF H.R. 3150

TITLE I—CONSUMER BANKRUPTCY PROVISIONS

Sec. 101. Needs-based bankruptcy.

This section would foreclose individual debtors from obtaining Chapter 7 relief if their incomes were 75% of the national median family income and they had $50 of monthly net income to pay nonpriority unsecured debts according to the prescribed formula. Families with very modest incomes would have to litigate the issue of Chapter 7 eligibility. This section is troubling on both logistical and principled grounds. Logistically, the means test is problematic for a number of reasons, including the following: (1) the means test does not adjust for regional disparities; (2) median income is not an adequate substitute for need, since the median income for a family with 5 or 6 members is lower than the median income for a family with 4 members; (3) there would be no accounting for significant expenses such as child care or work-related expenses; (4) the means test does not account for tithing or charitable contributions; (5) projected monthly net income frequently would be inaccurate due to the high occurrence of income interruption among the bankrupt debtor population; (6) projected monthly net income would not take into account additional Chapter 13 attorneys' fees or Chapter 13 administrative expenses; (7) averaging monthly secured debt payments over a sixty-month period would produce a number that could inflate the debtor's disposable income in the beginning of a plan; and (8) although the section would allow debtors to attempt to prove that they had extraordinary expenses that warranted a deviation from the means test, most debtors would not be able to afford to litigate this question, and the calculation still would not leave a cushion for unexpected expenses. The means test may not catch the debtors with more ability to pay; well-advised debtors could circumvent the means test by delaying their bankruptcy filings and incurring additional expenses, while debtors on the margins would be precludm to stop paying taxes and participate in an underground economy.

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Even if each of these shortcomings could be addressed satisfactorily, this proposal seems ill-advised without credible evidence that such radical change is cost-justified. The provisions would entail a dramatic increase in the workload of courts and trustees. Restrictions on eligibility for Chapter 7 relief potentially could affect the willingness of creditors to engage in out-of-court work-outs. Congress should enact the data collection provisions of H.R. 3150, sections 441443, before making this significant change.

Sec. 102. Adequate income shall be committed to a plan that pays unsecured creditors.

To determine the amount that a Chapter 13 plan would have to distribute to non-priority unsecured creditors, section 102 would replace the disposable income requirement with a new calculation of the requisite unsecured creditor distribution. H.R. 3150 would correct one shortcoming of H.R. 2500 by accounting for secured debt payments to calculate monthly net income. However, the definition of monthly net income still would not take into account secured debt arrearage, family size, regional variations, or tithing or charitable contributions, nor would it provide incentives for families to reduce their expenses and learn how to budget. By relying on average secured debt payments, the calculations could significantly understate a debtor's secured debt commitments in some circumstances. It is unclear what is included when secured debts are subtracted; for example, if an auto loan is under-secured, is the installment payment bifurcated, included, or excluded? Proving extraordinary circumstances would generate costly litigation, and the legislation would deter debtors from seeking plan adjustments because debtors would be required to pay an objecting creditor's attorneys' fees if the debtors were unsuccessful. Another interesting component of this section is that it requires debtors to pay at least $50 per month for nonpriority unsecured claims to be in Chapter 13. Debtors who wanted to be in Chapter 13 but did not have $50 per month to commit to unsecured creditors would be left to resort to Chapter 7.

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All in all,btors to qualify for Chapter 13 relief and more plans to fail. Since two-thirds of confirmed Chapter 13 plans already are not completed, Chapter 13 could become a less successful debt collection mechanism under this legislation.

Sec. 103. Definition of inappropriate use.

Section 103 would amend section 707(b) in several respects. Inappropriate use would trigger dismissal or conversion. Parties in interest would be able to bring section 707(b) motions. The bases for a section 707(b) motion would be Chapter 7 ineligibility (as described in section 101) or a totality of circumstances analysis.

As stated above, the eligibility requirements are troubling and thus should not be the basis for a section 707(b) motion. However, it is appropriate to authorize dismissal or conversion based on the totality of the circumstances that may reveal that a case is a clear abuse of Chapter 7. The provision should not permit creditors to bring substantial abuse motions, which could lead to non-meritorious allegations, strategic behavior, and overreaching to extract reaffirmation agreements; attempting to defend such actions would deplete the already-limited resources of debtors. Creditors believing that a case is abusive should take their allegations to the United States trustee, who can look into the matter and pursue it if appropriate.

Sec. 111. Notice of alternatives.

This provision would require debtors to receive information about debt counseling services and the various bankruptcy options. Clearly, debtors should be aware of non-bankruptcy alternatives as well as the options within the bankruptcy system. However, H.R. 3150 does not state what agency would pay for the notice or who would provide this notice to pro se debtors. Section 111 does not appear to intend to create a jurisdictional requirement to obtain the notice as a prerequisite to filing, but since the debtor's failure to certify receipt of such notice can result in dismissal ended jurisdictional result, particularly for pro se debtors who do not know they need to receive the notice in order to file for bankruptcy.

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Sec. 112. Debtor financial management training test program.

Under this section, the Executive Office for United States Trustees would establish pilot programs for financial education and would evaluate other educational programs that already are in existence. Financial education could be an important tool to prevent debtors from experiencing repeated financial failure and should be pursued in consultation with experts well-versed in the field.

Sec. 113. Definitions.

This section introduces new terms into the bankruptcy lexicon, namely bankruptcy assistance, assisted person, and debt relief counseling agency. These terms are used in subsequent sections of this bill that prescribe the activities of bankruptcy petition preparers. The definition of bankruptcy assistance is rather broad and could encompass unintended parties, such as stores that sell books on bankruptcy.

Sec. 114. Disclosures.

Bankruptcy petition preparers would be required by section 114 to provide certain disclosures to debtors, including the responsibilities that the petition preparer would undertake in the bankruptcy process. By requiring petition preparers to assist a debtor in determining exempt property and other related tasks, section 114 appears to condone the unauthorized practice of law by bankruptcy petition preparers.

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Sec. 115. Debtor's bill of rights.

This section creates additional requirements for bankruptcy petition preparers. For example, the petition preparer would have to provide a written contract that discloses the services and the fees, would have to identify its services accurately in advertisements, and would be precluded from advising a consumer to incur more debt in contemplation of bankruptcy. Although it is admirable to attempt to ensure that a consumer obtains more information about services, the fundamental assumptions underlying these provisions are problematic and run counter to other efforts to hinder the use of bankruptcy petition preparers altogether. The provision would require non-attorneys to advertise that they provide assistance that goes beyond mere typing, while typing is the only assistance that they can provide without violating state rules governing the unauthorized practice of law.

Sec. 116. Enforcement.

Under this provision, a bankruptcy petition preparer would have to disgorge fees or waive unpaid fees if he failed to comply with the afr converted. State attorneys general would be authorized to bring legal and injunctive actions against a petition preparer. This section would prevent consumers from being further harmed after being misled by bankruptcy petition preparers.

Sec. 121. Discouraging bad faith repeat firings.

Under section 121, a debtor's second filing within one year would trigger the automatic stay for 30 days and then would be terminated automatically unless the debtor could prove that the subsequent filing was in good faith. Section 121 also would authorize *in rem* relief.

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Something should be done to limit the ability of individuals to abuse the bankruptcy system by repeatedly seeking relief with no intent to reorganize, but only to obtain the benefit of the automatic stay. *In rem* relief should be authorized, as this section recommends. However, the approach to restricting filings in H.R. 3150 may not curb abusive filings; since the automatic stay would apply for 30 days, abusive filers still could use bankruptcy to cancel foreclosure sales. At the same time, this approach could work hardship on debtors legitimately seeking financial reorganization who have received insufficient legal advice, especially since inadvertent failure to file documents leading to dismissal and re-filing presumptively would not satisfy the good faith standard under this section. Thus, the changes contemplated in section 121 would not discourage bad faith repeat filings, but would prohibit good faith repeat filings.

Any effort to curb repeat filings must be accompanied by a national filing system that uses social security numbers to account for its users. Courts would be impeded in tracking repeat filers without such a system.

Sec. 122. Definitions of household goods and antiques.

Section 122 would define household goods using the definition employed by the Federal Trade Commission Trade Regulation Rule on Credit Practices, 16 C.F.R. 444.1. Providstances, but the recommended FTC definition would diverge from the prevailing current interpretations of household goods in section 522(f), and this substantive shift could result in increased litigation.

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Sec. 123. Debtor retention of personal property security.

This section would prohibit the ride-through of secured debt obligations in Chapter 7 absent a reaffirmation of the debt or redemption of the collateral, and thus would resolve the circus court split over whether secured debts can ride through bankruptcy. Ride-through can be beneficial to both debtors and creditors, and thus this choice should be considered carefully. However, if enacted, Congress should consider an exception for mortgages on primary residences; only a small proportion of homeowners in Chapter 7 reaffirm mortgage debt under current law because real estate is more likely to retain its value and thus protect the secured party.

Section 123 also would clarify that redemption requires payment in a single lump sum. This amendment would be consistent with the majority view of redemption.

Sec. 124. Relief from stay when the debtor does not complete intended surrender of consumer debt collateral.

If the debtor did not perform the intended action on collateral, section 124 would authorize automatic stay relief without court permission. Creditors should have a remedy when debtors fail to follow through on their intended actions. However, without providing warning or an opportunity to cure, the proposed amendment could prejudice individual debtors who lack sound legal advice.

Sec.125. Giving secured creditors fair treatment in chapter 13.

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According to this section, the holder of an allowed secured claim would retain its lien until payment of the entire debt, including the unsecured portion, or until the plan completion. This amendment would resolve a difference in application of current law. See In re Johnson, 213 B.R. 552 (Bankr. N.D. III. 1997) (collecting cases split on issue). It should be kept in mind that the majority of Chapter 13 debtors do not receive discharges, although many of them still have paid at least the value of the collateral as determined under section 506. Requiring lien retention might help encourage plan completion, but could result in a greater number of repossessions of homes and cars, especially if plans spanned 5 to 7 years.

Sec. 126. Prompt relief from stay in individual cases.

Section 126 would require courts to rule on motions for automatic stay relief within 60 days; if they did not, the stay would terminate automatically unless the parties agreed to an extension of the deadline or the court ordered its extension due to compelling circumstances. Historically, controlling bankruptcy court dockets through statutory amendments has not been successful. With the large volume of cases in the system, this provision may not promote the sound administration of justice. The meaning of compelling circumstances m create greater disparities among courts.

Sec. 127. Stopping abusive conversions from chapter 13.

This provision would repeal the 1994 amendment to section 348 that clarified the effect of conversion from Chapter 13 to Chapter 7. Section 127 would un-strip liens upon conversion, which would be consistent with requiring lien retention as recommended in section 123, and both likely would result in more repossessions of collateral. However, section 348(f)(2) already deals with bad faith conversions from Chapter 13, calling into question the need for this amendment.

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Sec.128. Restraining abusive purchases on secured credit.

For purchases made within 180 days prior to bankruptcy, the usual valuation rules would be inapplicable and the value of the property could not be deemed less than the outstanding balance, interest, and charges. Although this proposal apparently seeks to eliminate incentives to use bankruptcy to adjust one's obligations under a very recent installment sale agreement, 180 days is too long a period in which to presume that the debtor made the purchase with bad intent. Because this legislation would have significant distributional consequences for creditors, the frequency of abusive pre-bankruptcy purchases should be studied before such a change is implemented. However, a beneficial corollary to the proposal in H.R. 3150 would be to clarify that surrender of property in Chapters 11 or 13 would satisfy a debt in full.

Sec.129. Fair valuation of collateral.

Section 129 would set the valuation of collateral at replacement value, to be defined as the price a retail merchant would charge for property of that kind, age, and condition, with no deductions for marketing or sales costs. Although this section is entitled fair valuation of collateral, it would employ the highest possible valuation of collateral, which would be least advantageous for unsecured creditors in many instances. The proposed amendment apparently would overrule the United States Supreme Court's determination in *Associates Commercial Corp.* v. *Rash*, 117 S. Ct. 1879 (1997), that debtors should not have to give value for attributes they did not receive such as reconditioning, preparation, sales commissions, warranties, storage, inventory costs, and advertising. A compromise approach might be to use wholesale value, which is somewhat consistent with the Rash calculation and tends to be higher than liquidation and lower than retail.

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Sec.130. Protection of holders of claims secured by debtor's principal residence.

Section 1322(b)(2) anti-modification protection would be expanded further to include debts primarily secured by the debtor's persona debts secured by mobile homes, condominiums, or cooperatives. In so doing, section 130 would give preferential treatment to a wider range of mortgages and thus would divert value from other creditors and would reduce plan repayment flexibility. If taken too far, anti-modification protection would heighten the risk of home loss and thus would become inconsistent with federal policies encouraging home-ownership. Section 130 also would clarify that vacating one's personal residence within 180 days prior to filing for bankruptcy would not eliminate the anti-modification protection for that mortgage debt.

Sec.141. Debt. incurred to pay non-dischargeable debts.

This section would except from discharge any debts incurred to pay non-dischargeable debts and would give those debts the same priority under section 507 as the underlying obligations. While such a proposal sounds reasonable at first glance, it should be opposed. It would exacerbate unequal treatment for similar creditors, authorizing 100% payment for one creditor and 0% payment for another even though both have the same position with respect to the debtor. Public policy considerations do not support this change for several reasons. First, the need for payment of certain non-adjusting creditors already has been satisfied when a non-dischargeable debt was paid prior to the bankruptcy filing. For example, the Congressional policy that supports excepting child support payments from discharge does not justify non-dischargeability status for an obligation owed to a financial institution that the debtor may have used to pay the child support. Second, the scope of debts that are non-dischargeable under sections 523(a)(2), (a)(4), and (a)(6) is highly variable in different courts and jurisdictions. This amendment, in combination with the proposed change to section 523(a)(2)(A) in section 145, could yield a heightened number of non-meritorious non-dischargeability threats and allegations. Implementing these proposals is difficult since this section does not address many of the consequences of deeming these debts to have the priority and dischargeability status of the underlying obligations.

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Sec.142. Credit extensions on the eve of bankruptcy presumed non-dischargeable.

Under section 142, any debt incurred within 90 days prior to filing presumptively would be non-dischargeable. This change is inadvisable. Debts incurred ninety days prior to filing may not have been incurred in contemplation of bankruptcy, thus the policy basis for proposed amendment is questionable. Such a change would create a strong preference for recently-incurred debts over older debts that should receive equal priority. This section also would generate litigation over whether old debts refinanced within 90 days of bankruptcy or old revolving credit agreements are inside or outside the 90 day limit. Debtors in true financial difficulty and with inadequate or no legal representation essentially would be denied debt relief. However, this provision would not affect the dischargeability of debts of well-advised debtors who could plan around this provision and delay their filings.

Sec.143. Fraudulent debts are non-dischargeable in chapter 13 cases.

This section would make more debts non-dischargeable in Chapter 13, e.g., those that fall within sections 523(a)(2), (a)(4), or (a)(6). It may be appropriate to exclude debts falling under sections 523(a)(4) and (a)(6) from the super-discharge. However, the most significant problem with this proposal is that sections 141,142, and 145 would make nearly all credit card debts potentially nondischargeable under section 523(a)(2) without any proof of fraud and there is no policy reason to make ordinary credit card debts survive the bankruptcy process, especially after a Chapter 13 debtor has made plan payments for 3, 5, or even 7 years. Taken together, these amendments could promote extensive and costly litigation and provide a basis for creditor over the majority of Chapter 13 debtors do not actually receive discharges at all, and thus the super-discharge is inapplicable to those cases. It is not known how many Chapter 13 debtors have debts that might fall within the Chapter 13 super-discharge since the super-discharge limits the need for non-dischargeability litigation. By including debts falling under sections 523(a)(2) in the super-discharge, the proposed change might increase administrative costs and delay the Chapter 13 process through litigation.

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Sec.144. Applying the co-debtor stay only when it protects the debtor.

Under section 144, the co-debtor stay would apply in a more limited set of cases. In particular, the co-debtor stay would be inapplicable when the debtor did not receive consideration for the claim held by the creditor to the extent the creditor proceeds against the individual who received such consideration or against collateral not in the possession of the debtor. The co-debtor stay also would not apply when the debtor's plan provided for surrender or abandonment of the debtor's interest in personal property subject to a lease. This amendment arguably would streamline the Chapter 13 process. However, the exception to the co-debtor stay is somewhat fact-specific, and a creditor may erroneously determine that the stay did not apply. The Code should provide a specific remedy in the event that a creditor's actions actually violated the co-debtor stay.

Sec.145. Credit extensions without a reasonable expectation of repayment made non-dischargeable.

Section 145 would amend section 523(a)(2) so that credit card debts would be non-dischargeable without credit card lenders proving the elements of fraud, as all other lenders must do. The credit card lender merely would have to allege that the borrower used a credit card without a reasonable expectation or ability to repay. Section 145 also would amend subsection (B) of section 523(a)(2) so that lenders would not have to allege that a debtor intended to deceive the lender with a written representation, replacing the requirement with without taking reasonable steps to ensure the accuracy of the statement.

These amendments conflict with public policy and should not be enacted. They would give better treatment to credit card lenders than any other unsecured lenders and would encourage aggressive marketing of credit cards to risky borrowers. The amendments would make every borrower a guarantor of her future so the minimum monthly payments. Furthermore, section 523(a)(2)(A) has provided the basis for threats to obtain reaffirmations; the proposed standards would heighten this overreaching by certain creditors. It also is unclear why the creditor's burden of proof should be relaxed in section 523(a)(2)(B), which generally has been perceived to work well.

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Sec.161. Giving debtors the ability to keep leased personal property by assumption.

Section 161 would amend section 365 such that leased personal property would not be property of the estate and would not be protected by the automatic stay if a lease was rejected or was not timely assumed by the trustee. It also would offer a procedure by which the debtor could assume the lease himself. In individual Chapter 11 cases and Chapter 13 cases, the lease would be deemed rejected at the conclusion of the confirmation hearing, with similar consequences. If enacted, this provision should be clarified to provide that the lease would be abandoned to the debtor upon lack of assumption by the trustee. The same rule should apply in all chapters; the lease should revest as of the effective date of a plan.

Sec. 162. Adequate protection of lessors and purchase money secured creditors.

Under this section, a debtor would be required to make cash payments to lessors and secured creditors until the creditors started receiving plan payments. The section also would authorize a lessor or creditor to retain property rightfully obtained prior to the bankruptcy filing and would insulate such retention from automatic stay and turnover scrutiny. Debtors also would be required to provide each creditor or lessor reasonable evidence of the maintenance of any required insurance coverage. This section appears to entitle creditors to larger adequate protection payments than they actually would receive under the plan. Almost all retailers could assert adequate protection entitlement for debts for small ticket items in which they are nominally secured at best, providing them with treatment far superior to other creditors without a reasonable policy justification. The requisite insurance coverage also may be subject to some dispute.

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Sec. 163. Adequate protection for lessors.

Section 163 would amend section 362(b)(10) to provide an exception to the automatic stay for residential landlords so that they can continue eviction proceedings if they believe that the leases have expired pre-petition. The provision would permit landlords to evict debtors in public housing and rent-control housing in the midst of the bankruptcy case without court permission upon lease expiration even if the debtors were current in rent. Residential landlords already can get the stay lifted for cause on request to the bankruptcy court. Permitting residential landlords to proceed against the debtor without seeking bankruptcy court permission could severely undercut the bankruptcy process and the relief available for individual debtors. The automatic stay plays an important role in protecting the interests of other creditors, which could be hampered by this amendment. Although this propos section 362(b)(10) has not prevented litigation as it applies to non-residential landlords because it is not always clear whether a lease has expired pre-petition.

Sec. 171. Extend period bet Been bankruptcy discharges.

Under section 171, former Chapter 7 debtors could not receive another discharge for 10 years following the commencement of the prior case. Former Chapter 13 debtors who received discharges could not obtain a subsequent Chapter 7 discharge for 5 years after commencement of the prior case. The repeat filing problems under current law seem to involve debtors who have not received discharges in Chapter 13 cases. No evidence has been found showing that debtors who receive discharges are repeatedly or abusively seeking relief directly afterward.

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Sec. 181. Exemptions.

Section 181 would amend section 522(b)(2)(A) so that a debtor would have had to live in a state for the majority of 180 days to be entitled to that state's exemptions. Changing 180 to 365 days, while perhaps reasonable in itself, does not go far enough to prevent the use of unlimited exemptions in real and personal property. Exemptions should be capped.

TITLE II—BUSINESS BANKRUPTCY PROVISIONS

Sec. 201. Limitation relating to the use of fee examiners.

Section 201 would amend section 330 to prohibit the use of so-called fee examiners, persons appointed to examine requests for compensation or reimbursement. Determining fees is a statutorily-imposed duty of the bankruptcy judge that should not be relegated to private parties. A prohibition on fee examiners would cut administrative costs in Chapter 11 cases.

Sec. 202. Sharing of compensation.

Under section 202, section 504 would be amended to permit fee splitting with bona fide public service attorney referral programs that are run in accordance with applicable law. Although some find it controversial to permit fee sharing, this proposal recognizes that state and local regulation of these practices is sufficient to govern this area.

Sec. 203. Chapter 12 made permanent law.

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This section would eliminate the sunset provision for Chapter 12, and thus make Chapter 12 a permanent part of the Bankruptcy Code. Making Chapter 12 permanent reflects the general perception that Chapter 12 has worked well and should be retained.

Sec. 204. Meetings of creditors and equity security holders.

Under this section, the court would be authorized to waive the requirement of a section 341 meeting if the debtor had filed a pre-packaged plan of reorganization. Section 341 meetings generally do not serve a meaningful purpose when creditors have voted on a plan prior to the bankruptcy filing. Permitting waiver of the section 341 meeting requirement in this instance is a reasonable proposal that would reduce administrative costs, expedite plan confirmation, and encourage out-of-court consensual negotiations.

Sec. 205. Creditors' and equity security holders' committees.

This amendment would clarify that courts are authorized to review appointments to creditors' and equity security holders' committees, which are made by U.S. trustees. This proposal would resolve a sharp split in the case law and should be supported. The extent to which a creditors' committee adequately represents unsecured creditors is a question of law that may require judicial discretion.

Sec. 206. Post-petition disclosure and solicitation.

This section would permit post-petition solicitation of votes prior to court approval of a disclosure statement in a prepackaged plan of reorganization, but only for holders of claims that were solicited prior to commencement of the case in accordance with applicable non-bankruptcy law. This amendment probably would reduce administrative costs and encourage out-of-court consensual negotiations. However, it may not be clear at the time of post-petition solicitation whether the pre-petition solicitation complied with applicable non-bankruptcy law.

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Sec. 207. Preferences.

This provision would broaden the availability of the ordinary course of business defense to preference actions by de-coupling the requirement that a transaction be in the ordinary course of business between the debtor and creditor and in accordance with ordinary business terms for the industry at large. Under the amendment, the recipient of a preferential payment would not have to return the payment for distribution to all creditors if the payment was made in accordance with ordinary business terms even if the payment was not in the ordinary course between the debtor and the creditor. The NBC opposes this amendment because it would completely undercut the preference provisions. Congress enacted and subsequently amended section 547(c)(2) to balance the needs of ordinary commercial transactions with the goal of equality of distribution among similarly-situated creditors. De-coupling the requirements would disrupt this balance. This amendment effectively would insulate most pre-petition transfers from preference recovery, and thus would limit distributions to other creditors. If a payment is not in the ordinary course of dealing among the parties, the fact that the transaction comports with ordinary business terms of the industry should not be a defense. Moreover, even if a payment is in the ordinary course of dealing among the parties, it should also be in accordance with ordinary business terms for the industry to be insulated from preference attack.

Section 209 also would prevent preference actions to recover less than $5,000 in aggregate transfers to non-insider creditors in cases that do not involve primarily consumer debts. Preventing preference actions to recover small amounts should increase the likelihood that any amounts recovered will benefit creditors and not simply the trustee and the trustee's professionals. However, in small cases, these lost preferential payments may make a significant difference in creditors' recoveries.

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Sec. 208. Venue of certain proceedings.

This section would amend 28 U.S.C. 1409 so that a trustee may commence a preference action for a non-consumer debt of less than $10,000 only in the district in which the non-insider creditor resides. This proposal should reduce incentives to bring non-meritorious preference actions in which the aggregate litigation costs would be likely to equal or exceed the value of the assets recovered for the bankruptcy estate.

Sec. 209. Setting a date certain for trustees to accept or reject unexpired leases on nonresidential real property.

Section 209 would amend section 365(d)(4) to replace the 60-day period with a 120-day period for election to perform or breach a non-residential real property lease, and further would provide that the court could not extend the period beyond the date a plan is confirmed. As written, the amendment has some technical problems. First, it appears that the absence of the word real before property on page 61, line 8, was an oversight, since the section deals with real property leases. Second, while the decision to assume or reject all executory contracts or unexpired leases should be made and announced no later than the confirmation hearing, the actual assumption, rejection, or assignment should not have to occur before the effective date of the plan, which almost always occurs several days after the confirmation hearing. The NBC would support the amendment if section 365(d)(4)(B) were amended to read The court may not extend the period during which the trustee or plan proponent must elect to assume or reject a lease of nonresidential real property beyond the date of entry of the order confirming the plan, but such assumption or rejection may occur on or before the effective date of the plan.

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Sec. 231. Definitions.

The definition of small business debtor would encompass debtors (including any group of affiliated with aggregate non-contingent, liquidated secured and unsecured debts of $5,000,000 or less as of the petition date and single asset real estate debtors as defined in 11 U.S.C. 101 (51 B). Small business treatment would be mandatory for all debtors fitting the definition, not elective as under current law. This provision makes a significant change shortly after the 1994 amendments set the debt cap for voluntary small business treatment at $2,000,000. The new definition would encompass more than 85% of Chapter 11 cases overall, and nearly all Chapter 11 cases in most judicial districts. Some cases falling within the proposed definition have active creditor involvement, vitiating the principal justification for special small business rules. The definition contains no safety valve when the small business rules would not be appropriate or necessary for a particular debtor. Moreover, imposing the proposed requirements on all single asset real estate debtors, regardless of size, complexity, or amount of liability, is undesirable and inconsistent with the policy justifications for providing special treatment to a discrete group of debtors. Since the empirical evidence is insufficient to show that these Chapter 11 cases are being improperly administered, additional data should be collected before adopting such proposals. Moreover, the use of Chapters 12 or 13 for very small businesses should be considered as a less restrictive alternative.

Sec. 232. Flexible rules for disclosure statement and plan.

This section authorizes courts to waive or modify the disclosure statement requirements, to conditionally approve disclosure statements to allow solicitation to proceed, and to combine the disclosure statement hearing with the confirmation hearing. This section is unobjectionable. Congress adopted section 1125(f) in 1994, which authorizes courts to hold combined hearings on disclosure statements and plan confirmation, but only when debtors elect small business treatment. Section 232 would and would codify the practices of some courts. The efficacy of the disclosure statement has been challenged on numerous occasions. The modification of the disclosure statement requirement in small business cases is an important first step in the elimination of cumbersome disclosure statements.

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Sec. 233. Standard-form disclosure statements and plans.

Section 233 would order the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States (Rules Committee) to devise and adopt uniform forms for disclosure statements and plans of reorganization for debtors falling within the small business definition. The section advises that the rules should achieve a practical balance between parties' reasonable needs for complete information and economy and simplicity for debtors. The establishment of standardized disclosure statement forms is a good idea. Uniform disclosure statements could help provide clear and pertinent information to creditors and could facilitate the collection of better, more consistent data about the bankruptcy system overall.

Sec. 234. Uniform national reporting requirements.

This provision would require a small business debtor to file periodic financial reports that include information on profitability, projected cash receipts and disbursements, comparisons of actual receipts and disbursements with prior projections, whether the debtor is in compliance with post-petition requirements and has filed tax returns and paid taxes and other administrative claims, and other matters in the best interest of all parties. Uniform reporting requirements would be beneficial as long as they are kept simple. Since U.S. trustees already require debtors to submit balance sheets, income statements, and cash-flow statements, additional financial reporting requirements should be limited to simple forms that solicit basic pieces of information in a specified format. Overly extensive and complex reporting requirements could be difficult and perhaps unnecessary for some very small businesses, and past attempts of U.S. trustees to implement more intricate national financial reporting forms have been unsuccessful.

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Sec. 235. Uniform reporting rules and forms.

This section would require the Rules Committee to propose forms in accordance with the recommendations in section 234. Any financial reporting forms should be designed in consultation with parties with the appropriate expertise.

Sec. 236. Duties in small business cases.

Section 236 imposes numerous requirements on small business debtors early in the case. A small business debtor would have to provide balance sheets, statements of operations, cash-flow statements, and income tax returns within 3 days after filing a bankruptcy petition. The debtor's senior management would be required to attend numerous meetings with the U.S. trustee and court. Schedules and statements of financial affairs would have to be filed within 30 days after filing the bankruptcy petition absent extraordinary and compelling circumstances. The small business debtor specifically would be required to maintain insurance customary and appropriate to the industry. The small business debtor would have to establish a segregated bank account for taxes within 10 days after filing for bankruptcy and deposit such funds no later than 1 business day thereafter. Moreover, the small business debtor would have to allow the U.S. trustee to inspect the business premises.

The legislation makes unrealistic assumptions about what a small business debtor feasibly can accomplish within a very short time period while it attempts to maintain and reorganize business operations. Being required to make extensive submissions in the chaotic first few days of a Chapter 11 case, in combination with the many additional immediate requirements that these proposals would impose, would hamper small business reorganization. Preparing for and attending an extensive set of meetings could detract from management's primary role of running the business. In small business cases, management might be only one person or a handful of people, whose time might be better spent addressing the needs of the business and complying with the requirements already set forth in the Bankruptcy Code. Although it sounds reasonable to require debtors to maintain insurance customary and appropriate to the industry, parties may dispute what types of insurance fall within this description. Debtors should comply with post-petition obligations, but failure to do so already can lead to conversion or dismissal under current law. The enumeration of certain post-petition obligations might suggest that those listed are more significant than post-petition obligations that are omitted from the list. Taxes should not be isolated for special treatment when the small business debtor also must make significant payments to employees, environmental authorities, or other parties that would not have the benefit of segregated accounts. Moreover, since section 243 of this bill would make failure to pay taxes a specific ground for dismissal, conversion, or appointment of a trustee, the bank account requirement may be superfluous. It could lead to extraneous disputes and dealings that would detract from the small business' primary objectives of reorganizing and running the business.

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Sec. 237. Plan filing and confirmation deadlines.

This section would require the small business debtor to file a plan of reorganization within 90 days after filing for bankruptcy. To obtain an extension, the debtor would have to demonstrate prior to the expiration of the deadline by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable time.

If this proposal were enacted, the Bankruptcy Code would discriminate against struggling small businesses trying to reorganize and would force them to seek to confirm poorly-drafted or ill-conceived plans or to liquidate. Small business Chapter 11 debtors are less likely to have engaged in plan negotiations before filing. The time limits are far too short for many small enterprises, such as those with operational problems or seasonal businesses. Secured creditors might be able to use the shorter time restrictions as leverage to obtain more favorable treatment to the detriment of unsecured creditors.

Although the amendment offers the possibility of an extension, obtaining an extension under these standards would be nearly impossible for small business debtors. The court would have to conduct a mini-confirmation hearing, and the small business would have to offer to prove the very information that the business needs the extension to obtain.

This proposal is premised on the notion that prolonged Chapter 11 cases are more costly than expedited proceedings, but a study of Civil Justice Reform Act procedures suggests that shorter deadlines and extensive case management do not always reduce parties' costs, James Kakalik, *Just, Speedy and Inexpensive? Summary of Main Findings*, Facts & Trends, Rand Institute for Civil Justice 5 (1997), nor do they necessarily result in quicker dismissal of dead on arrival cases. See Marcy C.K. Tiffany, *Fast Track, Statistics, and Delay Reduction: A Comparative Analysis* (Draft, October 6, 1996). The proposed extension standards would result in a duplication of effort and court time, undermining the benefit of combining the disclosure statement and confirmation hearings. Too much judicial time would be consumed on hearings to extend a deadline that many observers already have concluded is too short. Since this proposal contemplates a heightened expenditure of judicial time on both litigation and administrative matters, the workload may increase the need for additional judges and court personnel, further diminishing any anticipated aggregate cost savings.

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Sec. 238. Plan confirmation deadline.

Under this section, plans of small business debtors would have to be confirmed no later than 150 days after the bankruptcy filing; the deadline could be extended only if the debtor meets the burden for an extension stated in section 237. The NBC's criticisms of the 90-day plan filing deadline and the extension requirements apply equally to this provision. This section again increases the likelihood of small business failure.

Sec. 239. Prohibition against extension of time.

Section 239 would amend section 105(d) to prohibit a court from exercising its discretion to extend a deadline in a manner inconsistent with sections 237 and 238. This section therefore further restricts courts' flexibility to be responsive to a particular circumstance.

Sec. 240. Duties of the United States trustee and bankruptcy administrator.

The U.S. trustee or bankruptcy administrator would be vested with new statutory duties in small business debtor cases, including the duty to conduct initial debtor interviews during which the U.S. trustee would investigate the debtor's viability and business plan. The U.S. trustee would have the duty to inspect the debtor's premises and would have to diligently monitor the debtor's activities to identify whether the debtor will be unable to confirm a plan.

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Rather than helping the small business debtor reorganize, retain jobs, and retain relations with suppliers, this section imposes U.S. trustee duties that are premised on small business failure. Without financial or business training, U.S. trustee or Bankruptcy Administrators' mandatory visits and examinations of books and records may be of limited utility and yet would raise costs considerably. When the National Bankruptcy Review Commission considered this issue, the Executive Office for U.S. Trustees estimated that an additional $3.2 million would have to be expended annually to comply with this set of proposals. *See Cost Benefit Analysis; United States Trustees' Implementation of Small Business Proposal* (April 7, 1997) (submitted by Executive Office for United States Trustees to National Bankruptcy Review Commission). Of this amount, $265,000 would be allocated to travel costs.

However, if other small business provisions were implemented, continuous monitoring to prevent cases from languishing should vitiate the need for extremely short deadlines proposed elsewhere.

Sec. 241. Scheduling conferences.

Section 241 would amend section 105(d) to require courts to hold status conferences as necessary to further the expeditious and economical resolution of the case. As long as status conferences are held sparingly, this provision should not cause a significant change in current law.

Sec. 242. Serial filer provisions.

Section 242 would completely withhold application of the automatic stay for a small business that filed a bankruptcy petition within two years after a prior Chapter 11 plan had been confirmed, or within two years after the entry of a dismissal order in a prior Chapter 11 case. If the former owners of a prior small business debtor have transferred the business to a successor entity, the automatic stay would not apply unless the debtor could prove by a preponderance of the evidence that the new case had resulted from circumstances beyond the control of the debtor not foreseeable at the time the first case was filed and that it is more likely than not that the debtor will confirm a feasible plan, but not a liquidating plan, within a reasonable time.

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Absent evidence that small business debtors regularly file serial bankruptcy petitions in inappropriate circumstances, the need for this amendment is doubtful. Courts already dismiss subsequent Chapter 11 cases when necessary. Applicable standards for imposing a stay under section 362 of the Bankruptcy Code should not vary depending on the debtor's size. The section does not appear to provide a procedure for a debtor to invoke the automatic stay unless it is a successor entity, and the recommended tests for obtaining automatic stay protection for a successor entity are litigation-intensive and would entail significant costs. The practical results would be either that courts would have to disregard the statute or that small businesses would be foreclosed from subsequent reorganization attempts altogether. It also is not clear why the proposal discourages liquidating plans. Other sections of the small business provisions would increase the likelihood of small business repeat filings because the proposed fast track confirmation would increase the number of poorly-developed plans and thus would lead to more post-confirmation defaults.

Sec. 243. Expanded grounds for dismissal or conversion and appointment of trustee.

This section recommends that section 1 11 2(b) be amended to provide that a court shall convert or dismiss a case, whichever is in the best interest of creditors and the estate, when a movant establishes cause, and would enumerate grounds for cause. Requests for dismissal or conversion would not be granted if the debtor objects and establishes that it is more likely than not that a plan will be confirmed within a time fixed by statute or by court order; *and*, if cause is an act or omission of the debtor, that there exists a reasonable justification for the act or omission and that the act or omission will be cured within a reasonable time fixed by the court not to exceed 30 days after the court decides the motion (unless the movant expressly consents to a continuance for a specific period of time or compelling circumstances beyond the debtor's control justify an extension beyond 30 days). Section 243 also would authorize the appointment of a trustee instead of conversion or dismissal if the court determined this would be in the best interest of the estate.

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The proposed changes to section 1112 apparently would apply to all Chapter 11 debtors, not just small business debtors. Unlike the current language of section 1112, which makes dismissal or conversion discretionary, this proposal would make dismissal or conversion mandatory upon the presence of factors indicating that such action would be in the best interest of the estate. The proposed standards that a debtor would have to satisfy to overcome dismissal or conversion are litigation-intensive and would prejudice small businesses that can ill-afford prolonged court proceedings. The presumption underlying this proposal, that most small business debtors should be quickly expelled from Chapter 11 due to the low probability of reorganization, conflicts with governmental policy favoring the encouragement of small business development and job creation and retention. Foreclosing opportunities to reorganize could discourage the appropriate level of risk-taking in small business enterprise. Because the list of causes is so specific, a court might feel inhibited to grant dismissal on a ground not delineated in the statute. Without knowing what situations would qualify as compelling circumstances to enable courts to extend the deadline, it is difficult to gauge the implications of the proposed deadline. Statutory attempts to manage court dockets have not been successful in the past. Appointment of a Chapter 11 trustee generally has been an extraordinary remedy responsive to wrongdoing or gross mismanagement. This proposed amendment would represent a substantial shift from current policy. Overzealous use of this provision could lead to displacement of small business owners and liquidations of potentially viable small businesses, to the detriment of the owners and their unsecured creditors. Mandatory dismissal or conversion also precludes proposal and confirmation of creditor plans that could be in the best interests of creditors.

Sec. 251. Single asset real estate defined.

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Section 251 would re-define single asset real estate and eliminate the debt cap on the definition. This definition would trigger the application of several special single asset real estate provisions in addition to the proposed fast track small business provisions. The proposed definition for single asset real estate cases has several shortcomings. First, the definition's wording would not exclude cases in which the real property is used by a debtor or related company in an active business. If this definition were adopted, sophisticated lenders could condition significant real estate loans to viable active businesses by requiring borrowers to place real estate collateral into a single-purpose subsidiary that would qualify for single asset real estate treatment in the event of default and bankruptcy. The definition should be worded to preclude this type of activity. The current $4 million debt limit on the definition should be raised to $15 million, but should not be lifted altogether. Valid reasons support distinguishing small-debt projects from large-debt projects. Many large projects involve jobs that will be lost if the reorganization process is forced down a fast track. Most projects with high debt levels have ample cash flow to maintain tax and maintenance payments and thus these cases are less likely to produce the abuses commonly associated with small single asset real estate cases. Other, unanticipated effects could flow from imposing rigid refinance rules and fast-track negotiations on such a wide range of projects. For example, these rules might diminish or eliminate possibility of claims trading to enhance liquidity in large projects and to increase both the leverage and return for the creditors. If Congress were to adopt this reasoning and to raise the definitional cap rather than eliminating it altogether, it should clarify that the face amount of the debt, not the value of the property, controls application of the definition.

Sec. 252. Plan confirmation.

Section 252 would amend section 1129(b) to provide different rules for single asset real estate debtors that seek to confirm plans over the objection of classes of unsecured claims that would not be paid in full. In particular, if a debtor sought to confirm a plan over the objection of a class of unsecured claims that included a secured creditor's deficiency claim, the debtor would have to pay down the allowed secured claim in cash so that the principal amount of the debt secured was no greater than 75% of the value of that real estate. This change is proposed in the absence of any empirical data justifying the change. A rigid standard requiring a 25% cash equity infusion may make sense in some cases, but may wreak havoc in others, forcing businesses to close on account of a technical financial rule. Moreover, tinkering with the fair and equitable rule in the absence of concrete data could have detrimental spill-over effects in both non-single asset real estate bankruptcy cases and, perhaps more significantly, in countless out of court wost would preclude out-of-court workout agreements in which lenders take less than a 75% restructured first mortgage, and would discourage lenders from taking fractional equity positions in workouts, as they often do now, because they could hold out for 25% cash or ownership of all of the equity in a Chapter 11 plan. As a practical matter, this change would preclude reorganization and confirmation of a wide range of cases that would fall within the very broad proposed definition of single asset real estate. A better approach that would protect lenders' interests without causing these adverse consequences would be to codify the new-value exception for all Chapter 11 cases, but to provide that plan exclusivity would be terminated when a plan proponent sought to confirm a Devalue plan under section 1129(b)(2)(B)(ii).

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Sec. 253. Payment of interest.

This section would amend section 362(d)(3) to make clear that the debtor can make the requisite payments from rents generated by the property. The section also would change the applicable interest rate to the non-default contract rate and would amend the deadline so that payments must be commenced or a plan filed on the later of 90 days after the petition date or 30 days after the court determines that the debtor is subject to these provisions. The NBC supports section 253. These changes will provide greater certainty and reduce litigation.

TITLE III—MUNICIPAL BANKRUPTCY PROVISIONS

Sec. 301. Petition and proceedings related to petition.

This section would clarify that a Chapter 9 petition constitutes an order for relief as in other chapters of the Bankruptcy Code. This is a reasonable amendment and the NBC supports it.

TITLE IV—BANKRUPTCY ADMINISTRATION

Sec. 401. Adequate preparation time for creditors before the first meeting of creditors in individual cases.

This section would require that the section 341 meeting be convened within 60 to 90 days after the bankruptcy petition was filed unless the court had reason to hold the meeting earlier. The delayed timing could result in extended application of automatic stay and delayed pay-outs to creditors. However, the preservation of court discretion might ameliorate this problem in appropriate cases.

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Sec. 402. Creditor representation at first meeting of creditors.

This section, which would permit non-lawyer creditor representatives to appear and participate in section 341 meetings, might create conflicts with some state laws by promoting the unauthorized practice of law. *See In re Maloney*, 209 B.R. 844 (Bankr. M.D. Pa. 1997) (examining debtor at section 341 meeting constitutes practice of law under Pennsylvania law); *but see State Unauthorized Practice of Law Committee* v. *Paul Mason & Associates*, 46 F.3d 469 (5th Cir. 1995) (administrative functions handled by non-lawyer creditor representatives did not constitute unauthorized practice of law under Texas law). If the Bankruptcy Code were to override state law on the governance of legal practice in this fashion, non-lawyers at least should be required to identify themselves as non-lawyers on the record.

Sec. 403. Filing proofs of claim.

This section would introduce the deemed filed rule in Chapter 7 and Chapter 13 cases, such that the holder of an undisputed, non-contingent, unliquidated claim or interest that appears in the schedules would not have to file a proof of claim. Since there has been some concern that the schedules of individual debtors are of questionable accuracy, applying the deemed filed rule may divert value from holders of properly-calculated claims and would favor those holding claims that debtors inadvertently inflated. By eliminating claims documentation from the files, the deemed filed rule would make the process more difficult and cumbersome for the case trustee, who has the obligation under section 704 to object to the allowance of claims that are improper.

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Sec. 404. Audit procedures.

Under this section, no fewer than 1 in every 50 cases in each judicial district would be selected randomly and would be audited by independent certified public accountants or independent licensed public accountants. Also to be audited would be cases with schedules showing income and expenses reflecting greater-than-average variances from the norm of the district. The Attorney General would establish procedures for fully funding such audits.

The NBC supports the implementation of an audit process. However, auditing 1 in 50 cases—perhaps over 28,000 cases a year—misallocates resources. To conduct audits properly and to avoid funding audits through higher filing fees, auditing 1 in 1,000 cases is a more attainable goal. Moreover, these audits should be geared toward the discovery of undisclosed assets, not the analysis of the debtor's books and records, which generally are minimal or non-existent in individual debtor cases; for this reason, accountants might not be the right professionals to conduct these audits. The Attorney General should have discretion to allocate higher audit percentages to debtors with higher incomes, where the prospects for asset recovery are higher.

Sec. 405. Giving creditors fair notice in chapter 7 and 13 cases.

Section 405 would amend section 342 to require notice to a creditor to include account numbers and specific address or agent if the creditor had so requested. The failure to include such information could invalidate the legal effect of the notice. Effective notice is a crucial component of any judicial process. However, the amendment would entitle a creditor to violate the automatic stay if the notice did not comply exactly with its purported request. This proposal therefore could prejudice the interests of other creditors when an unsophisticated individual debtor does not provide the precise information that a creditor claims it requested.

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Sec. 406. Timely filing and confirmation of plans in chapter 13.

This section would require the debtor to file a Chapter 13 plan within 30 days after filing the bankruptcy petition unless the court ordered otherwise. The confirmation hearing would have to be held within 45 days thereafter. This amendment would lengthen, not shorten, the time to file a repayment plan; Fed. R. Bankr. P. 3015(b) presently requires that the plan be filed within 15 days of filing the petition. These delays could yield higher administrative costs.

Sec. 407. Debtor to provide tax returns and other information.

Section 407 would amend section 521 to require debtors to file additional information, including any tax returns for the preceding three years, pay stubs, section 109 eligibility statement, statement of anticipated increase in income, current tax returns or amendments, statement providing basis for calculation of monthly income and expenses, sources of income, and th-responsible for dependents. Section 407 also would require a certificate of an attorney or petition preparer that he provided the debtor with notice of alternatives to bankruptcy. A pro se debtor would have to submit a certificate stating that she obtained and read the notice of alternatives. Information would have to be updated on an annual basis in Chapter 13 cases.

Much of the information listed in section 407 already is required under current law or pursuant to local district rule or orders or can be obtained through a Rule 2004 examination. While debtors should be required to disclose accurate information, the requirements should be limited to information that is relevant to the bankruptcy case. Privacy issues are implicated squarely by requiring tax returns for prior years, which likely would be subject to challenge by many organizations and individuals. Social security numbers should be added to the list to help track repeat filers and to help verify information. In the case of a pro se debtor, the section does not make clear who would advise the debtor of the requirement to submit the notice of alternatives certificate.

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Sec. 408. Dismissal for failure to file schedules timely or provide required information.

If the debtor did not submit all of the aforementioned information, the debtor's case would be dismissed automatically under this section. Extensions would be granted only with a compelling justification. Given the proposed restrictions on repeat filings contemplated in section 109 and the presumption that filing a second petition due to prior inadvertence is not good faith, this section would heighten the consequences of inadvertence or incompetent counsel. Obtaining copies of tax returns may take longer than the proposed extension period. Moreover, section 707(a)(3) already provides authorization for a U.S. trustee to seek dismissal for failure to file the information presently required by section 521(1). The efficacy of that approacing an automatic dismissal process.

Sec. 409. Adequate time to prepare for hearing on confirmation of the plan.

Section 1324 would be amended to provide that a confirmation hearing may be held no earlier than 20 days and no later than 45 days after the section 341 meeting. is sensible to hold the section 341 meeting prior to a Chapter 13 confirmation hearing.

Sec. 410. Chapter 13 plans to have a 5-year duration in certain cases.

Under section 410, a Chapter 13 plan would have to span at least 5 years if a debtor's income was at least 75% of national median income (national median family income for family of equal size, national median household income for individual earners), but plans could be as long as 7 years for this group of debtors. Two-thirds of confirmed voluntary Chapter 13 plans already result in default and are not completed, resulting in dismissal or conversion. Requiring debtors to commit to repayment periods beyond 5 years would lower the completion rate and would raise significant policy questions regarding the appropriate length of time for a repayment plan.

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Sec. 411. Sense of the Congress regarding expansion of rule 9011 of the Federal Rules of Bankruptcy Procedure.

Section 411 expresses the sense of Congress that Rule 9011 should be modified to include a requirement that all documents, including schedules, should be submitted to a court or trustee only after the debtor or the debtor's attorney has made reasonable inquiry to verify that the information is well-grounded in fact and is warranted by existing law or a good faith argument for extension, modification, or reversal of existing law. Parties and their attorneys should be encouraged to make diligent efforts to provide accurate information. The same standards should apply to all parties in a case and should apply in both business and consumer cases.

Sec. 412. Jurisdiction of courts of appeals.

Under this section, appeals from final orders of bankruptcy judges would be heard by the circuit courts of appeals, not by district courts or bankruptcy appellate panels. The NBC supports this amendment; it would streamline the bankruptcy process, reduce litigation costs, and heighten the precedential value of bankruptcy appeals, which ultimately should lower the number of appeals. It would bring bankruptcy appellate procedure into accordance with that of some other non-Article III tribunals.

Sec. 441. Improved bankruptcy statistics.

This section would order the Director of the Executive Office for United States Trustees to compile statistics (in a format established by the Administrative Office of the United States Courts) and to make them publicly available and to report to Congress annually on the following: total assets and liabilities, monthly income, projected income, average income and expenses, aggregate amount of debt discharged (using the following calculation: total debt minus predominantly non-dischargeable debts), average case length and reaffirmation information. For Chapter 13 cases, the following would have to be collected: number of cases with property valued less than the amount of the claim (stripped down debts), number of cases dismissed for failure to pay in accordance with the plan, and number of cases with successive filings within six years after the first filing.

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The need for accurate data is unquestionable, and the proposed amendments suggest that there currently exists little reliable evidence on which to justify dramatic changes to the system and any such reform should await the results of the proposed data collection. However, the legislation delineates reporting instructions that could produce inaccurate data. For example, the recommended calculation of total debt discharged would not account for reaffirmed debts, and thus would be seriously misleading. Accurately calculating predominantly non-dischargeable debts could not be accomplished due to widely divergent interpretations of what constitutes a non-dischargeable debt. The proposed Chapter 13 reporting requirements are under-inclusive and would omit pertinent information such as: the number of debtors obtaining hardship discharges and the number converted to Chapter 7 upon plan default; the number of months/years of plan compliance for debtors who ultimately default; percentage of general unsecured debt committed to be repaid in completed Chapter 13 cases as compared to Chapter 13 cases not completed; amount of priority and non-dischargeable debts to be repaid in Chapter 13 plans; objections to Chapter 13 plans; average length of time between filing and confirmation of Chapter 13 plans. Academics and government officials with expertise in data collection should be consulted to determine the proper method of collecting the desired information.

Sec. 442. Bankruptcy data.

This section would require the Attorney General to issue rules requiring uniform forms for final reports by trustees in all chapters and for debtors in possession. Trustees' reports would include information regarding the following: length of time case was pending, assets abandoned, assets exempted, receipts and disbursements of the estate, expenses of administration, claims asserted, claims allowed, distributions to claimants and claims discharged without payment. Chapter 11 reports would be required to include information regarding standard industry classification, length of case, number of employees, cash receipts, disbursements, and profitability, compliance with legal requirements, tax payments, professional fees, plans of reorganization filed, and recoveries of holders of each class of claims.

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These types of information would be useful for parties to a particular case and for Congress when it establishes bankruptcy policy. This information should be collected before enacting the proposed small business and single asset real estate provisions.

Sec. 443. Sense of the Congress regarding availability of bankruptcy data.

Section 443 would express the sense of Congress that all data held by bankruptcy clerks should be released in electronic form to the public on demand and that the bankruptcy system should use a single set of data definitions and forms to collect data nationwide. This section expresses appropriate goals that should guide further efforts in data collection.

Sec. 501. Treatment of certain liens.

This section would exempt ad valorem real or personal property tax liens from the subordination operation of section 724(b)(2), consistent with S. 1149, introduced by Senators Grassley and Durbin. Although other tax liens still would be subject to subordination, section 501 would require a trustee to first exhaust unencumbered assets of the estate and to surcharge collateral under section 506(c) for the reasonably necessary costs and expenses of preserving and disposing of that properly. The NBC supports the proposed exemption for ad valorem real property tax liens, but opposes the remainder of this recommendation. The reasons traditionally justifying the subordination of tax liens in this limited context remain in full force today. Imposing a statutory requirement to marshal assets and to surcharge collateral might create peripheral litigation that would diminish further the limited assets of the Chapter 7 estate. Moreover, many personal property tax liens are voided by section 545, and thus they are not affected by the operation of this provision.

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Section 501 also would withdraw jurisdiction from the bankruptcy court to determine the amount or legality of any ad valorem tax after expiration of the applicable period for contesting or redetermining that amount under non-bankruptcy law. This provision is problematic. The bankruptcy court should retain the jurisdiction to determine pre-petition and administrative taxes that affect distributions to other creditors.

Sec. 502. Enforcement of child and spousal support.

Also consistent with S.1149, this section would amend section 522(c)(1) to provide that property shall be liable for non-dischargeable taxes and family support obligations post-discharge regardless of whether state exemptions or federal exemptions were used. This amendment seems to be designed to clarify that even the most protective state exemptions cannot insulate property from non-dischargeable tax and domestic support obligations. *See, e.g., In re Davis*, 105 F.3d 1017 (5th Cir. 1997) (section 522(c)(1) preempts state law and makes homestead remain liable for pre-petition non-dischargeable domestic support obligations), *reh'g en banc granted*, 131 F.3d 1120 (5th Cir. 1997). Although this amendment might clarify one attribute of exemption law, navigating between federal and state law is likely to remain confused as long as bankruptcy exemptions continue to be governed by multiple laws.

Sec. 503. Effective notice to government.

This section sets forth parameters for providing notice to government units. Although some of the recommendations are reasonable, the details of adequate notice should be addressed in the Federal Rules of Bankruptcy Procedure, not the statute. One detail of concern is the requirement that if a debtor is liable to a governmental unit on account of an obligation owed or incurred by another party or under a different name, the debtor shall identify such entity; this means that a debtor who is unaware of a potential trust fund liability, or believed in good faith that no liability existed, might run afoul of the statute for failure to notify a governmental unit of this liability. A better approach that would accomplish the intended goals would be to require disclosure of business organizations in which the debtor owned a substantial equity interest or in which the debtor was an officer or director.

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Sec. 504. Notice of request for a determination of taxes.

This section would amend section 505(b) to require that any request for a determination of tax liability under that section would have to be made in a manner designated by the governmental unit. To be reasonable, this proposal should require governmental units to fife the requisite notice forms with the courts. Otherwise, the form of notice may not be available to a debtor in good faith who seeks to comply. Without the addition of a filing registry, the proposal should be opposed.

Sec. 505. Rate of interest on tax claims.

Under section 505, the rate of interest on deferred taxes, including state and local taxes, would bl would provide a clear rule and avoid litigation over the applicable interest rate, which otherwise can lead to gamesmanship and strategic behavior.

Sec. 506. Tolling of priority of tax claim time periods.

This section would make several moderate changes that reflect current law and several quite significant changes that should be opposed. First, section 506 would toll three-year and 240 clay periods of section 507(a)(8) of the Bankruptcy Code during the duration of a case, which is a reasonable proposal that reflects the majority of current law. In addition, section 506 also would make the 240-day period for offers and compromise apply to pre-assessment and post-assessment offers. However, section 506 also would add six months to the tolling period under section 507(a)(8)(A)(i) during which the prior bankruptcy case was pending, which does not appear to be necessary or to be supported by any policy justification. Further, section 506 would toll the 240-day period for the duration of an installment payment agreement, which could add years to the tolling period and is not a necessary or desirable change.

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Sec. 507. Assessment defined.

This section would amend section 101 to add a definition of assessment for state and local taxes and would provide that assessment of federal taxes would have the meaning provided by the Internal Revenue Code. This proposal would clarify current law and is unobjectionable. Unlike federal tax law, which provides a clear and reasonable definition of assessment, state laws do not have a uniform understanding of this term. This proposal would provide a uniform definition of assessment that is consistent with the federal tax law definition without disturbing the application of the federal definition.

Sec. 508. Chapter 13 discharge of fraudulent and other taxes.

This section would further restrict the scope of the Chapter 13 super-discharge by disallowing the discharge of taxes falling under section 523(a)(1), even if the debtor has paid in accordance with her Chapter 13 plan for 5–7 years. Thus, the remaining indebtedness on a wide range of tax claims could not be discharged. The super-discharge currently helps get debtors back into the tax system and to retrieve back taxes that otherwise would likely be uncollectible, and altering these provisions may have undesirable consequences. This section, in conjunction with section 143, would substantially reduce the debtor's ability to discharge debts after completing a long repayment plan, and thus may decrease the incentives to file for Chapter 13 or to complete a repayment plan.

Sec. 509. Chapter 11 discharge of fraudulent taxes.

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Section 509 would amend section 1141(d) of the Bankruptcy Code such that plan confirmation would not discharge a corporate debtor from a tax debt on which the debtor made a fraudulent return or which the debtor willfully attempted to evade or defeat. This provision is unobjectionable.

Sec. 510. The stay of proceedings in tax court.

This section would provide an exception to the automatic stay or appeals from certain court and administrative decisions determining a tax liability of the debtor. This provision appears to be unobjectionable and was supported unanimously by the Tax Advisory Committee of the National Bankruptcy Review Commission. However, various provisions of H.R. 3150 offer new exceptions to the automatic stay for various interests. The aggregate effect of these provisions should be considered carefully before enacting numerous provisions that will erode automatic stay protection for the collective interests of creditors and interest holders.

Sec. 511. Periodic payment of taxes in chapter 11 cases.

This section would make two changes. First, it would require plans to provide for uniform periodic payments of deferred priority taxes. The NBC opposes this proposal. Courts and parties should have flexibility to establish non-level payments for good business reasons. In addition, the amendment itself appears to have some implementation problems that would have to be repaired prior to enactment, (e.g., requiring payment of at least 15% of the claim over the first 5 years and no more than 20% of the claim in the final year).

This section also would apply the six-year stretch-out to secured tax claims, which appears to be unobjectionable.

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Sec. 512. The avoidance of statutory tax liens prohibited.

Section 512 would amend section 545(2) to codify that superpriority rights accorded to some purchasers by the Internal Revenue Code and parallel state and local law provisions cannot be used by a trustee to avoid tax liens in stocks, securities, motor vehicles, inventory, certain goods purchased at retail, and certain household goods. Although the NBC agrees that the section should be clarified to eliminate litigation, the NBC would resolve the matter differently. Specifically, section 545(2) should be clarified to give the trustee the status of a hypothetical bona fide purchaser without knowledge or notice of a lien, who takes possession of the item purchased and has not relinquished possession. This status would preserve for the benefit of all creditors those items of property on which the filed tax lien does not take priority in all circumstances under non-bankruptcy law. A similar change should be made to the definition of purchaser in section 544(a).

Sec. 513. Course of business payment of taxes.

This section would require that post-petition taxes be paid in the ordinary course of business, that ad valorem real property taxes be paid when due, and that administrative period tax liabilities be paid without a request from the governmental unit. It is reasonable to require that a Chapter 11 debtor that remains in business needs to pay taxes in the normal course as a business expense, and this is generally what occurs under current law. However, this provision does not address the situation of an administratively insolvent estate and whether this change inadvertently would give taxes a super priority over other administrative expenses.

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Sec. 514. Tardily filed priority tax claims.

This section would amend section 726(a)(1) so that late filed tax claims would be entitled to distribution under that subsection to the extent they are filed before the date on which the court approves the final report and accounting of the trustee. The proposed change should be supported, as it is consistent with the efficient administration of bankruptcy estates to require late filed tax claims to at least be filed prior to a trustee's final accounting.

Sec. 515. Income tax returns prepared by tax authorities.

Under this section, for purposes of section 523(a)(1)(B), return would include returns filed by the governmental unit or a written stipulation to judgment entered by a non-bankruptcy tribunal. This recommendation should be supported. When a tax liability has been fixed between the taxing authority and the debtor, the underlying rationale for excepting the tax debt as an unfired claim no longer is applicable. However, it is unclear why the amendment also would provide that the return must have been filed in a manner permitted by applicable non-bankruptcy law, which may cause confusion and is not necessary to effectuate the primary component of this section.

Sec. 516. The discharge of the estate's liability for unpaid taxes.

This provision would add the bankruptcy estate to the list of parties that would be protected from a tax claim upon failure of a governmental unit to respond to a request for a determination of taxes under section 505(b). The NBC supports this proposal. The consequences of a governmental unit's failure to respond to such a request should affect the estate if it affects the liability of the trustee, the debtor, and the successor to the debtor.

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Sec. 517. Requirement to file tax returns to confirm Chapter 13 plans.

As one of several new conditions to confirming Chapter 13 plans, section 517 would require debtors to have filed the past 6 years of tax returns prior to the first meeting of creditors, and would make some provisions for extensions for compliance. Although some wage earners arguably would be able to comply easily with this provision, others who have held multiple jobs or have had independent contractor status may have more difficulty. provision also might prolong the Chapter 13 process, although several other provisions of H.R. 3150 already extend the period between filing and confirmation. If this provision were enacted, the debtor should not have to prove her need for a further continuance by clear and convincing evidence when the preponderance of the evidence standard is generally used in bankruptcy proceedings.

Sec. 518. Standards for tax disclosure.

This section would amend section 1125 to require that disclosure statements contain a full discussion of the tax consequences of a plan of reorganization. This proposal would enable parties to be better informed about significant consequences of a plan of reorganization.

Sec. 519. Setoff of tax refunds.

Section 519 would amend section 362 to permit t-petition income tax obligations against pre-petition income tax refund rights without seeking court permission. The NBC opposes this proposal and believes that governmental units should continue to be required to request relief from the stay before proceeding against property in which the estate has an interest, notwithstanding the fact that some local rules already permit set off without court permission. The consequences of wrongful setoffs are particularly acute for the bankruptcy estate and other creditors if Congress is unable to abrogate state governments' sovereign immunity in federal court and cannot deem the government to have waived sovereign immunity by other acts. *Seminole Tribe of Florida* v. *Florida*, 116 S. Ct. 1114 (1996).

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Mr. **GEKAS.** We thank the gentleman. And the Chair will yield itself the customary 5 minutes and begin with a question to Prof. Morris.

I take it that you are opposed to the requirement that we have for the submission of tax returns, is that correct?

Mr. **MORRIS.** We think it's a good idea to have that information, Congressman.

Mr. **GEKAS.** How should we get it?

Mr. **MORRIS.** But making that a consequence of dismissal of a case is oftentimes a very harsh result for someone who may not even have been required to file a tax return or whose records are lost.

Mr. **GEKAS.** You believe that we would not provide for discretion if a tax return cannot be produced or is proved to be unavailable.

Mr. **MORRIS.** Well, I think that one of the consequences is that as you require more and more of this information that for many lower-income consumer debtors is very difficult to acquire, then someone is going to say go get it from the IRS and so forth. Now you are delaying their ability to file, you are increasing the costs that they incur until they're ready to file, and in the meantime, they may be facing a foreclosure or a repossession, a shutoff of utility services. It could be a variety of things that may lead to the bankruptcy filing, a garnishment, for example.

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Mr. **GEKAS.** You are going to have a tough time convincing me that that isn't a good provision in any bankruptcy reform that we undertake, to get as much information and verifiable documentation as possible on the condition of the person seeking bankruptcy. So you and I have an argument on that.

As to auditing, how do you appraise the situation that exists today on auditing?

Mr. **MORRIS.** Auditing is done on a regular basis by individual panel trustees. What happens essentially is that a smell test is applied by trustees and has been for as long as I am aware. Debtors who come in and have a particular address where they live, the trustee is probably from the area and says, gee, that's a pretty nice area. Why do you have $2,000 for all of your household goods? Those kind of things tend to catch the eye of trustees, and then in those instances, they will increase their own review of the debtor.

Mr. **GEKAS.** I think you have given a theoretical answer, but in what we have seen, there is very little of that auditing accomplished. That's just another point of conflict that we have.

Mr. McEneney, how would you answer Judge Wedoff's description of the, what I would call in his words—not in his words, but the way he described it—unjust enrichment for the secured creditor under the provisions that he described.

Mr. **MCENENEY.** Well, I would disagree with that characterization. I think that replacement value is the best value, the best measure of value of a particular asset. And I will give you an example. If a secured lender actually takes possession of the asset, that secured lender then has an opportunity to sell it and an opportunity to sell it at retail value, which is the accurate value that your bill would provide for. That's replacement value and I think that's probably the most accurate measure of the value of that particular asset.

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Mr. **GEKAS.** Mr. Duncan, how does your industry view the *Sears* case in the reaffirmation issue?

Mr. **DUNCAN.** The *Sears* case clearly shows that the system worked. Although I'm not privy to all the details of that case, Sears has acknowledged that it made a mistake, that it handled reaffirmations improperly, and it has been forced to pay rather significant penalties amounting to, at this point, refunds and penalties in excess of $200 million. So that's a case of the system working.

However, in other cases, reaffirmations do work to consumers' benefits because it allows them to tailor their chapter 7 relief.

Mr. **GEKAS.** Mr. Boone, you assert that in section 130, that we helped to solve the cram-down issue, is that correct?

Mr. **BOONE.** That's correct, sir.

Mr. **GEKAS.** And you agree, Mr. Tassey, I assume.

Mr. **TASSEY.** Yes, sir.

Mr. **GEKAS.** Well, maybe you weren't looking primarily at section 130, but you approve of our efforts to address the cram-down problem.

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Mr. **TASSEY.** Yes, sir.

Mr. **GEKAS.** In H.R. 3150, is that correct?

Mr. **TASSEY.** Yes.

Mr. **GEKAS.** I have no further questions. I yield back to the Chair the Chair's time it allotted to itself, and yield to the gentleman from New York.

Mr. **NADLER.** Thank you.

Mr. McEneney, you testified that in the so-called needs-based test in H.R. 3150, that regional variations are taken into account.

Mr. **MCENENEY.** Correct.

Mr. **NADLER.** Now, most people allegedly would be excluded from the needs-based test by the fact that there is a floor of 75 percent of median national income. Is that varied to reflect regional variation in the cost of living?

Mr. **MCENENEY.** Well, first, I would just point out that is not part of the expense standards.

Mr. **NADLER.** No, it's not, but it's part of the test.

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Mr. **MCENENEY.** It is part of the test. The expense standards do clearly take into account what the location is.

Mr. **NADLER.** I know that. But does this take that into account?

Mr. **MCENENEY.** The median family income number does not.

Mr. **NADLER.** Why not?

Mr. **MCENENEY.** It's a national number. Well, the median national income number is used mostly as an administrative cutoff which——

Mr. **NADLER.** Well, but wouldn't you agree, sir, that if you have a place where there's a very high cost of living and in fact where the median income is much higher. And if you're using the regular national median income, in fact, you're catching a lot of, in effect, lower-income people than elsewhere.

Mr. **MCENENEY.** Well, I would agree that——

Mr. **NADLER.** So should we change the bill to reflect that?

Mr. **MCENENEY.** If I may answer, I would agree that you are then requiring certain people to go through a very simple needs-based calculation, but in fact, if the expenses are higher in their geographic region, that is reflected in the expense standards and taken into account.

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And if I may point out, I think the chart there shows that as an administrative cutoff, the median income number works quite well as it stands right now. More than half of the people who filed chapter 7 in 1997 are taken off the table immediately——

Mr. **NADLER.** But if you had the median income varied by regional cost, then it would be a greater percent taken right off the top, wouldn't it?

Mr. **MCENENEY.** It may. In certain areas, that's correct, it may.

Mr. **NADLER.** Let me ask you, Mr. Duncan—well, actually, Mr. McEneney. On the needs-based test you take into account your income. Isn't it correct that if someone had an income of let's say, $50,000 or $60,000 and was suddenly laid off and hasn't been able to find a job in the last 3 months and now his income is $5,000, under this test his income is still considered $60,000?

Mr. **MCENENEY.** No.

Mr. **NADLER.** No? How does it work?

Mr. **MCENENEY.** It works by taking an average of the last 6 months' income. And the reason for taking an average rather than a snapshot at the point in time that the debtor files is to try and make some reasonable prediction that the debtor's original capacity——

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Mr. **NADLER.** All right, but if you are making a reasonable prediction, if someone worked for AT&T or for Kodak and has worked there 30 years as middle management and suddenly they have closed their plant or said you're not going to have a job again, he's never going to have another job worth more than, I don't know, $25,000. You get a very wrong picture, don't you?

Mr. **MCENENEY.** I think, again, if we look at the definition of currently monthly income, if the debtor does not currently have income, then I believe that's taken into account in the needs-based test.

Mr. **NADLER.** I thought you just said it's a 6-month average.

Mr. **MCENENEY.** It is a 6-month average of current income. And if the debtor has zero income in a month and does not have any current income, then I think that debtor is entitled to relief under the needs-based test that stands right now.

Mr. **NADLER.** Judge Wedoff, would you comment on how this would work in practice, in light of what I was just saying?

Mr. **WEDOFF.** Well, there are two ways in which the 75 percent threshold works. One is to determine whether a debtor is subjected to an individualized assessment of expenses. However, another use is to determine the length of a chapter 13 plan. Any debtor whose household income is 75 percent of the national median for a household of the same size is required to go through a 5-year, as opposed to a 3-year chapter 13 plan regardless of the level of household expense. So the income test has two effects, not just one.

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Moreover, the use of median income based on household size produces anomolous results. A household of two, for example, has a median income more than twice the median income of a household of one. Even more peculiarly, as household size increases beyond four, median income actually goes down. Median income for a household of six is less than median income for a household of three. If the intent of the bill was to allow higher income for larger families, it will actually produce the opposite effect.

Mr. **NADLER.** Let me ask you a different question, Judge Wedoff. Mr. Duncan was talking before about the fairness of reaffirmation proceedings and how it works or can work to the advantage of the debtor.

Can you comment on this whole situation about reaffirmations, especially in light of a situation such as the Bruzzese case where a $500 debt was reaffirmed at an effective interest rate of 124 percent, and how this works, especially when there is no counsel.

Mr. **WEDOFF.** Reaffirmations are subject to abuse. The problem of reaffirming any kind of unsecured debt is that the debtor is basically contracting for a future loan with no limit on the interest that can be charged on that loan.

What the debtor pays, in order to get new credit, is not only the fees and interest rate that apply to the new credit itself, but also whatever is being repaid on the discharged debt.

Mr. **NADLER.** Let me just follow that up, if I may, with one more question. This bill, H.R. 3150, proposes to let the parties in interest, not simply the court or the trustee, make motions to contest a lot of things.

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How would this affect the reaffirmation agreements for an unrepresented debtor, say?

Mr. **WEDOFF.** An unrepresented debtor is very unlikely to know what rights that person has under the Bankruptcy Code. Therefore, the Bankruptcy Code currently requires that unrepresented debtors may only enter into reaffirmation agreements with court approval.

Mr. **NADLER.** Then how would the change made by this bill affect that?

Mr. **WEDOFF.** It wouldn't affect that for an unrepresented debtor. Their reaffirmation agreements would still require court approval.

Mr. **NADLER.** It wouldn't be more coercive, in your opinion?

Mr. **WEDOFF.** You're talking about other issues. You're talking about the ability of other parties to bring 707(b) motions and things of that sort?

Mr. **NADLER.** Yes, yes, yes.

Mr. **WEDOFF.** That was discussed in the earlier panel. Yes, to the extent that there's more pressure brought on individual debtors by other mechanisms, reaffirmation would be a way of getting around that, yes.

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Mr. **GEKAS.** That's what the situation is today, is it not?

Mr. **WEDOFF.** Yes. Mr. Chairman, if I could answer that question. Right now, there is pressure brought on individual debtors to reaffirm debt that might be subject to dischargeability complaints. If there is greater potential for bringing other causes of action like 707(b) motions against debtors, there will be more pressure on them to reaffirm debt.

Mr. **GEKAS.** More pressure to reaffirm debt?

Mr. **WEDOFF.** Yes.

Mr. **GEKAS.** Thank you. The gentleman from South Carolina is recognized for 5 minutes.

Mr. **GRAHAM.** Thank you, Mr. Chairman. I'm new to the subcommittee and trying to learn as we go, so bear with me. As somebody that's new, does anyone disagree that it's time to bring about some reform and changes in bankruptcy law?

Mr. **MCENENEY.** I certainly don't. I think that based on what we know today, we know that in 1997 about $40 billion in debt was discharged without most of those debtors being asked if they needed that relief, and if so, how much. So I think on that basis alone the record is pretty clear that there is a need for some change to ensure that people get the relief that they need, but don't arbitrarily get more.

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And I think that based on H.R. 3150, what Ernst and Young has shown is that if H.R. 3150 were implemented today, that that could mean cost savings to the American bill paying public of about $4 billion a year.

Mr. **GRAHAM.** Thank you. Mr. Boone, what special concerns does the increase in consumer bankruptcy filings present to the residential real estate loan industry? And I want to add something to that. I had a group come by my office yesterday on the section 8 housing business, and they are talking about evicting someone who hasn't paid their rent and if they file bankruptcy, there is an automatic stay and it's like an eight-or 9-month process before you an get the matter settled. Could you comment on both of those, the effect.

Mr. **BOONE.** I can. I can comment on the first, particularly. The impact on us is increasing monitoring of bankruptcies. To the extent that we are secured and have real estate to sell, in general, our debt is satisfied to the extent that the property's value is there.

But to the extent that the current bankruptcy legislation allows the continual filing or abusive filing to occur with the automatic stay kicking, it extends the process unnecessarily, even after a mortgagor has failed to comply with a chapter 13 plan and then to continue to file bankruptcy and extend the process.

So it has a substantial administrative cost to us and to the industry overall. The properties are deteriorating and were continuing to pass through to the final security holders during the whole period of time, so the total debt or the amount outstanding on a particular loan continues to increase during the extended process.

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So the costs are substantial to us, and we believe under this legislation, under the proposed legislation, it will provide us some cures. Although we would appreciate some additional tightening of the legislation as it relates to the multiple filings of bankruptcies.

Mr. **GRAHAM.** Judge, would you like to comment? What's your view of this dilemma?

Mr. **WEDOFF.** The question of the automatic stay being abused is a real one, and my understanding is that it is a particularly serious problem in California, where there are efforts to transfer ownership of property to allow for repeated invocation of the automatic stay.

I think that this is an issue that very much needs to be addressed, and I think that the ideas in H.R. 3150 and H.R. 2500 are very helpful in addressing it. I have just one concern—in situations where there is actually equity in the property, there should not be automatic removal of the automatic stay where a chapter 7 trustee might want to sell that property for the benefit of all the unsecured creditors.

However, I think that's a change that could be fairly easily made. When we are dealing with property that doesn't have equity—and that's the concern of the mortgage industry—in rem relief from the automatic stay and prohibition of the stay coming into effect with repeated filings is a very good idea.

Mr. **GRAHAM.** Mr. Duncan, my colleague, Mr. Nadler, has a provision, I believe in the bill, sort of aimed at the reckless lending practices by the unsecured credit industry. Some of the facts I am looking over are astonishing; how much people get into debt and how much somebody is willing to lend them or let them run up credit card bills.

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Could you tell us how his provisions would effect the unsecured credit industry, if at all?

Mr. **DUNCAN.** Well, by making a large amount of debt nondischargeable, the effect is going to mean that less credit is going to be made available to individuals. And that has serious consequences not only for those people who have gotten into trouble, but for people who manage debt wisely.

We really can't have a system where we are letting the activities of a few people determine whether there is going to be credit availability for the majority.

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

Mr. **GEKAS.** We thank the gentleman. We turn to the gentleman from Massachusetts, Mr. Meehan, 5 minutes.

Mr. **MEEHAN.** Thank you, Mr. Chairman. Professor Morris, you seemed to suggest in your testimony that means testing eligibility for chapter 7 would not simply force certain debtors into chapter 13 as opposed to chapter 7; rather it would force some debtors out of the bankruptcy system altogether.

I was wondering if you could explain how that would happen. And furthermore, how would creditors fare in terms of collecting their debts where more debtors are subject to the operation of State collection laws, as opposed to the bankruptcy system. Would some creditors stand to gain more than others, for example?

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Mr. **MORRIS.** Well, certainly I think that if debtors are moved into an involuntary chapter 13 system, you are moving those people into a system where voluntarily only 30 to 35 percent are successful anyway. The success rate for involuntary chapter 13, by its very nature, has to be much lower.

Those people wash out of there. Where do they go? Just back to the State collection system, private collection system, or in fact, underground. If they're in the State collection system, then the most professional, if you will, creditors are most likely to be successful in engaging in those collection activities.

And those would be institutional lenders, credit card lenders, that sort of grouping of creditors, as opposed to other creditors like even alimony and support creditors who have long been complaining about their inability to collect claims. If the debtor is left with no place to turn after that, after continuing garnishment, some debtors—and a number of them will do this—they'll just learn how to work under the table. They'll opt out of the system entirely. Their wages in that sense won't be subject to garnishment because you won't be able to find them.

But they won't be paying taxes, they won't have any chance for health insurance, they won't be planning for their retirements, and their families will be at a relatively constant level of financial strain.

Mr. **MEEHAN.** In your written testimony, you argue that wealthy, well-advised debtors could easily circumvent a means test by their incurring more debts and adjusting their expenses perhaps on the eve of bankruptcy.

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I know that in the Bankruptcy Code right now there are some provisions that attempt to remedy precisely this problem, even though there is no means test yet. For example, luxury goods purchased on credit within sixty days of order for bankruptcy relief are presumed to be nondischargeable.

Do you believe that the current anti-fraud provisions of the Code are insufficient to prevent careful manipulation of a means test, and if so, what can be added to the Code to prevent such manipulation?

Mr. **MORRIS.** Well, by its very nature, manipulation involves people who are engaged in taking existing rules and trying to end run them. Every time a rule is put in place, there are going to be more attempts. So we're left with fraud which has always been a difficult thing to prove. It's been an easy thing to allege also, which is why historically there was a higher burden of proof at one time of clear and convincing evidence for fraud, rather than a preponderance of the evidence.

But the fact of the matter is that it's difficult on both sides. It's difficult to assert successfully and in some ways, it's difficult to defend successfully because it's a mushy concept. But if you substitute a hard-and-fast rule for it, it makes it even easier for the intentional person to avoid the application of those kinds of rules.

Mr. **MEEHAN.** You mention in your testimony and we've talked about it a little bit during the course of this hearing, that some creditors are far better equipped to pursue reaffirmations than others, and I was wondering if you could elaborate on that comment a little bit.

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Mr. **MORRIS.** Reaffirmations are oftentimes asserted to be an opportunity for the debtor to obtain further benefit. But in fact, the whole purpose of the reaffirmation is to take a creditor that Congress has said is no better than other creditors and, notwithstanding Congress' determination, override that rule and say well, I want to be free on the other side to continue to collect to the full extent that I can.

And debtors, by that very act, give up that which they have taken serious action to go ahead and do. The more reaffirmations we have, the less concern there is for a bankruptcy system because it's not providing the relief that clearly seems to be needed.

Mr. **MEEHAN.** Judge Wedoff, you make a fairly strong case that using median national household income as a threshold for testing the ability to pay one's debts is extremely problematic.

Can you suggest any alternatives for a threshold for scrutinizing ability to pay?

Mr. **WEDOFF.** One could adopt absolute numbers, depending on the number of dependents. I know that in H.R. 3146 there is a $60,000 number used at one point, with $5,000 per dependent. I'm not suggesting that that's the right number, but that's a manner in which a threshold could be approached, not tied to this median household income by size, which I don't think works.

Mr. **MEEHAN.** That's exactly what I'm interested in. What type of alternative could be——

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Mr. **WEDOFF.** Absolute numbers with adjustments for dependents.

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

Mr. **DUNCAN.** Mr. Chairman, could I amplify just one moment on the question.

Mr. **GEKAS.** By all means. We will make this the last comment.

Mr. **DUNCAN.** Thank you. Mr. Meehan, a number of individuals come to us after they've declared bankruptcy or as they are declaring bankruptcy and they realize that they are going to face an impossible time getting credit after the filing. This morning there was some discussion about the consequences of that.

And you have to keep in mind the reaffirmations, the ability to keep one or two lines of credit open so that you can survive, whether it's for renting a car or reserving a hotel or for emergency travel is important to people. And they can get that at a much more favorable rate after bankruptcy, with reaffirmations, than they could if they took some of the alternatives mentioned this morning.

Mr. **MEEHAN.** I mean, I hear the response, but I mean, I think what some of us are talking about is just an incredible explosion of availability of credit cards that is just unprecedented, it seems. Well, anyway I accept what you said.

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Mr. **DUNCAN.** But those kind of cards are not available to people who file bankruptcy. Retailers don't extend credit to people who file bankruptcy.

Mr. **GEKAS.** We thank this panel for the very wonderful exchange, and I for one—I think the others can vouch for it—have learned about the different attitudes.

Ms. **JACKSON LEE.** Mr. Chairman.

Mr. **GEKAS.** So we thank you very much.

Ms. **JACKSON LEE.** Mr. Chairman.

Mr. **GEKAS.** The lady from Texas is recognized.

Ms. **JACKSON LEE.** Thank you very much, Mr. Chairman. I thank the gentlemen for their appearance and I apologize for not hearing a lot of your testimony, inasmuch as there are debates going on on the floor of the House.

I have a general question that I would appreciate if each of you would answer. Let me say that I am distraught that we are in this process, not because there is not importance around finding some sort of balance between creditors and debtors, but I think that our basis premises, our statistical premises, are in error. I don't think the problem—may not be as large as some would like to think.

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So I'd like from each gentleman to give me the most dire circumstances—I see a lady here—that warrants remedying, and in particular, why not the Nadler-Conyers response to that. Mr. Boone.

Mr. **BOONE.** Thank you very much. Again, and I'll repeat what I said earlier, the issue that is most dire to us today as a secured lender is the ability of a creditor to continue to file—excuse me, a debtor to continue to file multiple bankruptcies by transferring a piece of their interest in the property to third parties and to continue to delay an inevitable foreclosure process after the point in time that a bankruptcy plan has already been submitted and not complied with by the original mortgagor.

That is our biggest challenge and it is addressed in H.R. 3150, and we have submitted evidence, some additional information. We believe it could be tightened up further. Thank you.

Mr. **TASSEY.** I think for our part of the industry that the thing we are most concerned about, again, is providing some way to slow down the increase in bankruptcies where there is a meaningful ability to pay.

Whatever social contract in the past that has governed the use of bankruptcy seems to be gone, and we strongly support the institution of some kind of new gatekeeper, such as in H.R. 3150, that would restore some trust and fairness to the bankruptcy system.

Mr. **DUNCAN.** I would have to echo what Mr. Tassey said. For us, it is quite literally the explosion in the numbers of individuals. We are literally seeing hundreds of thousands of individuals who are filing for bankruptcy without showing any prior indication that they've made an effort to try to work out their difficulties or to repay.

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We've reached the point in the retail industry that for many companies 50 percent of the people who are filing have never been seriously delinquent. It's just as if they decide, this is a great idea, I can eliminate a lot of debt by paying $500 or $700 to an attorney, and they do it.

Now I'm not saying that everyone is doing it, but it is a growing issue.

Ms. **JACKSON LEE.** Do you use credit cards, Mr. Duncan, in your retail association? I know you have grocery stores included, but do the bulk of them use credit cards of some form?

Mr. **DUNCAN.** Most of our members—virtually all of our members accept credit and many, many of our members offer credit as well.

Ms. **JACKSON LEE.** The difficulty I have is that when we look at the overall numbers, there are only 4 percent default on the credit cards and so I find that to be disturbing. But I appreciate—I don't have time, Mr. Tassey. I need to go through to Mr. McEneney. Thank you.

Mr. **MCENENEY.** Yes, I think the most dire circumstance that's a problem for all of us is the fact that last year bankruptcy discharged $40 billion in debt without asking people whether they needed it.

Now, where else would we tolerate giving away $40 billion of relief without asking the question whether individuals need it? And there's a real cost to American consumers. I think the Ernst and Young study, which you heard about last week, suggests that it costs about $4 billion. Now, $4 billion to the American bill-paying consumer—even in Washington, $4 billion is large number.

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And I think that alone is a dire enough consequence that ought to require that the Bankruptcy Code be changed and changed quickly.

Ms. **JACKSON LEE.** Judge Wedoff, you see this firsthand and so I'd like you to answer that question just in the practicalness of seeing litigants in court, but also, if we don't have—or without reaffirmation a debtor cannot get additional credit even after the discharge, so in this whole world where there is nothing but credit. You go to rent a car, as you well know, and you want to give them cash and you can't do it. Then we leave people without even the ability to live. But I'd appreciate your response.

Mr. **WEDOFF.** One of the reasons given for the necessity of reaffirmation agreements is that they give the debtor an opportunity to have a credit card after bankruptcy. I don't believe that this rationale is correct.

Credit cards are not necessary. A debit card may very well be sufficient to rent a car, and that does not require an extension of credit.

Ms. **JACKSON LEE.** Is there a dire need that you think that warrants this legislation?

Mr. **WEDOFF.** I think that the question of people abusing the bankruptcy system is one that needs to be looked at, but the cost of a system to address that problem also needs to be looked at. We had a debate at the ABI where those issues were very thoroughly explored, and I thought it was very helpful. We have the transcript on the web site.

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Ms. **JACKSON LEE.** Mr. Morris. Thank you.

Mr. **MORRIS.** Well, I would certainly agree, and the National Bankruptcy Conference agrees that these multiple distributions of real estate appear to be nothing more than a scam and to the extent that the bill takes care of that, that's a great idea. You just shouldn't be able to do that.

But generally speaking, a lot of the reform that's sought in both H.R. 2500 and H.R. 3150 can have a lot of unintended consequences that are not, I think, fully appreciated at this point and can lead to, in some sense, increased filings for unexpected reasons, and also exclusion from the system for people that everyone would agree are worthy of bankruptcy relief or in need of bankruptcy relief. So I think caution may be the watchword.

Ms. **JACKSON LEE.** Thank you very much. Mr. Chairman, I'd just ask that I had a statement for the record and I'd ask unanimous consent to have it admitted.

Mr. **GEKAS.** Without objection.

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

Mr. **GEKAS.** The gentleman from Tennessee is recognized for 5 minutes.

Mr. **BRYANT.** Thank you, Mr. Chairman. My apologies also for having again conflicting times. I have to be away.

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But Professor Morris, I know you've testified with this very strong panel. I understand that Mr. Ken Klee, who is a colleague of yours on the National Bankruptcy Conference, has indicated that he feels that some compulsory individual debt restructuring is in order. What are your feelings on that?

Mr. **MORRIS.** Well, I think Ken does have that individual feeling. But that's certainly not the position of the Conference, and in fact, our position was contrary to that. And Ken Klee is about as persuasive a speaker as you can get and he wasn't able to convince the Conference that that was the best policy for the bankruptcy law.

The conclusion we reached was that the bankruptcy laws of the United States for the last hundred years have struck a generally appropriate balance that to the extent there is inappropriate activity going on, it does need to be addressed. There shouldn't be a system that allows someone to relocate to Florida and take an unlimited homestead exemption, live in a palace and thumb their nose at their creditors. That's not a good system to allow via a uniform bankruptcy law. And we suggest that that be addressed.

Mr. **BRYANT.** You mentioned something just then when you say "uniform." I think, listening to Judge Donald who was on the first panel, who comes from the Western District of Tennessee, and knowing her, as I said, I think she has ideas here that can be useful in this discussion. And I don't think we can overlook that type of experience.

On the other hand, I hear too from creditors who are concerned. I know she mentioned discretion that the judges have in reforming 707(b). That keeps it in the hands of the judges ultimately to make that decision.

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And I think perhaps what we're looking at on the other side is trying to make this more uniform, not a sentencing guideline situation in the criminal law, but more uniform, so that you don't have pockets in this country that are suffering inordinately compared to everybody else in terms of bankruptcies.

And I guess that's where you get this hard standard, this means testing idea comes from. And I'm sort of in between this, because I see both sides of it. I feel very strongly about both sides of the issue.

But let me ask, on the other end, in terms of, again, the credit cards. I keep hearing credit cards taking the blame here and just the availability of credit. But I think what we've got here is an awful lot of solicitation.

I mean, I turn on the television and I see people soliciting me to buy all kinds of products and I get catalogues in the mail from companies that want me to come to their stores and buy things. And I sort of lump the credit card solicitations in that; it's advertising, it's free speech.

Surely, who can speak on this? You don't give credit cards to everybody you send this solicitation to, do you?

Mr. **MCENENEY.** Absolutely not. In fact, people don't get credit cards unless, based on a credit review, they qualify for the credit.

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Mr. **BRYANT.** Do you all send out unsolicited credit cards? The cards themselves?

Mr. **MCENENEY.** No. And in fact, as Mr. Tassey testified earlier, that's been illegal to do under the Truth in Lending Act for quite some time.

Mr. **BRYANT.** But do any of you have standards for reviewing these to see if they ought to get a credit card?

Mr. **MCENENEY.** If I could just elaborate on one point to show that, in fact, the standards that are used to grant credit, in fact, work. Only 1 percent of all bank card accounts, MasterCard, Visa accounts end up in bankruptcy. An additional two or 3 percent get written off for other reasons. That means that the industry as a whole is successful 96 or 97 percent of the time in terms of the credit decisions that are made.

That I think demonstrates that credit is being granted responsibly and strongly suggests that the focus ought not be on what credit grantors are doing to grant credit, but what's happening with respect to the 1 percent of the consumers who end up in bankruptcy. What makes them different?

Mr. **BRYANT.** Mr. Tassey?

Mr. **TASSEY.** I just wanted to say on the solicitation front, that's no more than a sign of competition in the industry. There were maybe 2.5 billion solicitations last year. Almost a billion of those came from one large issuer. That large issuer was listed in a Consumer Federation of America as having the lowest overall delinquency rates.

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If too much solicitation for credit cards is part of the problem, you would think there would be some correlation there as well. About 1 percent of those solicitations—one percent of those people that get those solicitations actually respond favorably, and they have to affirmatively sign the application, send it back in. They get reams of disclosures and there is a variety of other laws governing that sort of thing.

The credit card industry is mature. Everybody is fighting for market share. It's nowhere near as profitable as it used to be, and that's what you're seeing with these solicitations. And attached to my oral statement, Mr. Bryant, is a web site that you can visit that you can search the thousands of credit cards out there for the various characteristics that you're interested in.

If you do that, you'll see it's a very—there's a sample search printed on there. You'll see it's an extremely competitive industry and there's a lot of differentiation in product.

Mr. **GEKAS.** We thank the gentleman. The gentleman from Massachusetts.

Mr. **DELAHUNT.** Thank you, Mr. Chairman. Mr. Mc—how do you?

Mr. **MCENENEY.** McEneney.

Mr. **DELAHUNT.** That 1 percent, however, translates into how many individuals?

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Mr. **MCENENEY.** One percent of accounts. I can't give you the individual figure. I can tell you what it amounts to in losses. In 1997, I think the bank card industry lost about $10 billion as a result.

Mr. **DELAHUNT.** So that's $10 billion out of the $40 billion that we're talking about.

Mr. **MCENENEY.** It is.

Mr. **DELAHUNT.** So that's 25 percent. And one billion, we're talking about the number of filings. Can you give me a rough estimate in terms of that 1 percent? Is that a million credit card—would that approximate a million?

Mr. **MCENENEY.** I don't have that number for you, but I can get it for you.

Mr. **DELAHUNT.** I'd appreciate that.

Mr. **MCENENEY.** Happy to.

Mr. **DELAHUNT.** Because I have this uneasy feeling that we'd be looking at about one million, so when you use the term "one percent," let's be really careful because we're talking 1.4 million filings.

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Mr. **MCENENEY.** Well, but I would also point out that even at a million, that's an extremely small percentage of the people who have credit cards. And the overwhelming majority of those people——

Mr. **DELAHUNT.** I don't disagree with that, but I guess what you're hearing today is concern that in a societal context we are talking about the cashless society. And the concern that many of us have is the number of filings. I think it has quintupled in a decade. I mean, that's what we're here for today.

And you made a statement about this $40 billion, if we go with either one of these bills, have you cost-estimated out how much we're going to save? Can you make me feel secure that we're going to reduce that $40 billion down to a concrete figure rather than just to say, you know, $40 billion?

Mr. **MCENENEY.** I think I can.

Mr. **DELAHUNT.** Let's give it a shot.

Mr. **MCENENEY.** I've not evaluated it myself, but Ernst and Young has. And Ernst and Young estimates that if H.R. 3150 were enacted, it would be a cost savings to American consumers of $4 billion.

Mr. **DELAHUNT.** So, I mean—I don't have a lot of time, but the point is that if we pass H.R. 3150, we've reduced that $40 billion down to $36 billion.

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Mr. **MCENENEY.** According to Ernst and Young.

Mr. **DELAHUNT.** So we'll save 10 percent.

Mr. **MCENENEY.** We've saved $4 billion.

Mr. **DELAHUNT.** According to Ernst and Ernst. And will they hold us harmless if we pass it and then——

Mr. **MCENENEY.** Well, let me just point out that they estimate $4 billion. Let's say it's half of that, $2 billion. Again, even in Washington, D.C., $2 billion is a lot of money.

Mr. **DELAHUNT.** As Everett Dirksen said, "A billion here, a billion there and after a while you're talking about real money."

Mr. **MCENENEY.** And here we've got $2 billion to $4 billion.

Mr. **DELAHUNT.** I think, Mr. Tassey, you wanted to make a comment.

Mr. **TASSEY.** Yes, just a comment. Since the last major overhaul of the Bankruptcy Reform Act in 1978, bankruptcies have increased by over 800 percent. Now, we were talking about unintended consequences earlier and I think that's certainly one. And those costs have been externalized.

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So, you know, when you pass legislation, as you point out, you never know precisely what's going to happen, but we've been at this——

Mr. **DELAHUNT.** Let me interrupt you because I just have a limited amount of time, but I would welcome any comments you have in writing.

If we pass the Nadler-Conyers Bill, what would that $4 billion become? I mean, does Nadler-Conyers give us a billion, or $2 billion or $3 billion of savings? Has Ernst and Ernst done a study on that?

Mr. **MCENENEY.** They have not, but some of the provisions would actually increase that $40 billion number.

Mr. **DELAHUNT.** Would increase it?

Mr. **MCENENEY.** Would increase the $40 billion number.

Mr. **DELAHUNT.** But in the net, has anybody done a study that would give us a number, at least that we could talk about and toy with?

Mr. **MCENENEY.** Not that I'm aware of.

Mr. **DELAHUNT.** And speculate about.

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Mr. **MCENENEY.** No, if I had to speculate, I would speculate that H.R. 3146 would increase bankruptcy losses.

Mr. **DELAHUNT.** Okay. Well, thank you very much, and I yield the balance of my time to my colleague from Massachusetts.

Mr. **MEEHAN.** Just to quickly follow up, with your indulgence, Mr. Chairman, to go back to Mr. Duncan for a minute. You had indicated that you don't think if somebody declared bankruptcy, went through chapter 11 or bankruptcy proceedings, that you didn't think that retailers would extend credit.

Isn't it true that often retailers enter into agreements to reaffirm their debts, the debts of people who file for bankruptcy, and isn't it true that these reaffirmation agreements often include the extension of new credit? And isn't that fairly commonplace with retailers?

Mr. **DUNCAN.** What often happens is an individual will come to a retailer and say—I'm just going to use this as an example—I've had a J.C. Penney account for 20 years, I am filing for bankruptcy, I've always done my shopping at J.C. Penney, I'd like to continue to have an account.

Well, no one wants to be operating with someone who's just filed for bankruptcy. So an agreement can be structured where if the individual agrees to pay off their outstanding balance and by showing good faith on their side, Penney will extend them $300 or $400 of credit to show good faith on its side afterwards. But that preserves them access to credit on terms and conditions far better.

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Mr. **MEEHAN.** Okay, I just wanted to make that point. And finally, Mr. Chairman, I just want to ask one last question of Judge Wedoff. As you know, H.R. 3150 would provide that if a debtor used a credit card without reasonable expectation or ability to pay, the resulting debt would be nondischargeable.

Do you think the adoption of this provision would lead to a significant increase in the number of nondischargeability actions actually filed or threatened by creditors? Likewise, would its adoption result in a larger number of reaffirmation agreements?

Mr. **WEDOFF.** I have no doubt, no doubt at all, that it would increase the number of filings substantially. Right now, the general standard is that the debtor must have a subjective intent not to repay at the time the debt is incurred in order for it to be nondischargeable. That's often difficult to prove, and it's a case-by-case inquiry.

If we went to an objective standard—would a reasonable person have concluded that it was not going to be possible to pay this debt at the time that it was incurred—then people who use credit cards unwisely, but in good faith, would be subject to nondischargeability. It would be a much easier case to prove and I would expect very many more cases.

The pressure on people to reaffirm credit card debt of this sort would increase, yes.

Mr. **MEEHAN.** And also, is there any clear definition of reasonable expectation or ability to repay?

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Mr. **WEDOFF.** I expect it would be an economic process. That sort of thing has been argued in a number of cases already. Not all courts use the subjective test. Some use an objective test. And what's done is to calculate whether the debtor's disposable income would be sufficient to amortize the debt that's being incurred over a reasonable period of time. It's almost a mathematical process.

Mr. **MCENENEY.** If I could just add that that provision I think is intended to address abuse that occurs and anomalous results that come out of the existing subjective intent standard.

I'll give you one standard. There's a case in the Ninth Circuit where a debtor went on record as indicating the debtor incurred additional debt at a time the debtor knew he could not repay the debt. But he also testified that he intended to repay from future gambling winnings. And when his gambling plan didn't bear out, the Ninth Circuit nonetheless gave him a discharge because they found that this debtor in his mind intended to repay.

And that's the sort of result that a more objective standard would address. And I would say that an ability to pay test as part of the nondischargeability standard is much more objective and requires proof issues that are much less than complex than trying to figure out what's in the state of a debtor's mind.

Mr. **GEKAS.** We thank the gentleman. And now, for the fourth time, we express our gratitude to this panel and discharge them from their current responsibilities. Thank you very much.

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We invite the members of the third panel to approach the witness table. We welcome the final panel of the day. We begin the introductions by allowing the gentleman from New York to administer a welcome. I would like to welcome a fellow Pennsylvanian first, Michael J. Kane, who is the Deputy Secretary for Enforcement of the Pennsylvania Department of Revenue.

Prior to becoming Deputy Secretary for Enforcement at the Pennsylvania Department of Revenue, Mr. Kane was an Assistant U.S. Attorney in the Civil Division for 4 years. He has also previously served as Senior Deputy Attorney General in the Criminal Prosecution Section of the Pennsylvania Office of the Attorney General. Mr. Kane received his Bachelor of Science in Accounting cum laude from St. Joe's in Philadelphia. Thereafter he obtained his law degree from the University of Colorado School of Law. His office is in Strawberry Square where I go for refreshments.

He is joined by James I. Shepard, former Commissioner with the National Bankruptcy Review Commission from Fresno, California. He was appointed to the National Bankruptcy Review Commission by then Senator Bob Dole. Prior to and following his service with the Commission, Mr. Shepard has served as a bankruptcy tax consultant.

He is an adjunct professor of law at the McGeorge School of Law in Sacramento, California, and at the San Joaquin College of Law Graduate Tax Program in Fresno, California. Mr. Shepard has practiced law in Colorado, Iowa, and Nebraska. In 1987, Mr. Shepard became associated with a major accounting firm in Fresno. He has written and lectured extensively on bankruptcy taxation matters.

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Professor Grant W. Newton of Pepperdine University in Malibu, California is a professor of accounting in that institution. Since 1972, Professor Newton has concentrated on the subject of bankruptcy through his research, writing, and consulting activities. He served as a member of the Tax Advisory Committee of the National Bankruptcy Review Commission.

Currently, Professor Newton chairs the American Bankruptcy Institute's Taxation Committee. He is also a member of the Taxation Committee of the Association of Insolvency Accountant.

Paul H. Asofsky, former member of the Tax Advisory Committee of the National Bankruptcy Review Commission, is our final panelist. He is a member of the law firm of——

Mr. **ASOFSKY.** Weil.

Mr. **GEKAS.** Weil, Gotshal and Manges, where he heads the tax department at its Houston office. He is a member of numerous professional associations, including the American Bar Association where he served on several committees. He is also a member of the National Bankruptcy Conference where he chairs the Committee on Tax Matters.

In addition, Mr. Asofsky has actively participated in the New York University Tax Institute. He is a magna cum laude graduate of Columbia. He received his law degree cum laude from Harvard Law School.

We welcome the panel. We yield to the gentleman from New York for an additional set of remarks, and welcome.

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Mr. **NADLER.** Thank you, Mr. Chairman. I just wanted to extend a special welcome to Paul Asofsky, who though he now hails from Houston, Texas, from the district, I believe, of Ms. Jackson Lee, he grew up and lived for many years in the great borough of Brooklyn in New York, where he was a noted not only bankruptcy activist, but political activist, and was one of the very, very few people in the entire State who had any understanding at all of the New York State election law—of which nothing more complex has been devised by the mind of man.

Mr. **ASOFSKY.** Even the tax law and the bankruptcy law?

Mr. **NADLER.** That is true, the New York election law is more complicated than those. And I'm happy to see you back, I wish you had stayed in New York, happy to see you here.

Mr. **ASOFSKY.** Thank you, Mr. Nadler.

Mr. **GEKAS.** We thank the gentleman, we will turn to Mr. Kane. As we have told the other panels, the written statement will, without objection, become automatically a part of the record, and you will be asked kindly to reduce your oral testimony to about 5 minutes in review of your written statements. Mr. Kane.

STATEMENT OF MICHAEL J. KANE, DEPUTY SECRETARY FOR ENFORCEMENT, PENNSYLVANIA DEPARTMENT OF REVENUE

Mr. **KANE.** Thank you, Mr. Chairman, members of the subcommittee. My name is Michael Kane, I am Deputy Secretary for Enforcement in the Pennsylvania Department of Revenue. In that capacity, I oversee all of the Department of Revenue's enforcement programs, including the processing of cases pending in the bankruptcy courts.

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I have practiced in bankruptcy court, and I've represented the Internal Revenue Service, and other Federal agencies, and as an Assistant United States Attorney. Of course, none of my comments here today should be taken as representing the Department of Justice's views on the subject.

The Pennsylvania Department of Revenue welcomes the opportunity to provide the subcommittee with information regarding state tax issues in bankruptcy proceedings, and I hope that my comments on H.R. 3150, the Bankruptcy Reform Act of 1998, will be of value to the committee.

As Chairman Gekas has often pointed out, we are witnessing a curious paradox when one considers that today's vigorous economy has produced record numbers of bankruptcy filings. The bankruptcy courts in the Commonwealth of Pennsylvania have endured their share of this increase. According to the Administrative Office of the United States Courts, 1997 petitions in the Middle District of Pennsylvania increased 40 percent over the previous year, while the rate of increase in the Western District of Pennsylvania was 34 percent during the same period.

Though I am not qualified to offer any opinion about the root cause of this phenomenon, I can speak first hand about the effect of such a rapid expansion on the Department of Revenue's ability to protect its substantive rights in bankruptcy proceedings. Like most state agencies, we must apply limited resources to serve the citizens of the Commonwealth. Our core responsibilities must be met, often at the expense of effective administration of important programs. Bankruptcy processing is one of the areas that is continually under stress in that regard. The swelling of the caseloads has simply resulted in a lessened ability to properly meet the requirements of the Code with respect to the filing of claims, objecting to plans and other administrative tasks. I believe that our experience is typical of that of many other states.

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H.R. 3150 contains many substantive and procedural changes to the Bankruptcy Code. I will address my comments to some of these which are of particular significance to the state tax administrator.

It must be borne in mind that government creditors, particularly taxing authorities, face unique problems in protecting legitimate interests in a bankruptcy case. For example, most creditors know or can easily determine the amount of their claim as soon as they receive notice that a petition has been filed. Taxing authorities oftentimes do not have sufficient information readily available to determine the amount of their claim, or for that matter, whether they have a claim at all. This is so because tax determinations are usually the result of self assessment and reporting. Rather than issuing a bill for a series of discrete transactions, tax departments generally must rely on their "customer" to advise them of the amount that is owed. Additionally, tax authorities often administer a myriad of taxes, each of which is maintained in a separate data base. Unlike the department store or the credit card company, or other lenders, we can not simply access customer accounts for consolidated information from which to make a claim. Rather, each data base must be accessed to ensure that all obligations are addressed. In states like Pennsylvania, this may mean 20 or more taxes must be reviewed for delinquencies, before a claim can be filed or a plan can be approved.

Often, a petition is filed before the debtor has filed required returns and reports. In such cases, particularly in chapter 13 cases, the taxing authority must estimate what taxes are owed to protect its interest. Many times because of limited resources, short time frames and the lack of sufficient information, the taxing authority is not in a position to make a good faith estimate. In those cases, it may be forced to protect its interest by gathering information at the meeting of creditors, by filing a motion to compel the debtor to file tax returns or, particularly in a chapter 13 case, by filing an objection to the plan. This results in a waste of resources of both the creditor and the court. It is incongruous that a debtor may take advantage of the protection of the Federal courts, which are funded by tax dollars, while it has not complied with its own obligation to simply file required returns.

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H.R. 3150 places the burden on the debtor to file the required returns by mandating that they be filed before the meeting of creditors is held, and by authorizing the dismissal of a petition if the debtor does not comply. Likewise, the act would deem a claim to be filed timely if filed within 60 days of the filing of a required return. This latter provision will enable tax claims to be filed without the need to waste resources for court appearances.

In summary, I would like to state that we welcome the changes that have been proposed. They strike a balance that ensures that maximum revenue is available to governments to fund important programs and services, while providing a fresh start to those in need.

I will be happy to address any questions that the subcommittee may have.

[The prepared statement of Mr. Kane follows:]

PREPARED STATEMENT OF MICHAEL J. KANE, DEPUTY SECRETARY FOR ENFORCEMENT, PENNSYLVANIA DEPARTMENT OF REVENUE

Mr. Chairman, Members of the Committee, my name is Michael Kane and I am the Deputy Secretary for Enforcement in the Pennsylvania Department of Revenue. In that capacity, I oversee all of the Department of Revenue's enforcement programs, including the processing of cases pending in the bankruptcy courts.

I have also practiced in bankruptcy court, representing the Internal Revenue Service and other federal agencies as an Assistant United States Attorney. Of course, none of my comments should be taken as representing the Department of Justice's views on the subject.

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Often, a petition is filed before the debtor has filed required returns and reports. In such cases, particularly in a Chapter 13, the taxing authority must estimate what taxes may be owed to protect its interest. Many times, because of limited resources, short time frames and lack of sufficient information, the taxing authority is not in a position to make a good faith estimate. In those cases, it may be forced to protect its interest by gathering information at the meeting of creditors, by filing a motion to compel the debtor to file tax returns, or (particularly in a Chapter 13 case) by filing an objection to the plan. This results in a waste of resources of both the creditor and the court. It is incongruous that a debtor may take advantage of the protection of the federal courts, which are funded by tax dollars, while it has not complied with its own obligation to simply file required returns.

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Present procedures jeopardize the collection of post-petition trust fund taxes. The Code allows administrative taxes to be paid through a Chapter 13 plan. Administrative taxes in a Chapter 11 must be paid in full on the effective date of a Chapter 11 plan. Because of this, business debtors often use trust fund taxes to fund operations after the filing of the petition with the expectation that the funds will somehow become available at a later time. Commingling of these taxes often results in the inability of the debtor to fund a Chapter 13 plan, or a lack of necessary cash to confirm a Chapter 11 plan.

H.R. 3150 ensures that money collected or withheld post petition is not misused by requiring that the small business debtor timely file required tax returns and maintain trust fund taxes in a segregated account. As a result, we can anticipate that debtors who can not fund current operations without dipping into government funds will be rooted out at an early stage, before the liability grows larger.

Under present law, a proof of claim is not required in a Chapter 11 case, if the debt is scheduled. In such cases, the claim is deemed allowed without further action by the creditor. In a Chapter 13 case, however, a claim must be filed, even if the obligation is acknowledged by the debtor. There is simply no logical reason for the disparate treatment. In Chapter 11 cases that are converted to Chapter 13, this is particularly problematic.

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H.R. 3150 treats acknowledged liabilities in Chapter 13 cases the same as Chapter 11. By eliminating the need to file a claim for an undisputed amount, limited resources will be better applied by the tax administrator.

Notice of the filing of petitions and other documents is a matter of great concern to tax authorities. Obviously, the failure of the proper person within the agency to learn of matters in a timely fashion may have severe consequences.

Because an agency may have many satellite offices, such notices often are received by employees who are not aware of the importance. H.R. 3150 will eliminate much of this concern, without placing undue burden on debtors, by allowing the agency to designate the official address and representative to whom all such correspondence should be addressed.

In summary, I would like to state that we welcome the changes that have been proposed. They strike a balance that ensures that maximum revenue is available to government to fund important programs and services, while providing a fresh start to those in need. I will be happy to address any questions which the Committee may have.

Thank you.

Mr. **GEKAS.** We thank the gentleman and turn to Mr. Shepard.

STATEMENT OF JAMES I. SHEPARD, FORMER COMMISSIONER, BANKRUPTCY REVIEW COMMISSION

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Mr. **SHEPARD.** Thank you, Mr. Chairman. As you've indicated, my name is James Shepard from Fresno, California. I speak today more as, from my experience as a tax practitioner, having prepared tax returns for taxpayers for over 15 years, than as a law professor or any other background.

I'd like to make about six major points on bankruptcy tax policy, and then briefly comment on the tax provisions of H.R. 3150, the Bankruptcy Reform Act of 1998.

First, bankruptcy today is a big business, legal and other professional fees probably exceed $5 billion a year, that's just for the lawyers and professionals, and the accounts, and the other hangers-on. The debtors' lawyers alone were paid approximately $2.75 billion for the 1.4 million cases they filed in 1997. These costs of bankruptcy are ultimately paid by the public in the form of higher costs, higher interest rates, and the higher taxes.

Bankruptcy law—second, bankruptcy law, and thus Congress, must provide for all the people of this country, not just the debtors and the creditors and those who have a vested interest in the bankruptcy system. Drafting bankruptcy law should not be left to those who profit from the system or who have a vested interest in the system. Those who profit from the system advocate expansion of the system, because they want more power and more money. Bankruptcy law cannot become the omnipotent power, overriding all other laws. Public rights and interests cannot be subordinated to private interests.

Current bankruptcy law is confusing, vague, and often inadequate, leaving it to the courts and the lawyers to fill in the gaps, often producing inconsistent and unpredictable results.

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Fourth, the National Bankruptcy Review Commission, on which I served, appointed a Tax Advisory Committee consisting of many people, including my two companions to my left, to review over 100 proposals for change in the treatment of taxes and bankruptcy. The Committee presented the Commission with a list of more than 30 consensus proposals which were unanimously approved by the Commission. The bill contains most of the proposals which do not require a change in the Internal Revenue Code—no dispute with the House Ways and Means.

Fifth, the tax provisions of the bill do not enlarge the rights of the tax authorities, but improve the efficiency and fairness with which tax matters are handled in bankruptcy.

Sixth, it must be remembered that the tax provisions in the Bankruptcy Code impact all governments, particularly state and local, not just the Federal Government, being mindful of what has happened in the House in the area of tax reform, the reform act involving the Internal Revenue Service.

Referring to the tax provisions of H.R. 3150 then, the bill includes several comprehensive provisions designed to eliminate certain inadequacies, loopholes and "gotcha provisions," opportunities to manipulate the Code which prevent the taxing authorities from protecting the public's rights and interests, for instance, or provides for more effective notice.

A primary focus of the bill is to eliminate numerous instances where a tax authority is put at a decided disadvantage arising from lack of clarity in the Code, resulting in substantial litigation over the effect, for instance, of a prior bankruptcy code, which prevents the collection of taxes which the Bankruptcy Code otherwise permits. Another provision clarifies the definition of an "assessment," to eliminate problems some state tax authorities have where taxes are not assessed in the manner of Federal taxes.

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Other changes would clarify the obligations of a trustee when filing returns on behalf of the estate, as well as the rights of the tax authority to assert claims in respect to such returns. The Code provides a procedure but it is unclear in some respects.

The bill would also enhance the fairness of the treatment of debtors and creditors by imposing a greater degree of parity among the chapters and by establishing a fixed rate of interest, reducing litigation related to plans reorganization.

There are many other issues and problems which must be addressed at a later date, but this is a good start.

In conclusion, let me remind the panel that governments are not like the appliance store, which if it hired more salespeople might sell more appliances, or if it adds more floor space, it may be able to add another line of appliances, and sell more color T.V.'s. Government revenue is fixed and in the budget. If it costs more money to collect this revenue, there simply is less revenue, and this cost is passed on to the other taxpayers. As I say, I did returns for taxpayers for over 15 years. These were small taxpayers in rural Iowa, and I don't want to go back to Iowa and face these people and say they paid their taxes, everything they had to pay, but their neighbor down the street or down the road didn't have to pay the taxes because they filed bankruptcy even though they maintained their lifestyle. Thank you.

[The prepared statement of Mr. Shepard follows:]

PREPARED STATEMENT OF JAMES I. SHEPARD, FORMER COMMISSIONER, BANKRUPTCY REVIEW COMMISSION

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I. INTRODUCTION.

Thank you for inviting me to speak today. It was an honor to be appointed to serve on the National Bankruptcy Review Commission and to have the opportunity to seek improvements in the manner in which the rights and interests of the American people who do not file bankruptcy are treated under the Bankruptcy Code. The Commission's attempt to revise bankruptcy laws easily leads one to the conclusion that bankruptcy has grown too important to entrust to those who work within the bankruptcy industry, those who profit from the bankruptcy system—the drafting of bankruptcy laws should not be left to those who have a vested interest in the implementation of those laws, either creditors or debtors.

A. Bankruptcy is a Big Business.

In contemplating bankruptcy reform legislation, I would hope that the members of Congress keep in mind that there are only two things in bankruptcy for the players in the system, the lawyers and other professionals, money and power

—the Bankruptcy Code and courts provide the power and the system provides the money—if the law expands the power, the lawyers will find the money. The recently released statistics on case filings in 1997 has produced some interesting inferences. If the debtors' lawyers who filed the 54,027 business cases in 1997 received (or will receive) an average of $25,000 in fees, a conservative estimate according to most bankruptcy judges, that group received (or will receive) a total of over $1.35 billion dollars. If the consumer debtors' lawyers received an average of $1,000 for each of their 1,350,118 cases, a reasonable estimate, that group received over $1.35 billion dollars, for a total of approximately $2.7 billion dollars paid to the debtors' lawyers. Assuming that the creditors' lawyers were paid just a third of that amount and adding in the accountants, turn-around specialists and other hangers-on, bankruptcy is easily a $5 billion dollar-a-year industry, at the expense of the American public; and these figures don't include any of the costs of the judicial system or the costs of administering the cases, nor do they account for any of the debt that is discharged. The numbers point to a conclusion which is entirely inescapable, bankruptcy is a big business for lawyers and other professionals.

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B. The Proper Role of the Bankruptcy Courts and Bankruptcy Law.

Further, it must be recognized that bankruptcy courts cannot function as a "court of all social ills," real or perceived. Section 105(a) of the Bankruptcy Code—which, in the words of Judge Robert Ginsberg, who also served on the Bankruptcy Review Commission, is the "Last Bastion of a Desperate Lawyer"—is not the authority for a court to rewrite nonbankruptcy law according to the court's perception of whether or not the law should apply to the case at hand and the result it seeks. Bankruptcy judges must be discouraged from rendering result oriented decisions, those where the Bankruptcy Code is read in a manner never contemplated by Congress; such judicial legislation creates law that was not intended and invades the province of Congress. The Bankruptcy Code cannot be the source of omnipotent power, staving off the demands of creditors and rewriting law to suit the needs of every individual debtor, nor can every small business owner with a fervent hope of survival and a burning desire to profit be allowed to remain sheltered in that hospice of dying businesses, Chapter 11, until all assets are wasted and the list of creditors is longer than before. Where the courts have strayed from Congressional intent Congress must establish clear limitations and definitions to redirect not only the "rogue" judges but the majority of our judges who are intelligent and well meaning, but often are given liberty to create law because the Code is vague.

It should not be necessary to remind this panel that Congress and the United States Government must serve all the citizens of this country, not just the debtors and creditors, but, more importantly, the 260 million people who did not file bankruptcy in 1997. It must be remembered that the Bankruptcy process is but one function of government, a substructure within the panoply of governments, state, federal and local, which must provide for all citizens. Governments are unique not only as creditors but because of the function of government. Private creditors generally can not mimic a government—private creditors do not have the obligations of government, nor do they have the concomitant powers of government; consider, for instance, the exercise of the police power, the power to impose a tax, the states' duty to administer federally mandated programs, the need for revenue to provide for essential government services, and the obligation to perform regulatory functions for the protection of all the people. Consider also that governments are generally ex post facto, involuntary creditors. When performing strictly governmental functions, as opposed to acting as a lender or supplying utilities, for instance, government agencies do not have the ability to take actions available in the private sector. Governments are not able to restrict their activities to a particular geographic area or segment of the population nor can they withhold police or fire protection merely because taxes have not been paid. Any state or local government can, however, be required to protect the rights of the public in any bankruptcy court in the country. Public policy dictates that the public be protected from the unreasonable costs of bankruptcy and the burdens of overly complex rules and laws.

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The Constitution states that Congress shall "establish uniform laws on the subject of bankruptcies throughout the United States"—that bankruptcy law will be federal law to achieve uniformity as a part of the regulation of commerce —and to prevent fraud where debtors may have relocated property in other states. The Federalist No. 42, at 217 (James

Madison) (Garry Wills ed., 1982). The Constitution also imposes the obligation upon the sovereign to provide the functions of government for all the people; to pay for those functions the Constitution also gives the sovereign the power of taxation. Taxation is the cost of citizenship which we all must pay—the sovereign may tax anything it deems necessary and may also determine the extent of any relief from such taxes which it sees proper; to be fair, however, taxes must be imposed uniformly, relief from that charge can only be granted as may specifically and sparingly be provided within the confines of the law. The citizen accepts the privileges and benefits of citizenship, exercises the rights and powers granted thereby, and must accept the duties and obligations imposed in exchange. In order for government to function and to avoid anarchy these duties and obligations are not to be lightly taken nor readily excused. Society has a right to expect that citizens will respect the rules of acceptable behavior and will share the cost of government. The payment of taxes may limit the fresh start but that is as the public interest requires.

While the goals of the Bankruptcy Code are understandable and appropriate, the creation of special laws and procedures, loop-holes and "gotcha" provisions, which are not in furtherance of the legitimate goals of the Code can only be destructive of the fundamental proposition of taxation enunciated at the time of the adoption of the Bankruptcy Code which holds that,

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In a broad sense, the goals of rehabilitating debtors and giving equal treatment to private voluntary creditors must be balanced with the interests of governmental tax authorities who, if unpaid taxes exist, are also creditors in the proceeding.

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

S. Rep. No. 989, 95th Cong., 2d Sess. 13–14 (1978), *reprinted in 1978* U.S.C.C.A.N. 5787, 5799–5800; as quoted in *In re Conston, Inc.*, 181 B.R. 769 (D. Del. 1995). This statement is still a valid precept for those who are considering changes in bankruptcy law.

C. The Work of the National Bankruptcy Review Commission.

My primary goal, during the initial stages of the National Bankruptcy Review Commission, was to advance proposals which I viewed as necessary to protect the integrity of our tax system. Being a tax lawyer and tax practitioner, I was very concerned about what I saw as the development of rules for the determination and collection of taxes unique to the bankruptcy court, that a body of law and procedure was being developed under which uniformity and consistency with nonbankruptcy tax law is being lost. The Commission heard substantial testimony from numerous tax authorities describing their difficulties, for instance, in timely asserting claims or in being able to even determine that a claim existed; a substantial problem exists where debtors may have not filed returns. Every government representative that appeared before the Commission described major difficulties in being made aware of the mere filing of a case in sufficient time to protect the rights of the public; thus, not just one, but two provisions of the bill propose changes in the Code that will make changes necessary to remedy the deficiencies in ensuring that the parties receive meaningful notice.

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The Commission appointed a Tax Advisory Committee, made up of tax professionals and educators, knowledgeable in the special circumstances of bankruptcy, who reviewed over 100 specific suggestions for changes in tax and/or bankruptcy law and submitted their report recommending the adoption of over 30 "consensus" proposals. The National

Bankruptcy Review Commission, in turn, unanimously adopted those proposals, many of which are reflected in the bill.

Unfortunately time did not permit the Commission to resolve a large number of other extremely important problems. For instance, a proposal was made which would have resolved the problems created by the Supreme Court's decision in the case of *Energy Resources* without overruling the thrust of the decision, that bankruptcy courts may approve the allocation of payments under a plan of reorganization under certain circumstances, but which would have protected the government's right to collect taxes. The Tax Advisory Committee briefly discussed the matter but found it too controversial to act upon; a Working Subgroup of the Commission addressed the problem and suggested a compromise solution but the issue was never presented to the full Commission for its consideration. I would hope that Congress would recognize the benefit of that compromise proposal and enact such a law.

Other very important proposals were adopted by the Commission but which are not found in the bill, proposals which must be submitted to the Committee on Ways and Means because they would amend the Internal Revenue Code.

II. OVERVIEW OF THE TAX PROVISIONS OF THE BILL.

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The bill does not enlarge the rights of the tax authority, but eliminates certain loopholes and opportunities to manipulate the Code which prevent the tax authority from protecting the public's rights and interests. Consider, for instance, that the commencement of a bankruptcy case imposes the most powerful injunction provided by law without the opportunity for a prior hearing, the stay of proceedings under 11 U.S.C. 362. All that is necessary is to sign and file a form and pay a fee. This stay of proceedings is available to all debtors regardless of the merits of their case and enjoins, among other things, nearly all actions pursuant to state, federal or local law related to the debtor or the estate, including the collection of taxes, many aspects of the regulation of business, and the licensing and enforcement activities of most regulatory agencies. Together with the court's equitable jurisdiction under 11 U.S.C. 105(a) debtors have a formidable array of tools with which to achieve results and obtain benefits not available through any other means. The effect of this immense power is the ability of a bankruptcy court to stop the world from turning, as we know it. All too often, under current law, debtors and their lawyers are able to manipulate the various provisions of the Code to take advantage of this power and obtain results not intended by Congress.

The bill includes several comprehensive provisions designed to improve the efficiency and fairness with which tax matters are handled in bankruptcy. At the present there are a number of instances in the Bankruptcy Code where either the language is vague or the procedure imposed is inherently unfair or incomplete. In other instances, procedures which work for creditors, generally, are ill-suited for governmental agencies, particularly tax authorities. A primary focus of the provisions of the bill is to eliminate numerous instances where a tax authority is put at a decided disadvantage arising from lack of clarity in the Code, resulting in substantial litigation over the effect of a prior bankruptcy case, for instance, which prevents the collection of taxes which the Bankruptcy Code otherwise permits. Other changes would clarify the obligations of a trustee when filing returns on behalf of the estate, as well as the rights of a tax authority to assert claims in respect of such returns. The bill would also enhance the fairness of the treatment of debtors and creditors by imposing a greater degree of parity among the chapters and by establishing a fixed rate of interest, reducing litigation related to plans of reorganizations.

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III. COMMENTS ON THE TAX PROVISIONS OF H.R. 3150.

A. Sec. 501—The Protection of State and Local Tax Revenue.

The bill amends the Bankruptcy Code to increase local revenues derived from *ad valorem* property taxes, *i.e.*, taxes assessed based on the value of property. Currently, under Bankruptcy Code 724(b)(2), ad valorem tax dollars intended for use by local governments to provide police protection, fire protection and schools are being siphoned off to pay the lawyers and other professionals who drove a failed Chapter 11 case into conversion to Chapter 7.

As section 724(b) was originally enacted, Congress sought to guarantee the payment of only the costs of administration in a chapter 7 case and small wage claims by resort to the tax revenue represented by the tax liens on only *personal* property. The statute has since been significantly expanded beyond its original scope to allow an ever-increasing number of unsecured priority claimants to invade valid and properly perfected liens on *both* personal and real property. Further, as administrative claimants, the lawyers and other professionals with unpaid fees arising from employment in a failed chapter 11 case are entitled to be paid from tax revenues. Because state law usually provides that a lien securing *ad valorem* property taxes "primes" all other consensual and nonconsensual liens, the application of section 724(b) invariably causes the administrative and other priority claims to be paid from tax revenues otherwise destined for essential public purposes, *e.g.*, schools and police and fire protection.

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Bankruptcy judges now admit they are seeing numerous "fee driven" Chapter 11 cases—lawyers and other professionals for failing and failed businesses simply cannot be subsidized with the taxpayers' money. Why should the taxpayers subsidize the lawyers for a failed case when the numbers of cases that are converted to Chapter 7 or are dismissed are alarmingly high—the number of debtors that successfully complete their plan is dismally low.

B. Sec. 502—Enforcement of Child and Spousal Support.

To ensure that debtors will not be able to escape such obligations, the bill subjects exempt property to claims for child and spousal support.

C. Sec. 503—Provide Effective Notice to State, Local and Federal Government Agencies.

Governmental units, whether state, local or federal, should not lose their rights against the debtor or the bankruptcy estate in a case because of the debtor's failure to provide notice reasonably calculated to reach the proper representatives of the government and identify the nature of the obligation for which notice is provided. Without a reasonably targeted notice requirement under the Bankruptcy Code one can continue to expect state, federal and local governments to experience substantial difficulties because of the large and diffuse nature of governmental units and the difficulty they have in identifying claims and interests in the bankruptcy case.

The Commission considered no less than three proposals related to ensuring that the government was provided proper timely notice in all cases. The Tax Advisory Committee established by the Commission to review proposals related to tax problems in bankruptcy unanimously adopted a proposal which was then unanimously adopted by the Commission stressing the importance of enacting procedures for giving proper notice to government representatives. The proposal adopted by the Commission states that, "There is a consensus that the government should not lose its rights against the debtor or the bankruptcy estate in a bankruptcy case because of the debtor's failure to provide notice reasonably calculated to reach the proper representatives of the government." **REPORT OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION** 949 (Oct. 20, 1997). The bill provides that notice to governmental units must be reasonably calculated to reach the proper representatives of the government and must reasonably identify the debtor. Improved notice will enhance the fairness and efficiency of the bankruptcy process—it will reduce inadvertent violations of the automatic stay, reduce costs associated with the bankruptcy case, and reduce delay by eliminating litigation in regard to the efficacy of notices.

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D. Sec. 504—Notice of Request for a Determination of Taxes.

Section 505(b) of the Bankruptcy Code permits a trustee to request a prompt audit of the income tax returns filed on behalf of the estate from a taxing authority. If the taxing authority fails to respond within sixty days to the request, the trustee is discharged from liability for any taxes beyond the taxes shown on the return. Presently, the Internal Revenue Service has directed that section 505(b) requests be filed with the local District Director. Nonetheless, some courts have held that a trustee may ignore the IRS directive. Because governmental units are entitled to timely and reasonable notice in the bankruptcy process if their right to assert an administrative expense claim is to be barred, the bill provides that rules be established under which a governmental unit may designate the manner and location to which a request for a prompt audit be sent.

E. Sec. 505—Provide a Fixed Rate of Interest on Tax Claims.

The Bankruptcy Code does not specify the interest rate to which tax claims are entitled, requiring litigation in almost every court to determine a market rate or some other rate of interest to be applied and while the Federal statutory rate is relevant it is not binding. Litigating the issue of what the appropriate rate of interest should be wastes valuable judicial resources. Therefore, the bill amends the Bankruptcy Code to provide that where a governmental unit, state, local or federal, is entitled to receive interest on its claim, the fixed federal deficiency rate under section 6621(a)(2), as in effect on the date of confirmation of the plan, of the Internal Revenue Code should be applied, without reference to the compounding requirement otherwise applicable to Federal taxes.

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F. Sec. 506—Tolling of Priority of Tax Claim Time Periods.

The Bankruptcy Code identifies several tax claims as priority or as nondischargeable by reference to certain time limits, *e.g.*, taxes due for taxable years ending within three years of the filing of the petition are priority claims under section 507(a)(8) of the Bankruptcy Code and nondischargeable under section 523(a)(1). Currently it is not clear whether the filing of a prior bankruptcy case tolled the running of these time periods in a subsequent case, where, for instance, the debtor has filed successive bankruptcy petitions—if not, the debtor is able to prevent collection of the tax while sheltered by the stay of proceedings in one or more cases before discharging the tax in a subsequent bankruptcy case. The bill provides that in the event of successive bankruptcy filings, the relevant time periods specified in section 507(a)(8) shall be suspended during the period in which a governmental unit was prohibited from pursuing a claim by reason of the prior case. A debtor should not be entitled to stay the collection of a tax by filing a bankruptcy petition and then benefit from the pendency of the abortive case by reducing or eliminating the time in which the government's tax claims would otherwise have been entitled to priority, or altering the nondischargeability of a tax. Clarification of the law will eliminate unnecessary litigation and provide uniformity.

G. Sec. 507—Assessment Defined.

Some confusion has surrounded the use of the term "assessment" in the Bankruptcy Code when used in reference to state and local taxing authorities. The Bankruptcy Code was drafted in reliance of federal tax law terms and concepts. Unfortunately, those terms and concepts do not always comport with state and local procedures or law. Some state and local taxing authorities, for instance, have no assessment procedure whatsoever; some taxes are self-assessed. A provision in the bill will resolve this problem by providing a universal definition of assessment with respect to State or local tax collections, regardless whether conventional "assessment" procedures are employed.

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H. Sec. 508—Discharge of Fraudulent and Other Taxes in Chapter 13 Cases.

Currently, Chapter 13 debtors are able to discharge their tax obligations arising from fraudulent returns, willful attempts to evade, and late and unfiled returns; taxes which are not dischargeable in cases filed under any other chapter of the Code. Not only are such taxes dischargeable in a Chapter 13 case, there is no requirement that they be paid in full as a condition of confirmation of the plan, as are priority tax claims—taxes owed in respect of fraud and unfiled returns are treated as general, unsecured claims and are discharged after completion of the payments under the plan. If the plan "provides for" a tax, even though the amount stated is clearly wrong, the tax authority may be bound by the plan and unable to collect the proper amount due.

The rationale for not providing parallel treatment of priority taxes and taxes excepted from discharge was to benefit creditors, but was not intended to let the debtor benefit from his or her misdeeds. These provisions of law serve as motivation for Chapter 13 debtors to file deceptive plans which "provide for" the payment of tax claims by stating that the amount of taxes owed is "zero" or a minimal amount and to obfuscate notice to the tax authority in hopes that it will be delayed so that the tax authority will be unable to timely file a proof of claim for the correct amount due. As the law is applied, tax authorities often are required to search every Chapter 13 petition filed in an attempt to discover if they might have a claim for an outstanding tax; where returns have not been filed it is nearly impossible to timely file a proof of claim.

Taxes due to fraud or that have been evaded, or those for which the debtor has never filed returns do not deserve special, lenient treatment; it is unfair to honest taxpayers to allow debtors to escape such taxes. Thus the bill provides that tax obligations arising from fraudulent returns, willful attempts to evade, and late and unfiled returns shall be nondischargeable in Chapter 13 cases. The bill does not alter the current rules for priority—the other creditors are not affected, but the debtor will not be able to take advantage of his or her fraud or dilatory behavior.

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I. Sec. 509—Discharge of Fraudulent Taxes in Chapter 11 Cases.

Currently the confirmation of a Chapter 11 plan of reorganization discharges the debtor from any debt that arose before the date of confirmation, but does not discharge an *individual* debtor from taxes which arose because of fraudulent returns or an attempt to evade taxes. The discharge of corporate debtors, by contrast, is not restricted, taxes due to fraud and evasion are discharged. Both bankruptcy and tax policy dictate that corporate owners and management should not receive an undeserved benefit from their misdeeds and that this loophole be closed. The bill provides, therefore, that corporations may not discharge such taxes in Chapter 11 cases, the same as individuals.

J. Sec. 510—The Stay of Tax Proceedings.

Section 362(a)(8) of the Bankruptcy Code stays the commencement and continuation of a proceeding before the United States Tax Court concerning the debtor. A Tax Court decision held that this section stays the commencement or continuation of a proceeding involving an individual debtor's postpetition tax liabilities, even though such taxes are not an administrative expense of the estate. The bill overrules the Tax Court's decision in *Halpern* v. *Commissioner*, 96 T.C. 895 (1991), and provides that decisions in tax matters may be appealed without violating the automatic stay.

K. Sec. 511—Requiring Periodic Payment of Taxes in Chapter 11 Cases.

The bill provides that secured tax claims which, but for their secured status, would otherwise be payable as priority claims, shall be paid in the same manner as if the claims were merely priority and that all tax claims be paid in regular installments over the life of the plan. Currently Chapter 11 debtors are permitted to pay both secured and unsecured tax claims according to whatever plan the court approves. In some cases courts have approved plans providing no payments on tax claims until the end of the plan, thus placing the public revenue at risk and favoring other creditors in the all to often event that the plan fails. In other cases courts have permitted debtors to pay secured tax claims in much the same manner as a consensual lender's debt secured by a mortgage, over a period far in excess of the time permitted by law for the payment of taxes. Given that a tax claim becomes secured only after the taxpayer fails to pay the tax and that any tax obligation protected by a lien may be immediately collected, the "stretch-out" of such taxes under a plan of reorganization is the forced public financing of the debtor's business and is contrary to good bankruptcy policy.

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L. Sec. 512—The Avoidance of Statutory Tax Liens Prohibited.

The bill provides that a trustee is not a "hypothetical purchaser" for purposes of avoiding certain tax liens. Section 6323 of the Internal Revenue Code provides protection to certain purchasers of property even after a notice of federal tax lien has been filed in accordance with federal tax law. A "purchaser" is defined as a person who, for adequate consideration, acquires an interest (other than a lien or security interest) in property, which is valid under local law against subsequent purchasers without notice. Applicable purchases include securities, motor vehicles, personal property purchased at retail, and personal property purchased at casual sales. Section 545(2) of the Bankruptcy Code permits a trustee to avoid a tax lien that is either not perfected or not enforceable at the time of the filing of the petition against a bona fide purchaser, "whether or not such purchaser exists." Trustees and debtors in possession have attempted to employ section 545(2) to avoid tax liens on the basis that the trustee or debtor steps into the shoes of the hypothetical bona fide purchaser entitled to superpriority under the Internal Revenue Code. The purpose of the exceptions in the Internal Revenue Code is to facilitate the flow of these goods in commerce and should not be used to displace an otherwise valid lien for the protection of the public revenue. Applying 545(2) to tax liens may result in an unintended windfall to the debtor.

M. Sec. 513—Provide Course of Business Status for Administrative Taxes.

The Judicial Code, title 28 of the United States Code provides that bankruptcy estates are subject to all state, local and federal taxes. Because governmental units are creditors in the vast majority of bankruptcy cases, however, taxing authorities often have difficulty obtaining payment of the taxes owed by a bankruptcy estate. The problem is particularly pronounced in smaller Chapter 11 cases where cash-short debtors-in-possession frequently default on tax paying obligations in favor of paying legal fees, salaries or trade creditors.

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Currently taxing authorities can be required to file a request for payment of an administrative expense tax under 11 U.S.C. 503(a), the same as lawyers and other professionals seeking approval of their fees; a procedure is provided under 11 U.S.C. 505(b) for the determination of the estate's taxes. In at least one case, a bankruptcy court held that a request for payment was a mere notice and that the taxing authority was required to file a motion to obtain payment. The purpose of section 503(a) is to provide the mechanism by which administrative creditors, lawyers and other professionals, may be paid for their services to the estate, after court review and approval. Inasmuch as taxes are more like the usual and normal expenses payable in the ordinary course of the debtor's business it makes no sense to burden governmental authorities with the task of filing a request for payment, particularly when the Code already provides the trustee with a procedure to determine the propriety of any such tax. The bill makes it clear that the taxes incurred by a bankruptcy estate are a course of business expense and eliminates the need to make a request to pay taxes that are entitled to payment as an administrative expense.

N. Sec. 514—Clarify the Treatment of Tardily Filed Priority Tax Claims.

In Chapter 7 cases, section 726(a)(1) of the Bankruptcy Code allows a tardily filed claim for a priority tax if the claim is "filed before the date on which the trustee commences distribution," but does not specify when that event occurs, whether it is the date when the court approves the final report and accounting of the trustee, the date the checks are mailed or when the trustee's final report is sent to the United States Trustee for approval. The bill makes a housekeeping amendment designed to minimize future litigation that may arise from a literal reading of the statute by amending section 726(a)(1) to provide that a tardily filed claim must be filed before "the date on which the court approves the final report and accounting of the trustee."

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O. Sec. 515—Clarify the Definition of a Return.

Section 523(a)(1)B) of the Bankruptcy Code provides that taxes which are excepted from the debtor's discharge include those where the debtor has failed to file a return, but does not define a "return" or provide guidance as to the treatment of the various returns taxing authorities are permitted to make on behalf of delinquent taxpayers. The bill makes it clear that substitute returns made by taxing authorities, with the co-operation of the debtor and signed by the debtor, are included in the definition of a return.

P. Sec. 516—The Discharge of the Estate's Liability for Unpaid Taxes.

Section 505(b) of the Code provides that on the request for a determination of the tax by the taxing authority, the trustee, debtor, and any successor to the debtor are discharged from any tax liability other than that reflected on the return, unless the taxing authority notifies the taxpayer that the return will be examined. Courts have held, however, that this discharge of liability for additional tax does not apply to the estate, even though the trustee is the representative of the estate and even though logic suggests that the estate should be included in the provision providing for the discharge of tax liabilities, consistent with Congressional intent for providing for expedited audits and speedy, final determination of tax liabilities in bankruptcy. The bill makes it clear that the estate is discharged from any liability for additional taxes if the taxing authority fails to pursue its rights to assert additional taxes due as provided in the Code.

Q. Sec. 517—Requirement to File Tax Returns to Confirm Chapter 13 Plans.

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In a Chapter 13 plan, the debtor is required to provide for the full payment of all claims entitled to priority, including taxes which have not been assessed but are still assessable. Where the debtor has failed to file a return the taxing authority has no practical means of determining the correct amount of its claim. In some cases, the taxing authority has attempted to protect the public interest by filing estimated claims in all cases where the debtors have "open" years, a monumental task given the volume of Chapter 13 filings. The practice of filing estimated, "place holding" proofs of claim for periods for which no returns have been filed creates a number of problems for tax authorities, debtors and courts. Some courts have directed tax authorities to file claims labeled as estimates to protect their position, while other courts have sanctioned tax authorities for filing incorrect estimates—tax authorities are in a "no-win" situation when they must rely on estimated proofs of claim. To avoid such difficulties, the bill requires that Chapter 13 debtors file all returns which are due for the six taxable years ending before the petition in bankruptcy.

R. Sec. 518—Standards for Tax Disclosure in Chapter 11 Cases.

The bill amends section 1125(b) of the Bankruptcy Code to require a discussion of the potential material federal and state tax consequences of the plan to the debtor and any entity created pursuant to the plan, and a discussion of the potential material federal tax consequences of the plan to a hypothetical investor typical of the holders of claims or interests. A Chapter 11 plan's tax consequences represent an important aspect of the plan. The failure to discuss the potential tax consequences of a plan of reorganization in the disclosure statement can result in seriously misleading creditor constituencies and other parties in interest about the plan's economic effects.

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S. Sec. 519—Burden of Proof in Tax Matters.

The Bankruptcy Code does not require that either the debtor or the taxing authority sustain the burden of proof in regard to tax claims, whether the debtor must sustain the ultimate burden, the rule in nonbankruptcy tax matters, or whether the taxing authority has the burden, consistent with the treatment of other bankruptcy claims, generally. To resolve the conflict among judicial decisions, which have ruled favorably on both sides of the issue, and to establish consistency with the treatment of tax determinations outside of bankruptcy, the bill simply provides that the burden of proof in regard to tax claims shall be the same as in nonbankruptcy tax determinations, *regardless of what that rule may be*.

The National Bankruptcy Review Commission recommended that the burden of proof in tax matters in bankruptcy court be placed on the debtor.

The government's position as a tax creditor in a claims contest is different from other creditors in a normal debtor-creditor relationship. It is generally the debtor or the debtor-in-possession who has access to all of the relevant records, information and knowledge required to substantiate or contest the validity of a tax claim. . . . To the extent one creditor is prevented from being able to prove its claim due to lack of information, other creditors benefit to the detriment of that creditor. The Recommendation is designed to protect tax creditors from that result.

REPORT OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION 816 (Oct. 20, 1997).

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T. Sec. 520—Setoff of Tax Refunds.

After a consumer files a petition in bankruptcy, a taxing authority is required to seek relief from the automatic stay on a case-by-case basis if it wants to offset a refund of prepetition taxes against a claim for prepetition taxes, even if the claim is not disputed. The cost to the government of prosecuting often uncontested and routine motions as a prerequisite to enforcing an undisputed, mutual obligation is substantial. Because the interest and penalties which may continue to accrue are often nondischargeable, the inability to promptly apply income tax refunds against tax claims can cause individual debtors undue hardship. Thus the bill grants taxing authorities the ability to setoff an income tax refund that arose prepetition against an undisputed income tax liability which similarly arose prepetition.

IV. CONCLUSION.

We may not like paying taxes and we may not even like the tax system as it presently stands, but as citizens and tax payers we have a duty to try to make the system work until it is changed. We also have a duty to seek changes in the tax system which allow it to function properly and to seek changes in other laws which unduly impede the governmental process and impose unwarranted risks or burdens on those outside the bankruptcy system. In short, if the system doesn't work, from your perspective, if it doesn't do what you believe it should do or if, in your opinion, it treats some too harshly, seek to change the system, don't corrupt it and, most importantly, don't advocate the creation or maintenance of loopholes, such as those which presently exist in the Bankruptcy Code, which those who are undeserving can exploit; don't seek to maintain rules and procedures which impose undue complexity and unreasonable burdens on the parties and which frustrate the ability of those who are charged with performing essential government services from doing their duty under laws designed to protect all the people; and do what you can to discourage those who would foster such rules and requirements which increase the cost of government, a cost which we all must pay, and make it nearly impossible for government to serve all the people.

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Mr. **GEKAS.** We thank Mr. Shepard, and we turn to Professor Newton.

STATEMENT OF GRANT W. NEWTON, PROFESSOR OF ACCOUNTING, PEPPERDINE UNIVERSITY

Mr. **NEWTON.** Thank you, Mr. Chairman, and other committee members. I appreciate the opportunity to appear today.

I serve as Chairman of the American of Bankruptcy Institute's Taxation Committee, and a member of the Taxation Committee of the Association of Insolvency Accountants. And I have received advice from members of both organizations regarding my work as a member of the Tax Advisory Committee to the Bankruptcy Review Commission and my review of the tax provisions of H.R. 3150. However, these comments represent my views and not necessarily those of the organizations or committees I represent. I've included a paper that describes the analysis of H.R. 3150 in greater detail, and a copy of a paper I wrote some time ago describing the need for changes to state and local tax rules that's contained in the Bankruptcy Code.

Tax provisions are a very important part of H.R. 3150. They deserve careful consideration, and I appreciate the fact that the Chairman has allocated some time to examine these issues. There are four issues that I would like to encourage you to consider in addition to the tax issues in H.R. 3150 that I think need careful consideration.

The first deals with the need to modify the Bankruptcy Code for state and local taxes to follow the Federal income tax laws. As you know, the Bankruptcy Code contains the requirements for state and local bankruptcy tax issues and the Internal Revenue Code for Federal income tax issues related to bankruptcy. It was the intent when the Bankruptcy Tax Act of 1980 became law to modify the Bankruptcy Code to follow the provisions applicable to Federal taxes. Eighteen years later that modification has not been made. H.R. 3150 should make that modification to remove the state and local tax issues from the Bankruptcy Code or allow them to be governed by state law.

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My preference is that the special tax provisions that are in the Bankruptcy Code, Sections 346, 728, 1146, and 1231, be revised to follow the Federal income tax laws. These changes that are needed are contained in the National Bankruptcy Review Commission's proposals number 4.2.4, number 4.2.16, and 4.2.17, and they do not involve changes in the Internal Revenue Code.

To illustrate the problem: A short tax return must be filed for the estate of an individual debtor for state and local tax purposes, but it's an option for Federal tax purposes, and even if you make the election thinking that you'll have the same time period for state purposes that you have Federal purposes the year ends are different according to the law. For state and local tax purposes, a separate estate is created in chapter 12, but a separate estate is not created for Federal tax purposes. For a debtor that has income from debt discharge, only two attributes are reduced for state and local tax purposes and seven are reduced for Federal tax purposes.

These are just a sample of the problems that tax practitioners must deal with on a daily basis that could be reduced if the recommended changes were made to H.R. 3150. And, of course, the burden of these costs are with the individual debtor that the Bankruptcy Code is trying to help.

Second, I think the National Bankruptcy Review Commission recommended corporations have the same right as individuals to elect to have taxes incurred prior the filing that straddle the petition date to be considered pre-petition taxes up to the date of filing, and after the date of filing they would be considered administrative expenses. The Eighth and Ninth Circuits allow the debtor to bifurcate the taxes. I think it's important that Congress address this issue because H.R. 3150, Section 510, ignores this issue and it needs to be revised or the bifurcation area needs to be resolved before Section 510 becomes law.

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Two other provisions, requiring all taxing authorities to determine the tax impact of the plan and subordinating tax penalties in all chapter proceedings are other issues that were recommended by the National Bankruptcy Review Commission that should be included in H.R. 3150.

Section 403 of H.R. 3150 would not require creditors to file proof of claims in chapters 7 and 13 cases if the debtor's schedules list the claims. Adoption of this provision would, I believe, place a burden on chapter 7 trustees to determine the validity of all scheduled claims, because of their responsibility as a trustee, that would be greater than any benefits that would be gained from this proposal.

In addition, the tax issues that involve changes in the Bankruptcy Code, both the Tax Advisory Committee and the National Bankruptcy Review Commission, recommended changes to the Internal Revenue Code dealing with individual and corporate tax issues. Now I assume that these changes must be initiated with the House Ways and Means Committee, but I think it is important that the suggested revisions to the Internal Revenue Code are also considered. I hope this committee will encourage the House Ways and Means Committee to act on these issues.

I want to thank you for inviting me to appear today, and if I can provide assistance to the staff as these issues are considered, please call on me.

[The prepared statement of Mr. Newton follows:]

PREPARED STATEMENT OF GRANT W. NEWTON, PROFESSOR OF ACCOUNTING, PEPPERDINE UNIVERSITY

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H.R. 3150 contains several tax proposals that involve modifications of the Bankruptcy Code. Most of the proposals were recommendations made by the National Bankruptcy Review Commission ("NBRC"). However, several of the proposals contradict the recommendations of both the NBRC and the Tax Advisory Committee appointed by the Chairman of the NBRC. The objective of this paper is to explain the tax provisions that are in H.R. 3150 and identify some of the issues that need to be addressed before these provisions become law. The proposed changes made by the NBRC to the Bankruptcy Code that were not addressed by H.R. 3150 are described in the final section.

Listed below is a summary of the recommended changes to H.R. 3150.

Table 6

Subordination of Tax Liens (H.R. 3150, Section 501(a))

Section 724 of the Bankruptcy Code provides for the subordination of tax liens to administrative expenses and other priority taxes. H.R. 3150 would modify the subordination provision by not subordinating perfected, unavoidable tax lien arising in connection with an ad valorem tax on real or personal property, as recommended by the NBRC. Additionally, administrative expense incurred after the petition is filed is restricted to chapter 7 expenses unless the claim is for wages, salaries or commissions. The subordination only to chapter 7 expenses was not included in the recommendation of the NBRC.

H.R. 3150, as recommended by the NBRC, would also add a subsection (e) to section 724 that provides that before a tax lien may be subordinated, the trustee shall (1) exhaust the unencumbered assets of the estate, and (2) in a manner consistent with section 506(c) recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving or disposing of that property.

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Subsection (f) provides that notwithstanding the exclusion of ad valorem tax liens claims for wages, salaries, and commissions that are entitled to a section 507(a)(3) priority and claims for contributions to an employee benefit plan entitled to a 507(a)(4) priority may be paid from property of the estate which secures a tax lien, or the proceeds of such property.

COMMENT: The proposals to not subordinate property taxes, to use unencumbered assets, and to subordinate property tax claims to wage holders appears fair.

However, the provision to limit the subordination to chapter 7 expenses will limit the recovery of assets for unsecured creditors. A trustee appointed in a chapter 11 case, where there is a tax lien on all assets, has no incentive to go after known or potential recoveries because any costs that are incurred will not be allowed unless the tax claims are paid in full. Trustees are often better equipped to recover assets than the taxing authorities. Removing the incentive for the chapter 11 trustee may in fact result in less recovery to both the taxing authorities and to other creditors.

Studies have shown that state and local governments have suffered losses because of the subordination of ad valorem tax liens. However that generalization should not be applied to the IRS and other state income taxing authorities by not allowing the tax lien to be subordinated to chapter 11 administrative expenses. Abuses have occurred where administrative expenses have been in excess of what they should have been resulting in less return to taxing authorities. In most cases, the U.S. trustee appoints chapters 7 and 11 trustees. The activities of trustees are monitored by the U.S. trustees and their involvement should help control the actions of the appointed trustee. No doubt a much greater abuse occurs when a chapter 11 case with no prospects of successful reorganization is allowed to continue until all of the free assets are consumed by professionals and then the case is converted to chapter 7. The change to section 724 that limits subordination to chapter 7 administrative expenses does nothing to deal with this abuse.

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Determination of Tax Liability (H.R. 3150, Sections 501(b), 504 and 516))

H.R. 3150 modifies section 505(a)(2) to provide that the court may not determine an ad valorem tax if the applicable period for contesting or redetermining the amount under any law other than bankruptcy law has expired. Some bankruptcy courts have redetermined the tax because the bankruptcy court may determine all claims. The NBRC did not recommend this change be made.

H.R. 3150 also provides that the debtor-in-possession or trustee may request a determination of the tax at the time the tax return is filed. If upon payment of the amount shown on the return, the trustee, debtor, and any successor to the debtor is discharged unless the governmental unit notifies the trustee or debtor-in-possession within 60 days that the return has been selected for examination and completes the examination within180 days after the request was made. Note that the wording in section 505(b) does not discharge the estate. Courts have held that the IRS may assess additional taxes against the estate but not against the trustee or debtor. Thus, even though the estate received the letter stating that the taxes were accepted as filed, additional taxes may be assessed against the assets that remain in the estate. To correct this problem H.R. 3150 follows the recommendation of the NBRC and the Tax Advisory Committee and proposes to amend section 505(b) of the Bankruptcy Code by inserting "the estate."

H.R. section 505(b) of the Bankruptcy Code would be amended, as recommended by the NBRC, by providing that the request for tax determination must be made in the manner designated by the governmental unit (see notice section below).

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COMMENT: By not allowing the bankruptcy court to determine the ad valorem tax claim, the proposed change would allow a governmental unit to collect a tax that is greater than the amount allowed. If the tax were properly determined, the state will receive its priority payment. For example, in one case where a chapter 11 trustee was appointed, the debtor allegedly borrowed millions of dollars of debt under false pretense. The debtor did not file business tax forms and the taxing unit determined the tax based on values that were greater than the actual values of the assets. Under this proposal, since the time for redetermining the tax expired, the business tax would remain, even though all parties know the tax was incorrectly calculated. Taxes already have a priority over all other general unsecured claim holders and this change will allow the taxing authority to collect or retain taxes for amounts that are greater than the amount that should be allowed.

The inclusion of the "estate" in section 505(b) is a change that is needed.

The modification to section 505(b) requiring notice be made according to the manner designed by the governmental units seems reasonable; however, the section should also be modified to provide that a partnership and S corporation in bankruptcy and chapter 13 debtors are within the provisions of section 505(b). The IRS has issued a policy statement stating that section 505(b) does not apply to partnership and S corporations and has refused to apply section 505(b) to chapter 13 cases.

Use of Exempt Property (H.R. 3150, Section 502)

Section 522(c)(1) of title 11, United States Code, is amended by inserting at the end of the paragraph: "except that, notwithstanding any other Federal law or State law relating to exempted property, exempt property shall be liable for debts of a kind specified in section 523(a)(1) or (5) of this title." This proposed change was not recommended by the NBRC.

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COMMENT: The meaning of this section is not clear. Since the impact this change will have is not known, it is difficult to comment on the proposed change.

Effective Notice to Governmental Units (H.R. 3150, Section 503)

Section 342 of the Bankruptcy Code under H.R. 3150 would be modified to establish standard for effective notice and provide information about the taxpayer such as taxpayer identification number, loan, account or contract number, or real estate parcel number. H.R. 3150 also provides that the clerk shall keep and update quarterly, in the form and manner as the Director of the Administrative Office for the United States Courts prescribes and makes available to debtors the register in which a governmental unit may designate a safe harbor mailing address for service of notice in bankruptcy cases.

H.R. 3150 also directs the Advisory Committee on Bankruptcy Rules of the Judicial Conference to adopt rules that provide notice to state, federal and local governmental units that have regulatory authority over the debtor and suggests selected items that should be included.

H.R. 3150 also provides that no sanction under section 362(h) of the Bankruptcy Code or any other sanction that a court may impose on account of violations of the stay under section 362(a) of this title or failure to comply with section 542 or 543 of this title may be imposed unless the action takes place after notice of the commencement of the case as required by section 342 has been received.

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COMMENT: The NBRC adopted the Tax Advisory Committee's recommendation that all issues affecting governmental units notice be in the form of proposed changes to the Bankruptcy Rules. H.R. 3150 codifies part of the notice provisions and includes the revision to section 362(a) that was not part of the NBRC recommendations. This provision is intended to somewhat codify for the benefit of taxing authorities *In re Bloom*, 875 F.2d 224 (9th Cir. 1989), which held that "the statute provides for damages upon a finding that the defendant knew of the automatic stay and that the defendant's actions which violated the stay were intentional."

Section 342(g) is troublesome in that it appears that this section would require the debtor to notify a governmental entity of a potential trust fund tax (100 percent penalty) even though the debtor was not aware of the potential liability.

Taxing authorities need to be notified of bankruptcy filings; however, the requirements for such notice including content, timing of notice, sanctions for non-compliance, etc. should be covered by the Rules Committee.

Rate of Interest on Tax Claims (H.R. 3150, Section 505)

H R. 3150 would add a new section 511 to the Bankruptcy Code that would provide for interest on claims existing before the order of relief to be applied at the rate provided in section 6621(a)(2) of the Internal Revenue Code of 1986. Section 6621(a)(2) provides that the rate should be the federal-short-term rate determined under subsection (b) plus 3 percentage points. Subsection (b) provides that the Secretary shall determine the Federal short-term rate for the first month in each calendar quarter. Subsection (c) provides that the rate for large corporations should be increased by 2 percentage points. It is assumed that subsection (c) would not apply.

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COMMENT: The Bankruptcy Code does not specify the interest rate that is to be used for tax claims that are entitled to interest. Judicial consensus is that a market rate of interest should be used and that the federal statutory rate is relevant in determining the appropriate rate. To avoid the wasting of both judicial and debtor resources by litigating the rate, the NBRC followed the recommendation of the Tax Advisory Committee that the rate be fixed at the statutory rate under section 6621(a)(2), without reference to section 6621(c) and it should be the rate in effect as of the confirmation date. H.R. 3150 ignores the comment of the NBRC that the rate should not consider 6621(c) and that it should be set as of the confirmation date of the plan. If the rate in section 6621(a)(2) is allowed, it should be determined as of the confirmation date and should not be allowed to fluctuate from quarter to quarter. Since all other creditors generally must assume the risk of changes in the market rate of interest, the same consideration should also apply to the IRS. Regarding the rate under section 6621(c), since only the rate in section 6621(a) is mentioned, it is not clear if the section 6621(c) rate would also apply. These changes are needed, if for no other reason than to avoid the litigation necessary to clarify the point.

Tolling of Priority of Tax Claim Time Periods (H.R. 3150, Section 506)

The first changes would provide that the period of three years before the filing of the petition under section 507(a)(8)(A)(i) would be modified to provide for any time, plus 6 months, during which the stay of proceedings was in effect under a prior case.

The second change would provide a revised section 507(a)(8)(A)(ii): "(ii) assessed within 240 days before the date of the filing of the petition, exclusive of—(I) any time plus 30 days during which an offer in compromise or installment agreement with respect of such tax, was pending or in effect during such 240-day period, and (II) any time plus 6 months during which a stay of proceedings against collections was in effect in a prior case under this title during such 240-day period."

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COMMENT: The majority of courts (justifiably) have allowed for tolling of priority time periods during prior bankruptcies because the stay was in effect and the IRS was limited as to the type of action it could take. This provision codifies the impact of the tolling. The added time allows the IRS time to respond once the stay has been removed. Thus, rather than extending the time period by six months or 30 days (in case of an offer in compromise), the extension should be the greater of any time during which the stay of proceedings was in effect in a prior case (or offer in compromise pending) or six months (or 30 days for an offer in compromise).

H.R. 3150 would extend the tolling to installment agreements. During the time period prior to or at the time the IRS enters into an installment agreement, the IRS has the right to place liens on the debtor's property. Even during the installment period, the IRS may reserve the right to place liens on the debtor's property and take other actions to protect its interest. Some tax practitioners have indicated that they will recommend a larger number of their clients file bankruptcy rather than apply for an installment agreement if this change goes into effect. This change penalizes those individuals that in good faith extend the time period for payment of their claims, and a major illness, loss of job or other unfortunate events force them to file a bankruptcy petition. Prior years' taxes for this individual would be a priority claim because of the tolling provision, but if this individual had no interest in paying the taxes and had not contacted the IRS to work out an installment payment plan, the taxes may be discharged.

The IRS seeks this change because it has seen numerous cases where a taxpayer entered into a minimal installment agreement to buy time until the 240-day measuring period passed thereby making the tax nondischargeable.

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The NBRC stated in its report that the proposal for tolling during the period of compromise did not extend to installment agreements.

Assessment Defined (H.R. 3150, Section 507)

There has been some conflict with state law as to the meaning of the term "assessment." Section 101 of the Bankruptcy Code is amended by inserting a definition for assessment: "(3) 'assessment'-(A) for purposes of State and local taxes, means that action which is sufficiently final so that thereafter a taxing authority may commence an action to collect the tax, and (B) for Federal tax purposes has the meaning given such term in the Internal Revenue Code of 1986; and 'assessed' and 'assessable' shall be interpreted in light of the definition of assessment in this paragraph."

COMMENT: Assessment was defined in accordance with the recommendations of the NBRC.

Making Chapter 13 Nondischarge Provision Consistent with Chapter 7 (H.R. 3150, Section 508)

Section 1328(a)(2) of the Bankruptcy Code is amended by expanding the dischargeability of taxes to cover those taxes that are nondischargeable in chapter 7. Thus, the provisions for chapter 13 regarding tax discharge for fraudulent and unfiled tax returns under this proposal would be equivalent to those in chapter 7.

COMMENT: In general, it can be argued (as the author did for several years) that there should be no difference between the dischargeability of taxes under chapter 7 and chapter 13. Chapter 13 facilitates the workout of tax claims and is consistent with other provisions of H.R. 3150 that require taxpayers to pay some of their claims over the plan period. Taxing authorities collect substantial taxes because chapter 13 requires that all priority taxes be paid during the plan period and it places on the tax rolls individuals that have not paid taxes in several years.

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On the other hand in chapter 7, prior year tax returns are often not filed and limited, if any, of the taxes are paid during the collection period. In the final analysis taxing authorities receive a very small percent of the taxes due and probably less than would have been received in chapter 13.

This proposed change was debated by the NBRC, but the Commission was unable to obtain enough votes to pass the proposal.

To assist the taxing authorities in determining the tax, especially the priority taxes, the Tax Advisory Committee recommended that tax returns for six years be filed as described below. This author supported the six-year requirement on the assumption that the discharge provisions in chapter 13 would not be repealed.

Nondischarge of Corporate Taxes (H.R. 3150, Section 509)

Section 1141(d) of the Bankruptcy Code is amended by adding the following provision: "(4) Notwithstanding the provisions of paragraph (1), the confirmation of a plan does not discharge a debtor which is a corporation from any debt for a tax or customs duty with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax."

COMMENT: The NBRC recommended that section 1141(d) be modified to deny a discharge to a corporation for which a fraudulent return was filed. There is considerable opposition to this recommendation on the basis that the management of the company that was involved with the fraud is often replaced and a provision that prohibits a nonpriority tax from being discharged limits the ability of the creditors to reorganize the debtor. Because of the inability to restructure the troubled business due to the inability to obtain a discharge of nonpriority taxes, the Service may even collect less. The Service should file criminal action against the corporate officer that filed a fraudulent return, but the creditors should not be punished because of the errors of prior management. It should, however, be recognized that there is a significant difference between what constitutes civil fraud and what constitutes criminal fraud.

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Stay of Tax Proceedings (H.R. 3150, Section 510)

The stay under section 362(a)(8) would be revised to apply only to a tax liability for a taxable period ending before the order for relief. H.R. 3150 would revise section 362(b)(9) to provide that the stay does not apply to the appeal of a decision by a court or administrative tribunal that determines a tax liability of the debtor.

COMMENT: Although designed to apply to postpetition taxes, the stay as restricted in section 362(a)(8) would also apply to some prepetition taxes. For example, the Eight and Ninth Circuits, *In re L.J. O'Neill Shoe Co.*, 64 F. 3d 1146 (8th Cir. 1995) and *In re Pac-Alt. Trading Co.*, 64 F.3d 1292 (9th Cir. 1995), have held that the taxes of a corporation can be bifurcated into two parts—the part prior to the filing of the petition (a prepetition tax with eighth priority) and the tax incurred after the filing (an administrative expense). This change would allow the taxing authorities to collect the prepetition tax even before the plan is developed because the stay does not cover these taxes. While it can be argued that both the *O'Neill* and *Pac-Alt. Trading Co.* decisions are judge-made law and do not follow the provisions of tax law, it is necessary for the bifurcation issues to be settled before the proposed change becomes law.

Additionally, based on the provisions in section 507(a)(8) it has become a common practice for employers' taxes and trust fund tax withholdings that were made prior to the filing of the petition to be classified as prepetition taxes even though the tax period may end after the petition is filed. While this type of tax is not actually a quarterly or yearly tax, but an each-pay-day- tax, it is important that the proposed change is clear that it only applies to postpetition taxes.

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Thus, before this provision becomes effective, it needs to, at least, be revised to provide that it only applies to postpetition taxes.

Both the NBRC and the Tax Advisory Committee recommended that the relevant event for triggering the application of section 362(a) limitation is the filing of the petition and not the entry of the order for relief as advocated by H.R. 3150 and recommended the application of the stay to tax appeals as proposed in H.R. 3150.

Periodic Payment of Chapter 11 Taxes (H.R. 3150, Section 511)

H.R. 3150 proposes to amend the Bankruptcy Code to provide that the payments under section 1129(a)(9) must be periodic and must be "in at least quarterly installments designed to pay at least 15 percent of the claim in each of the first 5 years of the plan and no more than 20 percent of the claim in the final year of the plan."

H.R. 3150 follows the recommendation of both the NBRC and the Tax Advisory Committee in proposing that the requirements of section 1129(a)(9) should also apply to secured taxes that would be entitled to priority absent their secured status.

COMMENT: Both the NBRC and the Tax Advisory Committee suggested that the payments should be periodic, but did not define periodic other than to suggest that the payments should be monthly or quarterly and that balloon payments be prohibited. Because of the difficulty of establishing the time of assessment, both the NBRC and the Tax Advisory Committee recommend that the six-year period begin with the date of the order for relief. H.R. 3150 only deals with the issue of periodic and balloon payments. For some debtors, it is difficult for large payments to be made in the first year or two after emerging from bankruptcy. To facilitate that process, some creditors agree to limit the payments the first year or two to interest only or interest and limited principal payments. It seems reasonable that under these conditions the tax authorities should also receive less in the first year or two than is paid in the latter years. Thus, the recommendation of the NBRC provides, under these conditions, an opportunity for the court to approve payments that are less than equal payments, but would not allow plans to be approved that provide for one balloon payment at the end of the sixth year.

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The 15 percent and 20 percent rule will not work. For example, assume that the taxes were assessed one year before the petition was filed and that the company was in chapter 11 for two years. Payments under the plan would be made over three years.

However, payments could not be evenly distributed because only 20 percent of the claim could be paid in the third year. Another problem, in using the word "claim", does it include interest that begins to accrue on the allowed claim as of the effective date of the plan? If not, would the service allocate the first part of the payment as interest and the balance as payment on the claim? If so, then the payments in the first year would involve interest on the full amount of the claim plus a payment of 15 percent of the principal (claim). Thus, payments spread over six years may be required to be larger in the first year than in any other year. This proposal in its current conditions will create more problems than solutions and should not become law.

Tax Avoidance of Statutory Tax Liens (H.R. 3150, Section 512)

H.R. 3150 amends section 545(2), as recommended by the NBRC and the Tax Advisory Committee, to overrule cases that penalize the government due to certain benefits for purchasers provided for in the lien provision of the IRC or similar provisions of state or local law.

Course of Business Payment of Taxes (H.R. 3150, Section 513)

Payment of postpetition taxes is required when taxes are due in the course of such business unless the tax is a property tax secured by a lien against property that is abandoned by the trustee under section 554 of the Bankruptcy Code within a reasonable time after the lien attaches as provided for in H.R. 3150. Also H.R. 3150 modifies section 503 to provide that property taxes are to be paid as an administrative expense and that it is unnecessary for a governmental unit to make a request to the debtor to pay taxes that are entitled to payment as administrative expenses.

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COMMENT. These provisions were recommendations by both the NBRC and the Tax Advisory Committee.

Tardily Filed Priority Tax Claim (H.R. 3150, Section 514)

H.R. 3150 provides, as recommended by both the NBRC and the Tax Advisory Committee, that a taxing authority must file a claim for priority tax before the final order approving the trustee's report is entered by the court.

COMMENT: It is important that the claim be filed before the final order approving the trustee's report is entered to avoid requiring the trustee to recalculate the amount paid to creditors and equity holders, to rewrite the report, and to reschedule the hearings to approve the report. Filing a claim after the report is filed clearly impacts the efficient court administration of the case. See *Pioneer Investment Servs. Co.* v. New Brunswick Assocs. Ltd. 113 S. Ct. 1489 (1993).

Income Tax Returns Prepared by Tax Authorities (H.R. 3150, Section 515)

H.R. 3150 amends section 523(a)(1)(B) by providing a definition of a tax return for purposes of dischargeability as follows:

(iii) for purposes of this subsection, a return—

(I) must satisfy the requirements of applicable nonbankruptcy law, and includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code of 1986, or similar State or local law, or a written stipulation to a judgment entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code of 1986, or similar State or local law, and

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(II) must have been filed in a manner permitted by applicable nonbankruptcy law.

The last provision "(II) must have been filed in a manner permitted by applicable nonbankruptcy law" is confusing; it muddles a provision that was clarified in (I) above.

COMMENT: Both the Tax Advisory Committee and the NBRC recommended that a return filed under IRC section 6020(b) or similar federal, state, or local law provisions, should constitute a filed return for Bankruptcy Code dischargeability purposes where the taxpayer has taken reasonable steps to sign and file the return, even though the taxing authorities fail to accept such return for filing.

Tax Returns Required to Confirm Chapter 13 Plans (H.R. 3150, Section 517)

Section 1325 of the Bankruptcy Code is amended by H.R. 3150 to provide that one of the requirements for plan confirmation is the filing of income tax returns required under section 1308 of the Bankruptcy Code. The proposed section 1308 is as follows:

1308. Filing of prepetition tax returns

(a) On or before the day prior to the day on which the first meeting of the creditors is convened under section 341(a) of this title, the debtor shall have filed with appropriate tax authorities all tax returns for all taxable periods ending in the 6-year period ending on the date of filing of the petition.

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(b) If the tax returns required by subsection (a) have not been filed by the date on which the first meeting of creditors is convened under section 341(a) of this title, the trustee may continue such meeting for a reasonable period of time, to allow the debtor additional time to file any unfiled returns, but such additional time shall be no more than—

(1) for returns that are past due as of the date of the filing of the petition, 120 days from such date, and

(2) for returns which are not past due as of the date of the filing of the petition, the later of 120 days from such date or the due date for such returns under the last automatic extension of time for filing such returns to which the debtor is entitled, and for which request has been timely made, according to applicable nonbankruptcy law,

(3) upon notice and hearing, and order entered before the lapse of any deadline fixed according to this subsection, where the debtor demonstrates, by clear and convincing evidence, that the failure to file the returns as required is because of circumstances beyond the control of the debtor, the court may extend the deadlines set by the trustee as provided in this subsection for—

(A) a period of no more than 30 days for returns described in paragraph (1) of this subsection, and

(B) for no more than the period of time ending on the applicable extended due date for the returns described in paragraph (2).

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(c) For purposes of this section, a return—

(1) must satisfy the requirements of applicable nonbankruptcy law, and includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code of 1986, or similar State or local law, or a written stipulation to a judgment entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code of 1986, or similar State or local law, and

(2) must have been filed in a manner permitted by applicable nonbankruptcy law.".

Section 1307 of the Bankruptcy Code would be amended under H.R. 3150 to provide that upon the failure of the debtor to file the returns required under section 1308, on request of a party in interest or the U.S. trustee and after and a hearing, the court shall dismiss or convert the chapter 13 case to chapter 7, whichever is in the best interest of the estate.

H.R. 3150 proposes to amend section 502(b)(9) to provide that an objection to the confirmation of a plan is considered to be timely if it is filed within 60 days after the debtors' tax returns were filed under section 1308. Additionally, H.R. 3150 proposes that Congress direct the Advisory Committee on Bankruptcy Rules of the Judicial Conference to propose rules that provide for an opportunity for governmental units to object to (1) the confirmation of a plan on or before 60 days after the debtor files all tax returns required under sections 1308 and 1325(a)(7) of the Bankruptcy Code and (2) that no objection can be filed in reference to a tax of a return required to be filed under section 1308 until such return has been filed as required.

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COMMENT: The Tax Advisory Committee concluded that this provision would help reestablish the chapter 13 debtor as a "taxpayer" and would determine the priority tax that must be paid for a debtor to qualify for the chapter 13 super discharge. The Tax Advisory Committee concluded, after discussion with federal and local taxing authorities and with attorneys and accountants that render services for chapter 13 debtors, that requiring the chapter 13 debtor to file tax returns for six years, pay through the chapter 13 plan all of the priority taxes, and provide for some payment of the nonpriority taxes (realizing that some courts approve a zero plan for unsecured claim holders) along with other general unsecured claim holders will most likely result in the taxing authorities collecting more taxes now and in the future than would be collected with the filing of a chapter 7 petition. With the proposed repeal of the chapter 13 tax discharge provisions, tax professionals generally will not recommend that clients file chapter 13. As a result, this provision will not have the impact that was intended. This writer would not have supported the six-year chapter 13 filing requirement on the Tax Advisory Committee with a repeal of the chapter 13 discharge provisions.

As noted above, both the Tax Advisory Committee and the NBRC recommended that a return filed under IRC section 6020(b) or similar federal, state, or local law provisions, should constitute a filed return for Bankruptcy Code dischargeability purposes. H.R. 3150 would not treat a return filed under section 6020(b) as a filed return for tax discharge purposes.

Standard for Tax Disclosure (H.R. 3150, Section 518)

Section 1125(a) of the Bankruptcy Code dealing with the disclosure requirements is expanded by requiring the proponent of the plan to include full discussion of the potential material Federal and State tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case.

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COMMENT: In general, the disclosure requirements for income tax impact of the plan has not generated the desired results. Often, interested parties have been told to talk with their tax specialists to find out the income tax impact of the plan. Time will only tell if this requirement, if enacted, would result in the tax impact of the plan being explained in such a manner that readers of the disclosure statement would understand tax consequences. The purpose of the amendment is not to change existing law, but to make plan proponents adhere to the original intent of the law to effectively disclose the tax ramifications of the plan on the debtor.

Setoff of Tax Liability against Tax Refund (H.R. 3150, Section 519)

Section 362(b) of the Bankruptcy Code would be amended to provide that the setoff of an undisputed prepetition tax liability against an income tax refund does not violate the automatic stay. Setoff could not be taken if, prior to the setoff, an action was commenced under section 505(a) to determine the amount or the legality of the tax. However, if the setoff is tolled during the 505(a) hearing, the taxing authority may hold the refund.

COMMENT: The writer supported the recommendation of the Tax Advisory Committee. However, it has been pointed out by some writers that the impact of *Seminole Tribe of Florida*, 116 S. Ct. 1114 (1996), suggests that no change should be made regarding the tax setoff be considered because the debtor may be unable to recover tax refunds that were setoff improperly by a state taxing authority.

Additional Tax Issues

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Listed below are some of the changes that were recommended by the NBRC that were not a part of H.R. 3150 that should be considered.

Conform State and Local Tax Issues to Federal Laws

Conform section 346 of the Bankruptcy Code to the 1398(d)(2) election and conform state and local tax attributes that are transferred to the estate to those transferred for federal income tax purposes. Conform treatment of state and local claims to that provided for federal tax claims, including confirming state and local tax attributes to the federal list. Considerable conflicts exist between state and local taxes and federal taxes. Congress indicated at the time the Bankruptcy Reform Act of 1978 became law that the state and local tax issues would be changed when the Congress passed the federal bankruptcy tax laws. A few years later Congress passed the Bankruptcy Tax Act of 1980 and no action has been taken to eliminate the tax problems that arise because of the differences between the two federal laws. To correct these problems, changes need to be made only in the Bankruptcy Code, which means that these changes should be a part of the Bankruptcy Bill and not a Tax Bill. (NBRC Proposals 4.2.4, 4.2.16–4.2.17)

Bifurcation Corporate Taxes that Straddles the Petition Date

The NBRC recommended that corporations have the same right as individuals to elect to have taxes incurred prior to the filing for tax years that straddle the petition date to be considered a prepetition tax and tax incurred for the balance of the tax year after the petition is filed to be classified as an administrative expense. The Eighth and Ninth Circuits allow the debtor to bifurcate the taxes.

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Tax Impact of Plan

Currently, section 1146(d) of the Bankruptcy Code gives the bankruptcy court the power to determine the tax impact of a plan for state and local tax purposes. The NBRC recommended that this power also be extended to cover federal income taxes as well. Section 1146(d) should be modified by removing the "state or local."

Subordination of Tax Penalties

The NBRC recommended that the payment of prepetition tax penalties in chapters 11, 12 and 13 be subordinated to payment of general unsecured claims the payment is in chapter 7 cases. The NBRC noted that granting a priority to penalties works unfairness on general unsecured creditors by, in effect, punishing them for the debtor's misconduct. This is, according to NBRC, inequitable, especially where creditors have limited access and ability to monitor a taxpayer's compliance with tax reporting requirements.

SUGGESTED CHANGES TO STATE AND LOCAL TAX RULES(see footnote 10)

The Bankruptcy Reform Act of 1978, as originally drafted in H.R. 8200, contained many tax provisions including the handling of income from debt discharge, the use of net operating loss carryforwards, termination of taxable years of the estate, and responsibility for filing income tax returns. In the early stages of the revision of the bankruptcy law. it appeared to be acceptable to the House Ways and Means Committee to leave federal tax provisions in the bankruptcy bill. However, with a change in the chairmanship of the Ways and Means Committee, the federal tax provisions were removed from the bill by inserting "state and local" before the word "tax". It was contemplated that the federal tax laws would conform to the state and local tax laws or, if changes were made in the federal laws, the Judiciary Committees of both the House and the Senate would amend the state and local provisions of the Bankruptcy Code so that the state and local tax rules would conform with the federal. After a delay of over two years, the House and Senate passed the bill on December 13, 1980, and the President signed the Bankruptcy Tax Act of 1980 on December 24, 1980. Congress has not passed any bill that makes any attempt to conform the state and local tax laws with those contained in the Bankruptcy Act of 1980.

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Since the Bankruptcy Code only covers state and local taxes for an entity in title 11, the impact of debt discharge, preservation of net operating losses, etc., in an out-of-court workout will be governed by state and local tax laws. Thus, while the tax impact of debt discharge by an insolvent taxpayer in an out of court settlement or by a debtor in bankruptcy will be the same for federal tax purposes, the impact may differ significantly for state and local tax purposes.

The objectives of this article are to discuss some of the provisions of the Bankruptcy Code that impact state and local tax issues, to describe how the state and local taxes differ from federal income tax rules, and to suggest changes that should be considered by the Bankruptcy Review Commission.

Income from Debt Discharge

Section 346(j)(1) of the Bankruptcy Code provides that income is not realized by the estate, the debtor, or a successor to the debtor by reason of the forgiveness or cancellation of debt in a title 11 case.

Disallowance of Related Deductions

Section 346(j)(2) of the Bankruptcy Code provides that a deduction with respect to a canceled liability is not allowed for the year in which the debt was canceled or for future years. Thus, for example, if a liability is incurred to purchase a building and part of that debt was canceled, deductions for depreciation to the extent that the debt was canceled will be disallowed. This provision would also preclude the taxpayer from deducting all or part of a capital loss subsequently realized on the disposal of a capital asset that was pledged as security for a debt incurred at the time the asset was purchased. For federal tax purposes there is no provision in the Internal Revenue Code that would disallow deductions when related liability was canceled.

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Tax Attribute Reduction

As noted above, section 346(j)(1) provides that for state and local tax purposes, gain from debt forgiveness is not recognized by the estate, debtor or successor to the debtor. However, as is true for the cancellation of debt for federal tax purposes, tax attributes must be reduced. Section 346 (j) provides that two attributes will be reduced for state and local tax purposes while seven attributes are to be reduced for federal tax purposes. Two attributes reduced for state and local tax purposes are:

1. Net operating loss carryover

2. Basis of debtor's property but not in excess of the liabilities immediately after discharge.

Net Operating Loss Carryovers

Section 346(j)(3) indicates that net operating loss carryover is the first attribute to be reduced, but does not indicate the time at which the deduction should be made. It is presumed that the deduction would be made at the time of the discharge or forgiveness. Thus none of the net operating losses for the year in which the discharge occurs would be reduced unless there is a closing of the books as of the day the petition is filed or the taxpayer interprets this section to mean that the total net operating losses for the year should be prorated, based on time, between those losses incurred prior to the filing of the petition and those incurred after the filing of the petition. For federal tax purposes the deductions takes place after the computation of the tax loss for the year in which the discharge occurs. As a result of this timing difference, the tax impact of a discharge for state and federal purposes may differ significantly since the net operating loss in the year the petition is filed is often very large.

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Section 346(j)(4)(A) provides that the net operating loss is not reduced to the extent that canceled debt consisted of items of a deductible nature that were not deducted by the debtor. For example if the debtor is a cash basis taxpayer, the cancellation of a liability with no tax basis would not require the reduction of either net operating loss or basis. A similar provision applies in the case of federal income taxes.

Basis Reduction

The only other tax attribute that must be reduced is basis in property. No distinction is made between depreciable or nondepreciable property. Also, since there is no timing difference provided in section 346, it will be presumed that the basis will be reduced as of the date the discharge occurs. For federal tax purposes it takes place as of the first day of the taxable year after the year in which the discharge occurs.

The debtor may elect to include the gain from the discharge of debt in income rather than reduce the basis of property under section 3460)(6). For example, a chapter 11 debtor that is in a very low tax bracket for state income tax purposes may prefer to report the income and then be able to deduct depreciation expenses in future years when a higher tax bracket would apply. An individual may have itemized deductions that would offset any gain from the discharge of debt in the current period. Thus the taxpayer might under these conditions prefer to report the gain from debt discharge rather than reduce basis.

Section 346(j)(6) does not indicate the order in which basis will be reduced. It might be assumed that the order followed for federal income tax purposes could be used here.

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On the other hand since no order for the reduction is specified, it might seem logical to reduce all property proportionally. The net impact of this approach for state and local tax purposes should be significantly different from that for federal purposes. This would even be true in states that have elected to follow the Internal Revenue Code.

There is no provision for the debtor to elect to first reduce depreciable property and then reduce tax attributes as there is for federal tax purposes.

Stock for Debt

Section 346(j)(7) provides that no income from debt forgiveness or discharge is recognized when an equity security is issued in satisfaction of its debt. Section 101(16) of the Bankruptcy Code defines an equity security as a "share in a corporation, whether or not transferable or denominated 'stock' or similar security." it also includes a warrant or right to purchase, sell, or subscribe to a share or security, but does not include the right to convert. A security, as defined in section 101(16), also includes an interest of limited partner in a limited partnership. However, section 346(j)(7) excludes the interest of a limited partner from the exchange of an equity security for debt rules. This definition of equity security does not specifically mention preferred stock but because this definition is so broad, it is presumed that it applies to preferred stock.

Since the passage of the Bankruptcy Tax Act of 1980 there have been several restrictions placed on the exchange of stock for debt including the repeal of the exception to tax attribute reduction, effective January 1, 1995. It would appear that most of these restrictions would not apply for state and local tax purposes, such as the use of disqualified stock (redeemable stock) of nominal or token stock for petitions filed prior to January 1, 1994. For petitions filed after that date, tax attributes will be reduced by the amount from cancellation of debt when there is an exchange of stock for debt. Thus, tax attributes for federal purposes will now be reduced by the extent to which the amount of debt discharged exceeds the value of stock issued plus other consideration given. No reduction in tax attributed will be required for state and local tax purposes by chapter 11 debtors.

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Section 346(j)(7) provides that no income will be recognized from debt discharge to the extent that a shareholder contributed debt of the corporation to its capital. A similar rules applies for a contribution of debt to capital for federal tax purposes.

There is no specification provision in section 346 that provides for the exchange of general partnership interest for debt. Limited partnership interests are specially excluded as noted above. Some practitioners argue that an exchange of partnership interest (either general or limited) for debt should not result in income from debt discharge for federal tax purposes.

(a) Limitations

Section 346(j)(7) provides that the nonrecognition of income from debt discharge on the exchange of stock for debt or on the contribution of debt only apply:

1. To the extent that the indebtedness did not consist of items of a deductible nature or

2. If the issuance of such equity security has the same consequences under state or local income tax as a cash payment to the creditor in an amount equal to the fair market value of the security. the exception will apply to the lessor of the extent that the issuance has the same consequence or the extent of the fair market value of the equity security.

For example, there would be no reduction of tax attributes for a cash basis taxpayer. On the other hand, if the taxpayer is on accrual basis and issues stock with a fair market value of $1,000 to satisfy accrued interest expense in the amount of $ 1,000, no reduction of tax attributes would be required. If the value of stock was only $600, then tax attributes would be reduced by $400. The only tax attributes that will be reduced for state and local tax purposes are net operating loss carryforwards and basis of property.

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(b) Parent's Stock

Section 346(j)(7) does not provide whether the stock-for-debt exception would apply to a transfer of the stock of the parent to satisfy a debt of a subsidiary. The legislative history suggests that the use of parent's stock should be allowed in its statement that the debtor should be treated "as if it had originally issued stock instead of debt," H. Rep. No. 95–595, 95th Cong., 1st Sess. 334–7 (1977); S. Rep. No. 95–989, 95th Cong., 2nd Sess. 44–7 (1978). Since an exchange of a parent's stock of the subsidiary would not be subject to income tax from debt discharge, it should follow that stock be issued for debt that is considered as stock would not result in income from debt discharge. However, there is still some question as to the extent to which parent's stock may be used to cancel a subsidiary's debt. In cases where the courts has substantially consolidated the parent and its subsidiaries, there should not be any income from debt discharge.

NOL Carryback and Carryover

The extent to which the Bankruptcy Code will apply to a carryback or carryover of tax attributes is questionable. If the Bankruptcy Code is silent on a tax issue, the state and local tax laws should be applicable.

State Laws

Many states and local taxing authorities have tax laws that conform to the provisions of the Internal Revenue Code. State and local conformity can mean complete conformity or just the use of federal taxable income as the starting point for the determination of the state or local tax liability. Other states and local taxing authorities have their own laws that specify how tax liability is to be determined.

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With an increase in the number of very large bankruptcies involving many legal entities, the problems associated with state and local taxes have increased. Often, the plan provides for the reduction of the number of entities, but for federal tax purposes the reduction alone does not prevent the net operating losses from surviving. However. for state and local tax purposes the survival of the net operating losses may be less certain. Careful planning is therefore needed to preserve as much of the net operating loss as possible.

If the state and local tax laws follow the federal tax attribute carryover under section 381, the net operating losses may survive. Some states and localities may adopt the federal law with restrictions. One such restriction might be that in order to carry forward the net operating losses in a reorganization from a subsidiary must have been subject to state and local taxes in the period from which the loss arose.

Some states, while not directly incorporating the provisions of section 381, indirectly provide for the adoption of the federal laws by using the federal tax income, after net operating losses, as the starting point for determining state and local taxable income.

Approximately 20 states have conformed generally to the federal rule regarding carrybacks and carryforwards. Most of these states also require that the election to forego a carryback apply as well for state and local tax purposes. Some states allow carryforwards only and some limit the carryforward period to less than 15 years. During the budget problems faced by state and local governments, some states have temporarily suspended utilization of net operating loss carryforwards. Some states may also limit the use of net operating losses where the entity was not subject to a state or local tax in the year that the loss occurred.

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The treatment of net operating loss for state and local purposes may differ from that for federal taxes for consolidated groups, depending on whether the state allows or requires a consolidated, combined, nexus combined, or separate company filing option. For example, in California members of a unitary group filing a combined report may combine taxable income and losses in the current year. However, the members of the group must determine the net operating loss carryover on a separate company basis. This approach prevents the offset of one member's loss carryover against the future income of another member.

Bankruptcy Code

Section 346(g)(1)(C) provides that neither a gain or loss will be recognized by a debtor corporation under chapter 11 or 12 for state or local tax purposes on a transfer to an affiliate participating in a joint plan. However, a gain or loss will be recognized to same extent that such transfer results in the recognition of gain or loss under section 371 of the

Internal Revenue Code. Still. the extent to which a gain or loss will be recognized is questionable. Section 371, which was applicable to Chapter X of the Bankruptcy Act, did not apply to Chapter XI. When Chapter Xs and XI of the Bankruptcy Act were replaced by chapter 11 of the Bankruptcy Code, confusion was created as to the extent to which section 371 would be applicable to a chapter 11 case under the Bankruptcy Code.

In addition, section 371 of the Internal Revenue Code was repealed by the Bankruptcy Tax Act of 1980 and replaced by the "G" reorganization under section 368. Until this charge is made to the Bankruptcy Code, it could be argued that the repealed section 371 is still applicable since the Bankruptcy Code still states that it applies.(see footnote 11) Section 371 provided that no gain or loss would be recognized if property of a corporation is transferred in pursuance of an order of the court having jurisdiction over the corporation under Chapter X of the Bankruptcy Act to another corporation organized or used to effectuate a plan for reorganization, in exchange solely for stock or securities in the other corporation. If the property received consisted not only of stock or securities permitted to be received without gain recognition, but other properties or money considered as boot, no gain would be recognized if the corporation receiving the property distributed it to its creditors or shareholders under the terms of the plan reorganization. If the money was not distributed in accordance with a plan of reorganization. then the corporation would recognize the gain on transfer to the extent of the boot that was received and not distributed.

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Section 346(g)(2) provides that the transferee in a transfer of a kind specified in subsection (g), is to take the property with the same character, basis as adjusted under subsection (j)(5) for income for debt discharge, and holding period.

Bankruptcy Estate

Section 346(b) provides that a separate estate is created when a chapter 7, 11 or 12 petition is filed by an individual . As is true for federal tax purposes, a separate taxable entity is not created for partnerships and corporations and these entities will not close their taxable year as of the day the petition is filed. For federal tax purposes, a chapter 11 petition does not result in this creation of a separate estate since section 1398 of the Internal Revenue Code provides that a separate estate is only created in chapter 7 or 11.

Short Tax Year

Section 728(a), section 1146(a) and section 1231(a) together provide that the individual in a chapter 7, 11 and 12 case will terminate its taxable year on the date of the order for relief Thus the debtor will file two tax returns in the year the order for relief is granted. The order for relief is automatically granted at the time a voluntary bankruptcy petition is filed and in an involuntary case the court will issue the order for relief after a trial unless the debtor has timely converted the petition. One return begins on the first day of the taxable year and ends the day the bankruptcy petition is filed, and the other return will cover the period from the first day after the petition is filed to the end of the taxpayer's normal tax year. Note that the state and local tax provisions differ in at least three ways from the federal tax issues.

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1. Two tax returns must be filed during the year that the petition is filed; for federal tax purposes the debtor must make an election by the 1 5th of the fourth full month after the petition is filed in order to file two tax returns for the year the petition is filed.

2. The first tax year ends on the day the petition is filed; when the election is made to file two separate returns for federal tax purposes, the year ends the day before the bankruptcy petition is filed.

3. Under federal law a short-year election may not be made if the estate has no assets; a similar exception is not provided for state and local tax purposes.

A separate estate is created in the case of a chapter 12 petition while a separate estate is not created for federal tax purposes. In the case of a chapter 13 petition, a separate estate is not created for either federal or state and local tax purposes.

Method of Taxation

Under the state and local tax rules, the separate estate is taxed as an estate. Under the federal tax laws, the bankruptcy estate is taxed as a married person filing a separate return.

The State of California adopted legislation, effective January of 1990, that provided that the federal provisions that govern the taxation of estates in bankruptcy of individuals under chapters 7 and 11 also apply for state purposes. The law was modified, however, to reflect California's rates rather than federal rates, and section 1398 dealing with carryback and carryforward of unused administrative expenses was changed to provide that these expenses may only be carried forward for seven years. A statute of this nature is a state law even though it follows the provisions of the Bankruptcy Code. Approximately 50 percent of the states now have state laws that "piggy back" the federal tax laws. However, since the Bankruptcy Code is a federal statute, it has priority over the various state laws. Any state law that conflicts with sections 346, 738, 1146 or 1231 of the Bankruptcy Code is not enforceable.

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The state of California realized that its statute dealing with the special tax provisions for debtors in Bankruptcy was in conflict with section 346 of the Bankruptcy Code and repealed the state law. Effective October 2, 1991 Section 17047 of the California statute was repealed as of January 1, 1991. Thus, for all returns that are filed for calendar years 1991 and later, the State of California has officially indicated that sections 346, 728, 1146 and 1231 of the Bankruptcy Code apply. The instructions for form 541 indicate that the trustee or debtor-in-possession would file Form 541 for the estate in chapters 7, 11, or 12, if the estate has

Gross income for the taxable year of more than $8,000 (regardless of the amount of new income);

Net income for the taxable year more than $ 1,000, or

An alternative minimum tax liability.

California again failed to completely comply with the Bankruptcy Code. Section 728 of the Bankruptcy Code provides that in the case of a chapter 7, an individual and a corporation need file tax returns only if the estate has income for the entire period of the case.

Transfer of Property Estate

Section 346(g)(1) provides that neither a gain nor loss will be recognized on the transfer of the property to the estate at the time the petition is filed. This provision for state and local tax purposes is similar to section 1398(f)(1) that provides that for federal tax purposes there is no gain on transfer. However, section 346(g) does not contain a provision, for state and local tax purposes, that explain whether the transfer is or is not considered a disposition for purposes of recapture of any state and local tax credits. If the transfer was considered a disposition for state and local tax purposes, other unfavorable tax consequences might arise, such as the acceleration of income for state and local tax purposes. but not for federal. Also, the transfer of an installment obligation to a bankruptcy estate could result in income being accelerated due to the disposition.

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Sections 346(i) provides that the bankruptcy estate succeeds to all of the tax attributes of the debtor including:

1. Investment credit carryover

2. Any recovery exclusion

3. Any loss carry over

4. Any foreign tax carryover

5. Any capital loss carryover

6. Any claim of right.

The list for state and local tax purposes is nonexclusive since section 346(i)(1) provides that all tax attributes go to the estate. As noted in chapter 4, this is different for federal tax purposes where courts have held that only those attributes listed in section 1398 or added by the Service through the issuance of regulations are transferred to the estate. Thus, before the Service issued Treas. Reg. 1.1398–1, passive loss carryovers were transferred to the estate for state and local tax purposes.

Since under state and local tax rules, the individual is required to file a petition as of the date the bankruptcy petition is filed, the attributes will go over as of the end of the day in which petition is filed. It is also assumed that the tax liability that may be created as of the day the bankruptcy petition is filed will be a prepetition liability.

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Transfer to Debtor

Section 346(g)(1) provides that neither a gain nor loss will be recognized on the transfer, other than a sale, of property from estate to the debtor. If an abandonment is not considered a sale, there would be a gain or loss on the transfer. The provisions regarding the nontaxability of the transfer from the estate to the debtor for state and local tax purposes is not restricted, as is the case federal tax purposes under section 1398(f), to transfer on termination of the estate.

Section 346(i)(2) indicates that after a case is closed or dismissed, the debtor is to succeed to any tax attribute that was not utilized by the estate. It would appear that for state and local tax purposes the debtor would not be required to file an amended return, as would be true for federal tax purposes, when a petition is dismissed. Activities of the estate would be reported for state and local tax purposes on the appropriate estate tax forms as long as the case was not closed or dismissed.

According to section 346(i)(2), the time limitations associated with a tax attribute to which the debtor succeeded are suspended during the time the case was pending. There is no comparable provision for federal tax purposes.

Net Operating Loss Carryover and Carryback

Sections 346(i)(3) provides that the estate may carry back any loss of the estate to a taxable period of the debtor that ended before the order for relief. The debtor may not carry back a loss that he or she sustains while the case is open. However, section 346(i)(3) implies that the debtor may carry back a net operating loss once the case is closed, provided all the tax attributes were not used by the estate. The Internal Revenue Code does not have a similar provision indicating the debtor may carry back a loss after the case is closed.

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Responsibility for Filing Tax Returns

Section 728(b) provides that the trustee is responsible for filing the tax returns for an individual, partnership or corporation. If the estate of an individual debtor or corporation does not have a net taxable income for the entire period of the case, a return is not needed. If on the other hand, the individual or corporate estate does have a net taxable income, then returns must be filed for each taxable period during which the case was pending after the order for relief under chapter 7. The trustee for the estate of a partnership is required to file state and local tax returns whether or not the estate has net taxable income.

It would appear that if a corporation had taxable income for the period prior to the filing of the petition, but did not have net taxable income for the entire period the case is pending, no tax return would be required. If no tax return is required, it would be assumed that there would not be any tax liability.

Section 1146(b) provides, in a chapter 11 case, and section 123(b) provides, in a chapter 12 case, that the trustee or debtor-in-possession of an estate of an individual is responsible for filing a tax return for any taxable year ending during the period the case is pending. Since a short tax year return must be filed for state and local tax purposes, the trustee or debtor-in-possession is responsible for filing returns for the entire period the debtor is in bankruptcy.

Suggested Changes to Bankruptcy Code

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The failure to coordinate the Bankruptcy Code provision for state and local taxes with the federal provisions create problems similar to the following:

1. A short tax return must be filed for the estate of an individual debtor for state and local tax purposes, but it is an option for federal tax purposes.

2. Even if an individual debtor elects the short tax year for federal tax purposes, the year ends for the first short tax year return are different.

3. For state and local tax purposes, a separate estate will be created when an individual files a chapter 7, 1 1 or 12 petition, but for federal tax purposes a separate estate is created for only chapter 7 or 11 petitions.

4. When a separate estate is created for federal tax purposes, the estate succeeds to the attributes listed in section 1398 or in Treasury Regulations, but for state and local tax purposes the debtor succeeds to all appropriate tax attributes.

5. The tax for a separate estate is determined as if the entity was an estate for state and local tax purposes, but for federal tax purposes the estate is taxed as a married individual filing a separate return.

6. For a debtor that has income from debt discharge, only two attributes are reduced for state and local tax purposes and seven are reduced for federal tax purposes.

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7. The bankruptcy court may determine the future tax impact of a plan for state and local tax purposes. Any future federal tax consequences of a plan must be determined by requesting a private letter ruling.

Recommendations

1. **SECTION 346 SHOULD BE REVISED AS FOLLOWS:**

(a) Except to the extent otherwise provided in this title, for state and local tax purposes the provisions of the Internal Revenue Code of 1986 shall be used for the purposes of determining when a separate estate is created and how any income from the estate or individual (in case a new estate is not created for tax purposes) is taxed or how any tax attributes are reduced.

(b) The income tax rates of the state or local taxing authority shall be applied to any income determined in subsection (a).

REASON FOR THE CHANGE

Since the tax laws that cover bankruptcy proceedings are contained in the Internal Revenue Code for federal purposes and the Bankruptcy Code for state and local purposes, special effort needs to be made to minimize the cost to the estate, by providing that the effects of the laws are the same. This change would accomplish what was stated as the objective at the time the Bankruptcy Reform Act of 1978 was passed.

2. **SECTION 728 SHOULD BE DELETED.**

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REASON FOR THE CHANGE

Section 1398 and related provisions of the Internal Revenue Code as referred to in section 346 will cover the existing provisions of section 728.

3. **SECTION 1146 SHOULD BE MODIFIED AS FOLLOWS:**

1. Subsection (a) and (b) should be deleted since these provisions are now covered by section 346.

2. Subsection (c) should be labeled subsection (a)

3. Subsection (d) should be modified by

a. labeling subsection (d) as subsection (b)

b. striking "State or local"

c. by deleting in paragraph (2) "270" and inserting "180"

REASON FOR THE CHANGE

To facilitate the administration of the case and to provide consistent treatment for between federal and state and local tax issues, the bankruptcy court should be allowed to determine the future tax impact of a plan for federal tax issues as well as state and local tax issues. Consistent with the provision of reducing the time period that it takes to confirm a plan under title 11, the time period that the tax authority has to respond to a proposed plan has been reduced to 180 days. The "180 day" time period is also consistent with the period allowed for the Internal Revenue Service to determine the amount of a claim under section 505(b).

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4. **SECTION 1231 SHOULD BE MODIFIED AS FOLLOWS:**

1. Subsection (a) and (b) should be deleted since these provisions are now covered by section 346.

2. Subsection (c) should be labeled subsection (a)

3. Subsection (d) should be modified by

a. labeling subsection(d) as subsection (b)

b. striking "State or local"

deleting in paragraph (2) "270" and inserting "180".

REASON FOR THE CHANGE

To facilitate the administration of the case and to provide consistent treatment for between federal and state or local tax issues, the bankruptcy court should be allowed to determine the tax impact of a plan for federal tax issues as well as state and local tax issues. Consistent with the provision of reducing the time period that it takes to confirm a plan under title 11, the time period that the tax authority has to respond to a proposed plan has been reduced to 180 days. While, section 1224 provides that in the case of a chapter 12 plan a confirmation hearing is to be held within 45 days after the filing of the plan, a longer time period is suggested that is consistent with the time period under section 505(b).

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Mr. **GEKAS.** We have been requested by the Speaker of the House to repair to the chamber to vote on certain measures. We will stand in recess until 2:30, and we'll ask you please to remain. Thank you.

[Recess.]

The time of the recess has expired, the subcommittee will come to order. We will proceed with the testimony of Mr. Asofsky.

STATEMENT OF PAUL H. ASOFSKY, FORMER MEMBER OF THE TAX ADVISORY COMMITTEE, NATIONAL BANKRUPTCY REVIEW COMMISSION

Mr. **ASOFSKY.** Thank you, Mr. Chairman. My name is Paul H. Asofsky. I'm a partner in the law firm of Weil, Gotshal and Manges, resident in its Houston office. I have practiced tax law for more than 30 years, during most of which time I have devoted significant attention to the tax consequences of bankruptcy cases in general, and chapter 11 reorganizations in particular. I've been privileged to serve on, and to chair, committees of many bar associations and law improvement groups whose jurisdiction includes the tax consequences of bankruptcy. I was also privileged to serve as a member of the Tax Advisory Committee of the National Bankruptcy Review Commission, along with other private representatives, government representatives and members of the academic community. I'm appearing here today as an individual and not on behalf of any organization.

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I have submitted for the record a lengthy written statement that sets forth the background of the tax provisions of the present Bankruptcy Code, describes the development of the National Bankruptcy Review Commission's tax agenda, and gives a point-by-point analysis of all the tax provisions included in proposed H.R. 3150, and a list of items not contained in the present draft H.R. 3150 that I believe should be covered in any comprehensive bankruptcy legislation.

The time allotted for this oral statement does not allow me to discuss the particulars of any of those areas. Of course, I'd be glad to answer any questions put by members of the committee.

I appear here today to urge you to take a more careful look at the provisions contained in the bill, and to expand the scope of your project to include many additional provisions that must be addressed if this legislation is to make a significant improvement in the administration of the bankruptcy laws in regard to taxes.

As I point out in my written statement, the Advisory Committee consisted of a group of knowledgeable tax professionals representing the important perspectives on the relationship between the bankruptcy and tax laws. The Commission had the benefit of the hard work, inspiration and expertise of 10 individuals who labored selflessly in the public interest. It is impressive that those 10 individuals were able to reach consensus on many matters despite their differing perspectives. That they disagreed on other matters is not a commentary on their dedication to the task. It reflects the fact that many of these issues are not capable of easy solutions. But the difficulty in resolving some of these thorny issues does not relieve the committee of the necessity of trying. You are the people's representatives, and if the bankruptcy laws are defective in their operation, we look to you to improve them.

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It would be a shame if, in connection with enactment of this bill, the Congress did not take the opportunity to avail itself of the extensive work of the Advisory Committee by dealing with each and every tax issue designated as important by the Advisory Committee, enacting each consensus recommendations in the form proposed by the Advisory Committee, and making a searching examination of the unagreed issues in an effort to find the right answers.

I know that your staffs have the ability to do this. Over the years I've dealt with members of both your Majority staff and your Minority staff. Also, during the course of the Commission's deliberations, I interfaced regularly with Susan Jensen-Conklin to make sure that the important issues and the competing views were put in understandable form before the Commission. Thus, I can confidently assert complete faith in these dedicated staff members to get the job done right.

One final word. Any enacted legislation will work well only if it is the product of informed input by all interested parties. I understand the necessity for having called this hearing on short notice. However, I note that there are many groups out there which presently have this legislation under consideration, and hope to submit extensive comments after going through their own deliberative processes. This legislation is too important to be enacted in haste.

I hope this committee will seek input from, among others, the Internal Revenue Service, the Department of Justice, the National Association of Attorneys General, the National Bankruptcy Conference, the American Bar Association, both its tax and business law sections, the Association of Insolvency Accountants, the American Bankruptcy Institute, the National Association of Consumer Bankruptcy Attorneys, and the Association of the Bar of the City of New York. Each of these governmental and private organizations have public-spirited professionals who have devoted substantive attention to these matters throughout their careers. If this committee solicits their views before proceeding, there's a better chance that it will produce bankruptcy tax legislation responsive to the needs of a 21st century bankruptcy system.

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Thank you for the opportunity to appear.

[The prepared statement of Mr. Asofsky follows:]

PREPARED STATEMENT OF PAUL H. ASOFSKY, FORMER MEMBER OF THE TAX ADVISORY COMMITTEE, NATIONAL BANKRUPTCY REVIEW COMMISSION

INTRODUCTION

My name is Paul H. Asofsky. I am a partner in the law firm of Weil, Gotshal & Manges, LLP, resident in its Houston office. I have practiced tax law for more than thirty years, during most of which time I have devoted significant attention to the tax consequences of bankruptcy cases in general and Chapter 11 reorganizations in particular. I have been privileged to serve on and to chair committees of many bar associations and law improvement groups whose jurisdiction includes the tax consequences of bankruptcy. I am appearing today as an individual and not on behalf of any of those organizations, because not all of them have completed their analysis and recommendations with respect to the tax consequences of H.R. 3150. Although I will have something to say about the particulars of some of the provisions contained in this bill, my principal emphasis today will be upon the legislative process and the importance of a more extensive study by this committee of the tax aspects of the Commission's work.

The substantive and procedural tax aspects of bankruptcy cases, both individual and corporate, are badly in need of revision. Part of the problem lies in the peculiar position that "bankruptcy tax" occupies. The problem is that on the one hand, bankruptcy lawyers as a group do not understand tax, and many of them have little patience for it. They consider tax to be a specialty practiced by tax lawyers and accountants, and so when tax problems arise in bankruptcy, many bankruptcy practitioners instinctively look elsewhere hoping to find the requisite expertise. On the other hand, tax lawyers suffer from a similar myopia. They spend their professional careers dealing with clients whose problems grow out of economic success rather than failure, and they deal with the Internal Revenue Service and state and local tax bureaucracies through familiar procedures designed to resolve tax controversies in a deliberative fashion. When bankruptcy strikes, these professionals must often deal with different bureaucracies at the federal and local levels and must seek ultimate resolution in the bankruptcy court, a tribunal which is unfamiliar to most tax lawyers.

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Governmental taxing authorities suffer similar culture shock when dealing with taxpayers under the jurisdiction of the bankruptcy court. On the one hand, routine procedures for the assessment and collection of tax may be barred by the automatic stay. On the other hand, these taxing authorities often find it hard to adapt to statutes and rules requiring creditors to proceed in an expedited fashion to file their claims and resolve their disputes.

1978 BANKRUPTCY CODE TAX PROVISIONS

At the time of the enactment of the Bankruptcy Code in 1978, there was little statutory and regulatory guidance to give directions to debtors, creditors and governmental agencies. The first bankruptcy commission made a comprehensive attempt to rationalize these substantive rules and procedures and many new principles found their way into H.R. 8200, which formed the basis for current Title 11 of the United States Code. Many of these rules were well intentioned, but they were not grounded in widespread experience and scholarship. More important, jurisdictional disputes arose between the tax writing committees of the Congress and the judiciary committees. Chairman Ullman of the Ways and Means Committee insisted on sequential referral of the tax provisions to the Ways and Means Committee as a condition for ultimate floor consideration. In an effort to enact a comprehensive statute after many years of study and hearings without delay that would arise from Ways and Means consideration, the tax provisions were effectively stripped from the bill insofar as they related to the federal government. This was accomplished by inserting the words "state or local" before the word "tax" in many places where it was to appear in the Bankruptcy Code. The theory apparently was that although Ways and Means could claim initial jurisdiction over matters relating to federal taxes, the assessment and collection of state taxes in bankruptcy was initially a matter for the Judiciary Committee. Thus, the Bankruptcy Code as initially enacted contained substantive and procedural rules applicable to state and local taxes while parallel provisions dealing with federal taxes were left for future consideration. That consideration led, after additional years of study and hearings, to the Bankruptcy Tax Act of 1980, which produced a comprehensive set of federal rules to be applied in bankruptcy. Unfortunately, no effort was ever made to harmonize the federal tax provisions of the Bankruptcy Code with the state and local ones. The many discontinuities thus created are troublesome. For example, under Section 346 of the Bankruptcy Code, when an individual files a bankruptcy case under Chapter 7 or 11, his taxable year is terminated on that date. The purpose of this rule is to permit any tax liability arising in the prepetition portion of the filing year to be considered a liability of the bankruptcy estate (even though it may be non-dischargeable) so that estate assets can be used to pay such a tax, which is likely to be a priority. The draftsmen of the Bankruptcy Tax Act approached the same issue in a different way. They provided that the debtor's taxable year would not end unless he made an election. When such an election was made, the debtor's taxable year would be terminated on the day prior to the filing of the bankruptcy petition. The following anomalous results could occur as a result of the lack of parallelism between Section 346 of the Bankruptcy Code and Section 1398 of the Internal Revenue Code: If the debtor failed to timely make the federal election, he would be in the unfortunate position of having a full taxable year for federal income tax purposes, no portion of the liability for which would be a prepetition tax payable out of the assets of the bankruptcy estate. On the other hand, for state and local tax purposes, the debtor's taxable year would be divided in two. Most state income tax laws are designed to begin consideration with the debtor's federal taxable income for the full tax period, but this is not possible in the case of a debtor who fails to make the federal election. Even in the case of a debtor who makes the election, there is the minor glitch in that the federal taxable period will end on the day before the filing of the bankruptcy petition, and the taxable year for state and local tax purposes will end on the date the petition is filed, once again resulting in a lack of parallelism. There is no one who would argue that such disparate treatment is warranted as a matter of policy. All agree that it is a historical error.

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A similar anomaly was created when Congress enacted Chapter 12 as part of the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986. Under Chapter 12, for state and local tax purposes, the filing of a Chapter 12 petition creates a separate tax paying, tax reporting entity in the person of the bankruptcy estate, similar to a case under Chapter 7 and Chapter 11, but different from a case under Chapter 13, where no separate estate is created and a debtor reports and pays tax upon all of his income, whether prepetition or postpetition. At the time of the enactment of Chapter 12, no amendment was made to the Internal Revenue Code. As a result, a Chapter 12 family farmer finds himself in the anomalous position that income arising during the pendency of the case is reported on his personal return for federal income tax purposes, but is reported on an estate return for state and local tax purposes. Once again, every practitioner and scholar who has considered this question has concluded that there should be parallel treatment for federal and state and local tax purposes, and most of those, whether representing the government or the taxpayer, have concluded that the present federal rule, not the present state and local rule, is a more rationale rule that should form the basis for the uniform treatment.

The foregoing two examples are but the most irrational of the differences between federal tax treatment on the one hand, and state and local on the other. There are at least twenty others, and all of these differences should be reconciled.

Wholly aside from the problems created by the statutory inconsistencies, twenty years of experience has shown that there are many provisions of the Bankruptcy Code that have simply not worked well in practice, either because they have been abused or because the statute does not suggest a ready solution to an issue. The result is often conflicting decisions of numerous bankruptcy courts. There is an overwhelming public interest in the uniform application of tax laws regardless of the residence of a taxpayer. When these conflicts arise, there should be a way of eliminating them.

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NATIONAL BANKRUPTCY REVIEW COMMISSION TAX PROCESS

The National Bankruptcy Review Commission early recognized that taxes would be an important part of its mission, notwithstanding the arcane nature of some of the issues. Because it was important to draw on many perspectives in order to improve the workings of the tax law in the bankruptcy area, the Commission appointed an informal advisory committee (the "Advisory Committee") to help it sift and winnow the issues. The Advisory Committee consisted of four private practitioners, of whom I was privileged to be one. It also contained four experienced tax experts from the federal and state governments. Finally, it contained two professors with national reputations for expertise in the bankruptcy tax area. One of them, Professor Jack Williams of Georgia State College of Law, was designated to chair the Advisory Committee.

The Advisory Committee held many meetings and telephone conferences over a six-month period and produced a comprehensive report to the Commission. Notwithstanding the differing perspectives from which its members viewed the tax problems that arise in bankruptcy, the Advisory Committee was able to come up with more than thirty consensus recommendations for changes in the Bankruptcy Code and the Internal Revenue Code. With a single exception dealing with the payment of trust fund taxes in Chapter 9 municipal bankruptcies, the Commission endorsed all of these consensus recommendations either by a single vote incorporating them by reference or by specific consideration of the item. Among these consensus proposals were a lengthy series of amendments to various sections of the Bankruptcy Code designed to end the lack of parallelism between the federal and state tax proposals described above.

As might be expected, the members of the Advisory Committee had disagreements, some of them intense, as to many proposals put before it. Perhaps these disagreements resulted from the differing perspectives brought to bear by the Advisory Committee members. Nevertheless, in each of these cases, the Advisory Committee took a vote on each item at the request of the Commission and the votes of the individual members were recorded.

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The Advisory Committee's work product was set forth in a lengthy report delivered to the Commission in August, 1997 and that report is contained within the larger Commission report. In the community at large, the work of the Advisory Committee was widely praised for addressing real problems in the administration of bankruptcy cases, even where controversial proposals continue to give rise to disagreement. The Commission clearly hoped that the Advisory Committee's work would form the basis for legislation that would be part of a comprehensive bankruptcy statute.

THE CHALLENGE TO THIS COMMITTEE

Inexplicably, H.R. 3150 merely scratches the surface of the Advisory Committee's work and thus fails to take advantage of the great deal of work and expertise put at the service of the Congress by the Advisory Committee. There seems to be no reason why the Judiciary Committee should not include each and every one of the consensus recommendations, and especially the state/federal conformity provisions, in this piece of legislation.

Equally important, this Committee should not ignore the other tax issues debated before the Advisory Committee just because the Advisory Committee was unable to reach a consensus. The Advisory Committee agreed that all of these proposals were important. Government and private representatives may hold strongly-felt differing views on these proposals, but they all agree that Congress should address them.

This Committee should take up the following additional matters:

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Whether the six-year deferral period for payment of priority taxes in Section 1129(a)(9)(C) of the Bankruptcy Code should run from the date of the order for relief, rather than from the date of assessment. The Advisory Committee and the Commission adopted this proposal as part of a comprehensive amendment of Section 1129(a)(9)(C).

Whether the bankruptcy court should be given authority to issue a declaratory judgment concerning the tax consequences of a plan of reorganization. Section 1146(c) of the Bankruptcy Code presently provides for such a declaratory judgment in the case of state and local taxes, but does not contain a similar provision with respect to federal taxes. The Commission proposed granting such authority in a divided vote.

Whether the tax liability of a corporate debtor should be divided into a prepetition liability and a postpetition liability for the year in which a petition is filed. Two court of appeals cases hold that the liability should be bifurcated without the necessity of filing two sets of returns. The Commission adopted a compromise proposal pursuant to which a petition year liability would not generally be divided and would thus be treated in its entirety as an administrative expense, but under the Commission proposal, a corporate taxpayer would be given an election to terminate its taxable year on the date prior to the filing of the bankruptcy petition. This would preserve the substance of the court of appeals decisions, while giving a clear signal to governmental taxing authorities that there may be a separate liability for a prepetition period against which they would have to file a proof of claim.

Whether tax penalties not attributable to pecuniary losses would be subordinated in Chapter 11. The Commission voted to subordinate prepetition penalties, thus restoring the law to that declared by various courts of appeals prior to overruling by the Supreme Court of the United States in 1996. Neither the Commission nor the Advisory Committee took a position on whether the same rule should apply to postpetition penalties.

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Whether the Bankruptcy Code and the Internal Revenue Code should be amended to make clear that a trustee of a partnership has a duty to file partnership tax returns. The Advisory Committee and the Commission both adopted such a recommendation.

Whether there should be added as grounds for conversion or dismissal in Chapters 11, 12 and 13 cases the failure to file prepetition returns, the failure to file postpetition tax returns and the failure to file postpetition returns and pay postpetition taxes. The Advisory Committee in a divided vote recommended such a provision, but the Commission did not take any action on it.

Whether the Bankruptcy Code should be amended to make clear that on a default under a confirmed plan the taxing authority retains the rights of a governmental authority collecting taxes, and is not relegated to default remedies under the plan. The Advisory Committee recommended such a proposal in a divided vote, but the Commission did not act on it.

Whether Section 508(a)(8)(A)(iii) should be clarified so that priority status will be denied for taxes attributable to fraudulent and unfiled returns only when the taxing authority's ability to assess those taxes results solely from the taxpayer's fraud or failure to file. The proposal would provide priority status to those tax claims still assessable at the time of filing of the petition for reasons that are totally unrelated to the debtor's failure to file. The Advisory Committee adopted this proposal in a divided vote, but the Commission did not act on it.

Whether the Bankruptcy Code should be amended to make clear that the term "willfully attempt in any manner to evade or defeat . . . tax" requires a showing by a taxing authority in the bankruptcy case of an affirmative act or acts of misconduct and a state of mind requirement. In a divided vote, the Advisory Committee recommended this proposal but the Commission did not act on it.

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Whether in a Chapter 13 case where the tax authority elects, under Section 1305 of the Bankruptcy Code, to file a claim for postpetition taxes, interest on such claim will nevertheless be allowable, notwithstanding that it is otherwise generally treated as a prepetition claim. The Advisory Committee made such a recommendation by a divided vote, but the Commission did not act on it.

Whether the amount of a tax authority's secured claim determined under Section 506 excludes the value of property exempt from levy. The Advisory Committee adopted such a recommendation by a divided vote, but the Commission did not act on it.

All of the foregoing proposals are important to the administration of the tax laws. In the view of this writer, the Committee should take up each and every one of the foregoing proposals and reach a policy decision as to whether legislative action is needed and take such action where indicated.

In addition to all of the foregoing, there were a number of proposals considered by the Advisory Committee that were not adopted, or were rejected by a divided vote. It would be appropriate for this Committee to look into some of those proposals to determine whether congressional action is in fact needed.

Finally, there were a number of items considered by the Advisory Committee and the Commission that involve amendments to the Internal Revenue Code, not the Bankruptcy Code. Although such amendments are not within the jurisdiction of this Committee, this Committee should notify the Ways and Means Committee of the Commission's and the Advisory Committee's actions and ask the Ways and Means Committee to study them. These include:

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The tax consequences of abandonment of estate property to an individual debtor.

Net operating loss carryovers of debtor corporations experiencing a change of ownership in Chapter 11.

The date by which a debtor must make an election under Section 1398(d)(2) of the Internal Revenue Code in an involuntary case.

The application of alternative minimum tax rates and capital gains rates to bankruptcy estates.

The treatment of compensation paid by a bankruptcy estate to an individual debtor.

The availability of Internal Revenue Code exclusions for gain on the sale of a personal residence to a bankruptcy trustee.

The tax treatment of satisfaction of a non-recourse debt with estate property.

The date on which attribute reduction takes place under Section 108(b) of the Internal Revenue Code when there is a discharge of indebtedness.

It is the essence of my testimony that if the Congress is to undertake comprehensive Bankruptcy Code revision, it should do so comprehensively by addressing all of the tax provisions that were presented to and acted upon by the Advisory Committee and the Commission. There is a compelling need for the Congress to do so. In attacking this problem, this Committee has before it the product of hard work and mature consideration by the members of the Advisory Committee. By considering the Advisory Committee recommendations and coming to an independent judgment, this Committee will perform an important public service.

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SPECIFIC TAX PROVISIONS OF H.R. 3150

Of course, the Committee now has before it, and intends to act upon, nineteen discrete tax proposals that appear in Article 5 of H.R. 3150. Although my personal views on each of these discrete provisions is not the most important part of this statement, I will humbly give the Committee the benefit of these views. My real hope is that the Committee will solicit the views of the Internal Revenue Service, the Department of Justice, state taxing authorities, and the many bar associations and law improvement groups interested in the subject matter that now have the tax provisions of H.R. 3150 under consideration.

Section 501 of the Bill attempts to deal with two concerns of local school districts as to the effect of Chapter 7 bankruptcy filings on their *ad valorem* property tax claims. The proposal represents a classic problem of balancing the needs of the bankruptcy system and the needs of taxing authorities.

One portion of Section 501 of the Bill would amend Section 724(b) of the Bankruptcy Code, which now effectively treats secured tax claims as priority tax claims under Section 507(a) of the Bankruptcy Code, thus moving the associated liabilities below administrative expenses, wages and other higher priority claims. Section 724 has a long history, but is based upon two important considerations. First, Congress decided that the bankruptcy process should be financed to the maximum extent possible out of the assets of bankruptcy estates and should not be a burden on the taxpayers of the United States generally. Second, Congress decided that although taxing authorities may need statutory liens as a collection device against the delinquent taxpayer, the mere placement of a statutory lien upon a debtor's property should not elevate a tax claim above the priority which it would normally have under Section 507. The Bill would restore fully-secured status to such tax claims in bankruptcy in the case of *ad valorem* real or personal property taxes. The apparent reason for this is the argument of state and local tax authorities that the downgrading of tax liens in bankruptcy has an adverse effect upon the revenue collections of local school districts that are dependent upon such taxes to finance their systems. This argument was first made in hearings before the Judiciary Committee of the United States Senate in connection with Senator Grassley's Investment of Education Act of 1997. Yet, a perusal of the testimony and exhibits submitted in connection with that hearing indicates that the school districts have utterly failed to demonstrate that this is a real problem. In fact, a lengthy exhibit submitted in connection with one school district witness's testimony shows only one case in which the operation of Section 724(b) of the Bankruptcy Code reduced the revenue collections of the local school board.

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In addition, the actual proposal contained in the Bill appears to go far beyond what is needed to solve the supposed problem. On its face, the Bill applies to *ad valorem* personal as well as real property taxes. Under most state laws, the liens attributable to *ad valorem* personal property taxes are not valid as against *bona fide* purchasers, and therefore, would be avoidable by a trustee under Section 545(2) of the Bankruptcy Code. Thus, *ad valorem* personal property taxes should be deleted from the proposed amendments in all events.

The second branch of Section 501 of the Bill would withdraw jurisdiction from the bankruptcy court to redetermine the value of real or personal property subject to *ad valorem* taxes if the applicable period for contesting or redetermining that amount had otherwise expired. While there is surface appeal to this proposal, this Committee must take into account the unfair effect that it would have upon innocent third parties. Chapter 7 debtors often have little incentive to contest property tax valuations because of the fact that they have no equity in the property. Therefore, they may allow the time period for exercising their right to contest such valuations to go by because they cannot benefit from the expense of making such a contest. The creditors are the only real parties in interest, and, prior to bankruptcy, they would have no standing to make the contest themselves. Giving the bankruptcy court the right to determine the proper amount of the tax if it has not been previously contested in an appropriate non-bankruptcy forum insures a fair distribution of estate assets between taxing authorities and other innocent creditors.

Section 502 of the Bill appears to contain a drafting error, as the statutory language proposed would appear properly to substitute for, rather than add to, the present statutory language. If so, it is not clear what the proposal seeks to accomplish. In any event, the title of the section is clearly misleading as the subject matter goes beyond child and spousal support. Clarification is badly needed.

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Section 503 of the Bill contains some detailed requirements as to the form and content of notices required to be made to governmental units. Clearly, there are some problems to be addressed here, but this is one of those situations where the proposed cure is worse than the disease. The actual operation of the bankruptcy system has for many years been governed by rules promulgated from time to time by the Advisory Committee on Bankruptcy Rules of the Judicial Conference (the "Rules Committee "). Congress has long left the rule-making authority to this eminent body of bankruptcy scholars, which by general acclaim has done its job well.

The Commission understood that there may be instances in which unscrupulous debtors may try to hide the ball from taxing and other governmental authorities by mailing notices to addresses calculated not to reach the agency having jurisdiction over the subject matter. An example sometimes used, but probably never resorted to in practice, would be a notice of potential tax liabilities to the Internal Revenue Service addressed to Bill Clinton at the White House. It is not conceivable that any bankruptcy judge would grant a discharge to a debtor who notified the government of a potential tax liability in such a manner. What the government is entitled to is notice sent to a person having jurisdiction over the subject matter with a content reasonably calculated to apprise the government of the nature of its potential claim. Before the Advisory Committee, the Justice Department submitted just such a package of rules that included notice requirements. The Advisory Committee, after negotiating some protective changes, approved these rules proposals unanimously and passed them along with a recommendation to the Commission, which also approved them. The Commission, however, transmitted its recommendation not to the Congress, but to the Rules Committee, where it belonged. Congress should deal with this problem by a resolution directing the Rules Committee to act. What Congress might, and should, do is to provide that every district should create a registry where governmental taxing authorities may file an address for sending notice of tax claims for cases pending within that district. Presumably, the Rules Committee would then direct that notices be sent to that address once such a filing has been made. This would enable a debtor acting with reasonable diligence and in good faith to make the required filing. The problem today is that an honest debtor filing a case in, let's say, Texas, and knowing that he may owe a tax to a local taxing district in Missouri, might send a notice to a central office of a taxing authority in Missouri without knowing that the taxing agency has issued an announcement requiring the filing at a specific place or in care of a specific official. It is important that the Congress in addressing this problem not, in an effort to curb abusive practices by a small number of unscrupulous debtors, construct a system that would trap the larger number of honest taxpayers attempting to make proper notices in good faith.

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Another objectionable feature of Section 503 of the Bill is that it would require that "if the debtor's liability to a governmental unit arises from a debt or obligation owed or incurred by another individual, entity, or organization, or under a different name, the debtor shall identify such individual, entity, organization or name." A similar proposal was rejected by the Advisory Committee. The impact of the proposal would be to require a debtor to specifically notify a governmental authority of the possibility of a trust fund penalty against such debtor or risk failure of discharge should a taxing authority assert such a claim years after the bankruptcy. The Advisory Committee had a simple solution for this problem. It would have required that such a debtor schedule any business entities in which he was an officer or in which he held an equity interest and such a requirement was contained within the Justice Department rules package that was approved by the Advisory Committee and the Commission. In this way, the government would be on notice that the debtor had an interest in such a business entity and would have some obligation to determine whether or not a possible trust fund penalty had arisen. The Justice Department rules package as so amended fairly allocated the burdens between the debtors and the governmental taxing agencies. The proposal in the Bill was not endorsed by any body addressing the Commission and there is no justification for it. It should be removed from the proposed statute.

Section 504 of the Bill would amend Section 505(b) of the Bankruptcy Code by requiring that any notice to a governmental unit of a request for determination of taxes under that section be made "in the manner designated by the governmental unit." The problem that this statute attempts to address is a real problem that the Advisory Committee and the Commission sought to resolve with the approval of governmental representatives; but once again, the proposal goes beyond and falls short of what is needed to address the problem. Today, Section 505(b) of the Bankruptcy Code contains no requirements whatever as to the form and content of notice addressed to a governmental unit for a determination of administrative period taxes. As a result, many debtors routinely, and properly under present law, simply file their Section 505(b) request as a rider to their filed tax returns during the course of administration of the estate. In most cases, this notice escapes the attention of the appropriate official at the taxing authority. All agree that governmental taxing authorities are entitled to more effective notice than that apparently permissible under present law. The Advisory Committee, as in the case of similar proposed requirements under Section 503 of the Bill discussed above, would have solved this problem by resort to a filing registry that taxing authorities could avail themselves of, and if they did, could obtain the notice sent to a designee of their own choosing. If such a registry were created by statute or rule, this problem could be solved. But Section 504 of the Bill as presently proposed does not contain such a requirement. As a result, a governmental taxing authority may publish a place for notice in a routine publication of that taxing authority, and a debtor residing in a different jurisdiction might not find such notice in the exercise of reasonable diligence. In an effort to prevent debtors from hiding the ball, Congress will have countenanced hiding the ball by governmental taxing authorities. Everyone would agree that the objective sought to be accomplished by Section 504 of the Bill is reasonable and proper. However, if it is done right, the filing requirement to be imposed on governmental taxing authorities must be made a part of the Bill.

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Section 505 of the Bill would create a uniform interest rate for tax claims subject to payment deferral under the Bankruptcy Code. Enactment of this provision is in the interest of sound bankruptcy administration, because it would withdraw the possibility of litigation over an appropriate interest rate in the many cases where that now occurs.

Section 506 of the Bill would provide for tolling of the periods contained in Section 507(a)(8) of the Bankruptcy Code during the period in which a prior bankruptcy case was pending. If this is all that the proposal did, it would be unobjectionable. However, the proposal goes beyond the mere tolling in several important, and objectionable, respects. First, the provision would add six months to the three-year period contained in Section 507(a)(8)(A)(i). This six-month add-on goes beyond present law, and is unjustified. More significantly, the Bill would create a tolling period during the period of time when an installment payment agreement is in effect. This proposal was rejected by the Advisory Committee. It is objectionable on two grounds. First, it potentially stretches the non-dischargeable period for stale taxes to a very lengthy period of time, which is contrary to the purposes of the bankruptcy laws. Second, it punishes honest taxpayers who make a good faith attempt to settle their tax liabilities by entering installment payment agreements and gives a better bankruptcy result to taxpayers who spend the present three-year period successfully evading the government's tax collection efforts. This is unwise policy. Congress should clearly enact a simple tolling period for the time during which a prior bankruptcy case was pending, thus following the significant majority of courts who have reached this result under the present statute. The add-ons and the installment payment provisions should be rejected.

Section 507 of the Bill would remedy a defect in present law by creating a definition of the word "assessment" for Bankruptcy Code purposes. Many of the tax provisions of the Bankruptcy Code are geared to the date of assessment. Although this term has a well-defined and understood meaning under the Internal Revenue Code, it is not uniformly used under state and local tax regimes. Thus, the fixing of a date of assessment is not possible in such cases under present law. Section 507 would provide a useful definition.

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Section 508 of the Bill would withdraw "superdischarge" protection from certain fraudulent and unfiled taxes in Chapter 13. Once again, such proposals failed to win a majority at either the Advisory Committee or the Commission. In the view of this writer, the government's attempts to close this supposed loophole in the statute are shortsighted. Today, government taxing authorities consign some taxpayers to life-long purgatory by alleging fraud that cannot be demonstrated under normal standards for defining that term. The superdischarge provisions of Chapter 13 allow some number of delinquent taxpayers to find their way back into the system as law-abiding citizens. This writer believes that governmental taxing authorities probably increase their tax collection as a result of the availability of the superdischarge, although I do not have empirical evidence to prove it.

Section 509 of the Bill deals with the possibility of discharging fraudulent taxes in the case of corporations. Arguably, the considerations are different for corporate debtors than they are for individuals. I have no strong views on this issue.

Section 510 of the Bill makes an exception to the automatic stay for appeal from lower court decisions in tax cases and should be enacted. For some inexplicable reason, the Bill fails to propose another recommendation of the Advisory Committee that would overrule a Tax Court case applying the automatic stay to proceedings in the Tax Court in respect of postpetition taxes. Both provisions should be enacted.

Section 511 of the Bill would amend Section 1129(a)(9) of the Bankruptcy Code to prevent taxpayers from backloading deferred tax payments that are permitted under that section of the Bankruptcy Code. The Bill seeks to accomplish an appropriate result, but it is not well drafted. Although Congress should express a principle that payments over the deferral period be reasonably level, the attempt of the Bill to fix minimum payments in each of the deferral periods by statute is problematic. The court should have the power to approve a payment plan that reasonably varies from level payments under appropriate circumstances, but the schedules set forth in the Bill seem inappropriate for a statute. The arithmetic in the Bill also seems faulty.

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Insofar as Section 511 of the Bill would also apply the six-year payout period to secured as well as unsecured taxes, it should be enacted.

Section 512 of the Bill would prevent the trustee from avoiding tax liens based upon differences in statutory definitions of bona fide purchaser that now appear in Section 545(2) of the Bankruptcy Code and Section 6323 of the Internal Revenue Code. This writer supports the government's position, but notes for the Committee that the National Bankruptcy Conference opposes this provision of the Bill.

Section 513 of the Bill would amend various sections of the Bankruptcy Code and other federal statutes to make clear that postpetition taxes must be paid as a course of business expense and that no request by a governmental unit for payment of such tax as an administrative expense would be required. The Advisory Committee made such a recommendation and it is in general unobjectionable. My own experience is that, at least in large Chapter 11 cases, payment of such expenses in the ordinary course of business is the standard practice. I have a concern, however, that there may be cases that involve administratively insolvent estates. In such cases, the Bankruptcy Code does not generally give priority to one type of administrative expense over another, and if these proposals are adopted, there should be clarifying language to the effect that in the case of administratively insolvent estates, some or all of these taxes should be delayed so that there will be equitable distribution of estate assets among all administrative claimants.

Section 514 of the Bill would advance the last date on which a taxing authority could file a late claim and be entitled to distribution. Under present law, a late-filed claim is entitled to distribution in Chapter 7, provided it is filed before the trustee commences distribution. This has the potential for disruption of the distribution process, and the Advisory Committee recommended that the date be advanced to the date on which the court approves the final report and accounting of the trustee. Section 514 of the Bill adopts this recommendation of the Advisory Committee and it should be enacted.

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Section 515 of the Bill would remedy a defect in present law by providing that the unfiled returns exception to discharge under Section 523(a)(1)(B) not apply in cases where a return is filed pursuant to Section 6020(a) of the Internal Revenue Code of 1986 or similar state or local law or a written stipulation to a judgment entered by a non-bankruptcy tribunal. This proposal also reflects a consensus of the Advisory Committee and it should be enacted. However, there is a confusing qualification in proposed Section 523(a)(1)(B)(iii)(II) of the Bankruptcy Code as it would read as a result of Section 515 of the Bill to provide that any such return "must have been filed in a manner permitted by applicable non-bankruptcy law." This qualification is ambiguous, and a number of commentators have noted that if read literally, it would swallow the amendment in the guise of a qualification. The basic proposal should be adopted, but the proviso should be deleted.

Section 516 of the Bill adopts a proposal recommended by the Advisory Committee and approved unanimously by the Commission. It would provide that the estate be added to "the debtor, a successor to the debtor and the trustee" as a party protected from a subsequently filed tax claim when a governmental taxing agency does not reply to a request for a determination of taxes under Section 505(b) of the Bankruptcy Code. Some cases have reached the anomalous result that once the short audit period provided by Section 505(b) of the Code has expired, taxing authorities cannot pursue a successor to the debtor or a trustee, but can still file a late claim against the estate to the detriment of creditors if the estate has not yet been closed. Such court decisions are a triumph of literalism over common sense and Section 516 of the Bill does away with these illogical results. The provision as proposed in the Bill should be enacted.

Section 517 of the Bill substantially adopts an important consensus compromise of the Advisory Committee. In brief, it requires a debtor to file at least the last six years of tax returns as a condition for obtaining Chapter 13 relief. Three minor clarifications to the proposed statute should be adopted. First, the Bill language suggests that the trustee "may continue" the first meeting of creditors to enable the debtor additional time to file delinquent returns. I believe that the intent of the Advisory Committee was to give the debtor a right to such continuances, and that should be made clear in the statute. Second, the Bill provides that further continuances may be granted by the court where the debtor demonstrates by clear and convincing evidence that the failure to file returns is because of circumstances beyond the control of the debtor. The "clear and convincing" standard was not part of the Advisory Committee's recommendation and does not otherwise appear as a burden of proof standard in the Bankruptcy Code. The integrity of the proposal would not be compromised by deleting the clear and convincing threshold. Finally, the proposal contains a definition of return that is identical to the definition in proposed Section 515 of the Bill. In my discussion of Section 515, I noted that Congress should delete the proviso requiring a return filed in accordance with applicable state law. For the same reasons that I objected to this proviso in my discussion of Section 515, I object to it here.

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Section 518 of the Bill would set standards for tax discussions in disclosure statements under Section 1125(a) of the Bankruptcy Code. The proposal is generally a sound one, but a small amendment is required. As drafted, proposed Section 1125(a) would require a full discussion of the potential material federal and state tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of holders of claims or interests in the case. Insofar as the proposal requires a discussion of the material federal income tax consequences to the debtor, it is unobjectionable. However, the Bankruptcy Code should not require a discussion of the state tax consequences to holders of claims and interests, as that could potentially require an analysis of the laws of fifty different states. If the federal income tax consequences are clearly set forth, any holder of a claim or interest should be required to consult with his own individual tax advisor to determine whether there are state tax consequences that are peculiar to him.

Section 519 of the Bill would give taxing authorities a right to set off prepetition income tax refunds against uncontested prepetition income tax liabilities. This follows a unanimous Commission recommendation. Under present law, the right of setoff is preserved, but in general, a creditor must petition the bankruptcy court to implement the right. Taxing authorities generally object to the necessity for such a petition because their computers are programmed to make such setoffs which would arguably violate the automatic stay. As a result, many existing local rules and standing orders presently contain automatic setoff rights for certain taxes. Unfortunately, these exceptions to the necessity of applying for relief from the automatic stay are not uniform. The Bill would recognize the legitimate needs of taxing authorities and therefore would extend limited setoff rights for taxing authorities in all jurisdictions, even where present standing orders and local rules do not grant an automatic exception. The provision should be enacted. However, once it is enacted, the necessity of standing orders and local rules that vary from district to district becomes questionable. The Bill should contain a sense of Congress that upon enactment of this provision, such local rules and standing orders should be withdrawn.

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SUMMARY AND CONCLUSIONS

The Commission produced a massive work product in the area of tax issues in bankruptcy. It did so with the help of an Advisory Committee that represented governmental, private and academic interests. The consensus recommendations of the Advisory Committee and the Commission should be adopted in the form proposed, save for required technical clean up. Where the Advisory Committee and the Commission were divided on important issues, this Committee should set up a mechanism for considering the important issues presented and should include its considered resolution of such disputes in any bill that is sent to the floor of the House of Representatives.

Mr. **GEKAS.** We thank you, gentlemen. I have a round a questioning during the 5 minutes the Chair allots to itself. I have been saying in promoting the legislation, about which I feel so strongly, that enactment of it would save the consumers money, because we all, all consumers who do not go bankrupt have to bear the cost of those who do, this is my spiel that's continuously before groups. Secondly, it costs consumers and the general public a destabilization of the interest rates, and interest rates are affected adversely by the outstanding debt that has been foregone through the bankruptcy process.

And thirdly, I've been saying, that it actually costs the taxpayer money as well because of the additional cost to administer the record number of filings, et cetera, even to the extent of having to hire new bankruptcy judges, of which I was in the movement to accomplish since the last Bankruptcy Code came into effect.

But there's another one that I hadn't mentioned until you gentleman reminded me today, and that is that the taxpayers suffer because of revenues foregone, revenues lost forever because they did not, were not recoverable during the bankruptcy process itself. And that's an important feature of what we're trying to do in the reform legislation that we are—that, as I said, we're promoting.

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Mr. Newton, you said that one of your recommendations would be to compel the following of the I.R.S. guidelines in the pursuit of the tax revenues, is that correct?

Mr. **NEWTON.** Right, that's correct, yes.

Mr. **GEKAS.** What is the situation now, as you see it?

Mr. **NEWTON.** Well, the situation now is that Sections 346, 728, 1146 and 1231 of the Bankruptcy Code deal with the requirements related to debt discharge and filing returns are dictated in the Bankruptcy Code for state and local governments to follow. And initially, if you'll recall back in 1978, the initial draft of the Bankruptcy Reform Act, had the Federal taxes as well in the draft. They took out the word taxes and substituted in state and local taxes, and made these rules only apply to state and local governments. So what we have in the Bankruptcy Code as it currently exists, is tax laws that state that when you file a tax return in California, you file it according to what the Bankruptcy Code says. It says that if you file a chapter 11 case, you create a separate entity for tax purposes. And that, those guidelines are different in certain provisions than what you do under the Internal Revenue Code.

And my objective would be to see that we don't put the burden on the taxpayer to have to go through two different set of rules in order to file a tax return. If we're going to have a Federal statute then it should be the same as the Internal Revenue Code.

Mr. **GEKAS.** I'm going to mark that down as one of the unforeseen consequences of the Act of 1978.

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Mr. **NEWTON.** That's correct, that's exactly what happened.

Mr. **GEKAS.** So those who are going to complain about things that might be unforeseen in this plan, I'll have something to come back with on that. Mr. Shepard, I had a question for you but I can't find my notes. When we talk about less revenues for the various states or other municipalities or the taxing authorities, is that what we're talking about?

Mr. **SHEPARD.** Yes, absolutely.

Mr. **GEKAS.** So that all levels of taxation suffer from the inability to collect, is that correct?

Mr. **SHEPARD.** If the rules apply across the board, state and local, everything.

Mr. **GEKAS.** And is the lack of notice, Mr. Kane puts a lot of emphasis on the lack of proper notice, are we talking about, and I ask this to both of you, that we should be requiring actual notice, rather——

Mr. **SHEPARD.** Absolutely.

Mr. **GEKAS.**—than notice as prescribed by common law and all the other features of the law that we've been following for years. In other words, how can we make sure that the Commonwealth of Pennsylvania does get actual notice before it is rendered incapable of retrieving monies?

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Mr. **KANE.** I think that H.R. 3150 as it proposes to have an opportunity for a taxing agency to go on record in each of the bankruptcy courts with a proper address, with a proper contact person would go a long way, providing actual notice that might get into difficulties of proof, whether the department had notice or not. But I think that if we could simply have a rule that says that all notices should go to this person in this department, or to this designated head of this section in the department of revenue, that would go a long way because we have to remember that we're not funded like a business. A business can make a decision that they're losing a million dollars in an operation and they'll put $50,000 in it to secure that million. We can't, we get a fixed budget so that anything that requires us to go the extra mile, to track something down that could simply be saved by having it sent directly to the place that we designate is money in the bank for taxpayers. And I think that would be a wonderful approach.

Mr. **ASOFSKY.** May I have an opportunity to respond to that, Mr. Chairman, as well?

Mr. **GEKAS.** Yes, proceed.

Mr. **ASOFSKY.** I—this is an area on which I don't disagree with Mr. Shepard or with Mr. Kane. The problem is that the bill doesn't do that. We agreed in the Advisory Committee, all of the private representatives, that we don't want to tolerate a system in which a taxpayer can hide the ball from a government unit, so we said, "Yes, you're entitled to notice at a place that you direct, but let's file your address in the bankruptcy court," so that when a debtor who is a law-abiding system, and who wants to comply with the law, he'll know where to send a notice. If you publish it someplace in the State of Pennsylvania, and you have a person in Texas who doesn't know where to look in Pennsylvania if he may owe a tax, what's going to happen is, he's going to send something to the Department of Revenue in Pennsylvania, it won't be the address they list, and all of a sudden he's going to find that he didn't get a discharge. So we reached a compromise, we said, "Yes, the state should designate the place where it wants to get a notice, it should file that address with the clerk of the bankruptcy court in each district, and then a taxpayer is bound to file his papers with that particular address."

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Now, what's happened is we have a bill, H.R. 3150, which in section 503 and section 504 says that the state can designate an address for notice, but nothing in either of those sections requires it to be filed with the clerk of the bankruptcy court, and therefore we're substituting, perhaps one injustice for another one. So I would say we ought to enact section 503, well, we ought to enact section 504, 503 has some other problems, but we have to take care of all of the things that would make it fair in operation. And I can't understand why those provisions that got into H.R. 3150, where there was consensus in the Advisory Committee, did not follow each and every one of the details of the Advisory Committee consensus. I think this committee can fix that up, but it has to do that if these provisions are going to work right.

Mr. **GEKAS.** What about that Mr. Shepard?

Mr. **SHEPARD.** I think Mr. Asofsky is greatly mistaken. The bill clearly does provide for the establishment of a registry, and reading from the bill it says, "The clerk shall keep and update quarterly," on page 111 of H.R. 3150. "The clerk shall keep, and update quarterly, in the following manner as the director of administrative office of the U.S. court prescribes, a register," and it goes and describes that.

I think every detail that Mr. Asofsky is asking for is in the bill.

Mr. **ASOFSKY.** Where is that in 504?

Mr. **SHEPARD.** On page 111.

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Mr. **ASOFSKY.** That's in 503, where is it in 504?

Mr. **SHEPARD.** 504 doesn't apply, Mr. Asofsky.

Mr. **ASOFSKY.** No, I'm saying this is the notice for, the 505(b) determination, it's got the same issue. The government ought—all I'm saying, Jim, is we agree that the government should get all notices at a place where it designates, provided that there are protective provisions for the taxpayer so that it can't have a foot fault and make an innocent mistake, and not get the rights that the Bankruptcy Code entitles it to.

Mr. **GEKAS.** Well, Mr. Nadler and I will make sure that it applies——

Mr. **ASOFSKY.** Okay, good.

Mr. **GEKAS** [continuing.] Across the board. The Chair has run out of its own time. Mr. Nadler.

Mr. **NADLER.** Thank you, Mr. Chairman. Mr. Asofsky, in addition to your service to the National Bankruptcy Review Commission, you were also active with the American Bar Association Tax Section, I gather. Could you tell us what is your role, and what is the status of the ABA's review of the Commission's tax recommendations?

Mr. **ASOFSKY.** Yes. At the time that Commission was created, the American Bar Association Tax Section created a special task force to comment on the proposals before the Bankruptcy Commission. And I am the co-chair of that task force. We submitted a report to the Commission of over 250 pages giving detailed recommendations on 40 tax items. Many of our positions were ultimately adopted by the Advisory Committee and the Commission.

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In view of the fact that we now have proposed legislation, the American Bar Association has a different system. A report is in progress. It's in the process of going through the ABA bureaucracy, and I would hope that sometime within the next several weeks, that it will be put into final form. I believe, although I'm not empowered to speak for the American Bar Association, because it has not adopted the provisions, those being considered closely reflect the personal statement that I have made.

Mr. **NADLER.** And is the ABA following a similar process with respect to the tax provisions of H.R. 3150 and H.R. 3146?

Mr. **ASOFSKY.** Well, in H.R. 3150 they're doing that. H.R. 3146 the last time I looked at it, did not include these tax provisions.

Mr. **NADLER.** Okay, H.R. 3150 they're doing it, and when do you anticipate they'll be finished with that?

Mr. **ASOFSKY.** I would think in 3 to 4 weeks, the problem is——

Mr. **NADLER.** In the 3 to 4 weeks, we'll have their recommendation?

Mr. **ASOFSKY.** Yes, the problem is, Mr. Nadler, that it starts with a committee adopting it, getting it sent to the council of the Tax Section, they have to review it, and then get permission——

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Mr. **NADLER.** I understand you've got a whole bureaucracy there. Some of the tax provisions in H.R. 3150 were, I understand, actually rejected by the Commission and by the Tax Advisory Board to the Commission. Could you discuss the provisions in H.R. 3150 that were rejected by the Commission and by the Tax Advisory Board and why they were rejected?

Mr. **ASOFSKY.** Yes. Well, the one was at the top of my list is the one—well, let's go through it. First of all, the

Commission recommended that the bankruptcy court be given authority to issue a declaratory judgment as to the Federal income tax consequences of a plan of reorganization. The private bar considers that to be a very important provision, and the Commission adopted it. That provision is absent from the bill.

Now, I might say editorially, Mr. Nadler, there's a lot of talk in this Congress about the I.R.S. having too much power. I can think of few provisions that would curb some of that power as much as giving the bankruptcy court jurisdiction to issue these declaratory judgments so that the I.R.S. can't come in after the case is over and bust it up. The Commission made that recommendation. It does not appear in the bill.

A second provision that was adopted by the Commission is a provision that Grant Newton referred to, allowing a corporation to divide its taxable year in two in the year that the bankruptcy petition is filed. That's absent from the bill. There is a provision that the Commission adopted that says that tax penalties will be subordinated in chapter 11 cases, as they are in chapter 7 cases. This doesn't give the debtor any more money, it protects innocent creditors. That provision was not included in the bill. The Advisory Committee had a provision clearly stating what was meant by fraud in connection with a tax return. We heard a lot of comment before which I agree with. It's easy to allege fraud and not so easy to prove it. We had protective provisions in there for innocent taxpayers, meaning that to try to say that fraud really means fraud, and that you lose your discharge only when you commit an affirmative act with intent to defeat the tax, and not merely pay some other debt instead of paying a tax. That was rejected by your draftsman.

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And then the last one, which I think is a horror, the IRS had a recommendation that the statute, that the 3 year and 240-day period in the Bankruptcy Code for discharge—ability purposes, would be tolled during a period when an installment payment agreement was in effect. As a result, what would have happened is, any taxpayer who agreed to make installment payments of taxes effectively could never get a discharge from any taxes in the bankruptcy court, no matter how old they were. That provision was rejected by the Advisory Committee by a six to three vote. But we all did agree that to prevent abuses, the statutes of limitations would be tolled during previous bankruptcy cases to combat the abuse of successive filing.

Well, the successive filing rule found its way into 3150. That was approved by the Advisory Committee, but the installment payment rule also found its way into 3150 even though it was rejected by the Advisory Committee.

Mr. **NADLER.** That would be very unfair to whom?

Mr. **ASOFSKY.** To all taxpayers who make an honest effort to pay their taxes and fail, because they could never get a bankruptcy discharge even if they had filed their returns when not guilty of fraud, and the taxes were old. And I think this was one of the ones that was most strongly resisted by the private bar, and not even all of the government representatives voted for it in the Advisory Committee, and here it is in the bill. And I frankly don't understand it, because it's a bad rule and I think it is a very destructive rule.

Mr. **NADLER.** Thank you. Let me ask the Chairman's indulgence for two more questions. You've listed mostly things that the Advisory Committee recommended that you think should have been in the bill, but aren't. Do you have a list of things that are in the bill that the Advisory Committee rejected?

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Mr. **ASOFSKY.** Yes, I said one of them——

Mr. **NADLER.** You just mentioned one of them.

Mr. **ASOFSKY** [continuing]. The installment payment rule. Another one in the notice provisions was the rule that you had to notify the government of the possibility that a trust fund tax penalty would arise. And we objected to the provision in that form, and the Advisory Committee refused to adopt it because the proposed requirement makes the debtor say to the Government, "Here, come get me, I'm guilty. I've got a trust fund penalty."

But what we adopted was a recommendation for a rule that said, schedule, when you file your bankruptcy petition, any business in which you're an officer or director, or have an equity interest. And then if the government wants to assess a trust fund penalty, they're perfectly free to come and do that. But notwithstanding that we rejected that filing requirement in the Advisory Committee it finds its way back in Section 503 of the bill.

In the Advisory Committee we did not adopt a rule that we add on 6 months to the tolling provisions in addition to the prior bankruptcy cases. It's back in this bill anyway. We've got provisions dealing with the stretch-out of tax payments in chapter 11 cases where we rejected rigid rules for the determination of the tax. They're back in the bill as well. And there are several others that I've got in my written statement, and I think——

Mr. **NADLER.** These are all in your written statement?

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Mr. **ASOFSKY.** These are all in my written statement, and I believe that with respect to these provisions, it would be a relatively easy job for the staff of this committee, which as I say I know, because I've worked with many of them over the years, it's a very able staff, are perfectly capable of dealing with those problems.

Mr. **NADLER.** Thank you. My last question is, regards the I.R.S. As you know, Congress held a number of hearings on abuses by the I.R.S. against individual taxpayers, and some of the stories—we have heard of actions, of abuses—have been really frightening. Some Members, including the Majority Leader, have gone so far as to propose the repeal of the entire Internal Revenue Code for this, as well as other reasons. I consider that, personally, extreme, but I am concerned that the I.R.S. has abused the power it has too often.

As a practitioner, could you tell the committee to what extent the provisions of H.R. 3150, in your opinion, would enable the I.R.S. to behave more aggressively toward American families in financial crisis? Does the fact that many debtors are unable to contest legal issues in court threaten to open the door to further I.R.S. abuse even wider?

Mr. **ASOFSKY.** Well, as I said, I think the installment payment provision would be at the top of that list because of the fact that now a taxpayer can enter into an installment payment agreement, and somewhere down the road at least have the possibility of discharging that tax. And that would be a problem.

The other one is the issues with respect to the so-called "super-discharge," in chapter 13. Today what happens is that the I.R.S. alleges that there's fraud. They don't have to prove it in the bankruptcy case itself. They simply take the position after the case is over that fraud has been committed and they can hound individual debtor for the rest of his life. The bankruptcy law ought to clear that up, and getting rid of the super-discharge would make it worse. And then, as I say, the I.R.S. in some cases has taken the position that fraud is simply the failure to pay a tax when it's due, and paying some other creditor instead, and we need a provision in this bill that will allow a debtor to escape the fraud allegation unless it's classical fraud, meaning actual intent to evade or defeat the tax coupled with some affirmative act that does that.

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

Mr. **SHEPARD.** May I respond to Mr. Asofsky's lecture here?

Mr. **GEKAS.** Yes.

Mr. **ASOFSKY.** I only answered the question.

Mr. **SHEPARD.** Once again, Mr. Asofsky, you have mischaracterized the law. In regard to the installment provision, what you suggest would allow a debtor to stretch out the time payment to get past the 3 year rule, past the 240-day rule, whatever, and make minimal payments in the installment plan and file a discharge. With regard to fraudulent taxes, the law presently provides that a debtor may at any time, without paying a fee as a matter of fact, come in and contest the fraud, and the tax authority has the burden of proof on that issue.

Mr. **NADLER.** Let me ask a question to Mr. Shepard, if I may, in regard to what he just said. Let me just ask a very simple question, Mr. Shepard, did Mr. Asofsky in the opinions he just gave, accurately reflect the majority vote of the Commission on those questions?

Mr. **SHEPARD.** I beg your pardon?

Mr. **NADLER.** Is it correct that what Mr. Asofsky just said on these provisions represented the majority vote of the Commission, and what you just said did not represent the majority opinion of the Commission?

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Mr. **SHEPARD.** The Commission did not——

Mr. **NADLER.** Or the Advisory Board, excuse me, the Advisory Board. The Advisory Board, I think, he said.

Mr. **SHEPARD.** The Commission addressed very few of the proposals on substantive grounds. They simply voted to either accept or not accept the Tax Advisory Committee that believes, if Mr. Asofsky would review the report, the provisions in the bill comports largely with the report.

Mr. **NADLER.** No, but the specific things that were just being addressed, what Mr. Asofsky said represented the majority vote of the Advisory Board?

Mr. **SHEPARD.** There were some things that were simply five to four, some things unanimous——

Mr. **NADLER.** But they were the majority, yes or no? In other words, are you expressing the minority view, and he the majority view? I don't care whether it's five to four or unanimous, five, four is majority.

Mr. **SHEPARD.** I think probably most were at least majority, yes.

Mr. **NADLER.** Okay, so he was expressing the majority?

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Mr. **SHEPARD.** Well, his characterization is not.

Mr. **NADLER.** Professor Newton.

Mr. **NEWTON.** I would say he did characterize the conclusions set forth by the Tax Advisory Committee, and I think his comments on chapter 13 is very important to realize that the philosophy of chapter 13 is in line with what you're trying to do with this H.R. 3150. That is, chapter 13 encourages individual debtors to work out a deal with their taxes so they can survive the process, rather than just get them discharged in the bankruptcy court, and I think to do away with that provision is a mistake because it encourages individuals to get into it, and you get them back on the tax role if you get their priority taxes paid. Which, even we had state representatives on the tax force that voted for that provision, that was in favor of that provision.

And the other, one other issue, just very quickly if I can mention is, and that is, that the 501(b) that provides, that does away with the right for the bankruptcy court to look at a state property tax claim I think is a major mistake because in reality state taxes, property tax claims are filed, the debtor is in financial difficulty, they don't contest those claims.

I'm involved in a case where $60 million of money was borrowed under false pretense and the trustee comes in and must deal with the City of Los Angeles that filed a personal property tax claim. The values they used were way in excess of assets that this company owned, and yet in bankruptcy court, under this provision, the bankruptcy judge could not reduce the tax.

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Mr. **NADLER.** Which provision, it's in the bill?

Mr. **NEWTON.** 501(b), under 501(b), the bankruptcy court would be precluded from dealing with that particular claim.

Mr. **NADLER.** Whereas under the majority vote, under what Mr. Asofsky was saying——

Mr. **ASOFSKY.** It was never, this provision never came up.

Mr. **NEWTON.** Never came to the Advisory Committee and they didn't look at the issue.

Mr. **NADLER.** But getting back to a minute ago, Mr. Newton, you would concur in effect in terms with the majority of the Commission and the Advisory Board on the questions that Mr. Asofsky was addressing?

Mr. **NEWTON.** Yes, I would.

Mr. **NADLER.** Thank you.

Mr. **GEKAS.** We have no further questions, but I think it would be helpful because I kept bouncing back and forth in my thoughts on whether the Advisory Committee or the Commission, or the bill, which one bounced back and forth.

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Mr. **ASOFSKY.** I attempted——

Mr. **GEKAS.** We started off with the unofficial mandate, coming from this Chairman, to adopt as many of the Commission recommendations as possible, particularly those that had a nine zero outcome. Now you've got to, if you want to help us, show which part of the Committee's recommendations to the Commission were not voted on, or were not accepted and so forth because what you're asking us to do is to skip over the Commission in some cases, and go right to what we're trying to do with the bill, where we start off with the Commission.

Mr. **ASOFSKY.** No, I never, there's only one provision in here where my view did not follow the Commission, and that's in 501(a), dealing with section 724(b) of the Bankruptcy Code. In all of the other cases, the views that I expressed were the majority or unanimous views of the Commission or the Advisory Committee.

And by the way, I never took a position where the Advisory—there were only a couple of cases where the Commission did something that was other than what the Advisory Committee wanted to do, and all of the recommendations that I had followed the Commission in that case. And in each, in my report, which in detail tells what I think is in the bill that's wrong, and what's not in the bill that ought to be there, it states unequivocally what the Commission, and what the Advisory Committee, did.

And as I indicated to you, I know many of your staff on both the Majority and on the Minority side on a first name basis, any of them is capable of picking up the phone and calling me, and often they have over the years, and I'm perfectly happy as Grant Newton also volunteered, to make my services available to your staff in drafting this legislation. I've been doing it for 25 years, and it's been an important part of my life. And I hope that my views, although they may differ, some will be respected as being neither pro-government, nor pro-debtor, but in the public interest.

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Mr. **GEKAS.** We may put the tap on you. We thank this panel for engaging in this excellent dialogue, and we no doubt will be returning to you as individuals for further questioning. Thank you very much.

Mr. **NADLER.** Mr. Chairman?

Mr. **GEKAS.** Yes.

Mr. **NADLER.** Mr. Chairman, I ask unanimous consent that all members have seven legislative days to submit questions and additional materials for the record.

Mr. **GEKAS.** Without objection.

Mr. **NADLER.** Thank you.

Mr. **GEKAS.** And the subcommittee stands adjourned.

[Whereupon at 3:10 p.m., the committee adjourned subject to the call of the Chair.]

A P P E N D I X

Material Submitted for the Hearing Record

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

Again, this morning, I want to acknowledge Chairman Gekas for his zeal and dedication to finding a solution to the many troubling issues currently swirling around the world of consumer and commercial bankruptcy. Nevertheless, my previous comment notwithstanding, I must question his schedule of a total five hearings on this subject over the last three weeks, as my colleagues Mr. Nadler and Mr. Delahunt have already noted in our previous sessions. In sum, I think that the Chairman's brisk "drive-by" approach to the complexities presented to us by bankruptcy reform, is a bit hurried to say the least. Consumer bankruptcy reform, must not be taken lightly. Simply stated, the Congress should not attempt to pass untested legislative policy without first reviewing every reasonable option, possibility, and alternative to radical structural reform. If not, the American people are the ones that will have to pay the consequences for our hasty choices.

I know that there are legitimate merits to all three of these legislative proposals, but I am sure that there are also yet undetected deficiencies in them as well. We must take the time to analyze, criticize, contest, debate, consider and then review these measures before taking action. This is why the Congress took five (5) years to pass reforms after the last report by the National Bankruptcy Review Commission; because these weighty matters truly deserve our lasting and full attention. As distinguished as our witnesses are on this matter, hearings do not make up the totality of the process of legislative review; in the end, every member must have the necessary time to make up their own mind.

As for the substantive components of this issue, I must state that I am particularly concerned about the financial impact that the abuses of our present bankruptcy system could have on the American taxpayer, and how we, in the Congress, can take action to minimize them. However, I am not yet sure what is the best means to accomplish this goal without unnecessarily burdening the rights of the bankrupt debtor. I believe that our reforms must be balanced in their treatment of both debtor and creditor. Some debtors probably do abuse the current bankruptcy system, but let us not pretend that creditors do not do so also.

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Today, we have gathered together to first discuss some of the non-needs based provisions of the Chairman's bill, H.R. 3150, to then revisit the issue of needs-based bankruptcy, and finally, to discuss some of the tax provisions that would be implemented by the Chairman's bill. First of all, I want to state on the record that although I am opposed to needs-based bankruptcy reform as it is being presented in H.R. 3150, I have several points of congruity with the Chairman's efforts overall. For example, I want to applaud the Chairman for initiating the discussion on consumer credit/bankruptcy education, something that I think will be a key component in reducing the number of total bankruptcy filings in the very near future.

In spite of my criticisms, I am glad to be continuing this bankruptcy review process, and hope that a greater sense of clarity and understanding will be the result of these exhaustive hearings. At present, I am extremely unmoved by the arguments that I have heard in favor of needs-based testing, and hope that some compelling reasons for its addition to the law will be aired today. On the other hand, I am very sympathetic to the approaches of the Nadler-Conyers Bill, and only differ with it on a few minor matters of substance. However, I am still open minded about all three of these legislative initiatives and look forward to the opportunity to study them further in light of the testimony today. Thank you.

NEEDS BASED BANKRUPTCY "GATEKEEPER" DISCUSSION OUTLINE

A. *Needs Based Bankruptcy Test*

1. *Debtors Covered*

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a. Any debtor with gross annual income in excess of a specified threshold [to be determined] would be covered by the needs test described below.

2. *Possible Needs Test*

a. Calculate the debtor's ability to repay debts as follows:

Monthly Income

Less:

i . Monthly Living Expenses (Use IRS Expense Figures or Comparable Numbers)

ii . Average Monthly Payments for Secured Debt

iii. Average Monthly Payments for Priority Unsecured Debt

Equals: Monthly Income Available for Non-Priority Unsecured Creditors

b. If the debtor's monthly income available for non-priority unsecured creditors exceeds a specified threshold, the debtor may not file under Chapter 7. Otherwise, the debtor may choose which chapter to use.

B. *Possible Alternatives for Checking Reliability of Debtor's Income Figures*

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1. Random Audits.

2. Trustee must check income information against tax returns and pay stubs provided by the debtor.

C. *Possible Challenges to Debtor's Income or Expense Numbers*

1. Variations to IRS expense numbers could be allowed in exceptional circumstances.

2. Challenges could be raised by judges and trustees but, unlike existing section 707(b), creditors would be expressly permitted to also challenge questionable cases.

3. What limitations are needed to avoid excessive litigation? One possible alternative: if creditor challenges and loses, creditor must pay fees and costs of debtor and trustee in responding to challenge.

ORAL STATEMENT OF THE AMERICAN FINANCIAL SERVICES ASSOCIATION

Mr. Chairman, members of the Committee, my name is Jeff Tassey. I am presenting this testimony on behalf of the American Financial Services Association (AFSA).

AFSA appreciates this opportunity to express its views. I would like to first address some of the ongoing issues concerning needs based bankruptcy followed by some brief comments on secured lending issues.

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Bankruptcy is an extremely complex problem. Opponents of bankruptcy reform claim that the industry hers created the problem by indiscriminately extending too much credit in the form of credit cards. First of all, if bankruptcy was simply a matter of too much credit, bankruptcy rates would be uniform across the country. In fact, they are not—they show wild variations across the nation and within the individual states. For example, Shelby County, Tennessee ha a bankruptcy rate that is 32 times the national average. Does Shelby County get 32 times the amount of credit that the rest of the country does? No, of course not. Well, then, if not too much credit, what does cause bankruptcy? The causes are very complex. Some of the main causative correlations include divorce, lack of health insurance, lack of mandatory automobile insurance laws (7 states) and so on. Unemployment in and of itself is not a big factor. Urban areas have the highest bankruptcy rates—they also have the highest divorce rates. Young adults between the ages of 21 and 25 have low rates of bankruptcy filing as do adults over the age of 41. The age group most likely to file are those it their early 30s, particularly age 32. Low income individuals and minorities have relatively low rates of overall filing while filings take off as you approach a total annual household income of between $32-36,000. Filings remain high as income increases. There is no way to really screen for most of these types of events and characteristics during the underwriting process. Should we not lend to 32 year olds? Should we ask applicants if they are happily married?

What about credit cards? Bank credit cards account for approximately between 5 and 6 percent of total consumer debt. If you include other types of credit cards, you might get to 9 percent. Is this 9 percent of consumer debt causing all of the problems while the other 91 percent maintains a benign budgetary impact? This is counterintuitive—as all of us know, our big obligations are our housing, car, student loans etc. Do credit cards play a role in bankruptcy? Of course, but *they are in no way the* principal *cause*, any more than too much food in the supermarket is the cause of overeating. In general, the role that credit cards play is that they are the last form of credit available for use before filing for bankruptcy. When a debtor gets into financial trouble for whatever reason, they will frequently try to stay afloat using their credit cards, or if a debtor is planning to file a bankruptcy of convenience, they will frequently use their cards to acquire certain goods or make certain payments prior to filing. The industry has learned to identify some of this behavior and can sometimes reduce losses, but particularly in the case of planned or non-insolvent bankruptcies, this is difficult to impossible.

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What about credit card marketing? The fact that credit cards are heavily marketed like other products has resulted in the implication that this is somehow contributing to increased bankruptcies and is otherwise inappropriate. Why do you receive more than one credit card solicitation—why do you continue to receive solicitations? As with any other product, credit wed feel that their card has the best combination of features and that it is differentiated enough that consumers will want to use that card over others. Another myth that needs exploding is that credit cards are sent unsolicited to consumers. This has been illegal for 30 years. Consumers must affirmatively request the card-they must sign the pre-approved application and send it back in, all subject to the Fair Credit and Charge Card Disclosure Act, the Fair Credit Reporting Act and other Truth in Lending Act provisions.

Attachment II of my oral statement is a printout from an internet site that enables consumers to run their own searches on the thousands of credit cards available. Even a cursory search will indicate that this is a competitive market with a wide range of consumer choices.

It is always easier, when confronted with a societal problem, to focus on the instrumentality involved as opposed to finding a policy solution that confronts the behavior involved. We feel that H.R. 3150 strikes the right balance. If a debtor is indeed insolvents regardless of income or the reason for insolvency—that debtor has the same choice as today Chapter 7 or 13. Using an administrative cutoff based on income, if that debtor has a meaningful capacity to repay, then the debtor will file a plan in Chapter 13 to repay a modest amount of the indebtedness. H.R. 3150 does not somehow create income where there is none. In no way does H.R. 3150 reward the overextension of credit even if that was occurring.

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In addition to the causative factors that I mentioned a minute ago, there are two more factors that are worth examining. The first is lawyer advertising. While opponents of reform attack credit card marketing as a major cause of bankruptcy, legal marketing is never mentioned. Fortunately, the Federal Trade Commission has not remained silent on the issue. Attached to my statement is their *Consumer Alert* warning of potentially misleading lawyer advertising as well as some sample ads. Cities with high bankruptcy rates generally have high rates of lawyer advertising. You can draw your own conclusions. Credit cards, other credit products and their marketing are governed by a whole regime of detailed federal regulation containing stringent substantive and disclosure provisions, whereas lawyer advertising is virtually unregulated.

The final factor I would like to discuss involves secured lending. In 1978, during the last major overhaul of the bankruptcy code, one of the major changes that unbalanced the code between debtor and creditor and, in our view, has provided a substantial impetus to the increase in bankruptcies of convenience is the extraordinary device known as the "cram-down".

This is a statutorily based mechanism, found in Section 506(a) of the Code, which provides that every claim filed which is secured by a lien on property is an "allowed secured claim" to the extent of the creditors interest in such property. To the extent that that creditor's interest is less than the total amount of the claim, the claim is an allowed "*un*secured claim." Under the present Code, a secured claim cannot be allowed secured claim in an amount greater than the value of the collateral.

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As written in the National Consumer Law Center's *Consumer Bankruptcy Law and Practice, the cram down power provided to the Bankruptcy Court in favor of the debtor by the 1978 Code represents a significant example of a* *statutorily-supported wealth transfer between a debtor and creditor:*

One of the greatest advances for consumers under the (1978) Bankruptcy Code came in the powers they were given with respect to secured debts. Under the prior Bankruptcy Act, relatively little could be done to protect consumer debtors from the holders of such claims. A straight bankruptcy did not generally affect the status of otherwise valid liens or security interests and, as a practical matter, few Chapter XIII plans could get very far with respect to secured claims unless the holders of those claims agreed to the plan or were not affected by it. Now, in contrast, almost every conceivable type of security interest can be altered in some way through bankruptcy, often to a tremendous degree and with very significant benefits for the debtor. *Consumer Bankruptcy Law and Practice*, 4th Ed., p. 203.

The workings of the cram down with both real estate and non-real estate have created a large body of law on this mechanism alone. The most recent significant case on how to value collateral for the purposes of determining how to determine the value of the allowed secured claim was Associates Commercial Corporation v. Rash which provided that the value of a creditor's collateral for cram down purposes should be what the debtor would have to pay for comparable property ("the replacement-value" standard).

Secured credit is usually the only "deep pocket" in a consumer bankruptcy case. Since 1978, debtors' advocates have been moderately successful in "unlocking the secured creditor's pocket through cram downs, "ride throughs", and nonpayment while a plan is being confirmed, Chapter 13 conversions to Chapter 7 after cramdown or cure, and the like. These various developments erode the fundamental distinction between secured and unsecured credit. There are very definite reasons that a lender chooses to extend secured credit over unsecured credit and one of them is certainty of repayment. H.R. 3150 addresses these issues to varying degrees and AFSA supports these provisions. We do feel that the bills' prohibition on cram downs 180 days prior to filing should be substantially extended for secured vehicle lenders. as they suffer the greatest losses on cramdown in the early years of the vehicles life when depreciation is the greatest. We believe that this is an important fact in pre-bankruptcy planning.

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Mr. Chairman, thank you again for the opportunity to appear before you today. We strongly support the efforts of the Subcommittee to develop a modern legal framework for bankruptcy and urge you to move forward with H.R. 3150.

SUBMITTED FOR THE RECORD BY 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 H.R. 3150, the "Bankruptcy Reform Act of 1998," which you introduced on February 3, 1998. This testimony expands on earlier testimony the CMC submitted for the record to your Subcommittee on April 30, 1997, in which we identified several developments in the bankruptcy area that negatively impacted residential mortgage loans. We are pleased, Mr. Chairman, that H.R. 3150 addresses a number of the bankruptcy concerns raised in our earlier testimony. The testimony we submit today proposes modifications to Section 121 of H.R. 3150 that addresses abusive filings and suggests a revision to the cramdown provisions contained in Section 130 of your bill.

The Bankruptcy Crisis

CMC believes it is imperative to reverse the acceleration in personal bankruptcy filings, which exceeded 1.3 million in 1997, an all time high.

CMC acknowledges the potential societal 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 residential mortgage loans or 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 secured residence that is being maintained by a debtor with little or no stake in the property. Too often, by the time the automatic stay is lifted by the bankruptcy court and the lender is permitted to foreclose upon and sell the residence, the proceeds of the sale are insufficient to pay the mortgage loan in full. Lenders who want to remain in business spread their mortgage loan losses to other borrowers in the form of higher interest rates. 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.

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Abusive Filings

There are a number of abuses of the bankruptcy process that prevent lenders from foreclosing, even when the debtor is clearly unable to pay the mortgage debt. Attached to this testimony is a case history (Appendix A) that illustrates the reason mortgage lenders are concerned with abusive filings. In this case, the debtor 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 relief under Chapter 7. The filing by the third party triggered the automatic stay, delaying foreclosure on the property by two to three months. When the judge dismissed the Chapter 7 filed by the third party, the debtor simply found another transferee to whom a partial interest was conveyed and who filed under Chapter 7 following the conveyance again triggering the application of the automatic stay to the mortgaged property.

In this case example, the debtor 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 transferees could not be verified. Even after the court granted the motion for relief, the debtor again attempted the same technique, transferring a partial interest in the mortgaged property to yet another third party who immediately filed under Chapter 7. While this case example was in the context of a Chapter 7 bankruptcy, debtors utilize the third party transferee abuse in Chapter 13 filings as well. Unfortunately, the practice of transferring partial interests in mortgaged property to third parties who in turn file a bankruptcy petition to delay foreclosure has become more prevalent over the last few years. CMC would be pleased to present additional case histories to the Subcommittee or its staff upon request.

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In addition to the third party transferee abuse, a debtor may file a Chapter 13 petition, never make a single mortgage payment under the plan, voluntarily dismiss the case just before the hearing on the lender's motion to lift the automatic stay—and then file another petition just before the next foreclosure sale notwithstanding the provisions of Section lO9(g) of the Bankruptcy Code. Although these practices should subject the debtor to sanctions, the penalties in the current Bankruptcy Code are difficult to enforce.

Your bill, Mr. Chairman, addresses the above-described filing abuses. Section 121 of H.R. 3150 amends Section 362 of the Bankruptcy Code to provide that if a case filed by a debtor under Chapters 7, 1 1 or 13 was dismissed and if the same debtor files a second case within a year of the dismissal, the automatic stay will terminate within 30 days of the filing of the second case unless the court extends the stay upon a finding that the second case was filed in good faith.

In addition, Section 121 addresses the situation in which a debtor transfers undivided interests in secured property to third party transferees by permitting the bankruptcy judge to grant *in rem* relief from the automatic stay. Properly applied, the in rem relief would prevent third party transferees who file a petition in bankruptcy from delaying foreclosure on property covered by *in rem* relief because the automatic stay would not apply to the covered property.

CMCbelieves that Section 121 should be strengthened to discourage abusive filings by including the following provisions:

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First. To further discourage a debtor from filing numerous petitions, the provision in Section 121 requiring that the automatic stay be lifted in 30 days if a petition is filed by a debtor within one year of the dismissal of a prior case should be expanded to provide that the automatic stay will not apply if the debtor files "x" number of cases within a specified period of time following an earlier dismissal. For example, the automatic stay would not apply if a debtor filed a second or third petition within one year of the dismissal of a case. This approach would discourage a debtor from continuously filing bankruptcy petitions to take advantage of the 30 day stay that is available in Section 121 as currently drafted. At some point, repetitious filings should be treated as being so abusive that the debtor is not entitled to the benefit of the automatic stay.

Second. To further discourage third party transferees from filing successive petitions in bankruptcy to delay foreclosure on property covered by an order granting *in rem* relief from the automatic stay, Section 121 should be revised to provide that the *in rem* relief applies to all parties with an interest in the property—excluding only those parties identified by the judge in the *in rem* order.

The language in Section 121 providing *in rem* relief from the automatic stay currently provides that the *in rem* order will not apply to a third party holding an interest in the property covered by the order unless the third party:

Had reason to know of the in rem order at the time the party obtained an interest in the property covered by the order, or

Was notified of the commencement of the proceeding for relief from the stay, and at the time of the notification, no case in which the third party was a debtor was pending.

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Requiring that a third party have knowledge of the entry of an *in rem* order or notice of a proceeding for relief from the stay as a condition to imposing *in rem* relief against that party will not significantly curtail the third party transferee abuse described above and documented in Appendix A. For example, a debtor could deed fractional interests in property to three parties without consideration prior to the entry of an *in rem* order or the commencement of a proceeding for relief from the stay. The third parties would not be covered by the *in rem* order because they would not have reason to know of the order at the time their interests were acquired. Even if their interests were acquired after the order was entered, they would not have reason to know of the order if the interests were transferred before the order was recorded. They are not "notified" of the motion in which the *in rem* order was granted because the lender could not have known of their existence at the time the motion was filed. In this example, each of the third party transferees could successively file a petition in bankruptcy and cause the automatic stay to apply to the property covered by the order granting *in rem* relief.

Innocent third parties with a legitimate interest in the property subject to an *in rem* order can be protected. The court is not required to enter an *in rem* order under Section 121 of your bill. It is in the judge's discretion. If a third party has a legitimate interest in the property and that interest is properly recorded—or the judge is advised of that interest by the debtor—the judge can elect not to enter an *in rem* order or can identify the innocent parties who would not be subject to the terms of the order.

In a number of jurisdictions, bankruptcy judges currently grant unrestricted *in rem* relief when faced with abusive third-party filings. The *in rem* language in Section 121 as currently drafted would restrict the scope of those orders and could impede the ability of lenders, trustees and title companies to go to sale on property covered by an *in rem* order entered under Section 121.

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In addition, Mr. Chairman, CMC would encourage the Subcommittee to give consideration to adding language to Section 121 that requires a court to enter and record the orders it issues extending the stay beyond the 30-day period and/or granting *in rem* relief from the stay. The requirement would assist in the compilation of bankruptcy statistics required by Section 441 of your bill and the collection of bankruptcy data under Section 442 and would be helpful to creditors in determining whether a filing made by a debtor falls under the parameters of Section 121.

Language suggesting changes to Section 121 of H.R. 3150 reflecting CMC's comments is set out at Appendix B.

Cramdowns

As noted earlier in the testimony, Mr. Chairman, CMC appreciates and strongly supports the language in Section 130 of your bill addressing concerns related to cramdowns. We have set out below an analysis of those concerns to establish a record in support of Section 130.

Several recent decisions have held that a lien on a residence securing a mortgage loan is subject to cramdown in certain circumstances. A cramdown can negatively impact the lender's secured claim. In a cramdown, the secured claim—the amount due on the mortgage loan—is reduced to the amount of the lien that does not exceed the market value of the property. The remainder of the claim is considered unsecured, which reduces or eliminates its value.

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In addition, the lender's remaining lien 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 large balloon payment at maturity—which the debtor could not realistically be expected to be able to pay.

The United States Supreme Court in *Nobelman* v. *American Savings Bank,* 508 U.S. 324 (1993), disallowed a cramdown under a Chapter 13 on a residential mortgage loan that constituted the debtor's principal residence. 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 *Nobelman* decision. Section 1322(b)(2) of the Bankruptcy Code provides that a Chapter 13 plan may not cramdown a "claim secured *only* by a security interest in real property that is the debtor's principal residence." (Emphasis added). The Third Circuit in *Hammond* narrowly read the term "only" and held because the mortgage lien on the principal residence contained language creating a security interest in fixtures, rents, escrow balance and the like—in addition to the lien on the real property—the mortgage lien was no longer entitled to protection from cramdown under Section 1322(b)(2) of the Bankruptcy Code. Almost all residential real estate mortgages—including the standard Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) mortgage forms—contain language creating a security interest in fixtures, escrow balances, etc. The practical effect of decisions, such as *Hammond*, is to nullify the cramdown protections in the Bankruptcy Code as enacted by Congress and interpreted by the U.S. Supreme Court in *Nobelman* for a sizable number of residential mortgages.

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There are a number of reasons for according residential mortgage loans protection from the cramdown provisions of Chapter 13.

Protecting residential mortgage loans against cramdown encourages lenders to make higher loan-to-value loans and to lend to borrowers to whom they might otherwise not lend 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 programs.

Prohibiting cramdowns on residential mortgage loans protects and supports the secondary market for home mortgages. A sizable portion of Fannie Mae and Freddie Mac mortgage loans, together with other residential mortgage loans, are sold into the secondary market. The existence of the secondary market encourages mortgage origination by providing greater access to capital with which to fund residential mortgage loans.

If a debtor is permitted to cramdown a mortgage loan to the current market value of the residence securing the mortgage 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 following a cramdown, the debtor rather than the lender will obtain 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 residence often fluctuates in value over the life of a mortgage loan.

Since the procedures provided by real estate law for foreclosing on a residential mortgage loan 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 borrower's need for the ability to cramdown a mortgage loan is less and the prejudice to the mortgage lender of taking away the protection from cramdown, when combined with the stricter limitations on the lender's ability to foreclose is greater.

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Perhaps the best argument for protecting residential mortgage loans from cramdown was advanced by the Fourth Circuit Court of Appeals in its recent decision, *Witt* v. *United Companies Lending Corp*. 113 F.3d 508 (4th Cir. 1997) in which it noted that:

We recognize that the effect of our decision will require the Witts to pay back the full amount of their home mortgage loan, making it harder for them to get 'a fresh start in life, after they have made a good-faith attempt to pay what they can.' Report at 32. As Justice Stevens recognized in Nobelman, '[a]t first blush it seems somewhat strange that the Bankruptcy Code should provide less protection to an individual's interest in retaining possession of his or her home than of other assets.' Nobelman, 508 U.S. at 332 (Stevens, J., concurring). Permitting the bifurcation of home mortgage loans, however, could make lenders more hesitant to make such loans in the first place. Although a broader reading of [section] 1322(c)(2) might help the Witts today, it could make it more difficult in the future for those similarly situated to the Witts to obtain any financing at all. Congress appears to have designed another important section, [section] 1322(b)(2), with this result in mind. See id. (stating that [section] 1322(b)(2)'s 'legislative history indicat[es] that favorable treatment of residential mortgagees was intended to encourage the flow of capital into the home lending market)'; Perry, 945 F2d at 64 (finding that [section] 1322(b)(2) 'was intended to make home mortgage money on affordable terms more accessible to homeowners by assuring lenders that their expectations would not be frustrated'); Grubbs v. Houston Am. Sav. Ass'n, 730 Ed 236 (5th Cir. 1984) (noting that the exception for home mortgages in [section] 1322(b)(2) 'was apparently in response to perceptions, or to suggestions advanced in the legislative hearings . . . that home mortgage lenders, performing a valuable social service through their loans, needed special protections against modification thereof (i.e., reducing installment payments, secured valuations, etc.)'). *Witt* at page 514.

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Recognizing the importance of protecting residential mortgage loans from cramdown, Mr. Chairman, Section 130 of your bill amends section 101 of the Bankruptcy Code to add definitions for the terms "debtor's principal residence" and "incidental property" and amends paragraph (2) of Section 1322(b) of the Code to change the word "only" to "primarily." In addition to substituting "primarily" for "only," Section 130 of your bill adds language to paragraph (2) of Section 1322(b) providing that if a debtor has used his residence "at any time during the 180 days prior to the filing of the petition," it would be treated as the debtor's "principal residence" and the mortgage loan would not be subject to cramdown.

The 180-day provision addresses an abuse that has become more prevalent over the last few years. In order to obtain the benefit of a cramdown under Chapter 13, the debtor would move out of his residence shortly before filing his bankruptcy petition and would not identify the residence as his "principal residence" at the time of the filing -because he was not living there on the date of the filing. Following a determination by the bankruptcy court that the residence was not the debtor's "primary residence" entitled to protection from cramdown under Section 1322(b)(2)—the debtor would move back in. The 180-day requirement, as you are aware, Mr. Chairman, is intended to curb that abuse.

CMC would suggest minor modifications to the definition of "incidental property" to assure that the definition encompasses the types of property, in addition to the residence, that are generally recited in a standard mortgage document as security for the mortgage loan. To that end, CMC recommends that the definition of "incidental property" in Section 130 of H.R. 3150 (page 48, line 10) be revised to read as follows:

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"*(27A)* 'incidental property' means property incidental to such *debtor's principal* residence including, without limitation, property commonly conveyed with a principal residence where the real estate is located, window treatments, carpets, appliances and equipment located in the residence, and easements, appurtenances, *and* fixtures *that are or thereafter become a part of the debtor's principal residence or the real estate on which debtor's principal residence is located, including all replacements and additions, together with* rents, royalties, mineral rights, oil and gas rights, *water rights*, escrow funds and insurance proceeds.

Continuation of Foreclosure Proceedings in a Chapter 13

Another factor which had been exacerbating bankruptcy severity in the residential mortgage loan industry was a 1995 decision rendered by the Bankruptcy Appellate Panel for the Ninth Circuit which held that continuation of a prepetition foreclosure sale after confirmation of a Chapter 13 plan violated the automatic stay. *Peters* v. *Mason-McDuffie Mortgage Corp. (In re Peters)*, (B.P.A. 9th Cir. 1995). Fortunately, *In re Peters* was reversed by the Court of Appeals for the Ninth Circuit which concluded that lender's:

postponement of foreclosure sale of Chapter 13 debtor's house post confirmation merely maintained the status quo and did not violate the automatic stay. *Peters* v. *Mason-McDuffie Mortgage Corp.*, 101 F.3d 618 at 619 (9th Cir. 1996).

The Ninth Circuit Court of Appeals analyzed Sections 1322(b)(5) and 1327(c) of the Bankruptcy Code in reaching its decision that the continuation or postponement of a prepetition foreclosure sale did not violate the automatic stay provisions of the Code. However, the Court found in its analysis that Section 1327(c) was "troublesome because it was poorly worded." *Id.* at 620. CMC supports Subsection (3) of Section 130 of your bill, Mr. Chairman, that addresses the troublesome language contained in Section 1327(c) by amending Section 362(b) of the Bankruptcy Code to insert a new paragraph (19) to make clear the right of a lender to continue a prepetition foreclosure proceeding or sale after confirmation of a Chapter 13 plan.

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Conclusion

Mr. Chairman, CMC strongly support the approach taken in H.R. 3150 to address abusive filings and the cramdown concern and to clarify the ability of lender to continue a prepetition foreclosure proceeding following confirmation of a Chapter 13 plan. In addition, we very much appreciate the opportunity to present our recommendations on suggested modifications to Section 121 (abusive filings) and Section 130 (cramdowns) to better address issues of critical importance to the residential mortgage industry and to all American homeowners. We look forward to working with you and the other Members of the Subcommittee and the staff as you continue to develop bankruptcy reform legislation for consideration by the Committee on the Judiciary and the full House.

APPENDIX A

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 Quitdaim deed by Borrower granting 1/10 interest to Transferee B

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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 Quitdaim 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

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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

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CONSUMER BANKRUPTCY IN THE BALANCE: PROVIDING AN EFFECTIVE SAFETY NET FOR OVERWHELMED FAMILIES

BY GARY KLEIN, STAFF ATTORNEY

NATIONAL CONSUMER LAW CENTER

Mr. Chairman and Members of the Subcommittee, on behalf of our low-income clients, the National Consumer Law Center(see footnote 12) thanks you for inviting us to testify today regarding consumer bankruptcies and their impact on the banking system.

My own experience includes 12 years as an attorney representing clients in bankruptcy, as an advocate for consumers on bankruptcy issues, as a teacher and trainer of other lawyers, and as an author of books on bankruptcy and consumer debt. My work also focuses on helping homeowners with financial problems avoid foreclosure. The bankruptcy system has always provided an important means to that end.

There is a great deal of misinformation circulating about the increase in bankruptcy filings and purported abuses in the system. The reality is that more debtors use the bankruptcy system because more debtors are having serious financial problems. American families increasingly face foreclosure, repossession, utility shut-off, wage garnishment and extensive collection activity on unsecured credit card debt. In short, more American families are using the bankruptcy system, because more American families are having trouble paying their debts.

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My testimony will focus on four questions:

Why more filings?

Can the system efficiently more money for creditors?

Are substantial costs of bankruptcy passed on to consumers?

What reforms to the system are necessary?

I. WHAT HAS CAUSED THE INCREASE IN FILINGS?

The fact that more bankruptcies are being filed is not evidence, in itself, that debtors are abusing the system. Ike reality is that more cases are filed, because more American families are faced with crushing debt. There is much more consumer credit outstanding than ever before. With the additional extension of credit, comes additional risk. (See the Case Study in the Appendix for a typical example of an American family forced to file bankruptcy because of the convergence of consumer debt, job loss and divorce.)

The increase in bankruptcy filings is an unfortunate consequence of several significant structural changes in the American economy. These changes have combined to create a rise not only in bankruptcy, but also in foreclosures,(see footnote 13) repossessions, utility disconnections,(see footnote 14) credit card defaults(see footnote 15) and visits to consumer credit counseling agencies.(see footnote 16) Nevertheless banks continue to record profits, fueled in large part by credit card income.(see footnote 17)

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These are the factors which have contributed to the increase in filings:

Downsizing, economic dislocation, income disruptions and underemployment. Families are increasingly impacted by instability in employment income, particularly at the lower end of the wage spectrum.(see footnote 18) Although unemployment remains low, many workers file bankruptcy after being forced to shift to lower paying jobs.(see footnote 19)

Rising debt to income ratios. More families have more debt. Part of the reason for this is that the lending community has aggressively marketed credit card debt,(see footnote 20) because it profits from the very high interest rates. Another factor is the unprecedented increase in the cost of education and the corresponding increase in student loan debt.(see footnote 21) One family in six below $25,000 in annual income, spends more than 40% of its income on debt service.(see footnote 22)

Reliance on two wage earners to make ends meet. This change in a fundamental condition of the economy means that every family has double the risk. With two wage earners vulnerable to income instability, any change for either one creates enormous pressure on the family budget. Child-bearing and time off to raise children means that a family which was getting by on two incomes is forced to rely on only one.

Rising divorce rates. A corollary of the latter factor is that when a family splits up, the pressure of running a household with less total income is impossible. Bankruptcy debtors are disproportionately single parents.(see footnote 23)

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Uninsured medical debt. At a time when a two day stay in the hospital to deliver a baby can cost as much as $20,000, the uninsured have virtually no options to manage medical debts.(see footnote 24) Bankruptcy has played an increasing role as the only way out.(see footnote 25)

Aggressive Creditor Collection Action. Wage garnishments, debt collection by aggressive telephone calling, and pursuit of legal remedies push many families into bankruptcy.(see footnote 26) Few debtors can afford to pay an attorney to defend against a debt collection or wage garnishment action even when they have valid legal defenses.(see footnote 27) Many bankruptcy filers report that their attempts at non-bankruptcy payment arrangements were rebuffed.

Deregulation. As rates and terms of credit have been deregulated, an increasing number of American families have gotten credit on bad terms.(see footnote 28) High rate home equity loans, credit card interest rates exceeding 18%, and consumer fraud tied to credit are frequent contributing causes of bankruptcy.(see footnote 29) As some borrowers are increasingly pushed into "sub-prime" loans at high rates, the bankruptcy system is at the fulcrum of a "chicken and egg" problem. Are high risks justifying high rates, or are the high rates causing defaults which generate risk?

More Credit Means More Bankruptcy. The clearest correlation of bankruptcy cause and effect is between the increase in the amount of credit outstanding and the number of filings. The number of bankruptcies and the total amount of consumer debt in our society have moved upward together in lockstep.(see footnote 30) It is not surprising that as more Americans borrow more money, more families have financial troubles.

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These reasons for the increase in bankruptcy filings are complex. Although banks and other lenders are correct in pointing out that they are not entirely to blame, it is disingenuous of them to assert that they should not bear some responsibility, at least to the extent of their own conduct.

Credit solicitations and other forms of marketing are designed to encourage consumers to rely on credit. Much of the marketing is done to people who once would have been considered high risk. Due to high interest rates, the lending community has discovered that it profits when people get in over their heads so that they cannot pay their balance in full each month.(see footnote 31) This generates remarkable profits for banks. However, it also makes consumers vulnerable even to small life problems which can put them over the edge.

Appropriate consumer protections designed to address the lending community's responsibility to make good lending decisions might include:

enhanced disclosure to consumers about the consequences of making minimum payments,(see footnote 32) enhanced disclosures concerning teaser rates of interest,(see footnote 33)

protections against unilateral interest rate increases which are unrelated to a change in the lender's cost of funds,(see footnote 34)

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prohibition of unilateral credit limit increases,(see footnote 35)

prohibition of security interests based in credit card agreements,(see footnote 36)

protection against so called "cashed check loans",(see footnote 37)

prohibition of credit card cash advance machines in casinos,(see footnote 38)

prohibition against making credit cards available to persons such as students who have no present ability to make more than nominal payments,(see footnote 39) and

reregulation of interest rates.(see footnote 40)

Some of these provisions are in a bill which has been filed in the House of Representatives.(see footnote 41) If lenders choose not to address these problems themselves, they ought not to complain about the bankruptcies which are the inevitable result.

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II. IF WE CAN'T STOP AMERICAN FAMILIES FROM FILING BANKRUPTCY, CAN EVE REDESIGN THE SYSTEM TO MAKE THEM PAY?

Nobody likes to be owed a debt which is not paid back. Yet our society has a system of debt forgiveness which has roots in the Bible.(see footnote 42) Forgiveness and a fresh start have always been a part of that system.(see footnote 43)

A family's ability to repay its debts is limited by its income. Data shows that Americans in bankruptcy are far poorer than their non-bankrupt counterparts. The median income of a family in chapter 7 bankruptcy is approximately half the national median.(see footnote 44)

The credit industry has focused substantial resources on showing that despite this relative poverty, there are many families who are obtaining a bankruptcy fresh start even though they can afford to pay. Based on this assumption, they would set up a system in which debtors are forced into payment plans.(see footnote 45)

However, if such plans are not entered voluntarily by the debtor, they have little chance of success, absent extensive and impracticable coercive mechanisms. For this reason, forced participation in payment plans has consistently been rejected by Congress and the two most recent government sponsored commissions which have studied bankruptcy.(see footnote 46)

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Apart from this procedural difficulty, there is no empirical evidence which shows that debtors can afford to pay. In 1989, Professors Sullivan, Warren and Westbrook published the results of an evaluation of a substantial statistical database and concluded:

The overwhelming majority of Chapter 7 debtors—90% by any measure—could not pay their debts in Chapter 13 and maintain even the barest standard of living. . . . A new bankruptcy regime that invested more time to find and to investigate the potential can-pay debtors would prompt only a small amount of new repayment. This is the classic case in which a policy maker asks if the game is worth the candle.(see footnote 47)

The creditor industry's own study released last year,(see footnote 48) purporting to show the opposite, has been severely criticized by the General Accounting Office.(see footnote 49) Once the credit industry study's results are adjusted to take account of the GAO critique, it shows that only about 5% of debts could be repaid by debtors—if they undergo five year repayment plans.(see footnote 50) This means that the creditor's own study ultimately shows that bankruptcy debtors can afford to pay about a penny on the dollar per year.

Outside bankruptcy, no reasonable creditor would spend more than a penny to collect a penny. Proposals to require five year payment plans for many more debtors have a heavy price tag, including costs of administration and monitoring, costs to resolve disputes about capacity to repay, and costs of collecting and distributing payments.

Either the taxpayer would have to fund these costs, or if they are debtor funded, they will reduce the receipts available to creditors in a repayment plan. If taxpayer funded, every American would be helping banks and other creditors collect their one cent per dollar per year. If debtor funded, the one cent per dollar per year repayment capacity of debtors is even further reduced.

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Finally, requiring five year repayment plans would have enormous social and human costs. People use the bankruptcy system for many legitimate reasons. If navigating the system is made more difficult, if a meaningful fresh start is denied when some cases inevitably fail,(see footnote 51) more debtors would be left with the burden of unmanageable debts.(see footnote 52) Loss of homes, repossessions, wage garnishments, utility shut-off and family stress associated with unmanageable debts would be the inevitable result. While these social and human costs of denying chapter 7 relief to debtors may be difficult to quantify, they nevertheless remain an important part of the relevant equation.

III. ARE CONSUMERS PAYING THE COST OF THE CURRENT BANKRUPTCY SYSTEM?

The banking industry has claimed that it is losing 40 billion dollars each year to the bankruptcy system and that it is passing those costs on to consumers at the rate of $400 per family. *These numbers are utter nonsense.* Families may be discharging debt in bankruptcy, but the creditor's own study, discussed above, shows that these are not debts which consumers can afford to pay.

In reality, the lending community is scapegoating the bankruptcy system for losses associated with bad loans. The vast majority of debts which are discharged in bankruptcy would have been written off if no bankruptcy had intervened. The only impact of the bankruptcy case is that it gives debtors a legally enforceable fresh start—the same second chance which has been guaranteed since Biblical times.

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Equally important, there is no evidence that lenders would reduce rates on unsecured consumer lending if they could avoid bankruptcy losses. Between 1980 and 1992, the federal funds rate at which banks borrow fell from 13.4% to 3.5%. Nevertheless credit card interest rates actually rose.(see footnote 53) How likely is it that other types of savings, if any could be realized, would be passed on to consumers?

To a large extent, the bankruptcy "problem" is nothing but a "bad loan" problem. It could be fixed if lenders were more closely attentive to underwriting. For the most part, the lending community has chosen not to take this step. The present interest rate environment has taught lenders that substantial profits can be made from extending credit to risky borrowers, such as college students. However, in exchange, the banking community must accept that it is reaching some borrowers who cannot afford to pay.

IV. WHAT SHOULD BE DONE?

The bankruptcy system established in 1978 has been remarkably efficient. It provides critical relief to financially troubled American families at a low cost to taxpayers. Over the years, many open issues under the bankruptcy law have been resolved by court decisions and carefully crafted Congressional amendments.

To the extent the increase in the number of bankruptcies suggests that there are problems in the consumer lending system, responsibility for fixing those problems must be shared between consumers and lenders. Congressional reform, if any, should be balanced and narrowly targeted at abuses by both debtors and creditors.

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It would be a mistake to enact reforms without addressing reckless lender conduct which pushes people into bankruptcy. Offering additional credit, for example, to families already struggling to pay their debts hurts not only borrowers, but also the borrowers' honest creditors if the new credit pushes the family over the edge. Similarly, failure by one creditor to seriously consider payment arrangements outside bankruptcy for families facing hardship may lead to a bankruptcy filing which affects all creditors.

Although we do not agree in many respects with the Report of the National Bankruptcy Review Commission, that commission did important work, at Congressional behest, which should be treated seriously by Congress. The Bankruptcy Review Commission heard from hundreds of witnesses on consumer bankruptcy over the course of its work.(see footnote 54) Most of the neutral witnesses, judges, law professors, economists, and bankruptcy trustees have recommended and continue to support balanced reforms rather than enactment of a creditor's wish list. The majority report of the Review Commission is reasonably balanced and a good start for Congressional consideration.

To the extent there has been a focus on debtor misconduct, the burden of proof remains on the credit industry. To date it has not been met. Simply saying that more people are using the system, is not proof that people are misusing the system.

Some observers ignore the fact that the present system already has a variety of protections which are designed to effectively root out abuses by debtors. These include: Rule 9011,(see footnote 55) objections to discharge,(see footnote 56) complaints to determine dischargeability,(see footnote 57) good faith requirements,(see footnote 58) Rule 2004 examinations,(see footnote 59) creditor's meetings,(see footnote 60) dismissals for substantial abuse,(see footnote 61) and criminal sanctions.(see footnote 62) Indeed, it is unclear why the creditor community does not believe that the small number of cases where significant repayment appears possible are not resolvable under the "substantial abuse" test of 11 U.S.C. 707(b).(see footnote 63) Most of the anecdotal evidence of abuse which exists arises not because the system is broken, but rather because these provisions have been effective in bringing the abuse to light.

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An additional set of balanced reforms may be appropriate as long as they do no harm to the majority of honest debtors who urgently need help. Provisions should be narrowly targeted to address debtors who truly are abusing the system without affecting lower income debtors who would be hurt by having to litigate additional issues.(see footnote 64)

Appropriate reforms would also do more to create incentives for debtors to use a repayment plan option in bankruptcy in order to repay their debts. Significant actions could be taken to make the costs of those plans more manageable and to enhance outcomes for debtors who complete plans.(see footnote 65)

Additionally, the system should penalize dishonest creditors whose actions push people into bankruptcy. Honest creditors should be preferred to abusive debt collectors, lenders that encourage gambling in casinos, high rate mortgage lenders, and lenders who are unreasonable in refusing to accept non-bankruptcy payment plans. Lenders whose actions violate the bankruptcy laws should be subjected to meaningful and straightforward penalties.

CONCLUSION

The lending community should not be allowed to scapegoat the bankruptcy system for lending decisions which result in bad debt. The right to participate in the bankruptcy system should require honesty not just on the part of debtors, but also by creditors.

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Radical change has the potential to undermine the economy by changing the fundamental balance between debtors and creditors. Concerns about the health of the banking system are unwarranted during this period of record bank profits. No legislative action should ignore the significant hardships of the millions of American families who are overwhelmed by debt.

APPENDIX

Case Study

Mrs. M is a 39 year old mother of three children, two of whom are living at home. Her financial problems started in 1994 when her husband lost his job in construction. Since that time, he has been under-employed; his earnings have declined from an average of $52,000 annually between 1990 and 1993 to an average of $26,000 between 1994 and 1997. Starting in 1994, the family's primary income has been $30,000 which Mrs. M earns as an administrative assistant at an insurance company. Mr. and Mrs. M have struggled successfully to maintain payments on a home they bought in 1987 since their financial problems began in 1994.

Mr. and Mrs. M have also had significant credit card bills since the late 1980's. Despite their financial problems, they avoided default on those debts by making minimum payments between 1994 and 1997. However, the total amount of their credit card debts increased from about $ 11,000 in 1994 to about $29,000 in 1997, largely due to the accumulation of interest at an average annual rate of 17.5%.

In 1997, Mrs. M's financial problems worsened, because Mr. M moved out of the family home. An additional strain was created because Mrs. M attempted to provide financial help to her oldest daughter who began her first year of college. In family counseling, Mr. and Mrs. M acknowledged that their marriage was breaking up largely because of the constant pressure of financial problems and Mr. M's continuing inability to find steady work.

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Mrs. M attempted to make payment arrangements with her credit card lenders so that she could focus on her mortgage obligation. She was told that no payment arrangements were possible and that she should "borrow money to pay off the debts". Mrs. M went to consumer credit counseling where she was advised that her budget did not support any payments on credit cards. She was advised to consider chapter 7 bankruptcy in order to eliminate the credit card debts so that she could maintain her payments on the mortgage.

In September, 1997, Mrs. M obtained advice from a bankruptcy lawyer and reluctantly filed bankruptcy. She will discharge approximately $35,000 in unsecured debts. She will reaffirm and continue to make payments on her mortgage and car loan—totalling $1,320 monthly.

(Footnote 10 return)
Published in *Norton Bankruptcy Law and Practice, Annual Survey Of Bankruptcy Law* (Clark Boardman Callaghan).

(Footnote 11 return)
The Bankruptcy Reform Act of 1994 did not delete the reference to section 371. but did change the reference from the Internal Revenue Code of 1954 to the Internal Revenue Code of 1986.

(Footnote 12 return)
The National Consumer Law Center is a nonprofit organization specializing in consumer credit issues on behalf of low-income people. We work with thousands of legal services, government and private attorneys around the country, representing low-income and elderly individuals, who request our assistance with the analysis of credit transactions. The National Consumer Law Center also serves as an advocate for low-income consumers on consumer lending and bankruptcy. NCLC publishes materials for lawyers and consumers, including the nationally acclaimed book *Surviving Debt: A Guide for Consumers*. NCLC has trained lawyers and counselors nationwide on consumer protection issues relevant to low-income consumers.

(Footnote 13 return)
Foreclosures have more than tripled since 1980. There were approximately half a million foreclosures in 1996.

(Footnote 14 return)
See National Consumer Law Center, "The Energy Affordability Crisis of Older Americans" p. 23 (August, 1995).

(Footnote 15 return)
Ausubel, "Credit Card Defaults, Credit Card Profits and Bankruptcy", 71 Am. Bankr. L.J. 250

(Footnote 16 return)
The number of consumers who have visited consumer credit counseling for help in the last 20 years has increased at a faster rate than bankruptcy filings. More than two million families sought such help in 1997.

(Footnote 17 return)
Commercial banks earned 14.8 billion in the third quarter of 1997, the third consecutive quarter of record profits and the 19th consecutive quarter involving profits of more than 10 billion. *See* Ausubel, Credit Card Defaults, Credit Card Profits and Bankruptcy, 71 Am. Bankr. L.J. 250 (1997) for a discussion of the role of credit card profits in the current boom in banking.

(Footnote 18 return)
Even Mastercard recognizes this trend. In its recent report on debt and bankruptcy, its economist states: "Stagnation in real wages during the last 20 years and the growing disparity in income and wealth, . . . have almost certainly contributed to the rise in personal bankruptcies. Declines in income caused by job loss make it more difficult for those affected to service previously accumulated debt. " Chimerine, Americans in Debt: The Reality", p.24 (MasterCard International 1997).

(Footnote 19 return)
Sullivan, Warren, and Westbrook, As We Forgive Our Debtors, pp. 91–102 (Oxford University Press, 1989). *See generally* Medoff and Harless, The Indebted Society pp. 103–119 (Little Brown & Co. 1996) (in the last two decades real wages of the newly hired have fallen faster than those of longer tenured employees).

(Footnote 20 return)
More than two billion credit card solicitations were sent out in 1997. *See* Hays, "Banks Marketing Blitz Yields Rash of Defaults" Wall Street Journal, p. B1 (September 25, 1996). MBNA, one of the largest issuers, claims 30 million credit card solicitations each month in 1997 together with 6 million phone solicitations. Hansell, "A Banking Powerhouse of Cards", N.Y. Times, p. C1 (October 22, 1997).

(Footnote 21 return)
See Chacon, "Debt Burden Soaring for U.S. Students" Boston Globe, p. 1 (October 23, 1997). According to the Nellie Mae study on which the article is based, an average student's debt increased from $8,200 in 1991 to $18,800 in 1997.

(Footnote 22 return)
"Family Finances in the United States: Recent Evidence from the Survey of Consumer Finances" Federal Reserve Bulletin, p. 1, 21 at Table 14 (January, 1997). Overall, the rate is one family in nine.

(Footnote 23 return)
See Sullivan, Warren, and Westbrook, As We Forgive Our Debtors, pp. 147–165 (Oxford University Press, 1989).

(Footnote 24 return)
See Hildebrandt and Thomas, The Rising Cost of Medical Care and Its Effect on Inflation", Federal Reserve Bank of Kansas City, Econ. Rev. p. 47 (Sept./Oct. 1991).

(Footnote 25 return)
Domowitz & Sartrain, Determinants of the Consumer Bankruptcy Decision, p. 25 (1997).

(Footnote 26 return)
See Dugas, "Special Report: Going Broke, Wage Garnishments a Key Factor" USA Today, p. 1A (June 10, 1997); Hansell, "We Like You. We Care About You. Now Pay Up. Debt Collecting Gets a Perky Face and Longer Arms", NY Times, F.1 (Jan. 26, 1997).

(Footnote 27 return)
Sterling & Shrag, Default Judgments Against Consumers: Has the System Failed?" 67 Denv. U. L. R. 357, 384 (1990).

(Footnote 28 return)
See, e.g., Adding Insult to Injury: Credit on the Fringe, Hearing before the Subcommittee on Consumer Credit and Insurance of the House Committee on Banking, 103rd Cong., 1st Sess. (1993). Rehm, In a First, FDIC Warns Banks About Dangers of Sub-Prime Lending, 162 Am. Banker 2 (May 13, 1997).

(Footnote 29 return)
See Forrester, "Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of

Home Equity Financing" 69 Tul. L. Rev. 373 (1994).

(Footnote 30 return)
Three neutral academic studies show this remarkable correlation. Ausubel, Credit Card Defaults, Credit Card Profits and Bankruptcy, 71 Am. Bankr. L.J. 250 (1997); Bhandari & Weiss, The Increasing Bankruptcy Filing Rate: An Historical Analysis, 67 Am. Bankr. L. J. 1 (1993); Statement of Kim Kowalewski, Chief, Financial and General Macroeconomic Analysis Unit, Congressional Budget Office, before the Subcommittee on Administrative Oversight and the Courts, Committee on the Judiciary, United States Courts, (April 11, 1997). *See* Commission Report at pp. 84–86. These studies stand is sharp contrast to credit industry funded studies which purport to show otherwise.

(Footnote 31 return)
Borrowers who maintain balances pay interest at rates which typically range from 14.5 to 19.8%.

(Footnote 32 return)
Minimum payments on many credit cards will not amortize the loan, thus sucking people in over their heads. If minimum payment terms are offered which won't amortize the debt in two years, consumers should be told, in clear and conspicuous language, what they need to pay, if they make no further charges, in order to pay off the loan over a two year period.

(Footnote 33 return)
Low initial rates are designed to encourage consumers to use credit in the first months after credit is granted. Many consumers do not understand what the permanent rate will be or the impact of the rate change on a large unpaid balance.

(Footnote 34 return)
Some lenders raise rates arbitrarily after consumer balances reach a certain level. Interest rate changes should be tied to an actual change in the interest rate environment so that consumers are not caught unawares.

(Footnote 35 return)
When a lender extends a consumer's credit limit unilaterally, in some cases after a consumer is already struggling with the existing balance, the message is that the lender believes that the consumer can afford to take on more credit. Consumers would not be hurt by having to ask for more credit, rather than having it offered unilaterally. Such a request should trigger at least minimal underwriting requirements.

(Footnote 36 return)
These hidden security interests in items of property which have no resale value to the creditor provide inappropriate leverage to lenders in the collection process even though there is no potential that the lender could make money in the event of repossession.

(Footnote 37 return)
Consumers receive checks from several major lenders in the mail for as much as $5,000. Not everyone understands that cashing these checks can lead to acceptance of high rate credit terms. In addition, providing preapproved credit through cashed checks eliminates the cooling off period which more common credit application processes provide.

(Footnote 38 return)

With credit card cash advance machines prevalent in casinos, is it surprising that some gamblers get overextended on credit and file bankruptcy based on those credit card debts?

(Footnote 39 return)
Offering credit aggressively to college students who cannot afford to pay off their debts until they join the work force some years later is prevalent because interest mounts until the debt is paid. By lending aggressively to college students, at a time in life when money is scarce, our society runs the risk of saddling people early in life with an unmanageable problem which will later preclude more important uses of credit such as purchase of a home and car.

(Footnote 40 return)
Competition in the market has not worked to keep rates at reasonable levels. On a procedural level, the Supreme Court has held that credit card lenders can rely on the law in the state where they are incorporated in setting the interest rate and many of the other terms of credit for consumers nationwide. This has led to a "race to the bottom". States deregulate in order to create the best possible environment to encourage a credit card company to locate there in order to export terms of credit across the country. This helps certain states create jobs. However, it means that those other states that do want to regulate for the benefit of their citizens can no longer do so. Either states should be freed to create and enforce meaningful regulations or the federal government should step in with consumer protections.

(Footnote 41 return)
H.R. 1975, 105th Cong., 1st Sess. (1997) "Credit Card Consumer Protection Act of 1997". *See also* H.R. 3146, 105th Cong., 2d Sess. (February 3, 1998) "Consumers and Lenders Bankruptcy Accountability Act of 1997" for an approach to addressing these problems by changes to the bankruptcy system.

(Footnote 42 return)
Deuteronomy 15:1–2 ("At the end of every seven years thou shalt make a release. And this is the manner of the release: every creditor shall release that which he has lent unto his neighbor and his brother, because the Lord's release hath been proclaimed".)

(Footnote 43 return)
Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934). See Gross, Failure and Forgiveness, ch. 6 (Yale University Press 1997).*

(Footnote 44 return)
Sullivan, Warren and Westbrook, "Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981–1991", 68 Am Bankr. L. J. p. 121, 128 (1994).

(Footnote 45 return)
Proposed legislation favored by the credit industry includes: S. 1301, 105th Cong., 1st Sess. 102 (1997); H.R. 2500, 105th Cong., 1st Sess. 101, 102 (1997); H.R. 3150, 105th Cong., 2d Sess. 101 (1998). Consumer groups including the National Consumer Law Center, the Consumer Federation of America, the National Association of Consumer Bankruptcy Attorneys and the United Auto Workers are opposed.

(Footnote 46 return)
See Report of the Commission on the Bankruptcy Laws of the United States, Part I at 159 (1973); H.R. Rep. No. 595, 95th Cong., 1st. Sess. 120–121 (1977); Report of the National Bankruptcy Review Commission, Vol. 1, at pp. 89–91 (October 20, 1997) [hereinafter "Commission Report"].

(Footnote 47 return)
Teresa A. Sullivan, Elizabeth Warren, and Jay Lawrence Westbrook, As We Forgive Our Debtors, pp. 205–206 (Oxford University Press, 1989). This seminal book and the empirical work which underlies it remains the single most authoritative published source for studying bankruptcy demographics. It has been updated more recently in an article by the same authors which concludes that debtors are now even poorer and less able to pay their debts than they were when the initial study was done. "Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981–1991", 68 Am Bankr. L. J. 121 (1994).

(Footnote 48 return)
Barron and Staten, "Personal Bankruptcy: A Report on Petitioners' Ability to Pay", Monograph 33, Georgetown U. Credit Research Center (1997). This report is reprinted as Appendix G–2.b to the National Bankruptcy Review Commission Report.

(Footnote 49 return)
GAO Report at p. 6, February 8, 1998 (requested by Senators Charles E. Grassley and Richard J. Durbin). The GAO concluded that the study's "fundamental assumptions were not validated". In addition, the GAO review concluded that the credit industry's study: failed to assess the accuracy of the data collected; failed to account for major expenses which bankruptcy debtors have after filing including payments on non-housing secured debt and reaffirmed or non-discharged nonpriority debts; failed to evaluate potential differences among the sites chosen for the study; and failed to use statistically valid research techniques.

(Footnote 50 return)
Without allowing for the GAO's criticisms, the creditor's study concludes that debtors could pay 13.7% of their debts over five years. The GAO report points out that this conclusion must be modified because the creditors did not account for 1.) repayment plan failures (approximately 67% under current law), 2.) debts which must be paid back despite bankruptcy including car loans, student loans, reaffirmed debts and interest on those debts (payment obligations on these debts represent approximately 46% of total debts and thereby reduce a family's ability to pay other debts) and administrative costs of payment plans (10% of plan payments under current law). When these deductions from payment capacity are taken into account, what is left is the ability to pay about 5% of total debts over a five year period.

(Footnote 51 return)
67% of repayment plan cases fail under current law. There is every reason to think that if economically marginal debtors are forced into involuntary repayment plans, the failure rate would be higher.

(Footnote 52 return)
See D. Caplovitz, Consumers In Trouble: A Story of Debtors in Default pp. 280–285 (Free Press, 1974).

(Footnote 53 return)
Medoff and Harless, The Indebted Society, at pp. 12–13 Little, Brown & Co. 1996).

(Footnote 54 return)
Report of the National Bankruptcy Review Commission, Vol. 1, at p. ix (October 20, 1997) [hereinafter "Commission Report"].

(Footnote 55 return)
Fed. R. Bankr. P. 9011.

(Footnote 56 return)
See 11 U.S.C. 727.

(Footnote 57 return)
See 11 U.S.C 523(a)

(Footnote 58 return)
See, e.g., In re Barrett, 964 F.2d 588 (6th Cir. 1992) (finding that debtor's second chapter 13 filing, when he had insufficient income to support plan, was in bad faith but that third chapter 13 case, after circumstances had changed was not in bad faith); In re Love, 957F.2d 1350 (7th Cir. 1992).

(Footnote 59 return)
Fed. R. Bankr. P. 2004. It is hard to see why creditors concerned about abuses can't utilize the examination process to uncover them. If it is nonfinancially feasible for a creditor to pursue an examination, why should taxpayers instead bear that burden for the creditor's benefit.

(Footnote 60 return)
11 U.S.C. 341. Fed. R. Bankr. P. 2003.

(Footnote 61 return)
11 U.S.C. 707(b)

(Footnote 62 return)
18 U. S. C. 151–157. Bankruptcy fraud is punishable by fine and imprisonment for up to five years. 18 U.S.C. 157.

(Footnote 63 return)
That is the provision which Congress added to the Code in 1984 and which has functioned to root out debtors who can afford to pay their creditors. *See, e.g.*, In re Kelly, 841 B.R. 908 (9th Cir. 1988); In re Krohn, 886 F.3rd 123 (6th Cir. 1989) (substantial abuse found where debtors could pay back their debts with "good, old fashioned belt tightening").

(Footnote 64 return)
See e.g., H.R. 3146, 105th Cong., 2d Sess. 8 (February 3, 1998). Creditors should not be allowed to obtain leverage by forcing new litigation on consumers who cannot afford to pay.

(Footnote 65 return)
For example, efforts should be made to provide improved credit reporting for people who complete chapter 13 payment plans. In addition, the discharge available in chapter 13 should be as broad as possible in order to serve as incentive to choose that chapter. Costs can be lowered by encouraging secured lenders to accept modifications to their mortgages in exchange for more favorable treatment.