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1999

BANKRUPTCY REFORM ACT OF 1998;
RESPONSIBLE BORROWER PROTECTION ACT; AND
CONSUMER LENDERS AND BORROWERS BANKRUPTCY ACCOUNTABILITY ACT OF 1998
PART IV

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE
COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTH CONGRESS

SECOND SESSION

ON

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H.R. 3150, H.R. 2500, and H.R. 3146

PART IV

MARCH 19, 1998

Serial No. 70

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Graham, Christopher F., Thacher Proffit & Wood, New York, NY, Representing the American Bankruptcy Institute

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Perlstein, William J., Wilmer Cutler & Pickering, Washington, DC, Representing the American Bar Association, The Business Section

Resnick, Alan N., Hofstra University School of Law, Hempstead, NY, Representing the National Bankruptcy Conference

Smith, James E., President and CEO, Union State Bank and Trust Clinton, Clinton, MO, Representing the American Bankers Association

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BANKRUPTCY REFORM ACT OF 1998; RESPONSIBLE BORROWER PROTECTION ACT; AND CONSUMER LENDERS AND BORROWERS BANKRUPTCY ACCOUNTABILITY ACT OF 1998
PART IV

Thursday, March 19, 1998

House of Representatives,
Subcommittee on Commercial
and Administrative Law,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in Room 2226, Rayburn House Office Building, Hon. George W. Gekas [chairman of the subcommittee] presiding.

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Present: Representatives George W. Gekas, Ed Bryant, Steve Chabot, Jerrold Nadler, Martin T. Meehan, and William D. Delahunt.

Staff present: Susan Jensen-Conklin, Subcommittee Counsel; Raymond V. Smietanka, Subcommittee Chief Counsel; Audrey Clement, Subcommittee Staff Assistant; and David Lachmann, Minority Professional Staff Member.

OPENING STATEMENT OF CHAIRMAN GEKAS

Mr. **GEKAS.** The hour of 10 having arrived, the subcommittee will come to order. In conformity with the custom of the Chair to open the meetings exactly on time, we have accomplished that thus far.

But because of the rules of the House of Representatives, we must have two members present to constitute a hearing quorum. And so I am confined to those rules, and therefore have to declare a recess until a second member should appear. I ask your indulgence.

The subcommittee stands in recess.

[Recess.]

Mr. **GEKAS.** The recess having subsided, we will proceed with empaneling the first set of witnesses. The Chair will yield himself some time for an opening statement; and will do the same with the ranking member, Mr. Nadler of New York. And then we will proceed to have the witnesses present their testimony.

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Over the course of the time that we have been conducting hearings on this matter, we have heard from more than 60 witnesses, including some Members of Congress. And naturally, with such a growing number of people involved, we

had had a broad range of views on every pertinent subject covered by the bills in question.

In additions to debtors, judges, and practitioners on every angle of the bankruptcy scene, and others, administrators, et cetera, and credit union people, for example, tax lawyers for governments, and a whole host of individuals as we set across the spectrum of the financial and bankruptcy world. And representatives of many, many organizations who have a stake in the outcome. For example: the Business section of the American Bar Association; the American Bankers Association; the American Bankruptcy Institute; the American College of Bankruptcy; America's Community Bankers; the American Financial Services Association; the Bankruptcy Issues Council; the Commercial Law League of America; the Credit Union National Association; the National Association of Attorneys General; the National Association of Bankruptcy Trustees; the National Association of Consumer Bankruptcy Attorneys; the National Association of Credit Managers; the National Association of Federal Credit Unions; the National Bankruptcy Conference; the National Conference of Bankruptcy Judges; the National Multi-Housing and National Apartment Association; and the National Retail Federation.

So we have heard from representatives of every phase of our nation. We also heard from Federal and state government representatives; the National Bankruptcy Coalition, the Executive Office for the United States Trustees, the Government Accounting Office, the Judicial Conference of the United States, and the Law Enforcement Division of the Securities and Exchange Commission.

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And so we will proceed with still another hearing eager to grapple with the issues that will be presented by the witnesses. And then move on to the next phase of our work in this subcommittee to the full Judiciary Committee.

[The prepared statement of the Hon. George W. Gekas follows:]

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

Over the course of these four hearings, we will have heard from more than 60 witnesses, including three Members of Congress. The men and women who testified before this Subcommittee prepresented a broad range of views and interests.

In addition to judges, practitioners, bankruptcy trustees, accountants, academics, people in private industry, and even debtors, we heard from nearly every major professional organization having an interest in bankruptcy. They include the following:

American Bar Association through its Business Section
American Bankers Association
American Bankruptcy Institute
American College of Bankruptcy
America's Community Bankers
American Financial Services Association
Bankruptcy Issues Council

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Commercial Law League of America
Credit Union National Association
National Association of Attorneys General
National Association of Bankruptcy Trustees
National Association of Consumer Bankruptcy Attorneys
National Association of Credit Managers

National Association of Federal Credit Unions
National Bankruptcy Conference
National Conference of Bankruptcy Judges
National Multi Housing and National Apartment Association
National Retail Federation

We also heard from various federal and state government representatives, including former members of the National Bankruptcy Review Commission, the Executive Office for United States Trustees, the Government Accounting Office, the Judicial Conference of the United States, and the Law Enforcement Division of the Securities and Exchange Commission.

As you know, our inquiry into consumer bankruptcy actually began last year when we held a hearing on the National Bankruptcy Review Commission's Report to Congress.

The valuable insights and written submissions of the many witnesses who testified at these hearings have been enlightening, provocative and useful. I very much appreciate the efforts of all who have contributed to this process.

Mr. **GEKAS.** With that, we yield to the gentleman from New York.

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

Today concludes what regrettably is the last planned hearing on bankruptcy reform before the subcommittee marks up pending legislation. While we have made a good start in the process of understanding and sorting through the complex issues attending the proposed changes we have before us, it is only a start.

I do appreciate the willingness of the majority to move the mark-up date until after the April district work period, I do not believe that we are anywhere near ready to go forward with this legislation. But, of course, it is the prerogative of the majority to schedule votes.

Mr. Chairman, we would still need a careful examination of the data presented to our committee. Most of it is funded by parties with a direct financial interest in the outcome of the legislation.

It is no secret, Mr. Chairman, that there has been a tremendous amount of money spent on lobbying on this issue. That money has paid for some very glossy reports and charts. But we have a duty to conduct our own independent analysis of the issue, and as to the validity of the conclusions of those very glossy reports and charts.

We still need to have GAO review the studies. We still need to hear from the Congressional Budget Office. We should wait for organizations like the Tax Section of the American Bar Association to finish the work that they are doing on their reports to Congress.

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We should look carefully into the impact of the implementation of the various legislative proposals before us would have on our Bankruptcy Courts, on the courts of the states, and ultimately on the net return to creditors.

I understand the Chairman's desire to move expeditiously. But determination and deliberation need not be mutually exclusive. I think that we need to be more careful in this exercise. That has been the lesson of the hearings so far, and the testimony of some of the nation's leading bankruptcy experts and organizations.

Just yesterday, for example, we heard from distinguished witnesses diametrically opposite testimony on a number of different subjects. We need time to evaluate the accuracy of that testimony, and we need time to see what is really

going on. And the schedule does not provide that time.

Bankruptcy, Mr. Chairman, ain't bean bag. We are talking about the lives, small businesses, homes, and livelihoods of millions of Americans. We are talking about constituents' tax dollars. And we are talking about the integrity of the bankruptcy system. It deserves our attention and our time.

Now I will repeat what I said yesterday. The last time the Congress did a major rewrite of the bankruptcy laws in the mid-1970's, the House held not 5 days but 35 days of hearings. I think that there were 2700 pages of testimony that was submitted. The Senate did 31 more days of hearings. And you had a reasonably good job.

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As was pointed out by the Chairman yesterday, some things still slip by. There were unintended consequences that they did not anticipate. But that is an argument for more care and deliberation and not less.

Again, Mr. Chairman, I urge you to rethink the current schedule. I have no choice but to say that the current schedule is reckless, reckless and irresponsible with the money and the fortunes of millions of people in this country. And I hope that you will rethink the current schedule, and work with the minority to correct legislation that we can all be proud of.

Thank you, Mr. Chairman.

[The prepared statement of the Hon. Jerrold Nadler follows:]

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

Thank you, Mr. Chairman. Today we conclude what is, regrettably, our last hearing on bankruptcy reform before the subcommittee marks up pending legislation. While these hearings have made a good start of the process of understanding and sorting through the complex issues attending the proposed changes we have before us, it is only a start. While I do appreciate your willingness to move the mark up date until after the April District Work Period, I do not believe we are ready to move forward with this legislation, though it is the prerogative of the majority to schedule votes.

Mr. Chairman, we still need to have a careful examination of the data presented to our committee, most of it funded by parties with a direct financial interest in the outcome of this legislation. It is no secret, Mr. Chairman, that there has been a lot of money spent lobbying this issue. That money has paid for some very glossy reports and charts, but we have a duty to conduct our own independent analysis of the issue.

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We still need to have GAO review these studies. We still need to hear from the Congressional Budget Office. We should wait for organizations like the Tax Section of the American Bar Association to finish their report to Congress. We should look carefully into the impact that the implementation of the various legislative proposals before us would have on our bankruptcy courts, on the cost to the taxpayers, on the cost to the estates and ultimately what would be the net return to creditors?

I understand the Chairman's desire to move expeditious. But determination and deliberation need not be mutually exclusive. I think we need to be more careful in this exercise. That has been the lesson of the hearings so far, and the testimony of some of the nation's leading bankruptcy experts and organizations.

Bankruptcy, Mr. Chairman, ain't beanbag. We are talking about the lives, small businesses, homes and livelihoods of millions of Americans. We are talking about our constituents' tax dollars, and we are talking about the integrity of

the bankruptcy system.

It deserves our attention and our time. I urge you, Mr. Chairman, to rethink the current schedule, and work with the minority to craft legislation we can all be proud of.

Thank you, Mr. Chairman.

Mr. **GEKAS.** The Chair rejects any notion that the scheduling and the information was not granted to the minority on a regular, and open, and cooperative basis. This included the scheduling of witnesses and the interviewing of people involved in the process, and the number of witnesses and organizations, which if Mr. Nadler wants me I will repeat for his new knowledge. And the majority on this subcommittee in cooperation with the minority will proceed along the path of presenting a bankruptcy reform bill to the full Judiciary Committee, and thereafter to the House of Representatives.

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Mr. **NADLER.** Mr. Chairman.

Mr. **GEKAS.** We will not have rebuttal now.

Mr. **NADLER.** I think one thing that I must say. I do not have any quarrel, and let me repeat this, I have no quarrel with what the majority or anyone else has done so far. I do not mean to imply in any way that the majority has been less than cooperative with the minority, or that the majority has not supplied information or anything. I did not say that.

My quarrel is not with what has happened so far. My quarrel is with the schedule in the future. That is all I said, and that is all I mean to say.

Mr. **GEKAS.** We will quarrel in the future, then.

Mr. **NADLER.** The schedule, not the substance, I hope.

Mr. **GEKAS.** With that, we invite the first set of witnesses to approach the witness table.

We start with Stephen H. Case, who is of Davis, Polk & Wardwell of New York, former senior advisor to the National Bankruptcy Review Commission.

Before joining Davis, Polk & Wardwell in 1968, Mr. Case attended Columbia College, where he majored in philosophy. Upon graduating in 1964, he continued his studies at the University of Michigan as a Woodrow Wilson Fellow. Thereafter, he obtained his law degree cum laude from Columbia Law School.

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In addition to being an adjunct professor at Georgetown University Law Center, Mr. Case has taught continual legal education course on Chapter 11.

He has published numerous papers on bankruptcy and securities issues among other matters. Mr. Case is a member of the American Law Institute and the National Bankruptcy Conference where he serves as vice chair of the Committee on Legislation.

He is joined at the witness table by John A. Gose, senior partner in the Real Estate Department at Preston, Gates & Ellis, a Seattle law firm. His department focuses on mortgages, deeds of trust, forecloses, workouts, and bankruptcy matters.

Named by former Speaker of the House Thomas Foley, Mr. Gose has the distinction of being the first member appointed to the National Bankruptcy Review Commission.

Mr. Gose has practiced extensively in real property and insolvency law. He was the chairman of the Real Property, Probate, and Trust Section of the American Bar Association, as well as past president of the American College of Real Estate Lawyers.

Mr. Gose has written extensively on the subject of real estate law, and has lectured on various real estate issues, including leases, joint ventures, due-on-sale, and bankruptcy.

After graduating from the University of Virginia, Mr. Gose then received his law degree from the University of Washington where he was made a member of the Order of Coif.

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With them at the witness table is Patricia A. Staiano of Philadelphia, Pennsylvania. Since her appointment in 1996 by Attorney General Janet Reno, Ms. Staiano has served as the United States Trustee for Region 3, which includes the judicial districts in the States of Pennsylvania, New Jersey, and Delaware.

Before her appointment, Ms. Staiano was in private practice in New Jersey where she specialized in bankruptcy and commercial litigation. She previously has clerked for the Honorable William Gindin, Chief Bankruptcy Judge for the District of New Jersey.

Ms. Staiano received her Bachelor of Science degree in finance and marketing from Boston College. She then obtained her law degree from Seton Hall University School of Law.

They are joined by Christopher F. Graham of Thacher, Proffit & Wood of New York, who is here on behalf of the American Bankruptcy Institute.

He has served as chair of his firm's Workout Bankruptcy Department for the past 9 years. In addition, Mr. Graham is chair of the American Bankruptcy Institute's Real Estate Bankruptcy Committee. He also is the director of the American Bankruptcy Institute Medal of Excellence Program, which recognizes outstanding law school graduates for excellence in bankruptcy studies.

Mr. Graham received his Bachelor of Science degree from Georgetown University, and his juris doctor degree from the University of Pennsylvania.

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And the last member of this particular panel is Professor Alan N. Resnick of Hofstra University School of Law in Hempstead, Long Island, who is appearing on behalf of the American Bankruptcy Conference.

Professor Resnick has taught bankruptcy, contracts, and commercial law at Hofstra for 23 years. He is also of counsel to the New York law firm of Fried, Frank, Harris, Schriver & Jacobson.

In addition, he serves as the reporter to the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States.

Professor Resnick writes and lectures extensively on bankruptcy and commercial law issues. For example, he coauthored the Bankruptcy Law Manual, a leading treatise on bankruptcy law.

Professor Resnick is a member of the American Law Institute, the American Bankruptcy Institute, and is a fellow of

the American College of Bankruptcy. He is also a member of the National Bankruptcy Conference on whose behalf he appears today.

Professor Resnick received his Bachelor of Science degree in business administration from Rider College. Thereafter, he obtained his law degree from Georgetown Law Center and his master's degree from Harvard Law School.

With that, we can begin with the testimony. We will begin by asserting that the written testimony as prepared by each of the witnesses will be accepted automatically without objection for the record. And we will ask each witness to summarize that testimony in the oral presentation to be limited to 5 minutes.

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With that, we will begin with Mr. Case.

STATEMENT OF STEPHEN H. CASE, DAVIS, POLK & WARDWELL, NEW YORK, NY, FORMER SENIOR ADVISOR, NATIONAL BANKRUPTCY REVIEW COMMISSION

Mr. **CASE.** Good morning and thank you, Mr. Chairman, and Congressman Nadler.

In every region of the United States, there are hundreds of strong, smaller "silk purse" type businesses that once had a hiccough, used Chapter 11, and made it through successfully. These enterprises help the American economy. They provide jobs and pay taxes. They would not be there if Chapter 11 had not saved them.

However, to paraphrase a saying that we all know, "Even Chapter 11 cannot make a silk purse out of a sow's ear." The small business proposals in H.R. 3150 are well designed to make Chapter 11 more efficient in these "sow's ear" type of cases, where no healthy business can reasonably be expected to emerge from court proceedings.

Let me tell you, please, a war story from around 1990 involving my best friend from grade school. Before I ever knew about it, he hired lawyers and filed his machine shop in Chapter 11. Three years later, he called me. The U.S. Trustee had just gotten a court order appointing a Chapter 7 trustee. This would shut down the shop, put him, his two sons, and four other men out of work. Could I help him, he asked. Sure.

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I went to the shop. I asked him if I could see financial statements. Well, he did not have any. I asked to see the bank statements. He did not have any. He had been collecting from his customers in cash, and paying his men and his bills in cash. I asked to see tax returns. Well, he had been real busy trying to save the business, and he had not filed them for 2 years.

Then a Chapter 7 trustee arrived. He asked was my friend current on paying the taxes withheld from the employees' paychecks to the government. Well, no, he said. He was strapped for cash to stay open, and he had not paid that for several months. Next the trustee asked him about whether the fire insurance and the Workers Compensation insurance was current. No, he said that all expired a year ago, and he just had not gotten around to renewing it.

Through the window, I could see the men on the shop. The two boys of my friend in their early twenties were busy working with their hands about the machinery, and I thought about no Workers Comp insurance.

And I asked the Chapter 7 trustee to step outside with me. I looked down and said would you please padlock this place in a hurry before someone gets hurt. This he promptly did.

Here is a case where Chapter 11 is misused to perpetuate reckless business operations for too long. My friend, the owner, is a great machinist, and there was beautiful work sitting on the locking dock, but he did not have it as a

manager.

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Why did this case last so long? Well, the main reason was that he had enough cash to pay the secured creditor, the bank, as adequate protection on a current basis. So they did not care. All of the other creditors were too small in what they were owed to waste any time working on this case. So it just languished where somebody could have gotten hurt.

The story I just told is not an isolated instance. In my work as an advisor to the Commission, and Mr. Gose can verify this, lawyers and Chapter 7 trustees from all over the country confirmed to the Commission that stories like this and worse repeat themselves too often.

I want to thank you, Mr. Chairman, for putting all of the important proposals of the Commission on Small Business in H.R. 3150. I think it is wise, and it will be good for public confidence in Chapter 11. It has three main provisions.

It defines small business as anything less than $5 million of debt. That is going to capture a lot of Chapter 11 cases, and spruce up the administration.

Second, the duties of the U.S. Trustees are expanded to be sure that these fine hardworking in this part of the Justice Department know that their clear statutory responsibility will be to watch these small business cases more carefully than present law requires.

Third, the bill puts flexible deadlines on small business companies. Get your plan filed in 90 days and get it confirmed in 150 days, unless you can show the Court, and I believe that this is the heartbeat of the proposal, unless you can show the Court that if you are given an extension that you have a reasonable probability of getting a plan confirmed within a reasonable time.

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That, Mr. Chairman, to conclude my remarks is the heart of the proposal. Right now, the focus of too many Chapter 11s is on litigation tactics. Can your lawyers outwit the creditors and keep the case going, while you hope and pray that something happens to save your business.

Under the new proposal, the focus ought to be put right at the beginning at getting any analysis of the viability of the business, and then only the viable businesses will stay in Chapter 11.

Thank you.

[The prepared statement of Mr. Case follows:]

PREPARED STATEMENT OF STEPHEN H. CASE, DAVIS, POLK & WARDWELL, NEW YORK, NY, FORMER SENIOR ADVISOR, NATIONAL BANKRUPTCY REVIEW COMMISSION

Good Morning.

In every region of the United States there are hundreds of strong, smaller "silk-purse" type businesses that once had a hiccough but then made it through chapter 11. These enterprises provide jobs and pay taxes. They wouldn't be there if chapter 11 hadn't saved them.

However, to paraphrase a saying we all know, "Even chapter 11 can't make a silk purse out of a sow's ear". The small-business proposals in H.R. 3150 are designed to make chapter 11 more efficient in these "sow's ear" cases, where no healthy business can emerge from the court proceedings.

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Please consider this example from around 1990, involving a personal friend. Before I ever knew about it, he hired lawyers and filed his machine shop in chapter 11. Three years later he called me. The U.S. trustee had just gotten a court order appointing a chapter 7 trustee. This would put him, his two sons and four others out of work. Could I help him, he asked?.

I went to the shop. I noticed a good deal of beautiful-looking, finished work awaiting shipment on the loading dock. I asked to see the financial statements. He had none. I asked to see the bank statements. He had none. (He told me he had been running the business with cash from his pocket). I asked to see the tax returns. (He had not filed them for at least two years.)

Then, the chapter 7 trustee arrived. He asked: Was my friend current on paying to the government taxes withheld from the employees' pay? Well, no, said my friend, he hadn't paid those bills for several months. Next, the trustee asked about the workers' compensation insurance. Well, said my friend, that had expired a year or so ago without renewal. Through the window, I watched my friend's two sons, each in their early 20's, working with their hands around the machinery. I asked the chapter 7 trustee for a private talk. When we were alone, I said, "Please padlock this place fast, before someone gets hurt." This he promptly did.

Here, chapter 11 was misused to perpetuate reckless business operations. The owner was an outstanding machinist, but, sadly, not a good manager.

Why did this case last so long? Well, the main reason was that the secured creditor, the bank, was being paid on a current basis. The other creditors, all owed small amounts, weren't watching the case.

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The story I just told is not an isolated instance. Lawyers and chapter 7 trustees from all over the country confirmed to the Commission that stories like this—and worse—repeat themselves regularly. Responding to this problem, the Commission adopted a comprehensive proposal for reform.

I want to offer my thanks to Chairman Gekas, who has included all the important parts of the Commission's small-business proposal in H.R. 3150. The most important ones are as follows:

First, a small business is defined as one with less than $5,000,000 of debt. Below this level there isn't enough debt to expect the creditors to watch the cases.

Second, the duties of the U.S. Trustees are expanded to be sure that these fine, hardworking people know it will be their statutory responsibility to watch small-business cases more closely than present law requires.

Third, the bill would put flexible deadlines on small-business debtors to finish chapter 11 promptly or drop out. Yes, the proposed deadlines are short. However, the court can extend them almost indefinitely. All the debtor needs to do is prove that it will, more likely than not, confirm a plan within a reasonable time.

Right now, there is too much focus on whether the litigating skills of the debtor's lawyers can keep a chapter 11 case going (like the machine-shop case of my old friend), irrespective of the actual prospects of the business. The deadline structure and the extension rights are the heartbeat of the proposal. The need to show real, honest-to-goodness business viability will take center stage at the beginning of every small-business case. Under the new law, the focus will move away from where it now is, litigation tactics, to where it belongs, namely, the *business of the debtor and whether the business is viable and can benefit from chapter 11.*

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Thank you.

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

Mr. Gose, it is your turn.

STATEMENT OF JOHN A. GOSE, PRESTON, GATES & ELLIS, LLP, SEATTLE, WA, FORMER COMMISSIONER, NATIONAL BANKRUPTCY REVIEW COMMISSION

Mr. **GOSE.** Mr. Chairman, and Congressman Nadler, thank you for the opportunity to testify before you. I would like to testify on single asset real estate. I must say that after devoting 2 years as a member of the National Bankruptcy Review Commission, I still have a vested interest in this whole project.

I would like to point out that under the prior Bankruptcy Act, before 1978 there was a distinct chapter that dealt with real estate as a separate bankruptcy reorganization. This changed in the 1978 Bankruptcy Code. In fact, the 1978 Code created the Chapter 11 as a one size fits all in reorganizations.

In 15 years since then, we have gone through some real volatile real estate markets up and down. And Congress once again recognized in 1994 the weak aspect of real estate, and created a separate category, single asset real estate. But they limited that to projects having aggregate non-contingent liquidated secure debts of not more than $4 million.

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The testimony before the National Bankruptcy Review Commission is replete with not only justification for the single asset real estate category, but reasons why the category should be more clearly defined and expanded.

The Commission adopted four recommendations that we forwarded to Congress, the chief justice, and the president. These are not aimed at either the debtor or the creditor. They are aimed at rather to make the system work more efficiently and more fairly, separating the dead on arrival immediately, and giving those who have a chance a chance to survive.

The first recommendation, and I want to stress these recommendations, is removal of the $4 million cap. I have been practicing real estate law for too long, I think, for over 40 years. And there is no correlation between the size of a project and the complexity. There is absolutely no correlation.

Single asset real estate projects do not go by size. The $4 million cap, I understand, was a political compromise. There is no matter to have $4 million. Single asset real estate ought to be treated as such.

Secondly, we move to narrow the definition of single asset real estate, so the creditors could not force a conglomerate to put one piece of property in single asset real estate. We narrow the definition, so there is only a single piece of property, and it is not part of a conglomerate.

The third recommendation we made is to have new value be real new value. If the debtor is going to contribute new value, we recommended 80 percent, and your bill H.R. 3150 is 75 percent. Either are fair. We want the debtor to contribute real new value, 25 percent of the actual value of the property.

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And then we did a fourth recommendation, really three housekeeping chores. Make it clear that payments, and we require payments, can be made. And provide that interest would be at a contract rate rather than the current fair market value that the statute provides. The current fair market value does not give any guidelines to either the creditor or the debtor. It allows each judge to set whatever he or she may think of as fair market value. It leads to litigation and delay.

Finally, we say that the payments must be commenced on a real time line, 90 days after the petition date, or 30 days

after the Court determines that the debtor is subject to Section 362(d)(3).

These recommendations are all made with the idea of making this more efficient and more fair to both parties, and being able to identify the dead on arrival, and get them out of the system into liquidation, and have some hope for the rest of them that will be sustained and reorganized.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Gose follows:]

PREPARED STATEMENT OF JOHN A. GOSE, PRESTON, GATES & ELLIS, LLP, SEATTLE, WA, FORMER COMMISSIONER, NATIONAL BANKRUPTCY REVIEW COMMISSION
SUMMARY

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1. *Removal of the Four Million Dollar Cap.*

Section 251 of H.R. 3150 addresses this problem by removing the four million dollar cap on the definition of Single Asset Real Estate and narrowing the definition of Single Asset Real Estate to include real estate investors and to exclude debtors who use real estate for an active business.

The key consequence of removing the debt limit is to require large single-asset debtors to establish cause before being excused from the 90-day plan-or-payment deadline. That isn't too much to ask in light of the fact that the debtor has been given a sweeping injunction against its creditors without making the showing any other party seeking an injunction would have to make.

2. *Narrowing the Definition of Single Asset Real Estate*

A basic idea embedded in the Proposal is that SARE not include members of a consolidated group of debtors operating a substantial non-realty business in the real estate.

3. *Require substantial equity contribution in order to confirm a lien-stripping plan using the New Value Exception.*

The principal problem with the new-value exception is that its elements are not precisely defined and this imprecision leads to a diverse interpretation by the courts. Lack of certainty leads to litigation and delay. By setting forth a specific test—the new value contribution must equal 25% of the value of the property retained—the bill would reduce litigation, would reduce the likelihood of a second bankruptcy filing, and would increase the reorganized debtor's ability to pay for proper maintenance.

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4. *Change the requirements of section 362(d!(3! in three particulars.* [Sec. 253 of H.R. 3150]

(a) Make it clear that the payments required by section 362(d)(3) may be made from the rents generated from the property.

(b) Provide that the interest rate with respect to which payments are calculated shall be at the nondefault contract rate thus eliminating another litigation issue.

(c) Eliminates a trap for the unwary debtor by providing that the debtor need not file a plan, commence payments, or seek an extension of time until 30 days after the court has determined that the debtor is subject to the single-asset real estate provisions.

STATEMENT

Chapter 11 can work quite well when it deals with a viable business that has a survival chance. However, the testimony before the commission was replete with instance of its misuse. Nowhere was this more evident than in real estate projects. Real Estate projects were treated as unique entities in the Old Bankruptcy Act. However the 1978 code lumped them in with all other business entities.

A significant number of Chapter 11 cases involves a partnership or corporation whose sole significant asset is an office building, apartment complex, warehouse, or similar real property. In the typical case, the sole significant creditor is the mortgage holder. When the rental value of the property declines, or the debtor suffers an increase in vacancies, the debtor is no longer to pay debt service. The mortgage goes into default, the debtor and the lender fail to agree upon an out- of-court workout, and the debtor files Chapter 11 to stave off foreclosure.

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Two concerns are voiced most frequently by those who contend that abuse is rampant and must be stamped out. First, the automatic stay enables the debtor to prevent foreclosure for an extended period of time without filing a plan or making postpetition payments. This gives the debtor substantial leverage over the secured lender by imposing the principal costs of delay on that creditor. Second, Single Asset Real Estate (SARE) debtors sometimes attempt to use the provisions of Chapter 11 to keep overencumbered property without either paying the mortgage in full or obtaining the assent of a majority of creditors. These concerns are heightened because SARE cases rarely fulfill few of the recognized goals of Chapter 11. Reorganization is not generally necessary to preserve jobs and going-concern value in SARE cases. Whether the debtor keeps the real property or the secured creditor takes it back, the property will be operated in the same manner, creating the same jobs and economic activity.

Fifteen years of experience with the 1978 code demonstrated the wisdom of having special rules for single asset real estate.

The 1994 Bankruptcy Reform Act recognized this and addressed the concern that SARE debtors enjoy the benefit of the automatic stay for too long. In 1994, Congress enacted section 362(d)(3), which entitles secured creditors relief from stay, unless within 90 days after the order for relief the SARE debtor: (1) files a confirmable plan, (2) commences post petition mortgage payments, or (3) obtains an extension of the 90-day plan-or-payment deadline.

The effect of section 362(d)(3) is limited, however, by the fact that it does not apply to cases in which the secured debt exceeds $4 million provided for relief from the stay for single asset real estate (SARE).

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The Commission addressed the problems of Single Asset Real Estate and made four recommendations that are included in H.R. 3150 and I would like to thank Chairman Gekas and the other co-sponsors of H.R. 3150 for including the commission's proposals.

The four recommendations are

1. Removal of the Four Million Dollar Cap.

Section 251 of H.R. 3150 addresses this problem by removing the four million dollar cap on the definition of Single Asset Real Estate and narrowing the definition of Single Asset Real Estate to include real estate investors and to exclude debtors who use real estate for an active business.

The four million-dollar cap has no basis in logic. In my forty odd years as a real estate practitioner, I have dealt with many real estate projects. There is no necessary correlation between the monetary value of the project and its complexity or chance of survival.

The key consequence of removing the debt limit is to require large single-asset debtors to establish cause before being excused from the 90-day plan-or-payment deadline. That isn't too much to ask in light of the fact that the debtor has been given a sweeping injunction against its creditors without making the showing any other party seeking an injunction would have to make.

2. Narrowing the Definition of Single Asset Real Estate

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A basic idea embedded in the Proposal is that SARE not include members of a consolidated group of debtors operating a substantial non-realty business in the real estate.

The present definition contains several ambiguities. The phrase "which generates substantially all of the gross income of a debtor" has led at least one court to question whether the definition includes raw land. It is the intention of this Proposal that the SARE definition includes raw land. It is also unclear wither the $4 million debt limit refers to the face amount of the secured claim or to the lesser of he face amount or the value of the collateral. Eliminating the debt limit will moot this question.

3. Require substantial equity contribution in order to confirm a lien-stripping plan using the New Value Exception.

The principal problem with the new-value exception is that its elements are not precisely defined and this imprecision leads to a diverse interpretation by the courts. Lack of certainty leads to litigation and delay. By setting forth a specific test—the new value contribution must equal 25% of the value of the property retained—the bill would reduce litigation, would reduce the likelihood of a second bankruptcy filing, and would increase the reorganized debtor's ability to pay for proper maintenance.

4. Change the requirements of section 362(d)(3) in three particulars. [Sec. 253 of H.R. 3150]

(a) Make it clear that the payments required by section 362(d)(3) may be made from the rents generated from the property.

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(b) Provide that the interest rate with respect to which payments are calculated shall be at the nondefault contract rate thus eliminating another litigation issue.

(c) Eliminates a trap for the unwary debtor by providing that the debtor need not file a plan, commence payments, or seek an extension of time until 30 days after the court has determined that the debtor is subject to the single-asset real estate provisions.

Mr. **GEKAS.** We thank the gentleman. And we turn to Ms. Staiano.

STATEMENT OF PATRICIA A. STAIANO, U.S. TRUSTEE, REGION 3, PHILADELPHIA, PA

Ms. **STAIANO.** Thank you, Mr. Chairman, Congressman Nadler, and members of the subcommittee.

I am pleased to have the opportunity to appear before the subcommittee today to discuss the role of the United States Trustees in Chapter 11 with specific regard to the proposals contained in H.R. 3150.

I am the United States Trustee for Region 3, which covers the States of Pennsylvania, New Jersey, and Delaware. Region 3 has the largest Chapter 11 filings in the country. It is also the sixth largest region in terms of overall filings.

The mix of cases we see is very diverse. We cover large metropolitan areas like Philadelphia and Newark, and smaller communities like Harrisburg and Trenton.

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I also serve as Chair of the Chapter 11 Subcommittee of United States Trustees, which assists the Director in formulating policies for Chapter 11 case administration.

Those of us involved in the bankruptcy system on a daily basis have seen much change over the past decade. It has been for the better. Shortly after the completion of its nationwide expansion, the United States Trustee Program adopted a number of policies and practices that we now see codified in H.R. 3150. We applaud this move. We know these practices work.

Recent data confirm that a substantial percentage of Chapter 11 cases result in confirmation, and that Chapter 11 cases of all types are now moving through the system more quickly.

Since 1989, between 25 percent and 30 percent of the Chapter 11 cases filed each year have resulted in a confirmed plan of reorganization. The overall confirmation rate for cases filed between 1979 and 1986 was only 17 percent.

Over 60 percent of Chapter 11 cases are now disposed of by confirmation, conversion, or dismissal within 1 year of filing, and nearly 90 percent are disposed of within 2 years of the filing.

The United States Trustees monitor Chapter 11 cases, and promptly move to convert or dismiss them when appropriate. We have also worked to prevent unnecessary delay among the viable cases that move toward confirmation.

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Chapter 11 is a major focus of our work. In Chapter 11, debtors are allowed to remain in possession of their estate as they attempt to restructure the business and to formulate a plan that can get confirmed. There is no independent trustee unless the Court finds cause to have one appointed to displace management. We are involved in every case both large and small, but to differing degrees depending on what the circumstances warrant.

Some of our duties must be performed in every case, like conducting the meeting of creditors and seeking to appoint a creditors committee. Other duties are framed in discretionary terms, like monitoring cases to prevent undue delay. This allows us to target our resources on those cases and issues that are most in need of attention and prompt action.

We strive to meet with all of the Chapter 11 debtors shortly after a case is flied to assess their circumstances, and to apprise them of what is going to occur in Chapter 11. We examine every debtor at the Section 341(a) meeting of creditors. We ask to see the debtors' tax returns, and have them produce evidence of insurance.

We require debtors to file monthly operating reports. We review those reports to determine whether the debtor is meeting its post-petition obligations and progressing. We strive to ensure that debtors file timely disclosure statements and plans. As a result of these efforts to scrutinize and to hold the debtors more accountable, cases are being administered faster. That being said, there is still considerable work to do.

H.R. 3150 contains a number of revisions to Chapter 11 that would provide us, the courts, and other parties with clearer tools to expedite the administration of reorganization cases.

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H.R. 3150 establishes more definitive requirements for Chapter 11 debtors to report on their profitability, cash receipts, disbursements, and compliance with post-petition tax responsibilities.

Financial reports are essential in Chapter 11. The law presently requires them to be filed in all operating businesses. While cash basis reports remain important, accrual based accounting reports are a better indicator of a company's financial condition and profitability.

The United States Trustees track debtors to ensure they file reports as required. Our financial analysts review these reports every month to determine whether the debtor is floundering or making progress. We work with debtors to show them how to file reports, and try to make sure that they understand the importance of the reports.

H.R. 3150 clarifies other duties of the Chapter 11 debtor that will help in our oversight. At present, there is little in the Bankruptcy Code that tells a Chapter 11 debtor what it has to do, short of filing some periodic reports, and a disclosure statement and plan.

The bill would require the debtor to file certain financial records with its petition, to attend the first meeting of creditors, the initial debtor interview and other meetings. More importantly, it tells the debtor to maintain insurance and to comply with its post-filing tax requirements. It also requires the debtor to permit the United States Trustee to inspect the premises, books, and records.

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H.R. 3150 clarifies the grounds for conversion or dismissal of a Chapter 11 case. This would apply to all Chapter 11 cases regardless of size.

By codifying these fundamental requirements, H.R. 3150 sends a strong message that the debtor must attend these matters to remain under the protection of Chapter 11.

H.R. 3150 shortens the time for filing a plan and for confirming a plan in a small business case. These time frames are new, so we have no experience in dealing with them. But from our perspective, they appear to be both feasible and reasonable.

In short, one of the goals of H.R. 3150 is to see to it that Chapter 11 cases are moved along in a responsible, efficient, and expeditious manner. The provisions of H.R. 3150 will assist the United States Trustees and other parties in interest in achieving this goal.

Thank you.

[The prepared statement of Ms. Staiano follows:]

PREPARED STATEMENT OF PATRICIA A. STAIANO, U.S. TRUSTEE, REGION 3, PHILADELPHIA, PA

Mr. Chairman, Congressman Nadler and members of the Subcommittee. I am pleased to have the opportunity to appear before the Subcommittee today to discuss the role of the United States Trustees in Chapter 11 with specific regard the proposals contained in H.R. 3150.

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My name is Patricia A. Staiano. I am the United States Trustee for Region 3 which covers the states of Pennsylvania, New Jersey and Delaware. Region 3 has the largest chapter 11 filings in the country; it also is the sixth largest region in terms of overall filings. The mix of cases we see is very diverse. We cover large metropolitan areas like Philadelphia and Newark and smaller communities like Harrisburg and Trenton. I also serve as the Chair of the Chapter 11 Subcommittee of United States Trustee, which assists the Director in formulating policies for chapter 11 case administration.

Those of us involved in the bankruptcy system on a daily basis have seen much change over the past decade. It has been for the better. Shortly after the completion of its nationwide expansion, the United States Trustee Program adopted a number of policies and practices that we now see codified in H.R. 3150. We applaud this move. We know these practices work. Recent data confirm that a substantial percentage of chapter 11 cases result in confirmation, and that chapter 11 cases of all types are now moving through the system quickly.

Since 1989 between 25% and 30% of the chapter 11 cases filed each year have resulted in a confirmed plan of reorganization. The overall confirmation rate for cases filed between 1979 and 1986 was only 17%.

Over 60% of chapter 11 cases are now disposed of by confirmation, conversion or dismissal within one year of filing and nearly 90% are disposed of within two years. Chapter 11 cases are not languishing under present law, and the United States Trustees have played a vital role in helping move these cases along. The attached charts show the disposition rates of cases today. We have brought a sense of urgency to today's cases by identifying cases that have no chance of success and promptly moving to convert or dismiss them. We have also worked to prevent unnecessary delay among the viable cases that move toward confirmation.

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Chapter 11 is a major focus of our work. In chapter 11, debtors are allowed to remain in possession of their estate as they attempt to restructure the business and to formulate a plan that can get confirmed. There is no independent trustee unless the court finds cause to have one appointed to displace management. We are involved in every case, both large and small, but to differing degrees depending on what the circumstances warrant.

Some of our duties must be performed in every case, like conducting the meeting of creditors and seeking to appoint a creditors committee. Other duties are framed in discretionary terms, like monitoring cases to prevent undue delay. This allows us to target our resources on those cases and issues that are most in need of attention and prompt action.

We strive to meet with all chapter 11 debtors shortly after a case is filed to assess their circumstances and to apprize them of what is going to be expected of them in chapter 11. We examine every debtor at the section 341(a) meeting of creditors; we ask to see debtors' tax returns and have them produce evidence of insurance. We require debtors to file monthly operating reports. We review those reports to determine whether the debtor is meeting its post-petition obligations and progressing. We ensure the debtor files timely disclosure statement and plans. As a result of these efforts to scrutinize and to hold the debtors more accountable, cases are being administered faster. That being said, there is still considerable work to do.

H.R. 3150 contains a number of revisions to chapter 11 that would provide us, the courts, and other parties with clearer tools to expedite the administration of reorganization cases. Most of those revisions were contained in the Report of the National Bankruptcy Review Commission. As I indicated earlier, most of these proposals codify the best practices and policies of the United States Trustees.

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1. H.R. 3150 establishes more definitive requirements for chapter 11 debtors to report on their profitability, cash receipts and disbursements and compliance with post-petition tax responsibilities. Financial reports are essential in chapter 11. The law presently requires them to be filed in all operating businesses. *See* 11 U.S.C. 1106(a)(1) which incorporates the duty to file periodic reports and summaries contained in 11 U.S.C. 704(8). This provision codifies what we are presently doing in that it implicitly recognizes the value of accrual based accounting along with other reports. While cash-basis reports remain important, accrual based accounting reports are a better indicator of a company's financial condition and profitability. Recognition of this method of reporting will ensure greater consistency of its use among the judicial districts.

The United States Trustees track debtors to ensure they file reports as required. Our financial analysts, most of whom are Certified Public Accountants, review these reports every month to determine whether the debtor is

floundering or making progress. Many business debtors end up in bankruptcy because they were unable to manage their affairs properly. We see too many debtors who have no knowledge of business accounting and little in the way of business records. They might be great at sales, but they have only scanty records to show for their business affairs. To succeed in business, let alone in chapter 11, we have found that some business practices are fundamental. We work with debtors to show them how to file reports and try to make sure they understand the importance of the reports. The United States Trustees in Dallas and San Francisco have even gone so far as to hold a debtors' school once a month to help debtors file their financial reports. It is strictly voluntary and helps debtors understand the importance of these tools. We are also working on automating these reports in a form that is user friendly.

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2. H.R. 3150 clarifies other duties of the chapter 11 debtor that will be most helpful in our oversight. At present there is very little in the Bankruptcy Code that tells a chapter 11 debtor what it has to do, short of filing some periodic reports, and a disclosure statement and plan. The bill would require the debtor to file certain financial records with its petition, to attend the first meeting of creditors, the initial debtor interview and other meetings. More importantly, it tells the debtor to maintain insurance and to comply with its post-filing tax requirements. It also requires the debtor to permit the United States Trustee to inspect the premises and books.

None of these requirements are brand new to chapter 11—we expect every debtor to comply with them today. For example, it has been our policy since 1992 to conduct initial debtor interviews as resources permit. At the initial debtor interview or certainly no later than by the section 341(a) meeting of creditors, we require the debtor to provide copies of past tax returns, proof of insurance and other relevant materials. We monitor the debtor's ability keep current on all its post-petition obligations. If taxes are not being paid post-petition, for example, it is a strong indicator of administrative insolvency and other problems. A debtor who cannot maintain basic post-petition obligations is often unable to reorganize. It is common ground upon which we base our motions to convert or dismiss cases.

On-site inspections are not used widely today, however, one of our Regions conducts all their initial debtor interviews at the debtor's premises. Other United States Trustees report use of on-site visits on an "ad hoc" basis when they feel it warranted, in instances when we are uncertain about the accuracy of the debtor's statement, the extent of the business activity or assets, or to evaluate the debtor's disclosure statement or plan feasibility. We read the debtor's obligation to furnish information broadly under the Code to include on-site physical access. If a debtor resists an on-site inspection effort today, we go to court and show why the inspection is necessary and reasonable. This proposal will help to clarify our ability to obtain access.

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3. Another provision in H.R. 3150 imposes complementary responsibilities on the United States Trustees, mirroring those imposed on the debtor. In our view, these simply restate our present statutory responsibilities with one exception—whenever we deem it appropriate, we are required to conduct an on-site inspection before the section 341 meeting of creditors. The inspection is not mandatory in every case, but would hinge on the United States Trustee's evaluation of whether there is need to conduct one. This poses only a modest change in our responsibility and we welcome it.

4. H.R. 3150 also clarifies the grounds for conversion or dismissal of a chapter 11 case. This would apply to all chapter 11 cases regardless of size. The grounds are more clearly articulated and, together the proposed clarification of debtor duties, provide the debtor with a road map of what they should be doing—maintaining insurance, filing reports, maintaining post- petition tax obligations, and the like—with the associated consequences if they fail. Again, these are problems that we bring to the court's attention all the time in filing motions to dismiss or convert cases today but under the present statute we must show how these problems translate to a "continuing loss" or an "absence of reasonable likelihood of rehabilitation". By codifying these fundamental requirements, H.R. 3150 sends a strong message that the debtor must attend to these matters to remain under the protection of chapter 11.

5. If a party files a motion to dismiss to the case for cause, H.R. 3150 would require the debtor to show by a preponderance of the evidence that it can confirm a plan within a reasonable time and any act or omission has a

reasonable justification and can be cured. This is a beneficial because it requires the debtor to come forward and show that it is more likely than not that it can confirm a plan in a reasonable period of time.

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6. H.R. 3150 also shortens the time for filing a plan and for confirming a plan in a small business case. These time frames are new, so we have no experience in dealing with them, but from our perspective, they appear to be both feasible and reasonable.

Before closing, I would note several areas in H.R. 3150 that could be clarified. First, Section 235 provides that the Judicial Conference is to adopt reporting forms for small business debtors. This appears to conflict with the provisions of Section 442 which confers on the Attorney General the authority to issue reporting forms for chapter 11 debtors in possession. Given our role in reviewing reports, we prefer Section 442 because it is consistent with our role in reviewing reports. Second, there was much discussion before the National Bankruptcy Review Commission about the definition of a small business. We take no position on where the line should be drawn; at the very least, however, the small business provisions should not be read to limit our authority to require similar compliance in big cases (i.e., to attend an initial debtor conference, to file tax returns, to maintain insurance and to file periodic reports). Finally, Section 241 deals with status conferences but it also strikes language in 105(d)(2) that limits the court's authority to enter any order to ensure it is not inconsistent with other provisions of the Code and Federal Rules. We are not aware of the need to expand the court's authority to issue "any order" unconstrained by other provisions of the Code and Rules.

Mr. Chairman, that concludes my remarks. I welcome any questions that you or the other members of the Subcommittee might have.

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Mr. **GEKAS.** Thank you very much.

Mr. Graham.

STATEMENT OF CHRISTOPHER F. GRAHAM, THACHER PROFFIT & WOOD, NEW YORK, NY, REPRESENTING THE AMERICAN BANKRUPTCY INSTITUTE

Mr. **GRAHAM.** Good morning, Mr. Chairman and good morning, Congressmen. Thank you very much for giving me the opportunity to address the subcommittee today on behalf of the American Bankruptcy Institute concerning H.R. 3150.

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As I stated in my statement, Mr. Chairman, the American Bankruptcy Institute is a neutral nonpartisan organization. The positions that are espoused in my statement are essentially housekeeping and neutral criticisms of the bill that could possibly improve certain aspects of the bill. However, we do not take a position on aspects of the bill.

To the extent that I take a position today, it is my own personal position, and it is not the position of the American Bankruptcy Institute.

That said, most of my comments today will be addressed to the single asset real estate provisions of the proposed bill, since I am the chairman of the ABI's real estate committee, and most familiar with real estate bankruptcy matters, having been involved in hundreds of real estate bankruptcies over the last 20 years in the United States.

However, I do have two observations with respect to the small business debtor provisions of the bill. First, it is very clear from the small businesses debtor provisions that the Office of the United States Trustee, the duties of the United States Trustee, are going to be expanded.

I noted in my statement that the Congress certainly should understand that if the Office of the United States Trustee is going to take on these additional obligations, that will obviously require additional staffing, I believe.

The second point that I would make is with respect to the serial filing provision. I know that as a practitioner that even when there are provisions of the Code that say that an automatic stay would not apply to allow a creditor to take some action against a debtor, it is cautionary, I always caution my clients that it is always a good idea to go in and get permission from the Bankruptcy Court anyway. Because there are tremendous penalties for violating the automatic stay.

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So I made a recommendation in my statement that perhaps there could be a good faith exception with respect to actions taken against serial filers.

That said, I would like to move to the real estate provisions. Essentially, as Mr. Gose pointed out, single asset real estate companies were first recognized in the 1994 amendments. In my experience, hundreds of real estate bankruptcy cases, in almost all of those cases, the commercial property or multi-family apartment buildings involved are owned by single asset real estate companies. Generally, these are not operating companies. These are companies that are limited partnerships that own the real estate, which is the subject of the bankruptcy.

Essentially, what the disputes are in these bankruptcies are not so much a dispute over how the property will be sold or what will happen on the property. I think that most of these cases are fights over ownership of the property. And essentially, there are very few changes that actually occur to the property.

But what you have is a negotiation that occurs or a litigation that occurs between the mortgage lender and the real estate developer as to who is going to own the property. Most of these cases result in either a consensual plan, sale of the property, or litigation.

The new bill contains three issues that deal with single asset real estate companies. The first is the removal of the $4 million cap. I agree with the statement by Mr. Gose that the $4 million cap really does not have much applicability in the real world. In my experience, there are very few cases that fit within the $4 million cap. Most single asset real estate companies have more than $4 million in secured debt. So I do not think that the $4 million cap is very fruitful.

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I also would point out that since we only give major companies like Texaco and Dow Corning 120 days to file their

plan, expecting single asset real estate companies, regardless of their size, to file a plan or prove to the court that they can come up with a plan within 90 days, I do not believe is unreasonable from a congressional point of view. So I support that provision.

With respect to the codification of the new value section in the new bill, this is a very controversial topic that has been hotly litigated. And I did not include it in my statement, but with the Chairman's permission, I would like to add to my statement a copy of a Law Review article from the ABI called New Value and the Commission, How Bizarre by Robert N. Zinman in the last issue of the ABI Law Review.

Mr. **GEKAS.** Without objection, it will be so admitted.

Mr. **GRAHAM.** Thank you, Mr. Chairman.

Very briefly to wrap up with my extra 30 seconds here, I would just say, Mr. Chairman, that I believe that the codification of the new value section in the bill tips the scales in the favor of the debtors.

With respect to the interest rate provisions, I have only one housekeeping point. I agree with Mr. Gose. I think that the point about a fair market rate being replaced by contract rate, that is a very good change. Because a fair market rate is subject to litigation.

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With respect to delaying the payment of interest until such time as the single asset real estate status is determined, that is going to cause litigation by debtors aimed at delaying the date when interest starts.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Graham follows:]

PREPARED STATEMENT OF CHRISTOPHER F. GRAHAM, THACHER PROFFIT & WOOD, NEW YORK, NY, REPRESENTING THE AMERICAN BANKRUPTCY INSTITUTE

SUMMARY

Small Business Debtor

The Bankruptcy Reform Act of 1994 introduced the concept of a "small business debtor" to Chapter 11 of the Bankruptcy Code. The amendments proposed by H.R. 3150 go even further in streamlining the Chapter 11 case of a small business debtor which elects such treatment. More debtors will be eligible for treatment as a small business because the indebtedness cap will be raised from $2,000,000 to $5,000,000. Additionally, the disclosure statement and solicitation process will be further streamlined by, inter alia, not requiring a disclosure statement in all circumstances. However, to keep the process balanced and address the needs of creditors, the amendments call for increased reporting requirements, a longer solicitation period and strict rules prohibiting serial filings. An expansion of the role of the Office of the United States Trustee to increase its monitoring and oversight of debtors and their activities is proposed.

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Single Asset Real Estate Debtor

The Bankruptcy Reform Act of 1994 incorporated the concept of "single asset real estate" ("SARE") cases into the Bankruptcy Code. The major changes proposed by H.R. 3150 are to eliminate the $4,000,000 ceiling on SARE cases and codify the New Value Exception to the Absolute Priority Rule—a hotly debated issue over the past decade. Additionally, the bill proposes changes to the payment of post-petition interest by a SARE debtor. Practically speaking,

the amendments will result in a delay in the commencement of such payments. The bill proposes that interest be paid at the contract rate negotiated by the parties prior to the bankruptcy.

STATEMENT

Mr. Chairman and members of the Subcommittee, my name is Christopher F. Graham. I serve as Chairman of the Real Estate Committee of the American Bankruptcy Institute ("ABI") as well as Director of the ABI's Medal of Excellence Program for our nation's law schools. The ABI's 6,000 members, with backgrounds in law, accounting, academia and lending, form the nation's largest multi-disciplinary organization dedicated to education and research on bankruptcy issues.

The ABI is a non-profit and non-partisan organization. Therefore, even though members of the ABI regularly appear before Congressional Committees, the ABI does not take any advocacy position on pending legislation. To the extent that I take a personal position before you today rather than an official ABI position, it is based on my experience as a bankruptcy and creditors' rights practitioner and as a member of the firm of Thacher Proffitt & Wood in New York.

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The ABI commends Representative Gekas for conducting hearings on single asset real estate and small business cases as well as the Subcommittee for its continued interest in addressing problems, whether real or perceived, with the bankruptcy laws. The ABI is committed to assisting all of you in these endeavors.

BACKGROUND

Small Business Debtor

The Bankruptcy Reform Act of 1994 introduced the concept of a "small business debtor" to Chapter 11 of the Bankruptcy Code. Those amendments were designed to streamline the Chapter 11 proceedings of a qualifying debtor which elects such treatment within 60 days of the order for relief and reduce the administrative expenses incurred during such Chapter 11 proceedings, which expenses are often a true burden on small debtors. The amendments reduced the exclusive period during which only the debtor may file a plan of reorganization, relaxed the stringent requirements for disclosure statements and solicitation of acceptances for a plan of reorganization and did away with the automatic appointment of a creditors' committee.

The amendments proposed by H.R.3150 go even further in streamlining the Chapter 11 case of a small business debtor. More debtors will be eligible for treatment as a small business because the indebtedness cap will be raised from $2,000,000 to $5,000,000. Additionally, the disclosure statement and solicitation process will be further streamlined by, *inter alia*, not requiring a disclosure statement in all circumstances. The proposed bill also mandates the creation of uniform forms of disclosure statements and plans of reorganization. However, to keep the process balanced and address the needs of creditors, the amendments call for increased reporting requirements, a longer solicitation period and strict rules prohibiting serial filings. The role of the Office of the United States Trustee also becomes more prominent.

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Single Asset Real Estate Debtor

The Bankruptcy Reform Act of 1994 also incorporated the concept of "single asset real estate" ("SARE") cases into the Bankruptcy Code. SARE bankruptcy filings increased in the late 1980s and early 1990s as a result of rising interest rates, a surplus of commercial space and the loss of tenants—often through relocation or bankruptcy. The amendments to the Bankruptcy Code regarding SARE cases were designed to address potential abuses of the Bankruptcy Code by certain debtors. Typically, these debtors had one significant asset composed of improved real estate which was in foreclosure, one or two secured creditors, few unsecured creditors with relatively small claims, few or no employees and conducted no operations other than the maintenance and operation of the real estate asset. Frustrated mortgagees

would find their enforcement actions stayed on the eve of foreclosure, usually after protracted and expensive litigation. Thereafter, the mortgagees were required to wait even longer while debtors attempted to sort out their financial difficulties, often at the expense of the mortgagees.

The major change proposed by H.R.3150 is to eliminate the $4,000,000 ceiling on SARE cases and codify the New Value Exception to the Absolute Priority Rule—a hotly debated issue over the past decade. Additionally, the bill clarifies certain aspects of the Bankruptcy Code's SARE provisions. These clarifications are necessary because certain cases have tested the SARE provisions and found them to be open to differing interpretations.

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Small Business Debtor

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The small business bankruptcy provisions of the proposed bill—sections 321–343—are designed to create a "faster track" for debtors whose liabilities do not exceed $5,000,000 including SARE debtors with debts of $5,000,000 or less. The provisions of the new bill modify certain sections of Chapter 11 and create additional duties of the debtor and the United States Trustee. Most of the changes shorten various time periods by which debtors are required to perform certain acts. The appointment of a creditors' committee remains optional with the bankruptcy court in order to reduce administrative costs and expedite the Chapter 11 process.

Section 231. ("Definitions.")

Section 101(51C) of the Bankruptcy Code currently defines a "small business" as one in which the aggregate noncontingent liquidated secured and unsecured debts do not exceed $2,000,000. Section 231 of H.R. 3150 would expand the definition of "small business debtor" in three ways. First, section 231 clarifies that a small business debtor includes its affiliates. Second, section 231 increases the amount of debt from $2,000,000 to $5,000,000 that may be carried by a small business debtor. Finally, section 231 expressly includes SARE debtors, except to the extent that such a SARE debtor, together with its affiliates has aggregate debt greater than $5,000,000.

THE IMPACT OF THE CHANGE. Many more businesses would be eligible for the small business provisions of the Bankruptcy Code.

Section 232. ("Flexible Rules for Disclosure Statement and Plan.")

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Section 1125(f) of the Bankruptcy Code currently provides liberal rules for disclosure and solicitation of acceptances of a plan of reorganization which expedites the process by which a small business debtor may reorganize. Section 232 proposes to add substantially more flexibility to the requirements of section 1125(f). Specifically, section 232 would grant the court the flexibility to determine whether a disclosure statement provides adequate information by weighing the complexity of the case and a creditor's need for such information against the cost associated with providing such information. Additionally, section 232 would allow a court to combine the disclosure statement process with plan confirmation if the plan provides information that the court deems adequate for creditors to determine how their claims will be treated. Section 232 likewise would attempt to expedite the disclosure and confirmation process for small business debtors by allowing a court to conditionally approve a disclosure statement.

Section 233. ("Standard Form Disclosure Statements and Plans.")

To promote uniformity in Chapter 11 proceedings of small business debtors, Section 233 would require the Advisory Committee on Bankruptcy Rules of the Judicial Conference ("Advisory Committee") to develop and adopt a standard form of disclosure statement and plan.

Section 234. ("Uniform National Reporting Requirements.")

To balance the streamlined nature of a small business debtors' Chapter 11 proceeding with the creditors' need for information, section 234 would create new Bankruptcy Code section 308 which would require a small business debtor to file periodic financial and other reports not presently required.

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Section 235. ("Uniform Reporting Rules and Forms.")

Section 235 would require the Advisory Committee to propose amended federal rules of bankruptcy procedure and official forms consistent with new Bankruptcy Code section 308.

Section 236. ("Duties of Debtor in Small Business Cases.")

Section 236 would create a new Bankruptcy Code section 1115 which would create additional duties for a debtor to provide more timely information to the courts, its creditors and the Office of the United States Trustee.

THE IMPACT OF THE CHANGE. Section 236 of H.R. 3150 would impose quicker reporting requirements on debtors absent "extraordinary and compelling circumstances" as determined by the bankruptcy judge. The bankruptcy judge retains considerable discretion.

Section 237. ("Plan Filing and Confirmation Deadlines.")

Section 237 of H.R. 3150 would amend section 1121(e) of the Bankruptcy Code to shorten by 30 days the debtor's exclusive period within which only a debtor may propose a plan of reorganization. Furthermore, the threshold showing which a small business debtor would need to establish to extend such exclusive period is considerably higher and would essentially require a hearing and a showing by the debtor that it is "more likely than not that the court will confirm a plan in a reasonable amount of time."

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THE IMPACT OF THE CHANGE. Like section 236 of H.R. 3150, this section although continuing to give great discretion to the bankruptcy judge, indicates Congressional intent that a small business debtor cases should proceed to confirmation more quickly than larger cases. Failing this, the creditors will have greater rights to file their own plan of reorganization or liquidation in a small business Chapter 11 case.

Section 238. ("Plan Confirmation Deadline.")

Section 238 would mandate that a plan be confirmed within 150 days after the order for relief is entered. The 150 day deadline could only be extended by the Bankruptcy Judge if the debtor established that it is "more likely than not that the court will confirm a plan within a reasonable time period."

THE IMPACT OF THE CHANGE. Like sections 236 and 237, section 238 of H.R. 3150 is designed to expedite small business Chapter 11 cases.

Section 239. ("Prohibition Against Extension of Time.")

Section 239 would modify section 105(d) of the Bankruptcy Code by incorporating a higher standard for extension of time in a small business Chapter 11 case.

THE IMPACT OF THE CHANGE. Section 239 would not effect the level of equitable discretion accorded a

bankruptcy judge, it is merely instructive as to the level of proof which must be maintained by a small business debtor in order to avail itself of the equitable powers of the Bankruptcy Court to extend time deadlines. Again, this indicates Congressional intent that such small business cases should move more quickly than has occurred in the past.

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Section 240. ("Duties of the United States Trustee and Bankruptcy Administrator.")

Section 240 would greatly expand the responsibilities of the Office of the United States Trustee in small business bankruptcy cases.

THE IMPACT OF THE CHANGE. The United States Trustee would become more involved in the activities of debtors. The United States Trustee would be responsible for additional tasks and monitoring the activities of the small business debtor to ascertain whether a plan is confirmable. In order to ensure effective performance of such additional duties, the Office of the United States Trustee may need to be expanded.

Section 241. ("Scheduling Conferences.")

Currently, the Bankruptcy Code allows for optional status conferences regarding any case or proceeding. Section 241 would make such status conferences mandatory to the extent they are "necessary to further the expeditious and economical resolution of the case." The authority of the Bankruptcy Court to issue orders at such conferences appears to be expanded by deletion of the limiting language.

Section 242. ("Serial Filer Provisions.")

Section 242 would create a broad exception to the automatic stay under new Bankruptcy Code section 362(i). It would allow all actions described in Bankruptcy Code section 362(a) in a voluntary or collusive involuntary case if any of the following four conditions are met: (1) the debtor is already in a pending small business case when the current petition is filed; (2) the debtor was in a small business case which was dismissed by a final order for any reason within 2 years prior to the entry of the order for relief in the second/current bankruptcy case; (3) the debtor was in a small business case wherein a plan was confirmed within 2 years prior to the entry of the order for relief in the second/current bankruptcy case; or (4) the debtor has succeeded to substantially all of the assets or business of a small business debtor described in (1), (2) or (3) unless the debtor can prove that the current bankruptcy filing is due to circumstances beyond the control of and not foreseeable to the prior debtor when its case was pending, and that it is more likely than not that the court will confirm a feasible, non-liquidating plan within a reasonable time.

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THE IMPACT OF THE CHANGE. While seeming to address the problem of serial filings by small businesses by making the automatic stay inapplicable for bankruptcy filings within 2 years of each other, Section 242 would not, by itself, prevent delays of a creditor's actions by serial filings. Assuming that the applicable provision above is debatable —for example, whether the new debtor succeeded to "substantially all" of the prior debtor's assets—a creditor would be unlikely to take action without first obtaining a comfort order from the Bankruptcy Court. This is because the creditor runs the risk of losing the litigation concerning the proposed new section 362(i)(4) and thus being sanctioned for willfully violating the automatic stay pursuant to Bankruptcy Code Section 362(h).

ALTERNATIVES. One alternative would be to allow for relief from the stay or grant comfort orders on an expedited basis unless the debtor could prove one of the four exceptions listed above. Additionally, another alternative would be to amend Bankruptcy Code section 362(h) to provide that it does not apply to creditors who in good faith believe the automatic stay does not apply because of the application of Bankruptcy Code section 362(i).

Section 243. ("Expanded Grounds for Dismissal or Conversion and Appointment of Trustee.")

Section 243 would clarify and codify existing case law concerning conversion from a Chapter 11 case to a case under Chapter 7 or dismissal of the case pursuant to Bankruptcy Code section 1112(b). Additionally, it would provide for the appointment of a Chapter 11 trustee if cause existed for conversion or dismissal pursuant to Bankruptcy Code section 1112.

Single Asset Real Estate Debtor

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As noted earlier, the major changes proposed by H.R. 3150, with respect to SARE debtor cases, are the elimination of the $4,000,000 ceiling for entities that are SARE debtors as well as the codification of the controversial "New Value Exception" to the "Absolute Priority Rule." Additionally, the start date for post-petition payments to mortgage lenders is extended until the completion of litigation over the issue of whether or not the debtor is, in fact, a SARE debtor. All these issues have been fonts of bankruptcy litigation and the proposed changes would only eliminate litigation over the cap issue. Contested valuation and confirmation hearings in "New Value Exception" matters as well as litigation over the SARE status of debtors would continue.

Section 251. ("Single Asset Real Estate Defined.")

Under current law, in order to qualify as a SARE case, the debtor must have "aggregate noncontingent, liquidated secured debts in an amount no more than $4,000,000." In addition, SARE status is presently limited to debtors whose asset is not residential real property with less than four residential units and whose asset "generates substantially all of the gross income of [the] debtor and on which no substantial business is being conducted by [the] debtor other than operating the real property." Section 251 would eliminate the $4,000,000 cap for a single project or development but exclude a debtor whose property is being used by a "commonly controlled" group of entities, all of which are concurrently debtors in a Chapter 11 case, for a substantial business other than the real estate business. In short, SARE debtors whose affiliates operate a business on the debtors' property are not covered. For example, a single purpose property holding company that leases land to its affiliate which operates a computer factory on that land would not be considered a SARE debtor under the new bill.

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THE IMPACT OF THE CHANGE. The principal change is the elimination of the $4,000,000 cap.

ALTERNATIVES. The cap could be increased instead of being eliminated. Several other pending bills have addressed this issue. H.R. 73, if enacted, would also eliminate the $4,000,000 cap. H.R. 764, if enacted, would raise the $4,000,000 cap to $15,000,000. A $15,000,000 cap would cause many, if not most, real estate developer cases to be excluded from the SARE provisions. H.R. 764 was passed by the House of Representatives on November 12, 1997 and received in the Senate the following day.

Section 252. ("Plan Confirmation.")

Under current law, a plan of reorganization shall be confirmed if: (a) all the classes of creditors that would receive less than their full claim under the plan vote in favor of the plan; or (b) if one such class of creditors votes in favor of the plan and the court finds that the plan does not discriminate unfairly and is "fair and equitable" with respect to the classes that would not receive full payment on their claims under the plan. The latter alternative, colloquially called a "cram down" among bankruptcy practitioners, is a classic tactic employed by SARE debtors.

For example, suppose Dan Developer, Inc., a debtor in possession in a Chapter 11 bankruptcy, owns as its only significant asset a large apartment complex called Black Acre Apartments worth $3,000,000. Additionally, assume that the following claims have been filed against Dan Developer, Inc.: (i) Ace Insurance Corp. claim in the amount of $4,000,000 secured by a first mortgage on Black Acre Apartments and (ii) $100,000 in various general unsecured claims. Because Ace Insurance Corp.'s claim is undersecured, Ace Insurance Corp. has the right to elect to be treated

as having a secured claim in the amount of $4,000,000 or having a secured claim in the amount of $3,000,000 and an unsecured claim in the amount of $1,000,000. 11 U.S.C. 1111(b). Assume that Ace Insurance Corp. elects the latter treatment and has its claim bifurcated.

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Dan Developer, Inc., as a debtor-in-possession, presumably wants to retain control of the Black Acre Apartments. However, under what is commonly referred to as the "Absolute Priority Rule," a junior unsecured claim cannot receive any property or interest in property unless the unsecured claims senior to that claim receive an amount equal to the allowed amount of those senior unsecured claim(s). Therefore, the holder of equity shares in the debtor, cannot retain their equity interests because Dan Developer, Inc. does not have enough assets to pay the senior unsecured claims—Ace Insurance Corp.'s unsecured claim and the general unsecured claims—their full allowed amounts.

There may be an exception, however. Under the former Bankruptcy Act of 1898, the Supreme Court established the "New Value Exception" in *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939). The New Value Exception allows debtors to keep their equity interests, despite the Absolute Priority Rule, if they contribute new value to the debtor. *In re Bonner Mall Partnership*, 2 F.3d 899, 908 (9th Cir. 1993), *cert. granted*, 510 U.S. 1030, *case dismissed as moot*, 513 U.S. 118 (1994). Current case law has established five requirements for the use of the New Value Exception. *Id.* The new value must be: (1) new; (2) in money or money's worth; (3) substantial; (4) necessary; and (5) reasonably equivalent to the interest retained. *Id.* It is worth noting that there is significant controversy over whether the New Value Exception survived the passage of the Bankruptcy Code in 1978 which codified the "Absolute Priority Rule" but not the "New Value Exception." *See generally* 4 Collier on Bankruptcy 1129[4][c] (15th rev. ed. 1998).

In its plan of reorganization, the plan proponent typically classifies the claims. Returning to our hypothetical, Dan Developer, Inc. may classify the unsecured claims separately if a court approves the classification as "reasonable and necessary for administrative convenience." 11 U.S.C. 1122(b). Assuming that the New Value Exception has survived the passage of the Bankruptcy Code, under current law, Dan Developer, Inc. may propose the following treatment of claims in its plan of reorganization: Class One, consisting of administrative expenses such as attorneys fees and United States Trustee fees will be paid in full out of cash; Class Two, consisting of Ace Insurance Corp.'s secured claim, will continue as a secured claim on the property and will be paid according to the existing contractual payment schedule or an agreed upon payment schedule; Class Three, consisting of Ace Insurance Corp.'s unsecured claim, will be paid 10 cents on each dollar of unsecured claim or $10,000; Class Four, consisting of the general unsecured claims, will be paid 10 cents on each dollar of claims or $10,000; and, Class Five, consisting of the equity shareholders, will retain their equity interests in Dan Developer, Inc. and will contribute at least $500,000 in new value. (Note: there is no bright line test that determines the necessary amount of new value).

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Ace Insurance Corp. will likely vote against the plan because it would rather own the property and the upside potential rather than immediately lose $900,000 and have no upside potential. The general unsecured creditors will vote in favor of the plan. After this vote, Dan Developer, Inc. will ask the court to "cram down" the plan pursuant to Bankruptcy Code section 1129(b)(1). This type of plan is generally referred to as a "New Value—Lien Stripping Plan." Courts, to date, have "crammed down" or confirmed such a plan over the objection of secured creditors such as Ace Insurance Corp., Inc. *See generally Matter of 203 N. LaSalle St. Partn.*, 126 F.3d 955 (7th Cir. 1997).

Section 252 of H.R. 3150 would amend Bankruptcy Code section 1129(b) to codify the "New Value Exception" in SARE cases. Under section 252, a New Value-Lien Stripping Plan would be "fair and equitable" as is required by Bankruptcy Code section 1129 if three conditions are satisfied. First, the new value must be contributed on or before the effective date of the plan of reorganization, must be in cash and must be contributed as equity that cannot be converted into or exchanged for debt. Second, the new value must be applied on the effective date towards the reduction of the secured claims to at least a 75% loan to value ratio. Third, the payments and other terms for the remainder of the secured debt must satisfy the then-prevailing local market terms for new loans secured by liens on similar real estate regarding maturity dates, amortization, interest rates, fixed-charge coverages and loan

documentation.

THE IMPACT OF THE CHANGE. There has been considerable controversy over both whether the New Value Exception has survived the passage of the Bankruptcy Code, as well as whether the New Value Exception should be applied to SARE cases, or even any other type of case. While this section would provide clarity in an area that has been the subject of considerable litigation, it could circumvent the "higher and better offer" requirement thereby allowing a debtor to "purchase" its equity at a price lower than a third party might be willing to pay for it, to the detriment of the creditors, particularly to secured creditors. Since the "New Value Exception" is popular with real estate developers, passage of this provision would probably lead to more Chapter 11 filings by SARE companies. Lenders would receive a 25% cushion against further declines in property values. Lenders would gain no economic benefit if property values thereafter increased with all such appreciation being retained by the SARE debtor's owners. This provision would weaken the Absolute Priority Rule thus giving more leverage to SARE debtors in plan negotiations.

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Section 253. ("Payment of Interest.")

Section 362(d) of the Bankruptcy Code currently provides that the Bankruptcy Court shall grant relief from the stay to a creditor whose claim is secured by an interest in the real property of a SARE debtor if the debtor has not filed a feasible reorganization plan within 90 days of the entry of an order for relief, or commenced monthly payments to the secured creditor by such date. Section 253 would loosen the time restrictions within which a debtor must file its plan or commence making monthly payments to creditors secured by the real estate and modify Bankruptcy Code section 362(d) in two ways. First, section 253 specifies that relief from the stay will not be granted until after the later of the 90 day period or 30 days after a determination is made by the court that the debtor qualifies as a SARE debtor. Section 253 clarifies that the monthly payments that the debtor must make to the secured creditor may be made from rents generated from the property. Additionally, section 253 provides that the interest rate used to calculate payments is the then applicable nondefault contract rate, rather than the "current fair market rate" as now specified.

THE IMPACT OF THE CHANGE. This proposed change delays the commencement of monthly payments by a SARE debtor (or lifting of the stay) until 30 days after the Bankruptcy Court decides the issue of whether the debtor is a SARE debtor. Since this issue will be hotly litigated, the 90 days rule will rarely come into play.

ALTERNATIVES. Interest should accrue from the day of the order for relief or the 90th day thereafter to avoid tactical litigation over SARE status merely aimed at delaying the start date for the payment of interest.

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NEW VALUE AND THE COMMISSION: HOW BIZARRE!(see footnote 1)

ROBERT M. ZINMAN(see footnote 2)

It was bizarre. As the Emperor rode in splendor through the city, throngs of cheering subjects admired the Emperor's stature, the Emperor's grace—and the Emperor's clothes. It was common wisdom that the Emperor's dress was always the epitome of sartorial splendor. Then one small child, regardless of common wisdom, ingenuously exclaimed: "But the Emperor is wearing no clothes"' And, as everyone knows, the child was correct.(see footnote 3)

Abiding by the principle that age is a state of mind, I feel like that child when I exclaim through this article that when the Commission,(see footnote 4) in its report,(see footnote 5) advocates a new value exception or corollary to the absolute priority rule,(see footnote 6) it fails to clothe its proposal in meaning. Is the Commission's advocacy of new value an attempt to codify a fully articulated corollary to the absolute priority rule as the drafters appear to believe, or is the proposal simply semantic legerdemain designed to abolish the absolute-priority rule as some critics may believe?

There are at least two diametrically opposed theories as to what constitutes a new value plan, one that bars the

retention of an interest by old equity(see footnote 7) unless the full priority rights of creditors are protected, and the other, developed after the adoption of the Bankruptcy Code, that would allow old equity to retain an interest while creditors claims are wiped out. The key to which theory would predominate under the Commission proposal may be the position of the unsecured creditors after confirmation of the plan of reorganization. If old equity's new value contribution would result in a reorganized enterprise that preserves the priority rights of creditors while enabling old equity to obtain a reasonably equivalent pro rata interest in the enterprise, the proposal would codify a corollary to the absolute priority rule and creditors would have no reason to complain. If, however, the new value contribution would wipe out the interest of existing creditors while leaving the enterprise in the hands of old equity, new value would not be a corollary; it would be an exception to the absolute priority rule having the potential of undermining absolute priority completely.

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Remarkably, the Commission Report does not deal with the position of the creditors post-confirmation, although the Commission Report cites to cases where the new value plan effectively wiped out creditor's interests. Absolute priority has been the millrind, the central support of our corporate reorganization structure for almost a century.(see footnote 8) It should not be eviscerated either by inadvertence or by indirection.(see footnote 9)

Under present law, there is also significant confusion as to what prerequisites to a debtor's new value plan—necessity, reasonable equivalence, and substantiality(see footnote 10)—are still recognized as applicable, and if they are applicable, what each one means. The Commission's proposal allows old equity to "purchase" an interest without any conditions although the proposal seems to assume that the prerequisites are applicable.(see footnote 11) Even if prerequisites were meant to apply, the Commission does not attempt to determine what each means, thus perpetuating the current chaotic situation in which judges seem to be able to read prerequisites in or out of new value virtually at will.

In what may appear an attempt to temper potential opposition of creditors to its proposal, the Commission proposes the elimination of exclusivity upon the submission of a new value plan by the debtor.(see footnote 12) The concept certainly has validity. It is based on the fact that absolute priority would be abridged if old equity, on account of its former equity interest, is given an interest in the debtor while creditors remain unpaid. Where old equity is in control of a debtor with the exclusive right to submit a plan, it is difficult to conclude that the interest old equity assigns to itself is not obtained on account of its prior equity interest. If, however, bidding is opened up to all upon submission of a new value plan, in theory old equity will be on the same footing as anyone proposing to purchase assets or stock of the debtor. Unfortunately, however, the proposal itself does not explain how elimination of exclusivity will work and how it would protect creditors. Among other things, it *does not* disclose how a counter-plan may be proposed by a creditor from a mechanical standpoint; *does* urge that any creditor who manages to submit a counter-plan will not be able to offset its claim against the contribution required in such a plan;(see footnote 13) and *does not* explain how a creditor can be certain its plan, even if it offers more, will be confirmed by the court over the debtor's plan. Thus it is very possible that the elimination of exclusivity offers creditors very little.

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This article will discuss the development and importance of the absolute priority rule and the new value principle prior to the adoption of the Bankruptcy Code. This principle will be compared to its application in post-Code cases with special reference to its function in single asset real estate cases (including a discussion of a proposal by the Small Business Working Group to furnish some protection to single asset creditors that may be injured by the application of the post-Code new value principle). It will then look into the prerequisites to absolute priority to see if they exist and if so, what they mean under current decisions. Finally, the article will review the proposal to lift exclusivity on submission of a new value plan and its effect on creditors.

The article concludes that the Commission's new value proposal produces a situation that is truly bizarre—a proposal whose effect is unknown—and urges that it *not* be adopted by Congress because without further definition, it has the potential of creating more litigation and more inconsistencies in court decisions than we face today. Not only

did the Commission fail to articulate what its proposals actually do, but also, perhaps because of the short time frame allocated to the Commission to complete its report and its broad mandate to deal with the entire Bankruptcy Code, the Commission did not have the opportunity to explore the basic substantive plan confirmation issues that are the foundation for the current confusion in the courts. The article suggests some questions that must be asked in a thorough study of plan confirmation including an articulation of exactly what absolute priority and new value mean, what the purpose of exclusivity is, whether there are any prerequisites to new value plans, and why it would not make sense to have discrete plan confirmation rules for single asset as distinguished from going concern business enterprises.

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Notwithstanding the foregoing objection to the new value proposal, this author wishes to make it clear that objection to one proposal does not constitute an objection to the Commission Report as a whole. The National Bankruptcy Review Commission has performed an enormous service by opening the debate on Bankruptcy Code reform and through its comprehensive report, has furthered the universal goal of the entire insolvency community—to improve the fair and effective administration and adjudication of bankruptcy issues. The Commission Report, entitled "Bankruptcy: The Next Twenty Years," will undoubtedly influence the course of bankruptcy legislation for that period and beyond, in this nation and throughout the world.

I. THE COMMISSION PROPOSAL

It is not entirely clear that the Commission ever voted on the new value proposal contained in the Commission Report.(see footnote 14) In her dissent,(see footnote 15) Commissioner Jones refers to the proposal as "the five-member Commission proposal."(see footnote 16) For the purposes of this discussion it will be assumed that a majority of the Commission adopted Me new value proposal.

The Commission majority proposal on new value is section 2.4.15 of the Commission Report.(see footnote 17) It states:

U.S.C. 1129(b)(2)(B)(ii) should be amended to provide that the court may find a plan to be fair and equitable that provides for members of a junior class of claims or interests to purchase(see footnote 18) new interests in the reorganized debtor.(see footnote 19)

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11 U.S.C. 1121 should be amended to provide that on the request of a party in interest, the court will terminate exclusivity if a debtor moves to confirm a non-consensual plan that provides for the participation of a holder of a junior claim or interest under 1129(b)(2)(B) but does not satisfy the condition set forth in 1129(b)(2)(B)(i).(see footnote 20)

The proposal would thus permit the court to "cram down," (or impose) a plan over the objection of an impaired class or classes under which old equity is to "purchase" an interest in the debtor, and also provide for the termination of exclusivity upon submission of such a new value plan.(see footnote 21)

The Commission justifies its new value proposal as a means to resolve open questions that lead to litigation. The Commission Report states:

Any legal uncertainty regarding the rules of cramdown creates a turbulent environment for negotiating the reorganization of businesses. . . . [L]itigation over ambiguous cramdown rules can foreclose any possibility of reorganizing a family farm or a 'mom-and-pop' store because they cannot afford the extensive litigation that would be required.(see footnote 22) . . . [F]air and clear cramdown rules are necessary to maximize the likelihood that an appropriate opportunity for reorganization is available to the parties.(see footnote 23)

This article agrees fully with the sentiment that it is important to eliminate uncertainty. What is so bizarre is that the Commission Report not only fails to resolve the existing uncertainty concerning the meaning and effect of new value

plans but creates new uncertainties that promise to spawn litigation for many years to come.

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II. QUESTIONS UNANSWERED BY THE COMMISSION REPORT

A. What New Value Principle is the Commission Advocating?

There have been two very different interpretations of the effect of a new value plan, with dramatically different consequences for the rights of creditors. Notwithstanding the fact that the raison d'etre for the survival of a new value principle under the Bankruptcy Code is that Congress intended that pre-Code practice be incorporated into the Code,(see footnote 24) the new value principle as interpreted by courts under the Bankruptcy Code is not the same new value principle articulated under pre-Code law.

1. Absolute Priority

Absolute priority means that junior interests, especially old equity, cannot retain property in the debtor under a reorganization plan that impairs objecting senior interests.(see footnote 25) It has been this principle that has governed rights to the assets of failing enterprises going back at least to 1868 when the Supreme Court determined: "Equity regards the property of a corporation as held in trust for the payment of the debts of the corporation . . . [S]tockholders are not entitled to any share of the capital stock nor to any dividend of the profits until all the debts of the corporation are paid."(see footnote 26)

In more modern times it is said that absolute priority has been incorporated into bankruptcy law by the requirement that a plan be "fair and equitable."(see footnote 27) The courts have held that a glen is not considered to be fair and equitable if it does not afford absolute priority.(see footnote 28)

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150 In *Case*, the Supreme Court resolved the controversy by making it clear that fair and equitable meant "absolute priority." 308 U.S. at 115. If there were any doubt that absolute priority was the law, Justice Douglas appeared to eliminate it in his next decision on this subject. *See Consolidated Rock Prods.* v. *Du Bois*, 312 U.S. 51O, 520 (1941) (maintaining that strict absolute priority was test of fairness and equity of reorganization plan). *See, e.g.,* Arthur H. Dean, *A Review of the Law of Corporate Reorganizations*, 26 **CORNELL L.Q.** 537, 559 n.63 (1941) (suggesting absolute priority rule requires security holders be given new securities with market value equal to full amount of their respective claims); Jerome Frank, *Epithetical Jurisprudence and the Work of the Securities and Exchange Commission in the Administration of Chapter X of the Bankruptcy Act*, 18 N.Y.U. L.Q. **REV.** 317, 339–40 (1941) (noting that informal conclusions as to value were necessary in order to determine propriety of allocation of new securities among respective classes of security holders); DeForest Billyou, *Priority Rights of Security Holders in Bankruptcy Reorganization: New Directions*, 67 Harv. L. Rev. 553, 567–68 (1954) (discussing absolute priority rule of *Boyd*, requiring significant features of investment contract, is that of absolute priority in classical sense).

2. The New Value Principle of Case *v.* Los Angeles Lumber

In 1939, a plan in an equity receivership came before the U.S. Supreme Court in *Case* v. *Los Angeles Lumber Prods. Co.*,(see footnote 29) which had been approved by all classes of creditors but to which one individual creditor objected.(see footnote 30) The objection was based on violation of the principle of absolute priority in that old equity was given an interest (equal to 23% of the assets of the enterprise) in the reorganized corporation while creditors were not paid in full.(see footnote 31) The lower court approved the plan stating that it was important "to retain the old stockholders in the business because of 'their familiarity with the operation' of the business and their 'financial standing and influence in the community'; and because they can provide a 'continuity of management.' "(see footnote 32)

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In what can only be described as a paean to the principle of absolute priority, the Supreme Court reversed the decision below on the ground that the plan was not fair and equitable because old equity was allowed to participate while creditors were unpaid.(see footnote 33) Mr. Justice Douglas, writing for what appears to have been a unanimous court,(see footnote 34) cited a series of Supreme Court decisions affirming the " 'familiar rule' that 'the stockholder's interest in the property is subordinate to the rights of creditors; first of secured and then of unsecured creditors,"(see footnote 35) and that " '[a]ny arrangement . . . by which the subordinate rights and interests of stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation."(see footnote 36) The court went on to describe this as the

'fixed principle' according to which . . . the character of reorganization plans was to be evaluated . . . 'if the value of the road justified the issuance of stock in exchange for old shares, the creditors were entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control. In either event it was a right of property out of which the creditors were entitled to be paid before the stockholders could retain it for any purpose whatever.'(see footnote 37)

Having said this, the Court pointed out that it had previously stated that creditors could be protected "through other arrangements *which distinctly recognize their equitable right to be preferred to stockholders against the full value of all property belonging to the debtor*."(see footnote 38) However, these arrangements are still subject to "the rigors of the 'fixed principle.' "(see footnote 39) For example, the Court noted in *Northern Pac. Ry. Co.* v. *Boyd*,(see footnote 40) even though the stockholder bought new stock in cash, the plan violated absolute priority because the provision was not made for the unsecured creditor.(see footnote 41)

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Justice Douglas then made the oft quoted comments that gave birth to the new value dictum. He stated that where the necessity for funds exists and old equity makes a fresh contribution "and receivers] in return a participation *reasonably equivalent to their contribution*,"(see footnote 42) the creditors cannot object that they are not accorded their "*full right of priority* against the corporate assets."(see footnote 43) The Court then rejected the argument that the promised contribution of expertise by old equity was reasonably equivalent to old equity's participation because it merely reflected "vague hopes or possibilities."(see footnote 44) The plan could not be confirmed.(see footnote 45)

As articulated in *Case*, new value was not an exception, but a natural corollary to the rule of absolute priority.(see footnote 46) It implicated *both* the protection of the rights of creditors *and* the circumstances under which rights may be retained by old equity.(see footnote 47) Old equity could retain an interest reasonably equivalent to its new value contribution only if creditors were accorded "their full right of priority" against the debtor's assets.(see footnote 48) Old equity could not obtain its interest "at the expense of the prior rights of . . . creditors."(see footnote 49) In theory, the enterprise, including its control, remained with the creditors and old equity's interest was limited to the amount of new value contributed in the proportion it bore to the interest of the creditors.(see footnote 50)

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This balance may be easier said than achieved. While much has been made of the existence of a new value exception as the result of *Case*, giving rise to the implication that it was in fact already on the slate used by Congress to draft the Bankruptcy Code, in reality, as far as we have been able to determine, it was never employed pre-Code to cram down a nonconsensual new value plan.(see footnote 51) In his superb analysis of new value, Professor Ayer stated that:

[t]here appears to be no reported case in the entire period [1939 (decision in *Case*) to 1978 (Bankruptcy Reform Act)] in which the court expressly permitted the 'debtor,' or former equity owners, to retain assets on the strength of a new value contribution and for no other reason. . . . Justice Douglas' supposed 'exception,' . . . is nowhere present as a rule of decision in Chapter X cases. New value under Chapter X, then, is an illusion.(see footnote 52)

Why wasn't the new value corollary used? Perhaps it was the conceptual difficulty in applying new value so as to achieve the balance that Justice Douglas demanded.(see footnote 53) There are several different approaches that can be taken to Justice Douglas' challenge to protect the creditors full right of priority while allowing old equity to retain a new value interest. I read Professor Ayer to conclude that, conceptually, it cannot be done. This *impossibility theory* is based on the conclusion that (i) any new value contribution by old equity admits that the debtor has residual equity,(see footnote 54) and (ii) under absolute priority the entire residual equity belongs to the unpaid creditors.(see footnote 55) Furthermore, even if it were determined that the debtor had no equity, i.e. in single asset cases where the mortgage balance exceeds the value of the asset, the Supreme Court has rejected old equity's argument that its retention of the property would cause no injury to creditors.(see footnote 56) Thus, it would not be possible for old equity to retain any interest when creditors are not paid.(see footnote 57) New value simply does not work.

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[i]f a company which is otherwise worth $200 incurs $150 of debt in its plan of reorganization, then its post-confirmation value will reduce to $50. *Case* would seem to require the owner in this example to pay $50 for the debtor's equity. But if creditors receive nothing more than the $150 in reorganization debt, the reasonable equivalence requirement is not met. The contribution of $50 raised the post-confirmation value to $100. If no further value is given to creditors, the owner will have purchased the debtor for $50 less than its post-confirmation value.

Markell, *supra* note 6, at 97.

He suggests that it would therefore be necessary to transfer the $50 to the creditors, which illustrates the dilemma: if the new value were given directly to creditors, it would be unlikely that the funds were *necessary* for the survival of the enterprise. If the new value were pumped into the enterprise and the increased value were reflected in the share of the enterprise held by unpaid creditors, it would be difficult to see what, if anything, old equity would receive for its new value contribution.

However, there are at least two other approaches that may partially reconcile new value and creditor protection. They are based on the concept that absolute priority should not require that the unpaid creditors receive the *post-confirmation* value of the enterprise, but rather only the value of the enterprise *at confirmation.*(see footnote 58) One such theory might be called a "*share the equity theory*." Under this theory, the enterprise value remains with the creditors. If old equity contributes new value it would be entitled to an interest equal to the increase in the value of the enterprise caused by the contribution. If one compares the reorganizing enterprise to a loaf of bread, each creditor would receive a slice of the bread in order of priority. The interest of old equity acquired with new value would be equal to any increase in the size of the loaf occasioned by the new value infusion. While the existing creditors share of the enterprise might thus be reduced from a percentage standpoint because of the new value contribution, it would be a percentage of a larger whole and, in theory, these creditors would be unaffected from the standpoint of value. Old equity would simply share the reorganized enterprise with existing creditors pro rata. For example, assume an enterprise had ten creditors, each (for mathematical simplicity) with the same amount of debt. If the enterprise had a value of $100,000, each creditor would have 10% of the enterprise and each 10% interest would have a value of $10,000. If old equity contributed $10,000, the enterprise value would increase to $110,000. Now each of the creditors, and old equity, would have an interest equal to approximately 9% of the enterprise, but because the pot has been sweetened, each creditor's interest would continue to be worth $10,000.(see footnote 59)

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In the situation described, this approach helps to reconcile Me two competing interests. The problem for creditors is that what is being shared is whatever equity the enterprise has without any regard to the amount of unpaid debt. Thus, the lower the enterprise equity, the greater the amount of debt that will be unpaid while old equity participates. In the above example, if the enterprise had equity of $50,000 instead of $100,000, each creditor would have a 1/10 interest valued at $5,000 each while the $10,000 new value contribution would give old equity a 16% interest in the enterprise, worth $10,000. This result may be justified on the ground that creditors are receiving the value of the enterprise. However, if the debtor had *no* equity, under this theory the creditors might end up with nothing, losing their right of control, which the Supreme Court in *Boyd*(see footnote 60) said could not happen. Thus this theory would seem to work

only if there were some reasonably accurate method to value control.

Creditors would prefer a third approach, which might be called the "*share with the debt theory*." This approach also assumes that what creditors are entitled to is the value of the enterprise at, rather than post, confirmation.(see footnote 61) If this enterprise value belongs to creditors, including the value of control, then the enterprise is supporting the full amount of unpaid debt, and any new value contribution must be related to the amount of that debt. The balance between the competing interests is effected by affording old equity an interest equal to the percentage obtained by comparing the new value contribution with the unpaid debts to creditors. In the above example, then, if the unpaid debts owed to the ten creditors totaled $200,000 and the equity was the same $100,000, old equity's new value contribution of $10,000 would result in the retention of an interest equal to 4.7% ($10,000 divided by $200,000). By relating the new value contribution to amount of unpaid debt, this formula can be applied even where the debtor has no equity, such as in single asset cases.

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It is sufficient that each security holder in the order of his priority receives from that which is available for the satisfaction of his claim the equitable equivalent of the rights surrendered. That requires a comparison of the new securities allotted to him with the old securities which he exchanges to determine when the new are the equivalent of the old. . . .

If one is looking to the value of the securities surrendered, the securities would seem to represent the value of the enterprise at, but not after, confirmation.

On the other hand, old equity would be discouraged from making such an offer because the percentage interest received would not, on its face, have a value equal to the contribution offered(see footnote 62) assuming the valuation, over which the debtor has much control, is accurate.(see footnote 63) While it could be argued that any difference between the contribution and the interest obtained represents the value of the degree of control taken by old equity, this theory, as well as the *share the equity* theory, are somewhat problematic. This tends to lend credence to Professor Ayers' conclusion that the Douglas requirements may be impossible to achieve and offers one reason why new value cramdowns do not seem to have taken place pre-Code when the Douglas requirements were observed by the courts.

What these theories tend to indicate is that there may not have been a fully conceptualized new value corollary under pre-Code law, and even if there were such a corollary, it is not at all clear how or on what basis it would be applied. The one thing that should be clear to all, however, is that under the pre-Code Supreme Court decisions it would not be possible to conclude that a plan could be confirmed under which old equity's new value contribution would result in the debtor keeping the enterprise, while wiping out the obligations owed to creditors. We shall see, however, that this is exactly what many post-Code cases permit.

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B. The New New Value of Post-Code Cases

While it is not clear that new value survived the adoption of the Bankruptcy Code,(see footnote 64) in order to explore how new value affects the rights of creditors, this article assumes, without agreeing, that new value lives post-Code. While the Supreme Court in *Ahlers* did not reach the issue of whether the new value corollary was incorporated in the Bankruptcy Code,(see footnote 65) Justice White stated that the "statutory language and legislative history of section 1129(b) clearly bar any expansion of any exception to the absolute priority rule beyond that recognized in our cases at the time Congress enacted the 1978 Bankruptcy Code."(see footnote 66) Notwithstanding this statement, many of the new value cases decided post-Code have radically expanded pre-Code interpretation of the effect of new value plans. In these cases, a new value contribution has severely reduced or effectively wiped out the interest of existing unsecured creditors while old equity was permitted to retain the property free of debts.(see footnote 67) This approach appears to turn a simple corollary into an easily manipulated exception to the absolute priority rule, which can effectively destroy it.

This proposal created a storm of criticism, *see, e.g.* Victor Brudney, *The Bankruptcy Commission's Proposed "Modifications" of the Absolute Priority Rule*, 48 **AM. BANKR. L.J.** 305, 337 (1974); Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 **U.CHI. L. REV.** 651 (1974); Note, *The Proposed Bankruptcy Act: Changes in the Absolute Priority Rule for Corporate Reorganizations*, 87 **HARV. L. REV.** 1786, 1817 (1974)) and was rejected by Congress. In its place, Congress modified the absolute priority rule to provide that it applied only to dissenting impaired classes of creditors, thus freeing classes of creditors to admit junior interests by the requisite majority vote. If this Bankruptcy Code provision had been found in section 77B (later Chapter X) of the Bankruptcy Act, the Case plan would have been confirmed and the issue that gave rise to the creation of the new value corollary would never have arisen. Thus the purpose that gave rise to the Case articulation of new value was obviated by the Bankruptcy Code. Congress clearly considered a provision that would have incorporated new value, in strengthened form, into the Code and rejected it. Although those arguing that the new value corollary survived the adoption of the Bankruptcy Code do so on the basis of the fact that "Congress . . . does not write 'on a clean slate.' " *Dewsnup* v. *Timm*, 502 U.S. 410, 419 (1992), the facts would seem to indicate that Congress had erased new value from its slate when it began to write.

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In *Ahlers*, 485 U.S. 197 (1988), the United States took the position that new value did not survive the adoption of the Bankruptcy Code (Brief for the United States as Amicus Curiae Supporting Petition at 17–20). The Supreme Court acknowledged, but did not rule on this issue, having decided that the debtor's plan could not be confirmed even if there were a new value corollary or exception. However, as noted by Professor Ayer, Justice White "may have overruled the new value exception whether he intended it or not." Ayer *supra* note 50, at 1011–1012. He noted that by rejecting the debtors' argument that the plan caused no injury to creditors because the farm had no value, the Court concluded, *sub silentio*, that anything retained by old equity belonged to unpaid creditors. *Id.* at 1014–15.

The post-Code cases may possibly be explained by the fact that unlike the situation *Case* was addressing, old equity is *forcing* its way into the reorganized enterprise through the cramdown plan. In *Case*, all classes of creditors had approved old equity's participation by the requisite majority. The notion that old equity had a right to propose, and have confirmed, plans that would compel the transfer of interests to its over the objection of creditors, was obviously not even contemplated by Justice Douglas. As pointed out in the Commission Report, the absolute priority rule was first invoked to protect intermediate creditors from being squeezed out by an arrangement between the senior creditors and old equity.(see footnote 68) In post-Code cases, however, the debtor proposes the cramdown plan that effectively squeezes out the unpaid creditors.

Additionally, this post-Code change occurs under Chapter 11 of the Code where the debtor is normally in possession, while under pre-Code Chapter X, a trustee was appointed to manage the assets.(see footnote 69) As pointed out by Judge Fenning in *In re A.V.B.I., Inc.*,(see footnote 70) with the debtor in control of the books and operations, there is concern among creditors that the company is run "with the intent of unfairly squeezing out the creditors."(see footnote 71) The debtor in possession, in control of the information as to the enterprise's economic viability, is the driving force behind the new value proposal.(see footnote 72) No longer are we concerned about whether creditor classes can vote to include old equity; new value becomes a vehicle for preserving old equity at the expense of the creditors.

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While most post-Code new value cases involved single asset real estate, which has peculiar problems of its own and is discussed below, *In re U.S. Truck Co.*(see footnote 73) is a good example of a post-Code corporate case that turned the new value corollary into an exception.

1. Corporate—U.S. Truck

In December of 1982, after U.S. Truck Company filed in bankruptcy, it disaffirmed its collectively bargained agreement with the teamsters, resulting in a significant claim by the union. This contract was one of the major causes of the debtor's distressed financial situation. After disaffirmance, an interim agreement was worked out between

management and labor under which the major management objection to the old contract was removed.(see footnote 74) As a result, the company turned a deficit into monthly profits of $100,000 to $250,000.

Despite the profits, the bankruptcy and district courts (affirmed by the Sixth Circuit) found that the value of the company was only $100,000. The low value was based in large part on potential future problems arising because the union continued to insist on return to the onerous (to management) provisions of the old labor contract and threatened a strike if it did not get the changes it wanted in the negotiations that were to take place in the near future.(see footnote 75) The Court noted that the interim contract expired shortly after the plan would have been confirmed,(see footnote 76) placing the company in the difficult position of taking a strike or acceding to the union demand, either of which would have destroyed the profitability of the company.(see footnote 77)

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The debtor filed a plan of reorganization under which, *inter alia*, old equity would contribute $100,000 and receive all the stock of the company.(see footnote 78) Most creditors would be left unimpaired, but the Teamsters' claim, in a separate class, would be paid approximately 70% of the finally determined amount.(see footnote 79) While this result would seem clearly in conflict with absolute priority (old equity got the company and the creditor's full priority was reduced by 30%), the court determined that new value had survived the adoption of the Code and that because of the contribution of $100,000, the debtor's plan met section 1129(b)'s fair and equitable requirement.(see footnote 80) Thus the court approved confirmation of a plan that gave 100% of the corporation to the shareholder and wiped out 30% of the debt owed to the creditor.

Application of new value to plan confirmation is obviously complex and subject to different interpretations. However, is it not at least arguable that *Case* and *U.S. Truck* present different interpretations of new value and, if so, that the adoption of either theory will significantly affect the position of the debtor and the creditor and ultimately, the fundamental requirements of the insolvency laws? Yet the Commission's proposed change does not state which interpretation it favors. Without some explanation of what the effect of old equity's "purchase" of an interest will be, enacting the Commission's proposal would leave those significant questions for determination by the courts through extensive litigation. Isn't this exactly what the Commission majority wanted to prevent?(see footnote 81)

2. Single Asset Real Estate

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Single asset real estate brings the issue of the meaning of new value into sharper focus. In these cases the major creditor (the mortgagee) is usually undersecured. This means that the mortgage debt exceeds the value of the collateral and even when the mortgage is stripped down, under section 506(a),(see footnote 82) to the value of the collateral, there is no equity. In this situation many courts have not hesitated to ignore, or give only lip service to the absolute priority aspect of Justice Douglas' articulation of new value.

a. Cases

A few cases may serve as examples of cases where such plans were proposed or confirmed. In *Phoenix Mutual Life Ins. Co.* v. *Greystone III Joint Venture* (*In re Greystone III Joint Venture*),(see footnote 83) the mortgage debt was $9.3 million, but the court determined that the value of the collateral had declined to $5.8 million. This left the mortgagee with a secured claim equal to the value of the collateral, and an unsecured claim for the deficiency, $3.5 million. Other debt equaled $145,000 in taxes and $10,000 in trade debt.

The debtor's plan proposed a $500,000 new value contribution by the partners of the debtor, which would be applied to payment of unsecured creditors and 3% of the mortgagee's deficiency claim. The rest of the claim would be wiped out. The plan was confirmed by the bankruptcy court and affirmed by the district court. In the Fifth Circuit, the plan was rejected, *inter alia*, on the ground that there was no new value principle incorporated into the Bankruptcy Code; however, on rehearing that part of the opinion was withdrawn.(see footnote 84)

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Unlike many other single asset cases, the *Greystone* bankruptcy court gave thoughtful and sincere attention to the issue of how to achieve Justice Douglas' challenge to balance the rights of existing creditors and old equity. Judge Leif Clark recognized that while the creditor is entitled to the control of the debtor, old equity is entitled to compensation in exchange for the new value.(see footnote 85) This balance, he felt, could not be determined by looking only to whether old equity received value equal to its contribution. It was also necessary to consider "the 'value' of senior rights threatened by the capital infusion."(see footnote 86)

It is here, however, where Judge Clark's attempt to reconcile these rights collides with the reality that it may have been impossible to do so in the context of the type of plan the debtor submitted. The Court's conclusion that senior interests received compensatory treatment consistent with absolute priority has a *deus ex machina* quality. Compensatory treatment was found, it would seem, primarily because of old equity's superior management, the relatively short duration of the plan, and the application of the new value to the operation and maintenance of the asset serving as security for the creditors' secured claim. However, superior management echoes the sweat equity theory of *Ahlers*,(see footnote 87) and the plan's short duration in itself cannot be found on the asset column of the balance sheet.(see footnote 88) As for the secured claim, after confirmation the lien provides sufficient remedies if the borrower fails to maintain the property or pay the debt. In any case, the full right of priority issue here is not related to the secured claim but to the unsecured debt, and, at the end of the day, the *Greystone* new value plan would wipe out the unpaid deficiency claim.(see footnote 89) Judge Clark's genuine effort to reconcile these conflicting principles in single asset cases, however, illustrates that new value must be looked at from both the creditors' and debtor's point of view, and that the balancing of the interests of both parties is extremely complex—a complexity one would have expected the Commission to have dealt with.

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In *Bonner Mall Partnership* v. *U.S. Bancorp Mortgage Co.* (*In re Bonner Mall Partnership*),(see footnote 90) the secured claim was $6.6 million and the property value $3.4 million, leaving the creditor with a $3.4 million unsecured claim. The debtor's plan proposed to contribute $200,000 and receive all the issued common stock of a new corporation owning the property subject to the stripped down $3.2 million mortgage. Unpaid unsecured creditors would share 300,000 shares of preferred stock "valued," somehow, at $300,000, equal to 10% of the unsecured deficiency claim,(see footnote 91) thus wiping out the remaining portion of unpaid debt. The issue before the Ninth Circuit, however, did not involve the meaning of new value. The question was whether new value survived the adoption of the Bankruptcy Code. The court concluded that it had survived and remanded the case to the bankruptcy court to determine whether the plan met confirmation standards.(see footnote 92)

Bank of America v. *203 N. LaSalle Street Partnership* (*In re 203 N. LaSalle Street Partnership*),(see footnote 93) unlike *Bonner Mall*, represents the "full monte" approach to single asset plan confirmation, dealing with virtually every one of the requirements of section 1129.(see footnote 94) On the issue of new value, the case held that new value survived the adoption of the Bankruptcy Code and that the proposed plan met the confirmation standards of section 1129(b).(see footnote 95) The debtor's sole asset was ownership of fifteen floors of an office building. The asset was valued at $54.5 million but was encumbered by a mortgage held by Bank America of over $93 million, leaving Bank America with a deficiency claim of $38.5 million. Other debts of the partnership included a second mortgage of some $11 million held by a partner of the debtor, $2.3 million in real estate taxes and $90,000 in trade debt.

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The plan apparently provided that nothing would be paid on the unsecured deficiency until a future sale or refinancing (not expected for 7–10 years).(see footnote 96) At that time, fifty percent of the "net value of the property either as realized in a sale, or as appraised at the time of any refinancing"(see footnote 97) would be paid in the following order: first to the unsecured deficiency claim of over $38 million *without interest*; second to repay the new value contribution; third to pay the general partner on the second mortgage *with 10% interest* and finally to the debtor's partners in proportion to their new value contributions. It was agreed that the primary purpose of the filing of the

petition in bankruptcy was to avoid $20 million in tax liability that would be occasioned by a foreclosure of the property.(see footnote 98) The court concluded that if a sale or refinancing were to take place in ten years at the then value of the property as determined by the court, and if that amount were discounted at 12%, the payment on the deficiency claim would amount to 16%.(see footnote 99) Thus the confirmed plan wiped out 84% of the deficiency claim. The Court of Appeals panel, over a strong dissent by Judge Kanne, affirmed this result without even dealing with Justice Douglas' precondition to old equity's retention of an interest—according creditors their full right of priority.(see footnote 100)

Id. Bank America attempted to argue that this fact showed that the plan was not filed in good faith as required by section 1129(a)(3). *Lasalle*, 126 F.3d at 969. The *LaSalle* courts found that (1) good faith was not tested by the debtors subjective intent, but by the content and effect of the plan of reorganization, (citing *In re* Madison Hotel Assocs., 749 F.2d 41O, 424–25 (7th Cir. 1984)); and (2) even if subjective motivation were germane, "the desire to avoid significant tax liabilities, if legal, is a result consistent with the Bankruptcy Code." *LaSalle*, 126 F.3d at 969.

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There is no objection from this quarter to the concept that the receipt of tax benefits as the result of bankruptcy does not violate the principle of good faith. However, what seems to have been ignored in the discussion of tax avoidance is that here the debtor seeks not just to avoid tax liabilities but to avoid tax liabilities *at the expense of existing creditors*. This fact may not affect the debate over the good faith requirement in section 1129(a)(3), but it should be considered in determining the parameters of new value. If the new value approach of many post-Code cases is accepted, then we are not dealing with just the debtor and the IRS. The debtor is able to confirm a plan that will have the effect of avoiding tax liabilities only by eliminating a substantial portion of its debt to its lender. If there is a public purpose to providing relief trom the tax consequences of foreclosure, the appropriate way for Congress to handle that would be by amendment to the Internal Revenue Code. Whether the Bankruptcy Code should be the vehicle for accomplishing a tax result at the expense of creditors is an area to be considered thoughtfully. Unfortunately these effects of new value do not seem to have been a concern in the Commission Report.

The new value proposals in the foregoing plans have to raise some concern as to whether they comport with the word or spirit of the *Case* v. *Los Angeles Lumber* articulation. Shouldn't this issue be resolved *before* Congress acts?(see footnote 101)

Some courts have stated that the new value principles apply only when creditors are paid in full. Others assert that any contribution will suffice if the debtor is insolvent. Still others claim that some link between the contribution and the debt discharged by the plan must exist to trigger the new value rule. In short, interpretative chaos reigns.

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Markell, *supra* note 6, at 93–94 (citations omitted).

b. Congressional Intent

What is especially remarkable about the new, new value approach in single asset real estate cases is that it produces virtually the exact result the language of the Bankruptcy Code had been designed to prevent.

In *In re Pine Gate Associates, Ltd.*(see footnote 102) and its progeny, decided under chapter XII of the former Bankruptcy Act, the courts allowed debtors to retain their mortgaged property upon payment to the non-recourse mortgagee(see footnote 103) of the depressed (due to the mid-70's real estate recession) value of the collateral.(see footnote 104) Debtors attempted to retain the collateral through this means in order to avoid a foreclosure, which would result in recapture of accelerated depreciation with serious tax consequences for the sophisticated real estate investor limited partners.(see footnote 105) In direct response to the perceived inequity of the *Pine Gate* line of cases, Congress was asked to restore absolute priority to real estate arrangements under the new combined chapter 11 of the Bankruptcy Code.(see footnote 106) Recognizing that single asset real estate differed from normal business reorganizations because there was no business to preserve, no employees' jobs to be protected, and no product or service that would not continue to be performed or produced, Congress enacted a package of protection insuring that the mortgagee may have an unsecured

claim for the deficiency and providing absolute priority for each dissenting impaired class of creditors, including the unsecured class.(see footnote 107)

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The key to the door of protection afforded by Congress for the nonrecourse undersecured mortgagee in single asset situations was the absolute priority given to the unsecured class of creditors. New value, as it has been applied in many post-Code single asset cases, turns that key on its head to lock this door of protection. It restores the *Pine Gate* rule—but in much more sinister form. In both situations the debtor keeps the property. The difference is that in *Pine Gate*, the mortgagee received cash equal to the court determined value of the collateral whereas in new, new value cases, the mortgagee receives only a mortgage with a face amount equal to the court determined value of the collateral.(see footnote 108)

Any reading of the legislative history and contemporary comments will reveal that this retention of property by old equity without paying the deficiency claim of the mortgagee is exactly the opposite of what Congress intended.(see footnote 109)

Indeed the statutory language was designed to prevent the debtor in single asset cases from ever retaining the property when the mortgagee's deficiency claim is unpaid. Section 1129(b)(2)(see footnote 110) requires that the mortgagee's secured claim have a value as of the effective date of the plan equal to the value of the collateral.(see footnote 111) Since the only asset is the single property, a new value plan submitted by the debtor represents a bid for the property, which indicates a value(see footnote 112) in excess of the amount of the secured claim.(see footnote 113) The statutory language would have the effect of preventing confirmation of any plan over the objection of the secured creditor in any instance where the value of the collateral is greater than the secured claim.(see footnote 114) This is illustrative of Professor Ayer's impossibility theory, discussed earlier, as applied to the secured claim.(see footnote 115)

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With respect to real property the purchase price normally represents the value. As a child of real estate and a teacher of property law, it is anathema to this writer that one should look into the motivation of a buyer to determine if the price paid represents property value. If one buys a brick house, should we discount the price in computing value because the purchaser has a special fondness for brick houses? If an insurance company has an excess of funds from long term lines of business to invest in real estate equity investments and thus will pay somewhat more than it would have if most of its available funds were from short term lines of business designated for short term investments, should we discount the amount paid? Consider the manipulative possibilities if values can be changed based on a presumed motivation of the buyer. It should be remembered that while commercial properties are valued through income capitalization methods, those methods are employed to *predict* what someone would be willing to pay for the property. Since appraisers are not clairvoyant, the one thing we know about such a prediction is that it is at best an informed guess that will not be exactly accurate. Appraisal has been defined as "a guess compounded by an estimate." Peter F. Coogan, *Confirmation of a Plan under Bankruptcy Code*, 32 **CASE WEST. RES. L. REV**. 301, 313 n.62. The price actually paid for the property is the best indication of its value. *See* 5 **COLLIER** *supra* note 4, 506.03[4][a] at n.58 ("[I]f the collateral is actually sold during the course of the bankruptcy proceedings or pursuant to a confirmed plan, the consideration received from the sale will almost always resolve the question of value.").

It should be apparent that the new, new value cases represent a distinct change in course from the direction intended by Congress in 1978. Perhaps the Commission majority believes that Congress' direction *should* be changed. Perhaps it has reasons to revisit the mortgagee protection provisions of chapter 11. This should spark a debate of major proportions. The Commission Report, by not stating what type of new value it is supporting, makes such a debate extremely difficult.

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c. Small Business Working Group Pay Down Proposal

The Small Business, Single Asset and Partnership Working Group had single asset cases within its jurisdiction, but the new value issue was in the hands of the Chapter 11 Working Group. While accepting the judgment of the chapter 11 Working Group on new value. in order to afford single asset mortgagees some protection against the affect of new value plans in light of the tremendous ambiguities already discussed, the Small Business Working Group proposed a "clear, objective standard for new value plans in SARE [single asset real estate] cases."(see footnote 116) Rather than focus on the usual requirements for a new value plan, the Group proposed to add a requirement that no new value plan could be confirmed unless the plan pays down the secured portion of the debt to 80% of its market value.(see footnote 117)

Assuming a mortgage of $10 million on property with a value of $7 million, the mortgagee would have a secured claim of $7 million and an unsecured claim of $3 million. A plan would be fair and equitable as to the secured claim if the mortgage were stripped down to the $7 million value of the collateral and the stripped down mortgage had a value as of the effective date of the plan of $7 million.(see footnote 118) Under the proposal the new value plan could be confirmed only if it provided for a payment of $1.4 million to reduce the mortgage to $5.6 million.

Without dealing with the meaning of new value and its effect on unsecured creditors (the Chapter 11 Working Group's domain) the Small Business Group provided a measure of protection for the mortgagee. True, the mortgagee's unsecured claim may still be wiped out and old equity may be able to retain the property; but the mortgagee will at least have an 80% loan to value mortgage, which would be more likely to approximate the value of the collateral than a 100% loan to value mortgage.

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The problem with this suggestion is that we are dealing with something like a Rube Goldberg cartoon.(see footnote 119) The new value proposal is separate and distinct from the pay down proposal and the enactment of one does not mean the other will be enacted. The pay down proposal itself is virtually meaningless unless Congress also enacts the Small Business Group's other proposal to amend the Bankruptcy Code's definition of "single asset real estate" to eliminate the portion of the current definition of "single asset real estate" that limits it to those cases where secured debts do not exceed $4 million.(see footnote 120)

The worst scenario is that the Small Business Working Group's proposal will not be enacted, or not be enacted in a way that will cover most single asset cases, but will serve as a diversion that will draw the attention of creditors away from the serious and fundamental problems posed by the new value ambiguities, and facilitate the enactment of the Commission proposal on new value. This could have a serious impact on the very nature of capital accumulation in the Nation. While one must applaud the initiative of the Single Asset Working Group, there remain grounds for concern about the rights of unsecured creditors, and doubt that, in the end, the proposal will be able to resolve the new value problem for real estate lenders.

C. The Prerequisites to New Value Plans—Are there Any and What do they Mean?

As articulated by Justice Douglas, a new value plan might be confirmed if the full priority rights of creditors were confirmed *and* if the new value plan met certain prerequisites—necessary to the success of the undertaking; reasonably equivalent to old equity's contribution; and in money or money's worth.(see footnote 121) The Commission proposal gives junior interests the right to "purchase new interests in the reorganized debtor" without conditioning that right on any specific prerequisites. The explanation in the Commission Report indicates that the current prerequisites are expected to apply.(see footnote 122) However, given the objections by Commissioner Jones to the proposal's silence on prerequisites,(see footnote 123) it is remarkable that they were omitted. The problem is compounded by the fact that in post-Code cases dealing with new value plans, the prerequisites of necessity and reasonable equivalence have often been ignored, distorted, or dissolved into an additional amorphous requirement of substantiality(see footnote 124) leaving open the question of whether in fact any meaningful prerequisites to new value exist.

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1. Substantiality

The requirement that a contribution be substantial is not found in the Case prerequisites. It was added in post-Code cases as a corollary to the requirement of necessity,(see footnote 125) or as a substitute for all the factors.(see footnote 126)

Skewering the prerequisites toward substantiality seems, on its face, like a sublime *non sequitur.* If the contribution is a mere token amount, it is difficult conceive that it is necessary for success; but does it follow that if a contribution is substantial it is automatically necessary to the success of the undertaking? Can it ever be said that the interest retained by old equity will always be reasonably equivalent to any substantial contribution that is offered?

When substantiality is viewed from the standpoint of the standards the courts use to determine whether the new value is substantial, the skewering appears to have the effect of eliminating all prerequisites to new value confirmation. The courts appear to agree that there is no mathematical formula that may be employed to determine substantiality and that the determination should be made based on "common sense," especially in single asset cases.(see footnote 127) They don't seem to be able to pin down, however, what mix of factors should be used in making the "common sense" determination. One approach is to look to whether the proposed contribution is substantial in relation to the total unsecured debt.(see footnote 128) This presents a dilemma. If we judge substantiality by new value's relationship to the amount of unsecured debt, then it would follow that the proceeds of the contribution should go to pay the unsecured debt. However, if the funds go to pay the unsecured debt, it is difficult to argue that the contribution is necessary or essential to the success of the enterprise.

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Another approach is to look at the dollar amount of the contribution in relation to contributions that have been rejected by other courts as insufficient. In LaSalle, the contribution was found to be substantial in absolute terms because it "dwarfs" those involved in other cases.(see footnote 129) Perhaps somewhat inconsistently, the court also supports the *Snyder* conclusion that substantiality will depend "on the circumstances of the individual case."(see footnote 130) Finally, the court looked to new value's "impact on the case,"(see footnote 131) the court indicated that the contribution equaled 20% of the tax liability the partners were avoiding and permitted a "substantial" return on the bank's deficiency claim.(see footnote 132)

The disturbing thing here is not the conclusion, which may well be correct, that there is no mathematical formula to determine substantiality. Rather it is that, at least in some courts, the prerequisites to new value of *Case* seem to be metamorphosing into a single unstructured, undefinable prerequisite of substantiality. Such a standard leaves a court to define substantiality in any manner it sees fit.

a. Necessity

Some of the courts that still adhere to the "necessity" prerequisite have made a not so subtle shift in what "necessary" means. In pre-Code law, necessity appeared to be based on the essential needs of the business being reorganized. In *Kansas City Terminal Ry.* v. *Central Union Trust Co.*,(see footnote 133) for example, the Supreme Court recognized that additional funds may be "*essential* to the success of the undertaking and it may be impossible to obtain them unless stockholders are permitted to contribute"(see footnote 134) and, in articulating the new value principle in *Case*, Justice Douglas quotes, with approval, the "essential to the success of the undertaking" language.(see footnote 135)

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In many post-Code cases, however, new value no longer has to be essential to the success of the undertaking. Instead some courts refer to the new value being essential to the success of the debtor's *plan*. The language of *LaSalle* is illustrative. The Seventh Circuit approved the bankruptcy court's determination that "the infusion of new capital was necessary for the successful implementation of the plan."(see footnote 136) This would not seem to be what Justice Douglas had in mind when he referred to the success of the "undertaking."(see footnote 137) By this switch in the meaning of necessity, virtually every offer of new value by old equity is "necessary" since new value is proposed to

enable the old equity to obtain the property. Without the new value, the plan could not be confirmed.

U.S. Truck(see footnote 138) is another example of the new definition of necessity. There the $100,000 payment for the stock could only have been necessary because of the risks occasioned by the pending union negotiations. Had absolute priority been followed, and the stock in the new enterprise given to the union in compensation for its claim of up to $5 million, there would have been no *necessity* for the $100,000 contribution because the union presumably would have been able to resolve the impasse with itself. Thus the contribution was essential or necessary *only* if old equity were permitted to own all the stock of the reorganized enterprise.(see footnote 139)

In a situation similar to *U.S. Truck*, the Bankruptcy Court in *Greystone*, in finding that the necessity predicate had been met, acknowledged that the mortgagee had agreed to advance the necessary funds (to pay off the unsecured creditors and complete tenant finish obligations) but pointed out that the lender was not willing to fund future operations unless it were given ownership of the property (i.e. unless absolute priority were observed), "a condition precedent inimical to the reorganization." *In re* Greystone III Joint Venture, 102 B.R. 560, 577 (Bankr. W.D. Tex. 1989). The "reorganization" had to mean the debtor's plan because the reorganization was necessary only for the debtor to keep the property. No plan would be necessary if absolute priority had been observed since the property would continue to be operated by the mortgagee without old equity's contribution.

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Therefore, when dealing with whether a contribution is necessary, it is important to ask "necessary for what" or "necessary for whom?" The Commission Report does not provide an answer to this question.

2. Reasonable Equivalence

If old equity's interest is limited to one reasonably equivalent to the new value contribution, the determination of reasonable equivalence will depend in large measure on the valuation of the enterprise. However, that value may differ depending on who will own the debtor. For example, as noted above in connection with the prerequisite of necessity, the court in *U.S. Truck*(see footnote 140) limited the value of the company to $100,000, primarily because there was a significant possibility of labor difficulties that would reduce the value of the company. However, the holder of the unpaid claim was the union involved in the potential labor dispute. If absolute priority had been adhered to, the stock would be given to the Union and, undoubtedly, the Union would not strike against itself. With the stock in the Union's hands, the value of the company would certainly have exceeded the $100,000 value set by the court. As a result, old equity's contribution of $100,000 would not have been reasonably equivalent to 100% of the value of the stock. The question, then, is whether reasonable equivalence only relates to the value of the company in the hands of old equity, or whether it must also be determined based on the company's value if absolute priority had been observed without implementation of a new value plan. The Commission Report gives no answer, effectively leaving that determination to the litigation it seeks to prevent.(see footnote 141)

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In single asset cases there is usually no equity in the property. As a result, debtors have argued in the past that retention of the property does not deprive the creditor of its full right of priority because what the debtor proposes to retain is worthless. This no-value theory was clearly rejected by the Supreme Court. Long ago, in *Boyd*,(see footnote 142) the Court stated that "control" itself was an asset that constituted value and that such value belonged to the creditors, not old equity.(see footnote 143) If creditors were denied control they would not have been given their full right of priority. More recently, in 1988, the Supreme Court reaffirmed this determination in *Norwest Bank Worthington* v. *Ahlers*,(see footnote 144) when Mr. Justice White stated that "we join in the consensus of authority which has rejected this 'no value' theory."(see footnote 145)

Despite these decisions, however, the no-value theory did not go gentle into the night.(see footnote 146) It has had a partial resurrection in the area of reasonable equivalence. If control represents value, it can be argued that the plan may be confirmed if the new value is reasonably equivalent to the value of the control. The amount old equity must pay for

control is not easily calculable, however, leaving the determination in each case to the predilections of individual judges. Some have found reasonable equivalence based on the fact that with no equity, control was not worth much. In *LaSalle*, for example, the bankruptcy court invoked no-value in disposing of the reasonable equivalence issue. "[T]he contribution is easily the equivalent of the interests retained by the debtor's partners. Indeed, on the market, those interests are worthless."(see footnote 147)

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The issue becomes whether, without statutory language, the courts will recognize or give some credence to reasonable equivalence, and whether, in light of the lack of equity in single asset cases, there is any standard to determine the value of the control that old equity retains as a result of the contribution.

a. What Prerequisites?

As we review the state of the law with respect to the prerequisites to new value, we see the following: (1) the Commission does not propose any specific statutory prerequisites to new value; (2) to some courts the prerequisites required in Case no longer apply but are subsumed within a new requirement of substantiality; (3) the requirement of substantiality is so amorphous that it serves as a virtual blank check for approval of any new value plan; and (4) where the prerequisites of reasonable equivalence and necessity are recognized, they are easily circumvented when they are tested only by their impact on the debtor or the debtor's plan.

All of the above tends to indicate how ephemeral the *Case* prerequisites are in the hands of modern courts and how significant the failure of the Commission to propose a codification of these prerequisites may be.

III. ELIMINATION OF EXCLUSIVITY: HALF A LOAF?

The Commission proposes that when the debtor moves to confirm a non-consensual new value plan the court will terminate exclusivity on request of a party in interest. This makes sense. It is difficult to argue that old equity is not obtaining its new value interest on account of its old equity when the debtor has the exclusive right to propose a plan.(see footnote 148) When bidding is open to all, old equity is receiving no special right by virtue of its prior interest. It is unclear that the Commission proposal to open bidding only after an often extended period of exclusivity and the submission of a new value plan avoids this problem. Furthermore the proposal, coupled with the comments in the Commission Report, would not seem to accomplish the objective of protecting the absolute priority rights of creditors.

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In her strong dissent from this proposal,(see footnote 149) Hon. Edith Hollan Jones points out, *inter alia*, the following defects in the proposal: (1) the proposal lifts exclusivity but does not require the court to permit solicitation and distribution of a creditor's plan;(see footnote 150) (2) no provision was made to permit creditors to have access to information without signing of a confidentiality agreement with the debtor that may prohibit disclosure of the debtor's operational information;(see footnote 151) (3) by waiting until the debtor attempts a cramdown, the resolution of the case will be delayed as the creditor attempts to obtain information from the debtor-in-possession and devise a competing plan, thus increasing expense and professional fees;(see footnote 152) and (4) those voting on the debtor's original plan will not be aware that a competing plan will be proposed after exclusivity is lifted.(see footnote 153)

Creditors who may think that, despite these problems, the risks posed by the new, new value cases have been effectively papered over by the exclusivity proposal, should understand that the proposal gives no assurance that their competing plan will be confirmed by the court. Remember, the first part of the Commission's proposal makes the new value plan "fair and equitable" and thus confirmable.(see footnote 154) Will a court confronted with two fair and equitable plans—one submitted by the debtor and a second submitted by the creditor—necessarily select the creditor's plan even if it is richer than the debtor's plan? One can think of a host of rationalizations for rejecting the creditor's proposal: the creditor's plan might provide for liquidation; employees might be adversely affected; the debtor might be denied a "fresh start."

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Even in single asset cases where there is no business to protect, no employees whose jobs may be saved, and no prospect that the property will not continue to be operated, there is no assurance the fresh start concept will not sway a court to approve the debtor's plan. What if, for example if the plan is essential to enable the debtor to avoid substantial tax liabilities, a result "consistent with the Bankruptcy Code"?(see footnote 155)

Single asset mortgagees should also understand that the Commission drafters made clear in their comments that creditors submitting a competing plan should not be permitted to offset the debt owed to them against their bid for the property.(see footnote 156) The Commission Report finds that (1) the "credit bid" may not bear any relation to the actual value of the property;(see footnote 157) and (2) that a secured creditor with a security interest in some of the assets of the business should not be able to credit bid and obtain the entire business with going concern value in excess of what otherwise would be the creditors allowed secured claim.(see footnote 158) Since the competing plan deals with the entire enterprise, and the amount that may be offset in a credit bid is limited to the unpaid debt, it is difficult to understand this argument without further explanation. Furthermore, it is not clear exactly what constitutes credit bidding from the Commission Report's standpoint. For example, does the Commission's argument suggest that creditor's may not propose a plan that would convert debt into equity?

Even the stated reasons for rejecting credit were to have some validity in a large business reorganization where the security interest may not cover all of the debtor's property, they have no validity in connection with single asset real estate where there is no business, no going concern value, and only one asset encumbered 100% by the secured claim. Under sections 365(k) and 1129(a)(2), where property subject to a lien securing an allowed claim is sold under the plan, the mortgagee has the right to bid at any such sale of the property, and if it is the successful bidder, offset its claim against its bid. Is the Commission proposing to change these provisions? Or will the Commission argue that it is proposing no change, either because the "business," not the property, is being sold and the business is not subject to a lien, or because the proposal provides only for the removal of exclusivity rather than sale of property? In either case the Commission can not change the fact in single asset cases, what is being bid for is the single asset and what is being purchased by virtue of the plan is the asset subject to the lien.

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Prohibition of "credit bidding" may serve as a poison pill to the submission of competing plans in single asset cases. Assume, for example, that there is a mortgage on single asset real estate of $1.5 million and the value of the property is $1 million. There are trade debts of $10,000 and a second mortgage held by a general partner of $200,000. The debtor proposes to cramdown a $100,000 new value plan in which its partners keep the property. Exclusivity is lifted and the mortgagee in a competing plan proposes to invest $200,000 over the mortgage. Is the Commission suggesting that if the court should accept the mortgagee's plan, the mortgagee (already having lost $500,000) would have to contribute an additional $200,000 over its mortgage to obtain the property? If the mortgagee makes the contribution, would the $200,000 have to be used to pay junior creditors (trade creditors and old equity's general partner)? If the answer is yes, how realistic is it that a mortgagee would propose such a plan? If the answer is no, and the funds are retained for the property (now owned by the mortgagee) isn't this, in fact, credit bidding? Would the submission of a competing plan by the creditor that would apply the new value the creditor offers to the payment of the secured debt constitute credit bidding? Without a satisfactory resolution of these questions, any prohibition of "credit bidding" could very well act as a bar to the submission of competing plans when exclusivity is lifted.

Although the concept of open bidding is attractive, the Commission's proposal does not open the bidding until a new value plan is proposed, does not provide for a method by which lifting exclusivity would appear to work, provides no assurances that the competing bid will be accepted, and leaves open too many questions to be seriously considered as much more than a gimmick that can only divert attention away from a thorough and thoughtful analysis of the absolute priority rule and the new value principle in light of the questions unanswered by the Commission. From the creditors' standpoint, lifting exclusivity may not be half a loaf at all—it may be the crusty end of the bread.(see footnote 159)

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CONCLUSION

The Commission Report does not answer the following questions with respect to new value: What new value principle is it espousing, the new value of Case or the new value of some of the post-Code cases? How will the Commission's new value affect single asset real estate? How will it affect the absolute priority rule? Are the *Case* prerequisites applicable? If they are, what is the meaning of "necessary," "substantial," and "reasonably equivalent? How will the lifting of exclusivity work? Why is credit bidding barred from single asset cases?

This article concludes that it is impossible for Congress to decide on the validity of the Commission proposal without some certainty as to what is being proposed. When Congress comes to grips with the issues of new value and absolute priority, it must deal with the basic problems thus far unanswered satisfactorily by the courts, the Congress and the Commission. In dealing with these problems, four suggestions are offered.

First, if we are to follow a course similar to the Commission's proposals, it will be necessary to articulate exactly what the effect of a new value plan should be, and with some degree of particularity, what prerequisites are necessary for such a plan to be confirmed.

Second, it is suggested that Congress be willing to go beyond common wisdom to seek solutions that may be different from those proposed. For example, why not, as some have suggested, eliminate exclusivity altogether? If that is done, there would be no need for a provision giving old equity the right to purchase an interest. There are numerous constituencies that are involved in many Chapter 11 cases—the unpaid creditors, old equity, old management, and to a growing extent, the public(see footnote 160) (including the recipients of services or products, employees and the economy). Why should old equity be able to have an exclusive right to submit a plan? If mechanism can be created to provide access to relevant information for all parties in interest and resolve the credit bidding problem, will we not have true open bidding for the debtor, allow old equity to participate not on account of its prior interest but as any other bidder, and go a long way toward avoiding the ambiguities and issues involved in new value cases?

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Third, it must be determined how interests in the reorganized entity will be distributed to protect the priority rights of creditors without unreasonably chilling the bidding for the enterprise. To make this determination, it may first have to be decided whether and when a bid for the enterprise represents the value of the enterprise at confirmation, or the value after confirmation (as well as whether and when these valuations differ).(see footnote 161)

Fourth, a full and thoughtful review should be made of the concept that Single Asset Real Estate belongs in chapter 11. What is sacred about the one-size-fits-all approach when we see how the one size does not stretch to accommodate the major differences between going concern businesses (where all the constituencies discussed above are often represented) and single asset real estate ownership entities (where in most cases the debtor and creditor are the real players)? Would not different strokes for different folks make achieving solutions to the problems discussed in this article much easier and, in the end, greatly reduce the litigation the Commission seeks to avoid?

The point is that orderly plan confirmation process is too important to the economic health of the nation to be dealt with through quick fix legislation. The Commission with such a short term and broad mandate probably could not have done much more than it did. What it did accomplish is at least to raise and sometimes to focus the new value issues. Now it is up to Congress and the insolvency specialists to come up with workable and in depth solutions. To this author, however, it seems incredible that Congress should be asked to enact legislation embodying the Commission's proposals as submitted.

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On October 21, 1997, I was driving home after the portion of the Commission Report dealing with new value at last

came off my computer. My car radio was tuned to my favorite local station, WEIR, which was playing the title song of OMC's latest album, "How Bizarre," then at the height of its popularity. As I thought about the Commission proposal on new value, I began to appreciate the juxtaposition, and had to agree with Pauley Fuemana. "How Bizarre. How Bizarre. How Bizarre."

Mr. **GEKAS.** Thank you, Mr. Graham.

At this juncture, we are pressed to go to the floor of the House for pending votes. So we are bound to recess at this moment. We will resume with our last witness on this panel when we return. We expect to return to this room at 11. So we are recessed now until 11 a.m.

[Recess.]

Mr. **GEKAS.** The hour of 11 having been passed, the recess has been concluded, but we must still await the presence of a second member of the subcommittee. So we will recess on the recess.

[Recess.]

Mr. **GEKAS.** The time of the recess having expired, we will proceed with the last witness on this first panel. Professor Resnick, you may proceed.

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STATEMENT OF ALAN N. RESNICK, HOFSTRA UNIVERSITY SCHOOL OF LAW, HEMPSTEAD, NY, REPRESENTING THE NATIONAL BANKRUPTCY CONFERENCE

Mr. **RESNICK.** Thank you.

Mr. Chairman and members of the subcommittee, I am Alan Resnick, the Benjamin Weintraub Professor of Bankruptcy Law at Hofstra University School of Law; of counsel to the firm of Fried, Frank, Harris, Shriver & Jacobson; and reporter to the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States.

I am offering this testimony solely on behalf of the National Bankruptcy Conference, which is an organization consisting of approximately 70 judges, lawyers, and law professors. The Conference is grateful for the opportunity to present this testimony. And I am personally honored to appear here this morning.

My testimony is limited to two aspects of H.R. 3150, small business bankruptcy and single asset real estate. But attached to my written testimony is a section by section analysis of the entire bill.

The Conference is also preparing a draft omnibus bankruptcy bill, which I will submit before April 4th. And I respectfully request that it be made part of the record following my testimony.

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Mr. **GEKAS.** Without objection, it will be so included.

Mr. **RESNICK.** Thank you.

Although the Conference's position on this bill may differ from those of the other witnesses on this panel, I think that we would all agree that small businesses are vital to our economic well-being and serve critical needs in our society. They certainly deserve the continuing support of Congress.

Now several small business provisions of this bill are supported by the National Bankruptcy Conference. Such as the section providing for more flexibility with respect to disclosure statements.

But H.R. 3150, overall and on balance, is likely to be anti-small business in its effect. The bill could deny tens of thousands of small businesses a meaningful opportunity to continue in business through effective reorganization. By attempting to provide an early detection system designed to identify those small businesses that are not worth saving, the bill will have the effect of actually causing more small businesses to fail.

Indeed, the very presumption that underlies the bill is that many small businesses should be quickly expelled from Chapter 11 and terminated due to low probability of success. In particular, the Conference has the following key objections. First, the expanded definition of small business debtor is too broad and inflexible, capturing more than 85 percent of Chapter 11 cases overall. And single asset real estate debtors are encompassed in that definition regardless of the amount of debt.

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Next, the bill imposes new duties on small businesses. Collectively, these duties could actually hinder the reorganization effort increasing the likelihood of failure, and increasing legal and accounting fees.

And the short deadlines, 90 days for filing a plan and 150 days from the petition date for confirming a plan, will deprive many small businesses of a fair opportunity to reorganize. They will also force small businesses to file premature, ill-conceived, and poorly drafted plans.

Next, the new duties of the United States Trustee, such as conducting interviews and visiting the debtor's premises, are designed to detect the debtor's failure, rather than to assist the small business to succeed, retain jobs, and obtain needed financing. And these new policing duties will increase the expense of the bankruptcy system. I have seen estimates, one being that it would cost at least $3.2 million per year to carry out those duties.

Finally, the serial filer provisions would deprive the benefits of the automatic stay to a small business that has either confirmed a plan or was in a case that was dismissed within the two prior years. This discriminates against small businesses. Why should the size of a business determine whether it can seek subsequent relief under Chapter 11?

Single asset real estate. The Conference supports Section 253 of the bill which would clarify the requirements for payment of interest under Section 362(d)(3) of the Code. But the Conference is very troubled by other provisions that would place obstacles in the way of reorganizing distressed real estate ventures.

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It is important to note that there is a growing trend fueled by mutual funds and pension plans for individual consumers and workers to make equity investments in large real estate ventures. The vehicle for these investments are real estate investment trusts, REITs. Therefore, any amendment to the Bankruptcy Code that unduly prejudices such investments by effectively blocking attempts to reorganize could have an adverse impact on pension plans and middle income consumers.

The Conference is sympathetic to the concerns of undersecured lenders who have seen equity owners continue to own the debtor entity without a competitive bidding process, while the undersecured lenders do not get paid in full. In fact, the Conference has suggested that the Code be amended, so that such a plan could not be confirmed unless other parties are permitted to propose alternative plans.

In contrast to this approach, H.R. 3150 would require the existing owners to invest cash equal to at least 25 percent of the value of the property to pay down the mortgage debt. And again, remembering that the bill would include single asset real estate debtors, no matter how big, within the "small business" category, so that there would be 90- and 150-day fast track requirements.

It is not surprising that five of the nine Commissioners of the National Bankruptcy Review Commission has expressed support for an alternative proposal that would, among other provisions, redefine single asset real estate by raising the debt limit but not terminating it, and permit owners to participate in a "new value" plan so long as other parties may file competing plans.

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In any event, the existence of alternative proposals and the lack of empirical data to support meaningful projections on the effect of H.R. 3150 on real estate investments suggest that it would be prudent to slow down the legislative process until all alternatives are evaluated based on available evidence.

For these reasons, the National Bankruptcy Conference respectfully opposes the single asset real estate provisions in Sections 251 and 252 of H.R. 3150, but support Section 253.

Thank you.

[The prepared statement of Professor Resnick follows:]

PREPARED STATEMENT OF PROFESSOR ALAN N. RESNICK, HOFSTRA UNIVERSITY SCHOOL OF LAW, HEMPSTEAD, NY, REPRESENTING THE NATIONAL BANKRUPTCY CONFERENCE

Mr. Chairman and Members of the Subcommittee, I am Alan N. Resnick, the Benjamin Weintraub Professor of Bankruptcy Law at Hofstra University School of Law, Of Counsel to the firm of Fried, Frank, Harris, Shriver & Jacobson, and the Reporter to the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States. I am offering this testimony solely on behalf of the National Bankruptcy Conference, and this testimony does not necessarily represent the views of any other firms, committees, or organizations.

The National Bankruptcy Conference is a private organization consisting of approximately 70 bankruptcy judges, lawyers, and law professors formed in 1932 and dedicated to improving federal bankruptcy law and administration. The Conference is grateful to the Congress for regularly having considered its views for more than 60 years and is grateful for this opportunity to submit this testimony on H.R. 3150. I am personally honored to appear here today.

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H.R. 3150 covers numerous aspects of both consumer and business bankruptcies, but my testimony this morning is limited to two aspects of H.R. 3150: small business bankruptcy (sections 231–243) and single asset real estate (sections 251–253). Attached as an exhibit to my written testimony is a detailed section-by-section analysis of the entire bill, which sets forth specific comments and concerns.

SMALL BUSINESS CASES

I would like to begin with a few general comments on the small business provisions of the bill. We are all aware of the need to encourage and support small businesses in the United States. Family-owned and other small business ventures are vital to our economic well-being and serve critical needs in our society. These companies provide employment, goods and services, and tax revenue for federal, state, and local government. Appropriate levels of entrepreneurial risk-taking in small business enterprise has always been encouraged. The preservation and growth of existing small businesses are the goals of many federal programs, such as those administered by the Small Business Administration. These businesses deserve the continuing support of Congress.

But in contrast to our national policy in support of small businesses, H.R. 3150 is likely to be anti-small business in its effect. The bill would amend the Bankruptcy Code in ways that could deny tens of thousands of small businesses a meaningful opportunity to restructure their obligations and continue in business through effective reorganization under

chapter 11. The Conference is concerned that, by attempting to provide an early detection system designed to identify those small businesses that are not worth saving, the inflexible and burdensome provisions of the bill will have the effect of actually causing more small businesses to fail. These provisions are likely to result in closing the door on many small businesses that could be reorganized successfully if given the chance, but that are unable to meet difficult new requirements and thresholds in the early days of the case.

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The very presumption that underlies the small business provisions of H.R. 3150—that many or most small businesses should be quickly expelled from chapter 11 and terminated due to low probability of success—conflicts with the strong governmental policy favoring the encouragement of small business development, and job creation and retention.

Focusing on the particular aspects of the bill relating to small businesses, the National Bankruptcy Conference has the following key objections:

The expanded definition of "small business debtor" is too broad and inflexible. This category would capture business debtors (including affiliates of the debtor) with non-contingent, liquidated debts of $ 5 million or less (rather than $2 million under the current law). This category would include more than 85% of the chapter 11 cases overall, and nearly all chapter 11 cases in most judicial districts. The new small business provisions would be mandatory for the vast majority of businesses filing chapter 11 petitions, whether or not the facts and circumstances of the particular case warranted these requirements. This would result in increased costs, administrative burdens, and unnecessary steps in the majority of chapter 11 cases.

Single asset real estate debtors—no matter how large and complex—are encompassed within the definition of "small business debtor" regardless of the amount of debts (unless the debtor's affiliates file for bankruptcy too). This creates a difficult and unfair hurdle for one particular type of business without any empirical evidence that shows that such burdensome provisions are necessary or appropriate for this singled-out industry.

The bill imposes new requirements on small business debtors—often very early in the case. For example, Section 236 imposes numerous duties on the small business debtor and the debtor's management, such as the duty to attend interviews and meetings, to file periodic financial reports and projections, and to maintain insurance that is "customary and appropriate to the industry." Collectively, the provisions of the bill would impose burdensome duties that may actually hinder the reorganization effort and increase the likelihood of failure. These new duties are based on unreasonable assumptions about what every financially-troubled small business debtor can accomplish within a very short time period while attempting to stabilize, maintain, and reorganize business operations. These duties also will result in increased legal and accounting professional fees incurred in the preparation of financial reports and projections, and in connection with the attendance of meetings and negotiations (and perhaps litigation) over the meaning of insurance requirements. They also may detract management from its primary role of running the day-to-day operations of the business and focusing on restructuring its debts under a plan of reorganization. Failure to comply with any of these duties is likely to result in dismissal of the case.

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Inflexible short deadlines—90 days for filing a plan and 150 days (from the petition date) for confirming the plan—are also likely to increase business failures and deprive many small businesses of a fair opportunity to reorganize. Although the bill leaves room for the court to extend these deadlines, the court may not extend them unless it finds that it is "more likely than not" that a plan will be confirmed (a difficult burden for a debtor still negotiating in good faith the terms of a plan of reorganization). Such determinations would require the court to conduct a mini-confirmation hearing without the benefit of a filed plan. These deadlines are likely to force many small businesses to file prematurely ill-conceived and poorly- drafted plans as the only alternative to immediate liquidation by the court. These time provisions may be adequate in certain cases, but will be far too short for businesses with operational problems that take time to stabilize or for seasonal businesses.

New statutory duties of the United States trustee—such as conducting initial interviews with every small business debtor to investigate the debtor's "viability" and business plan, visiting the debtor's premises, inspecting books and records, monitoring the debtor's activities to identify whether the debtor will be unable to confirm a plan—are all designed to detect the debtor's failure. These are not intended to assist the small business to succeed, to retain jobs and relations with suppliers, or to obtain needed financing. These policing functions will greatly increase the expense of the bankruptcy system. In a cost-benefit analysis submitted by the Executive Office for United States Trustees to the National Bankruptcy Review Commission, it was estimated that an additional $3.2 million would have to be expended annually to comply with these new duties.

The serial filer provisions in section 242, which deprive the benefits of the automatic stay to a small business debtor and its creditors when the debtor has either confirmed a plan in a previous case or was in a case that was dismissed within the past two years, again discriminate against small businesses. Why should the size of a business determine whether it can seek subsequent relief under chapter 11? The importance of these provisions on serial filings are heightened by the possibility that the proposed inflexible fast-track deadlines for small businesses are likely to result in more poorly- developed plans. And this provision is unnecessary. Courts already dismiss subsequent chapter 11 cases when the facts of the case so warrant.

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SINGLE ASSET REAL ESTATE

The National Bankruptcy Conference supports section 253 of the bill which would clarify the requirements for payment of interest under section 362(d)(3) of the Code. For example, it will clarifying that the debtor may use rents to make required interest payments. These changes should reduce litigation.

But the Conference is troubled by other provisions of the bill that would place artificial and unnecessary obstacles in the way of reorganizing distressed real estate ventures. The result will be many more foreclosures and the elimination of equity interests in real estate.

It is important to note that the real estate ventures that would be deprived of the same reorganization opportunities available to other types of businesses are not limited to small or medium size properties, and will not discriminate only against professional real estate developers. There is a growing trend, fueled by mutual funds and pension plans, for individual consumers, workers, and others to make equity investments in large, complex real estate ventures. The vehicle for these investments are Real Estate Investment Trusts ("REITs"). Therefore, any amendments to the Bankruptcy Code that unduly prejudices such investments by effectively blocking good faith attempts to reorganize large complex real estate ventures could have an adverse impact on pension plans, Individual Retirement Accounts (IRA's), and middle-income consumers who invest their savings in equity REITs.

The Conference is sympathetic to the concerns of undersecured lenders who have seen, over their objection, equity owners continue to own the debtor entity without a competitive bidding process while the undersecured lenders do not get paid in full. In fact, the Conference has suggested that the Bankruptcy Code be amended so that the owners cannot force such a plan on an unwilling undersecured lender unless other parties (including the lender) are permitted to propose an alternative plan. This approach would (1) open the process to the free market to assure that new equity investments are consistent with the true value of the real estate, and (2) permit all parties, including REITs and other existing equity owners, to compete by bidding for the new equity interests.

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In contrast to this approach, H.R. 3150 would require that existing equity owners immediately invest cash equal to at least 25% of the value of the property to pay down the mortgage debt—an insurmountable burden in many cases—in order to confirm a plan over the objection of the undersecured lender. The result will be more foreclosures and loss of opportunity to invest in the reorganized debtor—solely because the debtor is the owner of single asset real estate rather

than some other type of business.

As mentioned before, the bill also includes single asset real estate debtors within the definition of "small business." This will impose undue burdens and fast-track requirements on the most complex real estate ventures regardless of size and amount of liabilities. Again, the effect is to exclude these businesses from a reasonable opportunity to reorganize and to increase the number of mortgage foreclosures.

In view of these concerns, it is not surprising that 5 of the 9 Commissioners on the National Bankruptcy Review Commission have expressed support for an alternative proposal submitted by Prof. Kenneth Klee. This proposal would, among other provisions, redefine "single asset real estate" by raising the debt limit from $4 million to $15 million (rather than terminating it altogether) and, similar to the Conference's proposal, permit equity owners to participate in a "new value" plan confirmed over the objection of an undersecured lender so long as other parties may file competing chapter 11 plans.

In any event, the existence of worthy less-radical alternative proposals and the lack of empirical data to support meaningful projections on the effect of H.R. 3150 on real estate investments and out-of-court workouts, suggest that it would be prudent to slow down the legislative process until all alternatives are evaluated based on available evidence.

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For these reasons, the National Bankruptcy Conference respectfully opposes the single asset real estate provisions in sections 251 and 252 of H.R. 3150, but supports section 253. Thank you.

BIOGRAPHY

ALAN N. RESNICK is the Benjamin Weintraub Distinguished Professor of Bankruptcy Law at Hofstra University School of Law in Hempstead, New York, where he has taught bankruptcy, contracts, and commercial law courses for twenty-three years. He also is Of Counsel to the firm of Fried, Frank, Harris, Shriver & Jacobson, and is the Reporter to the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States.

Professor Resnick is co-author of Weintraub & Resnick, *BANKRUPTCY LAW MANUAL*, published by the West Group, is the co-editor of *BANKRUPTCY REFORM ACT OF 1978: A LEGISLATIVE HISTORY*, published by William S. Hein & Co., and is the author of a quarterly column that appears in the *Uniform Commercial Code Law Journal*. He has written numerous articles, including law review articles that have appeared in the *American Bankruptcy Law Journal, Rutgers Law Review, William & Mary Law Review, Banking Law Journal* and in other publications. He also is a frequent speaker at professional seminars and has lectured to audiences of bankruptcy judges in every region of the nation.

Professor Resnick is a member of the American Law Institute, the National Bankruptcy Conference, the American Bankruptcy Institute, and the American Bar Association. He also is a Fellow of the American College of Bankruptcy.

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Professor Resnick was educated at Rider College (B.S. in Bus. Adm. 1969), Georgetown University Law Center (J.D. 1972), and Harvard Law School (LL.M. 1974).

DISCLOSURE

Except for compensation received for his services as Reporter to the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States, Professor Resnick has not received any federal grant, contract, or subcontract in the current or preceding two fiscal years. Professor Resnick is not receiving any compensation for his testimony on behalf of the National Bankruptcy Conference. The National Bankruptcy Conference has not received any federal grant, contract, or subcontract in the current or preceding two fiscal years.

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 precluded from debt relief, potentially leading them 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 441–443, 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, this legislation likely would cause fewer debtors 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.

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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 of the case under section 408, the section may have an unintended jurisdictional result, particularly for pro se debtors who do not know they need to receive the

notice in order to file for bankruptcy.

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.

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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.

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 aforementioned requirements or if he assisted a debtor in a case that ultimately was dismissed or 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.

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Sec. 121. Discouraging bad faith repeat filings.

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.

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.

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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. Providing statutory definitions can have a beneficial clarifying effect in some instances, 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.

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 circuit 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.

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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.

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. Ill. 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" may be subject to widely divergent interpretations and thus could create greater disparities among courts.

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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.

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 personal residence and would include debts also secured by incidental property and 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. Debts 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 in a consistent fashion would be 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 non-dischargeable 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 overreaching.

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It is important to note that 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.

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."

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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 solvency, and they appear to apply even if a borrower was able to make 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.

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 proposal is intended to be a cost saving device for landlords, 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 between 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 debtors) 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(51B). 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 extend the reach of that amendment 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 a balance sheet, a statement of operations, a cash-flow statement, and income tax returns with the petition, or provide a statement under penalty of perjury that these statements have not been prepared. 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 &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 1112(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 workout agreements. The loan-to-value test 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 new-value 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 the identity of others co-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 approach should be explored further before implementing 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. It 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 property. 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 file 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 be determined by Internal Revenue Code section 6621(a)(2). This proposal 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-day 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 superpriority 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 "unfiled 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. This 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 the government to set off ''uncontested'' pre-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 setoff 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 for his testimony.

I must say as to your last statement that you should know that we have been debating the single asset limitations for over 2 years. And as you say, we have different ideas coming from all sectors. So we have discussed the alternatives. We did delve into it thoroughly. And we are convinced that there should be no money limits at this point, the majority, that is, those who support H.R. 3150, that is. So it did not come out by lightning speed as just a guess. I wanted you to know that.

Secondly, Professor Resnick, you said that H.R. 3150 lacks an early detection system, as one of your criticisms of H.R. 3150. I think that is the phraseology that you used. But I heard Mr. Case, and Mr. Gose, and I think Mr. Graham in their own ways indicated that one of the benefits of H.R. 3150 is that there is early detection, or at least an early chance for detection.

Is that correct, Mr. Gose, or Mr. Graham, Mr. Case, or somebody help me?

Mr. **GOSE.** Yes, sir, it is. The thrust of our hearings were to determine if the entity was viable and to determine early on. Some of the tests are can they pay their insurance, can they pay their taxes. These seem to me to be rather

basic. The debtor ought to go to the first hearing. And we heard all types of testimonies that they did not. There ought to be a test of are their plans realistic.

We heard over and over again that what was filed was not realistic. Somehow we have to get into the real world there.

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Mr. **GEKAS.** I thank you for that.

Mr. Case, I drew from your testimony that the way that the Act of 1978 impacted upon bankruptcy after it becoming law was such that what we propose now will cure some of the unforeseen consequences of 1978, is that correct?

Mr. **CASE.** Yes.

Mr. **GEKAS.** That is a quick answer. If you could repeat that.

And, Mr. Gose, you said something similar to that. That the 1978 Code created a one size fits all concept, which of course did not fit all, and the size was not proper according to your testimony.

Mr. **GOSE.** Yes, Mr. Chairman. What we saw in 1978 in my estimation was an attempt to take all business ventures, real estate and business ventures large and small, and put them under one tent. In addition, to give the bankruptcy judges great flexibility.

The end result has been that they simply do not work especially in the real estate, as we learned, which I assume is why Congress passed single asset real estate in 1994. But more than that, without some strict criteria or guidelines, everything became litigation. And the only people who are making money off of this are the bankruptcy lawyers, because everything is a litigation tactic. And like all litigation, when you go into it, if you know the rules, you will probably settle. If you do not know the rules and it is a massive crap shoot, then why not roll the dice.

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Under the 1978 Act, some of these terms were not defined. There were no strict guidelines. And our testimony in the Commission was that in those courts where there are strict guidelines and definitions judicially imposed, things move along much faster.

We had a bankruptcy judge from Portland, Oregon, who has in effect reduced her Chapter 11 by something like 70 percent, because she has implemented a system that we are suggesting and you have adopted in H.R. 3150. And it works real well. Judge Perrin does an excellent job. And we use criteria embodied in the recommendations.

Mr. **GEKAS.** I thank you.

Ms. Staiano, I was struck also by the fact that you testified that as a result of, my words not yours, failings of the 1978 statute, that the United States Trustees on their own developed procedures and new concepts that cured a lot of what you felt were defects of 1978, of the Code of 1978. And that H.R. 3150 in some way incorporates improvements that the United States Trustee planning was able to accomplish.

Is that correct?

Ms. **STAIANO.** Yes, Mr. Chairman. We are excited about many of these provisions. Because the United States Trustees have been trying to ensure that the debtors have been in compliance with many of these responsibilities. The appearance at initial debtor interviews, the appearance at 341(a)s, the filing of schedules and the like, making sure that they pay their post-confirmation taxes, and making sure that they have insurance in place.

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However, we welcome H.R. 3150 in the sense that we will now have statutes to refer to in order to ensure debtors' compliance.

Mr. **GEKAS.** So the unforeseen consequences of the 1978 body of bankruptcy laws were cured in a way internally by the planning of the United States Trustees, is that correct?

Ms. **STAIANO.** I believe so. We have attempted to cure that, but it would be nice to have a statute.

Mr. **GEKAS.** Thank you for saying that.

Mr. Graham, my time has run out. I have just one quick question. And that is I am not fully capable of envisioning in my mind a good faith exception on the serial filings.

Could you give me a quick spotlight on that?

Mr. **GRAHAM.** Basically, what I would suggest is that there be some language added to the bill that would say that a motion that was made, or an action taken by a creditor against a serial filer in good faith, because the creditor believes that the automatic stay did not apply, would not result in sanctions being imposed for violation of the automatic stay.

I am not saying that the creditor should be exempted from the automatic stay. I am merely saying that the punitive damages that can be assessed against someone who takes actions in violation of the automatic stay should be softened, where someone believes that there has been a serial filing.

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Because I will tell you, Mr. Chairman, in my own personal experience, what happens. You get an order of relief from the stay or you get the case dismissed against the debtor who has filed in Florida or filed in New York, and then they file in Texas or in California just before you are about to take some action. And you have to run down to Texas and go before another bankruptcy judge who does not know about the first case. So I think that there should be some relief from the sanctions.

Mr. **GEKAS.** We are going to take that into consideration. It is an idea that I had not thought of until now. So we are going to take note of it, and see if it is worth including.

Mr. **GRAHAM.** Thank you, Mr. Chairman.

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

The gentleman from New York is recognized for 5 minutes.

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

Professor Resnick, you talked about some of the requirements of the expedited procedures for small business and the proposed changes to Chapter 11.

Could you explain why you think that this would really make it very difficult for many viable small businesses to survive; in other words, why you think we have gone overboard here?

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Mr. **RESNICK.** Many businesses, and especially the way that small businesses would be defined under this bill, so it is not just small business, but many businesses that are suffering from operational difficulties need some time to stabilize. There are many businesses out there that are seasonal. In these businesses, early on, the management must devote a lot of attention to stabilizing and trying to turn around the business.

And this is a collective effect. You could take any one of these things and say that does not seem like a big deal. But the debtor must, for example, attend interviews and more meetings, and must file many more reports. You hear from small businesses about the difficulty of complying with "big government" by filing a lot of reports. Now there will be more reports and more projections.

Mr. **NADLER.** More reports than the big businesses?

Mr. **RESNICK.** There will be under this bill. The small business provisions under this bill would require more projections and financial reporting applicable to the small businesses, more interviews, and meetings, and so on.

Mr. **NADLER.** Than of big businesses?

Mr. **RESNICK.** I believe so. They will have to maintain insurance. And everybody says that is fine. But very, very early, if the insurance is not maintained in the case as it normally is in the industry, that can result in dismissal.

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And the real problem that would cause the difficulty is if the debtor did not stabilize the business, turn it around, and negotiate a plan within 90 days, then the plug will be pulled.

Mr. **NADLER.** Mr. Case said that the 90 days is important to get realistic time pressure, but that they can get plenty of extensions if they are making progress.

Mr. **RESNICK.** That is not what the bill says. The bill will permit an extension, if they can show that it is more likely than not that they will be able to confirm a plan. The problem with that is that you are going to have courts holding mini-confirmation hearings without a plan being filed. And having a crystal ball, trying to figure out whether the debtor meets the burden of showing that there will be a plan confirmed.

In many businesses, and again the definition of small business will cover 85 percent of the businesses going into Chapter 11, it would be very hard to meet that burden. And even if they get past the 90 days, there is the 150 days. Basically, in 85 percent of the Chapter 11 cases, you must be in and out of Chapter 11 in about 5 months.

Mr. **NADLER.** What is the average time now?

Mr. **RESNICK.** I do not know. I could not tell you that.

Mr. **NADLER.** It is longer than 5 months?

Mr. **RESNICK.** It may be. In fact, we heard testimony from the United States Trustee, I believe, that most plans are confirmed within 1 year, 60 percent; and something like 90 percent in 2 years.

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Mr. **NADLER.** Would the 90 day time limit give an incentive to creditors not to negotiate?

Mr. **RESNICK.** I believe it would, sure. They would like to string it along. Because they know that after 90 days, if they go to court for a hearing after 90 days and just say we are not going to agree to anything, then the court really has no choice but to pull the plug on a business that could reorganize otherwise.

Mr. **NADLER.** Thank you.

Let me change the topic to single asset real estate. This bill would remove the cap. As you may know, the technical corrections bill that passed the House last year that is pending in the Senate waived the cap in a nonpartisan compromise from $4 million to $15 million. I assume that we are going to await to see the impact of that increase, and whether it worked out well or not as well as it should. And then decide based on that experience whether further changes were necessary.

Without the cap, the single asset real estate rules would apply to projects of any size. For example, Rockefeller Center.

What do you think that the effect of this would be on a large project such as Rockefeller Center treated as a single asset real estate venture under the expedited procedures without a cap?

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Mr. **RESNICK.** I think that it would be extraordinarily difficult. First of all, it is likely today that there will be real estate investment trusts with equity interests in it. These are sometimes very complex organizations. They are not the same as small business. They would have 90 days. And if the unsecured mortgage holder objected and would not go along with the plan, it would require the equity owners, if they wanted to keep that going and owning the entity, to come up with an amount equal, I think, to 25 percent of the value of the property, which would be frankly prohibitive.

So there would be many more foreclosures and much bigger foreclosures as a result of this bill.

Mr. **NADLER.** Because of doing away with the cap?

Mr. **RESNICK.** Because of doing away with the cap and including it within the "small business" definition with fast tracking, and also requiring 25 percent pay down on the mortgage in cash immediately in order to continue to operate the business.

Mr. **NADLER.** Just one more question.

Mr. Gose in his testimony said that there is no difference in his opinion in putting single asset realty projects simply based on size. In other ones, the small ones and the big ones are essentially the same, at least for our purposes.

Would you comment on that?

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Mr. **RESNICK.** I would respectfully disagree with that. To think that the strip shopping center down the street has the same complexity in reorganizing as something like Rockefeller Center, especially again today with the equity being owned by pension funds and public moneys, and much more complex financial transactions. And to expect that to be wrapped up within a 90-day period to put in a plan is just unrealistic. There is a very big difference between reorganizing Rockefeller Center and reorganizing the strip shopping center down the street.

Mr. **NADLER.** One last question, if I may, with the indulgence of the Chair.

What effect if any would this have, let us say on Rockefeller Center, what effect, if any, would this have on any collective bargaining agreements that might be in effect?

Mr. **RESNICK.** Well, it would affect the collective bargaining agreements. It would be a foreclosure of the property. And the bank would take it or it would be sold, and it certainly would have an effect on the existing

collective bargaining agreements with the owner. The property would be foreclosed upon. And that certainly can affect collective bargaining agreements with respect to those who work on the property. And especially with a large complex real estate venture such as Rockefeller Center, obviously it could be very significant.

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

Mr. **BRYANT** [presiding]. Thank you.

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The gentleman from Massachusetts, Mr. Delahunt.

Mr. **DELAHUNT.** I have no questions, Mr. Chairman. I will yield whatever time I may have to the ranking member, if he has any further questions.

Mr. **NADLER.** No. We will leave it at that. Thank you.

Mr. **BRYANT.** The other gentleman from Massachusetts, Mr. Meehan.

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

Mr. Case, how do you respond to Professor Resnick's criticism of the small business provisions of H.R. 3150, particularly his argument that the new duties imposed on small business debtors are so burdensome as to hinder reorganization, and that the filing deadlines will force small business debtors to file ill-conceived or perhaps poorly drafted plans?

Mr. **CASE.** I think that my friend Alan Resnick's response under-weighted the availability of extensions. And I believe that what the members of the Commission had in mind when they voted for this recommendation was the concept, and this is what I would do if a case like this walked into my office, if the legislation were enacted, I would say to the client you have got to prove to this judge that you can make it, let us go find somebody who will testify, who will look at your business, and testify that your business will make it. And the accounting professions and the consulting professions can do that.

And there is going to be a lot of benefit to that. And the benefit to that will be that it will get the debtor talking to somebody who might tell him what is wrong with the business. He might tell him you are kidding yourself, you cannot make it.

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Mr. **DELAHUNT.** Mr. Case, I just have a question, if my friend from Massachusetts would yield.

Mr. **MEEHAN.** I yield.

Mr. **DELAHUNT.** You say that. Yet at the same time, you have got to find somebody. It has to be a professional presumably.

What is the cost of that to the small business? I think that is the point that the gentleman is driving at. Is there an additional cost there, and what is the reality, what is the range of that cost? You obviously are experienced.

Mr. **CASE.** A few days of time of an experienced accountant might be $2000, $3000, $4000, in that order of magnitude.

John, is that not what we discussed at the Commission?

Mr. **GOSE.** That is what the testimony was at the Commission. The problem seems to be in the small business that the small business proprietors were not doing the things that we saw in large business, that is interviews. They would not show up for the 341 interviews. And there was no way to force them to go through really the basics. And this was an attempt to make a set of rules that would apply to everybody, and to work in a fair fashion.

There is a cost to these things. We heard testimony that there was great cost to these things, if the small business goes along and goes along, and 3 years later it then finally liquidates. The only people that make money out of that are the bankruptcy lawyers.

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Mr. **MEEHAN.** Professor, would you respond to that, and then I want to follow up with Mr. Case.

Mr. **RESNICK.** Well, I think, and I respect Steve Case's opinion on this, but I think that it is not just a question of going out early in the case, and find some expert who is going to come in for $2000 or $3000 and testify that this business is going to make it. First of all, the standard in the bill is not whether the business is going to make it, but for the plan to be confirmed more likely than not. And that depends on the willingness of creditors, and it takes negotiation and so on.

Mr. **MEEHAN.** Do you want to respond to that?

Mr. **CASE.** I agree with what Alan said. And I suppose that a reasonable Congress could change the standard if it wanted to, whether a business is viable enough to confirm a plan. So you do not have to find out whether the creditors will vote for it.

Mr. **MEEHAN.** Do you think that is doable?

Mr. **CASE.** Yes. One of the gentlemen who advised the commissioners was Judge Carlson from San Francisco, who has extensive experience in presiding over these cases. And he told the members of the working group that anybody who filed in his court, a small business now, you know, an ethnic restaurant with seven employees and cases like that, that the creditors would get nothing in the liquidation, and they would know it.

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They would vote to confirm any plan that was presented to them, five cents or ten cents on the dollar, if they thought that the entrepreneur was an honest guy. But they would never vote for a plan where they felt that they had been cheated. That is an empirical fact from one experienced judge.

So I do not think that in small business cases that the issue of new creditor negotiation with the unsecured is a big deal in getting confirmation.

Mr. **MEEHAN.** In your testimony, you suggested that it would not be so difficult for a small business debtor to secure an extension of the new filing and confirmation deadlines. But Professor Resnick seems to suggest that it would be difficult for small business debtors to secure extensions.

Two members of the Bankruptcy Review Commission, who dissented from the Commission's small business proposals, argued that the judges would be severely constrained even in the granting of extensions.

Can you explain the basis for this difference?

Mr. **CASE.** I think that the working group members who recommended this proposal to the Commission felt that if a good fact showing could be made at the extension hearing about the viability of the business, that the Court could be

very liberal in granting extensions in order to save a viable business.

Commissioner Alex, who voted for this, made his comment at the meeting in Detroit when he voted for it saying I believe in Chapter 11 and I like to see business saved. He said I am voting for this, because I think that if you are going to fail that you should fail early. Let us get the employees and the assets redeployed in the economy. And as Commissioner Gose says, let us not have a case that goes around for 3 years doing nothing for anybody except paying legal fees.

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Mr. **MEEHAN.** Professor, could you comment?

Mr. **BRYANT.** Without the objection, the gentleman is allowed one additional minute.

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

Mr. **RESNICK.** Again, I respectfully disagree with what Mr. Case is saying. Frankly, if you look at the current statute right now for Chapter 11 for small business plan development, there is 120 days to file a plan. That is the exclusivity period. I think that what Mr. Case is suggesting is that courts in the future if this bill is passed, 3150, will use much the same standard, but the bill expects a much higher standard. That more likely than not, a plan will be confirmed within 90 days.

And what I am hearing Mr. Case say, with all due respect, is that judges could be liberal on granting extensions. But the statute now says you have 120 days. As it stands right now, it does not have to be fixed.

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

Mr. **BRYANT.** Thank you.

Mr. **CASE.** Could I have a 10-second indulgence to correct what I believe is an error in what I believe my friend, Professor Resnick, said?

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Mr. **BRYANT.** The Chair would yield to Mr. Case.

Mr. **CASE.** The standard in the statute is you can get an extension, if it is more likely than not that the debtor can confirm a plan within a reasonable time. There is no requirement that extensions be limited to 90 days. I think that what the language contemplates is that if the debtor can make a showing of viability, and even if he can say it will take me 2 years to get there but I am going to get there, he can have a 2-year extension.

Mr. **RESNICK.** There is nothing inconsistent with that. But nevertheless, you have 90 days in the bill, in H.R. 3150. In the bill, there is 90 days. If you want to get beyond 90 days, you have this burden of showing that it is more likely than not that a plan will be confirmed within a reasonable time. I apologize for leaving out "within a reasonable time." But under the statute, the Bankruptcy Code, as it exists today, you have 120 days that could be extended by the Court.

And what I believe that I heard Mr. Case say with all due respect is that Bankruptcy Courts in the future, if H.R. 3150 is enacted, will be liberal in applying that. So therefore, we are back to exactly where we are today under the Bankruptcy Code. No discrimination against small businesses. Get 120 days or come to the court and show cause that the time should be extended.

Mr. **BRYANT.** Let me reclaim my time here.

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Mr. Gose, I know when I took the Chair that Professor Resnick was explaining about the single asset and how that might vary from circumstance to circumstance. I assume that now it would not be appropriate to put them under the same rules in effect.

With regard to lifting this cap, just having an unlimited cap or no cap, what is your feeling on that in response to Professor Resnick?

Mr. **GOSE.** Well, I would respectfully disagree. I do all types of real estate transactions, and have done hardly anything else for the past 30 years or so. And I can see ones that are $100,000 that are very complex, and $30 to $100 million that are very simple. I do not think that there is any necessary correlation between the two.

Further, he referred to REITs as falling under this category. The way that we have defined single asset real estate is we have now limited it to protect these conglomerates. It has to be one entity, one building, one function here. You cannot have a relationship.

Because we were scared that the creditors, and I represent a lot of creditors, would force a conglomerate to put their factory, their widget factory, into a separate single asset real estate, and we did not want that to happen.

If this is a conglomerate with a business, then that business should be reorganized with Chapter 11 and should not fall under single asset real estate.

This simply does not apply to REITs unless it is a single REIT and a single piece of property. With my experiences with REITs, that simply does not happen. They own shopping centers and apartments, and they have them all over the country.

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He also commented on the labor problem. I think that the labor problem is an attempt to build an impossible paradigm. Creditors are driven by economics. You know, they are like Willy Sutton, they go where the money is. And it flies in the face of their economic interest to get rid of labor.

In any foreclosure or liquidation that I have done, we never get rid of labor. We might get rid of management. But once you close this entity, once you have your labor out and you close the entity, then what are you into. You have got a closed building. First, you have lost your cash flow. Secondly, you have lost your grandfathering. So you are into building codes, zoning codes, and everything else. It flies in their economic face to do it.

And again, we have never done this. I only know one hotel where they did this. It is the Davenport Hotel in Spokane, Washington, and it is still closed 30 years later. Those people are a vital part of your economic cash flow.

Mr. **BRYANT.** Let me do this. We are still on the first panel. And I would like to bring this panel to a close, if we could.

Mr. **MEEHAN.** Mr. Chairman, I just wanted to follow up with one quick question on that.

Mr. **BRYANT.** One question would be fine.

Mr. **MEEHAN.** What is your reaction to Professor Ken Klee's alternative single asset real estate proposals, which seem to have enjoyed the support of the five members of the Bankruptcy Review Commission who did not serve on the small business working group?

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Mr. **GOSE.** I have the deepest respect for Professor Klee, and we debate this all over. And let me tell you how that came about. We had one vote on single asset real estate when the whole Commission was together. It was a five to four vote. The majority voted for it.

Ken approached me afterwards and said he would like to propose an alternative. I think this is fine. This is a vital part. To the best of my knowledge, the Commission never voted on that. And I simply disagree with the commission report that says five members did. If they did, nobody came to me as a commissioner. I do not know anybody. We only had one formal vote.

And I have said to Ken several times, tell me the difference between $12 million, $15.5 million, $27 million, pick your number. I do not think that they go out that way. I think that they go out on the project. I simply disagree with Professor Klee. But he is probably a lot smarter than I am.

Mr. **MEEHAN.** It seemed like the five members supported it.

Mr. **GOSE.** But sir, with all due respect, I do not think that vote ever took place. If it ever took place, I was at a different session. That is what that says.

Mr. **MEEHAN.** It happens with us sometimes. [Laughter.]

Mr. **BRYANT.** Let me thank this very distinguished panel, and excuse you at this time.

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And if the members of the second panel would come forward.

Let me welcome this panel. Just proceed at your pace. Do not let me rush those of you who are not ready. In the interest of time, I might say that we have a very distinguished panel, but I am not going to read the resumes. If you do mind, they certainly will be made part of the record. I will just briefly introduce each panelist with their title.

We have the Hon. Robert F. Hershner, Jr., Chief Bankruptcy Judge, the Middle District of Georgia. Mr. Norman Kranzdorf, who is President of Kranzco Realty Trust, out of Conshohocken, Pennsylvania. Mr. James E. Smith, President and Chief Executive Officer of the Union State Bank and Trust in Clinton, Missouri.

In addition, Charles M. Tatelbaum, Esquire with Johnson, Blakely, Pope, Bakar & Ruppel out of Tampa, Florida; Mr. Leon S. Forman, Esquire, Blank Rome Comisky & McCauley from Philadelphia; and Mr. William J. Perlstein, Esquire, Wilmer Cutler & Pickering of Washington are present. Mr. Harold J. Bordwin, Vice President of Keen Realty Consultants, Inc. out of Long Island is present as well.

Mr. **NADLER.** Mr. Chairman.

Mr. **BRYANT.** Yes.

Mr. **NADLER.** I would just like to say a word here. I would like to extend a welcome especially to Mr. Harold Bordwin, who is a very distinguished practitioner and a nationally known expert from New York City.

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Mr. **BRYANT.** Thank you.

Mr. **DELAHUNT.** Mr. Chairman.

Mr. **BRYANT.** Yes.

Mr. **DELAHUNT.** As a matter of record, I want to welcome every member of this panel. I know that there are seven members. And I made earlier remarks in terms of the number of witnesses testifying. I wish that these hearings had been spaced out over a more extended period of time, so that we could have an opportunity to listen fully and to examine each of these witnesses in a less hurried fashion.

I think that this is an example of having a resource available to us that is unfortunately going to get somewhat short shrift given our own individual schedules.

Mr. **BRYANT.** Thank you for your comments. And we will move forward.

Mr. **MEEHAN.** Mr. Chairman, I just want to echo that. This is three panels in one.

Mr. **BRYANT.** Thank you.

Judge Hershner, would you proceed.

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STATEMENT OF ROBERT F. HERSHNER, JR., CHIEF BANKRUPTCY JUDGE, MIDDLE DISTRICT OF GEORGIA, PRESIDENT, NATIONAL CONFERENCE OF BANKRUPTCY JUDGES

Mr. **HERSHNER.** Mr. Chairman and members of the subcommittee, I speak on behalf of the National Conference of Bankruptcy Judges. The National Conference of Bankruptcy Judges was founded in 1926. Of the 326 bankruptcy judges in the United States, 319 are members of the organization.

The National Conference of Bankruptcy Judges has been asked to testify on whether Chapter 12 should be made a permanent chapter of the Bankruptcy Code. The NCBJ is of the opinion that Chapter 12 is working well nationally, and that it is serving its purpose of enabling family farmers to deal with financial distress.

The NCBJ sees a continuing need for the availability of the relief provided by Chapter 12. It is the view of the NCBJ that Chapter 12 should be made a permanent chapter of the Bankruptcy Code. We, therefore, support the enactment of Section 203 of H.R. 3150, and we also support S. 1024 introduced by Senator Grassley.

As a personal observation, I would observe that at present we have 85 pending cases in the Middle District of Georgia. We had as much as 175 pending. It is working really well. It has afforded an opportunity for family farmers to save their farms, and it really has been a success.

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On behalf of the National Conference of Bankruptcy Judges, I have submitted written testimony, which is now part of the record. In the written testimony, I have addressed some other issues, such as implementation and the complexity of the H.R. l350, which may give unexpected results.

I thank you for the opportunity to participate in today's proceedings. And I know that I speak for all of the members of the National Conference of Bankruptcy Judges in saying that we relish the opportunity to work with Congress in this important legislative effort. Thank you.

[The prepared statement of Judge Hershner follows:]

PREPARED STATEMENT OF ROBERT F. HERSHNER, JR., CHIEF BANKRUPTCY JUDGE, MIDDLE DISTRICT OF GEORGIA, PRESIDENT, NATIONAL CONFERENCE OF BANKRUPTCY JUDGES

The National Conference of Bankruptcy Judges was founded in 1926. Since its founding, the NCBJ has been a resource for Congress in the drafting of bankruptcy legislation. Of the 326 bankruptcy judges in the United States, 319 are members of the organization.

The National Conference of Bankruptcy Judges has been asked to testify on whether Chapter 12 should be made a permanent chapter of the Bankruptcy Code. The NCBJ is of the opinion that Chapter 12 is working well nationally and that it is serving its purpose of enabling family farmers to deal with financial distress. The NCBJ sees a continuing need for the availability of the relief provided by Chapter 12. It is the view of the NCBJ that Chapter 12 should be made a permanent chapter of the Bankruptcy Code. We, therefore, support the enactment of Section 203 of H.R.3150, and we also support S. 1024, introduced by Senator Grassley.

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The National Conference of Bankruptcy Judges received an inquiry from the Subcommittee on Commercial and Administrative Law about testifying on implementation of H.R.3150. Members of the NCBJ immediately devoted considerable effort to this inquiry. The NCBJ has now been asked to testify on Chapter 12, and having reached some conclusions on the important issue of implementation, the NCBJ would like to share its conclusions with the Subcommittee. Attached, as a supplement to this written statement, is a ten-page analysis of how means testing and other provisions of H.R. 3150 would affect the workload of the bankruptcy judges, and by reference thereto, the NCBJ would like to incorporate that study into this written statement.

The National Conference of Bankruptcy Judges concludes that additional judicial and administrative resources would be needed to implement H.R. 3150. Because of the complexity of the legislation, it is impossible, without considerable study and consideration, to estimate the extent and the costs of the additional resources that would be needed.

The National Conference of Bankruptcy Judges respectfully submits that H.R. 3150 is major legislation which would result in fundamental changes in the bankruptcy law. The NCBJ shares the concern of Congress with the increased number of bankruptcy filings and with some of the obvious problems in the bankruptcy law. Still, such fundamental changes should only be considered by Congress after study and thoughtful analysis.

Review of this complex legislation reveals that it may give unexpected results which should be considered before passage. It is very likely that this legislation would cause consumers, both within and outside of the bankruptcy system, to be unable to pay such basic obligations as mortgages, alimony, child support, and student loans. Certain changes in the treatment of tax obligations may make the tax system more onerous. Debtors who have fallen out of the tax system might be deterred from attempting to re-enter it. It is possible that these changes might adversely impact upon the nation's economy.

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Fundamental changes in the bankruptcy law surely require thorough and thoughtful considerations. The NCBJ stands ready to help Congress in a deliberate approach to this legislation. Given the opportunity to compile data and to study implementation of this legislation, the member judges of the NCBJ would be a valuable resource to Congress.

H.R. 3150

1. Means Testing

A. Section 101—EIigibility To Be a Chapter 7 Debtor

Section lO9(b) of the Bankruptcy Code defines who is eligible to be a debtor under chapter 7 of the Code. Under current law, any individual may be a chapter 7 debtor. Certain types of entities, however, are not eligible to be a chapter 7 debtor, e.g., railroads, banks, insurance companies.

Section 101 of H.R. 3150 proposes to amend section lO9(b)of the Code to specify that an individual is not eligible to be a chapter 7 debtor if she has "income available to pay creditors." A debtor is considered to have "income available to pay creditors" if the debtor has: (1) current monthly total income that is 75% of the national median income for a household of equal size; (2) projected monthly net income greater than $50; and (3) projected monthly net income sufficient to repay 20% or more of unsecured, nonpriority claims during a 5-year period. "Projected monthly net income" is defined as current total monthly income less (1) the debtor's living expenses allowable according to standards established by the Internal Revenue Service, (2) the average monthly payment on secured debt, and (3) the average monthly payment on priority debt.

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If the debtor believes that she has additional expenses due to extraordinary circumstances, she must file a detailed statement and justification for these additional expenses with the bankruptcy petition. The trustee or a party in interest has 60 days to object to this statement. The debtor has the burden of establishing the right to claim these additional expenses.

Section 101 of H.R. 3150 also proposes to amend section 704 of the Code. Section 704 defines the duties of a chapter 7 trustee. The proposed amendment would require that the trustee, in addition to his other duties, review the financial information provided by the debtor under section 521 of the Code, investigate and verify the debtor's projected monthly net income, and, within 30 days of the petition date, file a report with the court whether the debtor qualifies for relief under section lO9(b) of the Code.

Section 407 of H.R. 3150 proposes to amend section 521 of the Code to require individual chapters 7 and 13 debtors to file, in addition to those documents already required, the following documents:

(1) federal tax returns for the preceding 3 years;

(2) copies of all "payment advices or other evidence of payment" received by the debtor from her employer within the preceding 60 days; and

(3) a statement of the debtor's projected monthly net income, itemized to show how it was calculated.

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Effect on Bankruptcy Judges:

The amendments proposed by section 101 of H.R. 3150 would place a substantial burden on bankruptcy judges. Thousands of chapter 7 cases are assigned to each bankruptcy judge every calendar year. Although, under the proposed amendments, the trustee is required to do the initial analysis, either the bankruptcy judge or the bankruptcy judge's designee must review each report. The bankruptcy judge could delegate the initial task of reviewing the reports to a clerk so that the bankruptcy judge need only consider those reports in which the trustee determined that the debtor was not eligible for chapter 7 relief. However, if it appears to the trustee that even 10% of these debtors are not eligible for chapter 7 relief, a motion to dismiss would have to be filed and notice given to interested parties. The bankruptcy judge would be required to review the motion and, in many instances, conduct a hearing. The proposed amendment does not specify who has the duty to prepare and file the motion. If the court rather than the trustee has this duty, this will involve more bankruptcy judge time.

An even greater burden would be created by debtors who do not file the required financial information on a timely basis. This burden is likely to be presented in the form of a debtor's motion to extend the time to file the financial information. Alternatively, when the debtor has filed the information too late to permit the trustee to file a timely report, the trustee would presumably need to file a motion to extend the deadline for filing a report. The number of cases in which debtors fail to file their financial information on a timely basis probably would be much greater than the number of cases in which the financial information would show that the debtors are not eligible for chapter 7 relief.

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B. Section 103—Dismissal under Section 707(b)

Section 103 of H.R. 3150 proposes to amend section 707(b) of the Code. Under current law, a chapter 7 case of an individual whose debts are primarily consumer may be dismissed if it constitutes a "substantial abuse" of the bankruptcy law. However, the action may not be taken at the request or suggestion of a creditor. Section 707(b) of the Code does not set forth the standards for finding "substantial abuse." Different circuit courts of appeal have developed different tests, although all courts consider to some extent the debtor's ability to repay debt either through a chapter 13 plan or outside of a bankruptcy case.

Section 103 proposes to amend section 707(b) of the Code to permit any party in interest to file a motion to dismiss. The court would be required to dismiss the case if the debtor is not eligible to be a debtor under amended section 109 of the Code. Thus, if the debtor has income available to pay creditors according to the standards discussed above, on motion filed by a party in interest, the court must dismiss the case. As an alternative ground, the bankruptcy judge must dismiss the case if the totality of the circumstances demonstrates that the bankruptcy filing was an inappropriate use of the Code.

Effect on Bankruptcy Judges:

This proposed amendment would add another issue to be decided by a bankruptcy judge. One way or the other, where the debtor fails to meet the standards to qualify to be a chapter 7 debtor, the bankruptcy judge will have to initiate and preside at a hearing, or consider whether adequate notice and opportunity to request a hearing has been given to a debtor and, if so, to sign an order dismissing the case. The trustee would be required to review each case and report to the court on the debtor's eligibility (assuming either the court or the trustee must initiate a motion to dismiss when the debtor is ineligible). The fact that the creditor is also given standing to bring a motion to dismiss will add an additional party who may bring an issue to the bankruptcy judge for decision.

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The approach taken by H.R. 3150 is too rigid. It removes the bankruptcy judge's discretion to deviate from the eligibility standards even when there are the strongest equities calling for such deviation.

It might appear that a threshold test based on national income averages could easily be administered, but the opposite would probably happen. Debtors would routinely request exceptions from the rigid standards. These requests would require resolution by the bankruptcy judge after a hearing.

C. Sections 101, 102, 407 and 408—Annual Review of Debtor's Income in Chapter 13 Cases

Under current law, in order to confirm a chapter 13 plan, if the trustee or an unsecured creditor objects, the bankruptcy judge must find that the debtor proposes to apply all her projected disposable income during a 3-year period to payments under the plan. 11 U.S.C. 1325(b)(1)(B). The plan may be-modified at any time after confirmation to increase or reduce the amount of payments on claims. 11 U.S.C. 1329(a)(1). Debtors frequently file motions to modify their plans to reduce the amount of payments because of reduced income or increased expenses. However, debtors have no incentive to modify the plan after confirmation to increase payments if their income increases, expenses decrease, or they win the lottery.

Section 102 proposes to add a new section to the Bankruptcy Code-section 111. Section 111 would provide that a debtor's "monthly net income for purposes of a plan under chapter 13" may be adjusted annually if the debtor files a statement establishing "extraordinary circumstances" requiring an adjustment on or before each anniversary date of the confirmation. The debtor is required to serve the statement only on the trustee. The trustee must give notice to creditors of the proposed adjustment within 15 days of its receipt. Creditors have 30 days from the date the statement is filed to

file objections. If an objection is filed, the bankruptcy judge must determine, after notice and a hearing, whether extraordinary circumstances exist that justify the adjustment. The debtor has the burden of proof.

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Section 407 of H.R. 3150 proposes to amend section 521 of the Code to add to the documents that a debtor must file with the bankruptcy court. The additional documents include copies of any tax returns filed while the case remains open at the same time the returns are filed with the taxing authority. As amended, section 521 would require that a chapter 13 debtor file an annual statement of income and expenditures for the preceding tax year and a statement of current monthly net income.

Section 408 of H.R. 3150 proposes to amend section 707 of the Code to add a new subsection (e) which would provide for an automatic dismissal of the bankruptcy case, without notice, hearing, or court order, if the required information is not filed within 45 days of the petition date. Although an order of dismissal is not required, if a creditor requests an order, the bankruptcy judge must enter the order within 5 days.

Section 408 also proposes to amend section 707 of the Code to add a new subsection (f) which would permit any party in interest to request that the court order the debtor to comply with the obligations under certain subsections of section 521 of the Code. The bankruptcy judge is required to issue the order within 10 days of the request and to give the debtor no more than 30 days to comply. If the debtor does not comply, the bankruptcy judge is required to dismiss the case within 5 days of a request for dismissal which contains a certification that the debtor has not complied with the court's order.

Effect on Bankruptcy Judges:

These sections substantially increase the participation of bankruptcy judges. The proposed amendments probably will not motivate debtors to modify their plan payments any more frequently than they do already. There will be many motions to modify plans filed by creditors based on a debtor's improved circumstances, as reflected in the debtor's tax returns. However, there may be a great number of cases in which debtors fail to timely file the required documents during the course of the plan.

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It is not clear whether a trustee must file a motion to dismiss if debtors fail to file these documents. If they do, this will necessitate more involvement by bankruptcy judges. In most instances, debtors will ask for additional time to file. The debtor's prompt cure will also need to be monitored. Even if the trustee is not required to monitor the timely filing of these documents, if creditors regularly review chapter 13 files to see if these documents have been filed, bankruptcy judges will be required to deal with creditors' requests for orders compelling debtors to comply and with their requests to dismiss the cases if they do not comply.

However, the most troubling part of these provisions are the time frames imposed on the bankruptcy judge when a creditor requests relief, i.e., either 5 or 10 days, depending on the type of relief requested. These time frames are not realistic given the number of bankruptcy cases and the volume of paperwork created by each case (which would dramatically increase under the proposed amendments). If expedited relief seems appropriate, it would be more practical and customary to specify these time periods as notice periods rather than deadlines within which the bankruptcy judge must act.

2. The Effect of Other Provisions on Bankruptcy Judges

A. Section 143—Fraud Debts Nondischargeable in Chapter 13

Under current law, certain debts that are nondischargeable in a chapter 7 case are dischargeable in a chapter 13 case, i.e., debts incurred through fraud (11 U.S.C. 523(a)(2)), breach of fiduciary duty (1 1 U.S.C. 523(a)(4)), and willful

and malicious injury (11 U.S.C. 523(a)(6)). Section 143 of H.R. 3150 proposes to amend section 1328(a)(2) of the Code to make these debts nondischargeable in a chapter 13 case.

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Effect on Bankruptcy Judges:

This provision will create a burden for bankruptcy judges. Most of the trials conducted in chapter 7 cases in the bankruptcy court are nondischargeability actions under section 523(a)(2), (4), or (6) of the Code. Under present law, chapter 13 cases do not involve these dischargeability issues. Trial of these adversary proceedings in chapter 13 cases will undoubtedly add to the workload of bankruptcy judges. It is likely that such adversary proceedings, with the requirements of civil procedure, discovery, and trials will delay the processing of Chapter 13 cases.

B. Section 121—Relief From Stay Provisions for Repeat Filers

Section 121 of H.R. 3150 provides that the automatic stay of the Code will expire 30 days after the petition is fried if the debtor had a prior bankruptcy case which was dismissed within the preceding year. The bankruptcy judge may extend the stay if the bankruptcy judge finds that the debtor filed the second case in good faith, but must make the determination within a 30-day period. The case is presumptively filed in bad faith under certain circumstances. The debtor may rebut this presumption only by a showing of clear and convincing evidence.

Effect on Bankruptcy Judges:

This proposed amendment would place a substantial burden on bankruptcy judges. Additionally, its effectiveness to combat the problems created by the truly abusive repeat filer is questioned.

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3. Miscellaneous

A. Sections 101 and 102—$50 per Month Requirements

Section 101 of H.R. 3150 provides, in part, that an individual debtor with primarily consumer debts is not eligible to file a chapter 7 case if the individual has projected monthly net income greater than $50. Projected monthly net income is calculated by deducting payments on secured debt and priority debt from current monthly total income.

Comment:

This approach has two potential substantive defects. First, a frequent complaint about the bankruptcy system is that it permits debtors with generous incomes to file bankruptcy relief while maintaining their lavish or at least comfortable life style. Frequently, a lavish life style is reflected by high secured debt payments. These debtors may have no projected monthly net income as that phrase is defined here. The amendment does not address that concern.

Second, section 102 proposes to amend section 1325(b)(1)(B) of the Code to require a chapter 13 plan to pay at least $50 per month to nonpriority unsecured creditors. Many chapter 13 cases are filed to permit debtors to cure the arrearage on their home mortgage. Some are filed to permit debtors to pay off their priority debt in a controlled fashion. In some of these cases, the debtors have little, if any, nonpriority unsecured debt. This provision would prevent these debtors from taking advantage of the provisions of chapter 13.

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B. Section 406—Revi$ed Schedule for Filing and Confirmation of Chapter 13 Plans

Under current law, a chapter 13 debtor has 15 days from the petition date to file a plan. Fed. R. Bankr. P. 3015(b). Section 406 of H.R. 3150 extends this deadline until 30 days after the petition date. Creditors are entitled to 25 days' notice prior to a hearing on confirmation. Fed. R. Bankr. P. 2002(b). Under section 406 of H.R. 3150, a confirmation hearing must be held within 45 days of the filing of the plan.

Comment:

The wisdom of extending the deadline for filing a plan is questioned. However, it does seem appropriate to provide for the deadline for filing a plan in a Code section, rather than as, at present, in a rule.

C. Section 161—Debtor's Assumption of Personal Property Lease

Under current law (11 U.S.C. 365), with some exceptions, a trustee is given the right to decide whether to assume or reject a lease or executory contract (i.e., a contract that has not been fully performed). The significance of "assumption" is that the obligations under the lease or contract become a priority obligation of the estate. The trustee will request the court's permission to "assume" the lease or contract only if the benefits to be gained under the lease or contract are greater than the obligations that must be satisfied. In a chapter 11 case, the debtor in possession exercises this power on behalf of the estate. Depending on whether the case is a chapter 7, 13, or 11 case and depending on the type of property, the lease or contract may be deemed rejected if it is not assumed within a specified time. Alternatively, the court may set a deadline for assumption. The lease or contract must be either assumed in the plan or it will be deemed rejected upon confirmation. Rejection of the lease or contract does not eliminate the obligation; the debt is simply relegated to nonpriority status.

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Section 161 of H.R. 3150 proposes to amend section 365 of the Code to add a new subsection—section 365(p). Section 365(p)(1) would provide that, if a chapter 7 trustee rejects the lease of personal property or does not assume within the required time, the leased property is no longer property of the estate and the automatic stay of section 362 of the Code is automatically terminated. Similarly, section 365(p)(3) would provide that, in an individual chapter 11 case and in a chapter 13 case, if the lease is not assumed in the plan and the plan is confirmed, the lease is deemed rejected at the conclusion of the confirmation hearing, and the automatic stay is automatically terminated. There is nothing wrong with these provisions.

However, proposed section 365(p)(2) provides that, in an individual chapter 7 case, the debtor may notify the creditor in writing that the debtor desires to "assume" the lease. The creditor may respond in writing that it is willing to have the debtor "assume" the lease and may require the cure of any outstanding indebtedness as a condition of the "assumption." The debtor then has 30 days to notify the creditor that the lease is "assumed." This "assumption" will create an obligation for the debtor, not the estate. Section 365(p)(2) specifies that neither section 362 of the Code (the automatic stay) nor section 524(a)(2) of the Code are violated by these communications.

Comment:

There are two problems with this provision. First, the use of the word "assumption" in this context is misleading. This provision is really talking about "reaffirmation." The Code has specific provisions governing a debtor's reaffirmation of debt. See 11 U.S.C. 524(c)-(d). If Congress concludes that different procedures should apply to a debtor's reaffirmation of an obligation with regard to leased personal property, this should be addressed in a straightforward manner rather than by calling the action something other than what it is.

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Second, it is unclear whether the debtor's right to reaffirm a lease of personal property so as to retain the property in question comes into play only after the trustee has rejected the lease or failed to assume it within the time required, or instead will cut off the trustee's right to assume the lease. If the lease has value for the estate and the debtor has not

established the right to exempt that value, it is unclear why the debtor should be able to cut off the trustee's right to assume the lease. If the debtor's right to reaffirm the lease and retain the leased property comes into play only after the lease is rejected or deemed rejected by the trustee, this should be made clear.

D. Sections 102 and 410—Confusing Standards for Plan Duration

Under current law, a chapter 13 plan may not last longer than 3 years unless the court, for cause, approves a longer plan duration not to exceed 5 years. 11 U.S.C. 1322(d). This provision applies to all chapter 13 debtors regardless of their income. Sections 102 and 410 of H.R. 3150 propose to amend sections 1322 and 1329 of the Code to establish various standards for determining the maximum length of the plan and, under some circumstances, extend the permissible length to 7 years. All of these standards relate to the debtor's income. However, the standards would be set forth in two different Code sections.

Section 1322(d) of the Code would be amended to provide that, if the debtor's total current monthly income is less than 75% of the national median, the plan duration is presumptively 3 years. If the debtor's total current monthly income is 75% or more of the national median, the plan duration is presumptively 5 years. In both instances, for cause, the court may approve a longer plan duration not to exceed an additional 2 years (i.e., a maximum 5-year duration for debtors with a total monthly income of less than 75%, a maximum 7-year duration for debtors with total monthly income of 75% or more).

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Comment:

Placing these two discrete standards governing plan duration in different sections may create confusion.

E. Section 408—Dismissal for Failure to File Schedules or to Comply with Other Duties

Section 408 of H.R. 3150 provides that, if an individual chapter 7 debtor or a 13 debtor fails to file all the information required by section 521 of the Code within 45 days after die filing of the petition, the case shall be automatically dismissed effective on the 46th day after the filing of the petition without the need for any order of the court.

Comment:

Section 408 provides that the dismissal will occur "without the need for any order of court." This provision for dismissal without court order is unwise from an administrative standpoint. Without a court order, at least one entered by a clerk, the status of a case will be ambiguous, delays in case closings may occur, and statistics may be skewed. If it is considered appropriate to dispense with prior notice to the debtor under these circumstances, it should be adequate to specify that the dismissal will be without notice and hearing or to permit the clerk to issue the dismissal. The dismissal could be made effective retroactively as of the 46th day.

Mr. **BRYANT.** Thank you, Judge. I must say that in 20 years of practice, that is about as brief as I have ever seen a judge. [Laughter.]

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Mr. **BRYANT.** Mr. Kranzdorf.

STATEMENT OF NORMAN KRANZDORF, PRESIDENT, KRANZCO REALTY TRUST, CONSHOHOCKEN, PA, REPRESENTING THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

Mr. **KRANZDORF.** Good morning. Thank you for the opportunity to participate with you. I have been a shopping

center owner and developer for 30 years, and I currently serve as chief executive officer of Kranzco Realty Trust, a REIT. We are headquartered in Conshohocken, Pennsylvania. And we own shopping centers from Rhode Island to Mississippi, 59 shopping centers.

I am testifying today on behalf of the International Council of Shopping Centers, a trade organization for our industry. Shopping centers, as you know, are America's marketplace. We employ over 10 million people and we pay over $40 billion a year in state sales taxes.

Prior to my testimony, let me read a list to you. Babbages, Barney's, Best, Bradlee's, Braun's, Bruno's, Caldor, Camelot Music, County Seat, Edison Brothers, Homeplace, Jamesway, Macy's, Merry-Go-Round, McCrory's, Montgomery Ward, Petrie, Sassafras, Sizzler, Today's Man, Woodward & Lothrop, Venture, The Wiz. I wrote this testimony last week, and we can now add Encore Books.

Your families have probably shopped in all of these stores in recent years, and it should come as no surprise to you that in the last 5 years that every one of those chains have filed Chapter 11 bankruptcy.

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During the past 5 years, over 75 major retail chains representing over 7500 leases have filed bankruptcy. Some of these filings can be tied to real economic distress. However, it appears that bankruptcy is too easily available, the stigma has disappeared, and it has become acceptable, even a praiseworthy business practice for companies not in economic distress to use bankruptcy as a means to undo business arrangements that they now find unfavorable or have just not worked out.

Retail bankruptcies are a hidden problem in the shopping center industry. We do not like to talk about them. They reflect badly on the tenants left in the shopping center, and they drive away new tenants who know that a bankrupt tenant was in the shopping center.

The delay in the bankruptcy process has produced inconsistent results with today's law. The use of a system for economic gain by non-distressed retailers has affected all creditors, not just shopping center owners.

However, shopping centers are especially affected by these problems, because of the unique treatment and the unique nature of the Bankruptcy Code. Shopping center owners are the only compelled creditors under the Bankruptcy Code. By law, a shopping center owner must continue to offer and provide space and services to the debtor.

The Bankruptcy Code protects other compelled creditors, such as utilities, by providing security in the form of large post-petition deposits. Landlords do not.

Other creditors, like a menswear manufacturer, no longer had to sell to Today's Man or Macy's after the bankruptcy, if they do not want to. But landlords are compelled creditors. Under the Code, we may not take any action. In stark contrast, we must provide space and services without any assurance of payment. No deposits are made. And the owner cannot force the debtor to vacate, even if rent is not paid.

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Under the bankruptcy system, attorneys have advised their tenants, bankrupt tenants, not to pay rent, even though the Code says that they must pay rent. If they do not pay the rent, the landlord must go to bankruptcy court every month to force the debtor to pay the rent.

I have a case today where the February rent was not paid. It is now March 19th. And the earliest date that we could get for a bankruptcy hearing to compel February's month to be paid is April 18th. If we were not a large national company, a REIT, if we were a small individual landlord, we would probably be bankrupt waiting for the tenants to pay their rent. Even though the Code says they must, they do not.

Let me give you another example of a problem associated with retail bankruptcies in shopping centers.

Mr. **BRYANT.** Mr. Kranzdorf.

Mr. **KRANZDORF.** Yes, sir.

Mr. **BRYANT.** We have to go vote here in a minute. Could you bring it down in the next minute or so.

Mr. **KRANZDORF.** Yes, sir. Bankruptcies bring problems to landlords. The main problem is the extended period of time of these bankruptcies.

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I mentioned McCrory's. The McCrory's retail chain has stayed in bankruptcy for 5 years. It is now winding up in complete liquidation. There will not be a single McCrory's store left. In 5 years, the attorneys will have collected $3 or $4 million in fees and no landlord will have a McCrory's store when it is all over.

Something has got to be fixed in the Code today. There are suggestions that we have made in our written testimony. And I would like to say to you that we would like to have the Congress, the House, consider strengthening a creditor's ability to have membership on the creditors' committee. As a landlord, I am prohibited from being a member of a creditors' committee, even though I may be the largest creditor that the tenant has. We think that should be remedied.

We support Section 205 of H.R. 3150. Our main concern is posting a deadline by which these debtors must get out of bankruptcy. We feel that 5 years is just unreasonable. It is just devastating to shopping center owners. And we suggest that 120 day deadline period in the report with no extensions.

Our last point is that damage claims are inadequate to a landlord under the present Bankruptcy Code. We are limited to an unsecured claim, unsecured, of 1 year's rent.

I have a case now where I have a Best Products store that went in bankruptcy. It is costing me 3 years rent just to fix up the premises to get a new tenant. I am really devastated getting 1 year's rent when I am going to have to pay three times that, three hundred percent of that, to get the tenant back into occupancy.

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Thank you.

[The prepared statement of Mr. Kranzdorf follows:]

PREPARED STATEMENT OF NORMAN KRANZDORF, PRESIDENT, KRANZCO REALTY TRUST, CONSHOHOCKEN, PA, REPRESENTING THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

I. Introduction

The International Council of Shopping Centers (ICSC) is pleased to present this written statement in conjunction with the Subcommittee's March 19, 1998 hearing on business bankruptcy issues.

Shopping centers are America's marketplace, representing economic growth, environmental responsibility, and community strength. Founded in 1957, the International Council of Shopping Centers is the trade association of the shopping center industry. Its 36,000 members in 70 countries represent owners, developers, retailers, lenders, and all others having a professional interest in the shopping center industry. Its over 30,000 U.S. members represent almost all of the 42,000 shopping centers in the United States. In 1996, these centers accounted for $974 billion in retail sales,

which is 52 percent of total retail sales, excluding sales by automotive dealers, and generated $40 billion in state sales tax revenue. In addition, shopping centers employ over 10 million people, about one of every ten non-agricultural jobs in the United States. In a typical month, 185 million adults shop at shopping centers—94 percent of the population over 18 years of age.

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II. The Adverse Impact of Retail Bankruptcies

Babbages, Barney's, Best, Bradlees, Braun's, Bruno's, Caldor, Camelot Music, County Seat, Edison Brothers, Homeplace, Jamesway, Macy's, Merry-Go-Round, McCrory's, Montgomery Ward, Petrie, Sassafrass, Sizzler, Today's Man, Woodward & Lothrop, Venture, The Wiz. This is just a partial listing of the many retail companies that have filed for bankruptcy in the past five years.

Retail bankruptcies are a "hidden" problem in the shopping center industry. Owners don't like to talk about them—and they do their utmost to resolve them as quickly as possible to lessen the impact on the other tenants in the center. However, the number of retail bankruptcies has increased so dramatically in the last several years, that many in the industry and elsewhere are taking a second look at the reasons behind retail bankruptcy filings and their ultimate impact on other segments of the economy.

ICSC members are concerned not only about the proliferation of bankruptcy filings, but also the delay and cost of the bankruptcy process, its failure to produce results consistent with the law, and the use of the system for economic gain by those who are not insolvent. These issues affect all creditors—not just shopping center owners.

However, shopping centers are especially affected by these problems because of the nature of the business and their treatment under the Bankruptcy Code. Thus, the position of shopping center owners and their solvent tenants is uniquely intertwined and their interests are often misunderstood or ignored.

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III. The Relationship Between a Shopping Center Owner and Its Retail Tenants

Shopping centers operate differently than other commercial enterprises. Shopping centers are a special type of commercial real estate that involves a unique interdependence and synergy between and among the shopping center owner and its tenants.

The shopping center owner designs a "tenant mix" to maximize the customer traffic drawn from a "market area" by leasing to a combination of stores that will draw customers. The tenant mix includes tenants based on their nature or "use", their quality, and their contribution to tenant mix, and is enforced by leases that describe the required uses, conditions, and terms of operation.

Rents and leases reflect the desirability of the tenant's use regarding tenant mix and vary among tenants. The owner's rental income generally is tied directly to the success of the center through "percentage rents".

The tenants pay common area maintenance fees and other fees for the common areas and advertising along with the shopping center owner.

That is how a shopping center operates—and how the relationship between the owner and tenants is nurtured and maintained. However, tenant bankruptcies can deal a tremendous blow to the delicate balance and relationship between owners and tenants—and a lingering economic blow to communities where shopping centers are located.

IV. The Shopping Center Owner as a Compelled Creditor

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Bankruptcy poses risks to shopping center owners that are not faced by other creditors because the owner is a compelled creditor of its debtor retail tenants. As a compelled creditor, the shopping center owner must, under the Bankruptcy Code, continue to provide leased space and services to the debtor tenant. The Bankruptcy Code protects other compelled creditors, such as utilities, by providing security in the form of large post-petition deposits. However, shopping center owners must continue to lease space and provide services to the bankrupt tenant without any real assurance of payment. These services continue until the lease is assumed or rejected. Such disparate treatment of shopping center owners vis-a-vis other compelled creditors falls outside the equal and fair treatment of creditors the Bankruptcy Code purports to insure.

V. Congress Recognizes the Impact of Retail Bankruptcies

In 1978, during consideration of the enactment of Section 365 of the Bankruptcy Code, Congress recognized the uniqueness of shopping center leases and the potential significant economic impact of a tenant bankruptcy on shopping centers and their solvent tenants. In 1984, Congress reaffirmed these policies by strengthening many of the provisions it enacted in 1978—in an effort to protect all parties who may be adversely impacted by retail bankruptcies.

Despite this strong commitment, the bankruptcy courts have eroded many of the protections Congress put in place. Today, we are faced with a bankruptcy system and process that is vastly different than what Congress envisioned.

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VI. Retail Bankruptcy Today: Economic Distress or Blatant Abuse?

Briefly, here is what is happening in retail bankruptcy today. During the past five years, over 75 major retail chains, representing over 7,500 leases, have filed for bankruptcy. Some of these filings

can be tied to economic distress. However, many in the shopping center industry have observed that bankruptcy is too easily available, the stigma has disappeared, and it has become acceptable—even praiseworthy—for companies who are not in economic distress to use bankruptcy as a means to undo business agreements that have not worked out for them.

Now, let us look at several "real life" examples of bankruptcy abuse. Sizzler, a national steakhouse chain, filed for bankruptcy protection in June, 1996. At the time of its filing, Sizzler was in excellent financial condition—claiming three times the amount of assets to liabilities. However, the company wanted to move into a new format and close down unprofitable locations. Sizzler's chief executive officer portrayed the filing as a strategic move that would allow it to escape costly leases. Further he stated, "Chapter 11 bankruptcy doesn't have the stigma it once did. It's seen as a legitimate business tool." This "business tool" allowed Sizzler to terminate 4,600 employees overnight.

Another example of blatant bankruptcy abuse involves the McCrory's Corporation. McCrory's, a large discount retailer, filed for bankruptcy in 1992. Amazingly, McCrory's managed to stay under the protection of Chapter 11—and safe from creditors—for more than five years before it eventually liquidated its remaining assets. During this time, the chairman of McCrory's continued to pay himself a salary in excess of $1 million per year, while the professionals hired by McCrory's to manage the bankruptcy case raked in another $40 million. And what did most of the creditors get in the end? Not a dime.

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Finally, here is an example of how retail bankruptcy can frustrate—and financially devastate—a shopping center and its owner. An ICSC member in Montgomery, Alabama recently negotiated the sale of his shopping center. The day prior to the closing, the major anchor in the center filed for bankruptcy. As a result, the sale has been placed "on hold" while the debtor determines whether it intends to keep that store operating. Meanwhile, the leases of several other tenants are coming up for renewal—and those tenants are very concerned about the future viability of the center and

whether they should continue to operate in a center whose major anchor store is in bankruptcy. Lastly, the purchaser of the center is undergoing intense scrutiny from its financiers—who are understandably concerned regarding the prospects for successful reorganization of the debtor and the impact the bankruptcy will have on future revenues into the shopping center.

Shopping center owners are not the only parties impacted by retail bankruptcies. Other tenants in the shopping center lose valuable customer traffic tied to the existence of a healthy anchor tenant—and their incomes suffer. Employees lose their jobs. Finally, local communities—whose budgets depend on the sales and property tax revenues generated by a healthy retail climate—can be harmed immediately and irreparably by retail bankruptcies.

VII. Three Critical Problems and Solutions

For shopping center owners and their nondebtor tenants, there are three critical problems in the current reorganization process for retail bankruptcies: 1) adequate representation of the creditors' interests; 2) determining the fate of a debtor's assets in a reasonable timeframe; and 3) providing adequate compensation to the holders of unexpired leases that have been rejected by the lessee. Following is a brief description of each of these problems and ICSC's proposed solutions.

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1. Adequate representation of the creditors' interests.

Problem: U.S. Trustees in many districts have an unofficial policy of excluding shopping center owners from creditors' committee appointments. This "exclusionary" rule limits the owner's ability to take a more active role in the reorganization process. Moreover, the U.S. Trustee's policy denies committees the special knowledge and perspective that shopping center owners bring to the table as a result of an owner's unique and historical relationship with the debtor.

Discussion: The creditors' committee is the key decisionmaking body in the bankruptcy case. The members of the creditors' committee are appointed by the district office of the United States Trustee. Sec. 1102(b)(1) of the Bankruptcy Code sets forth the qualifications for membership on a creditors' committee. By statute, a creditors' committee ordinarily consists of persons willing to serve holding the seven largest claims against the debtor. In nearly every retail bankruptcy case, the debtor's unexpired lease constitutes one of the largest assets to the estate. Thus, the shopping center owner, as the holder of that lease, would ordinarily qualify under Sec. 1102(b)(1) for membership on a creditors' committee.

In recent years, many representatives of the U.S. Trustee's office have been reluctant to appoint shopping center owners to serve as members of a creditors' committee. Some Trustees have cited the relationship in size of the owner's unsecured claim to those of other creditors' claims as a reason for excluding a shopping center owner from a creditors' committee. Also, they reason that an owner's focus will be too narrow (i.e., the owner will only be concerned about the stores it owns) to be a useful member of the committee. Neither rationale is correct.

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First, if a shopping center owner's claim is one of the seven largest claims against the estate, by statute, the owner qualifies for membership on the creditors' committee. Further, in many retail bankruptcies, a debtor's leases are held by a small number of shopping center owners—each holding leases on multiple locations. Thus, as members of a creditors' committee, shopping center owners will be focused on a successful reorganization as a means of protecting their interests in multiple locations.

Finally, the shopping center owner has maintained an integral relationship with the debtor—one that arms the owner with special knowledge of a debtor's business and prospects for successful reorganization. This knowledge can provide valuable insight to a creditors' committee as it assists the debtor in formulating its reorganization plan. As such,

excluding shopping center owners from creditors' committees robs the committee of members with a unique ability to assist in the reorganization process.

Proposed Solution: ICSC supports the provisions in Sec. 205 of HR 3150 to provide all unsecured creditors greater access to creditors' committees. We urge Congress to adopt this measure.

2. Determining the Fate of a Debtor's Assets Within a Reasonable Timeframe.

Problem: Bankruptcy and district courts are not enforcing the timeline set forth in Sec. 365(d)(4) for the prompt assumption/rejection of unexpired leases. Further, the current statute provides no clear deadline by which the debtor must assume/reject a lease.

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Discussion: For shopping center owners, the assumption/rejection of leases is one of the most frustrating aspects of a retail bankruptcy case. Due to overloaded dockets and the large number of retail case filings, courts have become increasingly biased in favor of the debtor in this area of law—and debtors have exploited this loophole in the Bankruptcy Code to their advantage.

Section 365(d)(4) of the Bankruptcy Code sets forth a timeline for assumption or rejection of a debtor's unexpired leases. At the inception of a bankruptcy case, the debtor is provided with a 60-day period in which to determine whether it intends to assume or reject unexpired leases. If 60 days is not sufficient time for the debtor to arrive at these decisions, the debtor can ask the court to extend this time period, for cause. Current law does not define cause, limit the length of this extension, or mandate a deadline for the assumption/rejection decision.

Rarely does a retail debtor determine the fate of its unexpired leases in the initial 60-day period. Further, bankruptcy and district courts are not uniform in their response to requests for extensions of time. For instance, in Homeplace, a national home furnishings chain, the bankruptcy court judge granted Homeplace an additional extension of six months past its initial 60-day period. The locally prominent Woodward & Lothrop chain was granted until confirmation of its plan of reorganization to determine the fate of its leases. (Woodward & Lothrop eventually liquidated its assets.) And, finally, in Edison Brothers, the bankruptcy court granted the debtor (on a lease by lease basis) a timeline that extended past the confirmation of the plan of reorganization to determine which stores it intended to keep open or shutdown.

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Shopping center owners often object to these unreasonable extensions, but courts routinely deny owners' motions to compel assumption or rejection. The unfortunate result is that shopping center owners are left in limbo without a fixed, certain date for assumption or rejection of its leases.

Proposed Solution: Sec. 209 of HR 3150 recommends amending Sec. 365(d)(4) of the Bankruptcy Code. Sec. 209 of HR 3150 provides the debtor with an initial 120-day period to assume or reject an unexpired lease with the option to extend the initial 120-day period, but no length of time is established for the extension. However, the assumption/rejection must occur by date of confirmation of the plan of reorganization.

Proposed Sec. 209 would exacerbate the situation prevalent in bankruptcy courts today. Instead of providing with an initial 60-day period to assume/reject a lease with the possibility of an indefinite extension, Sec. 209 provides an initial 120-day period with the possibility of a nearly indefinite extension. This clearly goes against the spirit of the Bankruptcy Code and ICSC, respectfully, opposes Sec 209.

ICSC proposes a different approach that balances the equities between debtors and creditors. Specifically, ICSC proposes that debtors be granted a longer time period at the inception of the bankruptcy case—120 days as opposed to the current statutory 60-day period—to make sound, rational decisions regarding its future reorganization. Further, we suggest that debtors be granted no more than an additional 60 days, for cause—for a total of 180 days—past the initial

120-day period, but only if deemed necessary. (We believe that the debtor must be current on its financial obligations under the lease to be granted this additional 60- day extension) Finally, ICSC recommends that Congress provide the shopping center owner with an administrative claim for the aggregate rent due under the lease for the time period granted past the initial 120-day period until the lease is assumed or rejected. This proposal would provide the debtor with additional time at the inception of the bankruptcy case to determine the fate of its assets. However, it would provide the shopping center owner, the employees, other tenants, and local communities with a date certain regarding the disposition of leases.

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An alternative solution to the extension dilemma is also supported by ICSC. Under this solution, the debtor would be granted 120 days following the inception of the bankruptcy case to determine the fate of its assets. If the debtor demonstrates that more time is truly needed, the affected shopping center owner would be permitted to move the court for an extension of the initial 120-day period with a firm deadline to the extension.

3. Providing adequate compensation to holders of unexpired leases that have been rejected by the lessee.

Problem: Section 502(b)(6) of the Bankruptcy Code limits the allowed amount of a lessor's claim for damages resulting from the rejection of a long-term lease. In addition, many courts require shopping center owners to mitigate the damages arising from the rejection of a lease. This further complicates the calculation of the rejection damage claim.

Background: Ultimately, a retail debtor will reject many of its long-term leases. Once a lease is rejected, the lessor can file an unsecured claim for damages for the rejection of its lease. Section 502(b)(6) of the Bankruptcy Code limits the allowed amount of a lessor's claim for damages resulting from the rejection of a long-term lease.

There is no satisfactory discussion in the legislative history of Sec. 502 to indicate the origin or rationale for the terms of the complicated formula limiting a lessor's damage claim. By statute, a lessor's claim is limited to "the rent reserved by such lease, without acceleration, for the greater of one year, or 15%, not to exceed three years, of the remaining term of such lease". However, in most cases courts limit the amount of a shopping center owner's claim to one year of future rent. In addition, many courts require shopping center owners to mitigate the damages arising from the rejection of a lease. In the current retail economic climate, and the increasing complexity of negotiating new lease terms, the supposition that the premises can be re-leased within one year is no longer valid.

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Contentions over the calculation of a shopping center owner's claim are the source of significant litigation in a bankruptcy proceeding. Owners, debtors, and the courts have struggled to calculate claims as set forth by the formula in Sec. 502(b)(6).

Shopping center leases typically have a term that is longer than most other leases in the real estate industry. For example, an anchor tenant may have a lease term of 25 to 30 years, and smaller tenants may have lease terms of 10 to 15 years. Therefore, a retail tenant who files for bankruptcy protection in the early years of its lease may have many years remaining in its lease term.

To illustrate how a damage claim is calculated, assume that a tenant has a lease with a base term of 10 years. The tenant files for bankruptcy protection after 4 years of operation. The tenant's remaining lease term is 6 years. Under current Sec. 502(b)(6), the shopping center owner is limited to a one-year cap on rent as damages because the alternative (15 percent of the 6 years of the remaining term of the lease) equals less than one year. Only items designated as rent are includable in a damage claim—no consideration is given to other financial obligations under the lease such as insurance, repairs, and maintenance obligations.

Shopping center owners who receive only a portion of the future rent payments anticipated under a lease as a result

of a bankruptcy may themselves be subject to severe economic consequences. However, the economic burden does not cease when the lease is rejected.

Once a lease is rejected, shopping center owners must absorb expenses associated with bringing a new tenant into the shopping center. Typically, it may take two to three years—with considerable costs incurred—to secure a new tenant. Costs associated with this process include marketing and advertising fees, broker fees, legal fees, and documentation and recording fees.

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Proposed Solution: No legislative language is included in HR 3150 to address this issue. However, ICSC believes that several changes should be made to Sec. 502(b)(6) to resolve one of the most onerous issues for shopping center owners. Specifically, ICSC recommends that Sec. 502(b)(6) be amended to allow all financial obligations reserved by the lease—such as rent, common area maintenance charges, and other fees—to be included in the shopping center owner's damage claim. Further, the claim should be calculated using the period following the date of rejection by the lessee. Finally, ICSC urges Congress to allow all actual costs incurred by the shopping center owner for the period of one year after the rejection for re-leasing the premises to a new tenant to be included by the shopping center owner in its unsecured claim for damages.

VIII. Summary

The number of retail bankruptcy filings—and the attendant abuse—continue unabated. ICSC believes the solutions set forth in this statement to address the problems associated with retail bankruptcy are reasonable and fair to both debtors and creditors. They will eliminate much of the abuse and protect those most heavily impacted—the employees, the local economies, the solvent tenants, and the owners. If implemented, they will return the Chapter 11 process to what Congress intended—a means of rehabilitating economically distressed businesses into gainful enterprises without placing healthy entities into financial jeopardy.

Mr. **BRYANT.** Thank you, sir.

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At this time, we have very little time to make our vote. If we could just recess probably until 1:00, I think, and that will give us time to be able to get something to eat. And we will have two or three more votes, I am sure, during that time. If you could be back here by 1:00, and we will start promptly then. Thank you very much.

[Recess.]

Mr. **GEKAS.** The hour of 1 having arrived, the subcommittee will come to order. Now that you are getting used to it, I can say that we will recess until the next member appears.

[Recess.]

Mr. **GEKAS.** The time of the recess having expired, and with the appearance of the gentleman from New York, a working quorum, a hearing quorum, is now in place. We will proceed where the panel left off beginning with the testimony of Mr. Smith.

STATEMENT OF JAMES E. SMITH, PRESIDENT AND CEO, UNION STATE BANK AND TRUST CLINTON, CLINTON, MO, REPRESENTING THE AMERICAN BANKERS ASSOCIATION

Mr. **SMITH.** Thank you, Mr. Chairman. I would like to thank you, and Representatives Moran, McCollum, and Boucher for your leadership on the issue of bankruptcy reform.

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Given the record number of bankruptcy filings, it is clear that the current system is broken. The ABA supports your bill, H.R. 3150, as an effective and bipartisan response to the current problem.

I know that this hearing is intended to focus on commercial bankruptcy. However, I would like to take a moment to discuss the improvement that your bill makes in the consumer area as well.

Last year, personal bankruptcy filings topped 1.3 million, despite a very strong economy and very low unemployment. This disconnect between economic conditions and personal bankruptcies is a clear indication that the current system is in serious trouble. The fundamental flaw is that consumers have complete discretion to chose Chapter 7 over Chapter 13. This allows individuals to wipe their debt slates clean, even though they have the capacity to repay all or a portion of their obligations.

We believe that the administrative needs based approach proposed in your bill is the best way to address the consumer bankruptcy problem. It will meet the twin goals of providing relief for debtors who truly need it, and preventing abuse of the system.

While the commercial bankruptcy system is not in crisis, there are some reforms that would improve the operation of Chapter 11. In particular, we are pleased that H.R. 3150 provides an expedited process for small business bankruptcy. That proposal would encompass 85 percent of all Chapter 11 filings. We also support the removal of the $4 million debt cap on single asset realty bankruptcies.

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There are two additional provisions we believe should be added to enhance the effectiveness of H.R. 3150. The first is to set firmer limits on a judge's ability to approved repeated extensions of the exclusivity period in Chapter 11. Chapter 11 was meant to give debtors a chance to reorganize. It was not meant to be a semi-permanent state of existence, as is often the case today.

The second is language clarifying that a judge may auction assets of a company in Chapter 11 in the absence of a reorganization plan. While this is the practice in some courts, others believe that statutory is required.

There are also a few provisions that we would like to see dropped from H.R. 3150. Most disturbing is the new value exception in single asset real estate cases. This provision would allow pre-petition equity holders to jump ahead of secured creditors, if they contribute new cash to a reorganizing company, thus undermining the status of a secured lender.

It has been my experience during the agriculture crisis that the addition of new cash rarely prevented the ultimate failure of the business. What invariably happened was that the process was dragged out for another year or so while the collateral continued to deteriorate. The end result was in effect a double cramdown of my loan.

The passage of the new value provision would clearly have a chilling effect on the willingness of lenders to extend secured credit, and it would make secured credit more expensive.

With regard to the farm bankruptcy, we would prefer to see Chapter 12 expire. However, if it is made a permanent part of the Code, we believe that two fundamental reforms are critical. First, Chapter 12 was intended to expedite the resolution of farmer debts. But in practice, repeated extensions are often granted without adequate justification. We believe that extensions should be limited to a maximum of 60 days, and that debtors should be given a maximum of 150 days to file a plan before claim holders can begin to liquidate.

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Second, excessive cramdowns of secured claims are often granted based on unduly low appraisal. Lenders then

cannot recover the full value of their claim, if the debtor defaults on the plan and sells the property. In business bankruptcies, lenders can make an election that allows them to recover unsecured claims, if the debtor defaults on the plan or sells the business. A similar provision in Chapter 12 would create a strong incentive for the debtor to successfully complete the plan, and would provide for equitable treatment of lenders in case of a default or voluntary sale.

Mr. Chairman, we appreciate the opportunity to offer our views on bankruptcy issues. We believe that your bill, H.R. 3150, takes the right approach. And we looking forward to working with you and the subcommittee to ensure that bankruptcy reform is enacted in Congress. Thank you.

[The prepared statement of Mr. Smith follows:]

PREPARED STATEMENT OF JAMES E. SMITH, PRESIDENT AND CEO, UNION STATE BANK AND TRUST CLINTON, CLINTON, MO, REPRESENTING THE AMERICAN BANKERS ASSOCIATION

Chairman Gekas and members of the Subcommittee, my name is James E. Smith. I am President and CEO of Union State Bank and Trust, in Clinton, Missouri, and Chairman of the American Bankers Association's Government Relations Council. I am pleased to be here today on behalf of the ABA. The ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks—makes ABA the largest banking trade association in the country.

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Mr. Chairman, I would like to thank you for your leadership on the issue of bankruptcy reform. Given record numbers of bankruptcy filings and their inevitable impact on both lenders and borrowers, these hearings are very timely. ABA strongly supports your bill, H.R. 3150, which would create an administrative needs-based approach to consumer bankruptcy, and make many necessary improvements in commercial bankruptcy law. With the original support of Representatives Moran, McCollum, and Boucher, H.R. 3150 is an effective and bipartisan response to current problems in the bankruptcy system.

I recognize that the focus of this hearing is on the commercial provisions of your bill. However, I would like to take this opportunity to discuss the very important improvements your bill makes in the consumer area as well. The fact is that our consumer bankruptcy system is in serious trouble. We believe that a needs-based approach is the best way to achieve an appropriate balance between providing relief for debtors who truly need it and preventing abuse of the system by those who have the capacity to repay at least a portion of their debt.

Under current law, bankruptcy is too often used as the first resort, rather than the last resort. By taking advantage of flaws in the current system, individuals can wipe their debt-slates clean even though they have the capacity to repay all or a portion of their obligations. Moreover, there is ample evidence that a small but growing minority of borrowers is abusing the credit system by taking loans with no real intent to repay.

H.R. 3150 also proposes some important improvements in commercial bankruptcy law. For example, it will create a simplified framework for small business bankruptcies. It will also end abusive single asset real estate bankruptcies by lifting entirely the debt cap on cases subject to expedited Code provisions. It streamlines and facilitates the completion of prepackaged Chapter 11s. And it will provide for more expeditious resolution of judicial conflicts under uniform legal precedents by providing for direct appeal from the Bankruptcy Court to the U.S. Court of Appeals.

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I would like to make three points in my statement today.

The record number of personal bankruptcies—occurring at a time when our economy is very healthy—is a clear sign

that our consumer bankruptcy system is broken. While the situation today does not pose a safety and soundness problem for banks or thrifts, it is important to recognize that rising bankruptcies will inevitably have an impact on the cost and availability of consumer credit which in turn will negatively affect overall economic growth.

An *administrative needs-based system* as proposed in H.R.3150 balances the twin goals of debtor relief and creditor recovery. The fundamental flaw in the current consumer bankruptcy system is that debtors are permitted complete discretion as to whether they will enter into a Chapter 7 liquidation plan or a Chapter 13 repayment plan. An administrative needs-based approach would send a strong message that bankruptcy should be a last resort for troubled borrowers.

While commercial bankruptcy filings have diminished due to strong economic conditions, certain reforms would be desirable. In particular, we recommend the following: expedited treatment of small business reorganizations; assuring that all single asset realty cases are resolved quickly and fairly; preventing endless extensions of Chapter 11; and, if Chapter 12 is made permanent, assuring a quick and fair resolution for lenders.

Before turning to a discussion of these points, let me reiterate our support for the reforms proposed in H.R. 3150. This bill effectively addresses the serious flaws in current law, especially in the consumer area where the problems are the most severe.

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I would also like to comment briefly on the National Bankruptcy Review Commission's recommendations. The Commission offered some helpful proposals to reform the commercial bankruptcy system, such as expedited treatment of small business and all single asset realty cases.

However, the Commission's consumer proposals should be firmly rejected by Congress. Adoption of these proposals would increase total consumer bankruptcy filings and encourage an even higher proportion to be filed in Chapter 7. Unfortunately, some of the Commission's bad ideas, plus a few new ones, are contained in H.R. 3146, the "Consumer Lenders and Borrowers Bankruptcy and Accountability Act of 1998". I have included a listing of our serious concerns regarding the Commission's consumer recommendations and some provisions of H.R. 3146 in Attachment A to this statement.

CONSUMER BANKRUPTCY

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Mr. Chairman, the final numbers are now in on personal bankruptcies for 1997, and they broke the old record with sonic-boom force. About 1.35 million people declared bankruptcy—a 19.5 percent increase over the 1996 level of 1.1 million. This means that *one in every eighty U.S. households filed for bankruptcy in 1997*. What is equally stunning is that this record was set in a year where Gross Domestic Product grew 3.8 percent—the highest in a decade—and the unemployment rate was 4.7 percent—the lowest in nearly 3 decades. Clearly, consumer bankruptcies are increasingly disconnected from the general state of the economy and suggest to us that underlying causes are likely rooted in today's flawed bankruptcy laws.

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The impact of the change in consumer bankruptcy law in 1978 is clearly demonstrated on the adjacent chart. Following passage of the Bankruptcy Reform Act of 1978, there has been a dramatic rise in the incidence of personal bankruptcy filings. The Bankruptcy Code currently contains many flaws which both encourage unnecessary filings and lead to abuse. These flaws include, first and foremost, the lack of any effective and uniform screening standards to determine whether a debtor truly needs Chapter 7 liquidation or has the financial ability to fund a meaningful Chapter 13 plan. Chapter 13s have a standard length of only three years, while most consumer loans today are for longer terms or entirely open-ended. Debtors find it too easy to "load up" on debt in contemplation of filing and to then discharge it,

even where it has been used to satisfy nondischargeable obligations. The amount owed on valuable collateral such as autos can be crammed down just weeks after purchase. Debts acquired through fraud can nonetheless be discharged in a Chapter 13 case. Creditors operate under a statutory "gag order" which prevent them from bringing evidence of abuse to the court's attention. And serial filings can endlessly forestall repossessions and other actions within creditors' rights when there is no intention to go through with the bankruptcy; while serial bankruptcies are available to discharge a debtor's responsibilities every half dozen years.

These and other defects in current law and practice have led to today's bankruptcy reality—an overloaded court system giving assembly line treatment to a record number of bankruptcy cases, many of which receive excessive or undeserved relief based on unsubstantiated claims.

Approximately 96 percent of the filings in 1997 were non-business bankruptcies. This is quite different from the experience of the 1980s. For example, from 1980 to 1987, consumer filings ranged between 82 to 86 percent of total filings. In 1988, personal bankruptcies grew to 89.6 percent of total filings, and the percentage has risen every year since then.

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Today's consumer bankruptcy crisis poses no imminent danger to the safety and soundness of the financial system. Banks and other lenders have tightened underwriting standards and reviewed pricing in light of current conditions, and they have ample capital and reserves.

But the fact that there is no immediate danger does not mean that there is no reason for concern. At some point, without bankruptcy reform, lenders will dramatically tighten lending standards, a move that will have consequences for the overall economy. For example, my bank is very active in making small "micro" loans to low income individuals. These loans are often as low as $200–$300 dollars. Given this small loan size, we cannot afford to do expensive background checks. Rather, these are truly "character" loans. The rise in personal bankruptcies has forced us to re-evaluate these types of loans, however. Even though the loans are not large, it does not take too many losses to make this entire line of micro loans not worth offering.

The same process of reconsideration is likely to occur for many other banks in all kinds of consumer loans. Simply put, a tightening of underwriting standards means either the price of credit rises, or less credit is offered or both. In my case, it may determine whether a whole line of credit products will be eliminated—something that would be sad for my bank and my community.

Perhaps even more troubling is what I call "stealth bankruptcies" in which borrowers show excellent credit histories right up to the day they file and wipe out their lenders. Those borrowers look just like many others who never file bankruptcy. There are two examples from my community that I would like to share with your Subcommittee, Mr. Chairman. The first was a case where a borrower bought a brand new Dodge truck three weeks before declaring bankruptcy. It was nearly a year before he had to turn the now used and abused truck back in to the lender. The second was a case of a rancher who borrowed to buy 50 head of cows and calves. He sold the animals in 30 days, declared bankruptcy and walked away with all the money.

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Clearly, these are severe abuses of the system. There are many more examples of borrowers who have chosen bankruptcy as a first resort, rather than trying other available alternatives such as working out revised payments with lenders or availing themselves of consumer credit counseling assistance. Let me share a few stories I have heard from bankers across the country.

A banker from New York says that a lawyer in his area is advising clients to pay their nondischargeable debt with

credit card cash advances, and then file Chapter 7. The credit card balances, which are unsecured debt, can then be discharged.

A New Mexico banker made a loan to an employed individual secured by an automobile in 1995. The individual declared Chapter 13 after having made only six payments over 14 months. Only one loan payment was made under the Chapter 13 repayment plan, and the bankruptcy trustee subsequently dismissed the plan. But when the bank repossessed the car, they were told the individual had filed another Chapter 13—so the bank had to return the car. The bottom line is that the individual still has a good job and still has the car—so far, the bank is out $21,000 and the bankruptcy hearing is not until May 1998.

A banker from Ohio reports that a customer borrowed money to buy two automobiles, then literally disassembled the cars, sold the parts, and declared bankruptcy.

A banker from Texas tells of a couple who took out a SBA loan to start a business. When the business did not do well, the bank tried to work with them to develop an appropriate course of action. Rather than working with the bank, however, they filed Chapter 7. They had good income from other jobs, owned a mortgage-free residence (which was protected under the bankruptcy law), and had virtually no other debt—in other words, they had the ability to repay all or some of the loan. The bank lost over $12,000.

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Consumers Have Complete Discretion for Choosing Chapter 7 Over Chapter 13

These stories point out that there are very serious flaws in the current consumer Bankruptcy Code. Perhaps the most fundamental flaw is that filers are allowed total discretion over whether they should file in Chapter 7 or Chapter 13, regardless of ability to repay. In Chapter 7, repayment is based on assets. Filers must either reaffirm their secured debts by acknowledging post-bankruptcy personal responsibility to pay them, redeem their secured debts by making full payment, or surrender their collateral. Unsecured lenders receive payment, if any, out of the bankruptcy trustee's liquidation of debtor property which exceeds applicable exemption levels (which are mostly set by state law). Nineteen out of twenty Chapter 7 filings are "no asset" cases in which there is no nonexempt property to liquidate and unsecured lenders lose 100 cents on the dollar. Chapter 7 cases constitute about seventy percent of all non-business filings.

In Chapter 13, repayment to creditors is based on income. The debtor agrees to a repayment plan with a three-to-five year duration. Home mortgage lenders are repaid according to the original payment schedule, other secured lenders are assured of full repayment of the portion of their loan which is collateralized, and unsecured lenders receive repayment based on remaining disposable income.

An individual filing in Chapter 7 may be directed to Chapter 13 under present law when the judge determines that a Chapter 7 discharge would constitute "substantial abuse." However, such instances are rare. This is due to the assembly line, overloaded nature of the consumer bankruptcy system and the lack of economic incentives for the trustee to undertake an in-depth inquiry into most cases. In addition, *current law prevents those who most likely have information regarding debtor abuses—the lenders—from bringing it to the attention of the court.*

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Chapter 7 bankruptcy is a highly unusual legal process. In other civil cases one seeking an injunction to bar legal actions must generally demonstrate the imminent threat of irreparable harm as well as a high probability of succeeding on the merits. But in the current system, the *mere filing* of a bankruptcy petition provides an automatic stay, which halts all foreclosures, garnishments, and other legal proceedings against the debtor. In addition, while the law is what we look to for contract enforcement, in bankruptcy the law cancels or rewrites contracts to relieve debtors of their obligation to perform on their contractual promise to pay. These are extraordinarily potent legal powers. They may be

necessary to accomplish the renewal function of bankruptcy, but providing them to virtually anyone just for the asking clearly opens up the bankruptcy system to abuse.

Chapter 13 also has been abused by individuals under the current system. Many who file in Chapter 13 never complete their full repayment plan—a fact some critics cite to question the enforceability of a needs-based bankruptcy system. But the real issue here is the ability of these individuals to use Chapter 13 simply to cure mortgage defaults, with no intention to complete their plan; they later file a "Chapter 20 bankruptcy by converting to Chapter 7 and wiping out unsecured lenders. In other words, current law permits debtors to obtain many of the benefits of Chapter 13 without carrying out their repayment responsibilities.

The high proportion of Chapter 7 cases regardless of repayment ability and the rapidly growing number of consumer bankruptcy filings together constitute a significant long-term threat to the availability of reasonably priced credit to U.S. consumers. The "bankruptcy tax", the cost of bankruptcies which is ultimately passed on to other borrowers, is already about $400 per U.S. household. This does not include the cost of the bankruptcy court system that has been overwhelmed by the record high filings. Adding new judges to handle the growing case load will cost taxpayers millions of dollars more. These unfair taxes on responsible borrowers will likely escalate without Congressional action.

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H.R. 3150 Balances the Twin Goals of Debtor Relief and Creditor Recovery

Administrative Needs-Based Approach to Consumer Bankruptcy

Adoption of an administrative needs-based policy would best achieve the appropriate balance between debtor relief and creditor recovery. We are gratified by the emerging bipartisan consensus that fundamental reforms are needed in the consumer bankruptcy process, and that the heart of these reforms is a needs-based bankruptcy system. Such a system would recognize that consumer bankruptcy, like every other part of the social safety net, should have safeguards to prevent abuse of its most generous benefits. It would also send a strong message that bankruptcy can no longer be regarded as an easy first resort for the financially reckless.

Needs-based bankruptcy reserves complete liquidation of unsecured debts for those borrowers who really need complete debt forgiveness. It is a system that prevents individuals with substantial disposable income from manipulating the bankruptcy system to avoid their repayment obligations if they have the resources to repay all or a part of what they owe.

An administrative needs-based approach is simple and straightforward. First, for those individuals with incomes below a prescribed level, there would always be the option to file in Chapter 7. Second, for those individuals with higher than the prescribed income level, there would be a simple formula to calculate how much an individual can afford to repay based on income and obligations. For example, the clerk of the court or bankruptcy trustee would review the information in the debtor's petition to determine income, deduct the portion required to meet household expenses and pay secured debts and unsecured priority debts, and then calculate how much remains, if any, for the payment of unsecured non-priority debts. If the amount available to pay that latter category of debt exceeds a certain percentage over the normal time span of a Chapter 13 plan, the debtor would be denied eligibility for Chapter 7.

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The Bankruptcy Commission recommended taking a *judicial* approach to determine eligibility for filing in Chapter 7. We are convinced that the *administrative* approach outlined above is more efficient and more fair. An administrative system provides uniform and predictable results based upon clear and objective standards. It does not require additional expenditures to have counsel argue a motion before a judge with an overcrowded calendar. And it gives clear notice to debtors, prior to filing, of exactly the extent of relief they can expect to obtain if they file for bankruptcy.

It is important to note that needs-based bankruptcy does not prevent debtors from obtaining substantial relief under the Federal bankruptcy laws. Those who cannot repay their debts would continue to be eligible for complete relief under Chapter 7. Furthermore, under a needs-based system, debtors still may file a Chapter 13 petition (or, in rare cases for high-income individuals, Chapter 11) and obtain the injunctive relief of the automatic stay. Chapter 13 provides avenues for curing defaults and restructuring payments on secured debts which are not available in Chapter 7, and it provides a broader bankruptcy discharge upon completion of the repayment plan. And debtors still can void their legal responsibility to pay a substantial portion of their unsecured debts. But they cannot avoid all repayment obligations when they have the disposable income to make good on a significant portion of what they owe unsecured creditors.

Other Important Reforms to Consumer Bankruptcy Law Contained in H.R. 3150

H.R. 3150 also proposes other important reforms in consumer bankruptcy law which ABA strongly supports. For example:

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establishing that consumer debts incurred within 90 days prior to filing for bankruptcy should be presumed nondischargeable;

making nondischargeable any debt incurred to pay a debt that is already nondischargeable under the Code;

barring the discharge of fraudulently obtained debt in all consumer bankruptcy cases;

establishing auditing and documentation requirements for debtor filings, and providing for legal actions if material misstatements are submitted;

barring bankruptcy refiling for 10 years after discharge;

permitting lenders to bring evidence of "substantial abuse" to the court's attention;

creating a national bankruptcy information docket;

expediting the initiation of Chapter 13 payments;

clarifying that debtors lose the benefit of the cramdown of under-secured debts when they convert from Chapter 13 to 7;

establishing that collateral securing a note cannot be subject to cramdown in any bankruptcy filed up to 180 days later;

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requiring that consumers receive information about alternatives to bankruptcy, and allowing the courts to require debtors to complete a financial management training program as a condition of the discharge;

doubling, to one year, the length of time a debtor must reside in a state to take advantage of its homestead exemption; and

establishing a "debtor's bill of rights" to provide legal rights against bankruptcy practitioners who do not provide adequate information or full and fair representation, and by cracking down on misleading debt relief advertisements.

COMMERCIAL AND FARM BANKRUPTCY

Commercial Bankruptcy

Business bankruptcies now constitute less than five percent of all bankruptcy filings, indicating that there is no business bankruptcy crisis. However, there are some reforms that could improve the operation and effectiveness of Chapter 11's framework for business reorganizations. In particular, Chapter 11 does not work very well for small businesses. One of the Bankruptcy Commission's better recommendations was for the creation of a less complex and expedited Chapter 11 process for businesses with less than $5 million in total debt. That proposal would encompass 85 percent of all Chapter 11 filings. We are delighted that H.R. 3150 includes a workable version of this proposal. It will help ensure that small businesses have the best possible chance of successfully reorganizing by taking advantage of a system which is less complex and expensive.

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We are anxious to see the removal of the $4 million debt cap that unwisely limits the effectiveness of the action taken by Congress in 1994 to curb abusive single asset realty bankruptcies. Again, your bill accomplishes this important goal.

There are two provisions we would like to see enacted which have not yet found a place in H.R. 3150. The first would be to set some firmer limits on a judge's ability to approve repeated extensions of the exclusivity period in Chapter 11s. This is the time span during which only the debtor-in-position may propose a plan of reorganization. Chapter 11 was meant to be a way station in which companies could adopt and implement a plan to rejoin the economic mainstream; it was not meant to be a semi-permanent state of existence which coddles existing management. At some point certain, other parties in interest to a case should have the right to step forward and propose their own reorganization plan for a vote, if the debtor has been unable or unwilling to do so.

The second addition would be language clarifying that a judge may auction assets of a company in Chapter 11 in the absence of a reorganization plan. While this is the practice in some courts, others believe that statutory authority is required.

Finally, we are compelled to oppose three commercial bankruptcy provisions of H.R. 3150.

The first and most disturbing is Section 252, which would codify the "new value" exception in single asset real estate cases. This judicially created doctrine allows pre-petition equity holders to jump ahead of secured creditors if they contribute new cash to a reorganizing company. It is not now in the Code and should not be added. Its creation would severely undermine the absolute priority rule and, therefore, the status of secured lenders. If that occurs, many businesses will find that secured loans are more difficult and expensive to obtain; and that lenders are less willing to stand by them and provide new Chapter 11 financing if they must reorganize under bankruptcy law protection.

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The second is section 205, which would allow the judge open-ended discretion to arbitrarily and unilaterally change the makeup of the creditors' committee. This would usurp the role of the U.S. Trustee, cause undue delay, and increase costs. It could also lead to the failure of reorganization attempts if the insertion of "vulture" investors on the committee leads to acrimonious conflict.

The third is section 209, which doubles the time limit for acceptance or rejection of an unexpired lease on nonresidential realty. It is unnecessary and will simply provide lessors with additional and undeserved administrative expenses.

Attachment B to this statement outlines our specific recommendations for changes to the commercial bankruptcy provisions of H.R. 3150.

Farm Bankruptcy

H.R. 3150 would make Chapter 12 a permanent part of the Bankruptcy Code. Chapter 12 was passed in 1986 in response to the greatest agricultural debt crisis since the 1920's. Because it was an emergency response to a crisis, the original act was set to sunset in October, 1993. In 1993 Chapter 12 was extended, with little modification, to October 1998. Since Chapter 12 was enacted, the agricultural economy has improved greatly. Agricultural asset values and farm incomes have rebounded or exceeded the levels they reached in the early 1980's. After an initial surge of filings, Chapter 12 filings have declined significantly.

While we would prefer to see Chapter 12 expire as Congress intended, we believe that, at a minimum, its permanent adoption should be accompanied by some fundamental reforms to address ongoing problems.

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First, discipline must be restored to reaffirm the original goal that Chapter 12 be an *expedited* resolution of farmer debts. The primary reason for creating Chapter 12 was that the existing bankruptcy chapters were too expensive and too time consuming for farmers to be able to effectively use to reorganize their businesses. Because of the crisis atmosphere that surrounded the legislation, Congress acted to make sure that any farmers that could quickly reorganize would be able to do so. Today a farmer under Chapter 12 protection has 90 days to file a reorganization plan after the order for relief has been filed. The debtor is supposed to be allowed extensions by the court only in cases where the debtor should not be "justly" held accountable. In practice, the courts have been far too willing to grant repeated extensions in Chapter 12 cases without adequate justification required by the code. We believe that extensions should be limited to a maximum of 60 days, and that debtors be given a maximum of 150 days to file a plan before claim holders can initiate liquidation actions.

Second, excessive cramdowns of secured claims are often granted on the basis of unduly low appraisals provided by the debtor. In Chapter 12, lenders that have their claims crammed down to the value of the collateral lose any opportunity to recover the value of their claim in the future if the debtor defaults on the plan, or if the debtor chooses to sell. In Chapter 11 (business bankruptcy), lenders may make an election that allows them to recover unsecured claims if the debtor defaults on the plan or sells the business. Under this election in Chapter 11, a debtor that successfully completes the plan will receive all of the benefits of the court ordered cram down. Only if the debtor defaults or voluntarily sells will the lender have the opportunity to try to recover the full value of the claim. A similar provision in Chapter 12 would create a powerful incentive for the debtor to successfully complete the plan, and would provide for equitable treatment of lenders in case of a default or voluntary sale.

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CONCLUSION

Mr. Chairman, the ABA appreciates this opportunity to address you this morning on bankruptcy issues. We think it would be a terrible mistake to ignore what the record levels of personal bankruptcies are telling us—namely, that the current system is broken and must be fixed. We believe that your bill, H.R. 3150, is the right approach to reform of the system. It would establish a bankruptcy system which provides appropriate debtor protection while also preventing abusive use of the system by individuals who have the capacity to repay all or a portion of their debts.

We appreciate your and the Subcommittee's interest in this issue, and we look forward to working with you and other Judiciary Committee members to ensure that bankruptcy reform is enacted in this Congress.

ATTACHMENT A
CONCERNS REGARDING THE NATIONAL BANKRUPTCY REVIEW COMMISSION CONSUMER BANKRUPTCY RECOMMENDATIONS AND H.R.3146

Comments on the Commission's Recommendations

Last October, the National Bankruptcy Review Commission submitted its report to Congress. While the Commissioners were dedicated and hard working and the Commission made worthwhile suggestions in a number of areas, their consumer proposals should be firmly rejected by Congress. The recommendations do not represent a consensus, but are the result of a sharp 5–4 split among the Commissioners. If implemented, the recommendations would increase total consumer bankruptcy filings and encourage an even higher proportion to be filed in Chapter 7. Worst of all, they are silent on any notion of personal responsibility for one's debt.

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There are many objectionable consumer bankruptcy recommendations forwarded by the Commission, including:

failing to adopt any needs-based approach or any strengthening of the existing "substantial abuse" provisions;

suggesting excessive national bankruptcy exemptions which would permit debtors to emerge from Chapter 7 with retained household wealth in the top quarter for all Americans (a proposal rejected by the Justice and Treasury Departments as far exceeding any reasonable notion of a "fresh start");

barring the voluntary reaffirmation of unsecured debt;

permitting cramdown of secured loans to wholesale value, in contradiction of a recent Supreme Court decision that replacement (generally retail) value is the proper standard;

inadequate payment guidelines for Chapter 13 plans;

allowing debtors to discharge all credit charges made more than 30 days prior to filing bankruptcy;

allowing student loans to be discharged immediately following graduation;

failing to establish financial education requirements; and

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retaining present law permitting a new bankruptcy to be filed every 6 years.

Adoption of these Commission recommendations would have a disastrous effect upon the bankruptcy courts and upon the availability and pricing of consumer credit.

Comments on H.R. 3146

Unfortunately, some of these bad ideas, plus a few new ones, are contained in a bill introduced on February 3rd, H.R. 3146, the "Consumer Lenders and Borrowers Bankruptcy and Accountability Act of 1998". This bill is largely based on a diagnosis of the consumer bankruptcy crisis with which we take strong issue—that its primary cause is excessive credit extensions by lenders with lax underwriting standards. Not only is the bill's diagnosis wrong, its prescription would fail to cure bankruptcy problems and could prove fatal to the broad availability of unsecured consumer credit.

H.R. 3146 proposes to indirectly influence lender behavior by eliminating many current legal rights for creditors and by expanding the ability of unscrupulous borrowers to "game" the bankruptcy system and escape their contractual obligations without economic accountability or consequences. If these provisions were to be incorporated into the Bankruptcy Code, they would so undermine creditor rights and increase the attractiveness of filing for bankruptcy relief that there probably would be a substantial increase in the cost of a constricted supply of consumer credit. Such a result would be a big negative for the U.S. economy, with the resulting falloff in consumer spending leading to slower.

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Particularly objectionable provisions on this bill include:

creditors who made prudent loans accompanied by all required consumer disclosures and who exercised only valid legal rights could nevertheless find that they had no legal claim against a debtor;

most open-end consumer credit would be automatically dischargeable in bankruptcy;

secured lenders could be crammed down to a valuation of wholesale or less; and

home equity lenders would lose their current legal protection against cramdown.

Needless to say, the ABA will vigorously oppose these proposals. In particular, it is inappropriate to dictate credit underwriting standards and practices through the Bankruptcy Code—particularly for insured depository institutions which are subject to extensive oversight and examination by federal bank regulators. Adoption of this approach would be contrary to all of the efforts undertaken by Congress over the past two decades to assure that low- and moderate-income individuals enjoy access to credit.

Our specific, section-by-section comments on H.R. 3146 are as follows:

Section 2

Section 2 of the bill would discourage "reckless lending practices" by providing that a creditor does not have a claim in bankruptcy where it knew, or should have known, that its loans might meet certain criteria or fit in a particular context. These supposedly reckless practices include:

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The extension of unsecured credit which caused debtor's unsecured debts to exceed 40% of income.

Extending mortgages and home equity loans which violate the Home Ownership and Equity Protection Act of 1994.

Refusing to waive interest when a debtor enters consumer credit counseling.

Increasing interest rates by more than 5 percent in the year preceding the filing.

Accepting minimum payments on an unsecured debt that would fail to fully amortize it within 15 years.

Lending funds in or adjacent to a gambling facility, or which the creditor "should have known" would be used for gambling.

Violating certain provisions of the Fair Credit Reporting Act relating to debt collection.

Section 2 would also restrict the bar to discharge to credit card debt on fraud grounds solely to fraud in the initial application, not in use; or to where the creditor can show that an express fraudulent statement caused an extension in excess of the credit limit. In either case, the creditor would have to prove his case by "clear and convincing evidence".

Section 2 addresses issues of credit underwriting and lending practices that lie in the Banking Committee's jurisdiction and have no place in the Bankruptcy Code. While the Code has engaged in certain value judgments in determining that certain debts—such as child support or judgments for willful and malicious injury—cannot be discharged, it has never before been used to second-guess the market as to which forms of credit are subjectively good or bad. It would strip a lender of its claim to repayment in bankruptcy; this failure to even recognize that a valid contract existed treads on dangerous new legal grounds. It would punish lenders for events they could not foresee, such

as that an open-ended line of credit might, years after being initially granted, become part of a total debt obligation exceeding 40% of a debtor's income; or that a debtor might use cash advances to engage in gambling (which would presumably include state-operated wagering such as lotteries and off-track betting parlors). It would also impose new restrictions on lenders, such as effectively requiring complete forgiveness of interest, not just partial reduction, for a borrower who entered consumer credit counseling; and prohibiting the levying of penalty interest rates on borrowers who repeatedly violated their repayment agreements. These are issues of credit underwriting and lender practices which should be examined, if at all, by the Banking Committee.

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Section 3

Section 3 allows the trustee to recover wages that were garnished in the 90-day period prior to filing.

This provision undermines the relief provided to creditors by state wage garnishment laws.

Section 4

Section 4 permits debtors to recover substantial money and potential punitive damages against creditors for alleged unnecessary bankruptcy litigation caused by creditors' "inflated or frivolous claims". This could occur if a creditor's claim was reduced by more than 5%; if a challenge to dischargeability did not prevail; if the creditor charged the debtor for "unreasonable" attorney's fees; if the automatic stay was violated; or if a motion that a debtor was not entitled to a chapter's relief was denied;

The standards in this provision are so unreasonable and subjective that they would effectively chill creditors' ability to assert their legal rights provided under the Bankruptcy Code. The fact that a particular judge does not agree with a lender's claim is in no way indicative that the claim was frivolous or made with malicious intent, and should not trigger excessive monetary damages. Bankruptcy judges already have all necessary power and discretion to sanction any party who abuses the bankruptcy process.

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Section 4 also allows debtors to retain collateral on which payments are current without reaffirming their personal liability. It also bans reaffirmations of both secured and unsecured debt. Finally, it permits the court to allow Chapter 7 debtors to redeem property in installments, on court-determined terms, rather than in a lump sum payment.

This section would significantly raise the risk of secured lending. It would allow borrowers to retain valuable collateral, such as a new auto, without reaffirming their personal liability on the full contract amount. In cases where a borrower failed to maintain or damaged that collateral, they could cease payments and the lender's only recourse would be to repossess the damaged or destroyed goods. Reaffirmations of all types of debt should continue to be allowed because the ability of the debtor to retain both property and particular credit lines are both important components of a meaningful fresh start.

Section 5

Section 5 requires that debtors be informed about all bankruptcy and credit counseling options. However, it also requires that they be informed of the sources of funding for credit counseling agencies and that such agencies cannot provide the same legal protections as bankruptcy.

We agree that borrowers should be fully informed about all their options for resolving financial difficulties. But that information must be presented in a fair and objective manner.

Section 6

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Section 6 would eliminate a successful Chapter 13 from a debtor's credit history 5 years after its commencement. We are sympathetic to listing Chapter 13 filings differently from Chapter 7s on an individual's credit history. However, this amendment alters the Fair Credit Reporting Act not the Bankruptcy Code.

Section 6 would also:

Eliminate judicially imposed minimum payment tests for Chapter 13 plans.

Allow for the repayment of nondischargeable debts in a Chapter 13 plan.

Allow for Chapter 13s of up to five years' duration; an increase beyond 3 years would be solely the debtor's option.

Permit mutually consensual mortgage modifications in Chapter 13.

We disagree with eliminating minimum payment requirements for Chapter 13 plans, and cannot support any provision which would legitimize "zero payment plans". Obtaining Chapter 13's benefits of secured debt restructuring and superdischarge of debt must be accompanied by meaningful repayment obligations. We also believe that the standard term of a Chapter 13 plan should be five years, as this reflects the reality of borrower's original payment obligations on both secured debt and open-ended consumer loans.

Section 7

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Section 7 would limit property exemptions to $100,000 if a debtor converted to property entitled to an unlimited exemption within a year prior to filing while insolvent. It would also establish the federal Chapter 7 exemptions as a "floor" on state exemptions.

We generally concur with a cap on homestead and other exemptions, particularly where a property has been acquired in close time proximity to a bankruptcy filing. The suggestion that the federal exemptions become a "floor" for the states needs extended scrutiny, both in terms of its impact on the separate states as well as on the 1978 policy decision to let states opt out of the Federal standards.

Section 8

Section 8 contains the bill's "needs based" approach. It amends Section 707(b) to find "abuse" when a debtor can pay all unsecured priority debts in full in a 36-month Chapter 13 plan. (This standard is less strict that that applied by many judges today.) Creditors could bring allegations of abuse to the trustee's attention. Families of three with household income of up to $60,000 (increased by $5,000 for each additional family member) could file in Chapter 7 regardless of repayment ability.

While this provision recognizes the merits of needs-based bankruptcy, its test is thoroughly inadequate. It would let debtors with the ability to pay off up to 99% of their unsecured loans in three years nonetheless file for Chapter 7 and clearly abuse the bankruptcy process. And its income exclusion level from the needs-based test is far too generous.

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Section 9

Section 9 adopts the Bankruptcy Review Commission's recommendations on repeat filings.

Creditors had criticized them as being ineffective. We support H.R. 3150's proposals as being far more likely to curb abusive serial filings.

Section 10

Section 10 would deny a Chapter 7 discharge to a debtor who omitted non-exempt property of the estate from the schedule of assets.

We support this provision.

Section 11

Section 11 would make 1994 Code amendments, banning interest on mortgage arrearages by debtors curing defaults, applicable to all mortgages and not just those extended after the date of enactment. It would also adopt the Bankruptcy Review Commission recommendation that secured creditors receive interest on deferred payments at the non-default contract rate, or at two percent over the rate paid on 6-month T-bills.

We object to changing the rules of the road to mortgages extended prior to enactment of the 1994 Code changes, as lenders had no notice of this treatment at the time the mortgages were extended and the effective date was carefully considered by Congress just four years ago. We also object to setting interest rates by statute.

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Section 12

Section 12 bars liens on household goods with a purchase price of $1,500 or less. Other provisions include setting the valuation of secured claims at no more than cash wholesale value (less than the "replacement value" standard adopted by the Supreme Court); and eliminating protection against cramdown in Chapter 13 for all home equity loans.

We strongly object to this entire section. It would substantially undermine the security interest of lenders on expensive property. It would reverse the Supreme Court's rash decision that replacement value (generally retail) is the proper Code valuation standard. And it would greatly increase the risk, and thereby the price, of home equity loans, which are the lowest price form of consumer credit available in today's marketplace; while also removing economic disincentives which today discourage lenders from seeking foreclosure when a home equity loan is delinquent.

Section 13

Section 13 would allow the discharge of debts (such as credit card cash advances or loans) incurred to pay a nondischargeable tax debt. This would repeal a provision put in the Code in 1994 to facilitate the use of credit cards for tax payments. This section also expands the types of retirement funds protected from being available to creditors in bankruptcy.

This provision would be at complete odds with the efforts of government to accept credit cards for tax payments, since it would put lenders at excessive risk for such use. Excessive expansion of protected retirement funds would increase the incentive to file abusive bankruptcy cases as part of pre-retirement financial planning.

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Section 14

Section 14 contains a variety of miscellaneous "clarifying" provisions.

Many of these provisions appear to have substantive effect. The Committee should proceed cautiously and should

not adopt any of these proposals without a full understanding of their effect.

ATTACHMENT B
COMMENTS ON SPECIFIC PROVISIONS OF THE COMMERCIAL BANKRUPTCY PROVISIONS OF H.R. 3150

Section 121 B Repeat Filings

Bars abusive repeat filings (includes sole proprietorship Chapter 11 filings).

We suggest amending this section to clarify that the court can bar refiling by an abusive debtor for a set term.

Section 205—Creditors= and Equity Security Holders= Committees

The court may on its own motion, or on the motion of a party in interest, may order a change in committee membership to ensure adequate representation of creditors or equity security holders.

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We oppose this provision. There will never be a perfect approach to the proper composition of a Chapter 11 creditors' committee. However, this proposed change would result in undue delay and increased costs for all parties, particularly in larger cases. It unwisely inserts the court into administrative decisions that are the province of the U.S. Trustee. Its lack of a time limit for changing a committee's composition is a particularly glaring defect, resulting in open-ended uncertainty. The most likely utilization of this provision would be by "vulture" purchasers of distressed claims, whose presence on the creditors' committee would tend to set off internal struggles detrimental to the best interests of the reorganizing company.

Section 209—Setting a Date Certain for Trustees to Accept or Reject Unexpired Leases on Nonresidential Real Property

Amends Section 365(d)(4) by extending the current 60 day limit within which to accept or reject a lease to 120 days and providing that extension may not be granted beyond the date of confirmation of the plan.

We oppose this provision. It is not necessary, as debtors can generally obtain extensions of their commercial real estate leases when necessary. It will simply provide commercial lessors with undeserved administrative expenses to the detriment of unsecured lenders.

Subtitle B—Chapter 1—Small Business Bankruptcy

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Section 231—Definitions

Defines a small business debtor as a person (including affiliates of such person) having aggregate noncontingent, liquidated secured and unsecured debts of $5 million or less (excluding debts to affiliates or insiders). Also includes a single asset real estate debtor without regard to the amount of debt, unless it is a part of an affiliated group of debtors with debts greater than $5 million.

We suggest a technical amendment to this section to clarify that covered affiliates must also be debtors under the Code. Without this change, many small businesses operated by outside management companies will be unable to utilize these expedited procedures.

Section 236—Duties in Small Business Cases

Creates a new Section 1115 which specifies filing of certain financial reports within 3 days of the order of relief, requires maintenance of insurance, payment of taxes, etc. Requires that the debtor establish bank accounts for taxes and to deposit "all taxes collected or withheld by it for governmental units."

This provision should be clarified so that the duty to establish deposit accounts, and to deposit therein all taxes collected or withheld for government units, applies only to post-petition "trust fund" taxes and not to the debtor's own tax liability. It should also be made clear that lenders' cash collateral cannot be used to fund taxes and insurance; at a minimum, an entity holding a security interest in property required to comply with this provision should have a right to consent or refuse to its use.

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Section 237—Plan Filing and Confirmation Deadlines

Amends Section 1121 by establishing a 90 day exclusivity period that may be extended for cause. The debtor must also show for an extension that it is more likely than not that the court will confirm a plan with in a reasonable time.

This provision should be tightened to prevent undue extensions of deadlines. Extensions should be granted only in circumstances for which the debtor should not be held accountable.

Section 238—Plan Confirmation Deadline

Amends Section 1129 by providing that the plan in a small business case must be confirmed within 150 days of the order of relief unless the period is extended pursuant to Section 1121.

This section should be amended by adding an absolute deadline for confirmation no later than 365 days after the date of the order for relief.

Section 240—Duties of the United States Trustee and Bankruptcy Administrator

Creates expansive duties for the US Trustee in small business cases. Amends 28 U.S.C. 586(a) to require: (1) an initial debtor interview after filing and before the 341 meeting in order to "investigate the debtor's viability" and explain duties and obligations, (2) visit the place of business of the debtor "when appropriate" to ascertain the state of books and records, (3) "review and monitor diligently" the activities of the debtor, (4) file a motion for dismissal or conversion if appropriate.

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This provision should be substantially narrowed to prevent the generation of excessive expenses and to prevent the U.S. Trustee from going beyond its administrative duties to intruding on judicial functions. Specifically, the U.S. Trustee should not investigate the debtor's viability; should not visit the debtor's business site; and should not be asked to judge whether the debtor will be able to confirm a plan.

Section 242—Serial Filer Provisions

Amends Section 362 by adding a new section (1) which provides that the stay does not apply (1) in a voluntary or "collusive involuntary" small business case if the debtor had filed a case within the previous 2 years (whether it was dismissed or confirmed) or (2) if the new debtor is an entity that succeeded to all the assets of the previous debtor, unless the debtor proves that the secondary filing resulted from "circumstances beyond the control of the debtor" or "not foreseeable at the time" of the previous case and that it is more likely than not that a court will confirm a "feasible plan, but not a liquidating plan."

This provision should make clear that a "collusive involuntary case" is one in which the debtor and a creditor

conspire together to defeat filing limits, but does not include legitimate joint creditor efforts to compel a bankruptcy filing.

Chapter 2—Single Asset Real Estate

Section 252—Plan Confirmation

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Section 1129(b)(2)(A) is amended by adding a new paragraph defining a "new value" exception for single asset real estate (SARE) cases. This amendment provides that if a single asset debtor is attempting to cram down a plan over a secured creditor's objections [and that creditor has not made the election under 1111(b)], the debtor must contribute new value in cash to pay down the secured claim such that the principal amount of debt secured is no greater than 75% of the value of the real estate. In addition, the remaining repayment terms must satisfy "all relevant, then-prevailing market terms in the locality for new loans secured by liens on comparable real estate" Finally, the new value contribution must be accounted for as equity capital that is not convertible into debt capital.

We are strongly opposed to this section. The dubious, judicially created "new value" exception is at direct odds with the Code's absolute priority rule and greatly undermines the protections afforded in the Code to secured creditors. Codifying it for SARE cases will simply give unjustified leverage to the debtor.

In addition, we would expect that even proponents of the new value rule would object to its codification for a single type of case, since by implication it would not be available in any other type of case. (Needless to say, commercial banks would vehemently fight any attempt to codify it for Chapter 11 generally).

Section 253—Payment of Interest

Amends Section 362(d)(3) by extending the time available to a SARE debtor to contest or litigate whether it satisfies the SARE definition before it has to pay interest as required under this subsection.

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Amends Section (b) of that subsection to allow payments to creditors to be made from rent and to require that the payments be equal to interest at the non-default contract rate on the value of the creditor's interest in the real estate.

This provision needs technical fixes. In addition, we object to the granting of sole discretion to the debtor.

Miscellaneous Provisions

Section 501—Treatment of Certain Liens

Amends Section 724 to elevate liens "arising in connection with an ad valorem tax on real or personal property" to a priority distribution above all other distributions, including a distribution to a holder of an allowed secured claim on such property, but excluding post-petition wage claims.

This provision should be amended to make the government subject to creditor defenses in regard to ad valorem taxes.

Additional Items

In addition to the commercial issues already addressed in H.R. 3150, we believe that two additional topics must be dealt with:

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Strict limits should be added to curb excessive and repeated judicial extensions of the Chapter 11 exclusivity period, during which only the debtor may propose a plan of reorganization.

Section 363 of the Code should be amended to clarify that a judge may permit an auction of assets in the absence of a reorganization plan.

In regard to these two suggestions, as well as our comments on existing provisions of H.R. 3150, we will forward proposed language to Committee staff.

Mr. **GEKAS.** Thank you very much.

We will turn to Mr. Tatelbaum.

STATEMENT OF CHARLES M. TATELBAUM, JOHNSON, BLAKELY, POPE, BAKAR & RUPPEL, CLEARWATER, FL, REPRESENTING THE NATIONAL ASSOCIATION OF CREDIT MANAGERS

Mr. **TATELBAUM.** Thank you, Mr. Chairman.

I am Charles Tatelbaum, and I am pleased to appear here as general counsel to the National Association of Credit Management. The NACM is celebrating its one hundred and second year as the largest nonprofit trade association representing the interests of more than 30,000 commercial credit granting businesses. The NACM's membership is spread throughout the United States, and is representative of businesses spanning every size and nature. And we are the ones who unfortunately become involuntary stockholders and partners with debtors when the failures come.

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Mr. Chairman, it is a personal pleasure to be here again. And also, to sit next to Mr. Leon Forman, who has been a mentor of mine since I have been 10 years old. It is quite an honor to be sitting next to him here.

NACM is very supportive of the small business provisions, as it is written. We believe that after careful study that it will help to provide the greatest prompt return to trade creditors where appropriate and where they can be reorganized. Also, to terminate Chapter 11s early on when they should not continue, and just run up more trade debt both as priority and as post-petition debt, when there is no hope of getting paid.

NACM is equally supportive of the provisions contained in Sections 207 and 208 to correct the inequities which exist with respect to the avoidance of preferential transfers. While NACM supports the concept of the equality of treatment of creditors, the current statute creates an environment for the feeding frenzy of trustees and attorneys at the expense of vigilant trade creditors. It has been proven that there is no ultimate benefit being derived by the creditors, but only the professionals.

These changes are consistent with the recommendations of the National Bankruptcy Review Commission. We believe that it will help to create an environment of an even playing field with respect to bankruptcy administration. Additionally, these provisions in your bill, if enacted, will eliminate unnecessary and unproductive litigation, which can affect the already overburdened Bankruptcy Court system, which as I noted, produces no real benefit to the creditors of the bankruptcy estate.

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NACM further supports the provisions of Section 205 dealing with the composition creditors' committees, and there being court overview if necessary. The U.S. Constitution established a system of checks and balances. And this is sometimes lacking when there is the appointment by the U.S. Trustees Office, and no court supervision.

Although these situations rarely occur, the current system permits the formation and continuance of creditors committees that do not reflect the balance mandated by Congress. I know of one instance where a $75 million unsecured trade creditor was excluded from the committee because the U.S. Trustee was required to make a judicial decision at the formation meeting, which, I might add, I think is totally contrary to the law. The way they decided it, they excluded that creditor from the committee. That creditor has no redress to the courts under the current system. Under the bill proposed, there would be an opportunity to be heard. We think that creditors of all types need adequate and representative representation on all creditors committees. That is what makes the system work, and your provision would help that along.

Section 402, in concept, continues provisions which are very much supported by NACM and its constituency, but we believe that it needs a slight modification. This is the section that says that if there is a local rule, state constitution, or state statutory provision, which prohibits a creditor from participating at a meeting of creditors without an attorney, Congress is saying that they can participate without an attorney.

Unfortunately, Section 402, as it is now written, limits the change to consumer cases in Chapter 13 and Chapter 7. We believe on reflection that it may be appropriate that the limitation to consumer cases be deleted to make it applicable for all cases, so that all creditors can appear without the necessity of hiring attorneys, whether it be a business or a consumer case. That would apply in Chapter 11 or Chapter 12 as well.

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Because the creditors' meeting is the one place that creditors can go, ask questions, be heard, and not be required to hire attorneys when it may not be necessary, just to ask what about this or what about that. We believe that this slight modification would be helpful.

Unfortunately, we do oppose the concept of Section 201, which would prohibit Bankruptcy Courts from appointing fee examiners. Professional fees, which are almost always in the nature of administrative expenses, have increasingly become a significant part of the assets that are disposed of the estate. Many times, bankruptcy judges do not have the time or the wherewithal to examine fee applications in the depth necessary. We believe that leaving it, as it currently is, where a judge can in his or her discretion appoint a fee examiner, will provide the ultimate financial benefit to the estate without incurring any additional cost.

We thank you for the opportunity of participating and benefit heard.

[The prepared statement of Mr. Tatelbaum follows:]

PREPARED STATEMENT OF CHARLES M. TATELBAUM, JOHNSON, BLAKELY, POPE, BAKAR & RUPPEL, CLEARWATER, FL, REPRESENTING THE NATIONAL ASSOCIATION OF CREDIT MANAGERS

I am Charles Tatelbaum, a practicing attorney with the Tampa/Clearwater law firm of Johnson, Blakely, Pope, Bokor, Ruppel & Burns, P.A., and I am pleased to appear before you in my capacity as general counsel to the National Association of Credit Management. The NACM is celebrating its one hundred and second year as the largest non profit trade association representing the interests of more than 30,000 commercial credit granting businesses. The NACM's membership is spread throughout the United States and is representative of businesses spanning every size and nature.

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The NACM is very pleased to support HR 3150 because of the commercial laws it improves, and my comments will only focus on these issues raised in the proposed legislation.

Sections 232 through 243 contain the provisions dealing with small business reorganizations. NACM supports the efforts to create substance and procedure to expedite the administration and conclusion of reorganization cases for

small businesses. Considering the hundreds of billions of dollars of creditor claims that are tied up in business bankruptcies, the expeditious conclusion of a reorganization proceeding, whether by confirmation or dismissal, promotes the economic interests of all concerned. Studies and statistics have shown at many times there is a situation where small businesses which could successfully reorganize, fully or partially satisfy claims of creditors, continue in the economic stream, create employment and pay taxes but are unable to do so because of the pressures of the time and expense when languishing in Chapter 11. NACM has been a constant supporter of efforts to streamline the process for the prompt resolution of small business reorganizations.

NACM is equally supportive of the provisions contained in Sections 207 and 208 of the Bill to correct inequities which currently exist with respect to the avoidance of preferential transfers. While NACM supports the concept of the equality of treatment of creditors, the current statute creates an environment for the feeding frenzy of trustees and attorneys at the expense of vigilant trade creditors, with no ultimate benefit being derived by creditors of the bankruptcy estate. These changes, which are consistent with the recommendations of the National Bankruptcy Review Commission, will help to create an environment of an "even playing field" with respect to bankruptcy administration. Additionally, these provisions, if enacted, will eliminate unnecessary and unproductive litigation which can affect the already overburdened bankruptcy court system which, as I have noted, produces no real benefit to the creditors of the bankruptcy estate.

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NACM further supports the provisions of Section 205 of the legislation. The current system of determining the composition of creditors' committees which does not permit court overview, supervision and intervention frustrates the check and balance system created by the U.S. Constitution. Although situations may only rarely occur, the current system permits the formation and continuance of creditors' committees that, while not reflecting the representative balance mandated by Congress, permits it to continue without the possibility of any judicial scrutiny. Unsecured creditors of all types must be able to insure that there is adequate and representative representation on all creditors' committees. This is what helps the system to work.

Section 402, in concept, contains provisions which are very much supported by NACM's constituency, but, as written, needs slight modification. Creditors' committees are the vehicle for creditor participation in the bankruptcy process. To permit local rule, state constitution or state statutory provision to mandate the representation of a creditor by an attorney is contrary to the nature of the process itself. However, NACM questions the propriety of this new provision which is limited to "consumer" creditors. This is a basic principle of bankruptcy law and fairness. While the vast majority of cases do involve consumer debtors, and the amount of money per claim may be far less in such cases, NACM believes that in this instance there need not be any distinction between consumer creditors and commercial or business creditors with respect to the right to participate in meetings of creditors without the necessity of the hiring of counsel. There does not appear to be a rational basis to create an artificial discrimination between consumer and business creditors, and, thus, the basic tenets of creditor participation should be expanded to all creditor constituencies. NACM urges this Committee to consider the elimination of the distinction of "consumer" creditors, and permit the legislation to apply to all creditor representatives.

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NACM does oppose the concept of Section 201 of the Bill which would prohibit bankruptcy courts from appointing fee examiners. Professional fees which are almost always in the nature of administrative expenses have increasingly become a significant part of the disposition of the assets of a bankruptcy estate. To the extent that professional fees utilize funds that would otherwise be available for distribution to creditors, they should be closely monitored. The current case load of most bankruptcy judges does not permit the time consuming independent review by a judge as contemplated by the Bankruptcy Code. In many instances, only if there is the appointment of a fee examiner can the court be given an independent and objective view of the propriety of the administrative expenses which are sought to be recovered as part of the estate administration. Any cost associated with the fee examiner is more than compensated for by the savings which are created for administrative expenses and the increase in the distribution to creditors. The current practice of permitting the discretionary appointment of fee examiners can only benefit all parties in interest to

the estate. The proposed legislation creates the perception that independent scrutiny should not be considered. When dealing in areas as sensitive as professional fees, perception is more important than reality, and the NACM believes that any attempt to frustrate this independent review is ill advised.

When dealing with the provisions of Section 204 of the Bill, as a practical matter, NACM recognizes that in most prepackaged reorganization proceedings, there is no need for a meeting of creditors, and, upon appropriate motion to the court, after appropriate notice, the court should be able to order that no meeting of creditors need be held. However, NACM does not believe that any situation should be created where a meeting of creditors is absolutely eliminated. NACM's members believe that a dangerous precedent could be set with any absolute and unequivocal elimination of a meeting of creditors, since such meeting and creditor participation is one of the main foundations of the Chapter 11 reorganization process. NACM suggests that Section 204 be modified to permit the elimination of a Section 341 meeting of creditors upon appropriate motion, notice and hearing.

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NACM urges the Committee to consider the propriety of Section 412 which would appear to eliminate bankruptcy appellate panels from the judicial review process. Since their limited adoption many years ago, and with the implementation of the panels in a number of federal judicial circuits, practitioners, jurists and creditors alike have recognized how much more efficiently the system works with the bankruptcy appellate panel system. NACM suggests that careful consideration should be given as to the impact on the administration of bankruptcy appeals and case loads if this vehicle for the appellate process were to be eliminated.

Section 142 deals with the consumer issue of creating a presumption for nondischargeability of debts incurred to a single creditor by an individual debtor within 90 days before a bankruptcy proceeding. This, of course, does not have any direct impact upon trade credit. However, NACM and its constituents are very concerned that the adoption of this provision would promote the extensive proliferation of nondischargeability adversary proceedings which would create a time consuming burden on the already overcrowded bankruptcy court system. The provisions of Section 142 would have the effect of encouraging consumer creditors to commence adversary proceedings seeking the nondischargeability of debts, irrespective of the ultimate ability to collect them. Adversary proceedings require judicial and clerical administration which cannot be avoided. If only an average of two nondischargeability actions were brought in each of the consumer cases that were filed, more than two million adversary proceedings could be added to the courts' case load. The time consuming log jam could have a negative impact upon the ability of the bankruptcy courts to promptly and efficiently deal with business cases, thus interfering with business creditors' rights to prompt payment, especially in reorganization cases partially negating the strides to be made with the small business provisions. NACM has no position on the substance of the issue, but urges consideration of the potential impact on the court system if the provisions of Section 142 were to be enacted. NACM does have suggestions to help alleviate the problem of the costs and delays in the court system.

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NACM supports the provisions of Section 403 which would eliminate the need for the filing of proofs of claim in cases under Chapter 7 or Chapter 13 if creditors' claims are properly scheduled as to amount, and are not scheduled as disputed, contingent or unliquidated. This principle is consistent with the statute as it exists with Chapter 11, and NACM believes that the creation of this consistency would not only benefit all creditors, but also eliminate some of the administrative burden currently placed on the court system.

NACM does not support the provisions of Section 518 which would require a Chapter 11 disclosure statement to provide a full discussion of the potential material federal and state tax consequences of the plan to the debtor, any successor to the debtor and hypothetical creditors and stockholders. The intent of a disclosure statement is to provide creditors with adequate information so that they may properly vote on a plan of reorganization. While the ultimate tax consequences could be of some significance, most creditors assume that the debtor and its professionals have taken such consequences into consideration when formulating the plan of reorganization. The adoption of this provision would require debtors to incur additional expenses for professionals to provide this information, when it may not be

necessary for the reorganization process. This is not to say that in every case such information is not appropriate. However, the current system permits the request for the inclusion of tax consequences where appropriate, but also permits the exclusion of the information where it may not be material. NACM believes that the status quo is currently sufficient in this area.

Finally, NACM totally supports the sense of the Congress reflected in Section 411 of the Bill which urges a modification of the bankruptcy rules to place a greater responsibility on principals of the debtor and attorneys for the debtor with respect to information provided to the court and creditors on which all parties and the court rely.

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Mr. Chairman, I ask that the written submission of the National Association of Credit Management which contains additional comments with respect to the proposed legislation be made a part of the record of these proceedings. I thank the Chair, the Committee and its staff for not only the opportunity to participate in these hearings, but also the cooperative responsiveness in working towards a prompt passage of this most important legislation.

The National Association of Credit Management appreciates this opportunity to provide assistance to the Subcommittee. Additional information can be obtained from Mr. Jim Wise, the Pace Companies, (703) 516–0600, Mr. Paul J. Mignini, Jr., President, National Association of Credit Management, (410) 740–5560, or Charles M. Tatelbaum, NACM counsel (813) 461–1818.

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

And we will turn to his mentor, Mr. Forman.

STATEMENT OF LEON S. FORMAN, BLANK ROME COMISKY & MCCAULEY, PHILADELPHIA, PA, REPRESENTING THE AMERICAN COLLEGE OF BANKRUPTCY

Mr. **FORMAN.** Thank you, Mr. Chairman, and other members of the committee. I am quite honored to be here. I testified before Congress over 20 years ago during the consideration of the Code, and it is an experience to be back.

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I appear on behalf of the American College of Bankruptcy, which is an honorary, and professional, and educational association of bankruptcy and insolvency professionals. Its fellows include commercial and consumer bankruptcy attorneys, insolvency accountants, corporate turn around and renewal specialists, law professors, judges, government officials, and others involved in the bankruptcy and insolvency community. We number almost 400 members.

The College, because of its size, has difficulty formulating positions on specific proposals. Because in order to do that, we need to canvas the entire membership.

The only subject on which we were able to do that, plus a general statement which I will come to, has been Chapter 11. We have adopted certain positions as a result of recommendations of what we call focus groups, which is another name for committee. And the College has actually voted on these proposals, and they are before you in the form of a written statement.

I do not think that it would be helpful to go over the entire statement, but I would like to highlight one or two of the proposals, which the College has adopted. Some of these do not appear in legislation but should. And what I think the focus group did was it took the recommendations of the National Bankruptcy Review Commission, and considered them as a starting point.

The College has approved the changes recommended by the Commission on Section 365. This is a very technical provision. It deals with executory contracts. And it is a place in bankruptcy law where a great deal of improvement is

needed, and we endorse the recommendations of the Commission.

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We agree with the Commission that pre-bankruptcy waivers of rights under bankruptcy law should not be enforceable. There are all sorts of reasons for that position. I think that it is consistent with the position of other organizations, and we certainly endorse the view of the Commission.

We agree, as Mr. Tatelbaum indicated, that the Court should be authorized to change the membership of the committees. That was an amendment that was made to the bankruptcy law by Congress a few years ago, and it has turned out to be a mistake. The courts should have control of the membership of committees where a change in circumstances requires that the membership be changed.

We agree that the new value exceptions should be codified with the provision that in such cases that exclusivity would be terminated, so that creditors could file their own plan, if they want to. The new value exception serves a real purpose in many cases, as long as there is a very substantial contribution of new capital made. And the case cannot really be reorganized unless that is done.

Now the one protection that is needed is that the leverage given to the debtor does not prevail. In other words, the debtor should not be the only one to make the new capital contribution. And by eliminating exclusivity, the exclusive right to file a plan when new capital is proposed, we think that levels the playing field.

We agree that the Commission changes relating to pre-package plans, which I believe are in this will, which are in your bill, Mr. Chairman, should be adopted. We think that they are proper suggestions.

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We have also formulated a position on proposed changes being considered by the committee generally, our position is a general position, but particularly as affecting the bankruptcy of individuals.

We have set forth this position in a statement, which you have on file. And it is not a position on specific provisions or specific questions, because the College has not been in a position to canvas its membership.

But very quickly, we recognize the phenomenon of the increased number of bankruptcy filings, but we believe that the legislative process is moving too rapidly. The problem is too complicated to be resolved in a hurry, and we recommend a slow down and further study.

There appears to be no emergency. The economy is robust. It does not appear to be suffering from the larger number of filings. If anything, the consumer debt seems to be going up higher and higher as bankruptcy filings increase. We recommend consideration of more modest proposals before changing the fundamental structure of bankruptcy law.

When Congress created the Commission just a couple of years ago, it said to the Commission that the bankruptcy system seems to be working reasonably well. Therefore, do not consider fundamental or structural changes. And here, just a couple of years later, without any real things happening in the bankruptcy practice or in the economy, the Congress is considering the radical change in philosophy of bankruptcy law.

We believe that there should be time to review a very serious and complicated situation before any substantial changes are undertaken. We would be glad to cooperate in any way in developing a consensus of our membership, if there were sufficient time allowed.

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[The prepared statement of Mr. Forman follows:]

PREPARED STATEMENT OF LEON S. FORMAN, BLANK ROME COMISKY & MCCAULEY, PHILADELPHIA, PA, REPRESENTING THE AMERICAN COLLEGE OF BANKRUPTCY

The American College of Bankruptcy (College) is an honorary, professional and educational association of bankruptcy and insolvency professionals. Its Fellows include commercial and consumer bankruptcy attorneys, insolvency accountants, corporate turnaround and renewal specialists, law professors, judges, government officials and others involved in the bankruptcy and insolvency community. Nominees are extended an invitation to join based on a proven record of the highest standards of professionalism.

The College, along with other professional associations and interested groups, has become fully aware of the ever increasing number of bankruptcy filings during the past decade, reaching over 1,400,000 in 1997, a record level. We agree that Congress should be looking into this phenomenon and if it represents a reason to be concerned, then the source of the problem should be addressed. But the question remains whether the trend is symptomatic of flaws with the bankruptcy law, a matter denied by many scholars, or is the consequence of other ills in our society.

The National Bankruptcy Review Commission spent over a year studying this trend and rejected a means test solution, suggesting that the enormous growth in the extension of consumer credit is a more appropriate place in which to seek the causes of this development.

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It has become apparent that there are many divergent points of view as to the reasons for the increased bankruptcy filings and how they should be addressed. Moreover, the situation is made more complicated because the public perception that many bankruptcy petitioners are able to pay from future income some part of their debts may not generally agree with the reality that many of them are desperately in need of bankruptcy relief. On the other hand, there is some evidence that the bankruptcy remedy is being abused in a number of cases and such abuses should be and must be curbed. But the right answers to all of these difficult issues are not readily apparent and accordingly, they should undergo more intense study.

Polarizing the positions of the most directly affected parties will not shed light on the correct path to a proper solution. The so-called extreme suggestion that Congress prescribe a very strict means test as an eligibility requirement for filing a bankruptcy petition antagonizes those who find bankruptcy relief a necessary remedy for the oppressed consumer subjected by the consumer lending industry to the burdens of readily available extensions of credit. On the other hand, many perceive the bankruptcy system as a too easy way of ridding oneself of substantial debts without even considering the possible application of future income. But whatever the alleged abuses and wherever the fault may lie, whether in consumer credit practices or the provisions of the Bankruptcy Code, the corrections may lie somewhere between the extremes. Modest proposals may be more appropriate until stronger measures are found to be desirable.

We believe there are dangers lurking in a rush to judgment without further study. Wrong answers could cause more problems than they solve. There will be an inherent cost increase in the bankruptcy system which must be considered in any solution. There appears to be no emergency in the higher filing numbers as the American economy is certainly robust and does not seem to be suffering from this phenomenon. To legislate complicated tests of eligibility for bankruptcy without further careful review of the causes may unduly burden the system by requiring more judges and higher costs, to say nothing about the difficulties of applying these tests. If such changes do not work out, we may create a new class in our society of those suffering financial misfortune but who are unable to obtain any relief in our legal system.

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Instead of rushing to quick changes with uncertain and untested prospects, we ought to seek a breathing spell to give us an opportunity to survey more carefully the views of our constituents and to study whether there are other and

perhaps better approaches. As to the College, we certainly need more time to determine the views of our membership and to ascertain whether we can muster a consensus. Perhaps Congress, if not satisfied with the report of the National Bankruptcy Review Commission, should seek the independent judgment of other experts with no special interest in the outcome of this debate. We therefore urgently request that serious consideration be given to slowing down the legislative process and for a more deliberative approach to evolving a modest solution. In this effort the College would be pleased to offer its cooperation.

THE POSITION OF THE AMERICAN COLLEGE OF BANKRUPTCY ON THE GENERAL CHAPTER 11 RECOMMENDATIONS OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION

The College has considered the proposals of the National Bankruptcy Review Commission (NBRC) respecting reform of Chapter 11, and has adopted the following positions.

These positions were reached after the College's Chapter 11 Focus Group debated each of the proposals and formulated its recommendations to the College. The entire College was then polled on each of the proposals. Eighty-two College members responded to the poll.

Each NBRC proposal is summarized below, followed by the Focus Group's recommendation, selected dissenting views of Focus Group members, and the numerical results of the College poll. Also enclosed for your reference is a set of the NBRC proposals in their full text.

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The Chapter 11 Focus Group consists of the following fellows: Ralph R. Mabey (Chair), Arthur J. Abramowitz, Francis L. Carter, I. William Cohen, Daniel C. Cohn, Joseph E. Friend, Malcolm M. Gaynor, Robert S. Hertzberg, Stuart Hirshfield, Lillian E. Kramer, Louis W. Levit, Alfred S. Lurey, Mark E. MacDonald, Honorable Paul Mannes, George J. Marcus, Leonard M. Rosen, Lowell E. Rothschild, G. Blaine Schwabe III, Raymond L. Shapiro, Michael R. Stewart and Neal L. Wolf.

Summary of NBRC Proposals 2.4.1 & 2.4.2:

The concept of "rejection" in Section 365 should be replaced with "election to breach," and the concept of "assumption" should be replaced with "election to perform."

Focus Group Recommendation: Support

Focus Group Comment: These proposals would make clear that under Section 365 the trustee cannot nullify, rescind, or unwind a contract although the contract might be avoided under some other provision of the Code. "Election to breach" would not, for instance, terminate a lease. Substantial confusion would be alleviated and simplification of the barnacle-encrusted Section 365 would be facilitated. By electing to breach, the trustee would submit the estate to a claim for money damages and the estate's further contract obligations would, as under state law, largely be discharged. The assumption terminology is replaced in order to be parallel with the new "election to breach" terminology.

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The College's Position: 75 Support; 6 Oppose

Summary of NBRC Proposal 24.3:

During the gap period before an executory contract is assumed or rejected (using the old terminology), this proposal would authorize the court to grant an order governing temporary performance by the parties—such as by requiring the non-debtor party to continue performance and the trustee to continue paying under the contract.

Focus Group Recommendation: Support

Focus Group Comment: This proposal governs the awkward period before it is appropriate to assume or reject a contract by authorizing the court to enter an order governing the parties' temporary performance. In the event the court order is breached, the proposal grants an administrative expense to the non-debtor party for "losses reasonably and unavoidably sustained."

Dissenting Comment: The NBRC proposal should be rejected because it will lead to at least two adverse consequences. First, the proposal invites a deluge of motions for temporary performance orders at the beginning of every Chapter 11 case, just at the point when the debtor's management is already swamped with issues relating to postpetition financing, stabilization of customer relationships, and so on, and at a time when the creditors' committee is just getting up to speed. Second, the economic effect of temporary performance orders could be disastrous. If a temporary performance order were entered and thereafter breached, the resulting administrative claim would, according to the NBRC report (page 468), equal "[w]hatever compensation would be awarded to the non-debtor party under similar non-bankruptcy circumstances." This could include lost profits, opportunity costs, interest expenses, counsel fees, consequential damages and whatever else the non-debtor party can think of. Current law works well enough so as not to require drastic change of this type. All prepetition creditors appropriately bear the burden of delay inherent in the Chapter 11 process, and in the rare case where a contracting party faces extraordinary injury, Section 365(d)(2) of the Bankruptcy Code as now in effect provides an adequate remedy.

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The College's Position: 76 Support; 2 Oppose

Summary of NBRC proposal 2.4.4:

Section 365 should no longer be triggered by a finding of executoriness.

Focus Group Recommendation: Support

Focus Group Comment: The concept has engendered result-oriented reasoning by the courts and originated at a time when court approval for assumption or rejection was not required. The concept has outlived its usefulness. Its elimination would not affect treatment of financial accommodation contracts and the like.

Dissenting Comment: Despite all the academic criticism of the concept of "executoriness," it ain't broke, so don't fix it.

The College's Position: 63 Support; 17 Oppose

Summary of NBRC proposal 2.4.5:

Section 558 of the code should provide that a pre-petition contract clause waiving rights under Title 11, such as rights to the automatic stay, is ineffective.

Focus Group Recommendation: Support

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Focus Group Comment: This proposal is intended to stop the erosion of Chapter 11 rights through pre-petition loan agreements and the like. The automatic stay, for instance, is for the benefit of the estate and not exclusively the debtor who might have entered into a pre-petition waiver. The proposal does not affect issues actually litigated or consensual agreements between the debtor and a governmental unit exercising its police or regulatory powers.

Dissenting Comment: The court should be permitted to determine the enforceability of a pre-petition waiver based on

the circumstances presented.

The College's Position: 54 Support; 28 Oppose

Summary of NBRC proposal 2.4.6:

This proposal allows the court, upon motion, to dispense with the Section 341 meeting where a prepackaged plan of reorganization has been filed.

Focus Group Recommendation: Support

Focus Group Comment: This proposal is intended to streamline consideration of prepackaged plans of reorganization and to avoid unnecessary and costly delay where creditors already have received disclosures from the debtor and already support a plan.

The College's Position: 72 Support; 8 Oppose

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Summary of NBRC proposal 2.4.7:

This proposal would authorize the court to order parties to mediate any issues other than judicial disciplinary matters or the payment of professionals. The court could order payment for the mediator out of the estate.

Focus Group Recommendation: Support

Focus Group Comment: This would make clear that the court can order mediation whether the parties want it or not, an order that is clearly constitutional. It also makes clear that the estate may pay the bill; but, unfortunately, does not explicitly authorize the court to tax the parties for the cost of mediation.

Dissenting Comment: Although they favor forceful encouragement by the court of mediation, a minority of twenty five percent of the members of the focus group voted against this proposal, because they question the wisdom of permitting forced mediation over the objection of a participant.

The College's Position: 38 Support; 42 Oppose

Summary of NBRC proposal 2.4.8:

This proposal would authorize the court on request of a party to change the membership of an official committee or to order the appointment of additional committees.

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Focus Group Recommendation: Support

Focus Group Comment: This clears up the confusion in the courts as to whether the court has the power to alter the membership of a committee. Otherwise, faced with a representational problem, some courts have felt it necessary to create an additional committee. The court's review of the entire situation would be de novo.

The College's Position: 81 Support; 0 Oppose

Summary of NBRC proposal 2.4.9:

(Omitted—non-statutory.)

Summary of NBRC proposal 2.4.10:

This proposal authorizes the retention of professionals by examiners for cause. The proposal also would eliminate Section 1104(c)(2) which requires the appointment of an examiner where the estate exceeds $5 million in certain unsecured debts.

Focus Group Recommendation: Support

Focus Group Comment: The proposal closes a statutory lacuna respecting the compensation of examiners and eliminates the unpopular and unnecessary debt litmus test for the appointment of examiners.

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The College's Position: 76 Support; 3 Oppose

Summary of NBRC proposal 2.4.11:

This proposal would value a creditor's secured claim in personal property at the property's wholesale price and its claim in real property at the property's fair market value, minus hypothetical costs of sale.

Focus Group Recommendation: Oppose

Focus Group Comment: This proposal responds to the Rash decision by providing a simpler, clearer bright line test. The proposal seems ill-considered in circumstances where the secured creditor has a claim, for instance, on plant and equipment, work in progress, receivables, and the like, and where the proper recipient of the "going concern value" is at issue.

Dissenting Comment: The NBRC proposal should be supported because it accomplishes two important goals. First, it will dramatically decrease litigation costs by establishing a bright-line valuation standard. Second, the NBRC proposal appropriately balances the interests of secured creditors and general unsecured creditors by supplying a valuation standard that allocates to general unsecured creditors the "going concern premium" (i.e., the amount by which the going concern value of a debtor's business exceeds wholesale price of the assets). It is appropriate for the bankruptcy estate to receive the going concern premium in the event of a successful reorganization because the requirement of adequate protection already imposes on the bankruptcy estate the cost and risk of protecting the secured creditor from an unsuccessful reorganization.

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The College's Position: 14 Support; 65 Oppose

Summary of NBRC proposal 2.4.12:

This proposal clarifies Section 363(f) to make clear that a sale free and clear of interests can be ordered whether or not the face amount of the liens on the property exceeds the value of the property.

Focus Group Recommendation: Support

Focus Group Comment: This proposal makes clear that sales free and clear can be ordered by the court even when the property is under water since, as opposed to foreclosure, such sales typically maximize the value received. The secured creditors can, of course, credit bid.

Dissenting Comment: For many years, debtors have had very substantial powers to conduct sales free and clear of liens under circumstances in which the secured creditor consents or there is a good faith dispute with respect to the amount of perfection of the liens on the property. If the debtor is offering the property subject to the lien for sale in a single contract in which there is no contractual allocation of the purchase price for the liened portion of the property, it is far from clear that a secured creditor has an effective ability to credit bid to prevent a misallocation of proceeds. Furthermore, under the present law, the ability of the secured creditor to negotiate the terms of its consent often enables the secured creditor to avoid being saddled with costs of administration effectively unrelated to the sale of its asset. The ability to sell without regard to consent will upset the current negotiating balance. Granting this express power to bankruptcy courts will encourage such sale abuses. There is not a substantial problem under existing law concerning the scope of power of the bankruptcy court to conduct effective sales. This proposed cure introduces a substantial potential for abuse.

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The College's Position: 55 Support; 27 Oppose

Summary of NBRC proposal 2.4.13:

This proposal would allow a plan proponent to solicit releases of non-debtor liabilities. The majority of a class could not bind any creditor with respect to its decision whether or not to release a non-debtor.

Focus Group Recommendation: Support

Focus Group Comment: The proposal seeks to unify disparate case law and to acknowledge that certain non-debtor releases are important to a plan of reorganization.

The College's Position: 76 Support; 6 Oppose

Summary of NBRC proposal 2.4.14:

This proposal would exclude from property of the estate monies deducted from wages paid within 180 days of the petition when the monies withheld are owed by employees to third parties other than taxing authorities—such as to employee credit unions. If the employer debtor who withheld the monies has commingled them and no longer has them, it is not clear what the result would be.

Focus Group Recommendation: None

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The College's Position: 20 Support; 37 Oppose

Summary of NBRC proposal 2.4.15:

This proposal would codify the "new value exception" by allowing plans that provide for members of a general class of claims or interests to purchase new interests in the reorganized debtor. At such time, however, as the debtor (following the vote on the plan) moved to confirm a non-consensual new value plan, exclusivity would be terminated and creditors would be given the time to file their own plan and solicit acceptances.

Focus Group Recommendation: Support

Focus Group Comment: This proposal recognizes that the only real problem with new value plans is that the debtor's exclusive period imposes on creditors undue leverage and artificial valuation techniques for determining the sufficiency of new value. If exclusivity disappears, the creditors, and the market they create through their own plan or

plans, eliminate the problem. On the other hand, by preserving exclusivity until the debtor's plan has been voted upon, a class has dissented, and cramdown of the new value plan is moved, new value plans are not killed entirely. Moreover, under present law the court can always terminate exclusivity earlier in the process if it is just to do so. Jack Dilenschneider and some others have argued that Section 1121(c)(3) automatically terminates exclusivity, anyway, when a voting class dissents since the statute revokes exclusivity when "the debtor has not filed a plan that has been accepted before 180 days. . . . "

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Dissenting Comment: Under the provisions of Section 1121(d) of the Bankruptcy Code, the Court may, after a hearing and notice, and for cause, reduce the period of exclusivity. Under the provisions of the NBRC proposal, certain events would trigger an automatic termination of exclusivity. Suspending the confirmation process for what may be an extended period of time merely because a creditor claims that it wants to submit a competing plan will increase costs, have an adverse delay upon an estate, and provide creditors with too much leverage in the process. Courts should be sensitive to the issue, and approach it on a case-by-case basis with the parameters of protections afforded in Section 1121 of the Bankruptcy Code.

The College's Position: 51 Support; 28 Oppose

Summary of NBRC proposal 2.4.16:

This proposal allows separate classification of similar claims if supported by a "rational business justification."

Focus Group Recommendation: Support

Focus Group Comment: This proposal would address the confusion in the courts over separate classification. If there were separate classification, there would still be, of course, protection against treatment that unfairly discriminates between classes. Repeal of 1129(a)(10) might be another way to diffuse this problem, but the Commission did not so recommend.

Dissenting Comment: The concern here is that the "rational business judgment" test may create a justification for discriminatory treatment among unsecured classes. In most circuits, the bankruptcy courts appear to be exercising their discretion appropriately in dealing with classification issues.

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The College's Position: 62 Support; 20 Oppose

Summary of NBRC proposal 2.4.17:

This proposal would suspend, for a 1934 Act reporting company, the disclosure and fraud provisions of the securities laws when the company solicited votes for a prepackaged plan of reorganization before filing a bankruptcy petition. Instead of the securities laws, the Bankruptcy Code disclosure requirements would appertain. This safe Bankruptcy Code harbor would be available if the company filed its petition within 120 days after the solicitation began or if, because for instance the vote was negative, the company's prepackaged plan solicitation resulted in no petition being filed at all and the company, therefore, entered into no transaction whatsoever based upon the solicitation. In order to reach this safe harbor, the company would have to serve the SEC with notice of the pre-petition solicitation.

Focus Group Recommendation: Support

Focus Group Comment: This proposal, apparently acceptable to the SEC, alleviates the present situation where a prepackaged plan solicitation is subject to the securities laws—and to the bankruptcy court's later scrutiny under the

Bankruptcy Code.

The College's Position: 77 Support; 2 Oppose

Summary of NBRC proposal 2.4.18:

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This proposal also deals with prepackaged plans of reorganization. It would allow solicitation of parties in interest which was commenced before a petition was filed to continue, only as to those parties being solicited pre-petition, after the petition is filed and before a disclosure statement has been approved.

Focus Group Recommendation: Support

Focus Group Comment: This proposal addresses the problem, for instance, of a prepackaged plan of reorganization for which solicitation has been begun but such solicitation is interrupted by the filing of an involuntary petition. The thought is that the solicitation should be able to be completed following the filing of the petition and without the imposition of post-petition solicitation rules on a process structured and begun under pre-petition solicitation rules.

Dissenting Comment: If solicitation for a prepackaged plan has not been completed before the bankruptcy petition is filed, then the process should begin again under Chapter 11 procedures.

The College's Position: 61 Support; 14 Oppose

Summary of NBRC proposal 2.4.19:

This proposal would repeal the prohibition on the issuance of nonvoting equity securities in a plan of reorganization.

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Focus Group Recommendation: Support

Focus Group Comment: The prohibition on non-voting securities restricts reorganization flexibility, sometimes to the detriment of the estate. It does not prevent the gerrymandering of voting rights. The remainder of Section 1123(a)(6) would continue in existence and would provide some protection as would Subsection (7).

Dissenting Comment: The prohibition on issuance of nonvoting equity securities arose from Justice Douglas' report in 1935 on the abuses of equity receiverships. It is perfectly appropriate to permit payment of creditor claims in reorganization plans by issuance of equity securities. The combination of flexibility in classification plus the ability to issue nonvoting equity securities provides the potential for the issuance of worthless paper with no effective remedies for nonpayment. The proposed amendment would permit disfavored creditors to be locked in a box and ignored since they have no voting rights within the reorganized corporation. Nonvoting common equity is such an insubstantial and meaningless interest in a corporation that it should not be issuable to any creditor under a plan without the consent of each such creditor. Especially in light of the fact that the current Code permits the issuance of preferred shares which have minimal or no voting rights until after an event of default, the proposed additional flexibility is not necessary and may form a basis for abuse.

The College's Position: 44 Support; 34 Oppose

Summary of NBRC proposal 2.4.20:

This proposal would allow plan modifications for at least two years after plan confirmation.

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Focus Group Recommendation: Support

Focus Group Comment: Present law allows plan modification only before "substantial consummation." This is often a short time frame and much can be left still undone. A plan modification would, of course, still have to jump through the voting and confirmation hoops.

Dissenting Comment: The proposal undermines finality of the confirmation process and confirmed plans. To avoid post-confirmation plan modifications, which may be contrary to parties' expectations, whatever may be left to be determined after plan confirmation should be identified in the plan and expressly reserved for future determination in the course of the plan confirmation process.

The College's Position: 41 Support; 39 Oppose

CHAPTER 2: GENERAL ISSUES IN CHAPTER 11

2.4.1 *Clarifying the Meaning of "Rejection"*

The concept of "rejection" in section 365 should be replaced with "election to breach."

Section 365 should provide that a trustee's ability to elect to breach a contract of the debtor is not an avoiding power.

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Section 502(g) should be amended to provide that a claim arising from the election to breach shall be allowed or disallowed the same as if such claim had arisen before the date of the filing of the petition.

2.4.2 *Clarifying the Option of "Assumption"*

"Assumption" should be replaced with "election to perform" in section 365.

2.4.3 *Interim Protection and Obligations of Nondebtor Parties*

A court should be authorized to grant an order governing temporary performance and/or providing protection of the interests of the nondebtor party until the court approves a decision to perform or breach a contract.

Section 503(b) should include as an administrative expense losses reasonably and unavoidably sustained by a nondebtor party to a contract, a standard based on nonbankruptcy contract principles, pending court approval of an election to perform or breach a contract if such nondebtor party was acting in accordance with a court order governing temporary performance.

2.4.4 *Contracts Subject to Section 365; Eliminating the "Executory" Requirement*

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Title 11 should be amended to delete all references to "executory" in section 365 and related provisions, and "executoriness" should be eliminated as a prerequisite to the trustee's election to assume or breach a contract.

2.4.5 *Prebankruptcy Waivers of Bankruptcy Code Provisions*

Section 558 of the Bankruptcy Code should provide that except as otherwise provided in title 11, a clause in a contract or lease or a provision in a court order or plan of reorganization executed or issued prior to the

commencement of a bankruptcy case does not waive, terminate, restrict, condition, or otherwise modify any rights or defenses provided by title 11. Any issue actually litigated or any issue resolved by consensual agreement between the debtor and a governmental unit in its police or regulatory capacity, whether embodied in a judgment, administrative order or settlement agreement, would be given preclusive effect.

2.4.6 *Prepackaged Plans of Reorganization; Section 341 Meeting of Creditors*

Section 341 should provide that upon the motion of any party in interest in a Chapter 11 case that entails a prepackaged plan of reorganization, the court may waive the requirement that the U.S. trustee convene a meeting of creditors.

2.4.7 *Authorization for Local Mediation Programs*

Congress should authorize judicial districts to enact local rules establishing mediation programs in which the court may order nonbinding, confidential mediation upon its own motion or upon the motion of any party in interest. The court may order mediation in an adversary proceeding, contested matter, or otherwise in a bankruptcy case, except that the court may not order mediation of a dispute arising in connection with the retention or payment of professionals or in connection with a motion for contempt, sanctions, or other judicial disciplinary matters. The court should have explicit statutory authority to approve the payment of persons performing mediation functions pursuant to the local rules of that district's mediation program who satisfy the training requirements or standards set by the local rules of that district. The statute should provide further that the details of such mediation programs that are not provided herein may be determined by local rule.

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2.4.8 *Court Review of Appointments to Creditors' Committees*

Subsection (a)(2) of 11 U.S.C. 1102, "Creditors' and equity security holders' committees," should be amended to read as follows:

(2) On request of a party in interest and after notice and a hearing, the court may order a change in membership of a committee appointed under subsection (a) of this section if necessary to ensure adequate representation of creditors or of equity security holders. On request of a party in interest, the court may order the appointment of additional committees of creditors or of equity security holders if necessary to assure adequate representation of creditors or of equity security holders. The United States Trustee shall appoint any such committee.

2.4.9 *Employee Participation in Bankruptcy Cases*

Changes to the Official Forms, the U.S. Trustee program guidelines and the Federal Rules of Bankruptcy Procedure, are recommended to the Administrative Office of the U.S. Courts, the Executive Office of the U.S. Trustee, and the Rules Committee, as appropriate, in order to improve identification of employment-related obligations and facilitate the participation by employee representatives in bankruptcy cases. The Official Forms for the bankruptcy petition, list of largest creditors, and/or schedules of liabilities should solicit more specific information regarding employee obligations. The U.S. Trustee program guidelines for the formation of creditors' committees should be amended to provide better guidance regarding employee and benefit fund claims. The appointment of employee creditors' committees should be encouraged in appropriate circumstances as a mechanism to resolve claims and other matters affecting the employees in a Chapter 11 case.

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2.4.10 *Enhancing the Efficacy of Examiners and Limiting the Grounds for Appointment of Examiners in Chapter 11 Cases*

Congress should amend section 327 to provide for the retention of professionals by examiners for cause under the same standards that govern the retention of other professionals.

The Advisory Committee on Bankruptcy Rule of the Judicial Conference should consider a recommendation that Federal Rule of Bankruptcy Procedure 2004(a) be amended to provide that "On motion of any party in interest or of an examiner appointed under section 1104 of title 11, the court may order the examination of any entity."

Congress should eliminate section 1104(c)(2), which requires the court to order appointment of an examiner upon the request of a party in interest if the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes or owing to an insider, exceed $5,000,000.

2.4.11 *Valuation of Property*

A creditor's secured claim in personal property should be determined by the property's wholesale price.

A creditor's secured claim in real property should be determined by the property's fair market value, minus hypothetical costs of sale.

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2.4.12 *Clarifying The Conditions for Sales Free & Clear Under 11 U.S.C. 363(f)*

Congress should make clear that bankruptcy courts can authorize sales of property of the estate free of creditors' interests regardless of the relationship between the face amount of any liens and the value of the property sold.

2.4.13 *Release of Claims Against Nondebtor Parties*

Congress should amend sections 1123 and 524(e) to clarify that it is within the discretion of the court to allow a plan proponent to solicit releases of nondebtor liabilities. Creditors that agree in a separate document to release nondebtor parties will be bound by such releases, whereas creditors that decline to release their claims against nondebtor parties will not be bound to release their claims.

2.4.14 *Exclusion of Payroll Deductions from Property of the Estate*

Congress should amend 11 U.S.C. 541(b) to clarify that funds deducted from paid wages within 180 days prior to the date of the commencement of a case under title 11, held by a debtor/employer, and owed by employees to third parties, other than a federal, state or local taxing authority, do not fall within the definition of "property of the estate."

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2.4.15 *Absolute Priority and Exclusivity*

11 U.S.C. 1129(b)(2)(B)(ii) should be amended to provide that the court may find a plan to be fair and equitable that provides for members of a junior class of claims or interests to purchase new interests in the reorganized debtor.

11 U.S.C. 1121 should be amended to provide that on the request of a party in interest, the court will terminate exclusivity if a debtor moves to confirm a non-consensual plan that provides for the participation of a holder of a junior claim or interest under 1129(b)(2)(B) but does not satisfy the condition set forth in section 1129(b)(2)(B)(i).

2.4.16 *Classification of Claims*

Section 1122 should be amended to provide that a plan proponent may classify legally similar claims separately if, upon objection, the proponent can demonstrate that the classification is supported by a "rational business

justification."

2.4.17 *Prepetition Solicitation for a Prepackaged Plan of Reorganization*

The standards and requirements provided in the Bankruptcy Code for postpetition solicitation should be applicable to a solicitation for a plan of reorganization within 120 days prior to filing a Chapter 11 petition by a company that is subject to and in compliance with the public periodic reporting requirements of the Securities Exchange Act of 1934. Notice of such prepetition solicitation should be served on the Securities and Exchange Commission. If a company solicits for a plan of reorganization but does not file for bankruptcy, the bankruptcy requirements and standards should be applicable if the company does not complete an exchange offer or any other transaction on the basis of such solicitation.

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2.4.18 *Postpetition Solicitation for a Prepackaged Plan of Reorganization*

Section 1125(b) should be amended to provide that the acceptance or rejection of a plan may be solicited after the commencement of a case under title 11 but before the court approves a written disclosure statement from those classes that were solicited for the plan prior to the filing of the bankruptcy petition.

2.4.19 *Elimination of Prohibition on Nonvoting Equity Securities*

Congress should amend section 1123(a)(6) to eliminate the requirement that the charter of the reorganized corporate debtor prohibit the issuance of nonvoting equity securities. Section 1123(a)(6) should otherwise remain unchanged.

2.4.20 *Postconfirmation Plan Modification*

11 U.S.C. 1127(b) should be amended to permit modification after confirmation of a plan until the late of 1) substantial consummation or 2) two years after the date on which the order of confirmation is entered. All other restrictions on postconfirmation plan modification in section 1127(b) should remain unaltered.

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

And we turn to Mr. Perlstein.

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STATEMENT OF WILLIAM J. PERLSTEIN, WILMER CUTLER & PICKERING, WASHINGTON, DC, REPRESENTING THE AMERICAN BAR ASSOCIATION, THE BUSINESS SECTION

Mr. **PERLSTEIN.** Thank you, Mr. Chairman. It is an honor to appear before this subcommittee this afternoon. Let me join with Mr. Tatelbaum in thanking the Commonwealth of Pennsylvania for sharing Mr. Forman with us and the City of Philadelphia. There are many of us here who owe much of what we have learned to Leon.

Mr. **GEKAS.** I recommend that all of these people not become lawyers.

Mr. **PERLSTEIN.** I appear on behalf of the Business Bankruptcy Committee of the Section on Business Law of the American Bar Association. The membership on the committee consists of more than 1500 lawyers, who deal with the business aspects of the Bankruptcy Code in their daily practice. We are also able to bring a practical perspective to the issues that this committee is facing today.

I need to mention that, except as otherwise noted, the testimony does not represent the official position of the

American Bar Association, but of the committee itself.

I would like to address first the important appeal provision of the bill. The legislation would make a major improvement in the administration of bankruptcy law cases, by eliminating the costly and inefficient two tiers of appellate review currently in the law. At the present time, appeals first go to the District Court, the alternative to a bankruptcy appellate panel. Appeals from the District Court or the panel are then taken to the Court of Appeals, thus resulting in two levels of appellate review of Bankruptcy Court orders.

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This system is costly in terms of time and money. As important perhaps is the glaring lack of consistency resulting from appellate decisions rendered by more than 650 District Court judges and several bankruptcy appellate panels. Until a decision on a particular matter is rendered by a Court of Appeals, neither the bankruptcy judges nor the district judges within a particular district or circuit feel themselves bound by a decision of their brethren. This can led to widely divergent opinions within a single district and much uncertainty among litigants. Direct appeal to the Court of Appeals would end this problem.

The proposed legislation would also speed appellate review by permitting interlocutory review by the Court of Appeals of Bankruptcy Court decisions. In addition to permitting interlocutory review, Section 412 of the bill would mandate appellate review of interlocutory orders granting or denying certain types of relief.

While we support allowing discretionary interlocutory review, we suggest that the committee consider narrowing the scope of the section as imposing too much mandatory interlocutory review.

For example, the bill would mandate interlocutory review of every order denying relief under Section 105. That section allows Bankruptcy Courts to issue necessary orders to carry out provisions of the Code. As might be expected, someone with no specific authority for relief that it is seeking before a Bankruptcy Court will often come in and seek relief under Section 105.

There is no evident reason that every order requested and denied under Section 105 should be subject to immediate mandatory interlocutory review. We suggest limiting the right of appeal to orders granting such relief, since such orders may affect the course of the case, but leaving appellate review of orders denying relief to the discretion of the Court of Appeals.

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Similarly, the bill would mandate interlocutory review of all orders extending or denying the extension of the exclusive period and all orders granting or denying the appointment of a trustee.

Again, we suggest that an order that simply upholds the statutory limits on the filing of the plan, the 120 and 180 day limits, not be subject to mandatory appellate review, and the same thing with orders seeking the appointment of a trustee when no trustee is appointed. Again as drafted, the bill would mandate that the Court of Appeals grant interlocutory review of every order denying the appointment of a trustee.

We would respectfully submit that that would burden the courts unnecessarily, and that we are far better off leaving that to discretionary review by the Court of Appeals rather than mandatory review.

Finally, the committee agrees with the other speakers that the provision in Section 205 confirming that the District Courts can control the membership on creditors and equity committees should be adopted. We support that proposal. We also agree with the Bankruptcy Commission that the standard of review by the courts should be de novo of a decision of the United States Trustee, since the adequacy of representation by a committee, we believe, is a matter of law as opposed to a matter of discretion.

Thank you. I would certainly be prepared to address any questions.

[The prepared statement of Mr. Perlstein follows:]

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PREPARED STATEMENT OF WILLIAM J. PERLSTEIN, WILMER CUTLER & PICKERING, WASHINGTON, DC, REPRESENTING THE AMERICAN BAR ASSOCIATION, THE BUSINESS SECTION

Mr. Chairman, it is an honor to appear before this Subcommittee this morning. I appear as Chairman of the Business Bankruptcy Committee Subcommittee on Legislation of the American Bar Association Section on Business Law. The membership of the Business Bankruptcy Committee consists of more than 1500 lawyers representing debtors, creditors and governmental units, who deal with the business aspects of the Bankruptcy Code in their daily practice. We are able to bring a practical perspective to the issues that this Committee is facing in developing legislative responses to the Recommendations of the National Bankruptcy Review Commission ("NBRC").

The Executive Council of the Business Bankruptcy Committee has reviewed the business-related Recommendations of the Commission. The results of that review have been compiled in a Survey, including suggestions for changes to some of the Recommendations. Copies of the first volumes of the Survey have been provided to Committee staff, as will further Surveys as they are completed. The Surveys and this testimony represent the views of the Executive Council of the Business Bankruptcy Committee and, except as otherwise noted in this testimony, do not represent an official position of the American Bar Association.

My testimony will concern the principal business law provisions of H.R. 3150, excluding the single asset and small business provisions which I understand are being addressed by another set of speakers. Our Committee endorses the principal business law provisions of H.R. 3150. I would like first to address the important appeal provisions of the bill and then deal with the more specialized provisions at the end of my testimony.

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1. Appellate Review. The legislation would make a major improvement in the administration of bankruptcy law cases by eliminating the costly and inefficient two tiers of appellate review now required of appeals from decisions of the bankruptcy courts. At the present time, appeals of bankruptcy court orders first go either to a district court or, in some circuits, to a bankruptcy appellate panel composed of three bankruptcy judges. Appeals of the decisions of the district court or the bankruptcy appellate panel are then taken to the court of appeals, thus resulting in two levels of appellate review of bankruptcy court orders.

This system is costly in terms of time and money and treats bankruptcy cases differently than almost all other federal law cases, which proceed through one level of review. As important, perhaps, is the glaring lack of consistency resulting from appellate decisions rendered by more than 650 district court judges and the several bankruptcy appellate panels. Until a decision on a particular matter is rendered by a court of appeals, neither the bankruptcy judges nor the district judges within a particular district or circuit feel themselves bound by decisions of their brethren. This can lead to widely divergent opinions within a single district and much uncertainty among litigants. It also encourages parties to take appeals notwithstanding clear contrary authority at the district court level, since the appeal may be assigned to another district judge who will be free to ignore the decision issued by one of his colleagues.

The Business Bankruptcy Committee has long been a supporter of eliminating the two tiers of review now required for appeals of bankruptcy court decisions. The ABA House of Delegates, responding to the Long Range Plan of the Judicial Conference, recommended in August 1995 that the NBRC carefully study the bankruptcy appellate process and that it recommend means to foster coherent, consistent development of bankruptcy precedents. The Commission responded to that suggestion by recommending the elimination of the two tiers of appellate review and by endorsing expansion of the interlocutory review of bankruptcy court orders. NBRC Recommendations 3.1.3, 3.1.4.

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By providing that all appeals from bankruptcy court orders will proceed to the court of appeals, the problem of inconsistent appellate court decisions should be eliminated, saving time and money, and providing clearer guidance to litigants and counsel as to the prevailing law within the circuit. We endorse this provision of section 412 of H.R. 3150.

The proposed legislation would similarly speed appellate review by permitting the court of appeals to exercise interlocutory review over certain categories of bankruptcy court decisions, thus allowing the court of appeals to resolve major issues in a case without having to await a final order of the bankruptcy court. There are two aspects to this provision of section 412. The first part, subsections (3) and (4), mandates appellate review of interlocutory orders granting or denying relief under three sections of the Bankruptcy Code: sections 105, 1104(a) and 1121(d). These sections concern the power of the bankruptcy court to issue orders to carry out the provisions of title 11 (section 105); orders appointing a trustee (section 1104); and orders increasing or decreasing the exclusive period in which to file a plan of reorganization (section 1121).

Under current law, interlocutory appeals may be taken as of right only from orders increasing or decreasing the exclusive period under section 1121(d). 28 U.S.C. sec. 158(a). The NBRC recommended enlarging that mandatory list to include orders concerning the issuance of an injunction, the modification of the automatic stay, the appointment of a trustee, or the authorization of the sale or other disposition of property. NBRC Recommendation 3.1.4.

We agree with the authors of H.R. 3150 that the NBRC Recommendations would mandate (as opposed to giving the court of appeals discretion to review) too much interlocutory review by the courts of appeal. The bill adopts the Recommendations of the Commission only with respect to the appointment of a trustee, while also expanding existing law concerning orders concerning the exclusive period under section 1121. It adds to the list of mandatory review those orders granting or denying relief requested under section 105 of the Bankruptcy Code.

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In this regard, we suggest that this Committee consider narrowing the scope of section 412. For example, the bill would mandate interlocutory review of every order denying relief under section 105. That section allows bankruptcy courts to issue orders to carry out the provisions of the Bankruptcy Code. As might be expected, a party with no specific authority for relief that it is seeking will sometimes contend that the bankruptcy court has authority under section 105. The bankruptcy court may decline to issue the requested order as beyond its powers or otherwise ill advised. There is no clear reason why every order requested and denied under section 105 should be subject to immediate appeal. We would suggest limiting the right of appeal to orders granting such relief, since that order may affect the course of the case, while leaving appellate review of orders denying relief to the discretion of the appellate court.

We similarly suggest narrowing the review of orders under sections 1104(a) and 1121(d). An order refusing to alter the statutory time periods under section 1121(d) is not presently reviewable as of right on interlocutory appeal. We suggest that a decision of a court not to alter the time deadlines set by Congress should not be entitled to appeal as of right. Similarly, while we agree that an order appointing a trustee should be immediately reviewable, since it is almost impossible effectively to review such an appointment at the end of the case, an order refusing to appoint a trustee should be reviewable at the discretion of the appellate court rather than as of right.

The final provision of section 412 establishes the grounds for the court of appeals to grant interlocutory relief outside of the areas requiring mandatory review. It provides for interlocutory review when the court of appeals finds that (i) the order at issue involves a controlling question of law as to which there is substantial ground for a difference of opinion, and (ii) an immediate appeal may materially advance the ultimate termination of the case or proceeding. These are the same standards as are used in certifying appeals for interlocutory review under 28 U.S.C. sec. 1292. The bill also would allow the court of appeals to exercise interlocutory review in the discretion of the court even without satisfying these standards. We believe that allowing such discretionary review is appropriate given the number of different proceedings that may arise within a single bankruptcy case.

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2. Other Provisions Adopting Recommendations of the Commission. Sections 201 through 208 of the bill generally adopt certain Recommendations contained in the Final Report of the Commission. These include making Chapter 12 (the Family Farmer chapter) permanent; banning the appointment of fee examiners (which have been appointed by certain courts to review fee applications of professionals whose fees must be approved by the bankruptcy court); limiting the venue of small preference actions (requiring a noninsider defendant to be sued in its own district if the amount is less than $10,000); setting a $5,000 minimum amount for any business preference claim; and making several changes to streamline the solicitation procedures in prepackaged cases. We support each of these proposals.

Section 205 of the bill adopts Commission Recommendation 2.4.8 to make clear that the bankruptcy court has the authority to order a change in the membership of any creditors' or equity committee appointed by the United States Trustee. The courts have divided on this issue since Congress amended the Bankruptcy Code in 1986, with some courts holding that the court could order the appointment of another committee but could not order a change in the membership of an existing committee. We support the provision of the bill making clear that the court can review the membership of any committee appointed by the United States Trustee to ensure adequate representation of the interests of creditors and equity holders. We also agree with the Commission that the standard of review by the court should be de novo since the adequacy of representation is a legal issue.(see footnote 162)

3. Other Provisions. The remaining business provision in the bill concerns nonresidential real property leases. The proposed amendment to section 365(d)(4) would extend the time period for requiring assumption or rejection of nonresidential real property leases to 120 days from the current 60 days. In practice, this deadline is routinely extended by most courts. The 60 day deadline is, in most cases, too early for the debtor or trustee to make an informed determination whether to assume or reject a lease. The result is to require the filing of a motion followed by an almost automatic extension granted by the court. We support the proposed change as conforming to actual practice. The other change in this section would require assumption or rejection to occur no later than the date of confirmation of the plan of reorganization. We agree that the nondebtor party is entitled to a final determination by the debtor or trustee by the time of plan confirmation.

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4. Additional Assistance. We appreciate the opportunity to appear before this Committee today. We look forward to providing whatever assistance that we can to the Members and the staff and would welcome the opportunity to appear on other occasions as this Committee considers other changes to the Bankruptcy Code.

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

And we turn to Mr. Bordwin.

STATEMENT OF HAROLD J. BORDWIN, KEEN REALTY CONSULTANTS, INC., GREAT NECK, NY

Mr. **BORDWIN.** Good afternoon. It is a pleasure and an honor to be here.

My company, Keen Realty Consultants Inc., is a real estate consulting firm that specializes in working with retailers and helping them to restructure their real estate and lease portfolios. Frequently, that work is done in the context of a Chapter 11. In that regard, I am going to address my comments today to Section 209 of H.R. 3150 dealing with the time to assume or reject leases. If I also have time, I will address some comments to Section 205.

The changes to Section 365(d)(4) of the Bankruptcy Code proposed by Section 209 of H.R. 3150 would extend the time to assume or reject a lease from 60 to 120 days. This is a positive but relatively insignificant change. What I am concerned about, troubled by, and will address my comments to are the changes that are being sought by the shopping center industry represented here today by the ICSC which go beyond the amendment set forth in Section 209.

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The ICSC would like to restrict the time for a debtor to assume or reject leases, and that creates a number of problems. The assumption of a lease triggers two legal obligations. First, it triggers the obligation to cure pre-petition defaults, in full. Pre-petition defaults are typically a month or two or maybe three of rent that were not paid immediately prior to the filing of a bankruptcy.

If a retail-debtor is required to assume its leases early, then those pre-petition defaults, which are otherwise unsecured general claims, just like the claims of a trade creditor, they get paid in full, one-hundred percent, at the time of assumption, whereas as other creditors have to wait until the end of bankruptcy to be paid in bankruptcy dollars, i.e., cents on the dollar.

This gives landlords, I believe, an unfair advantage over the other classes of creditors, because they are getting one-hundred cents on the dollar and getting paid earlier than everybody else.

The other implication of the assumption of a lease is that it changes the priority of the lease obligations through the end of the lease term. The remaining lease obligation at assumption becomes a priority administrative claim. I believe that it is unfair to force the estate to bear the burden of perhaps another year or 20 years of lease obligations as a priority administrative expense.

What that means is that if the debtor later determines that particular locations do not fit within its business plan and needs to close those stores or the business does not work and ends up liquidating, then when the assets of the estate are divvied up among the creditors, landlords who have assumed-leases are going to get paid hundred percent dollars before all other classes of creditors. I think that that is fundamentally unfair and is not something that public policy should support.

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In addition, forcing the assumption or rejection decision prematurely raises a fairness problem: why should a landlord who, according to the Code, is getting current payments of rent be entitled to force an election to assume or reject the lease.

Also, as a practical matter, a rigid assumption/rejection deadline does not take into account the significance of the Christmas season. There are many retail-debtors that put off putting a reorganization plan on the table until they see their Christmas sales. To force an assumption or rejection of leases prior to the Christmas season would be counterproductive.

The process of determining how a business can be reorganized and restructured takes time. One of our clients was Edison Brothers stores. Edison Brothers filed for bankruptcy in November 1995. It did not emerge for approximately 2 years. In that process, they started with a chain of approximately 2800 stores and 2 years later they were down to approximately 1700 stores.

The restructuring of Edison Bros. was a major corporate event. That company needed two years to assess which locations to keep and companies should not be forced to make that election early, especially if they pay their rent as required by the Code.

A current client of ours is Petrie. Petrie started in bankruptcy a little over 2 years ago with over 1000 Petrie stores. They are now down to 100 stores and that process is still unfolding. However, throughout that process, I believe that landlords were and are being paid currently, as required.

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Again I appreciate the opportunity to be here and I would be glad to answer any questions. Thank you.

[The prepared statement of Mr. Bordwin follows:]

PREPARED STATEMENT OF HAROLD J. BORDWIN, KEEN REALTY CONSULTANTS, INC., GREAT NECK, NY

INTRODUCTION & BACKGROUND

My name is Harold Bordwin and I am an officer and principal of Keen Realty Consultants Inc. I pleased and honored to be here today and hope that you find my perspective helpful with regard to selected provisions of H.R. 3150.

Keen is a real estate consulting firm with a specialized expertise assisting retailers to restructure their lease portfolio. We frequently provide our services in the context of a Chapter 11 proceeding. Since Keen Realty was founded in 1981, we have been involved in evaluating, consulting and/or selling over 130 million square feet of retail real estate and leases.

Recent clients of ours who have operated in a Chapter 7 and/or 11 proceeding include, All About Sports, Autoworks, Caldors, Clothestime, County Seat, Edison Bros., Fretter, Herman's Sporting Goods, Inside Outlet, JH Collectibles, Lauriats/Encore Books, Leslie Pay, Lil Things, Merry Go Round, and Petrie Retail, among others.

Recent retail (non-bankruptcy) clients of ours include Contempo Casuals, Cumberland Farms, Dunhams Sporting Goods, Fayva Shoes, Kmart, Koenig Sporting Goods, May Department Stores, Modern Woman, Pastille Stores, Service Merchandise, Sterling Jewelers, a national fast food restaurant chain, and a national men's wear chain, among others.

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Experiences like these—representing retailers across the country with locations nationwide—provide me with a unique perspective on how the provisions of the United States Bankruptcy Code ("Code") affect retailer businesses.

As a general matter, it not apparent to me that there is a need for legislative action to address Section 365 of the Code. I am unaware of any evidence of a dramatic rise in bankruptcy filings by retail businesses or of any extraordinary events or occurrences that the bankruptcy courts themselves have not been able to address. *In fact, the adoption of any amendments being proposed by the shopping center landlords would be likely only to exacerbate the preferential treatment that shopping center landlords are already enjoying at the expense of the other creditors (trade vendors, lenders, bondholders, etc.) and the retail-debtor.*

SECTION 209(2) OF H.R 3150

The change proposed by Section 209(2) of H.R. 3150 (extending the 60 day period to assume or reject leases to 120 days) is positive but insignificant. It is generally recognized in the Chapter 11 proceedings of retail businesses that the existing 60 day deadline is too short. As a result, bankruptcy courts routinely grant extensions of that deadline. What is significant and troubling are some of the suggestions and recommendations of the International Council of Shopping Centers ("ICSC") to restrict the time to assume or reject leases. Thus, I will address my statement to the legislative proposals of the ICSC.

I am opposed to restricting a retail-debtor's flexibility to seek extensions of the time to assume or reject leases under Section 365(d)(4) of the Code because it would impede the retail-debtor's ability to reorganize and because it would be a de facto grant of a priority to one group of general, unsecured creditors (Lid, shopping center landlords) over all other general, unsecured creditors.

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By way of background, Section 365 of the Code grants a debtor the right to assume or reject executory contracts. Leases of nonresidential real property (such as a retailer's store leases) are executory contracts. The right of a debtor to "assume" a lease refers to the right that the debtor has in a bankruptcy proceeding to agree to accept the continuing obligations of a lease while the right of a debtor to "reject" a lease refers to the right to avoid the lease, subject to the landlord's claim for damages.

During the period of time when the retail-debtor is determining whether to assume or reject a lease, the Code obligates the retail-debtor to pay its post-petition rent, in the amount stated in the lease, on a current basis. Neither the retail-debtor nor the Bankruptcy Court has the right to reduce an over-market rental rate to a fair market rate or to otherwise adjust the rent to account for the benefit of the premises to the Estate.

For purposes of my presentation, the assumption of a lease raises two significant points. First, when a lease is assumed, the debtor must cure all defaults. Most frequently, those defaults consist of one, two, maybe three months rent and perhaps common area maintenance adjustments and real estate tax adjustments that were unpaid as of the date of the bankruptcy filing. In the context of a bankruptcy proceeding, those arrearages are pre-petition, general unsecured claims. The Code as it exists today already grants landlords a significant advantage over other pre-petition, general unsecured creditors. By requiring the curing of defaults upon assumption, the Code mandates that the landlord of an assumed lease gets paid its pre-petition, general unsecured claim, in full, immediately upon assumption. All other general, unsecured creditors have to wait until the end of the proceeding to be paid and when they are paid, they are paid in "bankruptcy dollars", *i.e.*, cents on the dollar. That is an existing advantage that landlords have over other general, unsecured creditors.

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Second, when a lease is assumed, the remaining obligations under the lease through the term of lease become a priority, administrative claim of the estate to the landlord. As a result, retail-debtors (with the support of their creditors' committees) typically seek to extend:the time to assume or reject until the confirmation or effectuation of a plan of reorganization. If, however, the retail-debtor prematurely assumes a lease and, thereafter. determines that the leased location is not viable for its business or, alternatively, if the retail-debtor's business fails and liquidates, then the entire remaining lease obligation to the landlord (regardless of whether it is one year or twenty-five years) becomes a priority claim, payable in full—without application of the Section 502(b)(6) damage cap—before any of the claims of the trade or other unsecured creditors. Thus, the landlord of an assumed lease has a significant priority over other general, unsecured creditors.

Seen in this context, it is to the advantage of the ICSC to seek to amend Section 209(2) of H.R. 3150 so as to force the early assumption of leases. By forcing the early assumption of leases, the ICSC gets for its members the early payment in full, of prepetition, unsecured claims and the administrative, priority treatment of ongoing rents for the full remaining term of the lease. All of this is to the detriment of the debtor and its other creditors.

Furthermore, as a practical matter for a retail-debtor, any imposition of artificial deadlines for assuming or rejecting leases would be highly prejudicial. This is because the process of restructuring a retail business is time consuming and involves multiple constituencies, not just landlords. As an example of the amount of time that it takes to restructure a retail business, Edison Brothers Stores (St. Louis, Missouri) emerged from Chapter 11 in September 1997, 22 months and two Christmas seasons after its initial filing. Petrie Retail (Seacaucus, New Jersey) is preparing to emerge from Chapter 11 after over 2 years in bankruptcy.

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Finally, it should hardly be for the landlords to object to the amount of time that it takes for a retail-debtor to assume or reject its leases because *pursuant to the Code, landlords receive, on a current basis, rent and other post-petition obligations.*

SECTION 209(3) OF H.R. 3150

I am unaware of the impetus behind Section 209(3) of H.R. 3150 (a bill to prohibit a court from extending the time to assume or reject beyond plan confirmation). I am not familiar with courts granting extensions of the assume/reject deadline beyond plan confirmation nor am I familiar with any problems that that might raise. I would recommend that Congress solicit further comments on this proposal and allow the Federal Courts to address this matter without legislative intervention.

SECTION 205 OF H.R. 315O

Section 205 of H.R. 3150 seeks to amend the Code to grant the Bankruptcy Court oversight over the decisions of the United States Trustee in selecting the members of a creditors' committee. Although I do not have an opinion about this provision, as drafted, I am concerned about the efforts by shopping center landlords to gain membership on the creditors' committee of retail-debtors. Insofar as the reorganization of a retail-debtor frequently entails, in large part, the disposition of excess locations and the restructuring of the lease portfolio, the retail-debtor's landlords should not be members of the creditors' committee where they would become privy to the retail-debtor's plans vis-a-vis its landlords. Additionally, with respect to valuable excess leases of the retail-debtor, the interests of the landlords are divergent from the interests of other members of the creditors' committee: the landlords would want to regain possession of those locations without having to pay for them while the remaining creditors would want to maximize the value of those leases to the Estate.

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It is my recommendation that the Subcommittee further study this issue before adopting any recommendations of the ICSC.

CONCLUSION

A bankruptcy, by definition, means that there are insufficient funds to pay all creditors on a current basis. The shopping center landlords, acting through the ICSC, have aggressively tried to improve their position by pursuing legislative initiatives. The ICSC's successes are manifest in Section 365 of the Code.

The changes now being sought by the ICSC in H.R. 3150, in particular, restricting the time to assume or reject a lease, are a pernicious, back-door attempt to improve the priority of shopping center landlords over other creditors. Not only would this result be inequitable but also the means of achieving this result would significantly undermine a retail-debtor's ability to reorganize its business and emerge from Chapter 11.

I appreciate the opportunity to appear before this Committee today and look forward to providing whatever assistance I can to the Members and their staff.

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

We are going to exercise the prerogative of the Chair, and yield to the gentleman from New York first. Because I did not hear the first two witnesses, and I want to take some time to gather my thoughts on my questioning. So I will yield to the gentleman from New York.

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

Judge Hershner, drawing on your experiences from the last go around at bankruptcy reform in the late 1970's, do you see any benefit or risk from the rapid pace at which this legislation is being moved, do you think that it is being moved too fast or too slowly?

Mr. **HERSHNER.** Mr. Nadler, the bill is a very complex and major piece of legislation. It contemplates a fundamental change in the bankruptcy system. And the National Conference of Bankruptcy Judges said that 1 year is simply too short a time for Congress to consider and pass this type of legislation.

Mr. **NADLER.** So you think that we should slow down the pace?

Mr. **HERSHNER.** That is the view of 319 bankruptcy judge members of our organization.

Mr. **NADLER.** Thank you. Let me ask you a different question. Your testimony raised concerns about the cost to the system and to the parties of some of the provisions of this bill, H.R. 3150. The bankruptcy system is hopefully low cost and efficient, so most of the resources that pass through the system can go to the parties.

What impact in those terms do you think that this legislation would have on the system in terms of making the system more or less efficient, and diverting more or less of the resources as costs along the way.

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Mr. **HERSHNER.** Looking at H.R. 3150 and that approach and considering other provisions of the bill, it is obvious to us that judicial resources, both judicial and administrative, we contemplate that there will be additional costs to the government, to the debtors who are in the system, and the bankruptcy estates. That is a difficult question to answer.

Mr. **NADLER.** Can you characterize it by order of magnitude, are you talking about a major cost increase or a moderate?

Mr. **HERSHNER.** My feeling is that it would be substantial, but I do not know if I can really back that up. Because when you look at the approach and how it is going to be applied in the courts, and how it is going to be applied in California, Georgia, Mississippi, Iowa, it is probably going to be different. But it is just hard to really get a feel for the exact cost. But in looking at it, I just feel that the costs are going to be much higher than what we have right now.

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

Mr. Forman, you have already said that you think the legislation is going too fast and that it should be slowed down, so we can examine it more thoroughly.

Do you want to elaborate on that, or have you said enough on that?

Mr. **FORMAN.** Well, the Congress has had before it for maybe 60 years approaches to the system which are being considered now, and they have been rejected for that period of time. I would think that if Congress in its own wisdom thought that changes like that were not required for the past 60 years, we should think very seriously before we make them now.

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The fact that we have so many filings can be attributable to a great many things. It certainly is not the fault of the Code. If you abolish the Bankruptcy Code tomorrow, you would still have an enormous amount of consumer debt, and a part of it would not be paid. It does not seem to be affecting the consumer debt industry.

So to say that the bankruptcy system is the fault for all of those filings, it seems to me is putting the cart before the horse. It is like saying that a hospital is the reason that we have so many sick people. We have no many sick people, because they are sick. The hospital is there to help them. And that is what the purpose of the bankruptcy system is.

And I would think that before we make very sustantial changes in that system, we ought to have independent studies by people who have no special interest, and who can advise the Congress on what should be done.

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

Mr. Bordwin, in many cases, a commercial lease is the only significant asset of the estate. That is why the House attempted to deal with the issue of incurable defaults and unexpired leases.

In view of this, what concerns that are particular to your work, work-out situations for retail establishments, would relate to issues of creditor committees that I think you mentioned before?

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Mr. **BORDWIN.** There is a concern that I have, and it is not necessarily reflected in Section 205 of the current bill, which is a generally applicable provision. But I know that the ICSC is very interested in getting more members on creditors' committees. Now may concern as a practical matter is that in a retail bankruptcy, that a large part of the restructuring involves negotiating with landlords and having landlords sitting on a creditors' committee where there are essentially insiders, and can learn the debtors' strategies, and plans, and goals.

It makes it something equivalent to having the fox in the hen house when the debtor has to go out and negotiate with people who know the background.

Mr. **NADLER.** Thank you very much. With the indulgence of the Chair, I have more question, this one for Mr. Smith.

Mr. Smith, you testified that the rules in Chapter 12 for farm bankruptcies with more flexible time limits and so forth than some of the other chapters, that the trial period that we have had with Chapter 12 has gone well, and that you think that those fairly lenient or loose, however you want to characterize it, rules are working well, and should be extended.

Is that correct; that is what you said, right?

Mr. **SMITH.** Well, basically, what I said was that I think that the rule should apply to Chapter 12, in that if you have a cramdown on your asset and the debtor fails to complete the plan or voluntarily sells the property, then the secured lender ought to have the right to recover off of that cramdown. And basically, that is on the commercial side of it now, but it is not on the Chapter 12 side on that.

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

Thank you, Mr. Chairman.,

Mr. **GEKAS.** The Chair recognizes the gentleman from Massachusetts, Mr. Delahunt.

Mr. **DELAHUNT.** Thank you, Mr. Chairman. Again I was inclined to yield some of my time to the ranking member, because it would appear that he had additional questions. Which brings me back to my earlier comment, as I was sitting here and taking some notes and doodling, that this is a tremendous resource. All of your testimony is well appreciated.

But we have 5 minutes. Which means, if you divide it, we have 51 seconds to pose a question and to receive your answer. The ranking member has expressed his concern about the pace of this particular proposal.

Mr. Forman, your comment was welcomed by this particular member. I would like to hear others—and again, please recognize the time limitation—as to whether you feel that there is a need, an overwhelming need, or a substantial

need, to move swiftly on the proposal that is before us?

Mr. Tatelbaum, let me pick. That is the prerogative up here. We can pick.

Mr. **TATELBAUM.** Certainly, it is.

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Mr. **DELAHUNT.** If you can make it swift, we are down to probably 3 minutes.

Mr. **TATELBAUM.** If I may respond as a typical lawyer and answer that it depends. I would separate it between the consumer issues and the business issues. Neither the NACM nor I personally have studied the consumer issues. And my personal views I think are not representative of what should come before the committee.

With respect to the business issues, I personally do not find them to be so dramatic as to put the brakes on them. I think that these are refinements, most of which have been established by the National Bankruptcy Review Commission. And other than some minor variations, I particularly support it, other than perhaps the shopping center and landlord debate.

Mr. **DELAHUNT.** My memory of the Commission's report is that there was in excess of 150 recommendations that were unanimous.

Mr. **TATELBAUM.** Our group, except for the one that I mentioned, on fee examiners, supports all of these. I do not know if that is a proper response, but it is probably the only one that I can give.

Mr. **DELAHUNT.** Mr. Perlstein.

Mr. **PERLSTEIN.** On the business side, which is the only thing that the ABA committee that I am representing is addressing, we believe that these have been studied enough. We have been able to poll the members of the committee without great difficulty on the recommendations, and we turned over to your committee staff the results of that survey that goes into some detail. So I think on the business side, which is all I am addressing today, there has been enough study.

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Mr. **DELAHUNT.** Particularly the Bar Association sections, have they done any costing out? The ranking member asked earlier, I think he posed a question to Judge Hershner about what it is going to cost the taxpayers to meet the requirements of these various proposals in terms of additional resources.

Mr. **PERLSTEIN.** I do not believe on the business side that this will in fact require additional resources. Take small business, which was the subject of the earlier panel. One of the problems there is that those cases are so small that you do not have an active creditors' committee. So whether we call it a cost to the government, there is a cost to the economic system that is simply not economic for an individual creditor, a landlord or somebody else, with $5000 or $10,000 to pay attention to those cases.

So those cases are in fact running up a major cost to the economy. And what the bill does is give the Court more power, and the United States Trustee more power, of saying if you do not do X, Y, and Z in terms of the reports, then we will have a separate basis to be able to throw you out.

The judges will tell you that they have a pretty good sense early in the case of a small Chapter 11 whether it is going to work or not. They do not have the power today to do very much about it because there is nobody coming before them who has enough money at stake to want to press the issue.

Mr. **DELAHUNT.** Thank you.

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And I direct this to the Chair, and I yield back. I think that this testimony has been very informative again. And prior to the mark-up, I would make a request on behalf of myself and I am sure joined by other members to have available to us the testimony, the oral testimony, prior the mark-up.

Mr. **GEKAS.** I see no reason why that should not be made available. It is important to do so.

Mr. **DELAHUNT.** I yield back.

Mr. **GEKAS.** I yield again to the gentleman from New York.

Mr. **NADLER.** Thank you.

Mr. Perlstein, you just made one comment that suddenly struck off a couple of bells in my head, and I have to ask you a question.

I think in the earlier panel that it was stated that with the change in the definition of small business that 80 percent or something like that of cases would now be considered small business, so you are not all that small. But you said that in a lot of the small businesses that the average job may be $10,000 or $12,000. It is just not worth the time or the expense of the creditor to keep track of it.

Mr. **PERLSTEIN.** On the business cases where a business has to decide whether to hire a lawyer to go in on a motion, it is simply not worth it.

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Mr. **NADLER.** So in a lot of these cases on the business side, it is not worth the time or the expense of the creditor to keep track of it and to hire a lawyer and so forth. But under this proposal, it would now become the expense of the taxpayers, and a lot of extra work by the U.S. Trustees.

If the economic system does not support it, and it is not worth the expense to the creditor, why should the taxpayers spend money on it?

Mr. **PERLSTEIN.** All of this goes back to Economics 101. The social cost, Mr. Nadler, of the people occupying spaces that they are not paying for, and current taxes that they are not paying for is substantial in the aggregate. It is not, however, substantial enough for an individual creditor.

Mr. **NADLER.** The taxes maybe. If the taxes that they are not paying are substantial enough, then the government could make a business decision to try to enforce that.

But if that is not the case, what is the benefit to the public of spending the taxpayers' money in pursuing this?

Mr. **PERLSTEIN.** I will answer you on the basis of twenty years of experience, Mr. Nadler. It is in fact worthwhile for the system to have a collective way to do it. We do that basically in a larger case through the creditors' committee. Because even in a larger case, the creditors' committee will aggregate all of the claims, and you will have a single lawyer and a single accountant representing hundreds or thousands of creditors.

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In a small case where the amount at stake is a couple of million dollars, it is very hard to get a committee. Because

the committee only works if you get five or more to participate.

Mr. **GEKAS.** I understand that it will not work, and it is not worth the expense to the creditor to try to recover his money.

So what is the benefit to the public or to the taxpayer of spending the taxpayer's money to recover the money for the creditor?

Mr. **PERLSTEIN.** They are not recovering the money. What they are preventing doing is running up additional bills that are not going to get paid. There are many small businesses who believe that if the debtor is in bankruptcy, that the court will take care of them. I cannot tell you how many times I have been in court where the small creditor will come in and say, "Your Honor, I have an administrative claim."

And the judge will have to stay to him, "The court does not print money. There is no money here. The IRS is first, and the PBGC is there, and the other priorities that the Congress has set up. And there is no money to pay you. Even though yes, you have an administrative claim, but you cannot get blood out of a stone."

What that does is to prevent somebody from simply staying in business when there is no one out there who has enough of a stake to shut them down.

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I have been in cases where a judge will say, "I know that this is not going to work. I can look at this at the initial start of the case. I know this is not going to work." It just gets lost. It just simply gets lost. The U.S. Trustees Office has so many other things to do. Basically, you have a checklist that says if you do not fill this out, that there is going to be a presumption that the case is going to be thrown out. I believe that you will end up with two things. (a) You will have more attention paid to the case. (b) You will give a handle to the U.S. Trustee and to the court to be able to do things on their own.

Mr. **NADLER.** But we have to beef up that court also.

Mr. **FORMAN.** May I suggest a reply to your question?

Mr. **NADLER.** Please.

Mr. **FORMAN.** The interest of the government, of the Federal Government, in this situation is that it is much better to preserve the business, if it can be preserved, instead of liquidating it. And preserve an economic unit that functions in society. You have people who will keep jobs, and you will have production going on.

That does not mean that every business should be saved. The process is very difficult. It is very time consuming and it is very difficult for a judge or even lawyers, or even the parties themselves, to know whether they can make a viable plan or whether they can save this business. That is a delicate process.

And there are a lot of cases where you can go one way or the other. The extreme cases are easy. Everybody knows that this business is going to succeed, and everyone knows that this one is going to fail. There are a whole number of companies right in the middle, and it is hard to tell, and it takes time. And that is what the problem is.

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Over almost 60 years of practice, I have found that the more rigid the rules, the more likelihood that in a number of cases, you are going to have injustice. The more flexibility you have, the better chance you have of achieving the right answer somewhere along the line.

Now that depends on a great corps of good judges, and I think that we are achieving that now. You have a much better judicial system and much better judicial personnel today than we did say forty or fifty years ago.

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

Thank you, Mr. Chairman.

Mr. **GEKAS.** The Chair yields to itself the customary 5 minutes plus to stay balanced.

Mr. **DELAHUNT.** Take all the time you want.

Mr. **GEKAS.** Thank you, Mr. Delahunt.

Mr. **DELAHUNT.** Mr. Forman or any of you, did any of you participate in the congressional debates, or committee mark-ups or hearings in the completion of what turned out to be the Act of 1978?

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Mr. **FORMAN.** Well, I was active at that time. The National Bankruptcy Conference spent almost 10 years trying to formulate bills which preceded the Act of 1978. And, of course, there was a commission at that time. And I testified at least on two occasions.

Mr. **GEKAS.** I suspected so.

Mr. **FORMAN.** On behalf of the National Bankruptcy Conference, and I did consult with the staff at that time. We consulted on many occasions informally with respect to that bill.

Mr. **GEKAS.** Did you notice, Mr. Forman, that many parts of the testimony of your colleagues at the table there quarreled with what the current law does or fails to do, and thus commended or were satisfied with certain provisions that we are trying to provide in this reform measure. Because the Act of 1978, the current law, does not work, or has unforeseen consequences.

Are you ready to agree that that is the case?

Mr. **FORMAN.** No. I entirely disagree, and so does Congress. Congress disagreed with that a couple of years ago when it passed the commission bill. Congress said that the 1978 Code was working reasonably well, and that the commission should not consider structural changes.

Mr. **GEKAS.** You do not agree with Mr. Tatelbaum, for instance, when he says, "The current statute creates an environment for the feeding frenzy of trustees and attorneys at the expense of vigilant trade creditors," just that little piece where he says that this new formulation that we are presenting helps to cure, you apparently do not agree with Mr. Tatelbaum?

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Mr. **FORMAN.** No, I do not. Mr. Chairman, all of the bankruptcy cases that are filed, about two to 3 percent are featured in the newspapers. They are the big cases. There are 90 percent of the cases that nobody ever has anything to do with except the parties involved. They go along routinely, and they are handled very well by the courts. There are really no serious problems.

Mr. **GEKAS.** If the commission made recommendations to change the current law, which it did in many respects, do you disagree with the commission's report?

Mr. **FORMAN.** No.

Mr. **GEKAS.** The Congress said before that that it was working pretty well.

Do we agree with at least one-tenth of the Bankruptcy Commission's report, Mr. Forman?

Mr. **FORMAN.** I agree with most of it.

Mr. **GEKAS.** Is that not a change from the current law?

Mr. **FORMAN.** Yes. We are changing current law all of the time.

Mr. **GEKAS.** That is exactly my point. You get my point. Thank you very much.

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Mr. **FORMAN.** But they are not structural changes. They are not radical changes. They are changes to address specific problems in specific situations.

Mr. **GEKAS.** It is in the eyes of the beholder, I submit, as to whether it is radical or not.

Mr. **FORMAN.** But not whether it is structural or not.

Mr. **GEKAS.** In any event, Mr. Kranzdorf, I knew from reading your testimony that you were concerned about Section 209. And Mr. Bordwin, I think, testified to some of those provisions. We are reexamining 209 in all of its ramifications. I wanted you to know that. And we will submit to the gentleman from New York in the minority a plan to see if we can stipulate to certain changes.

Mr. **NADLER.** I would just like to make a comment that Mr. Bordwin says very proudly that in the *Edison Shoe* case that they start out with 2800 stores and they got down to 1800 stores, and they came out of bankruptcy. What goes unsaid in that case is that 1000 stores were closed. At ten people per store, 10,000 jobs were lost, while people diddled around as to whether or not those stores should be allowed to be reopened by the landlords.

The landlords sat there with empty space, and 10,000 jobs were lost while the debtor was allowed to make up his mind whether or not he could sell the stores. 10,000 jobs.

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Mr. **GEKAS.** Mr. Forman and I are very interested in preserving those 10,000 jobs, as you have said. We thank you for that.

Judge Hershner, you were talking about possible new costs that might be appended with any new legislation.

You did participate in the 1978 Code production, did you not?

Mr. **HERSHNER.** No, sir, I did not.

Mr. **GEKAS.** Do you know whether or not the record there showed an anticipated cost to the Congress or to the taxpayers?

Mr. **HERSHNER.** I do not. I am sorry.

Mr. **GEKAS.** Would you be surprised if I told you that any statements at that time or testimony as to anticipated

costs were not realized, that it was much more in some sectors than was anticipated and less in some others, would you be surprised if I told you that?

Mr. **HERSHNER.** I am not.

Mr. **GEKAS.** There is no way to anticipate what new costs there might be to this bill, is that not the case?

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Mr. **HERSHNER.** From my experience on the bench, when I look at the provisions for dischargeability and that type thing, the judicial work load is going to go up and also the administrative side will go up.

Mr. **GEKAS.** Do you factor into your feeling about it the modest inflation factor that appears in the economy and other unforeseen circumstances and unforeseen consequences of any new legislation? We have to do that. I am just hoping that you can.

Mr. **HERSHNER.** Yes, from my experience and also from discussing it with a number of my colleagues on the bankruptcy bench, Mr. Chairman.

Mr. **GEKAS.** I am seeking to get sympathy from you from what we have to establish. I have one other series of questions. I am going over my time, and I hate to do that.

Mr. Forman, you said in one of your statements that there is no reason for even looking at the structural changes, which of course in the consumer bankruptcy portion there might be if we prevail, and yet we have 1,400,000 new filings. Everyone agrees that something has to be done about them.

And that the need for reform is generally understood to be a priority among the financial communities, and the mom and pop stores, and the credit unions, and the tax authorities, and the state and local municipal tax collecting agencies. Everyone is concerned about the current state of the bankruptcy laws.

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Do you agree that there is that sentiment, or do you believe that only your sentiment, the one that says that there is no real need, should prevail?

Mr. **FORMAN.** If you mean that there is a large increase in filings, which of course there is, and whether Congress should look at the source of that problem, I agree.

But I think that the source of the problem is that people have too much debt. And they are suddenly hit with an illness or a loss of a job, or some other catastrophe. And they have no way of getting rid of that debt except through bankruptcy. If there were not any bankruptcy, the debt would still be there. But the bankruptcy law did not cause them to have all of that debt.

Mr. **GEKAS.** I understand.

But is there anything that you can see in H.R. 3150 that would prevent the person who has this extraordinary illness, or a job loss, or some catastrophe, from receiving a fresh start?

Mr. **FORMAN.** Well, it may not prevent him from receiving a fresh start, as long as you are not going to force him to use his future income to pay those debts when he is just a little bit above the poverty level.

Mr. **GEKAS.** If he is just a little bit above the poverty level, that is a different question.

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But if there is an ability to repay, according to what we decide in our wisdom is a feasible rationale to use on what might be an ability to repay, should we not encourage that?

Mr. **FORMAN.** Encourage it?

Mr. **GEKAS.** Yes.

Mr. **FORMAN.** You should always encourage people to pay their debts. But there is a big difference between encouraging them and mandating that they do it.

Mr. **GEKAS.** If we have a system whereby we can have a first picture or a first snapshot of whether a person has a possibility of repayment, do you think that we should not utilize that?

Mr. **FORMAN.** Well——

Mr. **GEKAS.** Does not the court do that now or supposedly does it?

Mr. **FORMAN.** No. Under 707(b), which is the section I assume you are referring to, the court is supposed to find an abusive case. An abusive case by most of the judges means someone who is left with a lot of property, because the exemptions are too high. There is a place where you could do some good.

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Or where perhaps you find the unusual case where somebody has the ability to make a couple hundred thousand dollars a year after he comes out of bankruptcy. Perhaps that is an abusive case.

If you look at the totality of the circumstances, you will find here and there some cases where they are abusing the Code, but they are a small number.

Mr. **GEKAS.** You would have to agree then that what you have learned here is that although we are both interested in solving the same problems, that there exists a difference in philosophy between that of Mr. Forman and the Chairman of this subcommittee?

Mr. **FORMAN.** I do not know that we disagree in philosophy at all.

Mr. **GEKAS.** If we both want to have the ability of an individual to have a fresh start, and we both have a notion of where a person can repay some or all of the debt, and that we should facilitate that, then it comes down to a question of which mechanism should be used to encourage both of those systems. And I say that it comes down to a difference in philosophy.

Mr. **FORMAN.** No. The one word that you used that I disagree with is "some." You said the ability to pay "some" or all of his debt. I do not agree that there should be an eligibility test that he can pay some of his debt. I think that if he can pay all of his debt that he should not be in bankruptcy, I agree with that. That would be an abusive case.

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Mr. **GEKAS.** Then our differences are, in my judgment, not only philosophical but mathematical.

Mr. **FORMAN.** It may be.

Mr. **GEKAS.** I thank the panel for its very energetic presentations to the subcommittee, and we dismiss them with our thanks. Thank you very much.

Now we ask the final panel to come before us. First we have with us Kevyn Orr, Esquire, Deputy Director of the Executive Office for the United States Trustees, who has been serving since 1995. Before that, he was the Assistant General Counsel for Complex Litigation at the Resolution Trust Corporation. In that capacity, he supervised litigation regarding the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and related Federal statutes.

Mr. Orr received his undergraduate degree in political science from the University of Michigan. He later obtained his law degree from the University of Michigan Law School. Over the course of his professional career, Mr. Orr has been a lecturer and panelist at numerous conferences, and continued legal educational seminars.

He is joined by Hon. Michael J. Kaplan, Chief Judge of the United States Bankruptcy Court of the Western District of New York, Buffalo. And he is testifying on behalf of the Judicial Conference.

Judge Kaplan was appointed to the bankruptcy bench in 1991. He has played an active role in improving bankruptcy administration, and has served on several committees and advisory groups.

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Since 1993, Judge Kaplan has been a member of the Judicial Conference's Committee on the Administration of the Bankruptcy System. He is a graduate of Columbia University and Boston University School of Law.

Professor LoPucki of Cornell Law School is the former senior advisor of the Data Study Project for the National Bankruptcy Review Commission. And for the past eighteen years, Professor LoPucki has been doing empirical research on bankruptcy and related areas.

We will begin with Mr. Orr with the usual assertion that the written statements will be accepted as part of the record. And we will ask you to summarize your written statements. Thank you.

STATEMENT OF KEVYN D. ORR, DEPUTY DIRECTOR, EXECUTIVE OFFICE FOR UNITED STATES TRUSTEES

Mr. **ORR.** Thank you, Mr. Chairman.

Mr. Chairman, Mr. Nadler, and other members of the subcommittee, thank you for the opportunity to appear before you today to discuss the United States Trustees' role in data collection.

As you noted, I am Kevyn D. Orr, Deputy Director of the Executive Office for United States Trustees. The mission of the United States Trustees program is to promote the efficiency and to protect and preserve the integrity of the bankruptcy system. In short, to assure the public confidence in the system. Because data collection and reporting give the public greater understanding of the operation of the bankruptcy system, they enhance the system's integrity.

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The program has made improved data collection and analysis one of its priorities in its long term plan. Admittedly, our efforts are in their infancy. We believe that this goal will take time to implement fully. Limited resources and the need to learn how to use the technology and interpret the data accurately dictate that we proceed carefully.

Our early efforts are guided by two principles. First, the data we collect must be of unquestioned integrity. The best way for any organization, including the United States Trustee Program, to assure accuracy and reliability of data is to collect it in conjunction with its regular operations and functions.

The second major principle guiding data collection for the United States Trustees is to take advantage of other sources of existing information. Many entities have information that can illuminate the bankruptcy system, and that can

assist the United States Trustees in the performance of their duties.

In particular, the courts and the private trustees gather information in the performance of their regular duties. They have already invested in gathering the information they believe is essential to their functions, and have the greatest interest in the reliability of that information. Where possible, the United States Trustees should take advantage of information that is already available from another source.

These principles have guided our early efforts to improve data collection. We have already taken steps to redesign the United States Trustee case management system to accommodate numerous fields of bankruptcy data beyond what is presently required by H.R. 3150.

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The implementation of the first stage is due out which will allow us to conduct national electronic queries about any element of information captured on the system. Currently, we are only able to gather select items of information on a quarterly, periodic, or ad hoc basis. Whatever information H.R. 3150 requires would be folded into the other statistical measures we have developed, and all of it would be made publicly available.

We are also reaching out to our counterparts and other constituencies to avoid redundancy, and to control the costs of improved data collection. These include the Administrative Office of the U.S. Courts and the Chapter 7 trustees through their organization, the National Association of Bankruptcy Trustees. This has been accomplished through roundtable discussions and other sessions. Pilots are also underway to automate Chapter 11 reports and Chapter 7 trustee reports.

We are also learning to make better use of our existing data. The database we maintain on Chapter 11 fee collections, for example, was recently redesigned to allow us to capture data on the timing and disposition of Chapter 11 cases. The results of that work were referred to in Ms. Staiano's testimony earlier today.

It reveals that confirmation rates of Chapter 11's are much higher than had been previously reported, and that Chapter 11 cases are moving through the bankruptcy system more quickly than in years past. Other data we presently collect can and will be put to better statistical use in the very near future.

We are determined to succeed in this endeavor, but it will require time and resources. It is also a matter of leadership. In that regard, H.R. 3150 provides much needed direction in making data collection a priority.

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H.R. 3150 requires the Director of the Executive Office for United States Trustees to compile certain statistics about individual debtors with primarily consumer debts who seek relief under Chapters 7, 11, and 13 of the Bankruptcy code. The bill requires the Executive Office to make these statistics public and to report annually to Congress.

It also gives the Attorney General the authority to prescribe uniform reporting forms for trustees under all chapters and Chapter 11 debtors in possession. We welcome the fact that H.R. 3150 creates a well defined role for the United States Trustee Program.

Many entities, including the United States Trustees, the courts and the private trustees, have information that can illuminate the system and its processes. Our combined efforts must be assimilated into a coherent structure that minimizes redundancy and maximizes public accountability. We think our organization is best situated, both in terms of logistics and function, to perform that role.

At the same time, we urge the subcommittee to reevaluate the data it is requesting the program to compile for the annual report. As currently structured, we believe Section 441 raises two issues.

First, it would be extraordinarily expensive to collect and compile much of the information listed on Section 441. Seven categories of information are listed. Unfortunately, very little of this information is currently gathered. For example, we do not presently compile the scheduled total of assets and liabilities, keep track of reaffirmations and the number of cases finding a secured claim under-secured, or calculate the amount of debt discharged in the course of our regular duties.

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We recognize that this information would be of relevance and may be gathered in particular cases. We look forward to participating in better data collection, but we also recognize that the systematic collection of this data in every individual case under Chapter 7, 11, and 13 would impose significant costs on the program.

Second, the report will be based largely on information derived from bankruptcy schedules filed by the debtors, and this information is often subject to questions about accuracy. The inaccuracies in an individual set of schedules may be material in the sense that more accurate information would affect the outcome of a particular case. Nonetheless, when aggregated, these inaccuracies may present a grossly distorted picture of what is happening in the bankruptcy system.

As an alternative to the report described in Section 441, we would suggest an annual report based on the data gathered in accordance with Section 442 of the bill. The information gathered in Chapter 11 monthly operating reports and in trustee final reports is data that is or will soon be gathered by the United States Trustees as part of their duty to monitor Chapter 11 debtors and Chapter 7 and 13 trustees. Compiling and providing this data annually would create a much smaller and less costly burden on the program than the report outlined in the current version of Section 441.

In short, we welcome H.R. 3150's data collection provisions. H.R. 3150 marks an important step for the future study of the bankruptcy system. We look forward to working with you to ensure that the data collection provisions of H.R. 3150 are effective and that the resources needed to implement them are available.

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Mr. Chairman, I would be glad to respond to any questions that the subcommittee may have. Thank you.

[The prepared statement of Mr. Orr follows:]

PREPARED STATEMENT OF KEVYN D. ORR, DEPUTY DIRECTOR, EXECUTIVE OFFICE FOR UNITED STATES TRUSTEES

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The Program has made improved data collection and analysis one of its priorities in its long term plan. Admittedly, our efforts are in their infancy. We believe this goal will take time to implement fully. Limited resources and the need to learn how to use the technology and interpret the data accurately dictate that we proceed carefully.

Our early efforts are guided by two principles. First, the data we collect must be of unquestioned integrity. The best way for any organization, including the United States Trustee Program, to assure accuracy and reliability of data is to collect it in conjunction with its regular operations and functions.

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These principles have guided our early efforts to improve data collection. We have already taken steps to redesign the United States Trustee case management system to accommodate numerous fields of bankruptcy data beyond what is presently required by H.R. 3150. The implementation of the first stage is due out January 1, 1999. By that time, we expect to be on a network which will allow us to conduct national electronic queries about any element of information captured on the system. Currently, we are only able to gather select items of information on a quarterly or periodic basis. Whatever information H.R. 3150 requires would be folded into the other statistical measures we have developed and all of it would be made publicly available.

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We are determined to succeed in this endeavor but it will require time and resources. It is also a matter of leadership. In that regard, H.R. 3150 provides much needed direction in making data collection a priority.

H.R. 3150 requires the Director of the Executive Office for United State Trustees to compile certain statistics about individuals debtors with primarily consumer debts who seek relief under chapters 7, 11, and 13 of the Bankruptcy Code. The bill requires the Executive Office to make these statistics public and to report annually to Congress. It also gives the Attorney General the authority to prescribe uniform reporting forms for trustees under all chapters and chapter 11 debtors in possession. We welcome the fact that H.R. 3150 creates a well-defined role for the United States Trustee Program. Many entities, including the United States Trustees, the courts and the private trustees, have information that can illuminate the system and its processes. Our combined efforts must be assimilated into a coherent structure that minimizes redundancy and maximizes public accountability. We think our organization is best situated, both in terms of logistics and function, to perform that role.

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regular duties. This information would be of relevance and may be gathered in particular cases. We look forward to participating in better data collection, but we recognize that the systematic collection of this data in every individual case under chapter 7, 11, and 13 would impose significant costs on the Program.

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In short, we welcome H.R. 3150's data collection provisions. H.R. 3150 marks an important step for the future study of the bankruptcy system. We look forward to working with you to ensure that the data collection provisions of H.R. 3150 are effective and that the resources needed to implement them are available. Mr. Chairman, I would be glad to respond to any questions that the Subcommittee may have. Thank you.

Mr. **GEKAS.** We thank you. And we will turn to Judge Kaplan.

STATEMENT OF MICHAEL J. KAPLAN, CHIEF BANKRUPTCY JUDGE, WESTERN DISTRICT OF NEW YORK

Mr. **KAPLAN.** Thank you. Mr. Chairman, Mr. Nadler, and other members of the subcommittee, I am privileged to be speaking to you today on behalf of the Judicial Conference of the United States.

I will focus principally on the point that I made on page 13 of my filed testimony. And it is the question of whether it is government, to whom people have come for protection, which should be disseminating and releasing the kind of data that is called for by this legislation.

When I compare the information sought to be compelled by H.R. 3150 with the information sought to be compelled by H.R. 2500, the information sought by my friend, Professor LoPucki, the information sought by the Commission, and my own knowledge of the information needs of the judiciary itself, I see an immensely broad spectrum of information needs.

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The needs depend on the user's purpose. Is the purpose academic, is it policy making, it is economic, is it administrative, or is it commercial. I do not see a consensus on what the information needs are in bankruptcy cases. Now, I never say "never." If Congress commands us to build or find a consensus, we can and will do so. But I believe that would take a great deal of time.

We in the judiciary are doing everything that present resources allow, to make all of the case-specific information that we have, available to all users on an equitable basis. It is true that we do not release it on a bulk-data aggregated basis, but we are doing everything that we can to turn over case-specific information on an equitable basis. And we will continue to improve that in the short run.

For the long term, I must say that the Commission was seriously in error in concluding that our database systems are highly sophisticated and can easily handle substantially greater needs. And while I commend Congress' sensitivity to

the issue of privacy, the courts do not presently have the technology to protect privacy the way that the legislation calls for it to be done.

To the contrary, our existing systems are verging on antiquated. And we have concluded after much study that they cannot be upgraded. They have to be replaced. And they need to be replaced with an entirely different type of system that will meet everyone's information needs, including Congress', academia's, ours, and the needs of the commercial public.

I am happy to tell you that the future is, to a certain extent, now. There is operating, in an embryonic stage indeed, in nine locations, a system called ECF, Electronic Case Files. ECF is our long view, the judiciary's long term view of the future of data collection and dissemination in bankruptcy. It is expected to be deployed in the courts within 4 years.

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It builds upon the notion that we are all being imprecise when we try to use the term statistics, data, and information interchangeably. In my personal view, I believe that "statistics" are aggregates, and do not require the name of the particular debtor or a Social Security number specific to any case.

"Data" often requires reference to information in specific cases and specific fields, but also it often does not need a debtor's name or a debtor's Social Security number. But "information" is a much broader thing. This depends on the purposes of the user. It will almost always be specific to a given debtor.

Now, as to true parties in interest—creditors—the need for debtor-specific information is obvious. But is it so obvious that debtor-specific information is needed for academicians? We know that for the credit reporting services, debtor-specific information is important. But should government be supporting that function? Probably, yes.

But there are other users that want debtor-specific information. And if they want the information to harm the debtor, to sell the debtor something, to cause the debtor distress, is that something that government should support? Or on the other hand, should that be left to the private sector, and the role of government in that regard be to *regulate* it, rather than to *create* these privacy problems.

What Electronic Case Files rest on is that the most that we can do is to ensure that everything that is filed with the court that is filed in an electronically readable form is available to everyone over the Internet. That is currently functioning in the Bankruptcy Court in the Southern District of New York and in the District Court of the Northern District of Ohio, and other courts are experimenting. Again, it is embryonic. But what is there, is working.

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Users, then, when we are fully on this system, will be free to extract all of the information that they want. The private sector will be the ones who will take the lead in extracting the information from the full-text information that is available to everyone.

While we have the specific information requirements of the proposed legislation under study, we do not yet have a position on an item-by-item basis. We do have a position and a plan that will serve everyone's needs, and it is ECF, Electronic Case Files.

The judiciary urges that you let it grow and blossom under whatever system of report-back you wish, and we hope that we will have your full support. And I can assure you that we will continue. We will not rest in our efforts to improve what we have. We will continue to improve PACER and VCIS.

We will try to capture and report more information. And we are working with my colleague, Kevyn Orr—with the Department of Justice—for further sharing of information between each other and the public.

We hope that you will let us continue on our path, and not require us to shift our efforts to something that will draw us away from our plan. Thank you.

[The prepared statement of Judge Kaplan follows:]

PREPARED STATEMENT OF MICHAEL J. KAPLAN, CHIEF BANKRUPTCY JUDGE, WESTERN DISTRICT OF NEW YORK

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Mr. Chairman, members of the Subcommittee, I appear today as a representative of the Judicial Conference of the United States pursuant to your invitation to address data collection and dissemination issues in the United States bankruptcy courts. in addition to serving as a member of the Judicial Conference Committee on the Administration of the Bankruptcy System, I am also the chairman of one of its two working groups established on data collection. Also, I have served as the clerk of court for both a United States bankruptcy court and a United States district court and now serve as the chief bankruptcy judge for the Western District of New York.

I hope that I can provide a perspective and understanding on the issues relating to data that will prove helpful in your efforts today by covering four major topics:

1. General Privacy Concerns: My concerns about taking information that now is nominally public, but functionally protected by its relative inaccessibility or "practical obscurity" and providing that information over the Internet;

2. Information Available Today: Some background and description of the extensive information the judiciary already makes available, much of it electronically, along with its plans for making additional, selected data available in the future;

3. Policy Development and Specific Projects: Our efforts to develop policies to guide us in making more information available;

4. Concerns about Rushing Change: My concerns about unlimited electronic access for the public to information in documents filed with the courts.

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GENERAL PRIVACY CONCERNS

I will begin by stating the obvious: how we decide data collection and dissemination issues in every area of life, both government and private, will make possible exhilarating opportunities, serious invasions of personal privacy, and greater understanding of subjects once thought impossible to grasp. This knowledge will undoubtedly benefit society in many ways. There are, however, potentials for misuse and abuse also never before thought possible, as available information begins to include ever more personal specifics regarding each individual's health, finances, social and professional memberships, hobbies, and routine activities. Even the debtor's address can be sensitive information. For example, a battered wife and children, successfully in hiding, might avoid seeking relief only the bankruptcy system could give if she felt it would reveal to the world—and her abusive spouse—her new home address and perhaps even the locations of the children's schools.

When Congress undertook the major bankruptcy reform that resulted in the 1978 Reform Act, an enormous amount of time and effort was devoted to creating a proper balance between the rights and interests of both the debtor and the creditor. I respectfully suggest that there is a vital need in the area of data collection and dissemination to balance the rights and interests of all parties—debtors and creditors, the individual and the corporation, the federal government and the local municipality. Personal, individual rights must also be balanced against the information needs of an open, free society. This balance is a difficult, yet important, issue facing this country today. How that balance is struck will affect

the future for all Americans.

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Now, let me move on to the less obvious, namely, the self-initiated actions of the federal judiciary to facilitate and enhance data collection and dissemination for its own use and that of others.

The judiciary's statutory mandate and interest have been in collecting statistics on the volume, nature, and distribution of work in the United States courts. This data is provided to Congress annually and used by the Judicial Conference itself in assessing performance, proposals for change, projections of future Staffing and other resource needs, etc. 28 U.S.C. 604.

The Judicial Conference also is deeply involved in more comprehensive data collection and dissemination, both as a matter of public interest and research and for case management purposes within the judiciary. But we in the judiciary also recognize that many important rights, expectations, and safeguards could potentially be adversely affected or denied if prudent, thoughtful policies and procedures are not established. We, along with other branches of government and the private sector, are earnestly pursuing these issues to determine appropriate, fair, effective, and efficient policies. Until the Judicial Conference has completed its work in this area and set forth policies which meet the needs of all without violating the rights of any, I am unable to comment specifically on the data collection provisions in your bill. I would respectfully request, however, that the fundamental concerns expressed above be considered in relation to your "Sense of the Congress Provision Regarding Availability of Bankruptcy Data."

INFORMATION AVAILABLE TODAY

Let me describe briefly the information that is available now. Court documents may be inspected by members of the public during normal business hours at the courthouse. In addition, the PACER system (Public Access to Court Electronic Records), an application run by almost all of the bankruptcy courts, is available 24 hours a day and may be accessed with a personal computer, from home or office. Users can easily obtain an identification/access number from the PACER Service Center, then dial into a court and view and download categories of information, such as the case docket and the claims register. Much of the data on any particular bankruptcy case is currently released to the public through PACER. This application and others were created to provide a synopsis of case information to the public, without requiring them to travel to the court house.

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Although not all the information regarding a case is available electronically, the docket serves as an index to case filings—the activities in the case—and the PACER system also contains basic information regarding party and attorney names, addresses, and type of filing.

The claims register contains a listing of the parties who have filed claims against the debtor's assets and the type of claim.

The Voice Case Information Service (VCIS) is available to the public free of charge. It is accessed by telephone and provides the users with key information about bankruptcy cases, without having to travel to the courthouse. Over nine million calls were made to VCIS last year.

Yet another program maintained by the judiciary is the U.S. Party/Case Index which is a national locator for the appellate, district, and bankruptcy courts. For bankruptcy cases, users may search by name to find the district where a person or business filed a bankruptcy petition.

Electronic case filing systems now in development have the potential, we believe, of enabling certain information to be extracted and ultimately presented in a report form.

The judiciary is keenly aware of the public's interest in court data, and we are providing considerable information in electronic format. We continue to enhance and improve these efforts.

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POLICY DEVELOPMENT AND SPECIFIC PROJECTS

In 1990, the Judicial Conference responded to one of the proposals of the Federal Courts Study Committee (whose illustrious members included former Congressmen and House Judiciary Subcommittee chairs, Robert Kastenmeier and Carlos Moorhead). Specifically, the Conference created a Committee on Long Range Planning, consisting of nine judges.

The Long Range Planning Committee Report was presented to the Judicial Conference in its March 1995 session. Almost 7,000 copies of the draft plan were sent to judges, members of Congress, government agencies, bar associations, public interest groups, academics, and others. The Committee also held three public hearings across the country.

The Judicial Conference carefully reviewed the Report, referred certain provisions to various Judicial Conference committees for additional consideration and emended others. After further public dissemination and comment, the Judicial Conference issued dispositive instructions in September 1995, and the final Long Range Plan for the Federal Courts was adopted in December 1995.

One of the Plan's recommendations, No. 73, provides that "[t]o refine both operations and policy, the federal courts should define, structure, and, as appropriate, expand their data collection and information-gathering capacity."

In early 1996, a Task Force was formed by the Administrative Office to expedite the process of implementing Recommendation 73 as it relates to bankruptcy statistics. Various judges, clerks, court officials, and representatives of the Administrative Office were appointed as members. In addition to consulting with numerous officers and employees within the judiciary, the Task Force convened a two-day symposium on data during which nonjudiciary entities were invited to attend, present testimony, and make presentations. Over fifty invitations were extended to members of the press; numerous federal agencies, *e.g.*, GAO, Federal Reserve System, FDIC, IRS; the Executive Office for United States Trustees; commercial lending entities; creditor representatives; public interest groups; members of consumer groups; the ABA; and numerous academics. The attendees fully participated, and it was an active and informative event.

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Last June, the Bankruptcy Committee of the Judicial Conference endorsed the general approach recommended by the Task Force, which provided:

(1) The primary statistical duty of the judiciary is to collect and report court caseload statistics and data to Congress and to the Judicial Conference.

(2) The collection and compilation of data not necessary to the court's mission and statutory mandates should normally be done by other entities, with cooperation provided by judiciary staff where appropriate.

(3) The judiciary's data collection efforts should focus on case filing and docketing events, consistent with its duties under 28 U.S.C. 604.

(4) Financial information regarding the assets, liabilities, distributions to creditors, etc. should be compiled by the United States Trustees, consistent with the United States Trustees' duties under 28 U.S.C. 586(a)(3).

A copy of the Task Force report is attached.

Also at its June 1997 meeting, the Bankruptcy Committee noted that duplication of duties between the Administrative Office of the United States Courts and the United States trustees should especially be avoided. Since the time of our report, we have been working with the Executive Office for United States Trustees, United States trustees, and case trustees to coordinate our data efforts with theirs. Currently, we are exploring the possibilities of implementing an electronic exchange of case data.

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The Bankruptcy Committee noted, as emphasized by the Task Force, that, once certain developing automation projects are implemented in all of the courts, the extraction of a considerable amount of additional information could be executed quickly and easily. One such initiative is the Electronic Case Files/Systems Modernization Project. One of the goals of the project is to provide a mechanism to permit attorneys to submit filings to the court electronically; the court will then be able to process the case without relying on paper records. Deployment of the project, now in the requirements-gathering stage, is expected within the next four years.

At its meeting last summer, the Bankruptcy Committee also established two working groups to continue the work of the Task Force. The first was asked to address issues concerning economic and demographic data identified by the Task Force. The second was asked to address the availability of information regarding court events and related issues, also identified by the Task Force.

As the chairman of the court events working group, I can assure you that both groups have devoted great time and effort and have made significant progress. Already, the working groups have analyzed their respective subject matters, placed tentative priorities on topics within them, and are in the process of completing recommendations regarding obtaining and disseminating the information.

An issue that must be considered, from all points of view in the data area, is the privacy rights of individuals whom the data portray. Numerous laws in addition to the Privacy Act—for example the Fair Credit Reporting Act, and the Americans with Disabilities Act—should be carefully considered to determine whether provisions of these Acts address the dissemination of sensitive personal information that may be included in a bankruptcy case file.

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CONCERNS ABOUT RUSHING CHANGE

As I noted earlier, the entire country, both Government and the private sector, are grappling with these issues of privacy, security, accuracy, and costs. I acknowledge that a considerable amount of the data in question is generally "public information," accessible to anyone who chooses to visit a courthouse and inspect the public record. But that is not the issue we are facing here. We are facing issues associated with the compilation of information by officers and employees of the court system into an electronic product that enables others to access, extract, and utilize the information easily for any reason. I have two major concerns. First, compiling information from court files and disseminating it to the public would be a major departure from the core responsibilities of courts for the last 200 years. We have always been, and still are, adjudicators of disputes and, in the process, recipients and archivists of documents submitted by parties for use by the judge, any jury, and the other parties in resolving a particular matter. Credit bureaus and other private entities already compile and disseminate court data that is of interest or commercial value to their customers. This bill, it seems to me, would replace this private market place with the courts themselves.

My second concern is one of cost and resources. Compiling and disseminating data on the scale envisioned would require a major investment, particularly in data transmission capacity, to accomplish an objective that lies far outside the traditional bounds of judiciary work. I thinly believe that there is a significant difference between a citizen with a particular interest in a case inquiring about that case at the local court house or through PACER or VCIS and the government in effect walking down to a "global bulletin board"—such as the Internet—to post the same fact for all to see. Without proper safeguards, this could chill the use of the court as a sanctuary for the orderly resolution of

disputes. It could lead to undue suffering or to settling disputes in the streets, to avoid the humiliation or danger that could accompany the widespread release of sensitive personal data required to be filed in a bankruptcy case. I recognize that ultimately the private sector will release as much information as is made available. The issue is whether the government, where flee citizens have come for protection, should be releasing the data.

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As I have indicated today, there is already a significant amount of information and access provided by the courts to the public, the bar, academics, and others. I believe expanding the scope of this access to Internet searches of each and every document on file in a federal court would be dangerous and unwise.

As I noted at the beginning of my testimony, however, there are many issues involved in data collection and dissemination that far transcend the data itself. As you are aware, these are issues that confront the entire federal government and the private sector. As a recent series of articles in The Washington Post makes very clear, they have not yet developed all the necessary safeguards, firewalls, policies, and procedures necessary to ensure basic privacy rights and the rights of a free society. Nor has the judiciary. Therefore, I urge this Subcommittee to proceed cautiously and carefully.

The same theme I expressed for data collection and dissemination, I repeat in connection with your plans for bankruptcy reform. Careful, thorough study of the changes proposed for this technical, complex, and vital system is important—even essential—to provide a full understanding of the potential consequences of the suggested changes and avoid unanticipated, harmful impact. Others have seen first hand what can happen when sensitive information is released without sufficient study. The Bankruptcy Courts do not want to repeat that unfortunate experience.

I thank the Chairman for his many past efforts on behalf of the judiciary, especially the bankruptcy judiciary, and look forward to our joint future efforts to enhance the operations of our United States bankruptcy courts.

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Mr. **GEKAS.** Thank you, Judge.

Mr. LoPucki.

STATEMENT OF LYNN M. LOPUCKI, CORNELL LAW SCHOOL, SENIOR ADVISOR, DATA STUDY PROJECT, NATIONAL BANKRUPTCY REVIEW COMMISSION

Mr. **LOPUCKI.** Thank you, Mr. Chairman.

The National Bankruptcy Review Commission was very disappointed with the lack of data and statistics to support their work, and I am very pleased to see these efforts to do something about that lack.

It is very important to understand why some of the data provisions of this bill are more likely to be effective than others. By effective, I mean that passing the bill will get future Congresses and future commissions the information that they need.

The part of the bill that will be effective, Section 443, makes it policy for bankruptcy clerks to release their databases to the public. Release will cost almost nothing. It is just like saving a file on your own computer. It is a very large file, but it just takes a few keystrokes to do it.

That file will not yet be in usable form for the public, but it will contain highly accurate and tremendously valuable information. Entrepreneurs will collect the files from the various clerks' offices. There are 200 of them, so it is a sizable job of aggregation. They will reformat them and combine them, and sell them to the public. This has already happened with the release of other government databases.

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Among the buyers will be law schools, business schools, and sociology departments where hundreds of scholars use the data to generate thousands of statistics. The most interesting of those statistics will be published in academic journals, and you will have your pick of them the next time there is a need for bankruptcy reform.

Lobbyists will also buy the database, and they will run their own statistics. When they show you the results, you need not fear cooked data or incorrectly added data, because all of us would have access to the data, and any of us could rerun the study. Release of the clerk's database would produce a wealth of bankruptcy statistics at virtually no cost to the government.

By contrast, Section 441 of the bill is a weak provision. It would require the U.S. Trustee to compile statistics from documents filed in bankruptcy cases. Some of the data is not yet electronic, so the government would have to pay to find it in hard copy files and then enter it.

Spending the money does not guarantee that you would get usable results. The court files may not show some of the data that you seek. And the system for collection, entry, and compilation may fail, as it has with a portion of the data currently collected by the administrative office.

On researcher documented that between 12 percent and 26 percent of the pieces of data that arrived in the administrative office did not match the data in the most reliable parts of the case files. Data with that kind of error rate is useless, and so are the statistics generated from it.

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The data in the clerk's office is better, because that data is cleaned daily through use in those offices for managing cases. My analysis suggests two small clarifying amendments to the bill. The first, which is mentioned in my written testimony, is at page 107, line 16. Add the words "in bulk" to make clear the kind of release that is contemplated. The other one I did not mention in my written statement is to add at page 104, line 10, the words "to the reports" after the word "public" to make clear that it is the reports generated, the original data, that would be released to the public, not simply summaries of the data.

I did not raise the issue of privacy in writing, because I felt that it was not relevant to what is being contemplated here. But others have raised it, so I want to address it.

If you want to stalk somebody through the use of the bankruptcy records, or if you want to harrass somebody, or if you want to find out private information about a person, the whole system necessary to do that is already out there in existence. You can get to it through the case party index. It is very easily available. You can find any debtor anywhere in the United States.

You can then go to that court, and you can get the court file. From that court file, you can learn their income for the past 2 years. You can learn how much money they are budgeting for laundry for the next 3 years. It is all available, if you want that kind of data for that kind of purpose.

But yet nobody is saying that we should back up on that, that we should close the records of the bankruptcy courts, which are now by law public records. The real sensitivity comes here when you start to talk about data that can be used to evaluate the bankruptcy system, and that is where we just get an avalanche of objections based on privacy, based on feasibility, and based on every other kind of reason that people can raise. That is what is bothering everybody. Thank you.

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[The prepared statement of Professor LoPucki follows:]

PREPARED STATEMENT OF LYNN M. LOPUCKI, CORNELL LAW SCHOOL, SENIOR ADVISOR, DATA STUDY PROJECT, NATIONAL BANKRUPTCY REVIEW COMMISSION

I am a law professor at the Cornell Law School and a visiting professor at the Harvard Law School. Before becoming an academic, I practiced bankruptcy law for eight years and served as a member of the panel of trustees. For the past 18 years, I have been doing empirical research in the areas of bankruptcy and debtor creditors relations and dealing with bankruptcy data on a daily basis. I served as Senior Advisor to the National Bankruptcy Review Commission's Data Study Project and in that capacity helped to draft the data portions of its report. I speak on my own behalf and do not represent any other person or organization. I have not received any federal grant, contract or subcontract in the current and preceding two fiscal years.

Congress will shortly be making important decisions about the future of the bankruptcy system. It will be doing that with inadequate information. Ironically, most of the information Congress needs already exists in the offices of the Bankruptcy Clerks.

The information to which I refer is in electronic form. Each year, bankruptcy clerks enter electronically an average of about 1000 pieces of data on over a million cases—more than a billion new pieces of data in all. The data is of very high quality, because it is the data that the bankruptcy judges, the bankruptcy clerks, and parties to the cases use every day in the management of their cases. If a piece of data is incorrect, someone is likely to notice it, and insist on correction.

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This data includes the answers to many of the questions this bill asks. For example:

1. The bill seeks to require trustees to file a report giving information about the length of time the case was pending. The beginning and ending dates for every case are already in the clerk's databases. By subtracting one data from the other, the computer can answer the question—without a new and probably less accurate report by the trustee.

2. The bill seeks to require the Executive Office of the US Trustee, to compile statistics on the number of cases in which a reaffirmation was filed and the number of cases dismissed for failure to make payments under the plan. Both those pieces of information are already in the clerks' databases.

The problem is that we cannot get this information out of the clerks' offices. In "we" I include not only academic researchers, but also the government agencies in charge—The Administrative Office of the US Courts, the Executive Office of the US Trustee, the National Bankruptcy Review Commission, and the Congress itself.

There are a variety of reasons.

(1) Over the counter and mail requests to the clerks are inhibited by high search fees.

(2) Only a small fraction of the clerks' data is on PACER.

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(3) The data the clerks furnish to the Administrative Office, is not clean data from case management. The data is responses to questions the responders and data entry people know will be used only for survey purposes. Responders know when they answer the questions, the data will not be used by the court in managing the case. This data has been shown to be highly inaccurate and few researchers use it for any purpose.

(4) Even if one could collect all the databases from the clerks' offices, the fields in one will not match the fields in others. Each clerk's office collects the data in slightly different ways, making the generation of national statistics

difficult.

Faced with this difficulty, there is a tendency to throw up one's hands and start over. Impose a duty on someone else, such as the debtor or the trustee to fill out yet another form—that can be used to generate statistics. That is not a solution. The new data from the debtor or the trustee will be less accurate than the data in the clerk's office. And history tells us that we won't be able to get the reports out of the new system any more than we could get them out of the old. The cheapest, easiest solution to the bankruptcy data problem, is for the bankruptcy clerks to release the data in their databases—in bulk—so we can see what they have and how we can use it.

Section 443, Sense of the Congress Regarding Availability of Bankruptcy Data, is an excellent start. It seeks to encourage the bankruptcy clerks—without requiring them—to release their databases to the public. Some of the clerks are anxious about releasing information. They fear it will lead to criticism of their work, or the work of the judges in their districts. In other districts these fears do not exist; both the judges and the clerks would be happy to release the information. Data release can begin with the latter districts. Once we have some experience with it, I think it will be less frightening to the other districts. Congress has declared, in Bankruptcy Code 107(a) that "a paper filed in a [bankruptcy] case and the dockets of a bankruptcy court are public records and open to examination . . . at reasonable times without charge." *All of the information that will be released under Section 443 is already of public record.*

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The in bulk release of public records has been highly successful in other areas. For example, the Patent Office releases its database for public use. As a result, it is now possible to buy a copy of the records on CD Rom, and to conduct a patent search on one's own computer. Most states sell copies of their computerized indexes to Uniform Commercial Code filings, and they are available on Westlaw and Lexis. The State of Arizona makes their index and filings available on the Internet, free of charge to anyone.

Private firms already copy large portions of the records of some bankruptcy courts and sell the data. If the clerks' databases are made available, some of these firms would reformat and resell them. Dozens of academic researchers and lobbyists would devote their time and efforts to generating statistics from the data—at no cost to the government. You would not need to specify in advance what statistics you want (as you have in Sections 441 and 442 of this bill). You could cheaply and easily have any statistic that could be generated from the data. You would not need to rely on the compiler for the accuracy of the statistics; anyone with access to the database could regenerate and recheck any statistic in minutes. Release of data by the agencies that generate it is the bottleneck—not the generation of statistics from the data.

I do have one suggestion for amendment to Section 443. It is to insert the words "in bulk" in line 16 on page 107, to make clear the kind of release contemplated.

Mr. **GEKAS.** The fact that it bothers everybody bothers me, too.

Are we saying that when one wants to inquire about the laundry detergent used for the next 3 years for one purpose or another, that that is not reason enough to block access to that information; but if one wants to seek out information as to how a bankruptcy works, that there are barriers to that?

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Mr. **LOPUCKI.** Bankruptcy Code Section 107 says that if it is in hard copy in the clerk's files, anyone can go in and get access to that, except sealed files of course, and there are very few sealed files in this system. So the data is available.

But when you talk about aggregate release of data, the kind that academics could use to run studies, then the privacy objections are raised. But I do not see anyone raising them to Bankruptcy Code 107.

Mr. **GEKAS.** Judge Kaplan.

Mr. **KAPLAN.** That is hogwash. To the extent that Professor LoPucki is suggesting that privacy is being raised by the judiciary as a red herring, as some kind of shield to hide what is going on in the bankruptcy system, that is hogwash. That is not happening.

I have been in the system since 1981. I've served on many, many important committees, including when, as a clerk of the Bankruptcy Court, I was one of three pilots to pilot the first BANCAP system, the first major database system.

Privacy has haunted the issue of the dissemination of public records by the Federal courts from the moment that automation was available to the courts. And as a spokesperson for the Judicial Conference of the United States, I adamantly deny and resent the implication of that statement.

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It is not true. We have had many, many meetings and many discussions, and we simply do not have the answers to the privacy question.

Mr. **GEKAS.** I was just going to say that we have no answers at the moment.

Mr. **KAPLAN.** That is correct, sir. And it is not for want of trying. But it is because we do not have the answer to the privacy question; that is the only reason that I know of that many of the people who are decision makers in the judiciary would not sign off. There may be other people with other reasons. But the notion that privacy is raised as some kind of a subterfuge is simply wrong.

Mr. **GEKAS.** I have a question that would go to both

Mr. Orr and to Judge Kaplan simultaneously, because you both testified in different ways on it. We are under the impression that we had enacted legislation back in 1986 that asked the offices to create a pilot data collection system. And I do not recall ever reading any summary or report, or even a line on it.

Where are we?

Mr. **ORR.** Well, your recollection is correct. We recognize that there was an admonition for us to work together on the pilot. And what eventually happened is we have a proposal pending in front of Congress now to repeal that provision with the thought that going forward on our current efforts will supplant that provision in terms of coordinating together. So that is where we are.

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Mr. **GEKAS.** I agree that if we can implement what we have here renders that moot.

Mr. **ORR.** The technology has really outstripped where we were back then.

Mr. **GEKAS.** One other question for Judge Kaplan. I have to look at my notes.

In the data that we want to collect out of Chapter 7, if we determine from the information that we have that only about 5 percent of those actually get to a point where we can find out that they were even filed, what good does it do to include Chapter 7 in the collection of data?

Mr. **KAPLAN.** Well, perhaps I do not understand the question, Mr. Chairman. Since Chapter 7s are the largest single percentage of cases filed, they really constitute the bulk of the workload of the courts.

Mr. **GEKAS.** You say that the collection, if you limit it to those that the trustees files in Chapter 7, is that not what you are saying?

Mr. **KAPLAN.** Oh, I am sorry. Yes, sir. This is a point of complete agreement between the Department of Justice—the Executive Office of the United States Trustees—and the Administrative Office of the United States Courts and the judiciary.

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And that is because it is part of the mission of the case trustees, Chapter 7 trustees, and Chapter 13 trustees, and Chapter 12 trustees, and because it is part of the mission of the United States Trustees to oversee much of the Chapter 11 estate administration process. It is a complete mesh with their mission to be the collector and disseminator of that information. Information on dollars that are distributed in these cases, and the other information that is uniquely available to the case trustees and the United States Trustees; the court itself has very little need for that information.

Mr. **GEKAS.** Does that hurt the rest of us who need that information?

Mr. **ORR.** If I may amplify, sir. Part of that discussion may be that 95 percent of the Chapter 7 cases are what we call no assets cases, that is they have no assets. So we know what happens to them in terms of filing. There simply are no figures except for some de minimus administrative and legal costs in terms of the administration of those cases.

The 5 percent of the cases that actually have assets, we track the filing of those cases and their ultimate disposition as well as the disposition of any assets in those cases in twelve different categories. Fees, prior costs, administrative costs, distribution to secure, distributed to unsecured, priority distribution, distribution to trustee for his commission, distribution to trustee and our associated counsel and several other categories.

And so we are already tracking some of those costs. As a matter of fact earlier this year, we started discussing ways of disseminating that information prior to H.R. 3150. So that information, as Judge Kaplan alluded to, that information we are going forward with, and we would like to continue doing that. We do track that information now.

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Mr. **KAPLAN.** Indeed, if I may. We have a meeting scheduled. I do not think that I will be in attendance, but a meeting scheduled on April 21st.

Mr. **ORR.** I know it is later on in April.

Mr. **KAPLAN.** Yes. To further coordinate precisely that information-gathering activity between the two agencies. That is why I indicated in my remarks that while we are developing ECF, Electronic Case Files, we are not going to stop trying to collect and do a better job of collecting and reporting meaningful information to the public, academia, and everyone else.

Mr. **GEKAS.** The Chair relinquishes its non-time to the gentleman from New York.

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

Mr. Orr, you mentioned that information from schedules obtained by aggregating debtors' schedules may produce inaccurate and misleading information.

Are you aware that this was one of the major criticisms leveled by the General Accounting Office at some of the industry funded studies of the causes of individual bankruptcies and debtors' ability to pay the debts?

Mr. **ORR.** I have read the General Accounting Office's report of some of those studies, and I believe that those

studies also focused on the size of the representative sample as not being representative enough. My comments in my testimony are focused more on the fact that individual discrepancies in any particular petition may not be material in that case. When you start to put them together over the course of say 900,000 Chapter 7s and 400,000 Chapter 13s, they give you a distorted picture of what in reality is going on.

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Mr. **NADLER.** Fine. But would you agree with the critique in the GAO analysis that its conclusions and its recommendations therefore are unreliable and should not be relied on, because they are based ultimately on aggregations of debtor schedule information, the accuracy of which we do not know?

Mr. **ORR.** Mr. Nadler, I would agree that aggregation of inaccurate information could lead to distorted views, yes.

Mr. **NADLER.** And therefore, we cannot rely on it, rely on distorted information?

Mr. **ORR.** We cannot rely on distorted information. That I can agree on.

Mr. **NADLER.** Thank you.

Judge Kaplan, you said that some people may want to use the information about debtors' personal information to harm the debtors. Now H.R. 3150 that we have before the committee proposes to elect a lot of new information from debtors such as tax returns which contain a lot of personal information.

Should we take a careful look at the privacy issues related to these new requirements, do you think that these new requirements raise a lot of privacy considerations that have been addressed?

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Mr. **KAPLAN.** I am comfortable as a spokesman for the Judicial Conference in stating that the Judicial Conference would feel that that is very, very important.

Mr. **NADLER.** That you would take a much more in depth look at those implications?

Mr. **KAPLAN.** Yes. In fact, I can call to your attention what I am sure you are already aware of. The United States Advisory Council on National Information Infrastructure has released a publication, part of which focuses on the need for the United States government to look very, very carefully at the information that is being required to be obtained and the requirement that it be, or permitting it to be, disseminated.

In your own Washington Post, there has been a series of articles.

Mr. **NADLER.** I do not own it.

Mr. **KAPLAN.** There has been a series of articles that has focused on this. I would be happy, if the Chair would like, to hand these up for inclusion in the record.

Mr. **NADLER.** I would request that.

Mr. **KAPLAN.** The first two deal with opening the doors to public records. The first two articles deal with what has been happening when records that have been denominated as public records suddenly meet the information superhighway. Let me give you a quote from somebody by the name of Robert Gelman. I do not recall who he was.

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Mr. **NADLER.** Excuse me, Judge Kaplan. I appreciate you offering that. I would ask that this be admitted.

Mr. **GEKAS.** Without objection, it is admitted for the record.

[The material to be provided follows:]

EYE IN THE KEYHOLE

PART ONE: New "data warehouses" have an unprecedented ability to compile personal facts about ordinary people for marketers and others, raising concerns about individual privacy.

PART TWO: Electronic versions of public government records have become an increasingly valuable source of information for businesses, fueling a debate over the proper use of such data.

PART THREE: A growing army of angry consumers is fighting back against data collectors in an effort to regain control of their personal information.

ARE DATA FIRMS GETTING TOO PERSONAL?

First of three articles

By Robert O'Harrow Jr.
Washington Post Staff Writer

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Sunday, March 8, 1998; Page A1

CONWAY, Ark.—You've probably never heard of Acxiom Corp., a giant information service tucked near the rolling Ozark foothills. But chances are that Acxiom knows quite a lot about you.

Twenty-four hours a day, Acxiom electronically gathers and sorts information about 196 million Americans. Credit card transactions and magazine subscriptions. Telephone numbers and real estate records. Car registrations and fishing licenses. Consumer surveys and demographic details.

What Acxiom does is perfectly legal—bringing together an array of facts from scattered sources. But the phenomenon known as "data warehousing" or "datamining" represents yet another example of how traditional notions of personal privacy have become obsolete, outstripped by technology's ability to peer into personal lives.

In a flash, data warehouses can assemble electronic dossiers that give marketers, insurers and in some cases law enforcement a stunningly clear look into your needs, lifestyle and spending habits. And without aggressive action to preempt the companies, individuals have no control over facts that are gathered and disseminated about them.

The explosion of data warehousing has sharpened the ethical, legal and political questions about an individual's right to privacy in an increasingly open society.

Access to minute details about prospective customers was once just a marketer's dream. Now, privacy advocates believe the fulfillment of that dream represents an unprecedented intrusion into individual lives.

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"The whole thing is scary," said Jim Settle, former supervisor of the FBI's National Computer Crimes Squad and now a security consultant in Fairfax. "It's not the government you need to worry about. It's private industry."

Acxiom often can determine whether you own a dog or a cat, enjoy camping or gourmet cooking, read the Bible or lots of other books. It often can pinpoint your occupations, the car you drive, your favorite vacations. And by analyzing the equivalent of billions of pages of data, it often projects for its customers who should be offered a credit card or who is likely to buy a personal computer.

Some believe this new power is fundamentally benign and ultimately benefits consumers by allowing quicker loan approvals and fewer annoying direct mail pitches.

"The data has always been there," said Donald Hinman, an Acxiom executive. "It's just that now, with the technology, you can access it."

Acxiom is a leader among hundreds of companies around the country that now maintain vast electronic reservoirs. These companies include retailers like Sears, Roebuck and Co., gift shop chains like Hallmark Cards Inc. and insurance companies like Allstate.

Data warehouses glean much of their information from consumers themselves, who often don't realize that the facts they provide in credit card applications or at the checkout counter are valuable commodities in this new age of information trading.

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Firms like Acxiom are under few obligations to divulge their files to consumers, and state and federal lawmakers are only beginning to address some of the privacy questions raised by aggressive data gathering.

Although banks and retailers have long kept files on customers, few have had the technological capability to sort information from various sources—everything from government records to magazine subscriptions—to produce a clearer picture of their patrons.

"Technology has been the enabler," said Hinman, who likens the advances to the invention of the printing press. "Today it's almost unbounded, our ability to gather, sort and make sense of the vast quantities of information."

The number of data warehouses, large and small, using faster computers, the Internet and other networks now exceeds 1,000, a tenfold increase in five years. Only a few—such as Metromail Corp. and R.L. Polk & Co.—have grown as large or powerful as Acxiom.

"They have gone on an information collecting binge," said Charles Morgan Jr., Acxiom's chief executive, describing the datamining explosion. "There's just this insatiable appetite for more information to make better decisions."

Privacy anxieties have drawn the attention of legislators and regulators in Washington and across the country. New federal restrictions on the use of credit reports and driving records took effect last fall; the federal Department of Health and Human Services recently made recommendations about the use of personal health information.

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The Clinton administration has pressed companies using the Internet to disclose more about their information gathering. And last year, the number of privacy bills introduced in state legislatures topped 8,500, according to an analysis by StateNet, which tracks legislation.

In Virginia, for example, legislators are considering sharper restrictions on pharmacies concerning the use of prescription information. And the U.S. Senate two weeks ago began considering several bills that would reinforce medical privacy protections.

But privacy specialists say such scattershot efforts lag far behind the race to build larger, faster data repositories.

"We have witnessed an enormous transformation in information collection and use, without any of the concomitant political debate," said Joel Reidenberg, a Fordham University law professor and author. "This stuff has dramatically increased and changed, largely hidden from public view."

Web of Information

The surge in aggressive data gathering is obvious to anyone who has cruised the Internet lately, although no one really monitors precisely how such information is used.

Sites on the World Wide Web now track visitor meanderings, using the information to target advertising online. Many also solicit names and other personal information from computer users—details that are sometimes matched to files kept in data warehouses.

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One New York clothing company targets children on the Web, asking for names, ages, addresses, genders and hobbies in exchange for a "Jet Set button," according to Shelley Pasnik, director of children's policy at the nonprofit Center for Media Education, a group pressing for regulation to control marketing to children. Pasnik said countless Web sites are "preying on children's desire to fit in and be cool."

Credit reporting is a booming business, but officials at the country's big three credit bureaus—Experian Inc., Equifax Inc. and Trans Union Corp.—declined to divulge just how many credit reports they issue. They say such information could help their competitors.

Associated Credit Bureaus Inc., a Washington-based trade group, estimates that 600 million reports were sold last year, a 25 percent jump since 1991. These reports typically contain a person's name, age, Social Security number, past and current addresses, as well as information on credit and payment histories.

There also has been an uncharted increase in the number of World Wide Web sites selling reports with personal data that helps locate individuals, evaluate them for jobs or bolster legal cases against them. These details frequently are culled, legally, from credit reports.

Jack Reed, chairman of Information Resource Service Co., estimated that his firm is one of several thousand—up from several hundred a few years ago—now making such information available. His company's sales of reports tied to Social Security numbers have more than tripled since 1990 to 25,000 a month. Like some other large information services, Reed said, IRSC sells data only to clients who dial in directly.

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A newcomer to this field is Discreet Research, a small Tamarac, Fla., operation. Discreet's home page on the Internet recently showed an eye peering through a peephole.

Discreet offers a "disguised free gift packaged" phone card that can be given to individuals a customer wants to track. The card secretly generates a report of telephone numbers the user dials.

Discreet also boasts of "fast turnaround" on requests for personal data. In a demonstration, owner David Muskowitz took about two minutes to find a caller's Social Security number, including the time required to correct a typing error.

"We're just trying to do a professional job," said Muskowitz, who gathers much of his information by paying a modest monthly fee for access to the files of information brokers. Tina Furlow, an assistant Florida attorney general, said, "We definitely are looking into this."

There are few laws restricting the collection and sale of most personal data, and federal agencies have stressed self-regulation and greater disclosure of data gathering.

The Direct Marketing Association, a trade group whose members rely on marketing research, recently announced that starting in 1999, its members will be required to publicly disclose how they gather and use data.

But such disclosure has its limitations. Acxiom officials, for example, will discuss how the company gathers information. But they say it is technically impractical to allow individuals to see their files.

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Acxiom doesn't typically provide reports on individuals. Rather, it identifies thousands or millions of people at a time who fit particular profiles: for instance, people of a certain age or weight who read certain magazines, drive certain cars or use certain credit cards could all get personalized promotions from a vacation company.

Acxiom's files also can be used to weed out people who lie when, say, applying for car insurance. An insurer could send a batch of 100,000 applications to Acxiom, which would then match its store of data about applicants with what the individuals reported to the insurance company.

The company does allow people to opt out of its databases, but fewer than 300 people had done so by the end of last year, according to Jennifer Barrett, Acxiom's group leader in charge of privacy issues. Barrett believes that is because the company does not abuse information. "The real issue is not what information is collected on you," she added, "it's how it's used."

But Leslie L. Byrne, the former director of the U.S. Office of Consumer Affairs, offered a different explanation. "In my travels," Byrne said, "most people don't have a clue what's being gathered about them."

That obfuscation is sometimes intentional, according to Maryalice Hurst, former chairman of the Direct Marketing Association's ethics committee. Some companies "go behind the customers' back to acquire what they know the customer wouldn't give them," Hurst said. "Datamining is just another word for using information the customer doesn't understand you have."

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"The government has to start thinking about the kinds of requirements for disclosures that should be made by information-collecting companies," said Paul Schwartz, a University of Arkansas law professor and privacy specialist. "Consumers are net getting a voice."

Convenience vs. Privacy

Americans are deeply ambivalent about all of these developments, even as they have grown to depend on the convenience electronic networks and databases offer.

Data warehousers contend their techniques already have improved customer service by insurance firms, banks and department stores. When a customer calls, a company can "flood" the computer screen with personal information, offering "one-on-one" service, according to Neil Mendelson, director of data warehousing for software firm Oracle Corp. "What we're going for as an industry is 'a segment of one,'" Mendelson said.

But these benefits haven't quelled public anxiety about privacy erosion. In a 1996 survey by Louis Harris & Associates for Equifax Inc., a major credit bureau, almost 9 of 10 respondents voiced concern about privacy threats. In another Louis Harris survey conducted last year for a privacy research group, 8 of 10 computer users agreed that "consumers have lost all control over how personal information about them is circulated and used by companies."

At Acxiom, officials acknowledge that many Americans are unnerved by the growing capacity to gather and manipulate personal data. "My mom says I work for Big Brother," joked spokeswoman Marice Gardner.

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But Hinman insists that rigorous self-regulation by companies has minimized abuse.

Acxiom also touts its prowess. A database query that took six minutes on a giant mainframe computer in 1994 now takes 19 seconds. Officials just announced they will soon be able to deliver massive amounts of data to customers over the Internet in a few hours—something that now takes up to a week.

The value of such computing power was illustrated in the recent sale of Experian, a giant credit bureau and information services company formerly known as TRW Information Systems & Services. It sold for more than $1 billion in the fall of 1996. Seven weeks later, it was resold for $1.7 billion.

Analysts at the META Group estimate that the money spent on building and maintaining data warehouses will increase from about $2 billion in 1995 to more than $10 billion in the year 2000.

"Our economy is not simply supplied by information, it is fueled by information," D. Van Skilling, Experian's chief executive, said at a conference last fall. "I believe we are at the beginning of a great new

Industry officials say companies also will find ever more clever ways to use data. Oracle's Mendelson, for example, predicts that companies will use databases to court friends and relatives of their most profitable customers.

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Members of a customer's "circle of influence"—perhaps a mother or best friend—could be targeted by an airline and offered perquisites to build customer loyalty, he said.

Other predictions go beyond marketing. With improved access, heart patients will be able to go online to compare track records of heart surgeons, or drivers will be able to get maintenance records of automobile dealerships, according to Michael J. Saylor, president of MicroStrategy Inc. in Vienna, a leading producer of warehousing software.

"There are all sorts of instances like that in which you are mining for some tidbit of information," he said.

For now, Acxiom, whose revenue has grown from $91 million to $402 million over the past five years, remains focused on compiling information about people and getting it to companies as quickly as possible.

After more than two decades of gathering facts, it has 350 trillion characters of consumer data in its computer library. That includes motor-vehicle registrations from 34 states, real estate records from 41 states, reverse telephone records from 1,100 communities and millions of credit card transactions.

It has access to legal marketing information from credit reports, including Social Security numbers and addresses, because it is partly owned by Trans Union and manages Trans Union's files.

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And twice a month, it receives every change of address filed with the U.S. Postal Service. Acxiom recently bought a share of Bigfoot Partners, a New York firm that maintains e-mail addresses and specializes in direct marketing on the Internet.

This spring, Acxiom customers will be able to buy access to its data storehouse via the World Wide Web.

"It's going to let a lot of smaller companies have access to the same things the very biggest guys have got," Morgan said. "It's just going to be a dramatic change."

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EYE IN THE KEYHOLE

DOORS FLING OPEN TO PUBLIC RECORDS

Second of three articles

By Rajiv Chandrasekaran
Washington Post Staff Writer
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For marketers in Maryland hawking wheelchairs to the handicapped, auto service to new-car buyers or weight-loss programs to the obese, obtaining the ideal mailing list requires no more than a phone call to the state's Motor Vehicle Administration.

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For a fee, the agency will conduct customized searches of its driver's license and car-registration records, which often contain a trove of detailed personal data about state residents, including weight, height, unlisted addresses and medical conditions. Or, if a marketer would rather chew through the data personally, the state will sell a copy of its entire database of more than 3 million drivers. All told, it's a business that generated $12.9 million for the state in 1996.

Across the nation, state and local governments are making the same discovery, repackaging public records into easy-to-search "information products" that are peddled to marketing firms.

"There are a lot of state agencies that are saying, 'Gee, I'm sitting on top of something worth a lot,'" said Otto Doll, South Dakota's chief information officer. "It's an easy way to make money. But it can open a whole new Pandora's box for the states."

Largely unnoticed, activities like these by state and local governments have fundamentally transformed the role of public records in American society. No longer confined to musty file rooms. documents are public in a new way today, courtesy of powerful computers and global electronic networks.

Although only a handful of states, including Maryland, actively hawk their data, every state—following the letter of public-records laws—has opened its filing cabinets to information brokers, who have copied and computerized millions of records. Accessing that material simply requires a computer and an account with an "information broker" like CDB Infotek of Santa Ana, Calif.

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A few seconds after typing the name of a Maryland resident in CDB's World Wide Web site, up pop driving records, car registrations, property deeds and court cases linked to the individual. Those documents often contain a slew of very personal data: unlisted phone numbers, Social Security numbers, physical details such as height and weight, as well as the description and value of the person's house.

The same easy access is available to personal data about residents of Virginia, the District and the other 48 states. That has allowed CDB, for example, to build a vast storehouse of personal data from public records. The company says it now has 1,600 databases, containing more than 3.5 billion public records.

Some states are more restrictive with their data than others. Virginia, for instance, does not allow access to driver's license or vehicle registration records, but it does permit businesses to tap into voter registration data, something that Maryland forbids.

The ability to search millions of public records across the country with a few taps on a keyboard has been instrumental in helping track down deadbeat dads, long-lost relatives and witnesses for court cases. Home buyers can quickly find information about real estate values. People needing a doctor, dentist or lawyer can easily examine professional licenses and other qualifications.

With electronic databases, "public records have become truly public," said Robert A. Mayer, the chief information officer for the state of Maine.

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But some consumer advocates argue that such records never were intended to be so exposed. Many records contain personal details that critics warn can be fodder for con artists and stalkers, or may simply be personal and embarrassing—the weight listings on a driver's license, for instance.

"If you can access all of the records from a state that are public, you can get an incredible wealth of personal information and build amazing profiles of people," said Robert Gellman, a consultant in Washington who focuses on privacy issues. "But that's not why these records were made public. It's a total misuse."

Making Data Easier to Find

Comprehensive dossiers today are available only to people who have commercial accounts with information brokers, or who are willing to pay a middleman upward of $25 to conduct a one-time search. But that is changing fast, as states themselves make trolling for personal data easier.

Traditional walk-in document libraries or public-records offices are costly to operate, what with their heating bills, copying charges and full-time staffs. As a result, an increasing number of government agencies are putting more of their information online.

Some county assessors, for example, post copies of property deeds on the Internet. Other agencies, like Maryland's Motor Vehicle Administration (MVA), raise money by selling electronic versions of entire databases or providing, for a fee, the ability to search their files.

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The MVA offers two ways to tap into its data files: an online service called the Direct Access Records System, used primarily by lawyers and insurance companies, and customized bulk searches, primarily for marketers.

"You can ask us to give you all the names and addresses of 20-year-olds in Anne Arundel County who are over six feet tall," said Jim Lang, an MVA spokesman. Although each record costs $5, the data is available electronically, which makes it easy to use for direct-mailing or telemarketing purposes.

Income from such bulk record sales help underwrite MVA's operating expenses, Lang said, but the department has not calculated its annual "profit" from the transactions. Only a tiny fraction of its record sales, MVA officials say, involve providing paper copies to ordinary citizens who have a driving-related need for the information, such as trying to track down witnesses to an accident.

The department's practice doesn't sit well with many Maryland residents. Last fall, Maryland adopted a law allowing residents to request that the MVA not release personal information about them, either in an individual record or as part

of a larger list. As of March 1, 646,000 drivers out of a total of 3.8 million in Maryland have asked that their records be blocked.

The Maryland law is part of a small but growing backlash against data sales. Although personal data maintained by the federal government, such as Social Security or income tax records, is covered by the Privacy Act of 1972 and cannot be disclosed to marketers or database firms, there are few prohibitions on the release of personal information at the state and local level.

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Several states have asked the courts to overturn a new federal law that would allow citizens throughout the country to restrict the release of personal information contained in driving and motor vehicle records. South Carolina, Oklahoma, Alabama and Wisconsin contend the measure infringes on their sovereignty.

Historically, open records have been considered central to American democracy. Government agencies also argue that the sale of records is a much-needed source of revenue. Marketers and news organizations, meanwhile, say restrictions on access to records will affect their businesses.

A convergence of interests has spawned some improbable alliances. In South Carolina, for example, groups representing the news media have asked to join the state in opposing the federal restrictions on driving and motor-vehicle records. Although some media organizations say it is unseemly for state agencies to churn out customized databases for marketers, they also argue that restricting certain records could harm legitimate news gathering and infringe on First Amendment rights.

"We're talking about things like tracking down slumlords," said Jane Kirtley, the executive director of the Reporters Committee for Freedom of the Press in Arlington. "Public records are central to investigative reporting."

Blocking one government database will not dissuade marketers or con artists from gleaning personal information from others, Kirtley said. "Ultimately, we'd have to close off every one of those databases," she added. "Then what happens to our open government?"

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For marketers, driver records also are worth fighting for because they contain some crucial information, particularly addresses and ages. "Public records are often a very accurate provider of some of our key indicators of whether someone might be interested in our products," said Patricia Faley, a vice president at the Direct Marketing Association in Washington.

An Arresting Situation

As the volume of records available online mushrooms, the use of such data is expanding beyond direct-mailers, lawyers and private investigators. College students, who often have free access to the Lexis-Nexis database, are using it to see if their dates' claims of age and marital status check out. Sales agents look for bankruptcies and tax liens in their customers' pasts. And human resources departments use the records to screen new hires, which is why Bronti Kelly believes he's had such a hard time finding steady employment.

In late 1990, Kelly lost his job as an electronics salesman at a Robinson-May department store in Riverside, Calif. Since then, he says, he's been turned down for dozens of retail sales jobs in the Los Angeles area, despite a resume laden with sales experience. When he has landed a job, Kelly said, he typically has been fired in a matter of days.

The 33-year-old Kelly, who eventually declared bankruptcy, says he finally traced his plight to a night in May 1990 when he was pickpocketed at a comedy club. His stolen identification was used by another man who allegedly committed shoplifting and other crimes and then was arrested.

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The arrest report wound up in public court files and a record of the shoplifting incident, which occurred at a Robinson-May store in Los Angeles, made its way to the Stores Protective Association, which shares information about retail employees with more than 100 retail chains. "It became clear that the stores I was trying to get a job with were using their computers to check the court files and the SPA database before hiring anybody," said Kelly, who now works at his parents' pool service company.

Kelly eventually got the shoplifting record deleted from the SPA database, but the arrest record lingers. Police don't want to expunge it in case the culprit, again at large, is caught, according to Kelly. Los Angeles Police Department officials declined to comment on the case. Although Kelly was given a "Certificate of Clearance," saying he wasn't the person arrested, that information isn't included in the same court records that can be searched online.

"It feels like I'm in the Twilight Zone," said Kelly. "I wish I could stop people from getting this record when they're looking me up, but there's nothing I can do. It's disgusting."

A record of Kelly's arrest still remains in computer databases.

"The records had not been expunged, so we reported it," said Kirby Lewis, president of Informus Corp., a Mississippi-based information-services company. "We didn't even know what was going on at the time. We screened him just like anyone else."

Lewis said that a private investigator accessed the record last year, telling Informus that the record was for a pre-employment check.

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Even if officials want to delete information from online databases, it's not always possible.

In Texas, a company called PublicData.com last year paid $1,600 to buy a database with the records of about 14 million licensed drivers and 3 million others with state-issued identification cards, which the company posted on the Web. But when the state legislature passed a law last summer requiring anyone purchasing motor vehicle information to pledge not to post the data without approval from individuals, PublicData simply moved abroad—to the British West Indies—and kept the information on the Web.

Texas state Rep. Ruth Jones McClendon sponsored the bill after hearing complaints a woman who was trying to hide from an abusive ex-husband—only to discover that her personal information, which she had asked the state to keep confidential, was on PublicData's site. "This is more than a little creepy," McClendon said in an interview. "By selling this information, the department unwittingly placed this woman's life and many others at risk."

Executives with PublicData say they have a right to post the Texas data because it comes from public records routinely sold to marketing companies and other businesses. Vincent Cate, the company's operations manager, said rules on information usage shouldn't be tougher just because the data is posted on the Web.

"If people don't like the information to be public," Cate added, "then why is the government selling it?"

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In Search of Middle Ground

The Texas case notwithstanding, some of the biggest defenders of unfettered access to public records are women's groups, who see electronic searches as a key weapon in enforcing child-support obligations.

"There is an amazing benefit to these new databases," said Geraldine Jensen, president of an Ohio-based child-support advocacy group. "They're usually the best way to track down deadbeats."

Trying to find a middle ground, some government agencies are selling the records but trying to limit how the buyers use them. The Federal Election Commission, which allows online searches of political campaign contribution reports, forbids candidates from using the data to target fund-raising solicitations. Twenty-four states restrict the commercial use of voter registration records, although all permit the disclosure of the information to political candidates and polling organizations.

Enforcing usage restrictions, however, can be difficult. FEC sprinkles its records with decoy names to see if fund-raisers solicit them; but critics contend the agency has not aggressively investigated reports of suspected misuse.

Not surprisingly, marketers resist the restrictions. "Certainly democracy extends to public records," said the Direct Marketing Association's Faley. "Who's to say what's fair use of information? If charities and the police and the press can have access to this data, why shouldn't businesses have fair access if they use it in very responsible ways and they don't harm consumers?"

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Faley maintains that most consumers "are interested in receiving information about products they're interested in. They don't want to opt out of all lists." Nevertheless, she and other marketers argue that people should be allowed to block disclosure of their personal records, a step the industry sees as less intrusive than broad rules restricting entire databases.

The popularity of such "opt-out" programs varies widely, but they appear to have some mass appeal—as seen in surge of Maryland drivers seeking to block access to their records.

"When our open-records laws were first written, no one ever imagined you could manipulate a database with thousands of names and addresses," said Mayer, Maine's chief information officer. "The ethical discussions we need to have haven't taken place yet. Right now, we're very, very naive with what we're playing with."

Staft writer Robert O'Harrow Jr. contributed to this report.

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PRIVACY LAWS: A QUILT WITH MANY HOLES

By Robert O'Harrow Jr.
Washington Post Staff Writer
Monday, March 9, 1998; Page A12

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More than a century ago, the future U.S. Supreme Court Justice Louis D. Brandeis described privacy as "the right to be let alone," a notion that continues to resonate deeply with Americans today.

But legal specialists say privacy is not explicitly mentioned in the U.S. Constitution and there are relatively few effective restrictions over how personal information is gathered and used.

Some business executives and Clinton administration officials generally argue against the creation of more laws to safeguard privacy. Industry should be given the chance to regulate itself, they say.

But many civil libertarians and privacy advocates say the growing technical capability to gather and collate personal

data is overwhelming what once were preserves of privacy.

"Most people assume that this information is private and that they have a privacy right to protect it," said Joel Reidenberg, a law professor and privacy specialist at Fordham University. "What we think is protected often is not."

The use of personal information such as names, Social Security numbers, communication on the Internet and a wealth of other details is governed by a "hodgepodge" of constitutional protections and state and federal laws, according to Reidenberg and other experts.

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The Fourth Amendment in the Bill of Rights guarantees "the right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures" by the government. The U.S. Supreme Court also has inferred a number of personal rights from various provisions in the Constitution, such as the freedom to make choices about marriage, procreation and the like.

But the court has never established a sweeping right to data privacy. There is no clear ruling, for example, on the level of access government investigators ought to have to information transmitted on the Internet. And the Supreme Court generally has left to state and federal lawmakers the task of deciding how businesses gather personal data, specialists say.

Various federal restrictions place limits on wiretapping, telemarketing and the ways government officials use individual's information.

One wide-ranging law is the federal Fair Credit Reporting Act, which regulates the use of detailed financial histories known as credit reports. The act, with new provisions that took effect last fall, requires credit bureaus to limit access to the reports and assure "maximum possible accuracy."

Federal law also prohibits video stores from releasing information about the movies customers buy or rent, a restriction adopted in 1988 after reporters obtained such information about Supreme Court nominee Robert Bork.

Privacy advocates say the Bork law highlights inconsistencies in privacy legislation because it gives video rental records more protection than health records.

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State lawmakers also have enacted laws safeguarding information in some public records. Some states are pressing for better controls of health records, particularly genetic testing results. Vermont and several other states also have approved stiffer controls on credit reports, said Robert Ellis Smith, publisher of Privacy Journal.

"Citizens are just becoming much more aware of the information that's collected and circulated about them," Smith said. "Consequently, they're going to be pressing for more laws."

But critics contend state privacy provisions are often inconsistent and sometimes ineffective. Virginia, for example, does not allow easy access to driver or motor-vehicle records, while Maryland does. The District and about half the states sell voter registration records for commercial purposes, but Virginia, Maryland and other states do not.

"There is no overarching law in this country that deals with the privacy of personal information," said Maureen S. Dorney, a California attorney who specializes in Internet law. "People do not have control over how their data is used."

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ONLINE SEARCHES FILL IN MANY HOLES

By Margot Williams and Robert O'Harrow Jr.
Washington Post Staff Writers

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Sunday, March 8, 1998; Page A19

It doesn't take much to find out details of someone's life: an Internet connection, some searching savvy or a few dollars to pay an information broker.

Consider what The Washington Post was able to find out about Martin Kaplan, a local photographer and small-business owner. Kaplan agreed to be the quarry in an online search and critique the accuracy of the findings.

The search began with a visit to InfoSpace Inc., a free look-up service on the World Wide Web that stores more than 100 million residential and commercial listings. After typing Kaplan's first and last names into a simple form (and guessing that he lived in Virginia), a reporter found his telephone number, Falls Church address and middle initial, "L." Within minutes, the service offered a map and directions for what InfoSpace described as an 11.2-mile drive to Kaplan's house from downtown, as well as names and addresses for 20 of Kaplan's neighbors.

More details came from several commercial services that do business on the Internet.

Informus Corp., a Mississippi-based company, provided a $9.50 "pre-employment" report that listed several of Kaplan's previous addresses in Virginia and New York. More important, Informus also conducted a $12 "name and address search" that yielded Kaplan's Social Security number and birthday.

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The Social Security number allowed access to Kaplan's driving record through a Tennessee company called Source Resources, which charges $15.50 for a report. Kaplan's license, first issued in Virginia in 1988, allows him to operate a motorcycle. He had a previous "endorsement" to work as a chauffeur.

The record showed Kaplan also had an infraction in 1995 or 1996 for driving 10 to 19 miles per hour above the Maryland speed limit.

To find the value of Kaplan's house, The Post used Lexis-Nexis, a database that includes county property records. The search, which cost $41, showed that Kaplan's home, purchased in 1996 for $155,000, is now assessed at $166,250. The 1,175 square-foot house has six rooms, two baths, a fireplace and a brick and stone exterior.

The Lexis-Nexis news database also yielded a 1995 story from the Palm Beach Post about a 55th wedding anniversary celebration for Kaplan's parents.

A $5 report from Dun & Bradstreet Information Service online showed that Kaplan's business, Kaplan Photography Inc., was started in 1977. The report included estimated sales.

A business credit profile listed a 1997 state tax lien against Kaplan's company. Information about the lien also popped up on a search of a fee-based public record provider on the Web called KnowX.

Kaplan acknowledged the lien, saying it was the result of a state tax audit of photographers. But he said he had quickly paid it off.

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Searching specialized public records databases like Autotrak, Information America and Information Resource

Service Co. revealed more information about Kaplan's family, including the names and ages of his children and length of residence in Fairfax. His two children lived in Blacksburg in the 1990s, records showed. A quick visit to Virginia Tech's free Internet site confirmed that both were former students at the Blacksburg school.

Accessing electronic networks is not always easy for beginners. Most of these searches took time, money or both. And the information was sometimes incomplete. Several information services, for instance, failed to note that Kaplan's tax lien was paid off.

Sometimes data availability was inconsistent. InfoSpace recently began using a new source of telephone numbers that temporarily omitted Kaplan from the white pages. But it continued to list his business address and directions to his house in the business directory.

And Kaplan's thoughts on his electronically assembled biography?

"It's amazing that all that stuff is available," said Kaplan, who was surprised by how accurate most of the information was. "And it's kind of scary that if someone had some ill will against you, they could get this information and use it against you."

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EYE IN THE KEYHOLE

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DATABASES START TO FUEL CONSUMER IRE

Last of three articles

By John Schwartz and Robert O'Harrow Jr.
Washington Post Staff Writers
Tuesday, March 10, 1998; Page A1

What finally sent Tom Meeks of Kensington over the top earlier this year was a birthday card inscribed "Happy Birthday from your friends at Radio Shack."

Meeks had no friends at Radio Shack. And it mystified him how the giant electronics chain even knew when his birthday was.

"I felt this was an invasion of my privacy," he said in an interview.

After a phone call to the company, Meeks discovered that Radio Shack bought his birth date and many others from an outside database and combined it with its mailing list of more than 147 million customers.

Meeks complained in a letter to company President Leonard Roberts that the birthday card, offering a 10 percent discount, "thoroughly shocked and appalled me." To reciprocate the feeling of invasion, Meeks included Roberts's home telephone number and his wife's first name in the letter.

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Meeks is part of a growing army of angry consumers. "Just say no," once the battle cry of the war on drugs, could be the slogan for another emerging fight in American society over protecting personal information. As data become ever more easily amassed, stored and transferred electronically, many people view safeguarding it as a sort of "street smarts" for the 1990s.

On the simple end, people are delisting phone numbers and omitting their Social Security numbers from applications. On the complicated end, they sort trash to protect credit card numbers of discarded receipts and scramble their electronic mail with encryption technology.

In California, roughly 50 percent of telephone subscribers have contacted Pacific Bell to disable the Caller ID signal on their outgoing calls (in California, that's a right guaranteed by law). When they place a call, a Caller ID telephone flashes the words "private number" on the screen.

Some people simply want to avoid dinnertime calls from pesky marketers. Others have a deep distrust of government and business, a fear that information ultimately will make its way to insurers or employers and be used against them.

For privacy activist Janlori Goldman, fighting back against privacy erosion starts with chiding sales clerks who ask for personal information—a common practice at retail chains such as the Gap and Toys R Us.

Her response? "You don't say 'hello,' you don't say 'how are you?'—you just ask for my Zip code. I don't want that kind of relationship with you. I just want to buy my shirt," said Goldman, who is on leave from the Washington-based advocacy group Center for Democracy and Technology.

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Leonard P. Levine, a computer science professor at the University of Wisconsin-Milwaukee, said consumers should be wary of "2 cents-off on a can of beans cards"—his name for supermarket savings club cards.

Today, the store that issues them tracks your buying habits in order to offer customized coupons and manage its own inventory. Tomorrow, there is nothing to prevent information that a customer is buying bacon and cigarettes from making its way to an insurance company, Levine said. His advice: Pay the extra pennies and preserve privacy.

Striking Back

Here and there, ordinary Americans are becoming privacy crusaders. Barbara Joyce of Montgomery County began a privacy campaign after telemarketers called her home one too many times.

"It is an intrusion of privacy," Joyce said. "These people are calling a phone I pay for, in my house, for my convenience. . . . Everybody has a right to be left alone in your own home."

She fought back with a little-known weapon: a federal law called the Telephone Consumer Protection Act of 1991, which, among other things, allows people to demand that telemarketers remove them from call lists or pay them financial penalties.

Using detailed logs, she found the callers often did not properly identify themselves or their companies and routinely called back after she asked them to stop. Though the system is cumbersome and frustrating, Joyce said that so far, she has won more than $5,000 in settlements. The number of intrusive calls to her house has dropped from two each night to one each week.

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"If everybody would ask to have their telephone numbers placed on the do-not-call list, it would choke the industry and lead to its demise," she said.

Donald Knox of Phoenix routinely blocks direct-market mailings by complaining that the material is sexually offensive. It doesn't matter to him what the solicitation actually says—he fills out a form provided by the U.S. Postal

Service to stop deliveries. For him, it is worth the effort "to kick them in the shins."

Even his telephone answering machine warns callers: "If you're calling me on a telemarketing thing, please hang up now. Right now!"

A Fear of 'Ghosts'

Whatever steps people take, a file is being built on them somewhere that may or may not be accurate.

"There really are ghosts—every one of us is followed around by an invisible profile that purports to be who we are," said Don Goldhammer, a University of Chicago computer network administrator. He tries to limit dissemination of his particulars by stamping his checks with this message: "By cashing this you agree not to use any information contained on it."

Credit reports frequently contain errors, said privacy expert Goldman, who urges consumers to review their credit reports before an important transaction. "They should do it before their credit comes into play," so that they can dispute incorrect information, he said.

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Psychiatrist Harold Burzstajn of Harvard is especially concerned about confidentiality breaches in medicine and mental health because patients have to be able to trust doctors to keep information private. "If you don't have privacy, you don't have psychoanalysis," he said.

Burzstajn said he worries about patients in managed care who often must sign release forms allowing anyone in the organization to read their records.

To preserve medical privacy, he said, patients should periodically demand a copy of their medical records and monitor new entries. Patients should try to get the managed-care company to purge anything that doesn't relate directly to health care, or might be misconstrued, he said.

As more people venture onto the Internet, protection of online privacy is a growing issue. People who take part in online discussions leave their e-mail addresses. Someone seeking sensitive information, such as treatment for AIDS, might not want the activity to be publicly known.

Many Web sites require people first to "register," or fill out a form about themselves. Sites also resell e-mail addresses of visitors, which can feed a glut of junk in the electronic mailbox.

Some Web surfers simply lie when asked for personal information at Web sites, according to an Internet survey conducted last year at Georgia Tech University. About 40 percent of the 19,000-plus Web users surveyed said they sometimes fib; almost 70 percent of those who decline to register on Web sites said the reason was worry over how the information would be used.

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Internet users can ensure that the sites they visit do not hit them with targeted ads next time they visit. This is done by disarming the "cookie" file on a computer—a sort of ID card that gives the site information about the user. (Instructions for doing so on most versions of popular browsers can be found at *http://www.junkbusters.com/ht/en/cookies.html#disable*) Cookies were designed into browsers to boost Internet business, allowing Web site publishers to track usage and market to visitors. But many users view them as a privacy invasion.

Those who are not comfortable reconfiguring their software instead sometimes visit such sites as the anonymizer

(www.anonymizer.com). The site strips personal information, such as e-mail addresses, away as visitors pass through it to go to other locations. At least 7,000 people routinely use this service. That's a 75 percent increase since last spring, said Anonymizer Inc. President Lance Cottrell.

Other Internet users who simply do not want their messages read by others are turning increasingly to encryption, the technology that scrambles messages so that only the intended recipient can read them. In recent years, encryption has become a low-cost software add-on that is relatively easy to use—a far cry from the cumbersome hardware-based systems of old.

Extreme Measures

For some people, protecting privacy has become an obsession.

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One Maryland man receives mail only at a post office box and keeps his phone under an assumed name. He encrypts many of his online communications and pays for long-distance calls with phone cards, so that there is no central electronic record of his calls.

He recognizes, he said, that "these things are sort of paranoid for the average person. Part of my view of life is, it's a game—how do you play the game? . . . I'm no deadbeat dad or anything like that, but I object to it. I object to George Orwell's being in charge of the FBI."

Not surprisingly, he asked that his name not be used in this article.

A more moderate, but still time-consuming approach is offered by Robert Ellis Smith, publisher of Privacy Times. The guiding notion, said Smith, is: "Remember Noah's Ark. You have to have two of everything."

Keeping two trash cans isn't hard, he said, and it lets you tear in half sensitive things such as credit card numbers on receipts. "Half in one trash can and one in the other and empty them on alternate days," Smith said—a simple system that makes paper shredding unnecessary.

He recommends two online accounts, one private, for sending and receiving e-mail and another for searching the World Wide Web. That way, the marketers who gather e-mail addresses from cookies will be sending their come-ons to a mailbox you never check.

Some people are discovering that when you say no to data gatherers, you do not necessarily miss out on what they are offering in return. Rich Brown, a consultant with a Lanham research firm, got a telemarketing call offering him a platinum credit card if he would answer a few questions. The caller proceeded from simple queries verifying his address and telephone numbers to complicated ones asking details of his salary, mortgage and other debts.

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Irked, Brown cut off the caller. "I said I was uncomfortable giving out that kind of information," especially on the phone, he recalled. Brown thought the deal was scuttled until a short time later, when a new credit card appeared in the mail. Brown figures the company had all it needed to issue the card but was using a prying phone call to fish for more personal information.

Some privacy advocates want to simplify the process of getting off lists. Entrepreneur Steven Bearak publishes a book titled "Privacy PowerPak" that explains privacy issues and includes ready-to-mail forms and postcards to demand removal from mailing and call lists, to dispute credit reports and more.

Bearak knows, however, that his $34.95 "tool kit" doesn't fix the problems: "You're not pushing a button and erasing

years of information that you have left behind. . . . Protecting your privacy is a process, it's not an event."

A Call for Curbs

A number of privacy advocates say that it's just too much work for the individual and laws should be strengthened. "The only reason individuals have to do day-to-day approaches is because the policy is inadequate," said Richard Sobel, a researcher at Harvard Law School.

Hence campaigns such as the American Civil Liberties Union's "Take Back Your Data!" effort. The privacy initiative offers brochures and reports about the use of Social Security numbers, electronic monitoring at work, the Internet and other matters.

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Activism can be local or company-specific. When Walt Disney Co. bought the ABC television network, the company issued new identification cards to employees that prominently displayed their Social Security numbers. Since many employees wear cards on the job, they objected—and the cards were changed.

Levine got his university to stop using Social Security numbers on faculty and student ID cards.

In the case of the Radio Shack birthday card, the company responded quickly to Meeks's complaints. Company officials apologized and took Meeks off the birthday card list. They pledged to follow up with a consumer survey to find out just how many people the program irritates. Meeks said he was gratified by the response.

Radio Shack representatives said the campaign also has generated compliments from consumers, and noted that while the company has collected facts on customers, it has not sold the information to any other company—even though it would be lucrative to do so.

"We have the absolutely highest respect for our customers' privacy that you could imagine," said David Edmondson, Radio Shack's senior vice president for marketing and sales. "I can only say that with everything that is within me, in terms of passion."

Meeks does not doubt that the company acted with good intentions—he just wants businesses to think before they mine data and act on it. "The attitude of most of these companies seems to be, 'because it can be done, it should be done—and if there's any value to the customer, it's perfectly okay.' They don't see it as a privacy issue.

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"Maybe companies should pause a few moments and ask, 'Just because it can be done, should it be done?',"

Shifting responsibility away from individuals is the only sensible path, said Marc Rotenberg of the Electronic Privacy Information Center. "I feel people should feel free to act in the ways they want to act, and their privacy will be protected. Which means we need to change the world," he said.

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TELEMARKETERS ANSWERING THEIR CALLING

By Caroline E. Mayer
Washington Post Staff Writer
Sunday, August 31, 1997; Page HI

It's dinner time at the Mayer house, and right on schedule—ring!—a telemarketer's call arrives between the grilled

chicken and fresh corn on the cob. What's a person to do?

Well, if anyone should know how to escape those unsolicited phone calls that interrupt my peas and quiet, it ought to be Douglas E. Palley, president of Unitel Corp., a small but rapidly growing telemarketing company headquartered in McLean.

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The six-year-old firm can handle 50,000 calls an hour, selling all sorts of consumer items, from exercise machines and vitamins to health insurance and financial services.

So what does a telemarketing executive do when telemarketers pester him at home? Nothing subtle here. Often, Palley says, "I tell them, 'I'm sorry, Mr. Palley died.' "

Nowadays, dying may be the only way to avoid telemarketers. They have become more invasive than the door-to-door salesmen who still pester Dagwood, more inevitable than the coupons and catalogues that stuff our letter boxes. And unlike those bulk mailings you can ignore, phone calls are intrusive and virtually unavoidable.

Palley's business partner, S. Tien Wong, is very blunt about it. Telemarketing, he says, "has become the junk mail of the '90s." As a result, Wong—Unitel's chief executive—predicts (and hopes for his company, of course) that telemarketing will become even more pervasive in the years ahead. "It is a relatively inexpensive form of marketing," he says.

For telephone companies, ironically, it's about the only way they have to talk to customers (and talk and talk!). Meanwhile, banks and retailers find it's much cheaper to reach customers through telephone calls than through new branch offices or stores. And for magazines and credit card companies, a personal, interactive sales pitch is usually more effective than soliciting business through the mail.

"The reason telemarketing works is you get a chance to speak directly to people," says one magazine executive who declined to be named. "When you mail something, many people may never ever take a look at it. But there's a dynamic with the phone that's very funny. We know from research that many people like to have people call them, that many like to buy from telemarketing solicitations and that some people just can't say no to someone on the phone."

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The sales rates confirm those findings, the executive adds. "If you're selling a $20 magazine subscription and you send you 100 pieces of mail, you may get two subscriptions," he says. But with 100 phone calls, you'll get about 15. Of course, he notes, there's a larger cancellation rate from subscribers who order by phone—but not enough to put a halt to telemarketing.

So, says Palley, "until it's not cost effective, this business will continue to flourish and consumers will continue to receive calls. That's the free-enterprise system of America."

In fact, Palley cautions, the assault has just begun. "The next wave is going to be your utility companies"—competing to sell you electricity once deregulation is approved.

Rrring!

But why is dinner time so vulnerable to telephonic invasion?

It's inevitable, Palley says. Federal rules forbid telemarketers from making calls after 9 p.m. "That gives us a three-hour window," says Palley, to catch people at home after work but before the 9 o'clock cutoff, and there's a good chance that in one of those three hours you'll either be making or eating dinner.

Rring, rrriiing!!

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You can try telling the callers that you want to be placed on their "do not call list" (see accompanying box). That's just fine with Palley and other telemarketing executives, who don't want to waste their time phoning people who have no interest in buying.

However, while such a request may get you off one or another of the lists, it won't remove your name from all. For one thing, nonprofit organizations are not required to keep "do not call" lists. Also, in some cases, telemarketers call all numbers in a certain neighborhood or telephone exchange (especially areas that market research has demonstrated to be rich with affluent consumers who are likely to buy products over the phone). Not even unlisted and nonpublished numbers escape the call list.

Your name and number can be traded, like a commodity. Once you've done business with a firm, that company often keeps your name and may call you again someday—or sell your name to other firms.

"Even if you didn't give out your number, companies can get your number," says Palley. A sure way to get on a telemarketing list, he adds, is to send in those warranty cards that come with new products. "If you put your name on that list, you're cooked," he says.

Major life changes also guarantee a spate of calls, he adds. Special companies carefully monitor home sales and births for telemarketing purposes.

"Telemarketing has gone from a mom-and-pop business that used to get the lists from a company and start making calls to a very sophisticated computer-oriented system that analyzes lists and cross checks names with past purchases for potential sales," said Ric Rickertsen, a partner with Thayer Capital Partners, a private equity investment firm that owns the telemarketing firm, IQI Marketing Solutions.

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Calls "used to be more random, like a shotgun, but have now become much more targeted," said Rickertsen. "Hopefully that should be better for consumers; they should be just getting blind calls, and people who don't buy stuff should be getting less calls."

But computerization also means more carefully scripted sales pitches—that can be changed quickly to handle objections that consumers may raise.

Just watch Rodney Roussy, one of Unitel's more successful teleservices representatives, as he tries to sell vitamins from the McLean call center.

A computer automatically dials the calls; in this case it's dialing customers who've recently purchased an exercise machine over the phone. Because these customers already have made a purchase by the phone, they are considered very good prospects. While the computer dials, Roussy electronically flips through the customer's profile, finding out where he or she lives and whether any previous calls had been made to the customer—and with what outcome.

If there's no answer, or if Roussy reaches an answering machine, the phone number is stored for a subsequent call, and another number is dialed. Once Roussy reaches the person he wants, he quickly introduces himself and starts his sales pitch, first thanking the customer for buying the exercise machine. "How's it working out?" he asks. "Because we consider you a valuable customer, we want to send you a free, 30-day starter kit of vitamins and nutritional supplements . . . specifically designed for adults as a high antioxidant dietary supplement. . . . " Roussy says the vitamins will be shipped directly to the customer; if dissatisfied, all a customer has to do is call an 800 telephone

number to drop out of the program. And with the vitamins come a free health and nutritional newsletter, Roussy adds.

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The minute a customer voices a concern, Roussy presses a key on his computer to call up a carefully scripted answer. When a customer says she has to talk to her spouse, Roussy quickly replies, "You don't have to make a payment for six weeks. Try it for 30 days and compare us with what your taking now. If you feel better and more energetic, keep it; if not, cancel."

Too expensive? "We send the vitamins directly to you and cut out the middleman so we can pass on the savings to you. The vitamins are high quality, fresh and at their peak potency when you get them," says Roussy.

One caller tells Roussy he already has a healthy diet and doesn't need vitamins. "Studies show that nine out of 10 people don't get enough nutrients even with a healthy diet," Roussy responds, but the customer still refuses.

The one thing Roussy hates is a simple "no thank you." He explained: "That's the hardest thing to overcome. If they say they're not interested, you might be able to trigger a sense of curiosity about the product" and still make a sale. Still, he adds, he'd rather know up front that the customer doesn't intend to make a purchase.

In a little more than two hours, Roussy makes 78 calls. Of these, 61 were to customers who did not answer or were unavailable. Ten said no and two (including the one who had to talk to her spouse) were scheduled for return calls. Five agreed to buy the vitamins.

That's typical for Roussy, who likes to make at least two sales an hour. For each sale, he gets a commission (it ranges from 50 cents to $5, depending on the product; for the vitamins, it's $2 a sale) on top of his hourly salary. Unitel's salaries begin around $9 an hour and rise quickly depending on skill and experience. And frequently there are additional bonuses—for good attendance and extraordinary sales days, bringing some salaries as high as $15 to $18 an hour. That's considerably higher than the top $10 an hour salary typically paid in the industry, Wong said, largely because Unitel's McLean employees work in a market where all wages are high.

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Roussy has been a telemarketer for 20 years—an exceptionally long time for an occupation whose burnout rate is so high that the average telemarketer doesn't last more than six months. "I love talking to people; I wouldn't want to do anything else," he says.

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Mr. **NADLER.** In summary, you think that there are inadequate protections for all of these private records that would be required under this bill?

Mr. **KAPLAN.** As I said before, the reason that the Judicial Conference has not disseminated, more fully, aggregated and bulk information is because we do not have an answer to the privacy concerns.

Let me say that I do apologize for my outburst at my dear friend, Professor LoPucki. But this is the first time ever, today, ever, that I heard that academicians would need a debtors' name and Social Security number——

Mr. **NADLER.** So my summary was correct?

Mr. **KAPLAN.** Yes, sir.

Mr. **NADLER.** Thank you.

Mr. Orr once again, we have had some discussion earlier today about the cost to the system and the parties by H.R. 3150.

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Has the Executive Office of the U.S. Trustees looked at this question, do you have any opinion as to whether the provisions of H.R. 3150 would substantially increase the cost to the Office of the U.S. Trustees and the other trustees in the system generally?

Mr. **ORR.** We are committed to data collection for instance, but some provisions do give us cause about resources that we have. We have not done a formal study of the accurate number, but we have looked at some of the requirements. For instance, the provision for auditing would require us to audit approximately 2 percent of all cases, one in fifty I think. One in fifty at filing rates of 2 percent and filing rates of 1.3 million cases anually would mean that we have the obligation to provide for the auditing of 26,000 cases. You can do the math.

Mr. **NADLER.** It is a lot of money.

Mr. **ORR.** It would be a lot of money. It could be a lot of additional resources.

Mr. **NADLER.** Do you know how much it costs on average to audit a case, roughly the magnitude? If you are auditing a case according to generally accepted accounting standards and generally accepted accounting principles, and an accountant's time billed out at a certain number of say $100 to $150 an hour.

There was testimony earlier this morning that at the Bankruptcy Review Commission that they estimated the time to be somewhere in the neighborhood of a $1000 or $2000 to audit. So $1000 to $2000 per audit?

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Mr. **ORR.** It could be more or it could be less. If we were to do it in-house, it could be different.

But at that rate, it would be $52 million.

Mr. **NADLER.** That is what my calculator says. It is simple math. If that were the charge, that would be the figure. That is just for the auditing.

Do you have an opinion as to the other costs to the system at all? It is difficult to say, because we do not have a definite number. We recognize that some of the additional requirements could require us to find a way and additional resources to do it.

Would you be able to report back to us with an estimate as to the costs imposed on the bankruptcy system, by which I mean the Office of Trustees and so forth?

Mr. **ORR.** To be honest with you, Mr. Nadler, that would be difficult for us to do with any certainty, because we have not sat down and done a determination about exactly what we would have to do with each provision to give you a number.

Mr. **NADLER.** How long would it take you to do that?

Mr. **ORR.** It could take us some time. It could take us several months, and it could take us less. As we look through the statute, we would have to figure out which specific provisions and how much time it would take.

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Mr. **NADLER.** That might be another argument in my continuing urging of the Chairman that we are proceeding too fast with this bill, if we do not know these costs.

Could you get back to us as soon as you can on that?

Mr. **ORR.** In conjunction with our normal processes, I can try to get back to you as well as I can as to what we could do. However, I do not want to mislead you into thinking that we have a definite number that we are able to calculate with any certainty as to what the costs are.

I do want to say that we have some concerns about resources, but I do not have a figure for you, Mr. Nadler.

Mr. **GEKAS.** You do not have it now?

Mr. **ORR.** No.

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

Mr. **GEKAS.** We thank the members of the final panel, and we discharge you with an expression of gratitude.

Mr. **NADLER.** Mr. Chairman.

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Mr. **GEKAS.** The gentleman from New York.

Mr. **NADLER.** Mr. Chairman, I ask unanimous consent that all members have seven legislative days to submit additional questions to the witnesses who have testified on these bills, and additional materials for the record.

Mr. **GEKAS.** Without objection, so ordered.

[The prepared statement of the Hon. Sheila Jackson-Lee follows:]

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

As I have begun my comments in each of our five hearings on this subject, I want to acknowledge Chairman Gekas for his 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 quick recipe for error. Ladies and gentlemen, consumer bankruptcy reform, must not be taken lightly. Plainly stated, the Congress should not attempt to pass untested legislative policy without first reviewing every reasonable option, possibility, and alternative to these kinds of radical structural reforms. If not, I promise you that it is the American people that will have to pay the consequences for our hasty choices.

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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.

Today, we have assembled to discuss the commercial bankruptcy aspects of the Chairman's bill, H.R. 3150. The greatest issue of contention in this area of the bankruptcy reforms are the provisions that deal with small business bankruptcy cases. The remaining question is how the proposed changes in this legislation will affect our standard Chapter 11 small business cases as well as those unincorporated small businesses that file under either Chapter 13 or Chapter 7. H.R. 3150's attempts to expedite the bankruptcy system for small business claims is extremely helpful to our business lenders, whose interests are of primary importance to me; however, I am not sure as of yet how this legislation will affect our bankrupt small businesses. Hopefully, this hearing will serve as a point of focus in uncovering the actual effects of this legislation on our small business owners as well as their credit lenders.

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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 has been the result of these exhaustive hearings. In general, I have been extremely unimpressed 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 might 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.

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

Mr. **GEKAS.** The committee stands adjourned.

[Whereupon, at 2:40 p.m., the subcommittee was adjourned.]

A P P E N D I X

Material Submitted for the Hearing Record

REPORT OF THE BANKRUPTCY STATISTICS TASK FORCE

I. BACKGROUND

Recommendation 73 of the *Long Range Plan for the Federal Courts*, approved by the Judicial Conference in December 1995, commits the judiciary to assessing its information needs and evaluating its data-collection operations and policies. The recommendation was adopted by the Judicial Conference to ensure that the future information needs of the courts, and, where possible, those of people who use the courts, are met.

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The assessment envisioned under Recommendation 73 includes the statistical reporting systems of the courts of appeals, district courts, bankruptcy courts, and supporting court offices and programs. The Administrative Office (AO) decided to begin the general assessment with a review of bankruptcy court statistics for several reasons. First, the recent surge in bankruptcy case filings has spurred keen interest in the business world, the credit community, the press,

and among government leaders. Second, the National Bankruptcy Review Commission, which was created to assess the overall operations of the bankruptcy system, is scheduled to submit its recommendations to Congress in October 1997. Some of its members and staff have suggested certain enhancements in the AO's statistical systems. Third, several commentators have written that the judiciary should improve and expand its bankruptcy statistical reporting system.

The judiciary has two major projects underway to implement the bankruptcy portion of Recommendation 73:

(1) an audit of 11 bankruptcy courts to determine the accuracy and completeness of the statistics gathered currently, and

(2) a review of the present and future statistical information needs of the judiciary and users outside the judiciary. This report covers the latter project only. It is being submitted to the Bankruptcy Committee and the Judicial Resources Committee for appropriate guidance and action.

In October 1996, the Director of the AO assigned responsibility for overall management of the Recommendation 73 project to the Office of Human Resources and Statistics and the Office of Judges Programs. The assistant directors of those offices, in turn, established a task force to help collect information and make decisions concerning the project. The task force consists of three bankruptcy judges, three bankruptcy clerks of court, a circuit executive, and representatives of the AO.

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The task force collected and prepared documents regarding the types of bankruptcy case statistics that are now being collected and the methods by which the information is collected, including descriptions of existing automated case management systems. The task force then identified the principal categories of users of the data, both within and outside the judiciary, and made a preliminary assessment of the users' needs.

The judiciary's own users of statistical information were identified first. They include individual judges and chief judges, circuit councils, court executives, the Judicial Conference and its committees, especially the Bankruptcy Committee, the AO, and the Federal Judicial Center (FJC). Statistical information is used within the judiciary, for example, to project case filings, justify requests for judgeships, allocate staff and resources, and assist in case management. Non-judiciary users include the Congress, U.S. trustees and case trustees, other government agencies, lending institutions and other commercial enterprises, researchers, the press, and the public.

Information was gathered directly from users in a pattern of expanding concentric circles. Beginning with the AO and the Judicial Conference, the scope of the inquiry radiated out toward the needs of the courts and the FJC, and then to groups outside the judiciary, such as other government entities, private associations, the press, and academia.

On December 13, 1996, the task force met in Washington to discuss the data needs of the federal court family. On March 3 and 4, 1997, it met with individuals and entities outside the judiciary, including representatives of the press and academia, the Executive Office for U.S. Trustees, the General Accounting Office, the National Bankruptcy Review Commission, the IRS, the Federal Reserve System, the Federal Deposit Insurance Corporation, the American Bar Association, and various consumer groups and creditor associations. Representatives of the FJC also attended and made a presentation. The level of interest in the project was high, and many valuable suggestions were received.

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Because of the different interests represented, a wide variety of information was requested. Yet, several common themes emerged from the meetings, particularly the need for statistics that reflect in an accurate, timely, and uniform way: (1) events and activities occurring in bankruptcy cases, and (2) the financial conditions of bankruptcy debtors.

II. BASIC PRINCIPLES

In formulating the recommendations set forth in part V. of this report, the task force has been guided by certain principles.

First, the primary statistical obligation of the judiciary is to produce court caseload statistics and other data essential to fulfill its reporting obligations and meet its management needs at the national, regional, and local levels.

Statistics and other data not essential for the judiciary's own operations should normally be collected and compiled by others, with coordination and cooperation provided by judiciary staff where appropriate. In most instances, for example, it might be more efficient and more accurate for the U.S. trustees and bankruptcy administrators to verify and/or collect financial information, such as the exact dollar amounts of assets, liabilities and income, the types of debt incurred by the debtor, the amounts of exempt property, and distributions to creditors. Information of this type is found in the individual case files of the courts, but it is not recorded locally or collected by the AO. The U.S. trustees and bankruptcy administrators, on the other hand, record and maintain some of these data on a regular basis, consistent with their statutory mandate to "supervise the administration of cases and trustees" in bankruptcy cases. *Cf.* 28 U.S.C. 586(a)(3).

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The judiciary's data collection efforts should be focused on case filing and docketing events, in accordance with the requirement of 28 U.S.C. 604(a) that the Director of the Administrative Office "examine the state of the dockets of the courts" and "secure information as to the courts' need of assistance." The record-keeping efforts of the courts and the U.S. trustees should not be duplicated. Rather, existing systems should be made compatible with one another, so that information can be readily shared.

Second, it must be emphasized that major advances are being made in the development of automated electronic filing, financial, personnel, and administrative systems. Recent and future advances in automation present significant opportunities to extract better information and collect additional information from court records. As part of the omnibus review of statistical information needs, the judiciary will explore what additional information might be extracted reliably from existing electronic docket systems and whether there is certain data collection that could be added or eliminated.

Third, wherever feasible, statistics should be generated as by-products of automated court transactions, including docket entries, electronic filings of documents, and automated financial transactions. It is important that all essential information be entered accurately into an electronic database at the source. Some minimum level of standardization of docket entries and other court data is necessary to facilitate the extraction and counting of necessary statistics.

Fourth, additional emphasis must be placed on the accuracy of data provided by debtors. Much of the information reported to the AO is provided at the opening of a case, when complete accuracy may not be possible. Consideration should be given to obtaining additional information about the debtor after the schedules and statements have been filed, after the 341 meeting has been held, or at the closing of a case.

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Fifth, the resources available to produce additional data will be limited. Data gathering and statistical reporting cost money, and they impose significant burdens on understaffed clerks' offices and U.S. trustees' offices. It is unlikely that Congress will provide sufficient appropriated funds to finance additional data collection activities. Alternate financing arrangements should be considered—including reasonable user fees—to defray the costs of gathering statistics and other information.

Some statistical needs may be satisfied through the use of surveys, questionnaires, and sampling, rather than by adding new requirements and costs to the national statistical systems. Consideration should also be given to identifying alternative sources that might generate and produce required data, including government agencies, commercial entities,

contractors, and academia.

Sixth, a system of "modular" database systems—maintained separately by the individual branches of government but communicating with each other and employing the same terminology—is preferable to one large system. At the task force meeting on March 3, 1997, one commentator suggested that a single, government-wide bankruptcy data system be created to accommodate the needs of the U.S. trustees, the courts, the Administrative Office, the individual case trustees, and the public.

But experience has shown that large, government-wide automated systems, i.e., "grand designs," are difficult to manage and fund. There are too many competing interests, needs, priorities and technical requirements to be satisfied. In 1986, the U.S. trustee system attempted without success to design and build a single, centralized system.

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The key to making modules work together is connectivity. If the separate components can be linked together in a meaningful and uniform way, they can communicate clearly and still be managed effectively.

III. ADDITIONAL STATISTICAL INFORMATION REQUESTED

During the course of the meetings, and in the written submissions of participants, a great deal of information was requested that is not currently being reported to the AO. The information can be grouped into two main categories—information available at case opening and information available later in a case or at case closing. A general list of the information requested is set forth below.

A. Information Available at Case Opening

1. Social Security Numbers of Debtors

2. Pro Se Cases

3. In Forma Pauperis Cases

4. Payments of Filing Fees in Installments

5. Whether a Case is a Business Case or a Consumer Case

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6. Refinement of the "Nature of Business" Classifications

7. Adjustment of the Creditor, Asset and Liability Ranges

8. Demographic Information on Debtors

B. Information Available Later in a Case or at Closing

1. More Accurate Financial Information Regarding the Debtor

2. Greater Breakdown as to the Nature of the Debts

3. Reasons Why the Debtor Filed for Bankruptcy

4. Section 707(b) Motions to Dismiss

5. Reaffirmation Agreements

6. Adversary Proceedings

7. Contested Matters

8. The Operation and "Success" of Chapter 11 Cases

9. Chapter 12 and 13 Cases

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10. Disposition of Cases

11. Appeals

12. Professional Fees Requested and Awarded

13. Distributions to Creditors

14. Information to Detect Fraud

15. Information for Administrative Purposes

16. Information on Visiting Judges and Retired Judges

IV. COLLECTING AND EXTRACTING CASE-RELATED INFORMATION

Bankruptcy information is currently found in the following formats and places:

A. Information entered into the courts' electronic docket systems (BANCAP and NIBS) in a uniform manner at the commencement of a case, based on paper records filed with the clerks of court.

The clerks open up a case and a docket sheet by entering into a local computer certain fields of data submitted by the debtor on a cover sheet. The cover sheet is incorporated into the petition itself (Official Form 1), and its use is mandatory. Fed.R.Bankr.P. 9009. That information, presently filed by the debtor in paper form and entered manually by the clerk's office, includes the names of the debtor(s), their social security numbers, the appropriate bankruptcy chapter, whether the case is a business case or a consumer case, estimates as to the number of creditors, the dollar amount of the debtor's total assets and liabilities, and other information.

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Case-opening statistical reports are submitted by the clerks to the AO. They are generated electronically by a program that extracts some (but not all) of the case-opening information from the court's data base. A complete list of the case-opening data collected by the AO at the present time is attached to this report.

Although most of the case-opening information is reliable, such as Social Security number, Code chapter and the like, there are inevitable problems with the accuracy of financial information supplied by debtors at case opening.

B. Information entered into the courts' electronic docket systems during the course of a case.

The courts' docket sheets are designed to reflect, in chronological order, all significant events occurring during the

course of a case. The dockets, for example, should normally reflect such key events as case conversions, motions and applications filed, disclosure statements and plans filed, and court orders and opinions.

Theoretically, it should be possible to design extraction programs that could count and report many of these matters to a central database or several different databases. These databases, for example, could reside in the courts, the AO, the U.S. trustees' offices, and elsewhere.

Unfortunately, except for case opening information, courts do not docket all case events uniformly. There are differences among courts as to whether certain events are docketed and how they are labeled. To compile reliable information on key events occurring in a case, it would be necessary: (1) to require that the desired information be entered into each court's docket system, and (2) to require that it be docketed using uniform terminology or codes.

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C. Information presented to the court and maintained by the court in paper form.

Pleadings and other documents filed with the court in paper form are usually maintained in folders on shelves and in file cabinets. Public access to case papers is guaranteed by the Bankruptcy Code. 11 U.S.C. 107. A person seeking information contained in a file normally must obtain the file from the clerk's office or request a search of the records by the clerk.

When the courts move to electronic case files and electronic case filing procedures, it should be possible to obtain substantial additional information that is now contained in paper files, such as schedules, statements, and reports. These new systems will accommodate many of the information needs of the courts and those of other users.

Fortunately, much of the information in the files, such as the statements and schedules, is set forth in standard format. Use of the Official Forms is mandatory, and the forms have been designed by the Advisory Committee on Bankruptcy Rules to foster uniformity and to facilitate eventual automation of the records. Work is well underway to publish instructions to assist users of the forms.

D. Information maintained or monitored by case trustees and U.S. Trustees.

U.S. trustees and bankruptcy administrators are responsible for the appointment and supervision of case trustees and for estate administration generally. Case trustees are responsible for reviewing the schedules and statements filed by debtors, for conducting 341 meetings, and for otherwise monitoring the financial activities of debtors. They also file financial reports, including reports of distributions, with the U.S. trustees. (A copy of these reports is also usually filed with the court.) The U.S. trustees and bankruptcy administrators are responsible for approving the distributions, monitoring for fraud, and assuring the courts that the estate has been fully administered and the case may be closed.

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At the meeting on March 3 and 4, 1997, a representative of the U.S. trustee system and a representative of a national trustee organization both reported that most trustees maintain their records in electronic form and that uniform financial reports could be designed and generated with minimal difficulty.

The financial information that the clerk reports to the AO at the close of a case is extracted manually from the paper reports submitted by the trustees. The court itself normally has little or no role to play in reviewing the amounts reported by the trustees or approving distributions to creditors.

A fruitful exchange of information could occur if the major parties involved—the judiciary and the Executive Office for U.S. Trustees—were to coordinate and standardize their data-collection activities and enter into written agreements regarding their collection responsibilities and how the information would be shared.

E. Information not presently maintained.

The courts do not request or need information regarding the personal background of the debtor, such as age, sex, race, marital status and the like. Except where a matter is raised during the course of litigation, most courts do not inquire into the reasons why a debtor has filed for bankruptcy. Indeed, very few consumer cases give rise to disputes or litigation. They are handled, in effect, as part of a very efficient, high-volume administrative process by clerks of court and trustees.

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The great majority of cases involve consumer debtors and are processed in the first instance by trustees who maintain extensive computer records.

V. RECOMMENDATIONS REGARDING THE INFORMATION REQUESTED

A. Recommendations Concerning Information Available at Case Opening

1. Social Security Numbers of Debtors

Information has been requested on Social Security numbers of debtors to enable the courts and U.S. trustees to identify repeat filers or abusive filers.

Debtors must provide their Social Security number to the court at case filing, and the number becomes an essential part of the title of the case. Fed.R.Bankr.P. 1005. The Social Security number is entered into the court's docket as a matter of public record, and it is a required part of the caption of pleadings and other documents that parties file with the court. Fed.R.Bankr.P. 9004(b); Official Form 16(A). The number is also set forth on notices sent to creditors, and it enables creditors to identify the debtor. Fed.R.Bankr.P. 2002(n).

Recommendation

The use and dissemination of Social Security numbers inevitably raises privacy concerns. It is a potentially sensitive and controversial matter, particularly in light of the recent controversies surrounding public access to IRS and Social Security Administration databases.

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The debtor's Social Security number is available locally on the paper records in the court and in the electronic database of each court. It is provided to case trustees and U.S. trustees, and it is available to the public through the PACER system.

The new National Case Party Index, presently under development, consolidates party information from all courts in one national database. It contains Social Security numbers and should enable the courts and U.S. trustees to identify most repeat filers.

The AO itself has no need for Social Security numbers, and it should not collect or disseminate them as a matter of policy.

2. Pro Se Cases

Information has been requested on debtors who file a bankruptcy case without an attorney. This information might also specify those pro se debtors who are assisted by a filing service, rather than an attorney.

In addition, information has been requested on the disposition of pro se cases and on the number of adversary

proceedings and motions filed by pro se debtors.

Recommendation

The AO's statistical database has recently been modified to include a new field to identify debtors who file their case without an attorney. Accordingly, in the future, information on debtors who file pro se could be collected nationally.

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3. In Forma Pauperis Cases

Information has been requested on debtors who file a petition without paying the required filing fees. Currently the option to file a case in forma pauperis is available by statute only in six districts participating in a pilot IFP project.

Recommendation

Information on IFP cases is presently being gathered in the six pilot districts to obtain data for assessing the statutory experiment. If the option to file IFP is extended by the Congress to all districts, the AO should collect basic information on IFP cases nationwide.

4. Payments of Filing Fees in Installments

Information has been requested on debtors who apply, and are granted permission, to pay the filing fee in installments. 28 U.S.C. 1930(a); Fed.R.Bank.P. 1006(b). Information has also been requested on whether the debtor actually makes all the installment payments.

Recommendation

At present the FINSYS court financial system, used by the bankruptcy court in the Eastern District of Virginia, captures up to four installment payments per case. In the near future, the functions of FINSYS will be integrated into FAST, the judiciary's new central accounting system. FAST will be capable of flagging and noticing installment payments that are due or overdue, and it will identify the originating district or division. It appears that the new system will provide statistics that are sufficient for the judiciary's purposes.

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5. Whether a Case is a Business Case or a Consumer Case

It has been suggested by several commentators that the judiciary should devise a more accurate method of determining whether a case is a business case or a non-business case.

Recommendation

A business/non-business box is contained on the official petition form filed by the debtor at case opening. Unfortunately, the information provided by some debtors is not accurate.

The current definition of whether the debtor is a "business" depends on whether the debts accumulated by the debtor are primarily business or personal in nature. Many small-capitalized debtors derive most of their income from their own business, and their business and personal assets and debts are often intertwined and not easily distinguishable, particularly if they do not maintain sound records.

A better approach to obtaining information on whether the debtor is a business might be to amend the forms to

require the debtor to provide information on specific facts, rather than make a subjective conclusion. Such facts might include, for example, whether the debtor filed a Schedule C or Schedule K with the federal income tax return for the preceding year or whether the debtor has been incorporated or has a business license.

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More accurate information on business categorization might be provided, moreover, if the information were verified, and perhaps reported, by the U.S. trustees.

6. Refinement of the "Nature of Business" Classifications

Several commentators have recommended that a better system be devised for determining the specific nature of the debtor's business, particularly for analyzing chapter 11 cases. Several suggested use of the Standard Industry Codes (SIC Codes).

Recommendation

Use of the SIC Codes is probably an appropriate solution, but it might be ineffective to have the debtor select the appropriate business code. One representative of the U.S. trustee system stated that information received from debtors on the nature of the business is generally unreliable. Therefore, the local U.S. trustee's office uses a financial analyst to review the case and assign a SIC code for internal agency purposes.

Accordingly, it might be preferable for the U.S. trustee to verify this information and provide it to the court at a specified point in a case.

7. Adjustment of the Asset, Liability and Creditor Ranges

Several participants recommended that the ranges of categories set forth on the petition and cover sheet—dealing with the estimated number of creditors and dollar amounts of assets and liabilities—be narrowed. No specific substitute ranges were recommended. One commentator recommended that actual numbers be used instead of ranges.

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One participant suggested adding the following new categories for the very smallest of consumer cases:

fewer than 10 creditors;

under $10,000 in assets; and

under $10,000 in liabilities.

Recommendation

The current ranges, as recently amended to include two new high-end categories, are workable. Moreover, they are an integral element of the present bankruptcy judgeship formula. They could not be changed at this time without causing disruption. It would be advisable, moreover, to sample cases before determining whether any additional or revised categories should be used.

8. Demographic Information on Debtors

The following information on debtors has been requested:

Marital status

Family breakups

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Gender

Race and ethnicity

Age

Education

Occupation

Recommendation

The information might be very helpful to certain commercial entities and to academics. But the judiciary should not attempt to collect it as a matter of policy. It might cooperate in the collection of the information by others who may need it. Yet caution must be exercised in this area because of the privacy interests of debtors.

B. Recommendations Regarding Information Available Later in a Case or at Case Closing

1. More Accurate Financial Information Regarding the Debtor

Several commentators emphasized the need for more detailed, and more accurate, financial information about the debtor. Specific items requested include:

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Accurate amounts on schedules

Nature of the debts—by type of debt

Information on the schedules—assets and property

Seniority of the debt (legal judgment, bank debt, etc.)

Amount and types of property claimed as exempt

Assets that may be subject to an equitable distribution

Income of the debtor

In addition, some judges have cited their need for financial data to help them make decisions about cases, particularly in chapter 11, 12, and 13 cases.

Recommendation

The present statistical system relies heavily on information provided by the debtor at the time a case is filed. The reliability of the information is subject to question. Later in many cases, however, financial information about the debtor becomes more complete and more reliable—at least in "asset" cases. The information tends to improve progressively after the debtor files the required schedules and statements, after the trustee reviews the papers and

conducts the 341 meeting of creditors, after amended schedules and statements are filed, after litigation activity occurs, after the trustee files a report and account, after distributions are made, and after the case is closed. In "no-asset" chapter 7 cases, however, it may never be possible to obtain completely accurate information because there is simply no financial incentive or practical need for trustees in these cases to investigate the debtors' financial statements and schedules.

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Case trustees, U.S. trustees, and bankruptcy administrators are responsible for estate administration. *Cf.* 28 U.S.C. 586. They are in a better position than the courts to review the records of the debtor and to question the debtor. Accordingly, some review and verification of financial information by the trustee and by the U.S. trustee or bankruptcy administrator should be used to improve the information provided to the court.

Also, the impact of past and future improvements in electronic systems cannot be underestimated. The introduction of electronic case files and the electronic filing of documents with the court—including the financial schedules and statements—will greatly enhance the ability to verify, match, and extract financial information on debtors.

In summary, the additional financial information requested is not readily available in the current statistical systems. But new electronic systems—especially the projected new electronic case file system—should make it available.

A key issue is *when* basic information about the debtor should be reported to the AO. Presently, the basic information reported at the time of case opening is used to classify cases and provide information for workload formulas. Some commentators, including Commissioner John Gose of the National Bankruptcy Review Commission, suggested that it would be better to collect the information at case closing. Alternatively, it might be possible, with advances in automation, to obtain the information at some point after the case has been opened, such as following the filing of schedules and statements or after the 341 meeting.

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On the other hand, it has been said that it is difficult to report and account for cases in which significant information is simply unavailable. The later in the case that information is collected, the higher the percentage of cases that will already have dropped out of the system, rending the data unavailable. Data collected or corrected later in continuing cases may not be directly comparable in reliability or comprehensiveness to opening case data in short-lived cases. These analytic issues should be addressed at the outset of the design of any new system in order to avoid systemic data biases.

It is the view of the task force that a case-opening report, including the financial estimates provided by the debtor, should be retained. Among other things, it supplies important information relied upon by the judiciary to justify and allocate resources.

But additional and more accurate financial data should also be collected at case closing. To this end, the judiciary should work with case trustees, U.S. trustees, and bankruptcy administrators to prescribe standard trustee financial reports to be filed electronically. These reports would form the basis of the financial data on the case-closing reports.

In chapter 11 cases the possibility should be explored of requiring the debtor to compile and file certain information electronically with the court as part of the final decree process. This approach could save substantial clerk time now spent manually searching case files to extract information for the case-closing reports.

2. Greater Breakdown as to the Nature of the Debts

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Academics and representatives of the commercial community have requested that additional information be provided

as to specific types of debts, such as gambling losses, and damages from fire, theft, or flood.

Recommendation

The schedules and statements (especially Official Form 7, Question 8) already require a breakdown of each debt in the requested categories. The present statistical system, however, cannot readily provide this information in electronic form. New electronic systems, though, could provide the information.

3. Reasons Why the Debtor Filed for Bankruptcy

Academics and representatives of the commercial community have asked for additional information as to the reasons the debtor filed a bankruptcy case, such as marital breakup or other personal reasons, or financial conditions, such as debts of a particular nature. The following information has been requested:

Information to establish a profile of the typical debtor

Breakdown on different categories of debt (gambling, etc.)

External events that caused the bankruptcy

Causes and consequences of bankruptcy

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Pre-bankruptcy counseling or debt education of debtors

Recommendation

Eliciting this information generally would require a review of the schedules and statements filed by the debtor. It would also require additional information not presently available in court records. That information might be obtained through interviews with, or questionnaires sent to debtors. Participation by the case trustees and U.S. trustees or bankruptcy administrators would be essential to obtaining the additional information. In some districts, U.S. trustees presently supply some of this information to the courts. Samples and surveys might also be considered. Caution must be exercised, however, because of the privacy interests of debtors.

4. Section 707(b) Motions to Dismiss

Information was requested on the number of motions filed by U.S. trustees to dismiss a case for substantial abuse under 11 U.S.C. 707(b) and the actions flowing from those motions.

Recommendation

The present AO statistical system is based on two reports submitted by the court to the AO—one sent at the time of filing and one at closing. Information about important events occurring during the course of a case, including litigation activity, should generally be reflected on the court's dockets. But this information—with few exceptions—is not currently reported to the AO.

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It would be possible to collect information on specific events, such as the filing or disposition of various categories of motions, but only in a newly-designed, expanded docket/statistical reporting system. The effectiveness of that new system, moreover, would require substantial uniformity among the courts in their docketing practices and terminology.

It is not possible to obtain the information requested in the current statistical system. Serious study must be given to designing new electronic docket/statistical systems and electronic case file systems so that they will provide accurate information to assist in case management, statistical reporting, and financial analysis.

5. Reaffirmation Agreements

Information has been requested on the existence and effect of reaffirmation agreements and whether they have been filed with the court.

Recommendation

Reaffirmation agreements are required to be filed with the court, 11 U.S.C. 524(c), and they should be entered on the courts' dockets as a matter of policy. But it is not certain that these legal and policy requirements are being followed uniformly.

It may be difficult to obtain the requested information from the current statistical reporting system. The possibility of doing so, however, should be explored. The new electronic docket/statistical system and the electronic case file project should be designed to produce this information.

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6. Adversary Proceedings

Requests have been made for information on the number of adversary proceedings, their nature (especially core vs. non-core), multi-count proceedings, jury demands, jury trials, the use of alternative dispute resolution techniques, the duration of proceedings, and the manner of their disposition. Among other things, the information would be of substantial assistance to the Judicial Conference, the courts, and circuit councils in assessing litigation activity and the need for bankruptcy judgeships. In addition, some judges have suggested that better statistics should be kept on the time spent by judges in the courtroom.

Recommendation

Adversary proceedings are akin to civil cases filed in the district courts. They are instituted by the filing of a complaint with the court; they entail payment of the filing fee in the same amount as for a civil action in the district court; and the Federal Rules of Civil Procedure are generally applicable to them. See Fed.R.Bankr.P. 7001.

The AO currently collects basic information regarding the number, nature, duration, and disposition of adversary proceedings. Additional information on tracking specific events occurring within adversary proceedings cannot readily be obtained under the current statistical reporting system.

If appropriate revisions can be made to the current statistical reporting system, information on the handling and disposition of adversary proceedings should be gathered. With new court electronic systems, and with greater uniformity in court docketing practices and terminology, substantial additional information could be obtained.

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7. Contested Matters

Requests have been made for information on the nature of contested matters, the number of contested matters filed, and how long it takes to decide them. Among other things, the information would be of substantial assistance to the Judicial Conference, the courts, and circuit councils in assessing litigation activity and the need for bankruptcy judgeships.

Recommendation

The distinction between adversary proceedings and contested matters derives from Fed.R.Bankr.P. 7001. Certain contested matters are as important and as complex as adversary proceedings. Rule 9014, moreover, permits the court effectively to convert a contested matter into an adversary proceeding. In particular, claims litigation has been cited by court commentators as inadequately reflected in current court caseload statistics.

The present statistical system does not report contested matters separately, but the possibility of revising the system to capture this information should be explored. The judiciary's new electronic docket systems and the electronic case file project should be designed to provide the requested information.

8. The Operation and "Success" of Chapter 11 Cases

Judges have requested additional information on the handling and disposition of chapter 11 cases to aid them in case management and to provide them with insight into the likelihood of confirmation and consummation of plans.

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Commercial interests have expressed a great deal of interest in information on the "success" of chapter 11 cases, i.e., information that will demonstrate how well the chapter is working generally and how it works for different categories of businesses and industries. Key to any analysis of chapter 11 cases would be a more refined breakdown of the types of cases, especially if SIC codes can be used and there is accurate information as to asset and liability amounts.

Regarding the outcomes of chapter 11 cases, the following non-financial items were requested:

Post-confirmation reports

Number of cases where the business is sold

Success rate of business entities in bankruptcy

"Small business" cases

Related cases and subsidiaries

Who files the plans?

Confirmation rates of plans

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Time from filing to confirmation

Consummation of plans

Information on the largest cases

Number of cases with creditor committees

Better breakdown on the reason for dismissals

Whether the case is prepackaged or prenegotiated

Number and dates of extensions of exclusivity

Trustee appointments and elections

Examiner appointments

Recommendation

The present statistical reporting system cannot readily provide the information requested. But new electronic docket/statistical and electronic case file systems could retrieve the information, at least information on events occurring up to the time that a chapter 11 plan is confirmed.

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Even under a new system, however, it would be difficult for a court to track a chapter 11 case after a plan has been confirmed. Relevant information on consummation is not generally provided to the court unless it happens to give rise to specific litigation.

Through sampling, some additional information could be provided, especially in large chapter 11 cases. It might be feasible, for example, for the clerks' offices to provide computer diskettes to the debtors' attorneys in certain chapter 11 cases, setting forth, for example, questions like those suggested by Stephen Case, legal advisor to the National Bankruptcy Review Commission. The answers could be entered by the attorneys for proponents of plans, and the diskettes could be submitted to a central source, such as the AO. In this manner, relevant data could be collected on important commercial cases. But the cost of this additional statistical-gathering process would have to be calculated, and the attorneys might be entitled to additional compensation for the time they spend in answering the questions.

9. Chapter 12 and 13 Cases

Chapter 12 and chapter 13 cases involve a court-approved plan to pay some or all of the debtor's debts over a period of time with the professional assistance of a standing trustee. Interest has been expressed in capturing certain key dates and events in chapter 12 and chapter 13 cases to give a better picture of the success or failure of these cases. Following are the non-financial data elements that would be needed:

Date that a plan was confirmed

Date of conversion

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Length of approved plan

Date and number of plan modifications

Wage attachment orders entered (chapter 13 only)

Hardship discharges

Debts paid outside the plan

Costs of administration

Pre-confirmation disbursements

Percentages paid to creditors under plan

Recommendation

The information is not readily available in the courts' present statistical systems, but it could be provided through new electronic docket in and case file systems.

Most of the information requested is currently available in the records of the standing trustees. Most trustees maintain the information in electronic format. Thus, it should be possible to build a system to have the trustees report the requested information electronically in standard format to the courts and the U.S. trustees.

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10. Disposition of Cases

Court and non-court commentators asked for additional information as to the disposition of cases, especially chapter 11 cases. Several wanted information regarding the implementation of confirmed plans and other activities following confirmation.

Recommendation

The AO currently collects information on the disposition of all bankruptcy cases, including discharges granted, denied, waived or revoked, petitions dismissed, and cases transferred to other districts.

Some additional information could be obtained if the present case-closing forms were expanded, but this could impose additional burdens on the clerks' offices. It would be cheaper and more accurate to obtain key data as by-products of the docketing process. The present statistical systems cannot readily obtain the information requested, but new electronic systems could.

Standardization of the individual courts' docketing practices and use of terminology would be required if the judiciary decided to collect further information. That kind of information could be captured in new electronic systems.

11. Appeals

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Commentators asked for information about bankruptcy appeals, including whether the appeals are in fact prosecuted by the appellants. It was also requested that the AO track each appeal from a bankruptcy court to the district court, to a bankruptcy appellate panel, to the court of appeals, and even to the Supreme Court.

Several court commentators pointed to the need to keep track of the frequency of bankruptcy appeals to the district courts and how long it takes the district courts to dispose of them.

Information was also requested on withdrawals of references requested by parties and granted by the district courts.

Recommendation

The BANCAP and NIBS systems should be modified to capture a case code that will carry over to the district and appellate court electronic docketing systems. Further refinement of the recommendation will occur during the study of the district and appellate court case statistics.

New electronic docket and electronic case file systems should include the capability of tracking each individual case on appeal. In the interim, a reporting method should be devised to capture information on bankruptcy appeals to the

district courts, possibly using a report on cases and motions under advisement.

12. Professional Fees

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Information has been requested as to the number, type, and amount of fee applications submitted to the court for approval, as well as the court's actions in approving or rejecting the applications. Specific requests for fee data include the dollar amounts of fees requested and awarded, sorted by type of professional, chapter, and size of case.

Recommendation

At present the BANCAP and NIBS systems capture the aggregated amount of professional fees awarded to trustees, professionals retained by trustees, and examiners. *See also* Fed.R.Bankr.P. 2013.

The United States trustees are called upon by statute to review, comment on, and adopt guidelines for professional fees. See 11 U.S.C. 586(a)(3). If more detailed information on fees is needed by entities outside the judiciary, it might be possible to collect it elsewhere, such as through the U.S. trustees. With the advent of an electronic case file system in the judiciary, it should become possible to track both requests and awards of all professional fees.

13. Distributions to Creditors

The AO currently collects summary financial data on distributions made to secured, priority, equity, and unsecured creditors in chapter 7 and chapter 13 cases. The great majority of these cases are "no-asset" consumer cases.

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Commentators also requested the following additional information:

Distributions to trade creditors in operating chapter 7 and chapter 11 cases

Separate statistics for individual creditors versus classes of creditors

Payments made to unsecured creditors compared to the amount of claims allowed

Payments to creditors in chapter 11 cases

Class of claims being paid (priority, secured, unsecured, etc.)

Payments by type of claimant (government, environmental, etc.)

Success of payout plans in chapter 13 cases

Information on chapter 13 debtors that would help determine who is more likely to repay and should be extended new credit

Recommendation

The case trustee, supervised by the U.S. trustee or bankruptcy administrator, is responsible for determining distributions made to creditors. Unless there is particular litigation activity, the court is not generally involved in distributions to creditors.

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The courts presently extract case-closing financial information from the reports and accounts submitted by the trustees and attorneys for debtors-in-possession. But many distributions are not in cash and may involve securities or other property of uncertain valuation. It may never be possible to place an accurate value on these non-cash distributions.

A uniform reporting system for the trustees should be devised, capturing the information needed in standard format for electronic transmission.

14. Information to Detect Fraud

Commentators pointed out that the collection and reporting of certain types of financial information might help the U.S. trustees and bankruptcy administrators identify instances of potential fraud by debtors, professionals, and trustees.

Recommendation

The type of information needed for detection of fraud needs to be defined further. That would appear to be the task of the U.S. trustees and bankruptcy administrators, who are statutorily responsible for supervision of debtors, trustees, and estates.

The judiciary should participate and cooperate in efforts to explore this issue.

15. Information for Administrative Purposes

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Requests have been made for information to assist the courts in operational matters, such as courtroom utilization, court reporting, and the use of interpreters.

Recommendation

Some of the information is available now in paper form, but more complete information would depend on the development of new electronic reporting systems.

16. Information on Visiting Judges and Retired Judges

Court commentators cited the need for more detailed information on the judicial activity conducted by judges in districts other than their own and by retired bankruptcy judges. The information would be very helpful in justifying judgeships and allocating resources.

Recommendation

Efforts should begin immediately to capture information on the services performed by visiting judges and retired judges.

VI. NEXT STEPS

To implement the above recommendations, concerted effort will be needed on a variety of fronts. Discrete projects need to be assigned and working groups appointed to address specific issues and work on details.

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The working groups should assist the Administrative Office in designating the specific data elements needed to produce the information that the judiciary and others require. These elements should be prioritized and built into the

requirements for the judiciary's new electronic docketing systems and the electronic case files project.

Liaisons should be established with trustee organizations and others to work on identifying specific data elements, designing forms and reports, and suggesting electronic reporting procedures. It is essential to maintain the spirit of cooperation developed between the judiciary and the U.S. trustees as a result of this project. The Executive Office for U.S. Trustees participated actively in the meeting on March 3 and 4, 1997, and in the statistical audit of two bankruptcy courts in California. Similarly, representatives of the judiciary played an active role at a meeting on bankruptcy statistics sponsored by the Executive Office for U.S. Trustees on April 25, 1977. A good working relationship has been initiated between the two groups which must be maintained in order to achieve many of the results recommended in this report. In particular, coordination will be needed in the development of future electronic record-keeping systems. The bankruptcy administrators must also be an integral part of these developments.

It would be appropriate for the Bankruptcy Committee of the Judicial Conference, as the primary program committee for the bankruptcy system, to establish a subcommittee to work with the AO and the courts on this bankruptcy data project and provide direction and policy guidance. It is anticipated that come recommendations could be presented to the Bankruptcy Committee and the Judicial Resources Committee for appropriate aciton at their Winter 1997 meetings.

Revised May 14, 1997

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Table 1

Table 2

Business Bankruptcy Reform Coalition,
Alexandria, VA, March 27, 1998.

Hon. **GEORGE W. GEKAS,** *Chairman,*
Subcommittee on Commercial and Administrative Law,
Committee on the Judiciary,
House of Representatives, Washington, DC.

DEAR CHAIRMAN GEKAS: On behalf of the Business Bankruptcy Reform Coalition, I am pleased to submit the following Statement for the Record of your Subcommittee's recent hearings on bankruptcy reform.

Respectfully,

Philip J. Brandl, *President,*
National Housewares Manufacturers Association
Chairman, Business Bankruptcy Reform Coalition

BUSINESS BANKRUPTCY REFORM COALITION

STATEMENT FOR THE RECORD OF PHILIP J. BRANDL

I am chairman of the Business Bankruptcy Coalition, a group consisting of trade organizations representing thousands of US manufacturers and suppliers of commercial goods nationwide. Most of our members are small and mid-sized privately owned companies. I appreciate this opportunity to submit this statement to the Subcommittee in support of US bankruptcy law reforms to promote the extension of commercial trade credit by manufacturers and

suppliers.

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Promoting Commercial Trade Credit

Every day thousands of companies sell goods to other businesses on credit. Typically, the buyer agrees to pay the seller for the goods within 10, 15, 30, 60 or more days after receipt of the goods. This commercial trade credit is the grease that keeps our economy moving. Trade credit amounts to hundreds of billions of dollars every year—more than bank loans and other formal types of credit. Our system of commercial trade credit works well most of the time. Buyers pay for the goods received as promised and the sellers continue to produce and ship new goods with the proceeds.

Because of the critical importance of commercial trade credit, state commercial law and federal bankruptcy law have historically attempted to protect sellers of goods. Under current law, a seller of goods that extends commercial trade credit is supposed to be able to protect itself in two ways if the buyer goes bankrupt and fails to pay for the goods.

1. The seller can obtain a security interest in the goods. If the buyer goes bankrupt, the seller has the first claim against the proceeds from the sale of the goods.

2. The seller has a right of "reclamation"—to reclaim (i.e., take back) the goods that were shipped.

Unfortunately, state and federal laws that were intended to promote commercial trade credit by protecting sellers of goods are not working.

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Obtaining A Security Interest Is Cumbersome, Costly And Impracticable

Under state law, in order to get a security interest in goods shipped, the seller must prepare a formal notice (called a financing statement) and file it with the official of records in the location where the goods are to be located. For businesses that sell goods to different companies located all across the country, or to a single company that has many places of business, preparing the financing statement and making sure that it is filed in all the places where the goods are delivered for sale is cumbersome and impracticable.

Further, in today's environment of "just-in-time" manufacturing and distribution practices, the current procedures for obtaining security interests by preparing and filing financing statements is time consuming and can delay the shipment of goods that are needed immediately by customers.

For small and mid-sized businesses that sell goods in relatively small shipments or sell goods that are relatively inexpensive, the costs of preparing and filing financing statements is prohibitive. This system makes no sense considering that the vast majority of goods are shipped and resold to customers on a day-today basis.

"Reclamation" Rights Create a Trap for Commercial Trade Creditors

Under the Federal Bankruptcy Code, a seller can reclaim goods sold in the ordinary course of business to a company that was insolvent when the goods were received.

The seller must exercise the right to reclaim the goods in writing.

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The seller must submit the claim within 10 days after the buyer received the goods or within 20 days if the buyer declares bankruptcy within 10 days after receiving the goods.

Requiring a written demand for reclamation within a short period of time creates a trap, especially for small and mid-sized companies. Businesses filing for bankruptcy are not required to notify their suppliers of such actions. In many instances manufacturers and wholesalers are not aware of the bankruptcy filing, and even when they become aware of such actions, they don't have the in-house legal expertise to comply with these procedures in a timely manner.

Apart from a seller's written request for reclamation, a bankruptcy court in a business reorganization under Chapter 11 may, if requested by a bankruptcy trustee, order the return of goods shipped to the buyer before the bankruptcy if the court determines that returning the goods is in the best interest of the bankrupt estate. Relying on the discretion of a trustee to request reclamation and a court's determination that resuming the goods is in the best interest of the bankrupt estate provides an uncertain and unreliable right of reclamation for the suppliers of goods.

The Protections of Commercial Trade Credit under Current Law Are Being Undermined

Businesses that sell goods on trade credit cannot protect themselves under current law. As a condition to making a loan, banks will often require that the borrower give the bank a security interest not only in goods that are owned and paid for at the time of the loan, but also any goods acquired after the loan is made. As a result, even though a business selling goods is extending commercial trade credit to enable the buyer to purchase the goods, a bank that does not extend the credit to buy the goods is able to get a security interest in those goods. The bank's security interest in the goods defeats a seller's right of reclamation in bankruptcy.

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In most instances, sellers' efforts to exercise their rights to obtain a security interest in goods sold on commercial trade credit are stymied by standard bank loan agreements that enable the bank to terminate the loan if a security interest is given to the suppliers of goods.

Commercial Trade Credit Deserves Better Protection

Businesses that extend commercial trade credit are losing millions of dollars a year as the result of bankruptcies. These losses can ruin small and mid-sized companies who depend on the payment of goods for their survival. The risk of losses due to bankruptcy can cause businesses to reduce or eliminate shipments of goods to solvent customers who may be facing financial difficulties.. As a result, the shipment of goods on credit that could have saved a financially troubled company is not made, thereby, lessening the likelihood it will emerge from bankruptcy.

Providing sellers with a simple and straightforward right to reclaim goods that have not been paid for will protect the flow of commercial trade credit. *The federal bankruptcy code should be reformed to give sellers who extend commercial trade credit the right to take back goods that have not been paid for and were shipped within 90 days of a bankruptcy. In order to simplify the process, the current requirement of filing a formal notice within 10 days should be eliminated.* Sellers who have not been paid for goods shipped are presumed to want the goods returned when the buyer goes bankrupt. Sellers who don't want to reclaim the goods can waive their right of reclamation.

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If the goods have been sold, the seller should be entitled to obtain the proceeds from the sale in lieu of a return of the goods. Sellers of goods on commercial trade credit are entitled to return of the goods or payment of the proceeds first before banks that have not extended any credit to pay for those goods. If banks extend credit to pay for the goods, the right of reclamation is automatically eliminated once the seller is paid.

The changes put forth will not harm secured lenders because they are in the best position to protect their security

interests. Indeed, the proposal gives incentives to banks to make sure that borrowers use the proceeds of the loans to pay for goods purchased. Once the seller is paid, the after-acquired property rights of banks is protected.

Finally, these reforms would decrease the number of bankruptcies by making credit more available before the bankruptcy occurs. Currently, when a retail establishment is known to be in financial trouble, suppliers and manufacturers stop shipping goods, leading to the firm's further deterioration. If suppliers and manufacturers could be sure of receiving a priority over secured lenders or bankruptcy lawyers, suppliers would likely continue to ship goods, reducing the need for bankruptcy proceedings in the first place.

I respectfully request that members of the subcommittee reform the bankruptcy laws to protect and promote the extension of commercial trade credit that is vital to our economy. Manufacturers and suppliers that ship goads on credit should have a clear, simple and straight-forward right in a bankruptcy proceedings to reclaim goods that have not been paid for. Since they extended the credit to enable the debtor to obtain the goods, they should be able to get the goods back in the event of a bankruptcy. On behalf of the thousands of members of Business Bankruptcy Reform Coalition, we look forward to working with this subcommittee to make our bankruptcy laws workable for hard-working manufacturers and suppliers across America who provide commercial trade credit.

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National Conference of
Bankruptcy Judges,
April 2, 1998.

Hon. **JERROLD NADLER,**
House of Representatives, Washington, DC.

Re: Bankruptcy Reform

DEAR MR. NADLER: The National Conference of Bankruptcy Judges was founded in 1926. Since its founding, the National Conference of Bankruptcy Judges has been a resource for Congress in the drafting of bankruptcy legislation. Of the 326 bankruptcy judges in the nation, 319 are members of the organization.

The National Conference of Bankruptcy Judges does not support or oppose any particular legislation. The National Conference of Bankruptcy Judges, however, does urge Congress to carefully consider the pending proposals to reform the Bankruptcy Code. The changes in the bankruptcy law being considered by Congress are fundamental changes that are extremely complex and have far-reaching effects. The fast-paced approach to this major legislation concerns the National Conference of Bankruptcy Judges. A number of bills that propose major changes to the consumer provisions of the Bankruptcy Code are being considered. There have been relatively few hearings on these bills. In contrast, Congress took over ten years to study and consider the bankruptcy law before enacting a revision of the bankruptcy law in 1978.

The National Conference of Bankruptcy Judges is also concerned about the testimony presented at the relatively few hearings that have been held. Given the time to study and consider the various changes being considered by Congress, the member judges of the National Conference of Bankruptcy Judges would be a valuable resource to Congress in its deliberations.

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Arguably, only the tax code and the Social Security laws affect more Americans than does bankruptcy law. It is very likely that some of the changes being considered by Congress would cause consumers, both within and outside the bankruptcy system, to be unable to pay such basic obligations as mortgages, alimony, child support, and student loans. It is possible that these changes might adversely impact upon the nation's economy.

In conclusion, the National Conference of Bankruptcy Judges believes that the current fast-paced debate is cause for concern. Fundamental changes in the bankruptcy law surely require thorough consideration. The National Conference of Bankruptcy Judges stands ready to help Congress in a deliberate approach to this major legislation.

Very truly yours,

Robert F. Hershner, Jr., *President.*

STATEMENT OF THE AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS SUBMITTED TO THE SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW HOUSE OF REPRESENTATIVES COMMITTEE ON THE JUDICIARY

This statement is submitted on behalf of the American Federation of Labor and Congress of Industrial Organizations, representing over 13 million working men and women and their unions. We would like to thank the Subcommittee for the opportunity to present our views on the important subject of bankruptcy reform.

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A sound economic policy must include an effective, efficient, fair and balanced system that helps individuals in financial trouble and allows failing businesses to reorganize and save jobs. Congress is now considering a broad array of changes to the current law in both consumer and business bankruptcy cases. Some of these changes raise important policy questions concerning the role of bankruptcy in the lives of individuals and their families, both as consumers in times of financial stress and as employees of economically distressed businesses. As an organization committed to improving the economic lives of working people and their families, the AFL–CIO supports bankruptcy law reforms that help the system work effectively for consumers in need of financial relief and ensures that workers in financially troubled businesses are protected.

Our statement addresses proposed revisions to the consumer bankruptcy law[1\] that, in our view, unfairly prejudice consumer debtors legitimately in need of assistance and burden the system with unnecessary litigation and administrative complications. Second, we address business bankruptcy amendments proposed in H.R. 3150 that the AFL–CIO believes are likely to place jobs at risk and hamper cost-effective business reorganization. Finally, we suggest reforms that would enhance employee interests in business bankruptcy cases and which we urge Congress to include in bankruptcy reform legislation this year.

CONSUMER BANKRUPTCY

In different ways and degrees, S.1301, H.R. 2500 and H.R. 3150 propose significant changes in the consumer bankruptcy laws designed to limit access to the system. These bills have been proposed in response to sharp increases in the number of consumer bankruptcy filings reported over the past two years. Each of the bills proposes to restrict bankruptcy filings by introducing different forms of means testing into consumer bankruptcy law and by imposing new restrictions on repeat bankruptcy filings. Although they include some features that would benefit consumer debtors, on the whole, these bills promote overbroad, excessive measures that go beyond demonstrated abuse of the system. If enacted, these amendments would prevent those truly in need from obtaining effective relief, unduly burden the administration of consumer bankruptcy cases, and raise the cost of the consumer bankruptcy system for all parties: debtors, creditors and taxpayers.

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The AFL–CIO shares Congress' concern over the rate of consumer filings. The statistics are particularly troubling because they expose distressingly high levels of household debt and reveal personal misfortunes seemingly at odds with a thriving economy. We believe that the rise in consumer bankruptcies cannot be explained or addressed by focusing only on the Bankruptcy Code. Congress should develop an integrated response to the problems associated with the mass accumulation of debt, one that addresses questionable lending practices as well as the application of the

bankruptcy laws.

In S. 1301, H.R. 2500 and H.R. 3150, Congress proposes to curb the rise in consumer bankruptcies and increase payments to creditors by introducing controversial needs-based tests, either through changes to Section 707(b), as proposed in S. 1301, or through "jurisdictional" exclusions to Chapter 7, as proposed in H.R. 2500 and H.R. 3150. Blanket means tests such as those proposed in these bills are premised on the notion that the system is supporting a large number of debtors who file for bankruptcy "casually" and not because of genuine financial distress. Well-publicized cases of abuse[2\] have sparked concern that bankruptcy has become a popular financial planning device for the wealthy.

Academic research has shown that the vast majority of consumers who file bankruptcy cases are truly in need of financial relief They are overloaded with debt in proportion to their incomes, they file bankruptcy cases because of catastrophic events in their lives such as job loss, divorce and unexpected medical bills; they have very low incomes by national standards—including many at or below poverty level.[3\] Data compiled by Professor Elizabeth Warren of Harvard Law School shows that the median family income of Chapter 7 consumer debtors has fallen in constant 1997 dollars from $23,254 in 1981 to $17,652 in 1997. By comparison the median income of all families in 1997 was $42,769.[4\] Professor Warren concludes that the data suggests that the cause of increased filings is a growing number of low income debtors, rather than growing abuse or a decline in the stigma of bankruptcy.[5\]

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One study funded by the credit industry and cited in support of means testing, the Georgetown Credit Research Center study, seemed to suggest that a sizable portion of Chapter 7 filers could actually pay their bills. But that study has now been criticized in a recent report by the General Accounting Office.[6\] The GAO Report casts serious doubt on the proposition that many people who are filing bankruptcy cases can actually afford to pay enough of their debts to justify imposing means testing rules on all debtors in the system.

Even though independent research has shown that most debtors who use the system are truly needy, many are still puzzled by rising consumer bankruptcies in a period of proclaimed economic strength. But closer examination reveals that this phenomenon is not so surprising. Job growth and economic expansion are not always indicators of financial well-being or security. Research shows that workers have suffered a long period of wage stagnation. Except for those in the top income levels, real wages actually declined between 1989 and 1995. According to studies by the Economic Policy Institute,[7\] hourly wages of the typical male worker dropped 6.3% during this period. For female workers, hourly wages fell 1.7% at the median during this period.[8\] The wage stagnation trend has gone "upscale," affecting more higher-wage, white-collar jobs.[9\] Moreover, according to EPI analyses, the gap between the top income level and those at the bottom widened considerably during the 1980's and net wealth holdings of middle-income families fell by some 14% between 1984 and 1993.[10]

Analysis also shows that the rate of job loss is higher in the 1990's than in the 1980's. As the EPI has also reported, "[t]he costs of insecurity and job loss are high. On average, workers who reported losing a job in the previous three years made 15% less at their current job (if they found one) than at the job from which they were laid off." [11] In addition to wage stagnation and insecurity, benefits that cushion financial catastrophe such as health care coverage have also declined. According to the Bureau of Labor Statistics 1995 Employer Benefit Survey, the number of full-time employees with medical coverage declined from 83% in 1993 to 77% in 1995.[12]

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Data collected in the 1980's showed that over half of those consumers filing under Chapter 7 had suffered job interruption during the two years prior to their filing.[13] While current data on this question has not yet been published, it is our understanding that it will confirm that this pattern has not changed in the intervening years.

Throughout the last thirty five years, consumer Chapter 7 filings have been almost perfectly correlated with consumer debt-to-income ratios.[14] Considering the dramatic increase in household debt over the past decade and the growth of the consumer lending industry, the rise in personal bankruptcies becomes a better understood consequence of these economic trends. Studies have documented that debt levels, particularly among households earning less than $50,000 per year, increased through the 1980's and into the l990's.[15] In 1997, the growth in household debt exceeded the growth in disposable income, according to the Federal Reserve.[16]

In addition, the growth in home equity lending has added another readily available source of credit that precariously places people's homes at risk.[17] In addition, seeking to expand their markets, lenders have sought out riskier borrowers with poor credit histories and now offer home equity financing at loan-to-value ratios exceeding 100%, charging high rates to offset the greater risk. Another lending practice targets low income neighborhoods with "serial" refinancing loans which carry high interest rates and other onerous terms.[18]

What becomes clear when these trends are viewed closely and in combination is that the phenomenon of rising consumer bankruptcy filings is likely to be related to the proliferation of poverty-level jobs and usuriously priced consumer credit marketed to the working poor. This is a far more likely explanation than unsupported assertions of widespread casual consumer bankruptcy filers, or a loss of the "stigma" associated with debt. Those who are filing bankruptcy cases today are most likely suffering from the same financial difficulties plagued by the same debt problems as those that research has demonstrated comprise the vast majority of consumer bankruptcy filers in the past.

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In sum, there is a crisis in working families' standard of living and general economic security. As to whether there is a distinct crisis in the consumer bankruptcy system, driven by abuse or moral decline, Professor Warren is correct when she concludes that

"the system is not in crisis; the evidence points toward a consistent use over time of consumer bankruptcy by the same kinds of families families in financial trouble. Despite the credit industry's repeated efforts, no credible evidence to the contrary exists.[19]

H.R. 3150 and H.R. 2500 would impose excessive and administratively burdensome means tests on consumer debtors. These tests would be complicated to implement and make unrealistic assumptions about the repayment capabilities of the consumer debtor population. Imposing administratively complex rules such as those proposed in these bills would significantly interfere with the system's ability to provide effective and efficient relief Nor are creditors likely to see an increase in repayments. The failure rate among Chapter 13 repayment plans is already high [20] for reasons that are not yet fully understood. Forcing more people into Chapter 13 under these circumstances will not improve the success rate or guarantee greater recoveries for creditors. Documented cases of abuse, such as wealthy individuals who protect their assets in exempt property, can be addressed through more specific changes in the law that will not overburden the system and prevent those legitimately in need from obtaining necessary relief Indeed, implementing restrictions of the kind proposed in H.R. 3150 and H.R. 2500 may have the undesirable effect of discouraging lenders from remedying their most questionable practices.[21]

Moreover, "abuse" or "inappropriate use" of Chapter 7 can be identified through the existing mechanism of Section 707(b). Courts have interpreted "substantial abuse" within the meaning of Section 707(b) to include circumstances where debtors can pay all or most of their debts. Another bill recently introduced in the House, H.R. 3146,[22] amends Section 707(b) by incorporating criteria more consistent with current case law and is more likely to expose those clearly able to pay their debts than either the blanket means tests proposed in H.R. 2500 and H.R. 3150, or the new "abuse" standard proposed in S. 1301.

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Finally, the consumer provisions of H.R. 3150, H.R. 2500 and S. 1301 will increase administrative costs and generate more litigation in consumer bankruptcy cases. The means tests create litigation opportunities for creditors that are not effectively deterred by the proposed fee shifting provisions. Repeat filing limits will also increase litigation over the application of the automatic stay.

In sum, debtors and creditors alike are responsible for maintaining the integrity and effectiveness of the consumer bankruptcy system. H.R. 3150, H.R. 2500 and S. 1301 place an inordinate burden on consumer debtors based upon insufficient evidence of abuse and impose administrative burdens that could considerably undermine the operation of the system.

BUSINESS BANKRUPTCY

H.R3150 proposes two significant changes affecting business bankruptcy cases which raise serious concerns about the potential for job loss as a result of a bankruptcy filing. First, proposed amendments to the rules applicable to "single asset real estate" ("SARE") debtors would change the current definition of SARE entities that would be covered by the special "lift stay" rules imposed by Section 362(d)(3). Second, new rules applicable to "small business" cases raise concerns that many business cases would be subject to inflexible rules that could prevent a company from reorganizing.

Single Asset Real Estate Amendments

Under current law, SARE debtors may be subject to an order lifting the automatic stay unless the debtor has either filed a credible reorganization plan within 90 days of the bankruptcy filing or has commenced interest payments on the secured debt. As currently defined, these rules apply to

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real property constituting a single property or project, other than residential property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto

where the entity's total secured debt does not exceed $4 million.[23]

What led to the enactment of these rules in 1994 were bankruptcy filings by single asset real estate properties such as office buildings and apartment complexes seeking to use bankruptcy to avoid mortgage foreclosures and gain leverage with the secured lender. Characteristically, these entities were owned by a corporation or partnership formed for investment or tax advantages; their sole "business" was to own the property and collect rents; they employed few, if any, workers, and the sole creditor was the secured lender. Because the properties had lost rent value, or had become vacant, as a result of the real estate down-turn of the 1 980's, they could not meet their mortgage obligations and were facing default. The lenders were generally undersecured.[24] Policy questions were raised about whether SARE entities should be permitted to use Chapter 11 on the same basis as other businesses because these bankruptcies did not appear to further the same goals as other business bankruptcies: the preservation of jobs and going concern value. Under current law, decisional lines have been drawn to exclude nonreal estate businesses such as a scrap steel plant from the definition of a SARE debtor.[25] However, office buildings are considered SARE debtors even though they may employ some workers, such as a maintenance staff and a building manager.[26]

The commonly held view that SARE debtors such as office buildings and apartment complexes do not employ workers, and therefore do not present job dislocation issues, fails to recognize that SARE entities can still be centers of economic activity even if the debtor's ownership interest is limited to rent collection. Employees working at the site of a SARE may be employed by a management company, or by tenants, rather than directly by the debtor. But a sudden foreclosure, a sale, or an abrupt change in the managing entity can still result in a loss of jobs even though the SARE debtor is not the direct employer. Viewed in this way, even the current SARE rules can place jobs at risk. A narrow focus on the debtor's "business" of collecting rents leads to the erroneous conclusion that job preservation is not

implicated by the SARE rules.

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In H.R. 3150, Congress proposes to make the SARE "fast track" rules available to more entities, thereby increasing the risks of job loss. First, the amendments lift the $4 million cap on the definition of SARE debtors. In addition, changes in the substantive description of SARE entities would add confusion and ambiguity to a definition that even now has not been consistently applied or interpreted.

The amendments proposed in H.R. 3150 are taken from recommendations in the Report of the National Bankruptcy Review Commission,[27] which recommends proposed new rules for SARE entities even as the Commission noted that SARE bankruptcies have declined in number and that the problems associated with these cases (such as undue delay and technical plan of reorganization issues) are now being adequately addressed by the bankruptcy courts and U.S Trustees.[28] As defined in H.R. 3150, single asset real estate means,

undeveloped real property or other real property constituting a single property or project, other than residential real property with fewer than 4 residential units, on which is located a single development or project which property or project generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor, or by a commonly controlled group of entities all of which are concurrently debtors in a case under chapter 11 of this title, other than the business of operating the real property and activities incidental thereto.[29]

The proposed definition is problematic in several respects. First, because there is no aggregate debt limit, projects and properties large and small, of any degree of financial complexity, are swept into the definition. Second, the attempt to avoid "active" businesses by exempting from the definition properties "on which no substantial business is being conducted by a debtor, or by a commonly controlled group of entities all of which are concurrently [Chapter 11] debtors" will not result in the exclusion of enterprises with significant jobs from the SARE rules.

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As explained in the NBRC Report, the proposed definition "is designed to include real estate investors, and to exclude debtors who use real estate in an active business, such as a wholly owned subsidiary that holds a building used as a factory by a parent [company] or a television broadcast tower held in a separate entity owned by the FCC licensee, but only where the parent or the licensee" is also a Chapter 11 debtor.[30] Thus, the separate real estate-holding entity would not be subject to the SARE rules so long as the others in the consolidated corporate group are all in bankruptcy together. The narrow purpose of this exclusion is to avoid situations where all the non-realty debtor entities are on one Chapter 11 track and the real estate entity is in another, and to avoid circumstances where lenders require that certain assets be placed in real estate holding properties in order to gain the advantages of Section 362(d)(3).[31]

The exception does not mean that active businesses are excluded from the SARE definition. It means that where there are other related Chapter 11 entities conducting a non-real estate business, one entity that happens to hold a building is not singled out for SARE treatment. Certainly where that building is a factory, the exception recognizes that job-producing enterprises should not be SARE debtors. Where the special purpose company holds title to a television tower, in all likelihood no jobs are implicated in any event.

A true "active business" exception should not be drawn so narrowly. It should not rely upon ambiguous terms such as whether business activity is "substantial," nor (as the NBRC explanation demonstrates) should it be conditioned on bankruptcy filings by related entities. The proposed rules are too vague and confusing to effectively avoid circumstances where jobs will be placed in jeopardy by fast track rules. Their ambiguity is illustrated by the examples included in the NBRC Report. There, a twenty-three store strip mall owned by the debtor where the debtor operates a small frozen yogurt stand is considered a SARE debtor because the debtor's non-real estate business is not considered "substantial," and a regional shopping mall containing a large chain store owned by a member of the debtor's controlled group is not a SARE because the nonrealty business is "substantial." [32] These examples leave a large definitional gap

which is not further aided by the proposed language.

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Congress has not adequately recognized the job dislocation risks of the current SARE rules. The job preservation goals of Chapter 11 require greater certainty about the kinds of entities that are subject to the current SARE rules before Congress considers expanding their scope. No urgent need to change the SARE rules has been identified. Expanding the application of the SARE provisions without a more thorough review of the employment issues, and absent better rules for protecting jobs, is certain to undermine one of the most basic goals of Chapter 11.

Small Business Amendments

The AFL–CIO has similar concerns about the proposed amendments to be applied to "small business" cases bankruptcy cases. The Bankruptcy Code already contains several provisions designed to simplify less complex cases. These are applicable to debtors with total noncontingent liquidated debt not exceeding $2 million. The proposals contained in H.R. 3150 raise the debt limit for "small business" cases to $5 million and add a series of mandatory, inflexible administrative and substantive requirements to these bankruptcy cases. At the $5 million level, many business cases in a given district would be affected by these rules. Mandatory rules such as those proposed in the amendments should not so burden a troubled company that it is driven to liquidation when, given more flexibility, a reorganization can be accomplished. The potentially broad reach of these provisions and the manner in which they restrict the workings of a bankruptcy case for these businesses will likely place numerous jobs at risk. Given the importance of small businesses to local economies, Congress should proceed with caution in enacting rules which could force these businesses to close and, as a consequence, adversely affect the employees, local suppliers and other businesses, and local tax revenues.

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Section 724(b) Amendments

Finally, H.R. 3150 would amend Section 724(b) to change the payment priority where proceeds of property subject to a tax lien are distributed. The amendment is drafted to preserve the relative position of the wage priority claims under Section 507(a)(3) and Section 507(a)(4) ahead of the tax liens, and in that respect follows current law favoring the payment of priority wages and benefits in Chapter 7 cases. The AFL–CIO supports and appreciates this provision of the proposed amendment. Further clarification is needed in proposed sections 724(e) and (f), however. These provisions would require the Trustee to recover from other secured creditors "reasonable, necessary costs and expenses" of preserving the property "in a manner consistent with section 506(c)" prior to invading the tax lien. Absent further statutory changes regarding the secured creditor's obligation for wages and benefits under section 506(c), employees may find themselves caught between the taxing authority and other secured creditors in attempting to obtain payment. If secured creditors are to be charged for some or all of the wage priority payments under these circumstances, then statutory language should clearly delineate the mechanics of this obligation so that unnecessary litigation can be avoided.

Other Reforms

Employees are directly and profoundly affected when their employers file bankruptcy cases. As Congress considers legislation to reform the business bankruptcy laws, the impact of proposed changes on the employees of companies in financial distress should be a prominent consideration in light of the recognized goal of Chapter 11 to preserve jobs.

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The Report of the National Bankruptcy Review Commission includes proposals that directly address employee concerns. One recommendation would free up employee payroll deduction monies trapped in company bank accounts by a bankruptcy filing. This recommendation would exclude monies such as an employee's Section 401 (k) plan

contributions, credit union payments and union dues, from the debtor's estate and allow payment to the intended third-party recipients.[33]

Another Commission recommendation would improve the ability of employee representatives to participate in Chapter 11 cases through greater disclosure of employee claims on bankruptcy petitions, explicit encouragement of employee creditors committees and better written policy guidelines for the United States Trustee when forming creditors committees. We urge Congress to endorse these proposed changes as well.

In addition, Congress should work with organized labor and other interested parties to draft rules that protect collective bargaining agreements in Chapter 9 municipality cases. Improving labor-management relations and encouraging collective bargaining led to the enactment of Section 1113 in 1994. These important and nationally recognized goals are equally important to bankruptcy reorganizations in the public sector. Reform in this area is long overdue.

The AFL–CIO looks forward to a continuing dialogue on these and other matters of concern as bankruptcy legislation moves forward.

ENDNOTES:

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1\ S.1301, 105th Cong. 1st session (1997) (Introduced October 21, 1997 by Senators Grassley and Durbin); H.R. 250O, 105th Cong. 1st session (1997) (Introduced September 18, 1997 by Reps. McCollum and Boucher); H.R. 315O, 105th Cong. 2nd session (1998) (Introduced February 3, 1998 by Rep. Gekas).

2\ See e.g., Morrow, "The Key to a Cozy Bankruptcy: Location," The New York Times, Al (January 7, 1998) (describing, among other cases, physicians who place their assets in exempt residential property and fail to carry malpractice insurance).

3\ See Sullivan, et al., "Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankruptcy 1981–1993," 68 Am. Bankr. L.J. 121 (1994).

4\ Data to be published in Elizabeth Warren, "The Bankruptcy Crisis", Indiana Law Journal (forthcoming Spring 1998).

5\ *Id.*

6\ "Personal Bankruptcy, The Credit Research Center Report on Debtors' Ability to Pay." United States General Accounting Office, Report to Congressional Requesters (February, 1998).

7\ "The State of Working America 1996–97," Washington, D.C.: Economic Policy Institute, 1996) (Executive Summary).

8\ One preliminary study of recent bankruptcy filings in Nebraska has shown that women comprised 32% of the individual bankruptcy filers in 1996–1997, surpassing individual filings by males of 27%, and that filings by women had increased over time. Pollack, "Gender and Bankruptcy: An Empirical Analysis of Evolving Trends in Chapter 7 and Chapter 13 Bankruptcy Filings 1967–1997," 102 Commercial Law Journal 333 (Fall 1997). Although not addressed by this study, the findings raise issues of continued pay inequities and other adverse conditions affecting women in the workforce .

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[9]\ "The State of Working American 1996–97," (Washington D.C.: Economic Policy Institute, 1996) (Executive Summary).

[10] *Id.*

[11] *Id.*

[12] 1995 Employer Benefits Survey, released July 25, 1997, reported in BRA Health Care Policy Report, Vol. 5 (August 4, 1997), p. 1234.

[13] Teresa A. Sullivan, Elizabeth Warren and Jay Lawrence Washington, As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America 98 (1989).

[14] Kim Kowalewski, Congressional Budget Office.

[15] Mark Zandi, "Easy Credit, Profligate Borrowing, Tough Lessons," Regional Financial Review (January, 1997).

[16] Monetary Policy Report to Congress, 83 Fed. Reserve Bull. 1, 19 (March 1, 1997). See also "Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances." Federal Reserve Bulletin (January, 1997).

[17] Nussbaum, "Lenders Laud the Value of Home Sweet Equity," The New York Times, Section 3, p. 10 (March 22, 1998).

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[18] Nussbaum, "Lenders Laud the Value of Home Sweet Equity," The New York Times, Section 3, p. 10 (March 22, 1998); Stevenson, "How Serial Refinancings Can Rob Equity," The New York Times, Section 3, p. 10 (March 22, 1998). See also Forrester, "Mortgaging the American Dream: A critical Evaluation of the Federal Government's Promotion of Home Equity Financing," 60 Tulane L. Rev. 373 (1994).

[19] Warren, "The Bankruptcy Crisis"

[20] "Bankruptcy: The Next Twenty Years," Report of the National Bankruptcy Review Commission, Vol. 1, pp. 273–76 (October 20, 1997).

[21] Mark Zandi, "Easy Credit, Profligate Borrowing, Tough Lessons," Regional Financial Review (January, 1997).

[22] H.R. 3146, 105th Cong. 2nd session (1948) (Introduced February 3, 1998 by Rep. Nadler).

[23] 11 U.S.C. 101(51B).

[24] See, Note, "The National Bankruptcy Review Commission Proposal for Single Asset Real Estate Debtors", 5 Amer. Bankr. Inst. L.R. 531, 532–36 (Winter 1997).

[25] *In re Maver Pollock Steel Corp.*, 174 B.R. 414 (Bankr. E.D. PA. 1994).

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[26]

In re Dollar Associates, 172 B.R. 945, 951 (Bankr. N.D. Cal. 1994).

[27] "Bankruptcy: The Next Twenty Years", Report of the National Bankruptcy Review Commission, Vol. 1, pp. 661–706 (October 2O, 1997) (hereafter, "NBRC, Vol. 1, p. **XX**").

[28] NBRC, Vol. 1, p. 662.

[29] The NBRC definition is almost identical. The phrase "all of which are concurrently debtors" instead reads "substantially all."

[30] NBRC Report, Vol. 1, p. 668.

[31] *Id.*

[32] *Id.*, p. 669.

[33] This recommendation takes on particular significance after the decision of the Seventh Circuit Court of Appeals in *In re Milwaukee Cheese of Wisconsin. Inc.*, 112 F.3d 845 (7th Cir. 1997). There, the court held that 'thrift savings plan" monies held by the employer and repaid to employees prior to the company's bankruptcy filing had to be turned back to the estate—with some 12 years' worth of accrued interest.

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LaFollette Sinykin,
Law Offices,
Madison, WI, March 30, 1998.

Hon. **GEORGE W. GEKAS,** *Chairman,*
Subcommittee on Commercial and Administrative Law,
Committee on the Judiciary,
House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Subcommittee's hearing on March 19, 1998 addressed single asset real estate issues, and several statements apparently were made there about the position of the National Bankruptcy Review Commission. To ensure there is no uncertainty on this matter, I am writing in response to a question asked by Congressman Marty Meehan on the single asset real estate proposals submitted by Professor Kenneth Klee of the UCLA School of Law. Professor Klee's proposals are a formal part of the Commission's report, and they appear in the report with the support of five Commission members.

The Commission Report states:

While there has been no Commission vote on the Alternative Proposals [prepared by Prof. Klee] discussed below, they have the support of five Commissioners who were not members of the Small Business Working Group. They [the five] view it as a well-reasoned alternative and hope that it will receive careful consideration by Congress.

Report, p. 680.

The full Commission did not have a fully-developed single asset real estate proposal available for analysis and voting until several weeks after the Commission's final meeting in mid-August of 1997. That proposal received five affirmative votes—in a mail ballot on September 24, 1997—and four negative votes. Although the four dissenting Commissioners were interested in making their own proposal on single asset real estate, especially to clarify section

362(d)(3) of the Bankruptcy Code, those four Commissioners were very concerned about the widespread implications of the adopted proposal, not only in bankruptcy proceedings but in out-of-court workouts as well.

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After reviewing Professor Klee's alternative proposal, those four Commissioners expressed explicit support for Professor Klee's more conservative and narrowly tailored approach. In addition, one Commissioner who had voted in favor of the adopted proposal expressed his support for Professor Klee's proposal. The Report accurately advises Congress, accordingly, that a majority of the Commissioners supported Professor Klee's proposal even if they did not have the opportunity to actually vote on it.

Please make this letter part of the hearing record and let me know if any further discussion on this or other matters would be helpful.

Brady C. Williamson

National Association of
Chapter 13 Trustees,
Nashville, TN, March 31, 1998.

Representative **GEORGE GEKAS,** *Chairman,*
Subcommittee on Commercial and Administrative Law
Committee on the Judiciary,
House of Representatives, Washington, DC.

DEAR REPRESENTATIVE GEKAS: For the past several weeks, your Subcommittee has examined the impact that current bankruptcy policy has upon the economy, the financial institutions of this country and upon the millions of families that struggle to do the best that they can in meeting their family obligations. You have proposed broad legislation that not only works a fundamental ship in our policy but also significantly restructures the methods by which that bankruptcy policy is implemented.

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The National Association of Chapter Thirteen Trustees has worked with you and the committee staff as the subcommittee examined the policy shift that H.R. 3150 would have. The NACTT, composed of trustees, creditor advocates and consumer representatives has avoided taking any position on the basic policies that the legislation seeks to effect. Many individual members of the NACTT strongly encourage and support the idea of a needs based bankruptcy system and efforts to curb abuses in the consumer credit and bankruptcy systems.

Our membership is, however, deeply concerned over the speed with which you are seeking to implement the provisions of H.R. 3150 and we encourage you to consider carefully the costly and counter-productive effect that many of those provisions would have on all parties to the bankruptcy system. Although our review has been limited due to the rapid nature in which the legislation has been considered, our trustee members are convinced that the bill would cost the credit community significantly in increased transactional costs, reduced recoveries, and excessive attorneys fees.

We would like to have the opportunity to examine closely the cost and effect that numerous provisions of H.R. 3150 would have upon all parties. We are willing to engage in a rapid effort to evaluate these provisions, particularly those that have a direct impact upon the implementation of chapter 13 programs. We are willing to work directly with your staff and provide to the subcommittee written and oral testimony on the impact of the bill.

We encourage you to give us that chance. We encourage you to give those parties that must implement the consumer

bankruptcy system an ear and consider the cost. The NACTT is not "pro-debtor" nor is it "pro-creditor." It is an education based organization that can be of real use to your subcommittee.

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Please reconsider the fast track that you have put this bill on. Consider the effect of unintended consequences. Give us the opportunity to help.

Sincerely,

Henry E. Hildebrand, III, *Chairman,*
Legislative Affairs Committee

April 2, 1998

To All Members of the United States Congress:

DEAR SENATOR OR REPRESENTATIVES: We are a group of 110 United States bankruptcy judges. Most of us have been bankruptcy judges for more than ten years and we have applied the complex provisions of the Bankruptcy Code to thousands of bankruptcy cases filed by individual debtors. Although we come from different political, intellectual and economic perspectives, and represent districts from every federal judicial circuit, we share a single, deep concern—that legislation presently before Congress would make fundamental changes in bankruptcy for individual debtors that have not been sufficiently considered.

The proposed bills—H.R. 2500, H.R. 3146, H.R. 3150, and S. 1301—all impose new limits on the availability of bankruptcy relief. Since 1898, an individual's debts have been discharged upon surrender of the individual's nonexempt property, and the property has been liquidated to pay the individual's creditors. The proposed legislation would deny this basis for discharge in many cases, requiring instead that individuals make payment out of their future earnings, for as much as seven years. The bills also propose major changes in what debt may be discharged, in the relative amounts paid to secured and unsecured creditors, and in the extent to which documentation must be filed and processed in connection with a bankruptcy case.

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We do not take any position on the merits of these bills, However, we strongly believe that these bills are too important and their proposed changes too sweeping to be acted upon without thorough consideration. We are alarmed by how little study appears to have been given to the pending bills. Although we understand that these bills are on the verge of floor consideration, fewer than a dozen hearings have been held on all of the bills combined. The oldest of the bills, H.R. 2500, was introduced little more than six months ago. The haste with which these bills are being processed can be seen by a comparison with the changes made by the Bankruptcy Code of 1978. That legislation was enacted only after sixty days of hearings during a five-year period of consideration.

Without sufficient study and consideration, it is likely that the proposed bills will (1) fail to fully accomplish their intended purpose, (2) generate unnecessary litigation over unclear terms, and (3) impose excessive costs on all of the participants in the bankruptcy system. As those charged with responsibility for applying the bankruptcy laws, we urge that the pending bills be given the full attention that they require, including additional hearings, held after sufficient time has been accorded for thorough study by all interested organizations, legal scholars, and participants in the bankruptcy process.

Respectfully,

Hon. Louise D. Adler, *Southern District of California.*

Hon. Frank R. Alley, *District of Oregon.*

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Hon. J. Vincent Aug, *Southern District of Ohio.*

Hon. Ronald S. Barliant, *Northern District of Illinois.*

Hon. Redfield T. Baum, *District of Arizona.*

Hon. Joyce Bihary, *Northern District of Georgia.*

Hon. William T. Bodoh, *Northern District of Ohio.*

Hon. Richard L. Bohanon, *Western District of Oklahoma.*

Hon. Henry J. Boroff, *District of Massachusetts.*

Hon. Peter W. Bowie, *Southern District of California.*

Hon. Philip H. Brandt, *Western District of Washington.*

Hon. Jerry A. Brown, *Eastern District of Louisiana.*

Hon. Samuel L. Bufford, *Central District of California*

Hon. Charles M. Caldwell, *Southern District of Ohio.*

Hon. Donald E. Calhoun, *Southern District of Ohio.*

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Hon. Ellen Carroll, *Central District of California.*

Hon. Catherine Carruthers, *Middle District of North Carolina.*

Hon. Charles G. Case, *District of Arizona.*

Hon. Leif M. Clark, *Western District of Texas.*

Hon. Tom R. Cornish, *Eastern District of Oklahoma.*

Hon. A. Jay Cristol, *Southern District of Florida.*

Hon. Sarah Sharer Curley, *District of Arizona.*

Hon. Sara E. deJesus, *District of Puerto Rico.*

Hon. Henry H. Dickinson, *Western District of Kentucky.*

Hon. Russell A. Eisenberg, *Eastern District of Wisconsin.*

Hon. Joan N. Feeney, *District of Massachusetts.*

Hon. Jerome Feller, *Eastern District of New York.*

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Hon. Lisa Hill Fenning, *Central District of California.*

Hon. Gerald D. Fines, *Central District of Illinois.*

Hon. Judith K. Fitzgerald, *Western District of Pennsylvania.*

Hon. John T. Flannagan, *District of Kansas.*

Hon. Steven H. Friedman, *Southern District of Florida.*

Hon. Robert F. Fussell, *Eastern and Western District of Arkansas.*

Hon. Stephen D. Gerling, *Northern District of New York.*

Hon. William H. Gindin, *District of New Jersey.*

Hon. James A. Goodman, *District of Maine.*

Hon. Robert E. Grant, *Northern District of Indiana.*

Hon. James D. Gregg, *Western District of Michigan.*

Hon. James R. Grube, *Northern District of California.*

Hon. Alfred C. Hagan, *District of Idaho.*

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Hon. James B. Haines, *District of Maine.*

Hon. John J. Hargrove, *Southern District of California.*

Hon. Polly S. Higdon, *District of Oregon.*

Hon. Russell J. Hill, *Southern District of Iowa.*

Hon. William C. Hillman, *District of Massachusetts.*

Hon. Marvin A. Holland, *Eastern District of New York.*

Hon. Jeffrey Hopkins, *Southern District of Ohio.*

Hon. Laurence E. Howard, *Western District of Michigan.*

Hon. Lewis M. Killian, *Northern District of Florida.*

Hon. John M. Klobucher, *Eastern District of Washington.*

Hon. Robert L. Krechevsky, *District of Connecticut.*

Hon. Enrique S. Lamoutte, *District of Puerto Rico.*

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Hon. Kathleen T. Lax, *Central District of California.*

Hon. Joan Lefkow, *Northern District of Illinois.*

Hon. Larry L. Lessen, *Central District of Illinois.*

Hon. Paul B. Lindsey, *Western District of Oklahoma.*

Hon. Basil H. Lorch, *Southern District of Indiana.*

Hon. Paul Mannes, *District of Maryland.*

Hon. Robert A. Mark, *Southern District of Florida.*

Hon. Robert D. Martin, *Western District of Wisconsin.*

Hon. Mark B. McFeeley, *District of New Mexico.*

Hon. Margaret D. McGarity, *Eastern District of Wisconsin.*

Hon. Kenneth J. Meyers, *Southern District of Illinois.*

Hon. Dennis Montali, *Northern District of California.*

Hon. Robert G. Mooreman, *District of Arizona.*

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Hon. Marilyn Morgan, *Northern District of California.*

Hon. Geraldine Mund, *Central District of California.*

Hon. Randall J. Newsome, *Northern District of California.*

Hon. Geroge B. Nielsen, *District of Arizona.*

Hon. Karen A. Overstreet, *Western District of Washington.*

Hon. Jim D. Pappas, *District of Idaho.*

Hon. Alexander L. Paskay, *Middle District of Florida.*

Hon. John K. Pearson, *District of Kansas.*

Hon. John L. Peterson, *District of Montana.*

Hon. James A. Pusateri, *District of Kansas.*

Hon. James F. Queenan, *District of Massachusetts.*

Hon. Julie A. Robinson, *District of Kansas.*

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Hon. Robert K. Rodibaugh, *Northern District of Indiana.*

Hon. Dana L. Rasure, *Northern District of Oklahoma.*

Hon. John A. Rossmeissl, *Eastern District of Washington.*

Hon. David E. Russell, *Eastern District of California.*

Hon. John E. Ryan, *Central District of California.*

Hon. Gerald H. Schiff, *Western District of Louisiana.*

Hon. David A. Scholl, *Eastern District of Pennsylvania.*

Hon. John D. Schwartz, *Northern District of Illinois.*

Hon. Mary Davies Scott, *Eastern and Western Districts of Arkansas.*

Hon. James E. Shapiro, *Eastern District of Wisconsin.*

Hon. Blackwell N. Shelley, *Eastern District of Virginia.*

Hon. David F. Snow, *Northern District of Ohio.*

Hon. John H. Squires, *Northern District of Illinois.*

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Hon. Paul Snyder, *Western District of Washington.*

Hon. Rodney R. Steele, *Middle District of Alabama.*

Hon. Jo Ann C. Stevenson, *Western District of Michigan.*

Hon. David T. Stosberg, *Western District of Kentucky.*

Hon. Stephen A. Stripp, *District of New Jersey.*

Hon. Laura Taylor Swain, *Eastern District of New York.*

Hon. Leslie J. Tchaikovsky, *Northern District of California.*

Hon. S. Martin Teel, Jr., *District of Columbia.*

Hon. John TeSelle, *Western District of Oklahoma.*

Hon. Douglas O. Tice, *Eastern District of Virginia.*

Hon. Thomas M. Twardowski, *Eastern District of Pennsylvania.*

Hon. Thomas S. Utschig, *Western District of Wisconsin.*

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Hon. Mark W. Vaughn, *District of New Hampshire.*

Hon. Arthur N. Votolato, *District of Rhode Island.*

Hon. Thomas F. Waldron, *Southern District of Ohio.*

Hon. Eugene R. Wedoff, *Northern District of Illinois*

Hon. Arthur S. Weissbrodt, *Northern District of California.*

Hon. James H. Williams, *Northern District of Ohio.*

Hon. Patricia C. Williams, *Eastern District of Washington.*

Hon. Vincent P. Zurzolo, *Central District of California.*

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58409o.eps

James J. White,
Ann Arbor, MI, April 2, 1998.

Hon. **HENRY HYDE,** *Chairman,*
Committee on the Judiciary,
House of Representatives, Washington, DC.

DEAR CONGRESSMAN HYDE AND MEMBERS OF THE COMMITTEE: I write to tell you that at least one law professor disagrees with the letter you received on March 31st from 57 academics. Like the 57 signers of the March 31st letter, I have taught bankruptcy law for many years, unlike the 57 signers, I endorse HR 3150 and encourage you promptly to enact it.

Despite its appearance to the contrary, the March 31 letter should not be regarded as a dispassionate, academic

response to hasty Congressional action. Even academics understand that delay is often the surest death for legislation. I doubt most of the signers really want more extensive consideration; they are hoping for the death of the bills—particularly of the consumer bill, HR 3150. Any claim of dispassionate objectivity is contradicted by the last sentence of the March 31 letter which urges Congress to "seek out a balanced, reasoned approach". Of course, the implication of the need to seek out a "balanced, reasoned approach" is that the current bill, HR 3150, is neither balanced nor reasoned. Claiming that legislation is neither "balanced nor reasoned" sounds like opposition to me.

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Unlike my academic colleagues who signed Professor Markell's letter but consistent with the views of most citizens, I believe debtors should generally be made to pay their debts, even debts that were improvidently made. I believe Chapter 7 now absolves too many citizens from the consequences of their own actions and it is time to cut back on the rights granted in Chapter 7.

I do not believe the changes to Chapter 7 proposed in HR 3150, are radical (as the March 31 letter suggests). By forcing some debtors into Chapter 13 and by restricting the use of Chapter 7 in other ways, the bill takes a small step to bolster individual responsibility. Though I might have drafted the legislation differently, House Bill 3150 is a step in the right direction.

Despite their claims to the contrary, I believe Professor Markell and the signers (at least those who have studied HR 3150 and appreciate the implications in his letter) are opposed to HR 3150. I believe they are not only disingenuous, but wrong. I hope you report the Gekas bill out and that, after appropriate amendments and modifications, it becomes law. It is time to put at least modest restrictions on a debtor's ability to escape from his or her just obligations.

Sincerely,

James J. White
Robert A. Sullivan Professor of Law,
University of Michigan

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National Home Equity
Mortgate Association,
Washington, DC, April 6, 1998.

Hon. **GEORGE GEKAS,** *Chairman,*
Subcommittee on Commercial and Administrative Law,
Committee on the Judiciary,
House of Representatives, Washington, DC.

DEAR CHAIRMAN GEKAS:
I am writing to you with regard to your hearings concerning H.R. 3146, "The Consumer Lenders and Borrowers Bankruptcy Accountability Act of 1998".

The following written testimony is being submitted on behalf of the National Home Equity Mortgage Association ("NHEMA"). NHEMA is a twenty-year-old trade organization representing more than 300 banks, finance companies and other firms that assist consumers in obtaining credit secured by their residences.

NHEMA supports the consumer's responsible use of credit. NHEMA's members pay close attention to employment history and borrowers' ability to pay, in choosing whether or not to provide the credit requested. Along with all other lenders, both secured and unsecured, NHEMA's members deal with consumers who choose bankruptcy in response to a

real or perceived financial crisis. Unfortunately, as many recent studies have shown, bankruptcy is often used by unscrupulous consumers to avoid legitimate debts.

It is in this context that NHEMA files this statement with respect to proposed amendment to Section 1332(b) of Title 11, United States Code.

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Section 1332(b) provides, at present:

"(b) Subject to subsections (a) and (c) of this section, the plan may. . . .
(2) modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims;"

As amended, 11322(b)(2) would provide:

"(2) modify the rights of holders of secured claims, other than a claim secured only by a *purchase money* security interest in real property that is the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims;"

The debtor is permitted by Code Section 1322(b)(2) to modify the rights of holders of unsecured and secured claims, except as to a claim secured only by a security interest in real property that is the debtor's principal residence. As discussed below, the ability of the Chapter 13 debtor to "split" the claim of an under-secured holder of a mortgage on the debtor's principal residence has been restricted by statute and the Supreme Court. Moreover, the exception to the Chapter 13 debtor's power to modify, contained in Code Section 1322(b)(2), is narrowly worded and, as discussed below, much litigation has ensued over how narrowly the exception is to be applied. This proposed amendment would further narrow the exception to apply only to purchase money mortgages. This would mean that all other mortgage loans would be subject to valuation under Section 506, and splitting into secured and unsecured claims with differing treatments.

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The second part of the amendment deals with Section 1325. The principal limitations on the power of a Chapter 13 debtor to modify the rights of secured and unsecured claim holders are found in the standards for confirmation in Code Section 1325 and the adequate protection requirement described in Code Section 361.

The proposed amendment would add a section to Section 1322(b) to clarify that "allowed" secured claims may be paid consistent with the provisions of Section 1325, which provide:

"(5) with respect to each allowed secured claim provided for by the plan-
(A) the holder of such claim has accepted the plan;
(B)(i) the plan provides that the holder of such claim retain a lien securing such claim; and
(ii) the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim; or
(C) the debtor surrenders the property securing such claim to such holder;"

This amendment clearly is intended to tie in the treatment of secured claims, including those secured by the debtor's principal residence with the permissible plan provisions allowed under Section 1322.

BACKGROUND DISCUSSION

Prior to the Supreme Court's decision in *Nobelman* v. *American Savings Bank*, 508 U.S. 324, 124 L. Ed. 2d 228, 113

S. Ct. 2106 (1993), one of the most intensely litigated questions in all of Chapter 13 practice was the question whether "splitting" an undersecured home mortgage claim into its secured and unsecured portions under Section 505(a) constituted an impermissible modification under 1322(b)(2). A strong majority of courts, including the United States Courts of Appeals for the Second, Third, Ninth and Tenth Circuits, held that a home mortgage holder's security interest was protected by the anti-modification clause in Section 1322(b)(2) only to the extent that the claim was actually a secured claim under Section 506(a). Under the holdings of these decisions, a Chapter 13 debtor could "split" the claim into its secured and unsecured portions; pay the secured portion consistent with the original contract terms, and pay the unsecured portion only in the same manner as general unsecured creditors under the plan. A respectable minority of courts, including the United States Court of Appeals for the Fifth Circuit, held that the bifurcation of a home mortgage into its secured and unsecured components effected a modification of the mortgage holder's rights in violation of Section 1322(b)(2).

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In 1992, the United States Supreme Court decided *Dewsnup* v. *Timm*, 502 U.S. 410, 116 L. Ed. 2d 903, 112 S. Ct. 773, (1992). In *Dewsnup*, the Supreme Court held that a Chapter 7 debtor could not use Section 506(d) to "strip down" an undersecured mortgage and void the unsecured portion of the mortgage holder's lien. Some courts, including the United States Court of Appeals for the Fifth Circuit in *Nobelman*, read *Dewsnup* to support the view that Section 1322(b)(2) prohibits bifurcation or claim splitting of home mortgages in a Chapter 13 case. Other courts, including the United States Courts of Appeals for the Second and Third Circuits, found nothing in *Dewsnup* prohibiting a Chapter 13 debtor from bifurcating an undersecured home mortgage into its secured and unsecured portions.

In *Nobelman*, a unanimous Supreme Court affirmed the result reached by the Fifth Circuit when it upheld the erstwhile minority view that Code Section 1322 (b)(2) prohibits splitting an undersecured home mortgage holder's claim into secured and unsecured portions for purposes of confirmation of a Chapter 13 plan. In reaching this conclusion, the Court did not rely heavily on *Dewsnup*, as had the Fifth Circuit, but instead focused on the phrase "rights of holder's" in Section 1322 (b)(2), concluding that the "rights" protected from modification by Section 1322(b)(2) are not limited by the valuation of the mortgage holder's secured claim. The Supreme Court, in *Nobelman*, defined the "rights" that are protected from modification by reference to property rights and contract rights "created and defined by state law." The Court stated that:

"[t]he bank's 'rights' therefore, are reflected in the relevant mortgage instruments . . . They include the right to repayment of the principal and monthly installments over a fixed term at specified adjustable rates of interest, the right to retain the lien until the debt is paid off, the right to accelerate the loan upon default and to proceed against petitioners' residence by foreclosure and public sale, and the right to bring an action to recover any deficiency remaining after foreclosure . . . These are the rights that are 'bargained for by the mortgagor and the mortgagee,' *Dewsnup* v. *Timm*, . . . and are rights protected from modification by Section 1322(b)(2)."

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Since the Court did not rely upon the reasoning of *Dewsnup* in reaching its result, it did not hold that the use of Section 506 is entirely precluded in Chapter 13 cases, as it is in Chapter 7 cases in light of *Dewsnup*. It appears that the use of Section 506 will be expanded in Chapter 13 cases as a result of the proposed amendments by allowing Chapter 13 debtors to "strip down" undersecured liens, other than those secured by a purchase money mortgages.

The end effect of the noted amendments in H.R. 3146 would be to allow consumers who have refinanced their homes to avoid a payment of a portion of the debt by bifurcating the lien to a secured and unsecured portion.

The first danger in such a practice will be to elevate bankruptcy proceedings to an appraisal fight. Debtors, and their attorneys will hire and pay for appraisers who are willing to offer "their opinions" that the property is "under water"—that is—worth less than the amount of the loan. This will necessitate the lenders to hire lawyers and appraisers to battle in front of the Bankruptcy Court this issue. All of this battling will raise the costs and expenses of the bankruptcy, the Bankruptcy Court operation, and increase the cost of bankruptcy for both debtors and creditors.

The ability of consumers to obtain credit by relying on the equity in their real estate is extremely important. The free use of this credit by the consumers allows them to utilize their assets in the most effective and meaningful way. Traditional uses include home improvements, financing education, unusual medical expenses, or even just a much-needed vacation. Limiting the use of this credit would be unfair to the consumer.

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If this unfortunate provision were passed, the overall cost of credit would inevitably have to be increased and or the amount of credit made available to the consumers, reduced. These changes would allow consumers to use the Bankruptcy Court to avoid otherwise valid debts. The losses occasioned would require the lenders to restrict the amount of credit available to the consumers, and to raise the cost to cover the anticipated losses. The efficient market of consumer real estate lending provides credit to comparable borrowers at costs that are equivalent to expected losses. The change in this legislation will without doubt increase losses and therefore either result in an increase to the cost of borrowing, or reduce the availability of this borrowing. Neither result is beneficial to the average American worker.

At another level, this law is unfair and dangerous. The real estate secured lending market is the largest single source of consumer credit in the United States. Every year, billions of dollars of real estate refinancing are made. A great portion of the capital for this real estate lending comes through the market system of Wall Street where the loans (in a process often originated by the Federal National Mortgage Association) are packaged and sold to pensions and other investors. The disastrous results of this change in the law will be losses occasioned on existing loans which translates to losses to the investors, 401K's and pension plans of the American workers. There is no rational that can justify this risk of loss based on an appraisal battle waged between attorneys in the Bankruptcy Court setting.

In all loans which have been made, the lenders relied on the rational and reasoning of the unanimous opinion in the Supreme Court case of *Nobelman* v. *American Savings Bank*, noted earlier, which concluded that despite falling real estate values, the borrower in a Chapter 13 proceeding should pay the entire amount of the original loan. The proposed amendment would retroactively change the security of these loans, thereby leading to an extremely unfair result. To make the changes requested would allow unscrupulous consumers to use the Bankruptcy Courts to avoid their financial obligations.

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The broad strokes of the bill's sections described above go too far. There are other more than adequate methods to protect borrowers from unscrupulous lenders. Lenders generally are honest and the market place keeps them this way. The noted changes proposed in this bill should not be passed, as it will damage consumers, the investing public, and a large important economic segment of our economy.

Respectfully submitted on behalf of NHEMA,

N. MITCHELL FEINSTEIN

(Footnote 1 return)

Cf. OMC, *How Bizarre, on* ***How Bizarre*** *(Mercury Records 1996).*

(Footnote 2 return)
Professor of Law, St. John's University, School of Law. The author is Immediate Past President of the American Bankruptcy Institute and Senior Counselor to Thacher Proffitt & Wood in New York. The views expressed are the author's own and do not necessarily represent the views of the American Bankrutpcy Institute or any other organization with which he is associated. The author wishes to thank his reserach assistant, Daniel L. McAuliffe; the editors and staff of the ABI Law Review; and Robin Phelan and other colleagues for their assistance and sound advice.

(Footnote 3 return)
See ***Hans Christian Anderson, The Emperor's New Clothes*** *(1949).*

(Footnote 4 return)
The National Bankruptcy Review Commission was established by Title VI of The Bankruptcy Reform Act of 1994, Pub. L. No. 103–394.

(Footnote 5 return)
See ***Nat'l Bankr. Rev. Comm'n, Bankruptcy: The Next Twenty Years, Final Report*** *(1997) [hereinafter* ***Commission Report****].*

(Footnote 6 return)
The new value proposal would permit junior parties to "purchase" an interest in the enterprise even though senior interests are not paid in full. The absolute priority rule generally holds that no junior interest may retain an interest in the debtor unless all seniors are fully compensated. *See* ***Collier on Bankruptcy*** 1129.04 [4][a][i], at 83 (Lawrence P. King et al. eds. 15th ed. rev. 1997) (stating absolute priority rule requires all senior interests be fully compensated before junior interests may retain an interest).

(Footnote 7 return)
The term "old equity" refers to the owners of the enterprise (e.g. stockholders of a debtor corporation or the partners of a partnership in bankruptcy) whose property is subject to distribution under a chapter 11 plan. Under the absolute priority rule, these parties are not entitled to retain property unless all creditors are paid in full or fully compensated. *See Louisville Trust Co.* v. *Louisville*, N.A. & C. Ry. Co., 174 U.S. 674, 684 (1899) (stating any arrangement of parties where subordinate shareholders' rights come before creditors' rights is subject to "judicial denunciation").

(Footnote 8 return)
See generally Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 **Stan. L. Rev.** 69, 74–90 (1991).

(Footnote 9 return)
Professor White states that he is not confident from a review of post-Code case law that "the new value exception will not tear a large hole in the fair and equitable rule and will not invite exactly the abuses that the fair and equitable rule is to prevent." James J. White, *Absolute Priority and New Value*, 8 **Thomas M. Cooley L. Rev.** 1, 13 (1991).

(Footnote 10 return)
See, e.g., In re 203 N. LaSalle St. Partnership, 126 F.3d at 964 (noting old equity is allowed to participate in

reorganization on " 'account of' a new, substantial, necessary and fair infusion of capital").

(Footnote 11 return)
For example, the Commission Report states that the "court retains a significant independent role in reviewing the debtor's new value plan: the plan must satisfy the *Case* v. *Los Angeles Lumber Products* factors . . . " **Commission Report**, *supra* note 3, at 563.

(Footnote 12 return)
See id. at 562

(Footnote 13 return)
See ***Commission Report****, supra* note 3. at 563–64 (discussing "credit bidding"). This is difficult to understand. Is the Commission saying that creditors may not propose a plan that provides for the conversion of debt to equity? Does it mean that when a creditor submits a plan, which, at least in single asset cases, seems to constitute a bid for the property, sections 1129(b)(2)(a)(ii) and 363(k) do not apply? *See* discussion *infra* Part III.

(Footnote 14 return)
A review of the minutes of the meeting of September 19, 1996 (attended by five of the nine Commissioners) at which the new value proposal was "adopted," indicates that no formal vote was ever taken, although it was clear that of the nine member Commission, the three person Article 11 Working Group had previously supported the proposal unanimously. *See* National Bankruptcy Review Commission *Chapter 11 Working Group Proposal Number One—Absolute Priority* (visited Nov. 25, 1997) <http://www.abiworld.org/legis/review/minutes/sep96min.html#chap11prop1>. Judge Jones submitted a memorandum in opposition and Commissioner Shepard also expressed concern with the proposal, the minutes stating that he "found the new value exception 'disagreeable' . . . [N]oting the absence of four Commissioners at this session, he said that he was not prepared to vote on the proposal." *Id.* He also pointed out that Commissioner Jones had urged that a vote not be taken. *Id.* The minutes then state "In keeping with prior practice, Chair Williamson observed that it was not necessary to take a formal vote such as a roll call or 'show of hands.' Accordingly, he said that given the unanimous support of the Chapter 11 Working Group for the proposal and noting the opposition of Commissioners Jones and Shepard, the proposal would be considered adopted." *Id.* The minutes report that the Chair stated that "he did not consider today's action to constitute a final vote as that will not occur until the Commission approved its final report." *Id.* We have not located any subsequent vote on the final report. See National Bankruptcy Review Commission (visited January 4, 1998) <http://www.abiworld.org/legis/ review/index.html> (stating final recommendations from National Bankruptcy Review Commission's final report).

(Footnote 15 return)
See Hon Edith H. Jones, *Dissent From Specific Proposals: III Absolute Priority and Exclusivity*, **Commission Report**, *supra* note 3, ch. 5, Individual Commissioner Views 16–29 [hereinafter *Dissent*]. Perhaps due to time constraints, all dissenting opinions, including that by Judge Jones, are not placed after the majority opinions to which they object, but are found in a separate Chapter 5 of the Commission Report entitled, "Individual Commissioner Views." Chapter 5 has neither a table of contents nor an index, and the pages of the Chapter are not consecutively numbered. Thus, it is somewhat difficult to find any specific dissent and virtually impossible to cite to any of them with even a modicum of "bluebook" style. Judge Jones' dissent on "new value" is found on page 16–29 of her more comprehensive dissenting memorandum entitled "Dissent from Certain Commission Recommendation on General Issues in Chapter 11." It is located somewhere close to three fourths of the way into Chapter 5.

(Footnote 16 return)
See id. at 19. Interestingly, the Commission Report does not appear to show who supported or dissented from any

proposal. Thus, a unanimous decision is not differentiated from a 5–4 decision, although it is possible to determine the vote by reviewing the Commission meeting minutes. The Commission staff stated in a telephone conversation that this is a result of Commission policy not to indicate the votes. The staff points out, however, that what votes there were could be discerned by reviewing the minutes of each of the meetings, which are found on <http://www.abiworld.org>.

(Footnote 17 return)
See ***Commission Report****, supra* note 3, at 545.

(Footnote 18 return)
The word "purchase" has a broad meaning and generally includes any means of obtaining an interest in property by grant, devise or even gift. *See* U.C.C. 1–201(32) (defining "purchase" as including "taking by sale, discount, negotiation, mortgage, pledge, lien, issue or re-issue, gift or any other voluntary transaction creating an interest in property"). Thus the implications from the choice of this word may go well beyond what one might normally expect.

(Footnote 19 return)
See ***Commission Report****, supra* note 3, at 545.

(Footnote 20 return)
See id.

(Footnote 21 return)
The Commission maintains that "[b]y putting forth the general principle that continued involvement of old equity is not precluded *per se* in nonconsensual plans, while ensuring adequate valuation and the opportunity for competition, the proposed rules will provide appropriate guidance in both large and small cases for fair and balanced negotiations." **Commission Report**, *supra* note 3, at 565. A reading of the majority proposal does not disclose to this author how "adequate valuation" is ensured. Indeed, it is this question and the related question of what, if any, portion of the debtor's value remains with the existing creditors that is the major unanswered question in the Commission Report.

(Footnote 22 return)
See ***Commission Report****, supra* note 3, at 547. This concern may be overblown. Family farmers need not choose Chapter 11. They have their own chapter of the Bankruptcy Code, Chapter 12, where absolute priority has been eliminated, making the new value issue somewhat moot. Furthermore, it is difficult to believe that there are an overwhelming number of Chapter 11 cases involving "mom-and-pop stores." *See id.*

(Footnote 23 return)
See id. at 547. The actual Working Group Proposal #1 that was considered by the Commission contained the following language: "*Any* recommendation made by the Commission that would settle this uncertainty [conflicting case law in small cases] would have a salutary effect on Chapter 11 cases." Chapter 11 Working Group Proposal #1: Absolute Priority and Exclusivity at 19 (September 4, 1996 draft) <http://www.abiworld.org/legis/review/proposals/apr.html> (emphasis added). This implies that the Commission proposal settles uncertainty, an idea with which this article strongly disagrees. It more than implies that if the proposal were to settle uncertainty it deserves enactment whether the proposal produces a beneficial result or not, an idea with which this article even more strongly disagrees. Fortunately, the quoted language appears to be absent in the Commission Report.

(Footnote 24 return)
See In re Snyder, 967 F.2d 1126, 1129 (7th Cir. 1992) (noting Congress' failure to codify new value exception does not

establish its elimination); *see also In re* 203 N. LaSalle St. Partnership, 126 F.3d 955, 965 (7th Cir. 1997) (stating past bankruptcy practices can not be abandoned absent clear indication Congress intended to break from those practices).

(Footnote 25 return)
See 7 **Collier**, *supra* note 4, 1129.04[4][a][i], at 84 (Lawrence P. King et al. eds., 15th ed. rev. 1997) (stating "[a] plan of reorganization may not allocate any property whatsoever to any junior class on account of the members' interest or claim in a debtor unless . . . senior classes receive property equal in value to . . . their allowed claims.").

(Footnote 26 return)
Railroad Co. v. *Howard*, 74 U.S. 392, 409–10 (1868). In that case an insolvent railroad had seven million dollars in mortgage bond obligations. An outside purchaser offered to pay $5.5 million for all the assets of the railroad if the transfer could be accomplished expeditiously. Apparently in order to get the cooperation of the stockholders in the quick, friendly, foreclosure of the mortgages, the bondholders agreed to allocate a portion of the proceeds to pay the stockholders 16% on their stock. Certain municipal bondholders whose bonds had been guaranteed by the railroad (the guarantee obligation was subordinate to the obligation owed to the mortgage bondholders) objected to the payment to the stockholders. The Supreme Court affirmed the courts below in holding that the assets derived from the sale of the railroad were a fund in trust for the benefit of creditors. *See id.* at 414. By agreeing to take less than all the assets in partial payment of the debt, the bondholders had, in effect, compromised their claim and as a result the amount of the sale proceeds earmarked for stockholders belonged to the other creditors. Old equity was not permitted to participate in that fund unless creditors were paid in full. *See id.* The decision that the agreement to take less constituted a compromise of the secured creditor's claim may have been something of a stretch. When the same issue came up 125 years later in the SPM bankruptcy, the First Circuit found that a similar agreement constituted either an assignment of the claim or a subordination. *See Unsecured Creditors' Comm.* v. *Stern* (*In re* SPM Mfg. Corp.), 984 F.2d 1305, 1318n.13 (1st Cir. 1993). The Court held that the bankruptcy court had not authority to abrogate the agreement between the secured creditor and the unsecured creditors committee (under which a portion of the proceeds to which the secured creditor was entitled would be given to unsecured creditors who were subordinate to the prior claim of the IRS). *See id.* at 1312. The argument was raised that rather than transferring its interest, the creditors committee had "carved out" or "divested itself" of a portion of its lien (similar to the "compromise" conclusion of Howard) giving the bankruptcy court the right under its equity powers to determine who was best entitled to the proceeds (the bankruptcy court had ordered that the money be paid to the IRS to the extent it had priority). *See id.* at 1318. What also follows from the argument—that the compromise would result in a distribution in violation of absolute priority, as determined in *Howard*—does not seem to have been raised. The First Circuit rejected the :compromise" argument on the ground that "no appeal was taken from the bankruptcy court's ruling that . . . [the mortgagee] was entitled to receive the entire sale proceeds" and because under Massachusetts law an assignment of a debt would not change the claim's priority or alter the debtor's obligation to pay the debt. *See id.* The decision did not distinguish, or cite, *Howard*.

(Footnote 27 return)
See Case v. *Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 115. 118 (1939) (defining proper use of term "fair and equitable" in reorganization proceeding).

(Footnote 28 return)
See id. The words, "fair and equitable" appeared in reorganization law with the enactment of section 77 of the Bankruptcy Act dealing with railroad insolvencies. Section 77(e), Act of March 3, 1933, 47 Stat. 1474. Under this provision, a plan could be confirmed only if the judge found it to be, *inter alia*, "fair and equitable." The first non-railroad corporate reorganization statute, section 77B of the Bankruptcy Act, was enacted one year later, and like section 77, it specifically set forth "fair and equitable" as the standard that all plans had to meet. Act of June 7, 1934, ch. 424, 48 Stat. 911, 912–25 (creating section 77B of 1898 Act). This standard was incorporated in the Chandler Act amendments in 1938. Act of June 22, 1938, ch. 575, 52 Stat. 840 (1938), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95–598, 92 Stat. 2549. It was not until the decision in *Case*, however, that it was determined authoritatively that "fair and equitable" meant "absolute priority." 308 U.S. at 115. During the period between the earlier cases

articulating the priority rights of creditors and *Case*, two conflicting theories, "relative priority" and "absolute priority" were developed. Relative priority would permit interests to be given to classes of creditors and stockholders in the reorganized enterprise provided that the relative preference of all classes of creditors and stockholders that existed prior to the reorganization would be preserved. This would allow stockholders to receive interests in the reorganized company even if the value of the enterprise were less than the claims against its assets. *See* James C. Bonbright & Milton M. Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 **Colum. L. Rev.** 127, 130–32 (1928) (distinguishing alternative theories of relative priority from absolute priority). They concluded that the doctrine of absolute priority would probably not adapt well to corporate organizations. *Id.* at 165. However, Bonbright later reversed his position and concluded that the arguments for using the doctrine of absolute priority in corporate reorganizations were more persuasive than the arguments for using the doctrine of relative priority. *See* 2 **James C. Bonbright, Valuation of Property: A Treatise on the Appraisal of Property for Different Legal Purposes**, n.64, at 867 (1937). John Gerdes found the relative priority doctrine unsound and unfair because it permitted participation by classes that no longer had any equity in the enterprise. John Gerdes, *General Principles of Plans of Corporate Reorganization*, 89 **U. Pa. L. Rev.** 39, 57–58 (1940). *But see* Churchill Rodgers & Littleton Groom, *Reorganization of Railroad Corporations Under Section 77 of the Bankruptcy Act*, 33 *Colum. L. Rev.* 571, 572–73 (1933) (questioning suggestions to abolish the relative priority doctrine "without any definite suggestions of how the absolute priority doctrine would be made to work").

(Footnote 29 return)
308 U.S. 106 (1939).

(Footnote 30 return)
The bondholders approved by 92.81%; the Class A stock by 99.75% and the Class B stock by 90%. The objecting creditor held $18,500 face amount of the almost tour million dollars in bonds. *Id.* at 115.

(Footnote 31 return)
See id. at 115.

(Footnote 32 return)
308 U.S. at 112–13 (quoting *In re* Los Angeles Lumber Prods. Co., 24 F.Supp. 501 (1938), *rev'd, Case* v. *Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 112–13 (1939)).

(Footnote 33 return)
Interestingly, had the Bankruptcy Code been in effect at the time, this plan would have been approved. Justice Douglas took pains to explain that the court was constrained to reject the plan under 77B (f) of the Bankruptcy Act (Chapter X of the Bankruptcy Act superseded 77B) because "Congress has required both that the required percentages of each class of security holders approve the plan and that the plan be found to be 'fair and equitable'. The former is not a substitute for the latter. . . . Accordingly the fact that the vast majority of the security holders have approved the plan is not the test of whether the plan is a fair and equitable one." *Case*, 308 U.S. at 114. Under the Bankruptcy Code, the fair and equitable requirement applies only to dissenting impaired classes of creditors. Since all classes approved the plan in *Case*, it would have been confirmed under the Code. *See* 11 U.S.C. 1129(b)(1) (1994).

(Footnote 34 return)
Justice Butler took no part in the consideration or disposition of the case. *See* Case, 308 U.S. at 132.

(Footnote 35 return)
See Case, 308 U.S. at 116 (stating stockholder and bondholder agreements are valid if execution of said agreement

does not subordinate creditor's claims to stockholders); *Northern Pac. Ry. Co.* v. *Boyd*, 228 U.S. 482, 504 (1913) (noting that creditors are entitled to assets of debtor before stockholders).

(Footnote 36 return)
See Case, 308 U.S. at 116.

(Footnote 37 return)
Id. at 116 (quoting *Northern Pac. Ry. Co.* v. *Boyd*, 228 U.S. 482, 508).

(Footnote 38 return)
Id. at 117 (quoting *Kansas City Terminal Ry. Co.* v. *Central Union Trust Co.* 271 U.S. 445, 454) (emphasis added).

(Footnote 39 return)
Id. (quoting Kansas City Terminal Ry. Co., 271 U.S. at 454).

(Footnote 40 return)
228 U.S. 482 (1913).

(Footnote 41 return)
Case, 308 U.S. at 117.

(Footnote 42 return)
See id. at 121 (emphasis added).

(Footnote 43 return)
Case, 308 U.S. at 117 (quoting *Kansas City Terminal Ry. Co.* v. *Cent. Union Trust Co.*, 271 U.S. 445, 456) (emphasis added).

(Footnote 44 return)
See id. at 123. Illustrative of the bizarre nature of court decisions in this area, some 45 years after *Case*, the Eighth Circuit confimned a debtor's plan providing for old equity participation on the ground that the debtor promised to supply expertise and devote efforts to the success of the farm in the future, citing *Case* as authority! *See Norwest Bank Worthington* v. *Ahlers* (*In re* Ahlers) 794 F.2d 388 (8th Cir. 1986). The Supreme Court reversal was unanimous (Mr. Justice Kennedy not participating). *See Norwest Bank Worthington* v. *Ahlers* (*In re* Ahlers), 485 U.S. 197 (1988).

(Footnote 45 return)
See Case, 308 U.S. at 123–24.

(Footnote 46 return)
See id.

(Footnote 47 return)

See id. at 115–16.

(Footnote 48 return)
See id. at 122 (noting that old equity could only purchase stock under certain circumstances, so as to protect creditors' priority).

(Footnote 49 return)
Id. at 116 (quoting *Louisville Trust Co.* v. *Louisville*, New Albany & Chicago Ry. Co., 174 U.S. 674, 684).

(Footnote 50 return)
See id. at 121; *see also* Edward S. Adams, *Toward a New Conceptualization of the Absolute Priority Rule and its New Value Exception*, 1993 **Det. C.L. Rev.** 1445, 1459 (1993) (noting that old equity retains ownership equal to new investment).

(Footnote 51 return)
This may seem surprising in light of "common wisdom" that permits a United States circuit court of appeals to conclude in 1997 that "[t]he new value corollary has been a major source of new funding in reorganizations for the past fifty years." *In re* 203 N. LaSalle St. Partnership, 126 F.3d 955, 966 (7th Cir. 1997). A few years earlier, the same circuit stated: "There is nothing in either the text or the legislative history of section 1129(b) that can be said to demonstrate a clear intent to modify seventy-five years of judicial construction of the absolute priority doctrine or its new value exception." *In re* Snyder, 967 F.2d 1126, 1129 (7th Cir. 1992). The *Snyder* court was also incorrect on the non-modification of absolute priority since section 1129(b), unlike pre-Code law, limits absolute priority to dissenting impaired classes in cramdown situations.

(Footnote 52 return)
John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 **Mich. L. Rev** 963, 1016 (1989). And, Professor Markell stated that "[i]n the Chapter X arena, no shareholder was ever able to convince a court that she contributed sufficient value to be able to retain an interest. Indeed, until the code's adoption in 1978, no reported case seems to have adopted Justice Douglas' *dicta* as its holding." Markell, *supra* note 6, at 93.

(Footnote 53 return)
See Case v. *Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 121 (1939) (explaining that balance must be achieved between stockholder contribution and giving creditors full right of priority to assets).

(Footnote 54 return)
See Ayer, *supra* note 50, at 1015 (stating that any value or equity retained by debtor is value for creditors, precluding shareholder participation in reorganization).

(Footnote 55 return)
See id. at 1015 (noting there is no equity for stockholders to purchase if creditors are entitled to going concern value).

(Footnote 56 return)
See Norwest Bank Worthington v. *Ahlers* (*In re* Ahlers), 485 U.S. 197, 207–08 (1988) (explaining that property retained by stockholders has value, even when debts far exceed assets); *Northern Pac. Ry. Co.* v. *Boyd*, 228 U.S. 482, 508 (1913) (noting creditors are entitled to value of shares issued to old equity).

(Footnote 57 return)
See Ayer, *supra* note 50, at 1011–16 (discussing that "going concern value" cannot be part of old equity's value because creditors are entitled to entire going concern value, thus leaving no equity for stockholders to buy). Professor Markell illustrates this seeming dilemma with the following example:

(Footnote 58 return)
Professor Ayer would probably contest that there is any difference between the value of the enterprise at the time of confirmation as compared with the value aRer confirmation of a new value plan. "Given that no one would pay $10 for a company with a net worth of zero, then the offer of a $10 payment has to be taken as an 'admission' that the company is worth more. . . . " Ayer, supra note 50, at lOi4. This may be correct when we are discussing an offer to buy particular property. or the proposal of a new value plan in most single asset cases where the essence of the plan is the purchase of property, but when we look at the debtor as a going business enterprise. it can be argued that the new value infusion increases the value of the enterprise. so that the enterprise after confirmation is worth more than the enterprise pre-confirmation.

(Footnote 59 return)
See Salvatore G. Gangemi & Stephen Bordanaro, Note, *The New Value Exception: Square Peg in a Round Hole*, 1 Am. Bankr. Inst. L. Rev. 173. 194 n.130 (1993).

(Footnote 60 return)
Northern Pacific Ry. v. *Boyd*, 228 U.S. 482 (1913).

(Footnote 61 return)
This assumption may have been intimated by *Justice Douglas in Group of Inst'l Investors* v. *Chicago*, M., St. P. & P.R. Co., 318 U.S. 523, 566–67 (1920), where he stated:

(Footnote 62 return)
This may not violate Justice Douglas' prerequisite of reasonable equivalence, since it seems to be a limit on the size of old equity's interest rather than a floor. "Where . . . old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made."308 U.S. at 121.

(Footnote 63 return)
See Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganization*, 41 **U. Chi. L. Rev.** 651, 656–57 (commenting that the valuation process is "highly conjectural and even speculative" leading to criticism that it is arbitrary, perverse and subject to abuse).

(Footnote 64 return)
In reality, it is unlikely that the new value corollary applies under the Bankruptcy Code. Even putting aside that the articulation of new value in *Case* was only dictum and that the new value principle had not been used pre-Code to cramdown a plan, there is substantial legislative history to indicate that the new value was deliberately omitted from the Code. In July of 1973, the Commission on the Bankruptcy Laws of the United States ("Code Commission") completed a three year study and submitted its report. H.R. Doc. No. 93–137 Parts I and II, 93rd Cong. 1st Sess. (1973). The report discussed the nature, development, justification and deficiencies of the absolute priority rule as it had been applied under the Bankruptcy Act, declaring that it had become a "straight jacket," Part I at 256–57, because, as applied, it did not permit old equity to participate, with the agreement of the requisite majority of all classes of

creditors. The Code Commission's solution was to modify the absolute priority rule by permitting juniors to participate by making a contribution "important to the operation of the reorganized debtor . . . under the plan" on a basis reasonably approximating the value of their contribution. *See* Code Commission Bill, H.R. Doc. No. 93–137, Part II, 93d Cong., Ist Sess. (1973) at 242, 7–303(4)). The language of the proposed change was broad enough to include the type of "sweat equity" contribution rejected in *Case*.

(Footnote 65 return)
See Ahlers, 485 U.S. at 203 n.3.

(Footnote 66 return)
Id. at 206.

(Footnote 67 return)
The Supreme Court stated in *Dewsnup* v. *Timm*, that courts will not interpret the Code "to effect a major change in pre-Code practice" without legislative history to that effect. 502 U.S. at 419. Yet the new value the courts now apply would seem quite different from that envisioned under pre-Code law. If there is a major change from pre-Code practice it may be the new, new value exception as applied in many of these cases. *See In re* 203 N. LaSalle St. Partnership, 126 F.3d 955, 976 (7th Cir. 1997) (Kanne, J., dissenting) (noting "[t]he majority, due to its uncritical adherence to *Dewsnup*, creates an anachronism by cutting and pasting pre-Code practice into a fundamentally different bankruptcy context").

(Footnote 68 return)
See **Commission Report**, *supra* note 3, at 547.

(Footnote 69 return)
See In re A.V.B.I., Inc., 143 B.R. 738, 743 (Bankr. C.D. Cal. 1992) (stating all section 77B cases had court appointed trustees while most Chapter 11 cases utilize debtor-in-possession).

(Footnote 70 return)
143 B.R. 738 (Bankr. C.D. Cal. 1992).

(Footnote 71 return)
Id. at 743.

(Footnote 72 return)
See id.

(Footnote 73 return)
Teamsters Nat'l Freight Indus. Negotiating Comm. v. *U.S. Truck Co.* (*In re* U.S. Truck Co.), 800 F.2d 581 (6th Cir. 1986).

(Footnote 74 return)
The rejected contract had required management to own the trucks that the union members drove. The new agreement provided for the so-called owner/operator system under which the driver would own the vehicle and lease it to the

company. *See U.S. Truck*, 800 F.2d at 583.

(Footnote 75 return)
See In re U.S. Truck Co., 47 B.R. 932, 942–43 (E.D. Mich. 1985). The court also offered a second reason for the low valuation, which is quite revealing: the union might have a claim for up to $5 million for breach of contract caused by the disaffirmance that might lower the value of the corporation. This indicates that one purpose for the confirmation of the new value plan was to reduce the creditor's claim substantially. *See id.* This is at odds with the statements in *Case* v. *Los Angeles Lumber Prods. Co.*, that notwithstanding the infusion of new capital the creditors were entitled to their full right of priority. *See Case*, 308 U.S. 106, 121–22 (1939). Actually, the size of the creditor's claim should not have affected the value in any case. Absolute priority does not mandate that creditors be paid. It only requires that nothing go to old equity *unless* the creditors are paid. Thus, if the stock were given to the creditor rather than old equity, the transfer would have eliminated the creditor's claim. *See* 11 U.S.C. 1141(c) (1994) (providing property under plan will be "free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor").

(Footnote 76 return)
See U.S. Truck, 47 B.R. at 942.

(Footnote 77 return)
See id. (noting potential problem of union attempting to regain original terms of national agreement during negotiations for new agreement at expiration of current agreement in March of 1985).

(Footnote 78 return)
See US Truck, 800 F.2d at 587.

(Footnote 79 return)
See U.S. Truck, 47 B.R. at 944–45, app.a. art. I.

(Footnote 80 return)
See id. at 941.

(Footnote 81 return)
See supra note 21 and accompanying text (discussing Commission's attempt to resolve uncertainty surrounding new value plans).

(Footnote 82 return)
See 11 U.S.C. 506(a) (1994)

(Footnote 83 return)
995 F.2d 1274 (5th Cir. 1991).

(Footnote 84 return)
See Phoenix Mutual Life Ins. Co. v. *Greystone III Joint Venture* (*In re* Greystone III Joint Venture), *petition for reh'g and suggestion for hearing en banc*, 995 F.2d 1284, 1285 (5th Cir. 1992) (Jones, J., dissenting).

(Footnote 85 return)
See Greystone, 102 B.R. at 578.

(Footnote 86 return)
Id. at 579.

(Footnote 87 return)
See Norwest Bank Worthington v. *Ahlers*, 485 U.S. 197, 204 (1988) (stating debtor's promise of future labor and management skills has no monetary value).

(Footnote 88 return)
See Case v. *Los Angeles Lumber Prods. Co.*, 308 U.S. 106. 122–23 (1939) (noting that items such as financial standing and continuity of management have no monetary value and have no place in asset column of balance sheet).

(Footnote 89 return)
See Greystone, 102 B.R. at 581.

(Footnote 90 return)
2 F.3d 899 (9th Cir. 1993).

(Footnote 91 return)
See id. at 905. The preferred stock was convertible to common stock after payment of the mortgage. *See id.*

(Footnote 92 return)
The case came up on a petition for relief from the stay by the mortgagee claiming that the debtor had no equity in the property and the property was not necessary for an effective reorganization under section 362(d)(2), the latter requirement meaning that there would have to be a possibility that an effective reorganization could be confirmed within a reasonable time. *See Bonner Mall Partnership*, 2 F.3d at 902. To determine whether such a reorganization was possible, the court gave the debtor 30 days to propose a plan. *See id.* In response the debtor proposed the above-described plan. *See id.* at 905. The Bankruptcy Court nevertheless dismissed the case, having determined that the new value exception did not survive the adoption of the Bankruptcy Code. *See id.* at 902. The District Court reversed. *See id.* Thus the question came to the Ninth Circuit as to whether the new value exception survived the adoption of the Bankruptcy Code. *See Bonner Mall Partnership*, 2 F.3d at 901. After certiorari was granted by the Supreme Court, *U.S. Bancorp Mortgage Co.* v. *Bonner Mall Partnership*, 510 U.S. 1039 (1994), the case was settled. But new value continues to live in the Ninth Circuit. *See U.S. Bancorp Mortgage Co.* v. *Bonner Mall Partnership*, 513 U.S. 18, 20 n.1 (1994) (denying motion to vacate Ninth Circuit judgment).

(Footnote 93 return)
126 F.3d 955 (7th Cir. 1997).

(Footnote 94 return)
See id. at 960.

(Footnote 95 return)
See id. at 959–60. The Seventh Circuit has been the source of numerous decisions on absolute priority and new value. Up until *LaSalle*, however, no decision squarely addressed the issue, but many gave intimations that the Circuit would come out one way or another when the issue was decided. It seemed that the result in the Circuit might depend on which panel of judges heard the case. For example, in *Official Creditors' Comm.* v. *Potter Material Serv.* (*In re* Potter Material Serv. Inc.), 781 F.2d 99 (7th Cir. 1986), Judge Harlington Wood assumed the validity of the new value principle when the court allowed the confirmation of a new value plan to stand. On the other hand, in *In re* Stegall 865 F.2d 140 (7th Cir. 1989), Judge Posner, in a delightful opinion, questioned whether the new value principle survived the Bankruptcy Code in holding that old equity's offer of sweat equity did not constitute new value. Again, in *Kham & Nate's Shoes No. 2* v. *First Bank*, 908 F.2d 1351, 1361 (7th Cir. 1990), Judge Easterbrook implied very strongly that the new value exception no longer existed after the codification of the absolute priority rule in the Bankruptcy Code. Then, in *In re* Snyder, 967 F.2d 1126 (7th Cir. 1992), Judge Cudahy assumed the validity of the new value rule in rejecting the debtor's plan as not meeting the requirements for such a plan and in *In re* Woodbrook Assocs., 19 F.3d 312 (7th Cir. 1994). District Judge Zagel, sitting by designation, and writing for a panel composed of himself, Chief Judge Posner, and Judge Cummings, rejected a new value plan because the proposed contribution did not satisfy the new value requirements, reserving decision on the viability of the new value exception or corollary.

(Footnote 96 return)
See Bank of Am., III. v. *203 N. LaSalle St. Partnership*, 195 B.R. 692, 705 (N.D. III. 1996), *aff'd*, 203 N. LaSalle St. Partnership, 126 F.3d 955 (7th Cir. 1997).

(Footnote 97 return)
See In re 203 N. LaSalle St. Ltd. Partnership, 190 B.R. 567, 576 (Bankr. N.D. III. 1995), *aff'd*, *Bank of Am., III.* v. *203 N. LaSalle St. Partnership*, 195 B.R. 692 (N.D. Ill. 1996).

(Footnote 98 return)
"This plan, and indeed, the entire bankruptcy case, was filed by the debtor primarily to avoid the severe tax consequences to the debtor's partners of a foreclosure sale of the debtor's property. The principal of the general partner estimated the collective tax liability of the partners, in the event of foreclosure, at $20 million."

(Footnote 99 return)
See 203 N. LaSalle St. Ltd. Partnership, 190 B.R. at 585.

(Footnote 100 return)
See 203 N. LaSalle St. Partnership, 126 F.3d at 969–70. Judge Kanne dissented on the theory that there is no new value exception in the code. *Id.* at 970 (Kanne, J., dissenting).

(Footnote 101 return)
Professor Markell sums it up:

(Footnote 102 return)
2 Bankr. Ct. Dec. (CRR) 1478 (Bankr. N.D. Ga. 1976).

(Footnote 103 return)
Under prior tax law, the non-recourse nature of the mortgage was a tax favor to the borrower given by the lender. In

order for the limited partners to make use of the entire mortgage as part of their tax basis, it was necessary to exculpate the partnership. *See* I.R.C. 1245, 1250 (1976) (current version at 26 U.S.C. 1245, 1250 (1994)).

(Footnote 104 return)

Chapter XII had afforded no absolute priority protection but provided some alternative protection to crammed down mortgagees. The protection alternative that figured so prominently in the *Pine Gate* line of cases was found in section 461 (11) of Chapter XII, which required that dissenting classes had to be paid in cash the value of the debt owed to them before a plan could be imposed. Since the mortgage was nonrecourse, the court concluded that the value of the debt equaled the value of the collateral—in the depressed market conditions at the time. *See Pine Gate*, 2 Bankr. Ct. Dec. (CRR) at 1478.

(Footnote 105 return)

In *State Mut. Life Assurance Co. of Am.* v. *KRO Assoc*. (*In re* KRO Assoc.), 4 Bankr. Ct. Dec. (CRR) 462, 470 (Bankr. S.D.N.Y. 1978), there were approximately $14 million in mortgages on the property. The court, using a 20% capitalization rate, found the value of the property to be $895,000. *Id.* The court suggested that tax avoidance should not be equated with tax evasion, and therefore, avoidance is not a valid basis to dismiss a Chapter 12 plan. *See id.* at 468. This is echoed in current decisions. *See, e.g., LaSalle*, 126 F.3d at 969 (stating that "the desire to avoid significant tax liabilities, if legal, is a result consistent with the Bankruptcy Code").

(Footnote 106 return)

See, e.g. Hearings on S. 2266 and H.R. 8200 before the Subcomm. on Improvements in the Judicial Machinery of the Senate Comm. on the Judiciary, 95th Cong., 853 855–56 and 864–876 (1977) (statement of John J. Creedon, American Council of Life Insurance).

(Footnote 107 return)

Specifically, section 506(a) bifurcates the undersecured mortgagee's claim into a secured claim for the value of the collateral and an unsecured claim for the deficiency. Section 1111(b) provided for conversion of the non-recourse claim into a recourse claim for the purpose of plan confirmation, thus assuring that the mortgage could have a claim for the unsecured debt as determined under section 506(a). Section 1129(b)(1) required absolute priority for every dissenting impaired class of creditors. The package was designed to protect the mortgagee in the single asset situation where the deficiency claim represented almost all of the unsecured class, but not the mortgagee in a large business reorganization where the deficiency claim would normally be lost in a sea of unsecured claims and the mortgagee's vote would not control the class.

(Footnote 108 return)

Whether the resultant 100% loan to value mortgage can under any circumstances have a value equal to the value of the collateral is the subject of serious question. *See, e.g., infra* note 116.

(Footnote 109 return)

See ***S. Rep. No.*** *95–598, at 65 (1978), reprinted in* 1978 U.S.C.C.A.N. 5787, 5851 (stating section 1111 "answers the nonrecourse loan problem and gives the creditor an unsecured claim for the difference between the value of the collateral and the debt in response to the decision in" *Pine Gate*); *see also In re* DRW Property Co. 82, 57 B.R. 987, 990 (Bankr. N.D. Tex. 1986) (stating Congress enacted section 1111(b) to restore "benefit of the bargain" to nonrecourse secured creditors).

(Footnote 110 return)

11 U.S.C. 1129(b)(2) (1994)

(Footnote 111 return)
Section 1129(b)(2)(A)(i)(II) provides that the plan is fair and equitable as to secured dissenting impaired classes if each holder of a claim in the class receives "deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property."

(Footnote 112 return)
Conceptually, it can be argued that this conclusion is inconsistent with the predicate for the two theories (*share the equity* and *share with the debt*) under which it has been suggested that the Douglas principle of protection of creditors' priority can be reconciled with the retention of an interest by old equity under a new value plan, discussed above at footnote 56 and accompanying text. The predicate is that absolute priority looks to the value of the enterprise at confirmation, not the value post-confirmation (which includes the new value contribution). If that predicate were to be applied in single asset cases, then old equity's bid could be seen as representing the value of the property post-confirmation and not *at* confirmation. Thus, if the predicate is defeated, it would follow that either (i) there never was a viable new value concept because the Douglas standard cannot be met (the *impossibility* theory); (ii) Congress' attempt to protect the secured creditor in single asset cases failed; or (iii) the situation in single asset real estate is distinguishable. Practically speaking, the distinction seems clear. The earlier discussion dealt with a going business enterprise where the new value contribution enhanced the value of the enterprise and the interests retained in the enterprise by unpaid unsecured creditors. Here, we are talking about a single asset that old equity is attempting to acquire by its offer of new value, subject to the lien held by the secured creditor. Essentially, we are dealing with a sale of property and the bid is old equity's estimate of the value of the property to it. The amount of the secured creditors' lien should equal this value. On the other hand, if the distinction does not hold conceptually, perhaps the problem lies in the drafter's attempt to accommodate single asset cases in a one size fits all chapter 11.

(Footnote 113 return)
Under section 1129(b)(2) the secured claim must be increased to this value. For example, if the mortgage is $10 million and the property value is determined under section 506(a) to equal $7 million, the mortgagee's claim will be bifurcated into a secured claim of $7 million and an unsecured claim of $3 million. If the debtor offers to purchase the property through a plan offering new value of $30O,000, the debtor is paying $7.3 million for the property ($300,000 in cash and $7 million by taking subject to the mortgage). If the property is worth $7.3 million and the secured claim under the proposed plan is $7 million, the plan is not "fair and equitable" as to the secured class and cannot be confirmed.

(Footnote 114 return)
New Value advocates argue that old equity's bid does not represent the "intrinsic" value of the property, but is made only because old equity wants the property to avoid adverse tax consequences. This theory seems to insinuate itself into the *LaSalle* case where the bankruptcy court states: "The debtor's partners thus seek to retain their interests not because of the intrinsic value of these interests, but because of the tax consequences that flow from their loss." *In re* 203 N. LaSalle St. Ltd. Partnership, 190 B.R. 567, 588 (Bankr. N.D. Ill. 1995). Interestingly the same court, in referring to the payments that would go to the unsecured deficiency creditor states that they will receive "50% of the net value of the property, either as realized in a sale, or as appraised at the time of any refinancing," *Id.* at 576, thus agreeing that any sale price would represent the value of the property without inquiring into the prospective purchaser's motivation.

(Footnote 115 return)
Ayer, *supra* note 50, at 1011.

(Footnote 116 return)
Commission Report, *supra* note 3, at 676.

(Footnote 117 return)
The two most significant parts of the pay down proposal are: "(1) The new value contribution must pay down the secured portion of the claim on the effective date of the plan so that, giving effect to the confirmation of the plan, sufficient cash payments on the secured portion of the claim shall have been made so that the principal amount of the debt secured by the property is no more than 80 percent of the court-determined fair market value of the property as of the confirmation date; (2) the payment terms for the secured portion of the claim must both (i) satisfy all applicable requirements of section 1129 of the Code, and (ii) satisfy then-prevailing market terms in the same locality regarding maturity date, amortization, interest rate, fixed-charge coverage and loan documentation . . . " **Commission Report,** ***supra*** *note 3. at 674–75.*

(Footnote 118 return)
Section 1129(b)(2)(A) provides that the stripped down lien have a value as of the effective date of the plan equal to the value of the collateral. This, however, is fiction, perhaps designed to preserve the constitutionality of the provision. *See* 11 U.S.C. 1129 (b)(2)(A) (1994). In *Wright* v. *Union Cent. Ins. Co.*, 311 U.S. 273, 278 (1940), Justice Douglas recognized that the mortgagee had constitutional protection for the value of the collateral. The constitutionality of the present Bankruptcy Code provisions dealing with the secured claim, however, is a subject for a different article (I have been given strict page limitations which I have already egregiously exceeded). Suffice it to say that it would be difficult to conceive of a mortgage with a 100% loan to value ratio (the security just coming out of bankruptcy) being sold in the secondary market for its face amount. An 80% loan to value ratio might fare somewhat better.

(Footnote 119 return)
Rube Goldberg has been described as "an inventor whose specialty was making simple tasks complicated." *See Physics Class Pays Tribute to Goldberg*, **Fla. Today**, Dec. 12, 1997, at 03B.

(Footnote 120 return)
See 11 U.S.C. 101(51B). At this writing the House of Representatives has passed H.R. 764, a bill that would increase the $4 million cap to $15 million, see H.R. Rep. No. 105–324, at 2 (1997), and the Senate has passed S. 1559, a bill to eliminate the cap altogether. It is not clear what will eventually be agreed upon but it is clear that $15 million will not cover major real estate single asset transactions. Most of the well known new value cases do not fit within this limit.

(Footnote 121 return)
See Case v. *Los Angeles Lumber Prod. Co., Ltd.*, 308 U.S. 106, 121 (1939).

(Footnote 122 return)
See, e.g., **Commission Report**, *supra* note 3, at 551 and 555.

(Footnote 123 return)
See Jones Dissent, supra note 13, at 23–24.

(Footnote 124 return)
The meaning of the "money or money's worth" prerequisite seems to have been firmly established as a result of the Supreme Court decisions in *Case* and *Ahlers*, which clearly rejected expertise or other so-called sweat equity as meeting this requirement. Eternal vigilance, however, is still in order. Note that in *In re* Snyder, 967 F.2d 1126, 1130

(7th Cir. 1992) the Court of Appeals finds as a strong policy argument for retention of the new value exception that "[o]wners often have valuable information about the enterprise that outsiders lack, and owner participation allows this information to be put to use." In *Greystone*, 102 B.R. 560, 575 (Bankr. W.D. Tex. 1989), one of the reasons that lead the bankruptcy court to determine that creditors received "full compensation" was that "current management is deemed by all to be superior."

(Footnote 125 return)
"The substantiality requirement is derived not from *Los Angeles Lumber's* third criterion [reasonable equivalence], but from its first—that an infusion of new capital must be necessary to the success of the undertaking."*In re* Snyder, 967 F.2d 1126, 1131 (7th Cir. 1992).

(Footnote 126 return)
See In re 203 North LaSalle Street Ltd. Partnership, 190 B.R. 567, 586 (Bankr. N.D. Ill. 1995), where the court sees an implication in *In re* Woodbrook Associates, 19 F.3d 312, 320 (7th Cir. 1994), that "substantiality serves as something of a summary of the other factors. . . . " The *Woodbrook* court lists all the *Case* factors as prerequisites, but in analyzing whether the factors have been met discusses only substantiality. 19 F.3d at 319–20. Also, in *U.S. Truck*, although the Sixth Circuit upholds the finding of the District Court that "the contribution was substantial and 'essential'," the district court actually did not purport to consider whether the contribution was essential. concentrating only on substantiality. *In re* U.S. Truck Co., Inc., 800 F.2d 581 (6th Cir. 1986), *aff'g* 47 B.R. 932 (E.D. Mich. 1985). Said the court: "The basic issue, then, is whether the $100,000 amount provided in the plan is 'substantial' enough to satisfy 1129(b)(2)(B)(ii)." 47 B.R. 932, 941 (E.D. Mich. 1985). In *Snyder*, 967 F.2d at 1131, the court points out that "[t]he requirement that a contribution be substantial is independent of the rule that a contribution must be at least equal to the value of the interest retained." 967 F.2d at 1131. However the only prerequisite issue in the case was whether the contribution was substantial.

(Footnote 127 return)
"Whether the infusion of new capital is 'substantial' is more a common sense determination than a mathematical calculation when the debtor comprises only a single real estate asset which is fully encumbered." *In re* 203 LaSalle St. Partnership, 126 F.3d 955, 967 (7th Cir. 1997) (quoting *In re* Woodbrook Assocs. 19 F.3d 312, 320 (7th Cir. 1994)).

(Footnote 128 return)
For example, in *LaSalle*, the court found that the contribution was equal to approximately 10.7% of the deficiency claim but agreed with other courts that substantiality " 'may not always hinge on a comparison of the proposed contribution to the total amount of unsecured debt.' " 190 B.R. at 587 (quoting *Woodbrook*, 19 F.3d at 320 and *Snyder*, 967 F.2d at 1131). This also serves as an interesting admission that Justice Douglas' requirement that creditors receive their *full* right of priority may no longer be an issue.

(Footnote 129 return)
LaSalle, 190 B.R. at 588 (finding contributions of $4.1 million in this case far greater than contributions of $30,000 and $100,00 in *Snyder* and *Woodbrook*, respectively).

(Footnote 130 return)
Id. (quoting *Snyder*, 967 F.2d at 1131–32).

(Footnote 131 return)
Id.

(Footnote 132 return)
See id.

(Footnote 133 return)
271 U.S. 445 (1926).

(Footnote 134 return)
Id. at 455 (emphasis added).

(Footnote 135 return)
Case v. *Los Angeles Lumber Co.* 308 U.S. 106, 117 (1939).

(Footnote 136 return)
126 F.3d 955, 967 (7th Cir. 1997).

(Footnote 137 return)
Case, 308 U.S. at 117.

(Footnote 138 return)
800 F.2d 581 (6th Cir. 1986), *aff'g* 47 B.R. 932 (E.D. Mich. 1985).

(Footnote 139 return)
The requirement of necessity was not really a factor in the lower court decision since the only prerequisite that court was referring to was that of substantiality. The Court of Appeals seemed to be saying that the District Court had dealt implicitly with the necessity requirement when it upheld the District Court's conclusion that the contribution was "substantial and 'essential'." *See* U.S. Truck, 800 F.2d at 588.

(Footnote 140 return)
Teamsters Nat'l Freight Indus. Negotiating Comm. v. *U.S. Truck Co.* (*In re* U.S. Truck Co.), 800 F.2d 581 (6th Cir. 1986), *aff'g In re* U. S. Truck Company Inc., 47 B.R. 932 (E.D. Mich. 1985).

(Footnote 141 return)
See generally, **Commission Report**, *supra* note 3, at 545–67

(Footnote 142 return)
Northern Pacific Ry. v. *Boyd*, 228 U.S. 482 (1913).

(Footnote 143 return)
See id. at 508 (stating creditors were entitled to benefit of value derived from control).

(Footnote 144 return)

485 U.S. 197 (1988).

(Footnote 145 return)
Id. at 207–08 (citing *Boyd*, 228 U.S. at 508).

(Footnote 146 return)
Cf. ***Dylan Thomas, Do Not Go Gentle Into That Good Night**, reprinted in **The Norton Anthology of Modern Poetry** 911 (Richard Ellmann & Robert O'Clair eds., 1973).*

(Footnote 147 return)
LaSalle, 190 B.R. at 588.

(Footnote 148 return)
See, e.g., Travelers Ins. Co. v. *Bryson Properties*, XVIII (*In re* Bryson Properties, XVIII), 961 F.2d 496, 504 (4th Cir. 1992) (stating exclusive right to propose new value plan constitutes property); *In re* Outlook/Century Ltd., 127 B.R. 650, 654 (Bankr. N.D. Cal. 1991) (finding exclusivity constitutes property old equity retains on account of existing interests).

(Footnote 149 return)
See Dissent, supra note 13, at 24–29.

(Footnote 150 return)
Id. at 25–26.

(Footnote 151 return)
Id. at 25.

(Footnote 152 return)
Id. at 25–26.

(Footnote 153 return)
Id. at 26–27.

(Footnote 154 return)
See ***Commission Report**, supra* note 3, at 545.

(Footnote 155 return)
In re 203 N. LaSalle Street Partnership, 126 F.3d at 955, 969 (7th Cir. 1997).

(Footnote 156 return)
See ***Commission Report**, supra* note 3, at 563–65 (discussing perceived problems with use of credit bidding).

(Footnote 157 return)
See id. at 563.

(Footnote 158 return)
See id.

(Footnote 159 return)
This analogy was originally made in another context by an old associate and friend, Frank E. Roegge.

(Footnote 160 return)
See generally, Karen Gross, Failure and Forgiveness, Chapter 12 (1997).

(Footnote 161 return)
See supra notes 56, 110 and accompanying text.

(Footnote 162 return)
We note that the first and second sentences of section 205 of the bill appear to be identical and suggest that the second sentence was added in error.