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11th Biennial Judge Joe Lee Bankruptcy Institute

Office of Continuing Legal Education at the University of Kentucky College of Law

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11th Biennial

JUDGE JOE LEE BANKRUPTCY INSTITUTE

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Presented by
OFFICE OF CONTINUING LEGAL EDUCATION
UNIVERSITY OF KENTUCKY COLLEGE OF LAW

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JUDGE JOE LEE BANKRUPTCY INSTITUTE

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SECTION A

SOME THOUGHTS FOR BANKRUPTCY PRACTITIONERS ON SARBANES-OXLEY, RELATED REGULATORY DEVELOPMENTS AND THE NEW LISTING STANDARDS

APPENDIX:

Some Thoughts for Bankruptcy Practitioners on Sarbanes-Oxley, Related Regulatory Developments and the New Listing Standards

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May 2003

The Sarbanes-Oxley Act of 2002[1] has become a CLE staple. It is dangerous to assume that Sarbanes-Oxley is relevant only to those who practice federal securities law. Sarbanes-Oxley and accompanying regulatory changes will alter the legal landscape in which publicly held corporations operate. A background on the provisions of Sarbanes-Oxley is thus part of being a well-informed lawyer.

Beyond the goal of staying informed, bankruptcy practitioners have particular reasons to become familiar with the changes that Sarbanes-Oxley has brought. Sarbanes-Oxley and related regulatory developments will affect bankruptcy practice directly, especially in the corporate reorganization area. Indeed, the new lawyer reporting requirements could have spillover effects for many business lawyers, even those who practice far away from the nation's financial centers. The same could be said for other provisions in Sarbanes-Oxley.

These materials review five aspects of Sarbanes-Oxley and related regulatory developments:

[1] Pub. L. No. 107-204, 116 Stat. 745.

Generally, these materials will cite to the Sarbanes-Oxley Act itself. Some provisions of Sarbanes-Oxley are codified in chapter 98 of title 15 of the *United States Code*. Some provisions of Sarbanes-Oxley amend the Securities Act of 1933 ("the Securities Act"), codified at 15 U.S.C. § 77 *et seq.*, and the Securities Exchange Act of 1934 ("the Exchange Act"), codified at 15 U.S.C. § 78 *et seq.* Where appropriate, these materials will cite to the Securities Act and the Exchange Act as well as the implementing regulations of the Securities Exchange Commission contained in parts 239 (Securities Act) and 240 (Exchange Act) of the *Code of Federal Regulations.*

1. New nondischargeability provisions for debts relating to securities fraud;
2. Sarbanes-Oxley's new lawyer reporting requirements for lawyers who discover fraud or breach of fiduciary duty (including a breach of the fiduciary duty to creditors);
3. Certification of financial statements by officers of reorganizing companies;
4. New causes of action created by Sarbanes-Oxley and what they mean for the bankruptcy estate; and
5. The effects of new listing standards at the New York Stock Exchange ("NYSE") and the Nasdaq on reorganizing companies.

1. New Nondischargeability Provision

The provision of Sarbanes-Oxley that has the most obvious relevance to bankruptcy practitioners is section 803, adding a new nondischargeability provision to Bankruptcy Code section 523(a)(19). A debt is now nondischargeable if it:

(A) is for—

(i) the violation of any of the Federal securities laws . . . any of the State securities laws, or any regulation or order issued under such Federal or State securities laws; or

(ii) common law fraud, deceit, or manipulation in connection with the purchase or sale of any security; and

(B) results from—

(i) any judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceeding;

(ii) any settlement agreement entered into by the debtor; or

(iii) any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor.

The terms of the nondischargeability provision is fairly straightforward. Debts resulting from securities law liability are nondischargeable, but it should be noted that the debt must be reduced to a judgment, embodied in a settlement, or contained in a court or administrative order. Of course, as a nondischargeability provision, it applies only to individual debtors.

Problems in application will come from the requirement that the debt be in a judgment, settlement, or court or administrative order. Securities law debts will be dischargeable unless they have reached this stage. Thus, a debtor *perhaps* can avoid a finding of nondischargeability by filing bankruptcy before the debt is in a judgment, settlement, or court or administrative order. The qualification "perhaps" is necessary because new section 523(a)(19) bears a resemblance to the pre-1990 version of 523(a)(9) which excepts drunk-driving debts. Before 1990, drunk driving debts were nondischargeable only if they were embodied in a court judgment or consent decree. To avoid unfair results, the bankruptcy courts developed a variety of doctrines that allowed a finding of nondischargeability even in the absence of a court judgment or consent decree. For example, some courts would find nondischargeability so long as the creditor had initiated a court proceeding related to the drunk-driving debt.[2] It is possible, even likely, that the experience under the pre-1990 version of section 523(a)(9) will repeat itself for

[2] A summary of the pre-1990 case law under section 523(a)(9) appears at Lawrence Kalevitch, *Cheers? The Drunk-Driving Exception to Discharge*, 63 AM. BANKR. L.J. 213 (1989). It is likely this pre-1990 case law may become influential in the interpretation of new section 523(a)(19).

the new nondischargeability provision of section 523(a)(19) and that courts will develop similar doctrines.

Also, nondischargeability will become another bargaining point in settlement negotiations for securities suits. Savvy defense lawyers will seek to have settlements characterize a debt for conversion or some other non-securities wrong. Savvy plaintiffs' lawyers will want to ensure the settlement agreement characterizes the debt as arising out of a securities law violation to preserve nondischargeability. Indeed, a well-drafted settlement agreement that aims to protect a plaintiff might even stipulate to nondischargeability.

2. Lawyer Reporting

Section 307 of Sarbanes-Oxley directs the SEC to issue regulations regarding the minimum standards of professional conduct attorneys appearing and practicing before the commission. Specifically, Congress directed the SEC to include a requirement that attorneys report evidence of a material violation of securities law or breach of fiduciary duty or a similar violation. The statute contemplated that attorneys would first report to general counsel or an officer of the corporation. If the officer did not appropriately respond, then the attorney was to report to the board of directors.

On November 21, 2002, the SEC issued proposed rules.[3] The proposed rules went beyond the statutory directive and in some circumstances would have required a lawyer who did not receive an appropriate response from the board of directors to "withdraw noisily." Upon withdrawal, the lawyer would have been required to notify the SEC. Because of the proposed rule's alteration of the fundamental attorney-client

[3] Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,670 (Dec. 2, 2002).

relationship, the proposal was very controversial. By the SEC's own characterization, the proposal received "significant comment and extensive debate." The SEC received 167 comment letters on the proposal.

On January 29, 2003, the SEC issued its final rule.[4] This rule will go into effect on August 5, 2003. Importantly, the final rule omitted the noisy withdrawal requirement. The SEC, however, proposed an alternative and extended the comment period for the noisy withdrawal requirement. The alternative would require the reporting company, not the attorney, to report the attorney's withdrawal. Thus, the attorney would not be the party directly reporting his or her withdrawal. There is little functional difference with the proposed alternative. Whether the attorney or the company reported the withdrawal, the information would still come out. Because the attorney's withdrawal would mean the attorney believed company insiders refused to remedy a material breach of the securities laws or their own fiduciary duties, the notice of such a withdrawal ordinarily would have a significant negative effect on the company's stock price.

Because the SEC's rule works in ways that are not necessarily intuitive, it is useful to review them in some detail. As a regulation of attorneys, the rule applies only to attorneys appearing before the commission.[5] The rule's scope, however, reaches far more individuals than that phrase might suggest. The phrase "appearing and practicing before the Commission" means:

(i) Transacting any business with the Commission, including communications in any form;

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[4] Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6296 (Feb. 6, 2003).
[5] 17 C.F.R. § 205.1 (the attorney reporting requirements will appear at part 205 of title 17 of the *Code of Federal Regulations* and all citations will refer to this codification of the rules).

(ii) Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena;

(iii) Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or

(iv) Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission.[6]

As can be seen by the scope of this rule, it is quite broad. It applies not only to those representing clients to the SEC directly, but it also can apply to anyone working on documents that at some point may become part of an SEC filing. The rule has two safe harbors (1) for entities to whom the attorney does not have an attorney-client relationship or (2) non-appearing foreign attorneys.[7] Violations of the rule not only subject an attorney to discipline before the SEC but also subject the attorney to the full range of civil penalties and remedies for a violation of the federal securities laws.[8]

The reporting process is triggered by the attorney becoming "aware of evidence of a material violation by the issuer" or its officers.[9] A "material violation" is:

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[6] *See* 17 C.F.R. § 205.2(a)(1).
[7] *See id.* § 205.2(a)(2) (the phrase "non-appearing foreign attorney" is itself a defined term, *see* 17 C.F.R. § 205.2(j))
[8] *See* 17 C.F.R. § 205.6.
[9] *See id.* § 205.3

> a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law.[10]

Once the attorney becomes aware of such a "material violation," the attorney *must* report to the chief legal officer or to both the chief legal officer and the chief executive officer.[11] The chief legal officer, in turn, is obligated to begin an inquiry unless he or she determines no material violation has occurred.

If the attorney reasonably believes that the chief legal officer or chief executive officer has "provided an appropriate response within a reasonable time," the reporting process ends. If not, the attorney must then report the violation to the board of directors.[12] An alternative process can occur if the company has established a "Qualified Legal Compliance Committee," which is basically a committee of independent directors acting in a manner somewhat akin to an audit committee except to oversee the company's legal services.[13] Regardless of the process, an attorney who does not receive an appropriate response within a reasonable time must explain his or reasons to the chief legal officer, the chief executive officer, and the board of directors.

The final rule gives the attorney an additional option. The attorney may reveal, without the company's consent, confidential information to the extent the attorney reasonably believes necessary to prevent the company from committing a material violation that is likely to cause substantial injury to the financial interest of the company or investors.[14] In addition, the rule allows disclosure to rectify the consequences of a

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[10] *Id.* § 205.2(i).
[11] *Id.* § 205.3.
[12] *See id.*
[13] *See id.* § 205.2(k).
[14] *See id.* § 205.3(d)(2).

material violation that already has occurred if it has or will lead to substantial injury to the financial interest of the company or investors. Note in either circumstance, the material violation must lead to a "substantial injury" to financial interests. Thus, the rule does not permit disclosure of client confidences to address small or trivial matters. The attorney also may reveal confidential information to prevent perjury or a fraud on the SEC.

The proposed rule was substantially different in that it required, as opposed to merely permitting, the disclosure of client confidences. In addition, as noted above, the proposed rule would have required the attorney to withdraw at this point and report the withdrawal to the SEC. Neither the required disclosure nor the withdrawal requirement are part of the final rule. The SEC is currently studying a proposal that would require withdrawal and the report of the withdrawal to come from the company.

At this point, it is worth reminding ourselves not only that these rules apply to attorneys appearing and practicing before the SEC but also that definition reaches many attorneys. Advising clients about the scope of the securities law exemption in Bankruptcy Code section 1145 arguably makes one an attorney appearing and practicing before the SEC. Remember also that the concept of a "material violation" includes a breach of fiduciary duty. This could include a breach of fiduciary duty to creditors. Therefore, an attorney preparing documents for an insolvent company could run afoul of the SEC reporting rules.

Another issue with the rules is that they could potentially create a standard of conduct for professional liability. The final rule expressly disclaims that it creates a private cause of action. There is a difference, however, between creating a cause of action and serving as the basis for an existing cause of action for professional malpractice. An attorney who fails to report risky financial behavior that puts the recovery of creditors in jeopardy may run afoul of the new reporting requirements, not for their own sake but as a standard of conduct in a professional malpractice action.

3. Certification of Financial Statements

Section 302 of Sarbanes-Oxley imposes new certification requirements on both the principal executive and principal financial officers of companies filing annual and quarterly reports with the SEC. These officers must sign the quarterly and annual reports filed with the SEC (typically the Forms 10-Q and 10-K). Signing these quarterly or annual reports constitutes certifications that can be summarized as follows:[15]

1. The signing officer has reviewed the report;
2. Based on the officer's knowledge, the report does not contain any untrue statement of a material fact (or omit to state a material fact necessary to make other statements not materially misleading);
3. Based on the officer's knowledge, the financial statements, and other financial information included in the report fairly present in all material respects the financial condition and results of operations of the issuer;
4. The signing officers have reviewed and assumed enumerated responsibilities for the "disclosure controls" of the company;[16]

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[15]These text contains only a summary of the actual provisions. The actual text of the statute and implementing rule contain more detailed language and should be consulted to determine the precise operation of these provisions.
[16]Although the statutory text uses the term "internal controls," the SEC rule interpreted this to mean "disclosure controls" as explained in the next paragraph.

5. The signing officers have disclosed to the audit committee all significant deficiencies in the design or operation of internal controls and any fraud, whether or not material, that involves management or any employee who has a significant role in the issuer's internal controls; and

6. The signing officers have indicated in the report significant changes in internal controls or other factors that could affect internal controls subsequent to the date of evaluation.

These rules apply to any companies required to file reports under the Securities Exchange Act of 1934.[17]

In its rules to implement section 302, the SEC provided some detail to these requirements. First, the SEC clarified that the certification in the fourth item about control designed to ensure adequate disclosure. The SEC termed these controls "disclosure controls" and defined that term as:

> controls and procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the [Securities Exchange] Act is recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the [Securities Exchange] Act is accumulated and communicated to the issuer's management, including its principal executive officer or officers and principal financial officer or

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[17] Generally speaking, companies traded on a national securities exchange or companies with publicly held equity and that have more than 500 shareholders of record and more than $10 million in total assets must register with the SEC, *see* Exchange Act § 12(g)(1); SEC Rule 12g-1, and are thereby subject to reporting requirements, *see* Securities Exchange Act § 13(a). In addition, section 15(d) of the Exchange Act requires registration and reporting by persons who issue securities pursuant to a registration statement under the Securities Act. The main effect of section 15(d) is to require reporting by companies that issue only publicly held debt that trades off the national exchanges.

> officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Thus, the SEC distinguished the concept of "disclosure controls" from the more common term "internal controls." As the SEC uses the term, disclosure controls help to ensure a company adequately meets its public reporting obligations, while financial controls concern a company's financial accounting. The signing corporate officers certify not only that they have designed the disclosure controls to be effective but also that they have evaluated the effectiveness of these controls within ninety days of making the certification.[18]

The other important feature of the SEC rules is that they require the corporate officers' certification to be in the exact form mandated by the rule. The wording of the required certification may not be changed in any respect even if the change would appear to be inconsequential in nature.[19]

Turnaround professionals and other newcomers to a financially distressed company may find these certification requirements troubling. A new executive stepping into a company will be required to make these certifications the same as one who had been there for years. The requirement of a review of the company's disclosure controls within ninety days before the certification also is the same for new as well as long-time executives. Although the rule's language would seem to allow reliance on a review conducted by a predecessor officer, that result is not clear. In the event, the new officer would be making a certification based on someone else's work, and in the context of a financially distressed or reorganizing company there are often reasons not to rely on the

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[18] *See* SEC Rules 13a-14(b)(4), 13a-15, 15d-14(b)(4), 15d-15

[19] *See* Certification of Disclosure in Companies' Quarterly and Annual Reports, 67 Fed. Reg.57,276 (Sept. 9, 2002). The forms for the required certification also contain a similar statement. *See id.*

predecessor officer. The certifications will be required any time distressed or reorganizing companies file quarterly or annual reports with the SEC.

The consequences for filing a false certification are potentially severe. All of the Exchange Act's liability provisions come into play, including liability under general antifraud provisions like Rule 10b-5. This includes potential criminal liability under the Exchange Act as well as civil enforcement actions by the SEC and private lawsuits by individual investors.

In addition to liability under the Exchange Act, section 906 of Sarbanes-Oxley (codified at 18 U.S.C. § 1350) added a new crime to the federal criminal code. A knowingly false certification carries a potential $1,000,000 fine and up to 10 years in prison, and a willfully false certification carries a potential $5,000,000 fine and up to 20 years in prison. Moreover, this new crime might have a potentially broader reach than the reporting requirements of section 302. Under the new crime, the chief executive and chief financial officers must certify that the information contained in a "periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer." Although the certification requirements in the section 302 reporting provisions contain similar language, the new provision in the criminal code is not tied to generally accepted accounting principles ("GAAP"). Thus, a plausible but extreme interpretation would criminalize a certification when financial statements complied with GAAP but off-balance sheet items meant the financial statements did not "fairly present" the financial condition of the company.

Given these substantial consequences, the Sarbanes-Oxley certification rules definitely raise the stakes for turnaround and reorganization professionals stepping into a financially distressed company. Certainly, new executives might simply refuse to sign the required certification. Such a decision, however, would place the company in breach of its reporting obligations under the Exchange Act. Both the company and executive would face enforcement proceedings from the SEC. With the stakes raised, the certification requirements will add another burden to turnaround and reorganization professionals. It is likely to lead to demands for higher compensation and possibly broader indemnification. There also exists the possibility that it will simply become more difficult to find turnaround professionals willing to take a job at a company unless assurances can be provided that the new executive will be able to make the certifications required by Sarbanes-Oxley.

4. New Causes of Action for the Bankruptcy Estate

Sarbanes-Oxley added a number of new causes of action to the federal securities laws. For the bankruptcy professional, an important question will be whether these causes of action will become part of the bankruptcy estate, and, if not, how these causes of action will affect the reorganization process.

1. Section 304: Return of Bonus and Incentive Compensation after an Accounting Restatement

Section 304 adds a new cause of action when an issuer must prepare an accounting restatement because of material noncompliance. If the restatement results from misconduct, the chief executive officer and chief financial officer must reimburse the issuer for:

(1) Any bonus or other incentive-based or equity-based compensation received by the CEO or CFO for the twelve-month period following the first public issuance or filing with the SEC of the document with the incorrect financial information and

(2) Any profits realized from the sale of securities of the issuer during that twelve-month period.

This section's operation is prophylactic. There is no requirement that the chief executive officer or chief financial officer have participated in the misconduct leading to the financial restatement. Because section 304 creates a cause of action in favor of the "issuer," it would clearly become property of the bankruptcy estate under Bankruptcy Code section 541. In chapter 11s that have been preceded by an accounting restatement, this new cause of action will be further grounds for appointment of a chapter 11 trustee if management has remained in place.

2. Section 306: Trading Bars on Corporate Directors and Executive Officers During Pension Fund Blackout Periods

Section 306 bars trading by corporate directors and executive officers in the company's stock during any pension fund blackout period. This section was adopted on the heels of reports that Enron insiders avoided huge losses by selling their company stock at a time when low-level employees were prohibited from selling their holdings because of temporary restrictions in the company's stock plans. To enforce the trading bar, section 306 states that any profit earned by a director or executive officer in violation of the trading bar will inure to the benefit of the company. In provisions that parallel section 16(b) of the Exchange Act,[20] the issuer may bring a suit to recover these profits, but any individual security holder may sue after the issuer fails or refuses to bring a suit within sixty days after the security holder requests. As with section 16(b), winning plaintiffs are likely to get their attorneys' fees under the common fund doctrine. The statute of limitations is two years.

Again, section 306 clearly states that the recovery inures to the issuer. Therefore, it certainly becomes part of the bankruptcy estate. Like the section 304 recovery of bonuses and trading profits, corporate insiders will have little interest to bring suits enforcing the trading ban during pension fund blackouts. Still, the right of an individual security holder to sue means it is less likely that the existence of "section 306 pension-fund trading ban" actions will be grounds for appointment of a trustee. There will be no need to appoint a chapter 11 trustee to prosecute the action because individual security holders may do so.

3. *Section 308: Fair Funds for Investors*

Known as the "Fair Funds for Investors" provision, section 308 of Sarbanes-Oxley does not add a new cause of action but instead changes how the SEC may distribute civil penalties. Previously, the SEC was required to return the amount of any civil penalty to the United States Treasury. Under section 308, if the SEC obtains a disgorgement order that returns funds to victims of a securities violation, the amount of any additional civil penalty the SEC also obtains may be added to the fund. The SEC

[20] Section 16(b) of the Exchange Act authorizes recover of short-swing insider trading profits, that is trading profits earned by a section 16 insider (a director, officer, or more than 10% shareholder) based on a matched purchase and sale (or sale and purchase) during a six-month period.

must request and receive court approval to add the civil penalty to the disgorgement fund for the benefit of the victims of the securities violation.

Of course, the rights under section 308 belong to the SEC and could not accrue to the bankruptcy estate. Nevertheless, section 308 could affect financially distressed or reorganizing companies. First, by creating a potentially larger recovery for victims of a securities violation, the "fair funds" provision could reduce the amount of claims victims assert against the issuer. Of course, this only matters if the civil penalty and disgorgement that create the fund come from sources other than the company itself, which might be the case if the corporation's individual officers or directors paid. Second, one wonders whether the company could subrogate to the rights of victims of a securities violation or otherwise recover from the fund. The statute directs that the fund be paid "for the benefit of the victims" of the securities violation. If a company has paid victims of a securities violation perpetrated by one of its officers and the officer then pays a civil penalty, the company might assert a claim against the fund by standing in the shoes of the victim. There might be two problems with such an assertion. Unless the company had paid the victims in full, it would be competing against out-of-pocket victims and trying to assert rights under an equitable doctrine of subrogation. In addition, the discretion to create the fund rests with the SEC, which may not feel moved to do so if the principal beneficiary of the fund will be the company from whence the fraud came.

4. Sections 201 & 206, 17 C.F.R. § 210.2-01(c)(4)

Pursuant to Sarbanes-Oxley sections 201 and 206 and the implementing SEC regulations adopted under section 208, the list of non-audit services that a public accountant may provide to its audit clients has been drastically shrunk. To be considered "independent," an auditor may not provide the following non-audit services to a client:

1. Bookkeeping or other services related to the accounting records or financial statements of the audit client;

2. Financial information systems design and implementation;

3. Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;

4. Actuarial services;

5. Internal audit outsourcing services;

6. Management functions;

7. Human resources;

8. Broker-dealer, investment adviser, or investment banking services;

9. Legal services; and

10. Expert services unrelated to the audit.

Section 10A(h) of the Exchange Act now provides that audit committees have to preapprove the provision of any nonaudit services, including tax services, that are not on this list and thereby still permissible.

Nothing in the statute or implementing regulations expressly creates a cause of action to enforce the ban on nonaudit services. Nevertheless, it would now be against public policy for an accountant to engage in the services listed above while at the same time doing the audit for a company filing reports with the SEC. Although the regulations provide some detail to the list of provided services, the list still has room for substantial ambiguity. It is conceivable some insolvent companies could seek to recharacterize some past services provided by an auditor as falling within a prohibited category and seek refund of the fees. Solvent companies would be less likely to seek a recharacterization because it would jeopardize their ongoing relationship with their auditors. In either case, the audit committee's approval of the nonaudit services might estop the issuer from pressing for the recharacterization.

For nonpublic companies, these rules also will have relevance as they reflect the legislative and regulatory expectations of professional conduct by accountants. In other words, these laws now represent the public policy regarding nonaudit services. Much like the attorney reporting rules discussed *supra* Part 2, the ban on nonaudit services could come to reflect a standard of professional conduct for even nonpublic companies. Insolvent smaller businesses might find it worthwhile to bring suit, arguing an auditor's nonaudit services were against public policy and demand a return of the auditor's fee. Certainly, smaller businesses have constraints not faced by large public companies, and it is unrealistic to expect smaller business to incur the financial costs of hiring a second accountant to perform all of the functions listed in the statute and regulations. These new rules should not be transported blindly onto small company fact patterns, but there surely will be cases that will tempt courts and attorneys to do so nonetheless.

5. Listing Standards

In addition to the requirements imposed by Sarbanes-Oxley, the NYSE and Nasdaq are in the process of adopting new corporate governance standards. Companies that wish to be listed on these exchanges will need to follow these corporate governance guidelines. As a practical matter, these rules will not affect many companies operating in chapter 11 as the stock is delisted either before or shortly after the filing of the chapter 11 petition. Indeed, the NYSE corporate governance rules specifically give some exemptions for companies operating in bankruptcy. Nevertheless, some of these rules will raise difficult issues for companies wishing to come out of bankruptcy with publicly traded securities or for companies operating near bankruptcy. As listing standards, these new rules are not "law" as traditionally conceived. Nevertheless, the listing standards are a type of private law that companies will have to follow if they want to publicly traded in the United States.

An overview of these corporate governance changes is attached as an appendix. As of this writing, these proposed rules are pending before the SEC for that agency's approval. It is this author's understanding that the SEC is working with the NYSE and Nasdaq to harmonize, to the extent possible, the requirements of the two exchanges. Once these negotiations conclude, it is expected the SEC will approve these changes.

Appendix

The NYSE and Nasdaq's New Corporate Governance Listing Requirements and Their Relationships to the Sarbanes-Oxley Act

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The full text of the NYSE and Nasdaq corporate governance listing requirements can be found at the following URLs:

NYSE original proposal: http://www.nyse.com/pdfs/corp_gov_pro_b.pdf
NYSE amendment: http://www.nyse.com/pdfs/amend1-04-09-03.pdf

Nasdaq original proposal and amendment: http://www.nasdaq.com/about/ProposedRuleChanges.stm#Recent

	Majority of Independent Directors	Definition of Independence	Directors Deemed to Lack Independence	Independent Director Meetings
Sarbanes-Oxley Act (primarily codified in various provisions of the Securities Exchange Act of 1934 and other federal securities laws)	No comparable provision	Special rules for audit committee members *See* Enhanced Audit Committee Independence	No comparable provision	No comparable provision
NYSE Listing Requirements (primarily codified in a new section 303A of the NYSE Listed Company Manual)	A majority of the board must consist of independent directors, except for companies with a controlling shareholder. (Effective 24 months after SEC approval)	A director lacks independence *unless* the board affirmatively finds the director has no material relationship with the company.	Subject to a FIVE-year "cooling off" period: • receipt of nondirector compensation in excess of $100,000 • former employees • affiliated w/ or employed by auditor • interlocking directors, compensation cmtes. • family members with above	Nonmanagement directors must meet "regularly" outside the presence of management directors. There may be a "presiding director" for these sessions. (Effective six months after SEC approval)
Nasdaq Listing Requirements (primarily codified as amendments to NASD Rules 4200 & 4350)	A majority of the board must consist of independent directors, except for companies with a controlling shareholder. (Effective for first annual meeting occurring after January 1, 2004)	A director lacks independence if (1) the director is an officer or employee of the issuer or (2) the director has a relationship which, in the opinion of the board, would interfere with the exercise of independent judgment in carrying out the responsibilities of director	Subject to a THREE-year "cooling off" period • same as above plus • receives nondirector compensation in excess of $60,000 • shareholder or officer of company that received $200,000 or more in payments	Independent directors must have "regularly scheduled" meetings at which only independent directors are present. (Effective six months after SEC approval)

	Executive Officer Compensation	Director Nominations	Audit Committee Function	Enhanced Audit Cmte. Independence
Sarbanes-Oxley Act (primarily codified in various provisions of the Securities Exchange Act of 1934 and other federal securities laws)	No comparable rules on compensation generally, but: • Bar on officer & director loans, § 402 • Disgorgement of performance-based compensation after material misstatements, § 304	No comparable provision	No exchange may allow trading of company which does not meet audit committee rules, § 301.	• Only directors who do not receive consulting or other compensatory fees from the company • Not an "affiliated person" with the company, § 301 • Disclose whether cmte. has a "financial expert," § 407
NYSE Listing Requirements (primarily codified in a new section 303A of the NYSE Listed Company Manual)	Must be a compensation committee, with a written charter, composed entirely of independent directors. The compensation committee must approve the CEO's compensation.	Must be a nominating committee, with a written charter, composed entirely of independent directors. Contractual obligations or securities rights to nominate directors will be honored.	• Must have written charter • Sole authority to hire/fire auditors • Must approve nonaudit relationships still allowed by Sarbanes-Oxley. • Other "laundry list" of duties	• No other compensation from issuer • All must be "financially literate." • One must have "financial management expertise"
Nasdaq Listing Requirements (primarily codified as amendments to NASD Rules 4200 & 4350)	A majority of independent directors or compensation committee with exclusively independent directors must determine CEO compensation. Other officer compensation determined the same way with possibility of CEO attendance at meeting.	Directors must be nominated by a majority of the independent directors or a nominations committee consisting solely of independent directors. (NOTE: Neither nomination nor compensation rules requirements apply to "controlled companies.")	• Must have written charter • Sole authority to hire/fire auditors • Must approve nonaudit relationships still allowed by Sarbanes-Oxley • Approve all related-party transactions.	• Can't own 20% or more of issuer's voting stock • No other compensation from issuer • Must have basic financial skills • Must be chaired by a "financial expert." • n/a to small-business filers

	Codes of Conduct	Foreign Private Issuers	Other
Sarbanes-Oxley Act (primarily codified in various provisions of the Securities Exchange Act of 1934 and other federal securities laws)	Each issuer must disclose whether company has a code of ethics for senior financial officers, § 406.	No comparable provision, which is causing concerns for foreign issuers that must comply with home-country legal requirements that conflict with Sarbanes-Oxley rules.	n/a
NYSE Listing Requirements (primarily codified in a new section 303A of the NYSE Listed Company Manual)	All listed companies will be expected to have a code of conduct applicable to all directors, officers, and employees.	Non-US companies will need to disclose the significant ways in which home-country practices differ from those followed by domestic companies under NYSE listing standards. This disclosure will need to be on the company's web site and/or annual report.	• Also new rules on shareholder approval of equity compensation plans • Disclose corporate governance practices on company web site • NYSE may issue a public reprimand for violation of corporate governance rules. Suspension of trading or delisting is a possibility for "flagrant and repeated" violation of the corporate governance rules.

Nasdaq Listing Requirements
 	
(primarily codified as amendments to NASD Rules 4200 & 4350)
	Each issuer must have a code of conduct applicable to all directors, officers, and employees.	Foreign issuers may continue to receive exemptions from Nasdaq corporate-governance rules that conflict with home-country law, but these exemptions will need to be disclosed annually in the foreign issuer's 10-K.	• Also new rules on shareholder approval of equity compensation plans
			• Nasdaq is considering new rules to
			  o Prohibit loans to officers and directors through the adoption of a NASDAQ rule that mirrors section 402 of Sarbanes-Oxley
			  o Require continuing education for directors
			  o Require accelerated disclosure of insider transactions that would harmonize with, and reinforce, the provisions of the Act and the SEC rules promulgated thereunder

RECENT DEVELOPMENTS IN RIDE-THROUGH, REDEMPTION AND REAFFIRMATION

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SECTION B

RECENT DEVELOPMENTS IN RIDE-THROUGH, REDEMPTION AND REAFFIRMATION

RECENT DEVELOPMENTS IN RIDE-THROUGH, REDEMPTION AND REAFFIRMATION

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I. RIDING LESSONS: HOW TO RIDE-THROUGH WITHOUT VIOLATING THE DEBTOR'S DISCHARGE

A. What is Ride-Through?

Debtors who wish to keep collateral after a discharge need not always enter into reaffirmation agreements with their creditors. Instead, they may be allowed to use "ride-through," a judicially developed nonstatutory variant of voluntary repayment.

Remember that while a Chapter 7 debtor's personal liability will be discharged, a secured creditor will retain its lien on the collateral. Suppose a Chapter 7 debtor's car is subject to a security interest, and the debtor either has never missed a car payment or has cured any arrearages before filing. If such a debtor wants to keep the car, the creditor might not insist on reaffirmation. Instead, the creditor might leave the car with the debtor and continue to accept payments, through and after the bankruptcy. The effect is to transform the claim into a nonrecourse debt. The debtor's personal liability has been discharged but the lien lives on as a strong incentive to voluntary payment. If the debtor stops mailing payments, the creditor may repossess the car. The debtor will not, however, be liable for a deficiency.

Creditors may consent to ride-through. The fighting question, however, is whether ride-through is available only by creditor consent or is instead a debtor's right. That question is not clearly answered by the Code, and has divided the circuits. As of this writing, four circuits hold that a debtor current on payments has a right to ride-through, to retain the collateral as long as the payments keep coming.[1] Four others hold that there is no right to ride-through, if the creditor objects.[2] In those circuits, the creditor may require the debtor to reaffirm to keep the car.

Ride-through is advantageous to debtors in that they need not reassume personal liability. If later they cannot continue the payments, they may lose the collateral, but will not be liable for a deficiency. However, to keep the collateral, the debtor will have to make all the payments required by the original contract, even if the collateral is worth much less. The fact that the debtor may repay more than the current value of the collateral may make ride-through attractive to creditors as well. However, creditors have raised concerns that debtors with no personal liability have little incentive to keep the collateral in good condition.[3] A further problem is uncertainty over what contacts creditors may have with ride-through debtors without violating the discharge injunction.Several recent decisions have addressed the post discharge procedural plight of the creditor whose debtor has elected ride-through.

B. Post Discharge Ride-Through Procedure

The court in *Ramirez v. General Motors Acceptance Corp., (In re Ramirez)*, 273 B.R. 620 (Bankr. C.D. Ca. 2002), rejected the debtor's argument that the creditor violated the discharge injunction when it sent its regular monthly billing statement to the debtor for

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[1] For cases holding a debtor may ride-through despite a creditor's objection, *see In re* Parker, 139 F.3d 668 (9th Cir. 1998); *In re* Boodrow, 126 F.3d 43 (2nd Cir. 1997); *In re* Belanger, 962 F.2d 345 (4th Cir. 1992); *In re* Lowry Federal Credit Union, 882 F.2d 1543 (10th Cir. 1989). *See generally* Michael P. Alley, *Redemption, Reaffirmation, Exemption, and Retention in Chapter 7 Bankruptcy: Extinction Looms Near for the Free Ride*, 47 U. KAN. L. REV. 683 (1999) (discussing the current status of ride-through). *See also* Ned W. Waxman, *Redemption or Reaffirmation: The Debtor's Exclusive Means of Retaining Possession of Collateral in Chapter 7*, 56 U. PITT. L. REV. 187 (1994); Oliver B. Pollak, *Reaffirmation and Retention in Bankruptcy: Conflict in the Circuits Over Protecting the Secured Creditor*, 111 BANKING L.J. 302 (1994); Thomas J. Cunningham, *Postpetition Payments on Secured Debt; Ipso Facto Clauses and Their Relationship to Reaffirmation Agreements*, 20 CAL. BANKR. J. 213 (1992).

[2] For cases holding the debtor has no right to ride-through if the creditor objects, *see In re* Burr, 160 F.3d 843 (1st Cir. 1998); *In re* Johnson, 89 F.3d 249 (5th Cir. 1996); *In re* Taylor, 3 F.3d 1512 (11th Cir. 1993); *In re* Edwards, 901 F.2d 1383 (7th Cir. 1990).

[3] NBRC Report, *supra* note 37, at 166.

six months following the discharge and thereafter sent a billing statement that contained a new heading: "Transaction Summary of Voluntary Payments Made" and a new comment "Voluntary Payments Must Be Timely Received by GMAC if You Wish to Retain Your Vehicle." The *Ramirez* court ruled that these statements amounted to an informational courtesy and not an effort to collect the debt as a personal liability. In so holding the court observed "to hold that a secured creditor is precluded from sending monthly billing statements to a debtor would not eliminate all contact between debtors and creditors. Rather, such a ruling would solely force debtors to guess, with little guidance, the due date and proper amount of their payments." *Id.* at 258.

A Ninth Circuit Bankruptcy Appellate Panel agreed with the Ramierez court that monthly billing statements sent by the creditor to its ride-through debtor did not violate the discharge injunction in *Garske v. Arcadia Financial Ltd. (In re Garske)*, 2002 W.L. 31922081 (9th Cir. BAP 2002). The court held that post discharge contacts with the debtor are necessary and do not violate the discharge injunction as long as the communications do not indicate that the debtor is personally liable for the debt. Moreover, post discharge telephone collection efforts directed at a debtor who is delinquent on ride-through payments do not constitute *per se* violations of the discharge injunction. As long as the creditor confines any conversation with the debtor to requests for payment as a condition to continued possession of the collateral, there is no violation of the discharge injunction because the injunction protects the debtor only from efforts to collect the debt as a personal liability. In so holding, the BAP disagreed with the bankruptcy court's ruling in *Henry v. Associates Equity Home Services*, 266 B.R. 457, 472-73 (Bankr. C.D. Cal. 2001) that only written communications between creditor and debtor are permitted is such circumstances.

In *Henry* the creditor attempted to contact the debtors "some 90 times" "at home and at work, left telephone messages, threatened action if the debtors did not make payments and sent delinquency letters." *Henry* at 470. Half of these calls were made before the debtors' discharge and half thereafter. In the process of holding that few of the 90 contacts were proper and that most violated the automatic stay or the discharge injunction, the bankruptcy court laid out in specific and practical terms permissible creditor conduct both pre and post discharge where a debtor intends to retain the collateral by ride-through. Here, according to Bankruptcy Judge Sam Bufford, are the **dos** and **don'ts**:

1) **Don't** contact the debtor concerning his or her intentions regarding collateral if the debtor has timely filed and properly stated his or her statement of intention concerning the collateral.

2) **Do** send monthly statements, payment coupons or other means of facilitating monthly payments where the debtor states an intention to ride-through.

3) **Do** give the debtor written notice of the creditor's intention to foreclose on the collateral in the event of a post-discharge default on ride-through payments.

4) **Do** give the debtor all the required notices necessary or appropriate to foreclose on collateral under applicable state law in the event of post-discharge defaults on ride-through payments.

In communicating with the debtor, careful word selection can be the deciding factor as to whether or not the discharge injunction is being violated. Recall that in *Ramirez,* GMAC sent a regular monthly billing statement to the debtor for six months following the discharge. Thereafter, GMAC sent a billing statement that contained a new heading: "Transaction Summary of Voluntary Payments Made" and a new comment "Voluntary Payments Must Be Timely Received by GMAC if You Wish to Retain Your Vehicle." The *Ramirez* court held that these statements amounted to an informational courtesy and not an effort to collect the debt as a personal liability.

II. POST DISCHARGE REDEMPTION AGREEMENTS

Sears' post-petition redemption agreements received the Circuit Court of Appeals' stamp of approval in *Arruda v. Sears, Roebuck & Co.*, 310 F.3d 13 (1st Cir. 2002). The former Chapter 7 debtors unsuccessfully argued that Sears violated the discharge injunction and the Fair Debt Collection Practices Act when it sent letters after discharge requesting the debtors to contact its office to arrange for turning over the household goods securing Sears' claims. When the debtors contacted Sears, they were advised they could either surrender the collateral or redeem it by paying its fair market value as determined by Sears. The Sears redemption agreements explicitly stated that a failure to pay the redemption amount would not impose a personal liability on the debtor. Therefore, the First Circuit held, the agreements were not disguised reaffirmation agreements and § 524(c) did not affect their enforceability. Nor was the discharge injunction violated because Sears was merely acting within its *in rem* rights when it contacted the debtors post discharge concerning the disposition of the collateral. Furthermore, said the court, bankruptcy court approval of redemption agreements is not required under section 722.

With respect to the FDCPA claim, the First Circuit held that the debtors' complaint did not allege that a debt collector falsely stated they had an obligation to pay money (a claim which would be cognizable under the FDCPA). Rather, the complaint alleged only that Sears had contacted them concerning the terms under which Sears was willing to abandon its right of repossession. As such, the debtors failed to state a claim because these facts did not amount to the collection (or the attempted collection) of a "debt" within the meaning of the FDCPA.

III. RECENT DEVELOPMENTS IN REAFFIRMATION

A. Reaffirmation Procedure

1. The Present

Under the Bankruptcy Act of 1898, Chapter 7 debtors often were persuaded to reaffirm so much debt that the benefit of the discharge was lost. To remedy this problem, the Code of 1978 placed strict limitations on reaffirmation in section 524. Section 524 makes "[R]eaffirmation agreements...unenforceable unless they are entered into before...discharge and are approved by the Court. These measures are necessary to prevent the debtor from being coerced into signing a reaffirmation agreement and to enable the debtor to be fully aware of its consequences." *In re Smurzynski*, 72 B.R. 368, 370 (Bankr. N.D. Ill. 1987).

Section 524 requires a valid reaffirmation to:

- ➢ Be enforceable under non-bankruptcy law.
- ➢ Be made before discharge.
- ➢ Contain a clear and conspicuous notice of the debtor's right to rescind and that the debtor is not required by law to reaffirm any debt.
- ➢ Be filed with the court.
- ➢ Be accompanied by an affidavit from debtor's counsel which states:
    - ➢➢ that the agreement is an informed and voluntary decision by the debtor;

- ➢➢ that the agreement will not be an undue burden for the debtor or his dependents; and
- ➢➢ that counsel has advised the debtor of the legal effect of the agreement and of default under the agreement.

- ➢ Be approved by the court. If the debtor was not represented by counsel during the negotiation of the reaffirmation agreement, the court must hold a hearing and approve the agreement. To approve it, the court must find that it is not an undue hardship and is in the best interest of the debtor (no court approval is required if the debt is secured by the consumer's real property); and
- ➢ Not be rescinded by the debtor before the later of the date of discharge or sixty days after the agreement is filed with the court.

11 U.S.C. § 524(c).

2. The Future?

On March 19, 2003, the House of Representatives passed H.R. 975, the "short" title of which is the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2003." Similar to prior legislative attempts to amend the Code, the 2003 House bill would alter the Bankruptcy Code in several ways. A useful resource on the 2003 legislation is Basic Documents Related to Bankruptcy Reform available at www.law.unlv.edu/faculty/bam/bkreform2003/bkreform.html. A brief summary of the provisions of H.R. 975 relating to ride-through, redemption and reaffirmation follows.

NO RIGHT TO RIDE-THROUGH. Chapter 7 debtors would no longer have the right, now recognized in four circuits, to retain collateral without reaffirmation or redemption if they are current on the debt. Under the proposed bills, the debtor must state an intent to surrender, reaffirm or redeem (or assume a lease) and then perform the stated intention within forty-five days after the § 341 meeting. If the debtor fails to comply, the stay automatically terminates as to affected personal property on the forty-sixth day. No motion or hearing is required; the creditor may proceed to repossess.

Exceptions: The stay does not automatically terminate: 1) as to real estate; 2) if the debtor intends to reaffirm but the creditor refuses to reaffirm on the original contract terms; or 3) if the trustee moves to retain because, and the court finds, the collateral is of value to the estate.

A creditor who violates the stay "in the good faith belief" that the stay had terminated will be liable only for actual, not punitive, damages. Apparently, a creditor can have this good faith belief even without asking the court to confirm that the stay has terminated. *See* §§ 304-05 of H.R. 975 and amending Code §§ 362 and 521.

POST-DISCHARGE BILLING ON NON-REAFFIRMED MORTGAGES. While debtors would have no right to impose ride-through on creditors, creditors could allow it. Home mortgage creditors have often done so. H.R. 975 would allow mortgagees to send bills and other communications to non-reaffirming debtors after discharge, if their intent is to seek periodic payments. There is no similar exception to the discharge injunction for other types of creditors, but the remedies for discharge violations are not very effective. *See* § 202 of H.R. 975 amending Code § 524.

REAFFIRMATION. The reform bill leaves most of the current reaffirmation requirements in place, but adds lots of new paperwork. Debtor's counsel will still be gatekeepers of reaffirmation, with the court acting for unrepresented debtors. The "undue burden" and "best interests" standards are retained, as is the right to rescind until the later of discharge or sixty days after filing with the court. The changes are:

- The creditor must give the debtor a lengthy disclosure statement, which includes Truth-in-Lending-type information and legal advice in a "Frequently Asked Questions" format. If the disclosures are wrong, they are still sufficient, that is, the reaffirmation is binding, unless the debtor proves the creditor made the false statements in bad faith.
- The debtor must fill out an updated income and expense statement at the time of reaffirmation. If that statement shows too little money for reaffirmation payments, the reaffirmation is presumed an undue hardship (unless the creditor is a credit union -- credit unions are apparently free to impose undue hardships). As Judge Wedoff noted at this year's ABI annual meeting, nothing requires this statement of income and expenses to be consistent with the original schedules. If the debtor and creditor fudge it to make the payments appear affordable, that is unlikely to come to the court's attention. Of course, if the debtor's attorney approves a reaffirmation based on a faulty income statement, the attorney could be sanctioned. There is no express good faith defense for <u>debtor's</u> counsel.
- The presumption of undue hardship lasts until sixty days after a reaffirmation agreement is filed with the court (and the court may extend the time for cause, after notice and hearing). If the court does not act within sixty days, apparently the presumption disappears and the reaffirmation becomes fully effective. The presumption may be rebutted if the debtor explains in writing where the money to pay will come from. The court "may" disapprove a reaffirmation if the presumption is not satisfactorily rebutted, but only upon notice and hearing to the debtor and creditor, and that hearing must be concluded before discharge.

- Reaffirmations certified by debtor's counsel become effective as soon as they are filed with the court, unless the undue hardship presumption applies. However, there is no time limit for filing with the court and there are few real sanctions for failing to file, except that the debtor's time to rescind does not begin to run until filing. However, a creditor may accept payments from the debtor 1) before the reaffirmation agreement has been filed, and 2) under an otherwise invalid reaffirmation agreement, if the creditor "believes in good faith" that it is effective. The debtor may have difficulty proving bad faith here.
- H.R. 975 leaves section 524 silent on remedies for discharge violation, and does not directly address the use of class actions and contempt in that context. However, as Judge Wedoff has opined with respect to earlier House and Senate bills, making the creditor's mental state an element will make class actions difficult.
- The bankruptcy court apparently has no power to disapprove a reaffirmation which debtor's counsel has approved, unless the undue hardship presumption applies.

See § 203 of H.R. 975.

B. Recent Developments: Post-Petition Reaffirmation Negotiations

Courts in the First and Ninth Circuits have held that the automatic stay does not forbid post-petition negotiations pertaining to a reaffirmation agreement as long as the creditor does not attempt to harass or coerce the debtor. *Jamo v. Katahdin Federal Credit Union*, 283 F.3d 392 (1st Cir. 2002); *Bassett v. American General Finance, Inc.*, 255 B.R. 747, 758 (BAP 9th Cir. 2000), *reversed in part on other grounds*, 285 F.3d 882 (9th Cir. 2002). Moreover, the fact the creditor conditions reaffirmation of a debt secured by the debtor's residence on the debtor's reaffirmation of an unsecured debt is not *per se* coercive according to the First Circuit in *Jamo.*

The *Jamo* court further held that the creditor did not "threaten" foreclosure when it made a written reference to its right to foreclose. Furthermore, said the First Circuit, linking the debtor's reaffirmation of the unsecured debt to reaffirmation of the secured debt was not coercive; the creditor is not prohibited from exercising its superior bargaining power in the course of reaffirmation negotiations.

C. Bankruptcy Courts as "Ethical Watchdogs"

1. May Bankruptcy Courts Review and Disapprove Reaffirmation Agreements Approved by Debtor's Counsel?

The 1994 amendments to section 524 make it clear that the court is not required to hold a hearing on any reaffirmation agreement that is accompanied by an affidavit or declaration from debtor's counsel approving the agreement. *See* § 524(d). But the question remains whether the court has residual power to review *sua sponte* and disapprove reaffirmation agreements which debtor's counsel has approved. Robert Hessling in his treatise *Reaffirmation and Redemption* (Michie 1994) states that a majority of courts have recognized a lack of power to approve or disapprove of reaffirmations in these circumstances. Hessling at 204. *In re Pendlebury*, 94 B.R. 120 (Bankr. E.D. Tenn. 1988), is an example of that view:

> Congress' intent that the court rely upon the declaration and affidavit filed by counsel is made manifest under the 1984 amendments by removal of the requirement of court approval except as to reaffirmation agreements entered into by *pro se* debtors. In practice reaffirmation hearings presently serve no useful purpose except for debtors filing *pro se*. Attorneys are rightly charged with the responsibility for advising their clients during the reaffirmation process.

Pendlebury, 94 B.R. at 124.

Other cases holding that the bankruptcy court has no power to override counsel's approval of a reaffirmation agreement include *In re Sweet*, 954 F.2d 610 (10th Cir. 1992); *In re Bauer*, 1997 WL 752652 (Bankr. E.D. Va. 1997); *In re French*, 185 B.R. 910 (Bankr. M.D. Fla. 1995); *In re*

Grinnell, 170 B.R. 495 (Bankr. D. R.I. 1994); *In re Dabbs*, 128 B.R. 307 (Bankr. N.D. Fla. 1991); *In re Wallace*, 102 B.R. 54 (Bankr. E.D. N.C. 1989). *See also Cox v. Zale Delaware*, 239 F.3d 910 (7th Cir. 2001) (judge cannot disallow reaffirmations that debtor's counsel approved) (dicta).

However, revelations of widespread abuse of the reaffirmation process, plus concern that some attorneys do not adequately protect debtors from ill-advised reaffirmations, have recently led many bankruptcy courts to review reaffirmation agreements even if they have the blessing of debtor's counsel. Only two years after the *Grinnell* decision above, the bankruptcy court in Rhode Island revisited the issue, saying "The absence of court oversight may be resulting in overreaching by certain creditors, misrepresentation by certain debtors and/or their attorneys and the perversion of the reaffirmation provisions of the Code." *In re Izzo*, 197 B.R. 11, 12 n. 2 (Bankr. D. R.I. 1996). Among the other courts asserting power to override approval of reaffirmations by debtor's counsel are *BankBoston N.A. v. Nanton*, 239 B.R. 419 (D. Mass. 1999) (listing cases on both sides of the issue); *In re Vargas*, 257 B.R. 157 (Bankr. D. N.J. 2001); *In re* Collins, 243 B.R. 217 (Bankr. D. Conn. 2000); *In re Melendez (Melendez II)*, 235 B.R. 173 (Bankr. D. Mass. 1999); *In re Lindley*, 216 B.R. 811 (Bankr. N.D. Ill. 1998); *In re Melendez (Melendez I)*, 224 B.R. 252 (Bankr. D. Mass. 1998); *In re Turner*, 208 B.R. 434 (Bankr. C.D. Ill. 1997); *In re Hovestadt,* 193 B.R. 382 (Bankr. D. Mass. 1996).

These courts locate the source of their authority to review such reaffirmations and monitor debtors' attorneys' compliance with section 524(c) in section 105 and Bankruptcy Rule of Procedure 9011. *See, e.g., In re Vargas*, 257 B.R. at 165-66; *Melendez II*, 235 B.R. at 188-90; *Melendez* I, 224 B.R. at 259-60; *In re Bruzzese*, 214 B.R. at 450; *In re Hovestadt*, 193 B.R. at 386. Review is authorized under section 105 because it allows the court to make any determination and take any action to ensure compliance with the Code, including the statutory predicates to a valid reaffirmation under section 524(c). Moreover, Bankruptcy Rule 9011 (making Fed. R. Civ. P. 11 applicable to bankruptcy proceedings) authorizes review of such agreements in order to monitor the conduct of the debtors' attorneys who may file pleadings or other papers with the court without an adequate factual foundation. *Id.*

The consequences of a judicial determination of debtors' attorneys' noncompliance with the statutory prerequisites to a reaffirmation have included annulling the reaffirmation agreement after striking the attorney's declaration (*In re Bruzzese*; *Melendez II; In re Vargas)* and ordering a return of the debtor's attorney's fees to the debtor (*In re Vargas; In re Bruzzese)* under the authority of section 329(b). Courts have also considered whether to impose Rule 9011 sanctions on debtors' attorneys for signing the section 524(c) attorney declaration without adequate factual investigation and support (*Melendez II; In re Bruzzese; In re Izzo*).

2. Bankruptcy Court Guidance on Debtors' Attorneys' Obligations in the Reaffirmation Process

The *Hovestadt, Bruzzese, Melendez I and II, Nanton* and *Vargas* line of cases have fleshed out, sometimes in great detail, the obligations of a debtor's attorney under section 524(c).

1. *Counsel Must Decide Whether to Fish or Cut Bait*

In *In re Vargas*, 257 B.R. at 163, the court admonished debtors' counsel to make a conscious, deliberate decision whether to involve themselves in the reaffirmation process.

> Debtors' attorneys have a choice to make when presented with their clients' reaffirmation agreements. They may remain strictly advocates and decline to sign the requisite declaration attached to the reaffirmation agreement. The court recognizes that attorneys' execution of these certifications may place some attorneys in a position of conflict * * * Specifically, attorneys may not wish to undertake the reaffirmation process because they would be taking on roles akin to *in loco parentis.* If this is the case, then attorneys are not obligated to take on the duties of independently assessing their clients' financial status.

The Model Rules of Professional Conduct make the client the decision maker on substantive matters and instruct the attorney to "abide by the client's decisions concerning the objectives of representation." Model Rules of Prof'l Conduct R. 1.2(a). The attorney is further required to "act with reasonable diligence and promptness in representing a client." Model Rule 1.3. The decision to reaffirm is with the client. The attorney must abide by the client's decision and use 'reasonable diligence' and "competent representation"[4] to negotiate the best possible agreement. However, the attorney may withdraw if "a client insists upon pursuing an objective that the lawyer considers... imprudent." Model Rule 1.16(b)(3).[5]

The attorney may "limit the objectives of the representation if the client consents after consultation." Model Rule 1.2(c). Limiting the scope of representation can be achieved by limiting the representation through an agreement with the client or by the terms under which the attorney provides the services, commonly in the retainer agreement. Official Comment 4, Model Rule 1.2. However, if the attorney undertakes to represent the debtor in a reaffirmation process, the certifying process of §524(c) imposes additional obligations on the attorney.

According to Rule 9011, the presentation of a reaffirmation agreement and the accompanying §524(c) declaration to the court represents that the contentions have evidentiary support after conducting a reasonable inquiry. Bankruptcy Rule 9011(b)(3). By certifying the reaffirmation agreement, the attorney is certifying that, after a reasonable inquiry, the reaffirmation is voluntary, the debtor has been fully informed as to the legal consequences, and the agreement will not impose an undue hardship. The attorney will have only complied with Rule 9011 after "an

[4] Model Rule 1.1 defining competence.

[5] Arguably, client insistence on reaffirming a dischargeable debt could be labeled 'imprudent.' Consider *In re Jamo* 262 B.R. 159 (B.A.P. 1st Cir 2001) where the client insisted on reaffirming over 82% of their prepetition debt. A strong argument could be made for withdrawal in a situation such as this.

appropriate investigation" that considers "the totality of the circumstances." *In re Melendez(II)*, 235 B.R. 173, 195 (Bankr. D. Mass. 1999).

Given the possibility that the debtor's attorney will be unable to sign off on the reaffirmation, counsel might be well advised early on to explain to her client the *in loco parentis* role that section 524(c) requires her to play. Model Rule 1.2(e) provides: "When a lawyer knows that a client expects assistance not permitted by the rules of professional conduct or other law, the lawyer *shall* consult with the client regarding the relevant limitations on the lawyer's conduct." (Emphasis added.) Model Rules of Prof'l Conduct R. 1.2(e). Moreover, Model Rule 1.16(a)(1) requires counsel to withdraw from representation of a client if the "representation will result in violation of the rules of professional conduct or other law." Model Rules of Prof'l Conduct R. 1.16(a)(1).

Accordingly, the debtor's attorney may wish to limit the scope of her representation of the debtor by expressly excluding reaffirmation from the retainer agreement. Model Rule 1.2(c) of the Model Rules of Professional Conduct provides: "A lawyer may limit the objectives of the representation if the client consents after consultation." If the attorney later decides not to represent the debtor concerning a reaffirmation, the Model Rules appear[6] to allow the attorney to withdraw from the representation. Model Rule 1.16(b)(3) allows withdrawal if "a client insists upon pursuing an objective that the lawyer considers . . . imprudent." The Model Rules further require the withdrawing attorney "to take steps to the extent reasonably practicable" to protect the client's interests. Model Rules of Prof'l Conduct R. 1.16(d).

2. *What Constitutes a Reasonable Inquiry Under Rule 9011?*

Undue Hardship

[6] This assumes that bankruptcy practitioners generally regard reaffirmations, unless expressly excluded, to be one of the multiple services they provide to Chapter 7 clients. If reaffirmations are not so regarded, withdrawal would be unnecessary since counsel never undertook to represent the debtor in connection with a reaffirmation.

One frequently cited description of a reaffirmation which poses an undue hardship is one that "would result in a significant, but otherwise avoidable, obstacle to the attainment or retention of necessaries by the debtor or the debtor's dependents." *Melendez I*, 224 B.R. at 261 (Bankr. D. Mass. 1998).

The "tests" of undue hardship focus largely on the debtor's and the debtor's dependents' postpetition ability to pay the reaffirmed debt. Thus, "payment of a reaffirmed debt cannot constitute an undue hardship where funds come from disposable income," *Melendez I*, 224 B.R. at 270 n. 23. Reaffirmations by debtors whose postpetition monthly income exceeds monthly expenses have been approved as not an undue hardship. *Melendez II*, 235 B.R. at 200.

However, where Schedules I and J reveal that the debtor's postpetition expenses exceed income and there have been no subsequent improvements in the debtor's financial circumstances, courts entertain "serious doubts" about the burden posed by the reaffirmation payments. *In re Strong*, 232 B.R. at 924 (Bankr. E.D. Tenn. 1999); *Melendez II*, 235 B.R. at 197; *Melendez I*, 224 B.R. at 261; *In re Hovestadt*, 193 B.R. at 386 (Bankr. D. Mass. 1996). Interestingly, the *Melendez II* court suggested that a monthly deficit is not necessarily dispositive of the undue hardship issue for the attorney considering whether to certify the debtor's reaffirmation. In making the undue hardship assessment, the attorney must

> be fully conversant with the financial circumstances of both the debtor and the debtor's dependents. An attorney should analyze the income and expenses of the debtor's household, including a review and update of the information contained in the debtor's Schedules I and J. If it appears that the debtor's expenses will exceed his or her postpetition income, and if reaffirmation of the debt is not necessary to retain an item which the debtor or his or her dependents require for their well-being—or if the item itself is not necessary—then payment of the reaffirmed debt in addition to the debtor's existing expenses would clearly jeopardize the debtor's ability to pay for necessary living expenses and impose an undue hardship on the debtor or his or her dependents.

Melendez II, 235 B.R. at 197.

Several recent decisions hold that where the reaffirmation is before the court for a determination whether it poses an undue hardship *and is in the best interests* of the debtor, the analysis is not solely a function of a debtor's income and expenses. In *BankBoston, N.A. v. Nanton*, 239 B.R. 419, 425-26 (D. Mass. 1999), the district court held that the debtor's Schedules I and J (showing a monthly deficit) raised only a *prima facie* concern about her ability to pay.

> While the standards of "undue hardship" and "best interest" may involve an evaluation of debtor's ability to pay, they may possibly implicate several other factors, including 1) what alternatives, other than reaffirmation, are available to a debtor who wishes to retain an interest in property, 2) whether the underlying debt is secured or unsecured, 3) if the debt is secured, the threat of repossession of and the amount of equity in the collateral, and the extent to which the collateral is a necessity to the Debtor, *see Melendez*, 224 B.R. at 259 n. 9, 260, and 4) the debtor's payment history on the collateral.

Nanton, 239 B.R. at 425-26. *Accord, In re Claflin*, 249 B.R. 840, 847 (BAP 1st Cir. 2000); *In re Strong*, 232 B.R. 921, 924 (Bankr. E.D. Tenn. 1999).

<u>Fully Informing the Debtor</u>

In *Melendez II*, the court summarized the minimum obligations of debtor's counsel before certifying that the debtor has been fully informed of the legal effect and consequences of a reaffirmation agreement and any default thereunder.

> At a minimum, debtor's counsel must:
>
> * * * *
>
> (2) review the security agreement, charge slips, payment history and other documentation constituting the security interest claimed by the creditor in order to verify the amount of the creditor's claim, the validity, extent and perfection of the alleged security interest and the non-avoidability of the alleged lien under the Bankruptcy Code;
>
> (3) question the value placed on the goods by the secured creditor and independently estimate that value;
>
> (4) evaluate the risk of replevy by the creditor, in light of the age, condition and value of the goods versus the need of and cost to the debtor to retain the items at risk; and demand a replevy decision from the secured creditor prior to execution of the reaffirmation agreement;
>
> (5) discuss relevant financial disclosures with the debtor;
>
> (6) ensure that the agreement was entered into voluntarily and without creditor misrepresentations or coercion;

> (7) ensure that the debtor understands the effect and consequences of the agreement and the consequences of default;
> (8) ensure that the debtor is informed as to his or her options with respect to the collateral under the Bankruptcy Code; and
> (9) advise the debtor as to alternative sources of credit.

Melendez II, 235 B.R. at 203. *Accord* , *see, e.g., In re Vargas*, 257 B.R. at 165-66; *In re Bruzzese*, 214 B.R. at 452-55; *In re Hovestadt*, 193 B.R. at 386-87.

Several items on this "to do" list deserve further comment. The "relevant financial disclosures" concerning the reaffirmation agreement (item 5 on the *Melendez II* list) are akin to the disclosures required by the Federal Truth in Lending Act, 15 U.S.C. § 1601, and similar applicable state law. These include the "annual percentage rate, a statement on when the payments are due, the applicable grace period, the method for determining finance charges and late payments or over-the-limit charges" as well as "the amount of the prepetition claim; the principal amount of the reaffirmed debt; the minimum monthly payment on the reaffirmed amount; and the amount, if any, of an extension or renewal of the debtor's credit line." *Melendez II*, 235 B.R. at 198-99. *See also In re Bruzzese*, 214 B.R. at 451.

Unfortunately for present purposes, Truth-in-Lending's disclosure requirements have been interpreted not to apply to reaffirmation agreements. Regulation Z exempts changes in credit terms that are due to "an agreement involving a court proceeding." 12 CFR §§ 226.9(c)(2); 226, 20(a) (1998). Federal Reserve Staff Interpretations have extended this exemption to reaffirmation agreements. Perhaps exemption made sense when bankruptcy courts were required to approve each reaffirmation. Court's oversight could protect debtors from deceptive and unduly burdensome reaffirmations. However, the 1984 amendments made debtor's counsel, if any, the reaffirmation gatekeeper. Under this regime, the great majority of reaffirmations are never seen by the judge; they are simply lodged in the debtor's court file. Thus, the reasons underlying the reaffirmation exemption have arguably ceased to prevail.

Two recent cases addressing the need for standard disclosure of credit terms and the application of Truth-in-Lending to reaffirmation agreements are *In re Kamps*, 217 B.R. 836, 848-50 (C.D. Cal. 1998); *In re Bruzzese*, 214 B.R. 444, 458 (Bankr. E.D.N.Y. 1997).

In *Melendez II*, 235 B.R. at 203, the court observed that such information is not "necessarily at the disposal of the debtor's attorney. Some of this information is exclusively within the control of the creditor. However, where a creditor refuses to provide that information, the debtor's attorney has no option. The attorney *must* decline to execute the § 524(c)(3) declaration." (Emphasis added.)

With respect to item 8 on the Court's list, counsel should consider the availability of "ride-through" in her jurisdiction. By "ride-through" I refer to the judicially developed nonstatutory variant of voluntary payment. Some courts allow a debtor who is current on a debt to retain the collateral without reaffirmation or redemption. The circuits are presently evenly split, with four circuits on each side of the question whether the debtor has this option. Circuit court cases allowing the debtor to retain without reaffirming include *In re Parker*, 139 F.3d 668, 672-73 (9th Cir. 1998); *In re Boodrow*, 126 F.3d 43, 53 (2d Cir. 1997); *In re Belanger*, 962 F.2d 345, 347-48 (4th Cir. 1992); *Lowery Fed. Credit Union v. West*, 882 F.2d 1543, 1546-47 (10th Cir. 1989). Circuit court cases requiring reaffirmation or redemption in order to retain include *In re Burr*, 160 F.3d 843 (1st Cir. 1998); *In re Johnson*, 89 F.3d 249, 250-52 (5th Cir. 1996); *In re Taylor*, 3 F.3d 1512, 1516-17 (11th Cir. 1993); *In re Edwards*, 901 F.2d 1383, 1385-87 (7th Cir. 1990).[7]

[7] An equally unsettled question is what happens after discharge when the debtor has retained collateral without reaffirmation or redemption. In that case, the creditor retains a valid lien on the collateral but the debtor's personal liability has been erased. Many creditors may be happy enough to allow a debtor to keep collateral as long as the debtor maintains payments. However, is a creditor *required* to do so if the loan documents provide that bankruptcy itself is a default (*ipso facto* clause) or include an insecurity clause? May the creditor repossess the property even if the debtor is willing and able to repay? The provisions of section 365 invalidating *ipso facto* clauses for executory contracts would seem not to apply and some courts have held the similar provisions of section 541(c) are also inapplicable in the post-discharge context. *See, e.g.,* Judge Leif Clark's discussion in *In re Castillo*, 209 B.R. 59 (Bankr. W.D. Tex. 1997) (creditor may rely on *ipso facto* clause) (*Castillo* was subsequently reversed by the district court as to the existence of the fourth option, but Judge Clark's views on creditors' rights after discharge absent reaffirmation are still worthy of consideration). *In re Lair*, 235 B.R.1 (Bk. M.D. La. 1999). *See also In re Gerling*, 175 B.R. 295 (Bankr. W.D. Mo. 1994), suggesting *in dicta* that absent reaffirmation, a creditor could

Assuming ride-through is not an available option, counsel must assess whether the liens in question can be avoided under section 522(f)(1)(B) (authorizing avoidance of non-purchase-money security interests in exempt household goods). Counsel should also inform debtors of the possibility of redeeming the collateral at fair market value as well as of the availability of a judicial valuation determination. Finally, attorneys must again tell clients about the availability of Chapter 13 as a method of retaining the collateral. *Melendez II*, 235 B.R. at 199-200. *See also In re Vargas*, 257 B.R. at 165-66.

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use an insecurity clause to justify post-discharge repossession even when the debtor is current on payments. The court noted that the release of personal liability would justify the creditor's belief that the prospect of payment was impaired.

There is authority to the contrary. Recently, the Second Circuit held, in *In re Sololowski*, 205 F.3d 532 (2d Cir. 2000), that the decision to allow retention without reaffirmation in *Boodrow* required a holding that creditors could not rely on bankruptcy default clauses to justify foreclosure on collateral. *In re Winters*, 69 B.R. 145 (Bankr. D. Or. 1986) holds that section 541(c)(1)(B) and the discharge injunction bar use of an *ipso facto* clause to justify post-discharge repossession from debtor who is current in payments.

THE CONSUMER BANKRUPTCY SYSTEM IN CANADA

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SECTION C

THE CONSUMER BANKRUPTCY SYSTEM IN CANADA

SECTION C

1. Socio-Economic Context of Personal Bankruptcy in Canada

The bankruptcy rate in Canada was approximately 3.3 persons per 1000 in 2001 compared with 5.75 per 1000 in the US. These rates are both much higher than other "Anglo-Saxon" jurisdictions (Australia, 1.2 and England and Wales, 0.50). There are significant similarities in the levels of consumer credit in Canada and the US. For example, approximately 75 percent of individuals have access to credit cards. In the US about 60 percent of consumers borrow on their cards; a Canadian study concluded that about 50 percent of individuals admitted to carrying a balance once in the past 12 months. Canadian charge-off and delinquency rates appears to be lower with net losses on cards about half that in the US from January 1999 to 2002. It is claimed that Canadian issuers have historically been more selective in those to whom they offer cards and have not moved as significantly into the sub-prime lending market as US lenders (see Canadian Credit Card Index, Moody's Investors Service, August 23, 2002). Canadians also have high debt-to-disposable income ratios.

There are few legal restrictions on credit granting. There are truth in lending laws, some regulation of credit contract terms and a Federal criminal interest rate of 60 percent.

There is a public national health care system in Canada which has the effect of reducing the numbers of bankruptcies related to medical debt, which seem to form a significant portion of US bankruptcies (see e.g. Bermant and Flynn, 'The Class of 2000' (2001) *American Bankruptcy Institute Journal* 20 noting that 56 percent of joint bankruptcy filers had some medical debt and of those 11 percent reported US$ 5,000 or over; Sullivan, Warren and Jacoby, 'Rethinking the Debates over Health Care Financing: Evidence from the Bankruptcy Courts'(2001) 76 *New York University Law Review* 375 note that 33 percent of filers incurred medical bills not covered by insurance in excess of $1,000 during the two years preceding bankruptcy).

1.1 Outline of Canadian system

Extract: Personal Insolvency Task Force, Final Report at 1-6, August 2002.

. How the Canadian System Works at Present

At present, the BIA provides two major alternatives to individuals trying to deal with their insolvency:

- filing for personal bankruptcy;
- filing a proposal, which is an arrangement with creditors to repay all or part of the debtor's liabilities over a specified period of time.

While other alternatives exist, both within the BIA and in other legislation, bankruptcies and proposals are the most common statutory alternatives chosen by insolvent debtors. The following subsections briefly summarize how bankruptcies and proposals work in the current Canadian insolvency system.

Bankruptcy

Debtors who file for bankruptcy under the BIA give control of their property to a trustee, an act which is called an "assignment in bankruptcy." Bankruptcy trustees work in the private sector but are licensed by the Superintendent of Bankruptcy. The role of the Superintendent and his staff is to supervise the trustees' work and to ensure that all parties comply with the BIA.

Trustees perform several roles advising the debtor, maximizing the returns to creditors from the bankrupt's estate and carrying out their duty to administer the bankruptcy while maintaining the integrity of the BIA. Along the way, they must deal with the potential conflicts of interest that their multiple roles sometimes create. Trustees often advertise widely and generally aim at being easily accessible to the low-income debtor. Unlike the practice in the United States, Canadian lawyers are rarely involved in consumer bankruptcies.

It is relatively easy procedurally, if not psychologically, for individual debtors to go bankrupt in Canada. Debtors must first demonstrate that they are insolvent. Roughly speaking, an "insolvent person" is a person who resides in Canada, whose liabilities to creditors amount to at least $1,000, and who is unable to meet repayment obligations as they become due. Documentation is simple: a one-page form assigning the debtor's property to the trustee, accompanied by a "statement of affairs" and a monthly budget. A trustee must be nominated and the assignment accepted by an "official receiver", an administrative official of the Superintendent of Bankruptcy.

In the statement of affairs, debtors must provide the trustee with accurate information about assets, liabilities, current income and expenses. At the debtors' first interview with the trustee, the trustee must assess their financial position and explain all of the available options, including the making of a proposal and various province-specific alternatives.

If debtors choose bankruptcy, the trustee will sell their non-exempt assets, if any, and distribute the proceeds to creditors according to the provisions of the BIA. Part or all of the trustee's fee is also taken from the money generated by the sale of the assets. In practice, most consumer bankrupts have few non-exempt assets. Exempt assets are determined by provincial law and vary from province to province both as to types of assets that are exempt and the maximum value that is exempt.

The trustee may require that debtors contribute some of the income that is earned after the date of bankruptcy, but prior to the discharge of their debts, to the estate. The 1997 amendments to the BIA required that the trustee collect a prescribed portion of the debtor's "surplus" income, as defined by the Superintendent of Bankruptcy. Approximately 15% of bankrupts have surplus income.

The 1992 BIA amendments recognized that many debtors had minimal exempt unsecured assets and needed a simple, inexpensive bankruptcy process. Prior to 1992, only debtors with assets less than $500 in value could use the then-existing simple process, called the summary administration process; the 1992 amendments raised this threshold to $5,000, thus widening access to summary administration. The asset threshold is now $10,000 and the summary administration process is used in over 90% of personal bankruptcies.

First-time bankrupts are automatically discharged nine months after the assignment in bankruptcy unless the discharge is opposed by a creditor, the trustee, or the Superintendent. Prior to discharge, a report summarizing the material aspects of the bankruptcy, including the debtor's conduct during the bankruptcy and the factors leading to the assignment, must be filed with the Superintendent by the trustee. In addition, the trustee must also report on whether the debtor has made the required surplus income payments, where applicable, and whether the debtor could have made a viable proposal.

Creditors rarely oppose discharge. Trustees sometimes oppose discharge because of misconduct or because the bankrupt has not contributed sufficient funds to pay administrative costs or trustees' fees. Where discharge is opposed, a judge or Bankruptcy Registrar holds a hearing. The judge or Registrar may delay or refuse the discharge or make a conditional order requiring future payments by the debtor.

If the unsecured non-exempt assets of the debtor are greater than $10,000, the ordinary administration process applies. The creditors meet and have an opportunity to confirm the appointment of the trustee chosen by the debtor or to substitute a trustee of their own choice. The creditors can vote for the appointment of inspectors to represent them and may give directions to the trustee about the administration of the bankrupt's estate. In practice, it may not be worthwhile for the unsecured creditors to play such an active role in the administration of the bankruptcy.

When bankrupts are discharged, they are relieved from liability for most debts. There are some exceptions, however. Section 178(1) of the BIA lists non-dischargeable debts; most of these exclusions have an identifiable public policy rationale that outweighs any interest in providing a "clean slate" for the debtor. The non-dischargeable debts include fines imposed in respect of an offence, and debt for alimony or child support. In addition, since 1998, debtors cannot be discharged from student loan debt unless the bankruptcy has been filed more than ten years after the debtor left school.

Proposals

Bankruptcy should be a solution of last resort for insolvent debtors. It is not, however, the only solution. There are a number of ways in which financially strapped individuals can deal with their financial troubles. For example, they can obtain a debt consolidation loan from a financial institution. They can seek credit counselling from provincial or other agencies to learn how to handle budgets or make non-statutory voluntary arrangements to pay creditors over an extended period of time.

In Quebec, individuals can make arrangements through the Association coopérative d'économie familiale (ACEF). The Lacombe Law, also known as Voluntary Deposits, also provides a process for Quebec wage earners to pay creditors what would be the seizable portion of their salaries under garnishment provisions. Such payments prevent creditors from enforcing payment of the debts. In some other provinces Alberta, British Columbia, Saskatchewan, Nova Scotia and Prince Edward Island debtors may choose to use the Orderly Payment of Debts (OPD) provisions of the BIA. These provisions set out the amounts and schedule of payments to the court, which in turn distributes the payments to creditors. While the timing of payments is altered by both the Lacombe Law and by OPD, full payment is expected.

There are two types of proposals that can be made under the BIA. This first is known as a "consumer proposal". The second is known as a "commercial" or "Division I" proposal.

Consumer Proposals: Beginning in 1992, the BIA has offered a new statutory alternative for eligible individuals the consumer proposal. The consumer proposal process allows debtors to make arrangements with their creditors to extend the time for payment or to reduce the amounts owed, or both, while potentially retaining more of their assets than in a bankruptcy.

To be eligible to make a consumer proposal, the insolvent individual's debts cannot exceed $75,000 (excluding the mortgage on a principal residence). The debtor must also have sufficient resources to permit the development of a fair and realistic proposal. Consumer proposals are attractive to debtors who wish to avoid bankruptcy while maintaining control of assets that are important to them. They are also attractive to people who, for personal reasons, want to pay their creditors as much as they possibly can. Proposals are not binding on secured creditors, who retain their right to realize on their security if payments are not up-to-date. In many cases, however, the debtor continues to make payments on secured assets, such as a house or car, in order to avoid losing them to foreclosure or repossession. The secured creditor is inclined to cooperate with this approach since the creditor is spared the costs of realizing on the security in order to obtain repayment.

To make a consumer proposal, the insolvent debtor seeks the aid of a private-sector administrator, who is usually a bankruptcy trustee. There are a number of incentives, created by amendments to the BIA in 1997, to encourage debtors to choose proposals rather than bankruptcies. First, the fees paid to proposal administrators were increased. Second, as discussed above, some debtors considering bankruptcy will be required to make surplus income payments; filing a proposal may allow a debtor more flexibility with payments to creditors than the surplus income provisions. Finally, the trustee is now under an obligation to report, when a discharge from bankruptcy is being considered, whether the debtor was in a position to have made a feasible proposal. If so, the court is likely to impose conditions on a discharge that may be similar to the payment arrangements in a proposal. When faced with the potential of such a situation, debtors may feel that they maintain more control by presenting a proposal designed in cooperation with an administrator.

Where a debtor elects to make a proposal, the administrator files the proposal with the Official Receiver and sends a copy to all the creditors. The creditors have 45 days to consider the proposal and may accept or reject it. The unsecured creditors cannot seize property or garnishee wages while the proposal is pending. If creditors representing a majority of the debt accept the proposal, its terms bind all the creditors and the debtor. If the proposal is rejected, the rights of the unsecured creditors are revived and they regain the right to take legal steps to recover their debts. If and when debtors have fulfilled the terms of their proposal, they are relieved of the debts covered by the proposal. Even a successful proposal, however, will not relieve debtors from non-dischargeable debts, such as student loans or support payments. The proposal is automatically annulled if the debtor defaults by not paying for over three months.

As noted below, debtors are taking advantage of the consumer proposal provisions, with about 14% of filings now taking that form. There was a clear increase in the number of proposals in 1998, an increase almost certainly due to the 1997 amendments. Among proposals filed between May 1, 1998 and December 31, 2000, 31.5% had failed by June of 2002, but almost half had not yet been successfully completed. The ultimate failure rate will thus be higher by an unknown amount. It is too early to be sure what the failure rate is for proposals filed in any given period since 1998.

Commercial proposals: The BIA, under Division I of Part III, allows proposals to be filed by businesses or individuals regardless of the amount of their indebtedness. "Commercial" may be a misnomer in some cases since debtors filing such proposals need not be engaged in any commercial activities. A major difference between commercial and consumer proposals is that, if a commercial proposal fails, what is known as a "deemed bankruptcy" occurs and the trustee liquidates the assets of the debtors. Apart from that, commercial proposals differ from consumer proposals primarily in the complexity of the required procedures.

...

IV. Who Files for Bankruptcy?

There is no stereotypical bankrupt debtor. All are "insolvent", in the sense that they are not meeting their debt payments as they come due, but they work in all kinds of occupations, vary widely in educational attainment and come from all ages, both genders and all geographic regions. A series of U.S. studies by Sullivan, Warren and Westbrook has established that bankrupts are broadly representative of the American middle class. Similar Canadian studies[9] suggest that Canadian bankrupts, while also representative of Canadian society, are somewhat more likely to have jobs with relatively low occupational prestige.

There is no consensus on the underlying causes of personal bankruptcy except for the deceptively simple explanation of "too much debt." Since debt is a common characteristic of modern life, the question is why some individuals come to have "too much" debt at a particular point in time. When asked, many bankrupts identify economic misfortune job loss or small business failure as the triggering cause of their bankruptcy. In other cases, bankrupts believe that personal crises such as ill health or marital disruption led to their insolvency. Finally, financial mismanagement is sometimes identified more often by trustees than by bankrupts as the cause of bankruptcy. While there is no agreement on which of the many potential causes is the most important, there is agreement that the causes are diverse and that, while financial mismanagement may play a role in some bankruptcies, the majority do not result only from financial mismanagement.

2. Central Institutional Characteristics of Canadian Personal Bankruptcy Administration

2.1 Role of Office of Superintendent of Bankruptcy

This is a Federal agency which oversees the administration of bankruptcy in Canada and is involved in the development of legislation. The powers of the superintendent of bankruptcy include: licensing trustees and conducting audits of trustees; receiving complaints from creditors and others; the power to intervene in any matter or proceeding where it considers it expedient to do; the issuance of directives to trustees and administrators in relation to the administration of the BIA (since 1992 these directives have the force of law); conducting investigations to determine if a bankruptcy offence has occurred; maintaining public records on the operation of the bankruptcy system (see ss5-12 BIA). All assignments in bankruptcy [voluntary petitions] must be filed with the Official Receiver (s49(3)), which is in substance part of the Office of the Superintendent of Bankruptcy.

The Office is a "Special Operating Agency" and intends to achieve self-financing status by recovering its costs from fees and the statutory levy on all bankruptcy estates. Special Operating Agencies are intended to have greater autonomy from government rules, operate more like a business and be answerable to their clients. They are viewed as being most appropriate where there is a relatively stable policy framework and their operation does not require ongoing Ministerial intervention. Ideally they generate revenues that make them self-financing.

The OSB describes its philosophy as "working together with the insolvency community" and working in partnership with its stakeholders and clients. Clients are identified as creditors, insolvent businesses and individuals, and potential lenders and investors. Stakeholders include trustees, courts, and insolvency counsellors. The Office is more likely to hear from its client creditors and bankruptcy professionals on a continuing basis than from consumer bankrupts or the general public. Employees of the OSB now have little contact with individual debtors, since Official Examinations of debtors are very rare in consumer bankruptcies. Its powers to receive complaints refer only to "creditors and others" without specifically referring to debtors and it is only recently that the Office has attempted to monitor complaints by bankrupts.

The relationship of the OSB to trustees is that of a regulator and policing agency. The OSB is in continuing interaction with trustees, since the OSB must approve all accounts in individual estates and individual officers are assigned several trustees to monitor on a continuing basis. Creditors take little interest in individual bankruptcies and the OSB may be regarded as their representative in monitoring the conduct of trustees to ensure that trustees are realising assets and income. A continuing grumble of creditors is that some trustees realise only sufficient assets to secure their fees but show little interest in searching for further assets.

2.2 The Trustee in Bankruptcy

Extract: Iain Ramsay, Market Imperatives, Professional Discretion and the Role of Intermediaries in Consumer Bankruptcy: A Comparative Study of the Canadian Trustee in Bankruptcy (2000) 74 American Bankruptcy Law Journal 399.

A unique aspect of Canadian consumer bankruptcy practice is the extent to which several potentially incompatible roles are bundled together in the person of the bankruptcy trustee. She is administrator of the bankruptcy estate, representative of creditors, and advisor and counselor to a debtor. In contrast to the United States, lawyers play little role in advising and counseling the majority of individual debtors who declare bankruptcy in Canada and there is no identifiable consumer bankruptcy bar. The trustee in bankruptcy, who is generally an accountant, is the person to whom an individual contemplating bankruptcy will turn for information and advice. It is also the trustee who will subsequently process the bankruptcy. The trustee has become therefore the central intermediary in the implementation of public policy in consumer bankruptcy...

I. LEGAL FRAMEWORK OF CANADIAN CONSUMER BANKRUPTCY ADMINISTRATION

A. TRUSTEE QUALIFICATIONS AND CONSUMER BANKRUPTCY LAW IN GENERAL

...

The legal model of the individual bankruptcy process in Canada is that of a process of creditor control subject to administrative and judicial regulation. Administrative supervision is exercised by a public agency, the Office of the Superintendent of Bankruptcy (OSB). The OSB is a federal agency staffed by civil servants, with fourteen regional offices in addition to the headquarters office in Ottawa. The OSB has a general supervisory role over the administration of all bankrupt estates, proposals and receiverships. It maintains public records on these topics, investigates complaints, licenses trustees, and through legal directives, establishes standards for the administration of bankruptcies. In addition to its licensing power, the OSB examines trustees' statements of receipts and disbursements in relation to bankrupt estates, conducts audits of trustees, and may initiate and intervene in court proceedings. A key power in summary consumer bankruptcies is the ability of the superintendent to require the accounts of a trustee to be taxed by the court with the possibility of a consequent reduction in the trustee's fee. All relevant documents in every bankruptcy file of a trustee are filed with a regional office of the OSB and individual bankruptcy officers in these offices have responsibility for a designated number of trustees. The agency plays a central policy role in implementing the statutory framework of bankruptcy administration through formal means such as the issuance of directives and through informal methods such as speeches to trustees encouraging particular policies. The agency receives a levy of five percent on any dividend paid to creditors in a bankruptcy estate but this does not fully finance its operation and under current government policy it is moving to a user pay model of service delivery.

There are no specialized bankruptcy courts in Canada and the superior courts of general jurisdiction have general jurisdiction in bankruptcy. There are also bankruptcy registrars with specific powers to hear a variety of matters including discharge applications. It is common knowledge that registrars in different bankruptcy districts have different practices in relation to issues such as the recovery of trustees' fees through the discharge process.

The minimum qualifications for obtaining a trustee licence include successful completion of a written examination as well as appearance before an examination board where the applicant must demonstrate knowledge of relevant legislation and jurisprudence, good understanding of business and consumer matters, good judgment in the administration of professional engagements and a high standard of business ethics and professionalism. It is therefore a hybrid profession requiring knowledge of both law and accountancy. However, lawyers may not be licensed as trustees unless they restrict their practice to acting as a trustee in bankruptcy. The Superintendent must also be satisfied that an individual has adequate financial resources and facilities to properly administer bankruptcies. Trustees do not constitute therefore a self- regulating profession although achieving this status is a major goal of the Canadian Insolvency Practitioners Association that represents the vast majority of the approximately 850 insolvency practitioners in Canada. Most trustees have a professional accounting qualification and are also members of the Canadian Institute of Chartered Accountants (CICA) with which the Association is affiliated.

... C. LEGAL CHARACTERIZATION OF THE TRUSTEE AND CONTROVERSY OVER HER ROLE

There is some disagreement as to the precise legal characterization of the trustee in bankruptcy. A standard Canadian text, Houlden and Morawetz, describes her as an officer of the court who is the impartial representative of the interests of creditors. Bohemier however stresses the role also of the trustee in assisting the debtor to rehabilitation and views the trustee as more of a neutral administrator acting in the interests of all parties. The Bankruptcy and Insolvency Act (BIA) envisages that when an individual makes an assignment in bankruptcy the Official Receiver (in reality the Office of the Superintendent of Bankruptcy) will appoint a trustee with reference to the wishes of "the most interested creditors." In practice, the debtor will almost always initiate the relationship with the trustee, perhaps after reading a trustee's advertisement in the yellow pages, and the trustee will file the assignment on her behalf. The trustee or her employees are the primary source of advice on bankruptcy options. She will shepherd the debtor through the insolvency process and may provide the mandatory counseling services to the bankrupt. Given this close involvement with a debtor, creditors often claim that trustees are too close to the debtor and are uninterested in pursuing debtors' assets once they have recovered sufficient funds to cover their fee.

The potentially conflicting roles of the trustee were highlighted during Parliamentary consideration of amendments to the Bankruptcy and Insolvency Act in 1996. At the Committee stage of the legislation several witnesses were asked their views on the potential conflicts of interest inherent in the current role of trustees in consumer bankruptcies. The President of the Canadian Insolvency Practitioners Association responded that:

We are squarely in the middle. We really are officers of the court. Our duty is to be impartial. We're not on the creditor's side and we're not on the debtor's side. Quite frankly, creditors often think that we work for the debtor and debtors often think we work for the people they owe money to. It would be nice to have everybody like us, but maybe having no one like us is good evidence that we're doing the job we should and we're impartial. It's a difficult situation. It's a part of our professional ethics.

Another trustee commented:

We administer the Bankruptcy Act. Our first allegiance is to the administration of the act. We can carry out the proper administration of the act and at the same time take care of the concerns of both debtors and the creditors, but we have to be aware of the concerns and needs of both. There is a balancing act, but of paramount importance is maintaining the integrity of the Act.

A representative of the Canadian Bar Association (CBA) responded:

Certainly from a creditor's perspective the sense is that the trustee is very much aligned with the debtor. In the consumer setting the trustee meets with the debtor, gives counseling to the debtor, and assists the debtor in coming to terms with credit difficulties, ushering the debtor through the bankruptcy process. There are a number of functions the trustee must perform purely from the debtor's perspective. By the same token, there are other functions in which the trustee is a fiduciary for creditors. By the same token, the trustee is licensed federally and has to abide by a code of conduct that is independent of both debtor and creditor.

So there are a variety of roles here. I think the trustees very much feel themselves in the middle of the process.

And later, in response to a question concerning how trustees avoid conflict of interest, the CBA representative commented:

Through professionalism; through a complaints procedure any participant in the system can pursue; through the superintendent of bankruptcy, through a licensing process that is quite rigorous ... our trustees are considered to be quite professional, and one of the hallmarks of professionalism is the ability to balance these various duties. But clearly it is a conflict.

A Quebec consumer group, which provides budget counseling, thought that a trustee's obligations under the 1992 Act to make an initial assessment of the needs of the debtor placed her in a conflict of interest since the trustee's income depends on the individual going bankrupt.

By assigning to the trustee the role of analyzing the budgetary and financial situation of the debtors consulting him, for the purpose not just of assessing the appropriateness of bankruptcy as an answer to the problem, but also of proposing a solution that reflects the debtor's overall position, we are putting him in an impossible situation. How can he, in all objectivity, propose the solution best tailored to the situation of the debtors consulting him when he knows that his income depends on their opting for bankruptcy? He thus places himself in a conflict of interest.

The image in this quotation of a trustee driven by financial self-interest contrasts with the earlier picture of the disinterested and neutral professional pursuing a public calling. This is a common contrast in studies of professionals such as lawyers. Several empirical studies of lawyers depict them as neglecting their clients' interests in favor of their own interests. Moreover, it is argued that where clients are individuals or unlikely to generate repeat business, the lawyer-client relationship is one of professional dominance. Studies of the consumer bankruptcy bar in the United States seem to confirm this thesis, with a picture of practice where lawyers' advice is a reflection of financial and ideological factors, constrained by the pressure of local legal culture. A central question is therefore the extent to which the trustee also may neglect the interests of her various "constituencies"--creditors, debtors and the mandates of bankruptcy policy--because of the factors identified in the United States studies. Specific areas where interests may conflict include advice on the choice between a bankruptcy and a proposal, a failure to realize all assets or review transactions for fraudulent preferences, and an unwillingness to fully inform debtors at the outset of the costs of bankruptcy or a debtor's rights.

The controversy over the role of the trustee has developed at the same time as trustees have been attempting to achieve a greater self-governing role for the profession. In Canada, as in the United States and United Kingdom, there has been a transformation in insolvency practice over the past twenty-five years as it has moved out of the shadows and into the mainstream. Elite law firms and the big five accountancy firms now have substantial "corporate recovery" departments and it is a lucrative area of practice. There is probably a divide between those very large firms oriented towards corporate receiverships and substantial corporate work and smaller firms that deal with consumers and small business. There appears to be some concern within the profession about their status, particularly those of the high volume "consumer shops." A senior member of the Canadian Insolvency Practitioners Association (CIPA) indicated to me that trustees were worried about their negative image as undertakers or professionals who helped individuals to "beat the system." There is also increasing professional competition with debt counselors and others who wish to construct the field of bankruptcy and overindebtedness in terms of individual pathologies requiring treatment, rather than the processing of a financial problem. The late 1990s were therefore an interesting period in the development of bankruptcy and the role of different professional groups in processing bankruptcies...

A. ORGANIZATION OF TRUSTEE PRACTICE IN INDIVIDUAL BANKRUPTCIES

Most consumer bankruptcy work in the Toronto bankruptcy district is undertaken by small or medium sized firms. The "big five" accounting firms have a limited presence in this market, although they may process larger numbers in some rural areas. Within the sample interviewed there were nine single trustee firms, eleven firms with two or more trustees and two firms which are international in scope...

Tables 1 and 2 indicate the extent to which trustees specialized in consumer bankruptcy and the number of consumer files processed per firm per annum. There are two caveats to these tables. First, trustees were providing estimates so that the numbers must be treated as a rough guide. Second, since the interviews took place over more than one year, the estimates do not relate to exactly the same time period.

Table 1

Percentage of business devoted to consumer filings	Number of Trustees
Over 90	13
50-90	8
Under 50	1

Table 2

Consumer Files per annum	Number of Firms
100-300	5
300-500	9
500-1000	4
1000+	4

The great majority of the firms, whether or not they were sole practitioners, operated more than one office with only three firms operating from one location. A common form of organization was to have one main office and a number of "satellite" offices in outlying catchment areas which would be staffed either by estate administrators or other support staff and which might not always be open. Estate administrators are individuals who do not hold a trustee licence. Some may be training to become trustees. They will generally have taken certain courses and indeed it is necessary for them to have taken a counseling course in order to undertake counseling of bankrupts. I gained the impression in several interviews that bankrupts will spend more time with estate administrators than with the trustee and this was a basis for criticism by some of the sole practitioners who claimed that they spent more time with each bankrupt than did those firms which relied heavily on estate administrators.

It would appear from these data that much consumer bankruptcy work has been routinized. Some accounts of the time spent by trustees on individual files have suggested a minimum of eight hours per trustee on the simplest of files, but this seems difficult to reconcile with the volumes noted above. One trustee in a high volume practice with significant support staff suggested an average time of two and one-half to three hours trustee time per file, while another, who had limited support staff, suggested five to six hours per file...

C. COMPETITION, MARKETING AND ADVERTISING

Many trustees indicated that consumer bankruptcy work had become very competitive in recent years. "Fierce" and "aggressive" were terms used by several trustees. I was interested in exploring how competition worked in a business where trustees would appear to be providing a similar, apparently highly structured, service where the price is fixed for the overwhelming majority of cases.

I raised the issue of how trustees marketed their practice. Almost all stressed the importance of yellow pages advertising and carried some form of yellow pages display advertising. Many commented on the substantial growth in these ads in recent years, with several (generally older practitioners) indicating that this form of advertising had become very "aggressive," had "got out of hand," was very expensive and unprofessional. Notwithstanding these comments there was also a general feeling that yellow pages advertising was a necessary evil. Advertising could help to sustain a high volume practice, which was in turn necessary to pay for the relatively high costs of substantial advertising. ...Analysis of the Toronto area yellow pages advertising during the 1990s does indicate a large growth in the amount of advertising space taken by trustees in bankruptcy including many of those interviewed in this study. The number of pages devoted to bankruptcy trustees has increased from two in 1991 to eleven in 1999-2000. Almost all the yellow page ads promise a free initial consultation but none of the advertisements provided much information on bankruptcy or the merits of the choices available. The one exception was a large accounting firm, which focused on the value of making a proposal without the necessity of declaring bankruptcy. Trustees mentioned various other forms of ads including local media (primarily the Toronto Sun which has a large blue collar and lower middle class readership), employment news, ethnic newspapers, radio and community television, buses and even apartment elevators in residential areas which had been identified as having a large number of potential bankrupts.

A second source of business was through referrals from previous bankrupts or personal networks...Of less importance were referrals from lawyers (e.g., in relation to clients with significant judgments against them), credit counseling agencies, paralegals, or other accountants. There is some additional evidence which seems to support the importance of personal networks. In a 1997 study of Canadian bankrupts almost sixty-two percent learned about bankruptcy through their personal network of family and friends with sixteen percent identifying "less personal sources" such as credit counselors, twelve percent identifying the yellow pages, twelve percent identifying the media, and twelve percent identifying lawyers.

Location is also an important aspect of competition with some trustees having offices in the same building as credit counseling agencies and one located in the same building as a trade union legal advice agency...

D. PRICE COMPETITION, PAYMENT ARRANGEMENTS AND RECOVERY OF "FEES"

I was interested in the extent of price competition among trustees. At first sight this may seem an odd question given the existence of a fixed tariff, and a brief detour on the Byzantine nature of trustees' "fees" is necessary. According to the BIA a consumer does not pay a direct fee to a trustee since she is not the client of the trustee and the trustee's payment is based on a percentage of the distribution of the bankruptcy estate. In addition, there is no concept of a minimum fee since a trustee's fee is simply based on the receipts in the estate. The current tariff for summary administration bankruptcies permits recovery of the first $975 of estate assets realized, thirty-five percent on the balance to $2000 and fifty percent on the portion above that amount. There is also a filing fee of $75 and the trustee may charge the estate $85 for each counseling session. The median trustee remuneration for individual bankruptcy cases filed in 1994 in the Toronto district was $1491. The concept of a "bankruptcy estate" is also somewhat of a misnomer since bankrupt individuals rarely have any substantial unsecured assets. In my statistical file analysis I found that there were three main sources of receipts in an individual bankruptcy estate: payments by a debtor, various forms of tax rebates (income tax and GST (VAT)) and sales of motor vehicles. This last category might not necessarily involve an actual sale since the trustee might accept the bankrupt paying a sum into the estate equivalent to the appraised value of the vehicle.

During the period when most interviews were conducted, a trustee could make a court application to require payments by a debtor where an individual had income beyond what was reasonably necessary for maintaining herself and her family (the superintendent of bankruptcy had issued guidelines indicating "surplus income" payments). According to trustees, these orders were almost never sought because of the cost and inconvenience of making a court application. Instead it is a common practice for trustees to require a debtor to sign a "voluntary" agreement that they will contribute a certain amount of income monthly to the estate for the period of nine months from filing until discharge. These payments might be based on surplus income guidelines but, as indicated earlier, many debtors without surplus income agree to make some form of income payment into the estate to pay the trustee's fees. This "voluntary" agreement might also be phrased in terms of an agreement by the debtor to make up any shortfall in "fees" with a term which stated that a failure to make the payment would entitle the trustee to seek a conditional discharge order against a debtor.

Whatever the legal description of payments being made to the estate, several trustees indicated that they would quote a fee to a potential bankrupt over the phone and indicate the terms on which the fee should be paid. For example one stated, "We tell them that the fee is $1200 for an individual, $300 deposit when they sign up and $150 for the next six months." An other was more circumspect: "We tell them, 'Look, there is a fixed fee but that doesn't mean that you have to pay that fixed fee. What you are more concerned with is how much has to come out of your pocket. That, I cannot tell you until I've discussed your financial affairs.'" The majority of trustees would permit the debtor to spread the fees over time and a significant source of competition related to how much was required as an initial payment. Some trustees would spread the payments over nine months or longer with one trustee being willing to accept $50 a month over twenty-five months in the case of low income debtors or those on social security.

[A]t least two trustees indicated that they would compete by pricecutting. One of these stated:

If I was going into a new area, I would take anything if it was justified that the person go bankrupt in terms of his financial affairs, I would put him through the process and I would bank on getting my fee out of his tax refunds ... That's the key to starting up in a new area. You'll take anything regardless of the fee just to get your position known in that area. People who have had difficulties, poor people or whatever, they have friends, they talk around. A lot of trustees don't do that. They try to start up in a new area, they want to maintain that price.

This approach was frowned upon by some trustees who felt that these "pricecutters" were not applying properly the surplus income guidelines, which at the time suggested income contributions by bankrupts. Two trustees also felt that some trustees might mislead potential clients by saying that the fee was $1000 and then adding on counseling fees at the time of the discharge.

These voluntary payments are supplemented by other forms of income payments such as pre-and postbankruptcy income tax rebates. Postbankruptcy rebates are not automatically part of the estate since they are conceptualized as income and the Supreme Court of Canada also decided in 1994 that trustees could not take assignments of a postbankruptcy income tax refund. Notwithstanding this decision, it appears to be a common practice for trustees to require the bankrupt to assign his postbankruptcy income tax rebate to the estate. Although the actual wording of the standard agreement between trustee and bankrupt does not now use the term assignment, this is the substance of the transaction. The upshot of this practice is that the price which a debtor may pay in terms of foregone income is often more than the $1200 quoted as the "fee" by a bankruptcy trustee. In the file analysis, I found that of debtors who made both voluntary payments and had a postbankruptcy income tax return, the median total payment into the estate from these sources in 1994 was $1733.

The issue of pricing and competition is related closely to the question of access to bankruptcy for those on low income. Several trustees indicated that they would finance bankruptcies for individuals on social assistance though a combination of monthly payments perhaps spread over as long as two years, and through tax refunds and GST credits. Some would simply accept a lower fee or "work something out." ... A number of trustees thought that it was rare in the Toronto Bankruptcy District for the Superintendent of Bankruptcy to appoint a trustee under the

Bankruptcy Assistance Program, given the strong competition among trustees for a limited pool of potential clients.

...

...

One further issue concerns the mechanisms used by trustees to ensure that their fees are paid. Some trustees use the discharge procedure to recover their fees. In the file study I found that there was an opposition to discharge in fourteen percent of cases with the majority of oppositions (8.6%) being brought by trustees. The opposition to discharge would often state that the "debtor has failed to make a payment ... as per the voluntary agreement." This procedure provided leverage to obtain payment since there was generally a significant period between the filing of the opposition and the discharge hearing and if the debtor paid the balance the opposition was withdrawn. Some trustees were quite frank about this practice with one trustee stating, "I tell the bankrupt I am opposing because you haven't paid my fee ... once we file the opposition the discharge does not happen, but there is often a six-month period or more before that gets to court. That gives the bankrupt time to give me what I want and then I just take it back."

There is controversy within the trustee community as to the propriety of this practice and there are also differing practices by registrars in the various bankruptcy districts concerning their willingness to permit trustees to use the discharge process as a means of recovering their fees...

E. THE CHOICE BETWEEN A BANKRUPTCY AND A CONSUMER PROPOSAL

A continuing theme in modern bankruptcy reform in Canada has been that individuals should be encouraged to come to a repayment arrangement with their creditors as an alternative to declaring bankruptcy and it is a major policy goal of the superintendent of bankruptcy to encourage the use of consumer proposals. In 1992, reforms to the BIA introduced the concept of a consumer proposal which would permit an individual debtor with debts of $75,000 or less (excluding residential mortgage debt) to make a proposal to pay his creditors all or a portion of his debts over a period of no longer than five years. Secured creditors are not included within the proposal. In some respects these provisions resemble Chapter 13 of the United States Bankruptcy Code (the wage earner provisions) before the 1978 revisions to the Code. Just as that alternative was not attractive to United States debtors so few Canadian debtors initially chose a proposal as an alternative to bankruptcy. From 1993 to 1997 consumer proposals increased from about two to a modest five percent of personal bankruptcy filings, notwithstanding the assessment procedure which required trustees to discuss the possibility of a proposal with a debtor. Reforms to the BIA which took effect in early 1998 made proposals more financially attractive to trustees as well as creating pressures on debtors with surplus income to file a proposal. These changes have been followed by significant increases in proposal filings in most bankruptcy districts so that proposals are now 13.6% of consumer bankruptcy filings nationally.

Few trustees were enthusiastic about proposals. A minority of trustees were not interested in doing proposals and I am confident that this would be communicated to individual debtors. One indicated that he did not do proposals and referred individuals who wished to go this route to another trustee. Another stated, "the people who come to me are not candidates for proposals," and a third stated, "usually they come to see me about bankruptcy." This latter trustee would mention proposals but not spend a lot of time on it in the initial meeting with the debtor. Of those who were more positive, at least two trustees indicated that they knew that the superintendent of bankruptcy would like to see more proposals and so they had been pushing more debtors into undertaking proposals. Some trustees suggested that proposals might be appropriate for individuals whose livelihood might be affected by a bankruptcy such as those holding professional licenses.

Others felt that they often had to dissuade individuals from undertaking proposals. In their view many individuals want to repay their debts when they initially consult the trustee and thought that a proposal was a good way of doing so. However, in those trustees' opinion, it was often not a realistic alternative and the trustee would have to point out that the debtor's income was not adequate to support a proposal...

I. THE CONFLICTING ROLES OF THE TRUSTEE

I asked all trustees directly about the potential conflicts in their role as representative of creditors but also de facto advisor of debtors. For a number of high volume processors this was not perceived to be a problem since their clients did not raise the issue with them and they had no assets for bankruptcy planning. The following replies are representative of this group.

"Not normally [an issue]. Usually people are willing to accept the fact that you say I'm going to be court appointed here. As soon as you give me your money and we get the documents ready, we're going to be court appointed and we're going to get you up and running as a good citizen again. But we do represent the creditors to get as much money out of your assets as possible. They look at you and say good luck because I haven't got any assets. Household furniture, personal effects, maybe a car worth $300."

"We don't deal with it as a general rule but if the discussion comes up and it sometimes does, we will point out to them that we are there to advise them about bankruptcy ... and once they've gone bankrupt, then we're working for the creditors to realize on the assets for them. We don't as a practice advise them of that initially."

There was an exception to this approach where trustees dealt with higher income professionals such as doctors, dentists and lawyers (under one percent of total personal bankrupts). These individuals would be advised to retain a lawyer. Most trustees indicated that at the initial interview before an individual declared bankruptcy they would inform the debtor of their role and state that although they were providing the debtor with advice at this stage, they were not acting on her behalf should she go bankrupt. Several saw no conflict in acting as the "honest broker," protecting the interests of both creditor and debtor. Most downplayed the significance of potential conflicts since in their opinion the great majority of debtors were honest, and had few assets to attempt to shield from bankruptcy, although it is not quite clear how a debtor would feel in response to the following advice delivered by one trustee:

I say to the debtor that, if what you're telling me is the truth, then I have absolutely no conflict between representing you or acting for you and acting for the creditors. If you're not telling me the truth, then I'm going to come down on you like a ton of bricks.

III. DISCUSSION AND COMPARISON

The professional dominance of the trustee over a debtor who generally lacks knowledge of the bankruptcy process and is in a vulnerable position permits the trustee to control the terms of the relationship and increases her power to define and propose solutions to a debtor. The asymmetry in information between trustee and debtor and the reliance by a debtor on the trustee suggest a classic problem of consumer vulnerability. Few debtors will initially view the trustee as a potential adversary particularly given the marketing by many trustees which emphasizes a sympathetic concern for individuals who are overindebted. Although we know little of debtor experiences of bankruptcy, anecdotal evidence suggests that debtors may be confused by the role of the trustee. There are several problems which I identify as flowing from these findings. Some debtors may be paying too much for bankruptcy protection and lack representation in conflicts with individual creditors. In addition, those debtors who have a genuine choice between declaring bankruptcy and making a consumer proposal may be influenced by advice that reflects a trustee's financial incentives and perception of the value of a proposal.

The financial interest of the trustee in maximizing revenue may clash with the interests of a debtor. This occurs in such areas as the unwillingness to process joint bankruptcies, the choice of a bankruptcy over a proposal, and "fee" payments by bankrupts. The issue of payment of postbankruptcy income tax refunds by bankrupts illustrates the potential clash of interest. Postbankruptcy income tax refunds are not automatically part of the bankruptcy estate and may not be assigned. A low income debtor, if independently advised, might be counseled that it was unlikely that a trustee could require a debtor to pay the rebate into the estate and that he should not sign an agreement in relation to his income tax refund. However, most debtors who wish to repay their debts will be eager to pay over this money as a gesture of good faith commitment to debt repayment. In addition the characterization of the refund as a foregone expectation rather than the loss of an existing asset will also reduce any unwillingness by the debtor to give up this asset.

Trustees are constrained also by law in the extent to which they actively can represent consumers in relation to debt collectors or finance companies and they do not appear for the debtor at a discharge hearing. Trustees may inform the debtor at the outset that they do not represent them and that a debtor cannot provide them with confidential information since they will be acting as the representative of the creditors. At the same time the trustee will later counsel the debtor and it is usually assumed that a counseling relationship is confidential. But if debtors reveal information about personal problems during the counseling process trustees must refer the debtor to a specialist counselor. In addition, if any information concerning assets is disclosed, then the trustee would be under a duty to ensure that this asset is taken into the estate. What is of interest is the general lack of concern until recently concerning these problematic practices. If trustees were a government agency there would undoubtedly be withering criticism of the conflicting roles and power exercised by "bureaucrats" over the lives of their clients. Indeed the potential conflicts inherent in the role of an administrative bankruptcy agency formed a major criticism of the proposed introduction of such an agency in the United States. It is only perhaps because bankruptcy has such a low visibility in Canada that the present practices continue.

This "consumer rights" critique of the trustee/debtor relationship might lead to the conclusion that debtors should have greater representation in the bankruptcy process. Certainly my findings on collection practices and repossession practices suggest that there is a significant failure in the implementation of consumer rights. We could look therefore to the United States model where the great majority of bankrupts have legal representation. However, studies of United States practice suggest that legal representation does not change dramatically the nature of the consumer bankruptcy process. Studies of legal professionals involved in consumer bankruptcy in the United States reveal interesting similarities in the lawyer/client relationship and the trustee/debtor relationship. They are both relationships of professional dominance, albeit a dominance where they may be "principals paternalistically operating in accordance with their sense of the clients' best interests." Routinization is a characteristic of both Canadian and United States consumer bankruptcy, with much consumer bankruptcy being handled by relatively small firms. Forms of marketing, competition and payment mechanisms appear to be remarkably similar as do questionable practices in relation to the collection of fees. The pressures of cost control mean that in practice there is unlikely to be much opportunity for adversarial confrontations or complex assertions of individual rights. There will rarely be extensive investigation of an average debtor's assets and liabilities. Both trustees and lawyers believe that debtors have little knowledge of bankruptcy choices and adopt an approach to consumer rights which involves coaching consumers to protect themselves and negotiate on their own behalf, avoiding actual representation. This may be justified in Canada by the fact that trustees are not lawyers and are constrained by their role in actively representing a debtor's interest, although my interviews suggest that trustees differ in their willingness to assist debtors. Studies in the United States also note the clash between the financial self-interest of the lawyer and the best interests of a debtor. Braucher argues that this occurs in relation to the choice of bankruptcy chapter with many overoptimistic debtors being channeled into Chapter 13 since this "is often the best way for a lawyer to make both a sale of services quickly and get the highest fee." Thus although there are fundamental problems in the trustee-debtor relationship it is not clear that introducing legal representation would make a substantial difference to the processing of consumer bankruptcy. It must also be added that neither the private bar in Canada nor publicly subsidized lawyers have shown interest in consumer credit problems of lower income consumers.

A characteristic of both the Canadian and the United States systems is that in practice the expert intermediaries who provide the service also diagnose the need for the service and the particular level of service (e.g., bankruptcy or proposal). This bundling together of diagnosis and treatment is particularly problematic with professional services which are purchased infrequently and where there are significant information gaps between consumer and producer. Consumer bankruptcy seems a particularly strong example of this phenomenon. A consumer may have difficulty in judging the quality of the diagnosis, the quality of the treatment, and whether the services are of the appropriate level. Individuals may often be unable to evaluate accurately the quality of services provided except through superficial signals such as inattention by the service provider. The problems associated with bundling are one reason for the fiduciary duty of lawyers to their clients but the evidence on consumer bankruptcy lawyers and Canadian trustees suggests that rational self-interested behavior may at times override this duty. One reform which has been proposed is therefore to unbundle diagnosis from treatment by requiring an overindebted debtor to obtain a "second opinion" or some form of independent advice. Thus it has been suggested in Canada that debtors should obtain advice from independent, publicly funded debt advice agencies before declaring bankruptcy. The problem is that the professional delivering the "second opinion" is unlikely to be neutral intermediary. Studies of intermediaries in the legal process, such as mediators, suggest that all intermediaries bring with them a baggage of interests and values. None are neutral and so the concept of independent debt counseling advice is probably a chimera.

Although bundling of services has disadvantages, it may have the advantage of reducing consumer costs where there is little choice facing a debtor. There is probably a large percentage of consumers with no assets and little income for whom a proposal is not a serious alternative to declaring bankruptcy. Since there is only one service provider in Canada, it might be hypothesized that this could provide a less expensive service than the United States approach for this group. It does not appear however that consumers in Canada pay less for a straight bankruptcy than consumers in the United States. In the United States a debtor will pay filing fees of $200 and in a straight Chapter 7 bankruptcy attorney's fees which may range at the median from $500 to $700. In Ontario debtors will currently be asked to pay approximately $1350 to $1400(Can) to a trustee which will go towards payment of the filing fee of $50, counseling fees of $170 and the trustee's fee. In addition, they may be asked to sign over an income tax refund of approximately $500 to $1000 and also certain other tax credits. As I indicated earlier, the median trustee remuneration in 1994 in the Toronto bankruptcy district was $1491. In return for these payments a debtor will obtain advice on bankruptcy options, discharge of debts, counseling and an income tax filing service. The ability of a Canadian trustee to access postbankruptcy income streams from a debtor results both in higher payments by debtors and significantly fewer no-asset cases in Canada. However, there remains little for distribution to unsecured creditors after payment of the trustee's fee with a median of only $558 in my file study.

If it is difficult to find neutral intermediaries for the delivery of bankruptcy services then one possible solution is greater simplification and routinization and the use of bright line rules which reduces the need for intermediaries. The need for bright line rules and the reduction in the use of costly intermediaries is one of the major lessons of the experience of consumer protection over the past thirty years. The great majority of consumer bankruptcies in Canada and the United States are effectively no-asset cases which require administrative processing. The United States National Bankruptcy Review Commission argued for a basic bankruptcy where bankruptcy would become a form of routinized processing with a certain percentage of claims subject to audit. Australia appears to have a low cost form of processing for no-asset cases. The thrust of Canadian reform proposals during the 70s and early 80s was towards this model-- a relatively swift discharge for the great majority of bankrupts--and the provision of a repayment alternative for a small minority of higher income debtors who could repay. The benefits of routinization include a swifter process than individualized scrutiny, an entitlement not subject to the discretion of a professional intermediary, and the reduction of stigma. The Canadian model is currently moving away from this approach with greater emphasis on scrutinizing the individual situation of debtors. Accompanying this there has also been an increase in forms and papers which must be filed in relation to consumer bankrupts, which in different regulatory contexts would be described as "red tape." If routinization might seem the rational approach to addressing the great majority of casualties of the credit system, the potential for its adoption must be set within the political economy of bankruptcy reform and the relative power of interest groups. Creditors are unlikely to support routinized processing since they may fear that it will increase the number of bankruptcies, and trustees, who have often been a voice for debtors in reform debates, also have a vested interest in the existing system. Government, in an era of privatization, will be unwilling to take greater responsibility for processing no-asset cases so that routinization may face significant opposition.

Potential bankrupts are often in a vulnerable position, appear to have little knowledge about the nature and effects of bankruptcy, and consequently may face difficulties in making rational choices. There now exists a large literature in behavioral law and economics which has drawn attention to the many deviations from rationality in individual decisionmaking and this literature may be of particular relevance to consumer bankruptcy decision-making. Thus Braucher indicates that many debtors suffer from an optimistic bias, where they wish to use Chapter 13 even though there is little hope of repayment and although it will have a marginal effect on their credit rating. While a full exploration of the application of behavioral law and economics to individual bankruptcy decision making is not possible here, it does suggest that, taken together with the findings of this and other studies, the ideal of informed debtor choice is one which is difficult to achieve.

2. 3 No specialized bankruptcy courts

There are no specialized bankruptcy courts in Canada. All superior provincial courts are vested with original, auxiliary and ancillary jurisdiction in bankruptcy. These judges are federally appointed judges. There are also bankruptcy registrars who are appointed by the Chief Justice of the Superior Court and who have specific powers which include hearing oppositions to discharge, taxing and passing accounts, hearing unopposed or ex parte applications and unopposed bankruptcy petitions (see s192(1) BIA).

3. Substantive Differences in Canadian and US personal bankruptcy rules

1. The ability to access post bankruptcy income if an individual has "surplus income". This will be payable for the nine months during which the debtor is an undischarged bankrupt but may be extended by the trustee to 21 months. [See below Directive on surplus income].
2.The possibility of creditors opposing discharge on relatively broad grounds (see s173) and obtaining a conditional discharge order. The court has broad discretion as to the terms of this order. [Examples where it may be used include "abuse" of credit cards, failure to pay income tax arrears (income tax authorities are unsecured creditors in bankruptcy), bankruptcy to avoid payment of a judgment in relation to wrongful or tortious conduct).
3. The requirement of mandatory counseling as part of the bankruptcy process and as condition for first-time bankrupt obtaining automatic discharge.
4. Absence of statutory control on reaffirmation agreements by consumers
5. The consumer proposal option does not provided the "carrots" associated with Chapter 13 such as the ability to address secured debt or the "superdischarge".
6. There is no statutory provision preventing discrimination against bankrupts based on bankruptcy status.

3.1 BIA provisions relating to discharge

Bankruptcy and Insolvency Act R.S.C, 1985, c. B-3.

Discharge of Bankrupts

First-time individual bankrupt

168.1 (1) Except as provided in subsection (2), the following provisions apply in respect of an individual bankrupt who has never before been bankrupt under the laws of Canada or of any prescribed jurisdiction:

...

(*a*.1) the trustee shall, not less than fifteen days before the date of automatic discharge provided for in paragraph (*f*), give notice of the impending discharge, in the prescribed form, to the Superintendent, the bankrupt and every creditor who has proved a claim, at the creditor's latest known address;
(*b*) where the Superintendent intends to oppose the discharge of the bankrupt, the Superintendent shall give notice of the intended opposition, stating the grounds therefor, to the trustee and to the bankrupt at any time prior to the expiration of the nine month period immediately following the bankruptcy;
(*c*) where a creditor intends to oppose the discharge of the bankrupt, the creditor shall give notice of the intended opposition, stating the grounds therefor, to the Superintendent, to the trustee and to the bankrupt at any time prior to the expiration of the nine month period immediately following the bankruptcy;
(*d*) where the trustee intends to oppose the discharge of the bankrupt, the trustee shall give notice of

the intended opposition in prescribed form and manner, stating the grounds therefor, to the bankrupt and the Superintendent at any time prior to the expiration of the nine month period immediately following the bankruptcy;

(*e*) where the Superintendent, the trustee or a creditor opposes the discharge of the bankrupt, the trustee shall, unless the matter is to be dealt with by mediation under section 170.1, forthwith apply to the court for an appointment for the hearing of the opposition in the manner referred to in sections 169 to 176, which hearing shall be held

(i) within thirty days after the day the appointment is made, or

(ii) at such later time as may be fixed by the court at the request of the bankrupt or the trustee; and

(*f*) where the Superintendent, the trustee or a creditor has not opposed the discharge of the bankrupt in the nine month period immediately following the bankruptcy, then, subject to subsection 157.1(3),

(i) on the expiration of that nine month period, the bankrupt is automatically discharged, and

(ii) forthwith after the expiration of that nine month period, the trustee shall issue a certificate to the discharged bankrupt, in the prescribed form, declaring that the bankrupt is discharged and is released from all debts except those matters referred to in subsection 178(1), and shall send a copy of the certificate to the Superintendent.

Application not precluded

(2) Nothing in subsection (1) precludes an individual bankrupt from applying to the court for discharge before the expiration of the nine month period immediately following the bankruptcy, and subsection (1) ceases to apply to an individual bankrupt who makes such an application before the expiration of that period.

Application of other provisions

(3) The provisions of this Act concerning the discharge of bankrupts apply in respect of an individual bankrupt who has never before been bankrupt under the laws of Canada or of any prescribed jurisdiction, to the extent that those provisions are not inconsistent with this section, whether or not the bankrupt applies to the court for a discharge referred to in subsection (2).

Effect of automatic discharge

(4) An automatic discharge by virtue of paragraph (1)(*f*) is deemed, for all purposes, to be an absolute and immediate order of discharge.
1992, c. 27, s. 61; 1997, c. 12, s. 98.

<u>Trustee to prepare report</u>

170. (1) The trustee shall prepare a report in the prescribed form with respect to

(*a*) the affairs of the bankrupt,

(*b*) the causes of his bankruptcy,

(*c*) the manner in which the bankrupt has performed the duties imposed on him under this Act or obeyed the orders of the court,

(*d*) the conduct of the bankrupt both before and after the date of the initial bankruptcy event,

(*e*) whether the bankrupt has been convicted of any offence under this Act, and

(*f*) any other fact, matter or circumstance that would justify the court in refusing an unconditional order of discharge,

and the report shall be accompanied by a resolution of the inspectors declaring whether or not they approve or disapprove of the report, and in the latter case the reasons of the disapproval shall be given.

Filing and service of report

(2) Where an application of a bankrupt for a discharge is pending, the trustee shall file the report prepared under subsection (1) in the court not less than two days, and forward a copy thereof to the Superintendent, to the bankrupt and to each creditor who requested a copy not less than ten days, before the day appointed for hearing the application, and in all other cases the trustee, before proceeding to the discharge, shall file the report in the court and forward a copy to the Superintendent.

Superintendent may file report

(3) The Superintendent may make such further or other report to the court as he deems expedient or as in his opinion ought to be before the court on the application referred to in subsection (2).

Representation by counsel

(4) The trustee or any creditor may attend the court and be heard in person or by counsel.

Evidence at hearing

(5) For the purposes of the application referred to in subsection (2), the report of the trustee is evidence of the statements therein contained.

Right of bankrupt to oppose statements in report

(6) Where a bankrupt intends to dispute any statement contained in the trustee's report prepared under subsection (1), the bankrupt shall at or before the time appointed for hearing the application for discharge give notice in writing to the trustee specifying the statements in the report that he proposes at the hearing to dispute.

Right of creditors to oppose

(7) A creditor who intends to oppose the discharge of a bankrupt on grounds other than those mentioned in the trustee's report shall give notice of the intended opposition, stating the grounds thereof to the trustee and to the bankrupt at or before the time appointed for the hearing of the application for discharge.
R.S., 1985, c. B-3, s. 170; 1997, c. 12, s. 100.

Recommendation

170.1 (1) The report prepared under subsection 170(1) shall include a recommendation as to whether or not the bankrupt should be discharged subject to conditions, having regard to the bankrupt's conduct and ability to make payments.

Factors to be considered

(2) The trustee shall consider the following matters in making a recommendation under subsection (1):

(*a*) whether the bankrupt has complied with a requirement imposed on the bankrupt under section 68;
(*b*) the total amount paid to the estate by the bankrupt, having regard to the bankrupt's indebtedness and financial resources; and
(*c*) whether the bankrupt, if the bankrupt could have made a viable proposal, chose to proceed to bankruptcy rather than to make a proposal as the means to resolve the indebtedness.

Presumption

(3) A recommendation that the bankrupt be discharged subject to conditions is deemed to be an opposition to the discharge of the bankrupt.

Request for mediation

(4) Where the bankrupt does not agree with the recommendation of the trustee, the bankrupt may, before the expiration of the ninth month after the date of the bankruptcy, send the trustee a request in writing to have the matter determined by mediation.

Mediation request to be sent to official receiver

(5) Where a request for mediation has been made under subsection (4) or the discharge of the bankrupt is opposed by a creditor or the trustee in whole or in part on a ground referred to in paragraph 173(1)(*m*) or (*n*), the trustee shall send an application for mediation in prescribed form to the official receiver within five days after the expiration of the nine month period referred to in subsection (4) or within such further time as the official receiver may allow.

Mediation procedure

(6) A mediation shall be in accordance with prescribed procedures.

Court hearing

(7) Where the issues submitted to mediation are not thereby resolved or the bankrupt has failed to comply with conditions that were established by the trustee or as a result of the mediation, the trustee shall forthwith apply to the court for an appointment for the hearing of the matter, which hearing shall be held

(*a*) within thirty days after the day the appointment is made, or
(*b*) at such later time as may be fixed by the court,

and the provisions of this Part relating to applications to the court in relation to the discharge of a bankrupt apply, with such modifications as the circumstances require, in respect of an application to the court under this subsection.

Certificate of discharge

(8) Where the bankrupt complies with the conditions imposed on the bankrupt by the trustee in relation to the discharge of the bankrupt or as a result of mediation referred to in this section, the trustee shall

(*a*) issue to the bankrupt a certificate of discharge in the prescribed form releasing the bankrupt from all debts other than a debt referred to in subsection 178(1); and
(*b*) send a copy of the certificate of discharge to the Superintendent.

File

(9) Documents contained in a file on the mediation of a matter under this section form part of the records referred to in subsection 11.1(2).
1997, c. 12, s. 101.

Trustee's report

171. (1) On a request therefor by the Superintendent the trustee shall, within two months after the trustee's appointment or within such longer period as the Superintendent may allow, prepare in the prescribed form and file with the Superintendent a report setting out the following information:

(*a*) the name of the debtor and, where the debtor is a corporation, the names and addresses of the directors and officers of the corporation and, when applicable, the names of the persons who in the opinion of the trustee actively controlled the day-to-day operations of the corporation or the business of the debtor or who in the opinion of the trustee were responsible for the greater proportion of the debtor's liabilities or under whose directions in the opinion of the trustee the greater proportion of the debtor's liabilities were incurred;
(*b*) whether in the opinion of the trustee the deficiency between the assets and the liabilities of the debtor has been satisfactorily accounted for or, if not, whether there is evidence of a substantial disappearance of property that is not accounted for;
(*c*) a statement of opinion by the trustee with respect to the probable causes of the bankruptcy, arrived at after consultation with the inspectors and other persons, which shall be expressed as resulting from one or more of the probable causes in the following enumeration:

(i) misfortune,
(ii) inexperience,
(iii) incompetence,
(iv) carelessness,
(v) over-expansion,
(vi) unwarranted speculation,

(vii) gross negligence,
(viii) fraud, and
(ix) other probable cause (to be specified); and
(*d*) a statement of the facts and information on which the trustee relied in arriving at the opinion expressed pursuant to paragraphs (*b*) and (*c*).

Report to persons concerned

(2) A separate report containing only the information to be given to the Superintendent pursuant to paragraphs (1)(*a*) and (*b*) shall be immediately prepared in the prescribed form by the trustee and a copy thereof shall be sent, by prepaid registered or certified mail in an envelope marked "private and confidential", to each of the persons named pursuant to paragraphs (1)(*a*) and (*b*) in the report to the Superintendent.

Report to official receiver

(3) After the expiration of two months from the date of filing the report with the Superintendent and not later than three months after that date, the trustee shall file with the official receiver the report prepared pursuant to subsection (2).

Application to court regarding report

(4) Notwithstanding subsection (3), where before he has filed his report with the official receiver pursuant to that subsection, the trustee is served with a copy of an application to the court, by any of the persons named pursuant to paragraphs (1)(*a*) and (*b*) in the report prepared pursuant to subsection (2), to have that report altered in any manner or to dispense with the requirements of subsection (3), the trustee shall not file the report under subsection (3) except as may be directed by the court.

Altering report to Superintendent

(5) Where the report to be filed under subsection (3) has been altered in any respect on the direction of the court, the trustee shall inform the Superintendent of any alteration so made, and the Superintendent shall alter the report made to him by the trustee accordingly.

Exoneration from liability

(6) The trustee is not liable for any statements made or opinions expressed by him in good faith and made or purporting to be made by him pursuant to this section, nor is any person liable for publishing, or referring to any matters contained in, the report of the trustee to the official receiver if the publication or reference is made after the filing of the report with the official receiver.
R.S., 1985, c. B-3, s. 171; 1992, c. 1, s. 20, c. 27, s. 63; 1997, c. 12, s. 102.

Court may grant or refuse discharge

172. (1) On the hearing of an application of a bankrupt for a discharge, the court may either grant or refuse an absolute order of discharge or suspend the operation of the order for a specified time, or grant an order of discharge subject to any terms or conditions with respect to any earnings or income that may afterwards become due to the bankrupt or with respect to his after-acquired property.

Powers of court to refuse or suspend discharge or grant conditional discharge

(2) The court shall on proof of any of the facts mentioned in section 173
(*a*) refuse the discharge of a bankrupt;
(*b*) suspend the discharge for such period as the court thinks proper; or
(*c*) require the bankrupt, as a condition of his discharge, to perform such acts, pay such moneys, consent to such judgments or comply with such other terms as the court may direct.

Court may modify after year

(3) Where at any time after the expiration of one year after the date of any order made under this section the bankrupt satisfies the court that there is no reasonable probability of his being in a position to comply with the terms of the order, the court may modify the terms of the order or of any substituted order, in such manner and on such conditions as it may think fit.

Power to suspend

(4) The powers of suspending and of attaching conditions to the discharge of a bankrupt may be exercised concurrently.
R.S., c. B-3, s. 142.

Facts for which discharge may be refused, suspended or granted conditionally

173. (1) The facts referred to in section 172 are:
(*a*) the assets of the bankrupt are not of a value equal to fifty cents on the dollar on the amount of the bankrupt's unsecured liabilities, unless the bankrupt satisfies the court that the fact that the assets are not of a value equal to fifty cents on the dollar on the amount of the bankrupt's unsecured liabilities has arisen from circumstances for which the bankrupt cannot justly be held responsible;
(*b*) the bankrupt has omitted to keep such books of account as are usual and proper in the business carried on by the bankrupt and as sufficiently disclose the business transactions and financial position of the bankrupt within the period beginning on the day that is three years before the date of the initial bankruptcy event and ending on the date of the bankruptcy, both dates included;
(*c*) the bankrupt has continued to trade after becoming aware of being insolvent;
(*d*) the bankrupt has failed to account satisfactorily for any loss of assets or for any deficiency of assets to meet the bankrupt's liabilities;
(*e*) the bankrupt has brought on, or contributed to, the bankruptcy by rash and hazardous speculations, by unjustifiable extravagance in living, by gambling or by culpable neglect of the bankrupt's business affairs;
(*f*) the bankrupt has put any of the bankrupt's creditors to unnecessary expense by a frivolous or vexatious defence to any action properly brought against the bankrupt;

(*g*) the bankrupt has, within the period beginning on the day that is three months before the date of the initial bankruptcy event and ending on the date of the bankruptcy, both dates included, incurred unjustifiable expense by bringing a frivolous or vexatious action;
(*h*) the bankrupt has, within the period beginning on the day that is three months before the date of the initial bankruptcy event and ending on the date of the bankruptcy, both dates included, when unable to pay debts as they became due, given an undue preference to any of the bankrupt's creditors;
(*i*) the bankrupt has, within the period beginning on the day that is three months before the date of the initial bankruptcy event and ending on the date of the bankruptcy, both dates included, incurred liabilities in order to make the bankrupt's assets equal to fifty cents on the dollar on the amount of the bankrupt's unsecured liabilities;
(*j*) the bankrupt has on any previous occasion been bankrupt or made a proposal to creditors;
(*k*) the bankrupt has been guilty of any fraud or fraudulent breach of trust;
(*l*) the bankrupt has committed any offence under this Act or any other statute in connection with the bankrupt's property, the bankruptcy or the proceedings thereunder;
(*m*) the bankrupt has failed to comply with a requirement to pay imposed under section 68;
(*n*) the bankrupt, if the bankrupt could have made a viable proposal, chose bankruptcy rather than a proposal to creditors as the means to resolve the indebtedness; and
(*o*) the bankrupt has failed to perform the duties imposed on the bankrupt under this Act or to comply with any order of the court.

Application to farmers

(2) Paragraphs (1)(*b*) and (*c*) do not apply in the case of an application for discharge by a bankrupt whose principal occupation and means of livelihood on the date of the initial bankruptcy event was farming or the tillage of the soil.
R.S., 1985, c. B-3, s. 173; 1997, c. 12, s. 103.

Assets of bankrupt when deemed equal to fifty cents in dollar

174. For the purposes of section 173, the assets of a bankrupt shall be deemed of a value equal to fifty cents on the dollar on the amount of his unsecured liabilities when the court is satisfied that the property of the bankrupt has realized, is likely to realize or, with due care in realization, might have realized an amount equal to fifty cents on the dollar on his unsecured liabilities.
R.S., c. B-3, s. 144.

Modification of order

(12) On the application of any interested person, the court may, at any time, amend an order made under this section to take into account material changes that have occurred in the personal or family situation of the bankrupt.

Default by other person

(13) An order of the court made under this section may be served on a person from whom the bankrupt is entitled to receive money and, in such case,

(*a*) the order binds the person to pay to the estate of the bankrupt the amount fixed by the order; and

(*b*) if the person fails to comply with the terms of the order, the court may, on the application of the trustee, order the person to pay the trustee the amount of money that the estate of the bankrupt would have received had the person complied with the terms of the order.

Application is a proceeding

(14) For the purposes of section 38, an application referred to in subsection (10) is deemed to be a proceeding for the benefit of the estate.

R.S., 1985, c. B-3, s. 68; 1992, c. 27, s. 34; 1997, c. 12, s. 60.

3.2 The Concept of Surplus Income

Historically there was some confusion as to whether post-bankruptcy income fell within the definition of estate property in section 67 of the BIA. In the 1950s a Supreme Court of Canada decision indicated that post-bankruptcy income did fall within the estate, subject to provincial exemptions. In 1966 the Bankruptcy Act was amended by the addition of section 68 which permitted a trustee to make an application to court for an income payment order. The court had a broad discretion in addressing the application "having regard to the family responsibilities and personal situation of the bankrupt". A later decision of the Supreme Court of Canada (*Marzetti v. Marzetti* [1994] 2 S.C.R. 765 held that section 68 was a complete code in relation to a debtor's salary, wages or other remuneration and that, absent an application to court, these do not automatically vest in the trustee. In practice trustees rarely used this time-consuming procedure in consumer bankruptcies and it was common to make an agreement with the bankrupt to "voluntarily" make monthly payments, which would in many cases cover the trustee's fees. The superintendent of bankruptcy issued guidelines, which were intended to provide guidance on the issue of surplus income.

In 1992 Canada introduced an automatic discharge after nine months for a first time debtor. It was no longer necessary to apply to court for a discharge. During the 1990s creditors argued that it was becoming too easy to declare bankruptcy and the OSB probably received this sentiment sympathetically. In 1997 amendments were made to section 68 of the BIA to encourage 'consumer debtors to act more responsibly'.

The central aspects of these amendments are:

1. Section 68 was amended to require the trustee at the outset of the bankruptcy to fix the amount of income to be paid to the estate by the bankrupt by reference to the surplus income standards established by the OSB and to "the personal and family situation of the bankrupt". This determination must be filed with the OSB (Official Receiver).
2. If the official receiver determines that the amount determined by the trustee is substantially not in accordance with the standards then the OR may make a recommendation for a surplus income payment to the trustee and if this is not followed by the trustee, apply to court for a judicial hearing of the issue.
3. There is provision for mediation if the debtor disagrees with the trustees' determination of surplus income. Creditors and the OSB may also request mediation. If mediation does not resolve the issue then a court hearing may be requested where the court has discretion under s68 (10) to establish the surplus income on the basis of the OSB standards and "having regard to the personal and financial situation of the bankrupt".

In addition the trustee when s/he makes her report on the debtor shortly before discharge may recommend that the debtor be discharged subject to a repayment condition if the debtor has not complied with section 68 or "having regard to the "total amount paid to the estate by the bankrupt, having regard to the bankrupt's indebtedness and financial resources" or "if the debtor could have made a viable proposal" (s170.1(1)). This condition will automatically take effect if the debtor does not object. The Superintendent of Bankruptcy has issued a directive, which limits the maximum period of this conditional discharge to 21 months.

Finally, the grounds for objection to discharge (by trustee, creditor or OSB) have been extended to include the fact that the bankrupt has failed to comply with a requirement to pay imposed under s68 or that the bankrupt could have made a viable proposal but chose bankruptcy rather than a proposal to creditors as a means to resolve the indebtedness.

3.2.1 Empirical Impact of the Amendments

Data provided by the OSB indicate that from August 1998 to August 2000 there were 169,680 total personal bankruptcies and in 29, 058 of these cases there was surplus income. Of these 2,775 were paying below the OSB standards and 1, 277 were paying more than $100 below the standard. There were 116 mediations requested in relation to surplus income during this period with the majority being requested by the trustee in bankruptcy.

In 2001 and 2002 8.28 percent and 6.45 percent of debtors with surplus income were paying below the standard established in the guidelines.

3.2.2 The basis of the surplus income assessment

Surplus income is based on Statistics Canada "low income cut-offs" which are sometimes used in Canada as an unofficial poverty line. They are established by identifying in the family expenditure survey those situations where individuals are paying 20 percent of their income more than the Canadian average on food, shelter and clothing. These data are then analysed to identify income levels where families spend this percentage on the basics. These income levels, differentiated by area of residence and family size are the low income cut offs. [See Statistics Canada. **Low income cut offs from 1992-2001 and low income measures 1991-2000** available at http://www.statcan.ca/cgibin/downpub/listpub.cgi?catno=75F0002MIE2002005 and see Low Income Cut-Offs, http://www.statcan.ca/english/census2001/dict/fam021.htm There are different levels for urban and rural areas, and for the population of an urban area [less than 30,000, 30,0000-99,999,100,000-499,999, 500,000 and over]. The Superintendent of Bankruptcy's guidelines are based on the licos for urban areas of 500,000 and over.

3.2.3. Comparison of Canadian surplus income provisions and recent US proposals.

1. The Canadian provisions provide relatively bright-line, inflexible rules without addressing individual needs or regional disparities. The costs of administration are not high for trustees.
2. They are initially based on income at the time of declaring bankruptcy not average income based on the previous six months income of the debtor.
3. In Canada the surplus income guidelines are determined in secondary legislation by an administrative agency.
4. No deduction of secured debt payments under Canadian system
5. Surplus income payments are only for nine months or possibly 21 months. US approach seems based on potential of five-year repayment alternative.

The courts have recognized some limited flexibility in the phrase having regard to "the personal and family situation of the bankrupt" to permit some deviation from the statutory guidelines.

3.3 Statutory provisions on surplus income: section 68 BIA and Directive No 11R.

Directives re standard of living factors

68. (1) The Superintendent shall, by directive, establish in respect of the provinces or one or more bankruptcy districts or parts of bankruptcy districts, the standards for determining the portion of the total income of an individual bankrupt that exceeds that which is necessary to enable the bankrupt to

maintain a reasonable standard of living.

Interpretation

(2) For the purposes of this section,

(a) "total income" referred to in subsection (1) includes, notwithstanding paragraphs 67(1)(b) and (b.1), all revenues of a bankrupt of whatever nature or source; and

(b) a requirement that a bankrupt pay an amount to the estate of the bankrupt is enforceable against all property of the bankrupt, other than property referred to in paragraphs 67(1)(b) and (b.1).

Trustee to fix amount to be paid

(3) The trustee shall

(a) having regard to the applicable standards established under subsection (1), and to the personal and family situation of the bankrupt, fix the amount that the bankrupt is required to pay to the estate of the bankrupt;

(b) inform the official receiver in writing of the amount fixed under paragraph (a); and

(c) take reasonable measures to ensure that the bankrupt complies with the requirement to pay.

Modification by trustee

(4) The trustee may, at any time, amend an amount fixed under subsection (3) to take into account

(a) material changes that have occurred in the personal or family situation of the bankrupt; or

(b) a recommendation made by the official receiver under subsection (5).

Official receiver recommendation

(5) Where the official receiver determines that the amount required to be paid by the bankrupt under subsection (3) or (4) is substantially not in accordance with the applicable standards established under subsection (1), the official receiver shall recommend to the trustee and to the bankrupt an amount required to be paid that the official receiver determines is in accordance with the applicable standards.

Trustee may request mediation

(6) Where the trustee and the bankrupt are not in agreement with the amount that the bankrupt is required to pay under subsection (3) or (4), the trustee shall, forthwith, in the prescribed form, send to the official receiver a request that the matter be determined by mediation and send a copy of the request to the bankrupt.

Creditor may request mediation

(7) On the request in writing of a creditor made within thirty days after the date of bankruptcy or an amendment referred to in subsection (4), the trustee shall, within the five days following the thirty day period, send to the official receiver a request in the prescribed form that the matter of the amount the bankrupt is required to pay under subsection (3) or (4) be determined by mediation and send a copy of the request to the bankrupt and the creditor.

Mediation procedure

(8) A mediation shall be in accordance with prescribed procedures.

File

(9) Documents contained in a file on the mediation of a matter under this section form part of the records referred to in subsection 11.1(2).

Court determination

(10) Where

(a) the trustee has not implemented a recommendation made by the official receiver under subsection (5),

(b) the issue submitted to mediation requested under subsection (6) or (7) is not thereby resolved, or

(c) the bankrupt fails to comply with the requirement to pay as determined under this section,

the trustee may, or on the request of the inspectors, any of the creditors or the official receiver shall, apply to the court for the hearing of the matter, and the court may, on the hearing, in accordance with the standards established under subsection (1) and having regard to the personal and family situation of the bankrupt, by order, fix the amount that the bankrupt is required to pay to the estate of the bankrupt.

Fixing fair and reasonable remuneration
in the case of related persons

(11) The court may fix an amount that is fair and reasonable

(a) as salary, wages or other remuneration for the services being performed by a bankrupt for a person employing the bankrupt, or

(b) as payment for or commission in respect of any services being performed by a bankrupt for a person, where the person is related to the bankrupt, and the court may, by order, determine the part of the salary, wages or other remuneration, or the part of the payment or commission, that shall be paid to the trustee on the basis of the amount so fixed by the court, unless it appears to the court that the services have been performed for the benefit of the bankrupt and are not of any substantial benefit to the person for whom they were performed.

Modification of order

(12) On the application of any interested person, the court may, at any time, amend an order made under this section to take into account material changes that have occurred in the personal or family situation of the bankrupt.

Default by other person

(13) An order of the court made under this section may be served on a person from whom the bankrupt is entitled to receive money and, in such case,

(a) the order binds the person to pay to the estate of the bankrupt the amount fixed by the order; and

(b) if the person fails to comply with the terms of the order, the court may, on the application of the trustee, order the person to pay the trustee the amount of money that the estate of the bankrupt would have received had the person complied with the terms of the order.

Application is a proceeding

(14) For the purposes of section 38, an application referred to in subsection (10) is deemed to be a proceeding for the benefit of the estate.

Directive N° 11R on Surplus Income

For your information, you will find attached a revised Appendix "A" which reflects the standards for the year 2003 and the revised page 5 of the directive. The revision of Appendix "A" has necessitated an update to the example provided on page 5.

N° 11R

Surplus Income

Issue : October 3rd 2000

This Directive replaces Directive No. 11, which came into force April 30th, 1998.
This Directive comes into force on November 1st, 2000.

Interpretation

1. In this Directive,

    a. **"Act"** means the *Bankruptcy and Insolvency Act*;

    b. **"Superintendent's standards"** refers to the table set out in Appendix A of this Directive.

Purpose

2. The purpose of this Directive, issued pursuant to paragraph 5(4)(c) and section 68 of the Act, is to assist the trustee in determining equitably and consistently the portion of the bankrupt's income that should be paid into the bankrupt's estate.

Sections of the Act concerned:

Sections 68 and 170.1.

Background

3. Subsection 68(3) of the Act states :

    a. "The trustee shall :

        i. having regard to the applicable standards established under subsection (1), and to the personal and family situation of the bankrupt, fix the amount that the bankrupt is required to pay to the estate of the bankrupt;
        ii. inform the official receiver in writing of the amount fixed under paragraph (a); and
        iii. take reasonable measures to ensure that the bankrupt complies with the requirement to pay."

Family Unit

4. In determining the bankrupt's personal and family situation, it is necessary to establish the earnings and expenses of both the bankrupt and the bankrupt's family unit. The bankrupt must disclose the earnings and expenses of each member of the family unit. As well, the trustee may question each member of the family unit as to their earnings and expenses.

5. For the purposes of this Directive, the bankrupt's family unit includes, in addition to the bankrupt, any persons who reside in the same household and who benefit from either the expenses incurred or income earned by the bankrupt, or who contribute to such expenses or earnings. A person who does not reside in the same household shall be considered as a member of the family unit if the person benefits from, or participates in, the bankrupt's income or expenses.

Calculation

6.

1. In order to apply the Superintendent's standards (Appendix A), the bankrupt shall first complete the income and expense statement of the family unit, including the bankrupt, in Form 65 entitled *Monthly Income and Expense Statement of the Bankrupt and the Family Unit and Information (or Amended Information) Concerning the Financial Situation of the Individual Bankrupt.*

2. The family unit's total monthly income shall be determined by subtracting from the total of all its members' monthly incomes the following amounts, as applicable:

   a. In the case of a salaried employee, minimum statutory remittances (income tax, pension and employment insurance deductions) and other mandatory deductions paid; or
   b. in the case of a person who is self-employed, business expenses and deductions as permitted by the *Income Tax Act* or similar provincial legislation, minimum statutory remittances and instalment tax payments.

3. The family unit's available monthly income is determined by subtracting from the family unit's total monthly income the monthly non-discretionary expenses applicable to the personal and family situations of both the bankrupt and the bankrupt's family unit:

   . child support payments;
   a. spousal support payments;
   b. child care expenses;
   c. expenses associated with a medical condition;
   d. court-imposed fines or penalties that are in process of being paid;
   e. expenses permitted by the *Income Tax Act* (or similar provincial legislation) that are a condition of employment; or
   f. any other debt where a stay of proceedings has been lifted by the court, and a recourse authorized.

4. The trustee shall verify the accuracy of the income and expense statement submitted by the bankrupt by requiring that the bankrupt provide:

   . proof of payments made *pursuant* to subsections (2) and (3) above;
   a. proof of income.

7.

1. The trustee determines the bankrupt's total monthly surplus income by subtracting from the family unit's available monthly income the amount which, according to the standards, corresponds to the number of persons in the family unit, as set out in Appendix A.

   a. Where the bankrupt's total monthly surplus income is equal to or greater than $100 and less than $1,000, 50% of the amount determined in subsection (1) shall be required from the bankrupt;

   b. Where the bankrupt's total monthly surplus income is equal to or greater than $1,000, at least 50%, but no more than 75% of the amount determined in subsection (1), shall be required from the bankrupt.

Family Situation Adjustment

8. The amount that the bankrupt is required to pay to the bankrupt's estate shall be adjusted to the same percentage as the bankrupt's portion of the family unit's available monthly income.

9. For the purposes of this Directive and subsection 68(3) of the Act, when the trustee has determined the amount the bankrupt is required to pay to the bankrupt's estate, the trustee shall inform the Official Receiver of that amount, in Form 65 entitled *Monthly Income and Expense Statement of the Bankrupt and the Family Unit and Information (or Amended Information) Concerning the Financial Situation of the Individual Bankrupt.*

Example (Family unit of 2)

Bankrupt's available monthly income	\$1,800
Other family unit member's available monthly income	\$1,000
Family unit's available monthly income	\$2,800
Minus the Superintendent's standard for a family unit of 2 as per Appendix A	\$2,054
Total monthly surplus income	\$746
Bankrupt's portion of the family unit's monthly income (1,800 ÷ 2,800 = 64.3 %)	
Payment required from bankrupt, as per paragraph 7(2)(a) of the Directive [(746 x 64.3 %) x 50 % = 239.84]	\$240

10. Where a person considered to be a member of the family unit as defined in section 5, who is not a bankrupt, refuses or neglects to divulge his or her family income and expenses, for the purposes of subsection 7(1), this person is deemed not to be a member of the family unit. The trustee shall describe these circumstances in Form 65 entitled *Monthly Income and Expense Statement of the Bankrupt and the Family Unit and Information (or Amended Information) Concerning the Financial Situation of the Individual Bankrupt* and in Form 82 entitled *Report of Trustee on Bankrupt's Application for Discharge.*

Irregular Income

11. When a bankrupt's income is irregular (e.g., sale commissions or seasonal employment), the amount that the bankrupt is required to pay to the bankrupt's estate may be deferred until the time of preparation of Form 82 entitled *Report of Trustee on Bankrupt's Application for Discharge*, if necessary. At that time, the average income for the period of bankruptcy would be considered for the purpose of determining the amount that the bankrupt is required to pay to the bankrupt's estate and a conditional discharge shall be recommended by the trustee for the total amount, if this has not already been paid.

12. The trustee shall comment on this situation when dealing with surplus income in Form 82 entitled *Report of Trustee on Bankrupt's Application for Discharge.*

Example

An individual with no regular income, but an occasional sales commission, files an assignment in bankruptcy. During the eighth month of bankruptcy, the bankrupt receives three commissions in the amount of \$6,000, \$4,000 and \$8,000 for a total of \$18,000. The monthly average during the nine month period of bankruptcy would be \$2,000, and the total monthly surplus income determination would be made retroactively with a recommendation for a conditional discharge being made in the amount of the determined surplus.

Discontinuation of payments

13. The payments which the bankrupt is required to make to the bankrupt's estate shall cease

upon the discharge of the bankrupt, or as otherwise ordered by the court.

Marc Mayrand

Superintendent of Bankruptcy

Appendix "A"

Superintendent's Standards - 2003 -

Total monthly surplus income														
Persons	**S**	**Family unit's available monthly income**												
		1743	**1843**	**1943**	**2043**	**2143**	**2343**	**2543**	**2743**	**2943**	**3143**	**3343**	**3543**	**3743**
1	1643	100	200	300	400	500	700	900	1100	1300	1500	1700	1900	2100
2	2054	0	0	0	0	100	289	489	689	889	1089	1289	1489	1689
3	2554	0	0	0	0	0	0	0	189	389	589	789	989	1189
4	3092	0	0	0	0	0	0	0	0	0	0	251	451	651
5	3456	0	0	0	0	0	0	0	0	0	0	0	0	287
6	3821	0	0	0	0	0	0	0	0	0	0	0	0	0
7 +	4185	0	0	0	0	0	0	0	0	0	0	0	0	0

The Superintendent's Standards ("S") are derived from the Low Income Cutoffs (LICO) released by Statistics Canada. The Superintendent uses the before-tax LICO for urban areas 500,000 people and over. The 2003 standards are updated adding to the 2001 LICO the 2002 Consumer Price Index (CPI), 2.2%, plus a 2.4% adjustment reflecting the 2003 CPI expectation.

The amounts shown above represent the monthly total surplus income of the bankrupt over the standards, from which the surplus income payment should be calculated.

4. Mandatory Counseling in Bankruptcy

Iain Ramsay 'Mandatory Bankruptcy Counseling: the Canadian Experience' (2002)

7 *Fordham J. Corp. & Fin. L.* 525

…II. The Introduction of Mandatory Counseling

Canada introduced mandatory counseling for bankrupts in 1992. The rationale for the introduction of counseling was to prevent repeat bankruptcies and to further rehabilitative goals of behavior modification. Creditors had lobbied for the inclusion of mandatory counseling during legislative debates. The concept of counseling was also supported by the Office of the Superintendent of Bankruptcy, the independent agency that regulates the bankruptcy process in Canada...

There are three instances in the Canadian bankruptcy process that could be characterized as counseling, although only two are formally described as such. At the point when an individual is considering bankruptcy and has visited a trustee, the trustee is required to make a pre-bankruptcy assessment of a potential bankrupt. This includes an outline of the debtor's financial affairs, a discussion of the debtor's options, including the option of a consumer proposal, and the various rights and responsibilities of the debtor. This directive was introduced in response to concerns that individuals were being processed through bankruptcy by clerical personnel in trustee firms without being provided with a full explanation of their options and without an opportunity to meet a trustee.

The first formal counselling session takes place shortly after the declaration of bankruptcy and is titled "Consumer and Credit Education." The counselor should provide the debtor at this stage with consumer advice in "(i) money management; (ii) spending and shopping habits; (iii) warning signs of financial difficulties; and (iv) obtaining and using credit." The second counseling session, which takes place shortly before the discharge in a straight bankruptcy is entitled "Identification of Road Blocks to Solvency and Rehabilitation." The focus here is to follow up on the principles of money management introduced in the first session and to assure the bankrupt better understands "his/her strengths and weaknesses with regards to money management and budgeting skills." It is also to "identify the non-budgetary causes (such as gambling abuse, compulsive behaviour, substance abuse, employment and marital or family difficulties) that may have contributed to his/her financial difficulties; to better understand his/her behavior in financial management and consumption habits" and "to develop recommendations and alternatives for a financial plan of action." The fee for each session is eighty-five dollars Canadian which is payable from the bankruptcy estate.] Since the estate usually comprises income payments by the debtor, one could argue that, in substance, the debtor pays for counseling. Each session is expected to last approximately one hour...

There are three groups who undertake counseling. These are trustees in bankruptcy, estate administrators in trustees' offices who have passed the required course, and credit counseling agencies. Reliance was placed initially on trustees in bankruptcy to carry out the required counseling as part of their duties in relation to the administration of the estate and most counseling is undertaken by trustees or individuals (estate managers) within their offices.

A mandatory training course was developed for all individuals who counsel debtors. Also, all counselors are required to complete successfully an examination based on the course materials. The course consists of a textbook, a videocassette, a help line and a two-hour true/false multiple-choice examination. It is assumed that the course will take about forty hours to complete. In addition, counselors must work under the supervision of a qualified counselor for one hundred hours. These are the only formal credentialing requirements for bankruptcy counseling.

It is not clear whether the introduction of counseling has made a significant difference in the practice of many trustees. Counseling sessions could be tacked on to other required meetings with a debtor, so that counseling may not have altered significantly the office routine. Perhaps reflecting the above comments, the Insolvency Institute, a group composed of trustees and lawyers that models itself on the National Bankruptcy Conference in the U.S., has questioned whether counseling should be mandatory for all debtors.

Trustees may delegate counseling to credit counseling agencies, and there is a variety of credit counseling agencies in Canada. In English Canada, the most common model for such agencies is a non- profit agency that receives significant financing from creditors. This funding takes the form of a percentage of remittances (twenty-five percent) in administering voluntary repayment plans, and income from bankruptcy counseling augments this income. They may also charge clients a percentage of remittances (usually ten percent) paid by the client on repayment programs. In contrast, Quebec's main credit counseling agency, the ACEF, is funded by the government and charities and does not accept funding from creditors or debtors since the agency is concerned with retaining its independence. There are, however, privatization pressures on government funding of counseling agencies, so that one might predict that the first model outlined above may become increasingly common. A central question therefore concerns the independence of the agencies from creditors. In a review of credit counseling in Canada, Andrew Dekany concludes that for "a combination of historical and financial reasons agencies are more and more assuming a 'dual' role whereby they also represent the interests of creditors."

There is also the influence of the values and interests of intermediaries in administering a counseling program. For example, a major credit counseling service in Canada indicates in its annual report that "more and more consumers [are considering] personal bankruptcy as a 'quick fix' to their financial woes. Fortunately, we have been able to help almost 3,000 individuals . . . to avoid bankruptcy."

IV. Assessing the Effectiveness of Counseling

There have been two reviews of bankruptcy counseling. An initial review was undertaken shortly after its implementation. This report was based on interviews with bankrupts who had undergone counseling, as well as interviews with trustees and private counselors. Trustees were of the view that counseling would have, at best, a moderate or non-existent influence on bankrupts' understanding of the causes of bankruptcy, knowledge of financial management, and ability to be productive in the future. Almost two-thirds of trustees thought that counseling made little or no difference to a bankrupts' understanding of how the bankruptcy affected their creditors or their willingness to act in a financially responsible manner in the future. Trustees also indicated that the introduction of counseling had required little increased expenditure in their practices and that they rarely referred individuals to other counselors for counseling on non-financial problems.

In contrast, bankrupts were much more enthusiastic than trustees about the success of counseling. Fifty-one percent of bankrupts thought that counseling improved their knowledge about handling their money and sixty eight percent reported that counseling would have a considerable or extensive effect on their ability to avoid future bankruptcy. Sixty-seven percent thought that it would have a considerable or extensive impact on their ability to keep their financial affairs in order in the future. Finally, seventy-one percent thought that counseling would have a considerable effect on their willingness to act in a responsible manner in the future. Overall, sixty percent rated the bankruptcy counseling as very useful.

The researchers also distinguished the effect of the education and occupational status of the bankrupts on their views of the value of counseling. Those in the semi-skilled and unskilled categories found counseling to be more valuable than those in higher occupational categories in relation to its impact on preventing future bankruptcy, knowledge of handling money, and ability to keep financial affairs in order and act in a financially responsible manner in the future.

These findings are of interest for several reasons. They indicate that bankrupts seem to find counseling valuable and that satisfaction with the counseling varies across social class. Studies of debtor education in the U.S. seem to confirm that individuals appreciate debtor-education programs. It would be interesting to probe why debtors appreciate counseling. For example, it may reflect the fact that they have had the opportunity to discuss their problems with a sympathetic listener. In addition, there is the dissonance between trustees' and debtors' views of the value of the process. This dissonance does not seem to be as strong in the case of credit counselors who appear slightly more enthusiastic about the potential impact of counseling on the future financial stability of a debtor. It is not clear whether trustees are skeptical of the value of the process because counseling challenges their knowledge and professional status. Since many trustees are accountants they will rarely have had training in counseling.

A second study of the effectiveness of counseling was completed recently as part of a current review of personal insolvency. While the draft findings of this study record a similar enthusiasm among debtors for counseling, they suggest also that those providing counseling are more optimistic about its overall utility with over forty percent of counselors believing that counseling is very useful. However, there is a substantial difference between trustees and counselors in their assessment of counseling, with fifty-five percent of counselors rating counseling to be very useful versus thirty percent of trustees. This might suggest that those whose primary vocation is counseling are significantly more optimistic about its impact.

Directive No. 1R2

Counselling in Insolvency Matters

Issued on December 21, 1994

This Directive applies to trustees and administrators of consumer proposals acting for individuals who make a consumer proposal and trustees acting for individuals who become bankrupt after December 31, 1994. For the above purposes, this Directive supersedes Directive No.1R (issued June 1, 1993).

Short Title

1. Counselling Directive.

Interpretation

2. In this Directive,

"Act"
means the *Bankruptcy and Insolvency Act;*
"counselling"
means to assist and educate bankrupts and/or relatives of bankrupts, or consumer debtors, on good financial management, including prudent use of consumer credit and budgeting principles; in developing successful strategies for achieving financial goals and overcoming financial setbacks; and at any time, where appropriate, making referrals to deal with non-budgetary causes of insolvency (e.g.: gambling, addiction, marital and family problems, etc.);
"effective date of bankruptcy"
means the date on which the bankrupt filed an assignment with the official receiver or the date on which the bankrupt became a bankrupt as a result of a receiving order being issued, or of a proposal under Division I of Part III of the Act being terminated before completion;
"qualified counsellor"
means an individual (independent counsellor authorized by the trustee, a trustee, an administrator of consumer proposals, and an employee of a trustee or administrator of consumer proposals) who has obtained the qualifications and skills to provide financial counselling to a debtor, consumer debtor, bankrupt or relative of a bankrupt;
"relative"
means an individual connected by blood relationship, marriage or common-law relationship, or adoption, to the bankrupt, and includes same sex partners;
"Rules"
means the *Bankruptcy and Insolvency Rules* made pursuant to subsection 209(1) of the Act;
"trustee"
means a trustee licensed under section 13.1 of the Act and an administrator of consumer proposals as defined in section 66.11 of the Act.

Authority

3. Section 157.1 and paragraph 66.13(2)(b) of the Act state that trustees shall provide, or provide for, counselling.
4. This Directive, issued pursuant to the authority of paragraphs 5(4)(b) and (c) of the Act, establishes that the trustee is responsible for ensuring compliance with this Directive and that the individual performing the counselling, as described herein, must be a qualified counsellor.

Purpose and Application

5.
    1. This Directive:
        a. describes the minimum content of the counselling stages and associated tasks;
        b. subject to subsection (2), applies to trustees acting for individuals who make a consumer proposal or become bankrupt after December 31, 1994.
    2. Counselling obligations incurred on or before December 31, 1994, pursuant to Directive No. 1R (issued June 1, 1993) shall continue to be governed by the provisions of Directive No. 1R.

Policy

6. The counselling referred to in section 157.1 and paragraph 66.13(2)(b) of the Act shall consist of the following two stages:
    a. a first stage to be conducted, in accordance with subsection 7(1) of this Directive,
        i. between 10 and 60 days following the effective date of bankruptcy or the filing of a consumer proposal, or
        ii. within 10 days following the first meeting of creditors held pursuant to subparagraph 57(c)(i) of the Act where a Division I proposal was refused by the creditors.
    b. a second stage to be conducted, in accordance with subsection 8(1) of this Directive not before the end of a 30 day period after the first stage and no later than 210 days following the effective date of bankruptcy in the case of a bankrupt or of the filing of a consumer proposal in the case of a consumer debtor.

Standards

First Counselling Stage - Consumer and Credit Education

7. 1.

    a. In the first stage, the qualified counsellor shall present information to provide the bankrupt and/or relative, or a consumer debtor, with consumer advice in the areas of:
        i. money management;
        ii. spending and shopping habits;
        iii. warning signs of financial difficulties; and
        iv. obtaining and using credit.

    b. With the agreement of the bankrupt and/or relative, or consumer debtor, this stage may be conducted in a group presentation. A group shall be more than two but no more than 20 participants.

2. On the completion of the first stage, the qualified counsellor shall:

    a.complete and sign the Counselling Certificate (Schedule I);

    b.request the bankrupt or consumer debtor to sign the Acknowledgement (Schedule I), indicating that counselling has been provided; and

    c.were applicable, send to the trustee the Counselling Certificate for retention as part of the estate file of the bankrupt or consumer debtor.

3. On request by the Official Receiver, the trustee shall provide the Official Receiver with a copy of the certificate referred to in paragraph 2(c).
4. Once the trustee has executed, or received from a qualified counsellor, the certificate referred to in paragraph 2(c), the trustee may withdraw from the trust account to his/her benefit, or remit to the qualified counsellor, the prescribed amount for the payment of the first stage.

Second Counselling Stage - Identification of Road Blocks to Solvency and Rehabilitation

8.

1. The second stage is to determine the budgetary and/or non-budgetary causes of insolvency or bankruptcy and requires that the qualified counsellor:

    a. follow-up on the application by the debtor of the principles presented in the first stage to assist the bankrupt and/or relative, or the consumer debtor, to better understand his/her strengths and weaknesses with regards to money management and budgeting skills;
    b. assist, where appropriate, the bankrupt and/or relative, or a consumer debtor:
        i. to identify the non-budgetary causes (such as gambling abuse, compulsive behaviour, substance abuse, employment and marital or family difficulties) that may have contributed to his/her financial difficulties;
        ii. to better understand his/her behaviour in financial management and consumption habits; and,
        iii. to make him/her aware of the existence of resources that will help him/her achieve and maintain economic stability; and
    c. cooperatively with the bankrupt and/or relative, or a consumer debtor, develop recommendations and alternatives for a financial plan of action which, if appropriate, may include referral for specialised counselling to deal with non-budgetary causes of insolvency.

2. When the bankrupt or consumer debtor has satisfied the requirements of this stage, the qualified counsellor shall:

    a.complete and sign the Counselling Certificate (Schedule II);

    b.request the bankrupt or consumer debtor to sign the Acknowledgement (Schedule II), indicating that counselling has been provided; and

    c.where applicable, send to the trustee the Counselling Certificate for retention as part of the estate file of the bankrupt or consumer debtor.

3. On request by the Official Receiver, the trustee shall provide the Official Receiver with a copy of the certificate referred to in paragraph 2(c).
4. Once the trustee has executed, or received from the qualified counsellor, the certificate referred to in subsection 2(c), the trustee may withdraw from the trust account to his/her benefit, or remit to the qualified counsellor, the prescribed amount for the payment of the second stage.

General

Explanatory Note

(This note is not part of the Directive)

1. It is recognized that counselling services should be provided by skilled and qualified individuals and that standards be established for the delivery of the service.
   In this respect, it is suggested that everyone, including trustees, take a training program if they wish to provide counselling. A training program should establish a level playing field as to the skills and qualifications of the individuals who will be providing counselling

services.
The establishment of standards is meant to reinforce and facilitate the rehabilitation of all individual debtors. Standards will establish a uniform structure for the delivery of content. The implementation of the above recommendations will ensure that individual debtors facing financial difficulties will receive professional advice from qualified people, who will assist them in adopting more responsible practices with respect to financial matters and avoiding reoccurrence.

5. Fees in Summary Administration Bankruptcies and Consumer Proposals

TRUSTEE'S FEES AND DISBURSEMENTS IN SUMMARY ADMINISTRATION

128. (1) The fees of the trustee for services performed in a summary administration are calculated on the total receipts remaining after deducting necessary disbursements relating directly to the realization of the property of the bankrupt, and the payments to secured creditors, according to the following percentages:

(a) 100 per cent on the first $975 or less of receipts;

(b) 35 per cent on the portion of the receipts exceeding $975 but not exceeding $2,000; and

(c) 50 per cent on the portion of the receipts exceeding $2,000.

(2) A trustee in a summary administration may claim, in addition to the amount set out in subsection (1),

(a) the costs of counselling referred to in subsection 131(2); [*currently $85 where counselling provided on an individual basis*]

(b) the fee for filing an assignment referred to in paragraph 132(a); [*currently $75 for first time bankrupt*]

(c) the fee payable to the registrar under paragraph 1(a) of Part II of the schedule;

(d) the amount of applicable federal and provincial taxes for goods and services; and

(e) a lump sum of $100 in respect of administrative disbursements.

(3) A trustee in a summary administration may withdraw from the bank account used in administering the estate of the bankrupt, as an advance on the amount set out in subsection (1),

(a) $250, at the time of the mailing of the notice of bankruptcy;

(b) an additional $250, thirty days after the date of the bankruptcy; and

(c) an additional $250, four months after the date of the bankruptcy.

(4) Subsections (1) to (3) apply to bankruptcies in respect of which proceedings are commenced on or after September 30, 1997 and the accounts are taxed on or after April 30, 1998. SOR/98-240, s. 1.

ADMINISTRATOR'S FEES AND EXPENSES IN A CONSUMER PROPOSAL

129. (1) For the purposes of paragraph 66.12(6)(b) of the Act, the fees and expenses of the administrator of a consumer proposal that must be provided for in a consumer proposal are as follows:

(a) $750, payable on filing a copy of the consumer proposal with the official receiver;

(b) $750, payable on the approval or deemed approval of the consumer proposal by the court;

(c) 20 per cent of the moneys distributed to creditors under the consumer proposal, payable on the distribution of the moneys;

(d) the costs of counselling referred to in subsection 131(1);

(e) the fee for filing a consumer proposal referred to in paragraph 132(c);

(f) the fee payable to the registrar under paragraph 3(b) of Part II of the schedule; and

(g) the amount of applicable federal and provincial taxes for goods and services.

(2) Subsection (1) applies to consumer proposals in respect of which proceedings are commenced on or after April 30, 1998. SOR/98-240, s. 1.

APPLICATION OF SUMMARY ADMINISTRATION PROVISIONS

130. For the purposes of subsections 49(6) and (8) of the Act, the prescribed amount is $10,000. SOR/98-240, s. 1.

MISCELLANEOUS FEES

131. (1) For the purposes of paragraph 66.12(6)(b) of the Act, the fees and expenses in respect of counselling are $85 per session where counselling is provided on an individual basis, and $25 per person per session where counselling is provided on a group basis.

(2) For the purposes of subsection 157.1(1) of the Act, the costs of counselling are $85 per session where counselling is provided on an individual basis, and $25 per person per session where counselling is provided on a group basis. SOR/98-240, s. 1.

132. (1) The total fee to file all documents relating to an estate with the official receiver is as follows:

(a) $75 for an estate under summary administration in respect of an individual bankrupt who has never before been bankrupt under the laws of Canada or of any jurisdiction prescribed under section 168.1 of the Act and, in the case of any other bankruptcy, $150, payable at the time of filing an assignment pursuant to subsection 49(3) of the Act or at the time of the making of a receiving order pursuant to subsection 43(6) of the Act;

(b) in the case of a proposal made by an insolvent person, $150, payable at the time of filing a copy of the proposal pursuant to subsection 62(1) of the Act;

(c) in the case of a consumer proposal made by a consumer debtor, $100, payable at the time of filing a copy of the consumer proposal pursuant to paragraph 66.13(2)(d) of the Act; and

(d) if the official receiver directs, pursuant to subsection 49(8) of the Act, that subsection 49(6) of the Act ceases to apply in respect of a bankrupt, $75, payable at the time of the official receiver's direction.

(2) The fees set out in paragraphs (1)(a), (c) and (d) apply to all documents filed on or after the coming into force of those paragraphs. SOR/98-240, s. 1; SOR/2001-155, s. 2.

133. For the purposes of subsection 11.1(1) of the Act, the fee payable for each request for information contained in the public record is $8. SOR/98-240, s. 1.

134. (1) For the purposes of subsection 13.2(1) of the Act, the fee payable by an applicant for a licence to act as a trustee is $300.

(2) For the purposes of subsection 13.2(2) of the Act, the annual fee payable by a trustee is $850.

(3) For the purposes of paragraph 13.2(4)(a) of the Act, the penalty amount that must be paid by a trustee is $100. SOR/98-240, s. 1; SOR/2001-155, s. 3.

135. For the purposes of subsection 120(5) of the Act, the fees per meeting that may be paid to an inspector, to be determined on the net receipts as calculated by subtracting the payments to secured creditors from the amount of total receipts received by the trustee, are as follows:

(a) $10, where the estate has net receipts of less than $10,000;

(b) $20, where the estate has net receipts of $10,000 or more but less than $50,000;

(c) $30, where the estate has net receipts of $50,000 or more but less than $100,000; or

(d) $40, where the estate has net receipts of $100,000 or more. SOR/98-240, s. 1; SOR/99-416, s. 1.

136. For the purposes of subsection 245(1) of the Act, the fee that accompanies the notice sent to the Superintendent is $70. SOR/98-240, s. 1.

PRESCRIBED DATE

137. For the purposes of paragraphs 136(1)(h) and (j) of the Act, the prescribed date is November 30, 1992. SOR/98-240, s. 1.

136.1 (1) The fee payable by a creditor who applies for payment of a dividend pursuant to subsection 154(2) of the Act is $30 for each dividend applied for.

(2) The fee set out in subsection (1) applies to all applications for dividends made on or after the coming into force of that subsection. SOR/2001-155, s. 4.

BANKRUPTCY MEETS REVISED UCC ARTICLE 9

Case Study: Section 103 of the Durbin-Delahunt Bill

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SECTION D

BANKRUPTCY MEETS REVISED UCC ARTICLE 9

Bankruptcy Meets Revised UCC Article 9
Case Study: Section 103 of the Durbin–Delahunt Bill

Steven L. Harris, Professor of Law, Chicago-Kent College of Law

Charles W. Mooney, Jr., Professor of Law, University of Pennsylvania Law School

Not for quotation or distribution

April 24, 2003

I. How the Durbin–Delahunt bill (Employee Abuse Prevention Act of 2002, S. 2798 and H.R. 5221), would have affected security interests.

II. How the bill came to include section 103.

III. Possible assumptions underlying section 103.

A. *Assumption #1*: Anything that scales back security interests in bankruptcy is good for employees.

1. This is true in cases where the debtor enters bankruptcy. However, these additional benefits must be offset by the benefits that are lost as a consequence. These lost benefits include the low cost and wide availability of secured credit.

2. If scaling back security interests in bankruptcy is desirable, why did the bill provide for this result only indirectly?

B. *Assumption #2*: A security interest that *anyone* could avoid under *any* circumstances should be avoidable in bankruptcy.

1. This argument completely overlooks differences in legal outcomes that turn on relevant facts. A buyer of collateral is treated differently from a subsequent secured party and a subsequent lien creditor for good reasons.

2. The failure to respect these differences yields results that could not possibly have been intended.

C. *Assumption #3*: A security interest that is not effective against *another secured party* is not "really" perfected and so should be avoidable.

1. This, too, reflects a misunderstanding of how Revised Article 9 works. Revised Article 9 treats subsequent judicial lien creditors differently from subsequent secured parties for commercially relevant reasons.

2. An example: A legally sufficient financing statement is filed against the equipment of a corporate debtor, but it provides the wrong corporate identification number.

   a. The misinformation is relevant only to someone who is informed of the contents of the financing statement and gives value in reasonable reliance on the misinformation. Accordingly, Revised 9-338 provides that the security interest perfected by the filing is subordinate to the security interest of such a purchaser. The bankruptcy trustee neither looks at the financing statement, nor gives value, nor relies (let alone reasonably relies).

   b. One might argue that giving the bankruptcy trustee the equivalent of Revised 9-338 rights does no more than reflect the pre–bankruptcy reality: Unsecured creditors, in a pre-bankruptcy workout, *could have* taken a security interest and trumped the "bad" security interest but failed to do so because they conducted a search, found the filed financing statement, but *did not* realize that the debtor named in the properly-indexed financing statement was in fact their debtor. Is this risk any different from the risk that the property in question would become encumbered after the workout?

3. Other examples include the non–temporal priority afforded to a secured who purchases chattel paper or instruments that previously were encumbered by a security interest perfected by filing. These rules are designed to enable the prevailing secured parties to rely on certain facts, such as the debtor's possession of the chattel paper or instruments, without having to investigate. The reasons do not apply to the bankruptcy trustee or unsecured creditors.

D. *Assumption #4*: Giving the trustee the rights of a purchaser in BC 544(a)(1) does nothing more than make personal property subject to the same rules as real estate in BC 544(a)(3). If Congress's override of state law's "secret lien" policy for real property is unobjectionable, why shouldn't Congress also override state law's "secret lien" policy for personal property?

   1. Congress's concern is (and should be) limited to avoiding secret liens where *nothing* has been filed/recorded, but leaving state law to determine exactly what must be put in the public record.

2. The powers also could be made parallel by giving the trustee the rights of a judicial lien creditor with respect to real property. However, in a number of states, lien creditors do not prevail over unrecorded mortgages. Giving the trustee the rights of a purchaser of real property puts the trustee in the same position with respect to unrecorded mortgages as a lien creditor with respect to unperfected security interests, not in a better position.

3. Moreover, Congress has shown appreciation for the fact that differences between the non-bankruptcy law of real property and of personal property justify using different "hypothetical" claimants.

   a. Corn Exchange National Bank v. Klauder, 318 U.S. 434 (1943), and the 1950 amendment of the former Bankruptcy Act.

   b. The 1984 amendment to BC 544(a), which removed "fixtures" from the real–property avoidance rule in BC 544(a)(3).

E. *Assumption #5*: Anyone who puts *anything* in the record that *is* or *becomes seriously misleading* should lose in bankruptcy, regardless of the state law outcome.

1. A rule of this kind arguably would provide proper incentives for secured parties to keep the record complete and accurate.

2. This argument misconstrues the purpose of the Article 9 filing system.

   a. The Article 9 public record never has been complete and accurate. It is not, and does not purport to be, a substitute for warranties of title, credit investigation (e.g., through Dun & Bradstreet), and other due diligence.

   b. State law weighs the costs and benefits of making the record more accurate, as well as the costs and benefits of requiring a searcher to look beyond the public record. It reaches a principled accommodation that is not peculiar to bankruptcy or even targeted at subsequent lien creditors.

NOTES

NOTES

REPORT ON AVOIDANCE, SUBORDINATION, SUPER PRIORITY, AND RECHARACTERIZATION PROVISIONS OF THE PROPOSED EMPLOYEE ABUSE PREVENTION ACT OF 2002

September 3, 2002

Submitted in our individual capacities:

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I. Executive Summary.

Senator Richard J. Durbin (D-IL) and Rep. William D. Delahunt (D-MA) introduced the Employee Abuse Prevention Act of 2002 (S. 2798 and H.R. 5221) (the "Act") on July 25, 2002. The stated purpose of the Act is to provide additional protections for "employees and retirees from corporate practices that rob them of their earnings and retirement savings when businesses collapse into bankruptcy."[1] That is a laudable goal and we applaud the sponsors' efforts and concerns. This report does not address the provisions of the Act that deal directly with those corporate practices. Instead, this report limits its focus to three especially troubling provisions of the Act that are designed to override important aspects of state law. These provisions are not directed to the corporate practices that are the principal focus of the Act.

The provisions of the Act addressed here would materially amend the Bankruptcy Code ("BC"). In doing so, they would impose significant constraints on state laws and have a substantial and adverse effect on the economy. Significantly, these provisions would impede future transactions and would be applied retroactively to invalidate property rights in existing transactions in which billions of dollars of credit have been extended to both business enterprises and consumers.

First, the Act would confer on a trustee in bankruptcy considerably expanded avoidance powers with respect to a debtor's pre-bankruptcy transfers of property, including security interests in personal property. Second, the Act would subordinate secured claims to certain new administrative expense priority claims and create a "super" priority for the new priority claims.

These two sets of provisions would significantly impair in bankruptcy many nonpossessory and possessory security interests in personal property. These changes would effectively repeal, immediately and retroactively, much of Uniform Commercial Code (UCC) Article 9, thus relegating secured transactions law in the United States to the *genre* of legal regimes that exist in many developing countries, with the corresponding impediments to financing and capital formation. This repeal would come not long after all 50 states, the District of Columbia, and the U.S. Virgin Islands adopted changes to UCC Article 9 intended to modernize the statute to facilitate the capital formation that is so crucial to the health of our national economy. Indeed, the sponsors indicate that the expanded avoidance powers in the Act are specifically intended to override certain of these changes to UCC Article 9.[2] The proposed avoidance powers in the Act go far beyond negating the recent changes made to UCC Article 9. They would render UCC Article 9 largely without effect to support extensions of secured credit because many secured transactions would not be effective in bankruptcy.

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1. *See* Section-By-Section Summary at 1.

2. *See* Section-By-Section Summary at 2.

Third, the Act would federalize the question whether a pre-bankruptcy sale, lease, or other transfer of property is to be recharacterized as a secured loan, replacing generally applicable and settled state law with a vague federal test. For example, an outright (or "true") sale of property removes the property from a debtor's estate and should be effective and nonavoidable if made in exchange for reasonably equivalent value. Under most state laws, transactions that nominally are sales may, in appropriate cases, be recharacterized as transfers of an interest in property that is less than complete and outright ownership. When state law does not permit such a recharacterization, federal courts in bankruptcy cases already have the power to adjust state law when required to advance a significant federal interest. The new federal test for recharacterization would introduce substantial uncertainty for a variety of commercial transactions that have been used as a source of capital and liquidity for businesses.

Part II of this report summarizes its conclusions. Parts III through V address the substantive proposals mentioned above. In each case the discussion explains how the provisions of the Act probably would be interpreted and applied, the likely transactional and economic impact of the provisions, and the merits of the proposals in the context of well-accepted bankruptcy policies and history. Part VI addresses the Act's proposed immediate effectiveness and retroactive application. Part VII then considers the importance of thorough, well-publicized legislative hearings on this bankruptcy legislation before adoption of the Act or any of its provisions. Part VIII concludes the report.

The following analysis of the relevant provisions of the Act seeks to identify the most plausible interpretation of the Act.

II. Summary of Conclusions.

- The trustee's expanded avoidance powers under the Act would:
  - essentially eliminate nonpossessory secured transactions (and probably possessory secured transactions) in virtually all areas of personal property financing, including the financing of inventory, intangibles such as receivables, securities, and other investment property, and equipment;
  - effectively repeal UCC Article 9 (as recently revised and enacted in substantially the uniform version in all 50 States, the District of Columbia, and the U.S. Virgin Islands) and deprive the United States of a modern law on secured transactions (as opposed to nullifying recent amendments to UCC Article 9, as claimed by the sponsors);
  - reduce the availability and increase the cost of credit, thus imposing significant costs on a wide range of businesses and individual consumers;
  - have a substantial and adverse effect on the economy; and

- conflict with well-accepted theoretical and historical bankruptcy policies on the appropriate role of avoidance powers.

- Even if the Act were rewritten to address only secured transactions as to which a public registry actually contains incorrect information, it nonetheless would increase costs, have adverse economic effects, conflict with well-accepted bankruptcy avoidance policies, and impair UCC Article 9.

- The Act's provision for subordination of secured claims to new pension-related priority claims and its new super priority rule:

  - are unclear as to their operation and application;

  - would place unacceptable burdens on secured financing and raise the cost of credit; and

  - do not reflect a sound or balanced bankruptcy policy.

- The Act's federal test for recharacterizing pre-bankruptcy transfers of property:

  - provides no guidance on the factors relevant to recharacterization, leaving the courts with no principled basis to evaluate transfers;

  - provides the courts with unbridled and dangerous discretion to recharacterize transfers that have been structured and negotiated between parties to legitimate commercial transactions,

  - is unnecessary because (i) state law, as interpreted by the courts, normally provides sufficient guidance and has worked well in determining when transfers should be recharacterized and (ii) federal courts already have the power to adjust state property law if required to protect a compelling federal interest; and

  - would create substantial and undesirable uncertainty for:

    - securitization transactions (including those involving sales of residential mortgage loans) and other transactions in which sales of financial assets take place, thereby reducing the availability and increasing the cost of credit and funding; and

    - virtually all transfers of real and personal property, including leases, licenses, consignments, and other bailments.

- would have a substantial and adverse effect on the economy.

- The Act's provision for immediate and retroactive effectiveness is unfair and unnecessary and would upset fixed and vested rights and interests, including property interests.

- Neither Congress nor any of its Committees should take action on the Act or any of its provisions until open hearings have been held, after well-publicized notice, and all interested parties have been given the opportunity to be heard.

III. Proposed Avoidance Provisions.

A. Description, Application, and Interpretation.

1. BC § 544(a) "Strong Arm" Avoidance Power.

Section 103(a) of the Act would amend BC § 544(a) (the trustee's so-called "strong arm" power) to add a new paragraph (4). The new provision would give a trustee the rights of a hypothetical good faith purchaser of property who (i) gave value, (ii) relied on incorrect information in a public record, and (iii) either (x) took possession of the property (even if it could not be possessed) or (y) took steps to make the purchaser's interest invulnerable to a judicial lien creditor. The trustee would have those rights even though no such purchaser actually existed[3] and even if no incorrect information on a public record existed. The hypothetical purchaser could be either an outright buyer or another secured party receiving a security interest. Under current BC § 544(a)(1), the trustee only has the rights of a hypothetical judicial lien creditor as to personal property and fixtures on the date bankruptcy commences.[4]

The principal effect of the new avoiding power would be to render most nonpossessory security interests vulnerable to avoidance by a trustee. This proposal is an enormous expansion of rights of a trustee beyond those that exist under current law as to personal property and fixtures.

Consider an example:

> **Example 1.** Dealer obtains a loan from Lender and grants to Lender a security interest in its inventory of goods and in its rights to payment for goods that it has sold or leased, as evidenced by installment sales contracts and leasing agreements

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3. We read the reference to "such creditor" in proposed new BC § 544(a)(4)(C)(1) to mean "such purchaser." This gives effect to the apparent intent and, otherwise, there would be no antecedent to which "such" could refer.

4. Under current BC § 544(a)(3) the trustee has the rights of a good faith purchaser of real property, but not of personal property or fixtures. This distinction is considered below.

with Dealer's customers. Lender perfects its security interest under UCC Article 9 by filing a proper financing statement in the appropriate public filing office. One year later Dealer files a bankruptcy petition.

The perfected status resulting from public notice (Lender's filing of the financing statement) affords Lender priority over a later-in-time judicial lien creditor of the debtor.[5] It also protects Lender's security interest from avoidance under current BC § 544(a)(1). Under the Act's new BC § 544(a)(4), however, the trustee could avoid Lender's *perfected* security interest, as to which Lender had proceeded *correctly* in all respects including the filing of a financing statement in the *correct* public office containing *correct information*. As to the inventory on hand, the trustee's new hypothetical good faith purchaser status would afford it the right of a "buyer in ordinary course of business," to buy the inventory free of Lender's security interest.[6] As to the installment sales agreements and leasing agreements (denominated "chattel paper" under UCC § 9-102(a)(11)) generated when Dealer sells the inventory, the trustee would have the rights of an ordinary course purchaser of the rights to payment under the chattel paper who has taken possession of the chattel paper and given new value in order to achieve priority over the Lender.[7] Lender's only possible means of protecting itself against a future bankruptcy of Dealer would be to take physical possession of Dealer's inventory and chattel paper--a step that would be practically impossible in the case of most inventory financing and that often is not practical in the case of chattel paper.

Arguably, even Lender's taking possession of the inventory and chattel paper would not protect it from the trustee's proposed enhanced avoidance powers. Because the Act's new BC § 544(a)(4) hypothesizes that the trustee takes possession of the collateral, it might be read to imply that Lender no longer holds possession itself. The same reasoning might be applied to secured party that has "control" of intangible assets such as uncertificated securities or security entitlements, even if actual possession were impossible. This reading would negate Lender's *actual* possession or control in favor of the trustee's subsequent *hypothetical* possession. On this

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5. UCC § 9-317(a).

6. UCC § 9-320(a).

7. UCC§ 9-330(a), (b). In like manner, the Act's new BC § 544(a)(4) also would permit avoidance of security interests perfected by filing in instruments (such as promissory notes), documents of title, and securities. UCC §§ 9-330; 9-331. Note that most of the good faith purchase rules discussed in this section (UCC §§ 9-320, 9-330, and 9-331) had very similar antecedents that would have produced identical results under former (*i.e.*, pre-revision) UCC Article 9. *See* former UCC §§ 9-307; 9-308; 9-309.

reasoning even security interests perfected by possession or control would be vulnerable in bankruptcy.[8]

The Act's expansion of the trustee's strong arm avoidance power is even broader than indicated above. Consider another example:

> **Example 2.** Manufacturer obtains a working capital loan from Lender and grants to Lender a security interest in Manufacturer's equipment. Lender perfects its security interest by filing a proper financing statement in the appropriate filing office. One year later Manufacturer files a bankruptcy petition.

Once again, Lender has taken all appropriate steps to perfect its security interest by filing, but under the Act's new BC § 544(a)(4), the trustee is entitled to avoid Lender's security interest. This is because the trustee is armed with hypothetical reliance on hypothetical incorrect information in the filing office. The trustee may rely on the rights of a purchaser relying on incorrect information to take free of a security interest under UCC § 9-338(2).

One possible interpretation of proposed new BC § 544(a)(4) is that it addresses, and is intended to address, *only* the rights of a good faith purchaser who has relied on incorrect information under UCC § 9-338(1) and (2). Even if the language is so limited, the Act nonetheless would give the trustee the rights of a hypothetical good faith purchaser who hypothetically relied on hypothetical incorrect information in a filed financing statement. Having these rights, the trustee would be able to avoid correctly perfected security interests that had been perfected by filing. In Example 1, the trustee would still be able to avoid the correctly perfected security interests in inventory and chattel paper.

These examples do not reflect a complete account of the problems and do not exhaust the circumstances in which the trustee's enhanced avoidance powers could be exercised under the Act's proposed new BC § 544(a)(4). There are several other circumstances under UCC Article 9 in which, under the proposed expanded strong arm power, a trustee could exercise the rights of a good faith purchaser to avoid properly perfected security interests.

2. BC § 547 "Preference" Avoidance Power.

Section 103(b) of the Act would change the rule for determining when a transfer is made for purposes of avoiding preferential transfers. Under current BC § 547(b) transfers made by an insolvent debtor to a non-insider within 90 days before a bankruptcy filing and on account of an antecedent debt generally are avoidable. A somewhat complex statutory system for determining when a transfer is made is found in BC § 547(e). The timing of a transfer is important for determining both whether the transfer was made within the 90-day window and for determining

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8. *See, e.g.*, UCC §§ 9-331 (rights of purchasers of instruments, documents, and securities under UCC Articles 3, 7, and 8); 9-328(1) (control priority).

whether the transfer was for an antecedent debt. Under BC § 547(e)(2), the timing of a transfer is a function of whether and when a transfer is "perfected." For personal property and fixtures, a transfer is perfected when it is invulnerable to a judicial lien obtained by a creditor on a simple contract.[9] (This is essentially analogous to the judicial lien creditor test for personal property and fixtures in current BC § 544(a)(1), discussed above.) The Act would change the results in bankruptcy significantly by substituting a good faith purchaser test for the judicial lien creditor test. This would mean, for example, that a security interest perfected under UCC Article 9 would not be perfected for purposes of preference avoidance so long as the security interest were vulnerable to the claim of a superior good faith purchaser.

> **Example 3.** Vendor sells a consumer appliance to Consumer on credit under an installment sales agreement in which Vendor obtains a security interest in the goods to secure the unpaid price. Sixty days later Consumer files a bankruptcy petition.

Under UCC § 9-309(1), Vendor's security interest is perfected automatically, without the need to file a financing statement or otherwise give public notice, because it is a purchase-money security interest in consumer goods. Because Vendor's security interest is perfected under UCC Article 9, Vendor's security interest has priority over a judicial lien creditor of Consumer. The security interest would not be avoidable under BC § 547(b) because it was perfected under current BC § 547(e)(1)(B) when it was created and therefore was not on account of an antecedent debt.[10] But, under the Act's version of BC § 547(e)(1)(B), even though Vendor complied in every respect with UCC Article 9, the security interest was never perfected for preference avoidance purposes because it remained at all times vulnerable to a consumer good faith purchaser under UCC § 9-320(b). Consequently, Vendor's security interest would be avoidable under the Act because it would be deemed to have been transferred "immediately before the date of the filing of the [bankruptcy] petition" and therefore was on account of an antecedent debt.[11]

Under UCC Article 9, a secured party with purchase-money security interest in consumer goods who has concern about a good faith purchaser of those goods acquiring superior rights can protect its security interest by filing a financing statement covering the goods.[12] The filing would subject the good faith purchaser of these goods from the consumer buyer to the security interest in the goods. Vendor in Example 3 could ensure that its rights in the goods would be superior to

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9. BC § 547(e)(1)(B).

10. Alternatively, the security interest would be protected from avoidance under BC § 547(c)(1) (contemporaneous exchange for new value) or (3) (purchase-money security interest).

11. BC § 547(e)(2)(C). The security interest also would not be sheltered from avoidance by BC § 547(c)(1) or (3).

12. UCC § 9-320(b).

those of a good faith purchaser for value by filing a financing statement. The experience under former Article 9, which contained the same provision, was that purchase-money secured parties rarely filed financing statements in these circumstances because of the low risk that the consumer buyer would wrongfully sell the goods subject to the security interest and the cost savings of not filing a financing statement. The Act would instantly change the cost/benefit analysis by forcing the secured party to go the trouble and expense of filing a financing statement in order to have a security interest that is effective in bankruptcy. These costs would, of course, be passed on to the consumer.

On the same reasoning applied to Example 3, because Lender's security interests in inventory and chattel paper in Example 1 remained vulnerable to good faith purchasers, they also could be avoided as preferences under the Act's proposed revision of BC § 547(e)(1)(B).

Unlike the proposed expansion of the strong arm power in proposed new BC § 544(a)(4), the proposed revision of BC § 547(e)(1)(B) makes no reference to "incorrect information." Consequently, the proposed test for perfection is not limited to the rights of a good faith purchaser relying on hypothetical incorrect information under UCC § 9-338(1) and (2).

B. Transactional and Economic Impact; Rationale.

The impact of the proposed revised avoidance powers cannot be overemphasized. In particular, the use of inventory, chattel paper, equipment, and other collateral in business financing is ubiquitous. Each year an enormous amount of credit is extended in business financing transactions in reliance on security interests in these types of collateral. The Act would largely render those security interests ineffective in bankruptcy, thus striking a blow at capital formation. The impact of this *de facto* repeal of much of UCC Article 9 would be especially harsh for small businesses that lack access to the capital markets and which must rely on secured commercial financing for working capital. Contrary to the stated purposes of the Act, its detrimental effects on the cost and availability of business credit necessarily would seriously harm employees and their employers alike. It would leave the United States essentially without a modern secured transactions law.

While we can speak to the impact that the Act would have on transactions with which we are familiar, we suspect that the businesses that rely on secured credit for their existence will have even more to say on the subject. The central insight here is that the principal negative impact of the proposed new avoidance powers would not be confined to debtors *in actual bankruptcies*, present and future. Following a period of time (involving disruptions of expectations arising out of the Act's retroactivity), credit markets would adjust. Thereafter, for example, no lender would make a secured inventory loan once forewarned that the security interest would be avoidable in bankruptcy. Thus, the principal impact by far would be on solvent, healthy debtors that never file a bankruptcy petition. By rendering ineffective in bankruptcy a wide swath of secured transactions, many borrowers and buyers would be unable to obtain needed credit or only could obtain less credit at the much higher cost associated with unsecured credit. That is precisely the result that every state and the District of Columbia sought to avoid when, effective just last year, they adopted Revised UCC Article 9 in order to facilitate secured financing in the United States.

The Act's negative effect on debtors also is not limited to future debtors. The Act would affect every security interest in existence on the day of enactment. On the day of enactment all secured parties would reevaluate their extensions of credit. Almost all secured parties would conclude that, as a practical matter, the credit they had extended on the assumption that their security interests would be respected in bankruptcy had become unsecured. Virtually all security agreements allow a secured party that reasonably concludes that its security is impaired to accelerate the secured loan, making it payable in full at once. Of course, not all debtors would be able to pay in full instantly. But Lenders most certainly would invoke these provisions to accelerate loans or renegotiate loans to take account of the much higher credit risk associated with the fact that the loans had effectively become unsecured. In the end, debtors would be denied credit or would be obliged to pay the higher interest rates normally charged for unsecured loans. Indeed, given the proposed retroactivity of Title I of the Act, if any serious support for the Act surfaced, creditors might begin the renegotiation process even before enactment.

C. Bankruptcy Policy and History.

In addition to the serious potential transactional and economic impact of the proposed avoiding power revisions, the proposals also conflict with well-accepted and uncontroversial understandings about bankruptcy avoiding powers.

Bankruptcy theoreticians and analysts of bankruptcy history have explored the underlying conceptual bases for the trustee's strong arm (BC § 544(a)) and preference (BC § 547) avoiding powers. Unsurprisingly, they have not always agreed. For example, there are plausible arguments that the strong arm power derives from the trustee's role as the representative of creditors, from the collectivist goals and structure of bankruptcy law, from concerns about ostensible ownership and secret liens, or from more than one of these possible justifications. Similarly, as to justifications for preference avoidance, arguments advanced include the deterrence of eve-of-bankruptcy grabs, the goal of creditor equality, and a combination of both factors. Quite possibly there are no clear, overriding theoretical justifications. However, no complete theory and historical account of these avoiding powers is needed in order to understand that the Act's proposed modifications would push the law far from the mainstream and against the current of conventional wisdom about acceptable bankruptcy policy.

Consider first the trustee's existing BC § 544(a)(1) strong arm power to avoid transfers that would be ineffective against a hypothetical judicial lien creditor of the debtor in the typical context of a security interest in personal property that is unperfected (under UCC Article 9). Outside bankruptcy, the secured party has rights in the property that are superior to those of the debtor's unsecured creditors, who have no rights at all. On the other hand, outside bankruptcy and under UCC Article 9, any unsecured creditor has at least the *potential* to become a judicial lien creditor whose lien would defeat (*i.e.*, subordinate) the unperfected security interest. Upon the bankruptcy filing, however, the automatic stay (and, essentially, the whole structure of the BC) prevents these creditors from acquiring a judicial lien and thereby priming the unperfected secured party. Without something like the strong arm power, those creditors would be deprived of any possibility of realizing anything from the debtor's encumbered property, a possibility that existed outside bankruptcy.

Under the strong arm power the trustee inherits the power of the hypothetical judicial lien creditor and can avoid the unperfected security interest for the benefit of all unsecured creditors--a potential power held by creditors outside bankruptcy. After avoidance, the former unperfected secured party itself becomes an unsecured creditor. This structure recognizes that before bankruptcy all creditors (except the unperfected secured party) had equal rights. The strong arm power preserves this equality by freeing the property from the security interest of the unperfected secured party for the benefit of the unsecured creditors generally. In effect, if not in precise doctrine, upon the filing of a bankruptcy petition the trustee metaphorically seizes the debtor's property, obtains rights equivalent to that of a hypothetical judicial lien creditor, and preserves the value for all unsecured creditors.

The strong arm power has been criticized on the basis that it is too favorable to unsecured creditors because the power fails to recognize the clear priority of the unperfected secured party's interest outside bankruptcy. However, the power nevertheless strikes a fair balance by recognizing that some nonbankruptcy entitlements must yield to the benefits of a collective bankruptcy proceeding.

By conferring the power of a hypothetical good faith purchaser on the trustee, the Act deviates from this well-understood effect of the strong arm power to avoid transfers that were vulnerable to judicial lien creditors outside bankruptcy. In general bankruptcy law respects nonbankruptcy rights and entitlements and does not create new rights. The Act, however, confers on the unsecured creditors benefits that they could not have enjoyed outside bankruptcy. Moreover, it ignores the fact that an entire national system of personal property secured financing and law (one that is the envy of much of the world) has been created and recently revised, updated, and reenacted based on the expectation that transfers of personal property and fixtures will be tested in bankruptcy against a hypothetical judicial lien creditor.[13]

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13. The same can be said of the similar test for testing the time of transfer in the context of preferences, discussed below. It is interesting that as secured financing practices and law developed during the mid-twentieth century, especially following the Second World War, the development of bankruptcy avoidance law proceeded alongside. See the discussion below of *Corn Exchange National Bank v. Klauder*, 318 U.S. 434 (1943), and the 1950 amendment of the former Bankruptcy Act. This may account for the fact that some prominent bankruptcy law experts also were widely recognized experts in secured transactions law and were involved in the development of UCC Article 9. Legendary figures in the law such as Peter F. Coogan and Grant Gilmore come to mind.

There is nothing suspect, sinister, or inconsistent with bankruptcy policy about nonbankruptcy priority rules that provide good faith purchasers with rights vis-a-vis a perfected security interest that are greater than the rights of judicial lien creditors. Under both former UCC Article 9 and Revised UCC Article 9, the holder of a security interest is afforded perfected status and, accordingly, protection against judicial lien creditors, even though the security interest may be subordinated or cut off by a subsequent good faith purchaser. This is because, unlike purchasers, judicial lien creditors rarely if ever rely in extending credit on the property subject to their judicial liens. Accordingly and appropriately, UCC Article 9 affords them a weaker status than good faith purchasers vis-a-vis a perfected security interest.

To be sure, the strong arm power to avoid transfers of real property, unlike personal property and fixtures, has been based on a bona fide purchaser test in BC § 544(a)(3) since 1978.[14] It has remained unchanged, however, both for strong arm and preference transfer purposes, as discussed below.[15] But the distinction is more apparent than real as a result of differences between real property law and personal property law. Under the real property law of many states the rights of judicial lien creditors are comparatively weak. For example, in these states a judicial lien creditor takes subject to even an *un*recorded mortgage. The practical effect of the bona fide purchaser test for real property, then, is similar to the judicial lien creditor test for personal property under which the lien creditor obtains rights superior to an unperfected security interest.[16]

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14. Section 70(c) of the former Bankruptcy Act provided for the trustee's strong arm power until it was superseded by BC § 544(a). Former section 70(c) did not contain a bona fide purchaser test for transfers of real property.

15. We note that proposed new BC § 544(a)(4) would apply to all property and is not limited to personal property and fixtures. What effect would the expanded strong arm powers, based on hypothetical reliance on hypothetical incorrect information in a public registry, have on transfers of real property such as mortgages and deeds of trust? Might the new powers render these transfers avoidable through the application real property law doctrines? While we have not considered these questions on the merits, certainly they deserve attention from the real property bar.

16. A hypothetical bona fide purchaser test also is found in BC § 545(2), dealing with avoidance of statutory liens. Its origin was a concern about hidden priorities and the belief that if a state creates a statutory lien so weak that it succumbs to a bona fide purchaser it was a disguised attempt to fix priorities among creditors. One recommendation of the National Bankruptcy Review Commission was to cut back on the BC § 545(2) bona fide purchaser test as it has been applied against federal tax liens. National Bankruptcy Review Commission Final Report, Bankruptcy: The Next Twenty Years, Recommendation 4.2.11 at 955 (October 20, 1997).

Preference avoidance law, including late-perfection, also generally is understood to be based in substantial part on concerns about creditor equality. Much of the foregoing reasoning concerning the strong arm power also applies in the preference context. As with the strong arm power, the judicial lien creditor test for determining when a transfer of personal property takes place for preference purposes has worked well. Indeed, a bona fide purchaser test for determining when a transfer of personal property occurs for preference purposes was abandoned more than 50 years ago because it did *not* work and substantially impeded the development and use of secured credit. In 1950, Congress amended the Bankruptcy Act[17] so as to override the (in)famous case of *Corn Exchange National Bank v. Klauder.*[18] The then effective Bankruptcy Act conferred on the trustee, in exercising its power to avoid preferences, the rights of a hypothetical bona fide purchaser of personal property (assigned accounts receivable, in *Klauder*). *Klauder*, in effect, also gave the trustee the rights of a hypothetical purchaser that was the first assignee to give notice to the underlying account obligor.[19] From the 1950 amendment forward, the test for transfers of personal property in the context of preference avoidance has been based on the priority of a hypothetical judicial lien creditor.

As far as we are aware the Act's proposed changes to the strong arm and preference avoidance powers do not respond to any widespread dissatisfaction with current law on the part of the bankruptcy bar, the financing bar, debtors, creditors, or any other identifiable affected segment. Fewer than five years ago the National Bankruptcy Review Commission issued its massive Final Report, making numerous recommendations for changes to the Bankruptcy Code. But the Report's recommendations barely mention the trustee's avoiding powers. Certainly the Commission did not recommend any fundamental changes in the strong arm and preference powers.[20] Significantly, the recommendations that do relate to avoidance uniformly propose *restricting*, rather than expanding, the trustee's avoidance powers.[21]

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17. Pub. L. No. 461, 81st Cong., 2d Sess. (March 18, 1950) (amending former §§ 60 and 70(c) of the Bankruptcy Act).

18. 318 U.S. 434 (1943).

19. *Klauder* was decided long before the UCC existed as a uniform law, much less as actual law. At the time states had various conflicting rules on the priority of competing assignments of intangibles.

20. Moreover, the Commission must have been aware of the status of the planned revisions to UCC Article 9. By 1997 most of the substantive proposals already were on the table. For example, a provision substantially similar to UCC § 9-338 was included as § 9-335 in the 1997 drafts of the revised Article presented to The American Law Institute and the National Conference of Commissioners on Uniform State Laws.

21. *See* National Bankruptcy Review Commission Final Report, Bankruptcy: The Next Twenty Years, Recommendations 3.2.1 at 797-98 (transfers of less than $5,000 may not be

The Act's sponsors have asserted that Section 103 of the Act "restores to trustees in bankruptcy the ability to review and set aside suspect transactions which they enjoyed as lien creditors under Article 9 of the Uniform Commercial Code prior to the UCC amendments that became effective on January 1, 2002."[22] That statement is manifestly incorrect.

First, as demonstrated above, the striking impact that the new avoidance powers would have on secured financing goes far beyond overturning the changes made in Revised UCC Article 9. Second, it would "restore" nothing other than arguments about preference avoidance powers that were settled more than fifty years ago. Third, Revised UCC Article 9 did not diminish the powers of a trustee. Fourth, the vast majority of the transactions that would be rendered ineffective in bankruptcy by the Act are far from "suspect." Instead, they are mainstream business and consumer finance transactions on which our economy depends. And these financing transactions are supported by a legal platform, UCC Article 9, that is the most modern and efficient in the world.

Finally, even if modification of the avoidance powers could somehow be limited to the recent changes in UCC Article 9, why would Congress have any interest in dismissing the clearly demonstrated public will? Revised UCC Article 9 emerged from almost a decade of work by The American Law Institute and the National Conference of Commissioners on Uniform State Laws, the co-sponsors of the UCC and two of the most respected law reform institutions in the world. Representatives of virtually every interest affected by secured transactions participated in the drafting process, including the bankruptcy bar and consumer and business debtors. Drafts of the new statute were extensively discussed and debated in panels and meetings sponsored by organizations such as the American Bar Association, the American College of Bankruptcy, The American College of Commercial Finance Lawyers, the American College of Mortgage Attorneys, and the American Bankruptcy Institute.[23] Following its unanimous approval in 1998, it was presented to the legislatures for adoption, a process that normally takes 8 to 10 years.

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sought in action to avoid nonconsumer debt preference); 3.2.2 at 799-800 (preference recovery action of less than $10,000 must be brought in district in which transferee has principal business); 3.2.3 at 800-03 (strengthening protection from preference avoidance for ordinary course payments); 4.2.11 at 955 (October 20, 1997) (cut back on BC § 545(2) bona fide purchaser test to provide federal tax liens greater protection from avoidance).

22. *See also* Press Release following the August 1, 2002 Durbin and Delahunt Press Conference ("[I]t [the Act] restores to bankruptcy trustees the full authority to challenge and set aside pre-bankruptcy transactions that take assets out of the company.") Of course, in the transactions addressed in this report, assets of an equal or greater value (*e.g.*, loaned funds or purchased property) *come in* as the debtor's property consisting of new assets, a feature the sponsors have not mentioned.

23. Note, for example, that Revised UCC Article 9 received the strong approval of the American College of Bankruptcy.

Because of the strong national support, the need for immediate adoption, and the lack of any organized opposition to the changes, Revised UCC Article 9 was adopted by the legislatures in all 50 states and by the District of Columbia by July 1, 2001, and is now effective in all 50 states, the District of Columbia, and the U.S. Virgin Islands. Indeed, Revised UCC Article 9 enjoys the fastest adoption record in the more than 100-year history of the National Conference. Article 9 has been considered the "crown jewel" of the UCC for almost 50 years, being the most bold and innovative of the UCC's articles. Why would the United States Congress wish to flout this important and successful domain of state law?

D. Effect of Limiting Expanded Avoidance Powers to Cases of Actual Incorrect Information in Public Registry.

The Act's expanded avoidance powers could be curbed by revising it to address only (i) the rights of a good faith purchaser that relies on incorrect information under UCC § 9-338 and (ii) cases in which the public registry *actually contains* incorrect information in connection with the particular transfer to be avoided. Under this approach, for example, if a financing statement on file actually contained incorrect information that did not render a security interest unperfected under UCC Article 9,[24] the trustee would have the rights of a hypothetical purchaser that hypothetically relied on the actually incorrect information.[25] So revised, the expanded avoidance powers would reach a narrower slice of transactions. However, even this narrower version would create a material adverse transactional and economic impact, would offend longstanding policies, and would be unnecessary and unwise.

UCC § 9-338 permits a secured party or other purchaser to obtain priority over or cut off a security interest perfected by a filed financing statement if the financing statement contains information specified in UCC § 9-516(b)(5) that is incorrect, but only if the secured party or purchaser reasonably relied on the incorrect information in giving value. The information specified in UCC § 9-516(b)(5) consists of (i) a mailing address for the debtor, (ii) an indication of whether the debtor is an individual or an organization, (iii) if the financing statement indicates that the debtor is an organization, (x) a type of organization for the debtor, (y) a jurisdiction of organization for the debtor; and (z) the debtor's organizational identification number or an indication that the debtor has none. In evaluating this new filing requirement it is important to understand the structure of the statute. If any of the specified information is missing, the filing

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24. A financing statement is effective to perfect a security interest if it contains the names of the debtor and secured party and indicates the collateral that it covers. UCC § 9-502(a). If, for example, the name of the debtor were incorrect and seriously misleading, the financing statement would not be effective and the related unperfected security interest could be avoided under current BC § 544(a)(1). Resort to the Act's expanded powers would be unnecessary.

25. Of course, not only the proposed expanded strong arm power but also the perfection test for preference avoidance would require adjustment to achieve the intended narrowing effect.

office is entitled to reject the filing.[26] However, if the filing office nevertheless accepts the filing with the missing information, or if any of the information is incorrect, the filing is effective to perfect a security interest.[27] The goal of this structure is twofold. First, it encourages the inclusion of possibly useful information in the public record and thereby provides a better quality of public notice. Second, it requires the secured party to provide this information without raising the specter of nonperfection of a security interest if the information provided is inaccurate. UCC § 9-338 strikes the appropriate balance by giving a competing secured party or purchaser a prior claim to collateral only if the secured party or purchaser can show that it was aware of the contents of a financing statement and actually and reasonably relied on the incorrect information.[28]

Even a narrowed "actual incorrect information" version of the Act's avoidance powers would substantially increase the trustee's power over that which existed under former UCC Article 9 and the trustee's power that currently exists under Revised UCC Article 9. This is because former Article 9 did not require a financing statement to contain any of the information set forth in UCC§ 9-338, with the single exception of a mailing address for the debtor.[29] And under former Article 9 there were precious few reported cases in which financing statements were held ineffective as a result of an inaccurate or incomplete mailing address for the debtor. Some cases even upheld financing statements in the complete absence of a debtor's address where no prejudice could be shown. Under Revised UCC Article 9 (UCC § 9-338) a security interest perfected by a filing containing this type of incorrect information will be cut off or subordinated only in the face of actual reasonable reliance by a competing secured party or other purchaser. But under the Act's hypothetical reliance standard, a trustee *in all cases* of incorrect information may assume a power rarely available to an actual purchaser outside bankruptcy and may thereby convert a rare event in the real world into an automatic event in bankruptcy.

Because the subordination and cut-off provisions of UCC § 9-338 present a very narrow risk and do not impair the perfection of a security interest, there is every reason to believe that the

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26. UCC § 9-516(b).

27. UCC § 9-502(a).

28. As the official comments to UCC § 9-516 make clear, reliance on the specified of information would be quite rare. And it must be shown that the reliance was reasonable. For example, assume a prospective purchaser searches the public record and finds a financing statement filed against the debtor's correct name. The searcher, however, notices that the address given for the debtor is not correct. In order to benefit from UCC § 9-338, the searcher would be required to convince a court that it acted reasonably in purchasing the collateral in reliance on its belief that the financing statement filed against the debtor's correct name was not filed against the debtor, but actually was filed against someone else altogether.

29. Former UCC § 9-402(1).

information prescribed by UCC § 9-516(b)(5) that is found on actual, filed financing statements is much more likely to contain inaccuracies than the more important perfection-related information (name of debtor, name of secured party, an identification of collateral[30]). For this reason, one could expect that even the narrowed version of the Act would render ineffective many security interests in transactions consummated before the Act would take effect.

A likely effect of a narrowed avoidance provision in the Act would be either the repeal of UCC § 9-338 or the elimination of the information specified in UCC § 9-516(b)(5) from Article 9 by state legislatures. This result would recognize that the drafters of Revised UCC Article 9, and the state legislatures that have enacted it, would never have required this additional information to be included in a financing statement if the result of an inaccuracy would be the certain avoidance by the debtor's trustee in bankruptcy.

Finally, much of the discussion of effects and policy in sections B. and C. above is relevant as well even to a narrowed version of the Act's avoidance powers.

IV. Recovery of Certain Administrative Expense Claims from Property Securing Allowed Secured Claims: Subordination; "Super" Priority Administrative Expense Claims.

A. Description, Application, and Interpretation.

Section 203(a) of the Act would add a new paragraph (7) to BC § 503(b). New paragraph (7) would create a new class of administrative expense priority claims for claims arising out of the breach of a fiduciary duty under ERISA or applicable state law relating to a debtor's pension plan. Under section 203(c) of the Act the new administrative expense claims would receive a "super" priority, superior to other administrative expense priority claims under BC § 507(a)(1). Section 203(b) of the Act also would modify BC § 506 by adding a new subsection (e). That subsection would provide that the holders of unpaid administrative claims of the type specified in proposed BC § 503(b)(7) "may recover any unpaid amount of such claims from any property securing an allowed secured claim."

Note that subordination under new superpriority would extend beyond traditional secured transactions. An "allowed secured claim" also includes a right of setoff under BC § 506(a). Consequently this section would afford an administrative expense claim priority over a bank's right of setoff against a deposit account and other rights of setoff.

This report does not address on the merits the proposed creation of a new priority administrative expense claim. It does address, however, the proposed superpriority rule and proposed new BC § 506(e). As an initial proposition, proposed new BC § 506(e) is unclear as to how it would be applied because it does not specify a method for determining which property

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30. UCC § 9-502(a).

securing which secured claims would be applied first to satisfy the new administrative priority claims. Would the application be *pro rata* among all secured claimants and the property securing the claims? Would any such *pro rata* distribution be based on the value of the collateral involved or (if different) the amount of the secured claim? Would the "unpaid amount" be calculated after or before taking into account distributions to the super-priority claimants from unencumbered assets (presumably after, but the provision does not specify)? Or, would these claimants look first to the property that secures secured claims before looking to unencumbered assets?

> **Example 4.** Debtor owns assets valued at $800,000. One asset has a value of $100,000 and is subject to a security interest held by Lender securing a $10,000 loan. Lender is "oversecured" and its allowed secured claim is $10,000. (For purposes of simplicity, ignore accruing interest, expenses, etc.) There are super-priority pension-related administrative claims under new BC §506(e) in the amount of $800,000. After application of the $700,000 in value of the unencumbered assets, a $100,000 unpaid priority claim remains.

Example 4 presents the simple case involving only one secured claim. Presumably the priority claimants would recover $10,000 in value from Lender's collateral (the allowed secured claim), reducing Lender's secured claim to zero. Then the priority claimants would recover the remaining $90,000 in value. The end result is that a fully-secured, indeed over-secured, creditor would recover nothing. Nor would the other remaining unsecured creditors.

In sum: What is clear from the proposed new BC § 506(e) is that one person's property (a secured claimant's) would be transferred to another person (the holder of the new super-priority administrative claim), even though the basis of the priority claim (breach of pension-related fiduciary duty) and the secured claim are in no respect related. In that respect, the proposal has the substantive effect of a limited avoidance power from the perspective of the secured claimant, although in form it is structured as a subordination.

As noted above, under a new BC § 507(b)(2), the new pension-related administrative expense claims would receive a "super" priority, superior to other administrative expense priority claims under BC § 507(a)(1). Under this provision, claimants afforded a super priority under current BC § 507(b) (which would be renumbered as BC § 507(b)(1)) would share *pro rata* with the new BC § 507(b)(2) claimants if there were insufficient assets to satisfy all super priority claims.[31] Claimants under BC § 507(b)(1) (after the proposed renumbering) are those for whom adequate protection of their secured claims failed--it proved to be *inadequate* protection. Consequently, the new BC § 507(b)(2) claimants could dilute satisfaction of BC § 507(b)(1) (formerly secured) claims in addition to having consumed (under new BC § 506(e)) the collateral that originally secured those claims.

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31. BC § 726(b).

B. Transactional and Economic Impact; Rationale.

The rationale indicated by the sponsors for the subordination rule of proposed new BC § 506(e) is that it would "create[] an incentive for financial institutions to protect their collateral by requiring assurances that the company is living up to its fiduciary obligations."[32] This explanation is implausible and is not based on an accurate assessment of the role of secured credit in the economy. Apparently the sponsors believe that secured creditors generally are financial institutions. That is widely known to be incorrect. Apparently they believe as well that secured creditors have the ability to effectively monitor performance of a debtor's fiduciary obligations and compel the debtor's performance. That is incorrect as well. Indeed, the sponsor's justification for 506(e)--that it would promote financial institution monitoring of a debtor's pension-related behavior--is based on fundamental misunderstandings of the theory and practice of secured transactions.

Credit agreements in ongoing relational credits often contain representations and warranties and affirmative and negative covenants, including financial covenants and financial reporting requirements. But these arrangements are, by necessity and by law, largely self-policing on the part of the borrower. In the first place, lenders are not in a position to second guess auditors, auditing committees of boards, or regulators, or to serve as daily monitors and gatekeepers for their borrowers. Moreover, since the lender liability litigation of the 1980s, well advised lenders have taken precautions not to step across the boundaries of corporate governance by interjecting themselves in the management of their borrowers. To be sure, this normally passive role does not protect a lender that discovers or participates in corporate wrongdoing. The BC already contains the means for a court to equitably subordinate a claim, security interest, or other lien in an appropriate case under BC § 510(c). The point here is simply that there is no reason to believe that the draconian penalties in proposed new BC § 506(e) would cause lenders to take on a daily monitoring role that is both impractical and improper under established legal doctrine. Instead, new BC § 506(e) would likely cause lenders not to extend credit in reliance on collateral or to extend less credit at higher rates of interest. Clearly these effects would not redound to the benefit of the debtor's employees.

Even if some relational secured creditors were positioned to be effective monitors (and they are not), the sponsors apparently believe that these relationships are a dominant feature in secured transactions. That also is incorrect. Much secured credit, especially that entered into with large, public firms, tends to be more of the "one-shot" or "asset-based" variety. That is to say, a lender places substantial reliance on the collateral value *for the very reason* that the collateral materially reduces the lender's need to monitor the debtor's financial condition. Indeed, that is one factor that has been identified as a justification for the social benefits of secured credit. Moreover, in some markets the relationships among market participants are large in number and high in volume. Consider, for example, the securities markets. Functioning of the largest such market, that for U.S. federal Treasury and agency securities, for example, depends

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32. Section-By-Section Summary at 4.

on short-term (often overnight) financing in truly staggering amounts. Participants in these markets cannot be expected to tolerate the possibility that their interests in securities are constantly exposed to a potential subordination. The same can be said of the commodity futures markets in which providing collateral ("margin") is a daily event.

Assuming that the sponsors' beliefs about the identity of secured creditors and their abilities to effectively monitor were correct, the sponsors' stated rationale nonetheless does not support enactment of proposed new BC § 506(e). The provision is essentially unjust because it does not reflect a sound or balanced policy. There is no rational basis for singling out one group of property claimants who must give up their property as a form of bankruptcy tax for the benefit of another unrelated favored class. If the goal is to protect these priority claimants at all cost, why not confiscate a lessor's residual value for the claimants' benefit or permit the lessee-debtor to use the leased property rent free for an indefinite period as well? Better yet, why not look to the people who are unquestionably those best situated to prevent a breach of fiduciary duties by providing for confiscation of the property of the debtor's managers and their families?

Finally, proposed BC § 506(e) in tandem with the super priority under proposed BC § 507(b)(2) could yield exactly the opposite results that the sponsors seek to promote. These provisions give the pension-related claims first call on all of a firm's assets, save only the possibility of sharing with failed adequate protection claimants discussed above. Such a high level of "insurance" could give rise to a serious "moral hazard" problem for the firm's managers during the period before bankruptcy. It is entirely plausible that this "protection" actually could *induce* managers to play fast and loose with pension assets, or at least reduce substantially the deterrence provided by the nonbankruptcy overlay of legal, accounting, and regulatory constraints.

C. Bankruptcy Policy and History.

BC § 506(e) represents a radical departure from and well-accepted bankruptcy policies concerning the interrelationship between secured claims and priority claims.

Priority claims among unsecured creditors have long been a part of bankruptcy law. Inasmuch as they contravene the general principle of creditor equality, the justification for priority claims sometimes has been controversial. But they have proven to be a resilient feature of the bankruptcy law landscape. For this reason, this report takes no position on the new proposed pension-related administrative expense priority claims.

However, priority claims must not be confused with secured claims, in which a secured claimant has a property interest (a security interest created by agreement or another lien) securing an obligation. The relationship between the treatment of priority claims and secured claims generally has not been controversial. Secured claims are satisfied first out of (but only to the extent of) the property securing the claims. Priority claims then are satisfied out of remaining unencumbered assets in their respective order of priority under BC § 507(a). If any assets remain, the non-priority unsecured creditors are next in line. New BC § 506(e) would change all of this solely for the benefit of the new pension-related priority claims. These priority claims would override and subordinate a secured claimant's property interest. This being the case, it is perhaps not surprising that, as discussed above, it is unclear just how proposed BC § 506(e)'s *sui generis* conceptual structure would be applied in practice and that its statutory construct seems incomplete.

Not only proposed BC § 506(e) but also the new super priority status under proposed BC § 507(b)(2) conflicts with the BC's essential structure for dealing with secured and priority claims. The essential point of the existing BC § 506(a) and (b) is to provide for a secured claimant to receive the value of its collateral or, if fully secured, the full amount of its claim. The BC goes to pains to meet this goal, in particular, by entitling a secured claimant to adequate protection of its interest in a variety of circumstances in which its property interest is being used by the debtor in bankruptcy.[33] The idea is straightforward. If the debtor in possession wishes to use the secured claimant's collateral in the debtor's attempts to reorganize for the benefit of the unsecured creditors, it must adequately protect the collateral. In effect, if the unsecured creditors wish to roll the dice they should not be entitled to bet the secured claimant's collateral. If the judge awards adequate protection (say, a lien or periodic payments) that turns out to be *in*adequate, the system has failed the secured claimant. That is the basis for the remarkable super priority found in current BC § 507(b)--the inadequately protected secured claimants are entitled to look to all of the firm's unencumbered assets ahead of any other claimant as a form of compensation for the use of the secured claimants' property interest. But the Act's proposed super priority would permit the new pension-related administrative priority claimants to share on a *pro rata* basis with the claims of the inadequately protected former secured claimants (after those pension-related claimants had already received the entire value of all remaining encumbered assets under proposed BC § 506(e)). Whatever the merits of the proposed administrative expense priority for pension-related claimants, proposed BC §§ 506(e) and 507(b)(2) would yield for secured claims an unprecedented and unfair statutory structure indeed.

Finally, we note the position taken by the American Bar Association House of Delegates in August 1991, as proposed by the Section of Business Law:

> FURTHER RESOLVED, that the American Bar Association opposes the enactment, in the absence of the most compelling circumstances, of special interest legislation designed to increase the types of claims entitled to priority under the Bankruptcy Code.

Our concerns about sections 203(b) and (c) of the Act are fully consistent with the ABA's opposition.

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33. The right to adequate protection derives from the interplay of BC §§ 361-364.

V. Recharacterizing Sales and Other Transactions.

A. Description, Application, and Interpretation.

Section 102 of the Act would add a new subsection (e) to BC § 105, which deals with the power of courts exercising bankruptcy jurisdiction. Proposed BC § 105(e) would confer power on a court to "recharacterize as a secured loan, a sale, lease, or transaction if the material characteristics of the sale, lease, or transaction are substantially similar to the characteristics of a secured loan." The new provision apparently would make the characterization of a putative sale, lease, or any other transaction a matter of federal bankruptcy law as opposed to state property law, which normally governs these questions.

B. Transactional and Economic Impact; Rationale

Most state law on the issue of recharacterizing property transactions is case law that has developed well-understood guidelines that enable counsel to give customary written legal opinions on the characterization of a transaction in a variety of settings. This is true not only for securitization transactions, mentioned below, but for leases and various other transactions in which a property interest is transferred. In stark contrast, the proposed federal test provides no guidelines whatsoever other than a vague "material characteristics"/"substantially similar" test. Indeed, it is quite conceivable that a court could conclude that a putative sale is a secured loan merely because it involves the transfer of funds in exchange for a transfer of a property interest, which are the "material characteristics of a secured loan."

Each year a huge amount of funding is provided through securitization transactions. These transactions can provide a lower-cost method of providing liquidity to virtually all firms, but the cost savings of securitization transactions are most dramatic for those that cannot issue investment grade securities. For example, by allowing the firm to sell receivables to a special purpose entity that will issue securities backed by the receivables, the firm's cost of financing can be substantially reduced. But these cost savings can be realized only if the rating agencies are satisfied that there is little or no risk that the receivables would be treated as property of the firm's estate were the firm subsequently to file a bankruptcy petition. They generally rely on "true sale" legal opinions. By removing the sale characterization from state law and imposing a vague, unpredictable, and open-ended federal "test," the Act would create an indeterminate range of uncertainty on the true sale question, which would be commercially devastating. This uncertainty also could impose additional risks and costs in "repo" transactions in the securities markets as well as on more traditional non-recourse factoring arrangements.

Note also that proposed BC § 105(e) is agnostic as to whether a putative sale, lease, or other transaction purports to transfer property *by* or *to* a debtor. In either case a court could recast the sale as a secured loan. Moreover, the statute does not explicitly confer on a court the power to recast a secured loan as a sale or lease. The proposed revision, then, leaves the characterization of transactions partially to a federal standard and partially to state-law standards. The role of state law is discussed further below.

C. Bankruptcy Policy and History.

The filing of a bankruptcy petition creates an "estate" that in general includes "all legal or equitable interests of the debtor in property as of the commencement of the case."[34] What is "property" in this context conceptually is a question for federal bankruptcy law. But as interpreted by the Supreme Court in the *Butner* case, courts must look to nonbankruptcy--normally state--law in order to determine whether and the extent to which property of the debtor exists "unless some federal interest requires a different result."[35] As discussed above, Section 102 of the Act would add a new BC § 105(e), which would give a court explicit authority to recharacterize a transaction, such as a sale, as a secured loan if has the characteristics of a secured loan.

We do not question the proposition that a court should attempt to characterize the economic substance of a transaction in determining its appropriate character for purposes of applying bankruptcy law. This happens regularly under current law by the application of well-established state laws. We do question, however, the wisdom of statutorily federalizing this important issue of property law for purposes of bankruptcy--at least without additional thought and deliberation. We are aware that a very few states have enacted laws that would permit "true sale" treatment for transactions without regard to economic substance and we express no view on the merits of those laws.[36] Instead, we suggest that the question of the effectiveness of those laws in bankruptcy be left to the courts in their determination as to whether a conflicting federal interest exists, as *Butner* instructs.[37] Thus, to the extent that state law may create or lead to abuses from a bankruptcy perspective, federal law already contains the cure. The proposed statutory fix is totally unnecessary, particularly given the devastating impact that it would have on an industry that supplies much needed capital to business enterprises both here and abroad. State law, when examined in the bankruptcy context, for the most part has proved workable and sensible.[38]

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34. BC § 541(a)(1).

35. Butner v. United States, 400 U.S. 48, 55 (1979).

36. *See, e.g.*, 6 Delaware Code §§ 2702A, 2703A.

37. If the statute were merely an effort to codify *Butner*'s "federal interest" test it could do so with much narrower language.

38. While the negative impact on securitization transactions may present the most obvious problem raised by the proposed recharacterization test, it is important to note as well the extreme breadth of the proposal. It encompasses not only sales and leases but virtually any

VI. Retroactive Effectiveness.

A. Description, Application, and Interpretation.

Section 106 of the Act provides that Title I (including the proposed revised avoidance powers and recharacterization provision) is immediately effective upon enactment and applies to bankruptcy cases and proceedings "commenced before, on, or after the date of enactment of this Act." Avoidance or recharacterization would mean that pre-existing and vested property rights would be upset even in pending cases. Under Section 206 of the Act, Section 203(b) (subordinating secured claims to the new pension-related administrative expense priority claims) would apply only to "liens created on or after the date of enactment of the Act."

B. Transactional and Economic Impact; Rationale.

The immediate and retroactive application of Title I of the Act upon enactment would have a material impact. Because it would apply even in pending bankruptcy cases and proceedings, it would spawn many new avoidance actions under both the strong arm and preference avoidance powers. Perfected security interests previously entitled to adequate protection and secured claims that ultimately would have been satisfied by a distribution or under a reorganization plan would become unsecured. Depending on the stage and posture of a case or proceeding, difficult procedural questions well might arise. For example, what would be the effect of the Act in a pending case in which a plan already had been confirmed based on the pre-Act avoidance regime?

C. Bankruptcy Policy and History.

In a report on bankruptcy legislation the Chair of the Section of Business Law of the American Bar Association observed:

> Most American laws are designed to operate prospectively. This is not the place for an extended exposition on the meaning of Article 1, Section 9, Clause 3 of the United States Constitution, which provides that no "Bill of Attainder or ex post facto Law shall be passed." The sense in that constitutional provision is that it is

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property-related transaction, such as consignments, licenses, and all forms of bailments. It would apply not only to personal property but also to real property. We are unaware of any bankruptcy-related problems that would require such broad statutory authority. For example, cases are legion in which bankruptcy courts have applied state law to recharacterize putative leases of goods as secured transactions subject to the perfection and priority rules of UCC Article 9. *See* UCC § 1-203 (Leases Distinguished From Security Interests) (revised 2001); UCC § 1-201(37) (definition of "security interest," including guidelines on the lease versus security interest distinction) (as generally enacted).

> fundamentally unfair to change rights which existed, and on which citizens relied, prior to the time that Congress or another appropriate body changed the law."

George Clemon Freeman, Jr., Report, at 7 (August 1991). Although Mr. Freeman recognized that federal taxation legislation sometimes operated from the time it was introduced in Congress, he lamented that in the case of bankruptcy legislation "[r]etroactivity had become fashionable." *Id.* at 10.

Unfortunately, as Mr. Freeman noted, bankruptcy legislation has not always spoken only prospectively. However, the proposed immediate and retroactive effect of the Act generally is much more aggressive than other recent bills. Especially given the striking nature of the modifications of property rights that the Act would impose, the immediate and retroactive application of the proposed avoidance and sale-recharacterization provisions would be both unwise and unfair.

VII. Open Hearings on Appropriate Notice.

We note the position taken by the American Bar Association House of Delegates in August 1991, as proposed by the Section of Business Law:

> RESOLVED, that the American Bar Association opposes amendment of the Bankruptcy Code by a legislative process which avoids fair opportunity for open hearings, on well-publicized notice, before the Judiciary Committees of Congress (the Committees in whose jurisdiction bankruptcy legislation is vested).

The flaws in the Act which we have identified in this report illustrate the wisdom of the position taken by the ABA, which we support. In addition, it is essential that well-publicized legislative hearings be held before the Congress or *any* of its committees takes action on the Act or any of its provisions. In particular, all affected parties and organizations must be given a reasonable opportunity to be heard or represented.

VIII. Conclusion.

We seriously doubt that responsible legislators such as the Act's sponsors fully appreciate the enormous adverse effects that would result from enactment of the provisions of the Act discussed here. The sponsors and their staffs may have received some ill-conceived or incomplete advice as to the operation and effects of these provisions. This observation underscores the need for a careful, deliberate, and transparent legislative process. The process should employ open and well-publicized hearings and afford opportunities to testify to a broad spectrum of affected persons and entities.

It is commonly known that there exists considerable political turmoil in the fall of this election year. This largely results from highly publicized recent examples of corporate misbehavior, large corporate bankruptcy filings, and waning public confidence in the economy. Having studied the Act, we have grave concerns about attempts to enact material amendments to the Bankruptcy Code in a rush to react to these events in the present political climate. The provisions of the Act that we have addressed here would have an immediate and severe adverse effect on the national economy. They should not become law.

BANKRUPTCY RULE CHANGES YOU SHOULD KNOW ABOUT: UPDATE AND ANALYSIS

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SECTION E

BANKRUPTCY RULE CHANGES YOU SHOULD KNOW ABOUT: UPDATE AND ANALYSIS

BANKRUPTCY RULE CHANGES YOU SHOULD KNOW ABOUT: UPDATE AND ANALYSIS[1]

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I. Introduction and Overview

II. Major Amendments to the Federal Rules of Bankruptcy Procedure- Effective December 1, 2002

A. Rule 1004. Involuntary Petition Against a Partnership.

After filing an involuntary petition under § 303(b)(3) of the Code, (1) the petitioning partners or other petitioners shall promptly send to or serve on each general partner who is not a petitioner a copy of the petition; and (2) the clerk shall promptly issue a summons for service on each general partner who is not a petitioner. Rule 1010 applies to the form and service of the summons.

Explanation and Analysis: This amendment eliminates a prior provision (1004(a)) which implied that all general partners must consent to the filing of a voluntary petition by a partnership. Since this is a matter of substantive law beyond the scope of the bankruptcy rules ("the rules"), Rule 1004 (a) has been deleted. See *Price v. Gurney,* 324 U.S. 100 (1945); *Jolly v. Pittore*, 170 B.R. 793 (S.D.N.Y. 1994); *Union Planters National Bank v. Hunters Horn Associates,* 158 B.R. 729 (Bankr. M.D. Tenn. 1993). With the deletion of Rule 1004(a), the rules do not, in purpose or effect, establish a substantive standard for the commencement of a voluntary case by a partnership.

B. Rule 1004.1. Petition for an Infant or Incompetent Person.

If an infant or incompetent person has a representative, including a general guardian, committee conservator, or similar fiduciary, the representative may file a voluntary petition on behalf of the infant or incompetent person. An infant or incompetent person who does not have a duly appointed representative may file a voluntary petition by next friend or guardian ad litem. The court shall appoint a guardian ad litem for an infant or incompetent person who is a debtor and is not otherwise represented or shall make any other order to

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protect the infant or incompetent debtor.

Explanation and Analysis: This is a completely new rule. It has been added to establish the manner in which a case is commenced on behalf of an infant or incompetent person. This Rule is derived from Rule 17(c) F.R. Civ. P. Presumably, case law interpreting the provisions of the civil rule will provide an analytical frame of reference for future interpretations of the procedural aspects of this new bankruptcy rule.

C. Rule 2004. Examination.

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(c) COMPELLING ATTENDANCE AND PRODUCTION OF DOCUMENTS. The attendance of an entity for examination and for the production of documents, whether the examination is to be conducted within or without the district in which the case is pending, may be compelled as provided in Rule 9016 for the attendance of a witness at hearing or trial. As an officer of the court, an attorney may issue and sign a subpoena on behalf of the court for the district in which the examination is to be held if the attorney is admitted to practice in that court or in the court in which the case is pending.

Explanation and Analysis: This rule amendment clarifies that an examination ordered under Rule 2004 can be held outside of the district in which the case is pending. Additionally, the rule now makes clear that an attorney may issue and sign the subpoena if that attorney is authorized to practice in either of two places: 1)in the court in which the case is pending or, 2)in the court for the district in which the examination will be held. According to the Committee Notes, this amendment is intended to more closely conform Rule 2004 to Rule 45 F.R. Civ. Pro and to facilitate efficient intra district law practice.

D. Rule 4004. Grant or Denial of Discharge.

* * * * *

(c) GRANT OF DISCHARGE.

(1) In a chapter 7 case, on expiration of the time fixed for filing a complaint objecting to discharge and the time fixed for filing a motion to dismiss a case under Rule 1017(e), the court shall forthwith grant the discharge unless:

(A) the debtor is not an individual,

(B) a complaint objecting to the discharge has been filed,

(C) the debtor has filed a waiver under § 727(a)(10),
(D) a motion to dismiss the case under § 707 is pending,
(E) a motion to extend the time for filing a complaint objecting to discharge is pending,
(F) a motion to extend the time for filing a motion to dismiss the case under Rule 1017 (e) is pending, or
(G) the debtor has not paid in full the filing fee prescribed by 28 U.S.C. § 1930(a) and any other fee prescribed by the Judicial Conference of the United States under 28 U.S.C. § 1930(b) that is payable to the clerk upon the commencement of a case under the Code.

* * * * *

Explanation and Analysis: This rule amendment to Rule 4004(c)(1)(D) should be of great interest to attorneys for consumer debtors in cases where creditors and/or trustees bring motions to dismiss under § 707 of the Code. This rule amendment to 4004(c) widens the scope of dismissal motions that postpone the entry of the discharge. It provides that the filing of a motion under § 707 of the Code postpones the entry of discharge. Prior to this rule change, only motions brought under § 707(b) ("substantial abuse") postponed entry of discharge. This directly changes a result that had made its way into the case law in several jurisdictions.

E. Rule 9014. Contested Matters

(a) MOTION. In a contested matter not otherwise governed by these rules, relief shall be requested by motion, and reasonable notice and opportunity for hearing shall be afforded the party against whom relief is sought. No response is required under this rule unless the court directs otherwise.

(b) SERVICE. The motion shall be served in the manner provided for service of a summons and complaint by Rule 7004. Any paper served after the motion shall be served in the manner provided by Rule 5(b) F. R. Civ. P.

(c) APPLICATION OF PART VII RULES. Unless the court directs otherwise, the following rules shall apply: 7009, 7017, 7021, 7025, 7026, 7028-7037, 7041, 7042, 7052, 7054-7056, 7064, 7069, 7071. An entity that desires to perpetuate testimony may proceed in the same manner as provided in Rule 7027 for the taking of a deposition before an adversary proceeding. The court may at any stage in a particular matter direct that one or more of the other rules in Part VII shall apply. The court shall give the parties notice of any order issue under this paragraph to afford them a reasonable opportunity to comply with the procedures prescribed by the order.

(d) TESTIMONY OF WITNESSES. Testimony of witnesses with respect to disputed material factual issues shall be taken in the same manner as testimony in an adversary proceeding.

(e) ATTENDANCE OF WITNESSES. The court shall provide procedures that enable parties to ascertain at a reasonable time before any scheduled hearing whether the hearing will be an evidentiary hearing at which witnesses may testify.

Explanation and Analysis: Rule 9014 has been amended in significant ways that seek mainly to clarify and make more transparent the handling of contested matters in bankruptcy courts. Pursuant to this rule change, Rule 7009 and Rule 7017 are included in the list of rules applicable in contested matters. Additionally, it is now clear that papers after the initial motion can be served under Rule 5(b) F.R. Civ. P. and that testimony regarding material factual matters must be taken in the same manner as in adversary proceedings. Finally, the rule directs local bankruptcy courts to provide procedures that will enable attorneys to know whether the presence of a witness is necessary for a hearing. Attorneys should consult local procedural rules and/or standing orders for these procedures.

F. Rule 9027. Removal

(a) NOTICE OF REMOVAL

* * * * *

(3) *Time for filing; civil action initiated after commencement of the case under the Code.*

If a claim or cause of action is asserted in another court after the commencement of a case under the Code, a notice of removal may be filed with the clerk only with the shorter of (A) 30 days after receipt, through service or otherwise, of a copy of the initial pleading setting forth the claim or cause of action sought to be removed, or (B) 30 days after receipt of the summons if the initial pleading has been filed with the court but not served with the summons.

*****

Explanation and Analysis: This amendment clarifies that the time limits for the filing of a notice of removal of a claim or cause of action apply to any claim or cause of action initiated after the commencement of the bankruptcy case, regardless of whether the bankruptcy case is pending, suspended, dismissed, or closed.

G. Technical amendments

Rule 2015(a)(5)

H. Official Forms

Form 1
Form 15

III. Major Proposed Amendments to the Federal Rules of Bankruptcy Procedure-Effective December 1, 2003[2]

A. Rule 1005. Caption of Petition

The caption of a petition commencing a case under the Code shall contain the name of the court, the title of the case, and the docket number. The title of the case shall include the following information about the debtor: name, employer identification number, last four digits of the social security number, any other federal tax identification number, and all names used within six years before filing the petition. If the petition is not filed by the debtor, it shall include all names used by the debtor which are known to the petitioners.

Explanation and Analysis: Rule 1005 will alter the information required in the caption of a bankruptcy petition. Only the last four digits of the debtor's social security number will need to be disclosed on the petition. The policy objective behind this rule change is to ensure some degree of privacy in the filing process. Other numerical identifiers must still be set out in full and the debtor must list any other federal tax identification number(s) that may be in use. Pursuant to proposed rule 1007(f), infra, debtors must submit with the petition a verified statement setting out the debtor's full social security number or stating that the debtor does not have such a number.

B. Rule 1007. Lists, Schedules, and Statements; Time Limits

(a) LIST OF CREDITORS AND EQUITY SECURITY HOLDERS, AND CORPORATE OWNERSHIP STATEMENT.

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[2]The amendments were endorsed by the U.S. Supreme Court on March 27, 2003. The amendments were transmitted to Congress pursuant to 28 U.S.C. §§ 2072-2075. Unless altered by Congress, the amended rules will take effect December 1, 2003. For more information, including committee notes, committee summaries, and transmittal letters, see the Administrative Office of the U.S. Court's web site at http://www.uscourts.gov/rules/newrules6.html.

(1) *Voluntary Case.* In a voluntary case, the debtor shall file with the petition a list containing the name and address of each creditor unless the petition is accompanied by a schedule of liabilities. If the debtor is a corporation, other than a governmental unit, the debtor shall file with the petition a corporate ownership statement containing the information described in Rule 7007.1. The debtor shall file a supplemental statement promptly upon any change in circumstances that renders the corporate ownership statement inaccurate.

* * * * *

(c) TIME LIMITS. The schedules and statements, other than the statement of intention, shall be filed with the petition in a voluntary case, or if the petition is accompanied by a list of all the debtor's creditors and their addresses, within 15 days thereafter, except as otherwise provided in subdivisions (d), (e), (f), and (h) of this rule. In an involuntary case, the schedules and statements, other than the statement of intention, shall be filed by the debtor within 15 days of the entry of the order for relief. Schedules and statements filed prior to the conversion of a case to another chapter shall be deemed filed in the converted case unless the court directs otherwise. Any extension of time for the filing of the schedules and statements may be granted only on motion for cause shown and on notice to the United States trustee and to any committee elected under § 705 or appointed under § 1102 of the Code, trustee, examiner, or other party as the court may direct. Notice of an extension shall be given to the United States trustee and to any committee, trustee, or other party as the court may direct.

* * * * *

(f) STATEMENT OF SOCIAL SECURITY NUMBER.

An individual debtor shall submit a verified statement that sets out the debtor's social security number, or states that the debtor does not have a social security number. In a voluntary case, the debtor shall submit the statement with the petition. In an involuntary case, the debtor shall submit the statement within 15 days after the entry of the order for relief.

* * * * *

Explanation and Analysis: This proposed rule change will impose new requirements on both corporate and individual debtors. Rule 1007 will require corporate debtors to disclose any parent corporation and any publicly held corporation that owns more ten (10) percent or more of its equity. The purpose of this amendment is to assist judges in recusal determinations. Subsection (f) requires individual debtors to submit a verified statement that sets out the debtor social security number of stating that the debtor does not have such a number. The statement will be submitted, not filed, and thus will not become part of the public court record in the case. See § 107 of the Code (noting that only papers filed in a case and the docket of the court are public records).

C. Rule 2003. Meeting of Creditors or Equity Security Holders

* * * * *

(b) ORDER OF MEETING.

(1) *Meeting of Creditors.* The United States trustee shall preside at the meeting of creditors. The business of the meeting shall include the examination of the debtor under oath and, in a chapter 7 liquidation case, may include the election of a creditors' committee, and if the case is not under subchapter V of chapter 7, the election of a trustee. The presiding officer shall have authority to administer oaths.

* * * * *

Explanation and Analysis: This proposed rule amendment makes clear that, in a Chapter 7 liquidation case, the creditors' meeting may include the election of a creditor's committee and the election of a trustee. However, pursuant to § 782 if the Code, the meeting of creditors in a multilateral clearing organization liquidation cannot include the election of a trustee since the designation of the trustee is the province of the Federal Reserve Board. The new sub chapter V of Chapter 7 (§§ 782-784), enacted in December, 2002, makes multi-lateral clearing organizations ("clearing banks") eligible for Chapter 7 liquidation.

D. Rule 2016. Compensation for Services Rendered and Reimbursement of Expenses

* * * * *

(c) DISCLOSURE OF COMPENSATION PAID OR PROMISED TO BANKRUPTCY PETITION PREPARER.

Every bankruptcy petition preparer for a debtor shall file a declaration under penalty of perjury and transmit the declaration to the United States trustee within 10 days after the date of the filing of the petition, or at another time as the court may direct, as required by § 110(h)(1). The declaration must disclose any fee, and the source of any fee, received from or on behalf of the debtor within 12 months of the filing of the case and all unpaid fees charged to the debtor. The declaration must describe the services performed and documents prepared or caused to be prepared by the bankruptcy petition preparer. A supplemental statement shall be filed within 10 days after any payment or agreement not previously disclosed.

Explanation and Analysis: This proposed rule has been amended to add subsection (c). Pursuant to § 110(h)(1) of the Code, a bankruptcy petition preparer must file with the court a declaration disclosing any fee received from or on behalf of the debtor within 12 months before the filing. This rule simply implements the disclosure mandates of that section.

E. Rule 7007.1 Corporate Ownership Statement

(a) REQUIRED DISCLOSURE. Any corporation that is a party to an adversary proceeding, other than the debtor or a governmental unit, shall file two copies of a statement that identifies any corporation, other than a governmental unit, the directly or indirectly owns 10% or more of any class of the corporation's equity interests, or states that there are no entities to report under this subdivision.

(b) TIME FOR FILING. A party shall file the statement required under Rule 7007.1(a) with its first pleading in an adversary proceeding. A party shall file a supplemental statement promptly upon any change in circumstances that this rule requires the party to identify or disclose.

Explanation and Analysis: This proposed rule requires non-governmental corporate parties to an adversary proceeding to disclose any corporation that owns 10% or more of its equity. The rule is derived from Rule 26.1 of the Federal Rules of Appellate Procedure. The rule is designed to assist judges in making recusal determinations. The Committee Notes to the proposed rule state that the rule does not prevent local districts from adopting disclosure rules that go beyond those contained in this rule. It is difficult to predict whether such districts will adopt additional disclosure rules. Much depends, of course, on whether respective districts think these rules go too far or not far enough toward striking the proper balance between promoting disclosure and minimizing transactions costs.

F. Technical Amendments

Rule 2002(a)(1)
Rule 2009

G. Official Forms

Forms 1, 3, 5, 6, 7, 8, 9, 10, 16A, 16C, 17and 19.

IV. Conclusion.

STUDENT LOANS IN BANKRUPTCY

Henry J. Sommer
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SECTION F

STUDENT LOANS IN BANKRUPTCY

STUDENT LOANS IN BANKRUPTCY

Henry J. Sommer

I Introduction – History and Importance of Student Loan Dischargeability Provisions

A. Evolution of Current Law and Legislative Proposals

1. 1978 – loans dischargeable if 5 years old, chapter 13, or undue hardship

2. Current law – Only undue hardship left

3. Proposed bill – would add for-profit loans

B. Student Loan Creditor Remedies

1. Tax intercept – Loss of Earned Income Credit

2. Wage garnishment

3. Other federal benefit intercept including social security and veterans benefits

4. No statute of limitations

C. Nonbankruptcy Remedies – See 34 C.F.R § 682.402

1. Disability discharge

2. Closed school discharge

3. Ability to benefit test

4. Unpaid refund discharge

5. Income contingent consolidation loan

6. W-5 Form – Advance Payment of Earned Income Credit

II What is a Minimal Standard of Living for Purposes of the Brunner Test?

A. Typical Income Levels Found Minimal by Courts

1. Virtually never under $20,000 per year

2. Usually cuts off between $25,000 and $30,000 depending on family size and other circumstances

B. Accepted Measures of Minimal Living Standards – See In re Ivory, 269 B.R. 890 (Bankr.N.D.Ala. 2001).

1. Poverty level universally discredited

2. Self-sufficiency standard

3. Use of debtor's budget – Lender attempts to nitpick the budget

4. Need to recognize necessities debtors often go without, e.g., dental care, auto, insurance, home repairs.

III Proof that Income is not Likely to Increase Significantly

A. Past Work History and Education

B. Future Job Prospects

C. Is Expert Testimony Needed?

D. Standard is Likelihood, not Certainty

IV. Effect of the Availability of Income Contingent Repayment Plans (ICRP)

A. What is Available?

1. Pay only amount determined by income; nothing if income below poverty

2. Can have negative amortization

3. After 25 years, debt discharged; may be taxable discharge of indebtedness income

B. Interplay with Code Provisions

1. Poverty level below a minimal standard of living

2. Code provision asks whether <u>repayment</u> would cause hardship

3. Postponement of problem does not eliminate future hardship

4. Logical conclusion of lenders' argument is that undue hardship discharge would never be available. Congress did not intend to repeal §523(a)(8) by implication and, in fact, amended it after enactment of income contingent provisions

5. Most courts will take it into consideration. Could provide relief to debtor for a few years until income increases. Availability of ICRP by itself does not preclude hardship discharge. <u>See</u> <u>In re Ford</u>, 269 B.R. 673 (B.A.P. 8th Cir. 2001).

V. Partial Discharge

A. Is it Permitted?

1. Sixth and Ninth Circuits Allow – <u>In re Saxman</u>, 2003 U.S. App. LEXIS 6999 (9th Cir. 2003); <u>In re Hornsby</u>, 144 F.3d 433 (6th Cir. 1998).

2. Other Courts say Statutory Language Does not Permit.

B. Is Availability Good or Bad for Debtors?

VI. Student Loans in Chapter 13

A. When should dischargeability be determined?

1. Desirability of knowing at the outset of the case

2. In re Ekenasi, 2003 U.S. App. LEXIS 7157 (4thCir. 2003) – Normally should be determined at end unless clear earlier.

B. Propriety of Provisions determining undue hardship

1. <u>In re Andersen</u>, 179 F.3d 1253 (10th Cir. 1999) – provisions finding undue hardship binding on creditor

2. <u>In re Pardee,</u> 193 F.3d 1083 (9th Cir. 1999) – provision waiving postpetition interest binding on creditor

3. Other courts have threatened sanctions

4. Nothing improper, provided adequate notice is given

    a. Plan is debtor's proposal – terms not permitted by Code are often allowed if no party objects.

    b Any terms not inconsistent with statute permitted – §1322(b)(10)

    c. Rule 7001 allows injunctive or equitable relief through plan

VII. Eleventh Amendment Limits on Student Loan Litigation

1. In re Hood, 319 F.3d 755 (6th Cir. 2003) – Not an issue in 6th Circuit

2. Other Circuits – Can't Sue State Directly

3. Can Use Ex Parte Young Doctrine – Ellett v. Goldberg, 254 F.3d 1135 (9th Cir. 2001).

UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

IN RE:	:	**Bankruptcy No. 98-30182**
Evelyn Hatfield-Smith,	:	
	:	
Plaintiff/Debtor	:	**Adversary No. 00-863**
	:	
V.	:	
	:	
Michael Hershock, President,	:	
Pennsylvania Higher Education	:	
Assistance Agency,	:	
Defendant	:	

PLAINTIFF'S PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW

PROPOSED FINDINGS OF FACT

1. Plaintiff Evelyn Hatfield Smith is 59 years old. (Tr.9).

2. Ms. Smith did not complete the 10th grade. (Tr.9)

3. Ms. Smith's sole sources of income are her job at Ampco Express Parking and workers' compensation payments.(Tr.13-17).

4. Ms. Smith earns $7.40/hr at her job which, although she has worked all her life since 10th grade, is the highest wage she has ever earned in her life. She now can only work part time because she is partially disabled from a work injury to her back that makes it impossible for her to sit or stand for long periods of time.(Tr.14,23,37)

5. Ms. Smith suffers from disc problems in her back. The pain Ms. Smith suffers from her injury makes her unable to work more than four hours a day, and she sometimes cannot work that long. Her condition is not improving, but instead is getting worse.(Tr.18-19, 48-49)

6. Although Ms. Smith has training in cosmetology, her injury does not permit her to take a job in that field, which would require too much standing and bending. She also cannot perform the tasks required by manufacturing jobs she previously had. (Tr.19, 49)

7. Although Ms. Smith took a course related to computers, she did not obtain training from that course that enabled her to obtain employment in that field and none of the people she knows who completed the course were able to obtain such employment. She can type

only ten words per minute and is not familiar with software programs currently in use. She is also unable to sit for the prolonged periods such a job would require.(Tr.20-23)

8. In the year 2000, Ms. Smith's gross wages from her job were $2,039.24 and from January through October of 2001 her gross wages were $5882.57. Her net wages for the first ten months of 2001 were $4837.74. (Exhibits P-1, P-2)

9. Ms. Smith receives $193.02 every two weeks in workers' compensation benefits, which replaces the income she cannot earn because she cannot work full time.(Tr.16-17)

10. Ms. Smith has no health benefits from her employment and therefore cannot afford to pay for prescription pain medications or treatment that might alleviate her back problems. She cannot afford the payroll deductions necessary to obtain health insurance through her employer. (Tr.23-25, 30)

11. Ms. Smith has no retirement plan that would afford her income beyond social security when she retires.(Tr.23)

12. Ms. Smith lives alone in her home, which she owns subject to two mortgages.(Tr.9-10)

13. The second mortgage was an emergency loan from the Pennsylvania Housing Finance Agency that was necessary to prevent foreclosure when Ms. Smith was unable to make payments on her first mortgage. (Tr.10)

14. The payments on the first mortgage are $310 per month and on the second mortgage are $25 per month.(Tr.10)

15. Ms. Smith's utility expenses are $25/month for telephone, $30/month for water, $30 per month for electricity and $50-$150/month for gas. The amounts listed for gas take into account a reduction due to energy assistance payments made on her behalf to the gas company.(Tr.10-11)

16. Ms. Smith also pays $35 for cable television, which is her primary source of recreation. She does not subscribe to any newspapers or magazines or go out for entertainment such as movies or restaurant meals, except for an occasional fast food meal. She previously paid $59 per month for expanded service but could not afford to continue paying that rate.(Tr.12, 27)

17. Ms. Smith cannot afford necessary repairs on her home to correct leaking pipes, nonfunctioning electric outlets and other wiring defects.(Tr.12-13)

18. Ms. Smith cannot afford to repair or replace a broken washer and, as a result, must spend $40 per month at a laundromat.(Tr.13)

19. Ms. Smith owns a 1977 Mercury automobile, which she needs to travel to work and

medical appointments, as well as to shopping and the laundromat, because her disability makes it very difficult for her to use public transportation.(Tr.25-26)

20. Ms. Smith spends $69 per month for car insurance and $60 per month for gas and oil. The car needs brakes and the transmission is slipping, but Ms. Smith cannot afford to make these repairs. (Tr. 25-26)

21. Ms. Smith spends about $200 per month on food, but sometimes runs low because she cannot afford to spend that much.(Tr.26-27,30)

22. Ms. Smith spends money on clothes only if she can afford them.(Tr.26, 30)

23. Ms. Smith's income does not permit her to meet all of her basic needs, much less allow for any cushion to meet unexpected expenses.

24. Ms. Smith paid in full earlier student for cosmetology training.(Tr.27-28).

25. Ms. Smith has paid many hundreds of dollars towards the student loans she now owes, as demonstrated by the fact that her principal balance went down by approximately $700, but was unable to continue the payments once she was no longer earning as much money. At that point, she applied for and received deferments on the loan. (Tr.28-29, 75-77; Ex.

26. Ms. Smith fell behind on her bills other than student loans, as well as her mortgage, when she was unemployed and receiving public assistance, and the burden of those bills caused her to file her bankruptcy case. (Tr.29-30).

27. The balance on the student loan is $2451.30.(Tr.59)

28. Ms. Smith cannot maintain, based on her current income and expenses, a minimal standard of living if forced to repay her student loans.

29. Due to her age, disability, and lack of training in any skills that would enable her to earn a higher income, Ms. Smith's financial situation is not likely to change in a way that would enable her to repay her student loans and maintain a minimal standard of living.

30. Ms. Smith has made good faith efforts to repay her student loans.

PROPOSED CONCLUSIONS OF LAW

1. "Undue hardship" under 11 U.S.C. § 523(a)(8) requires a three-part showing: (1) that the debtor cannot maintain, based on current income and expenses, a minimal standard of living for herself and her dependents if forced to repay the loans; (2) that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment

period for student loans; and (3) that the debtor has made good faith efforts to repay the loans. In re Brightful, 267 F.3d 324, 327 (3d Cir. 2001).

2. A debtor need not be living at the poverty level to be at a minimal standard of living. (See attached Memorandum).

3. A debtor need not show that it is certain that her situation will not improve sufficiently to repay her student loans, but only that it is "likely". In re Brightful, 267 F.3d 324, 327 (3d Cir. 2001).

4. Although the lack of quality in the education obtained by a debtor is not by itself grounds for an undue hardship discharge, the Court may take it into consideration in determining the likelihood of the debtor earning a higher income. In re Pena, 155 F.3d 1108, 1114 (9th Cir. 1998).

5. The debtor need not introduce expert medical testimony to prove her medical condition. In re Brightful, 267 F.3d 324, 330 (3d Cir. 2001).

6. There is no requirement that a debtor must have applied for every possible loan forbearance or deferment program prior to obtaining an undue hardship discharge.

7. The availability of an income-contingent consolidation loan is not, by itself, a basis for denying an undue hardship discharge. In re Newman, Bankr. No. 00-30784, Adv. No. 01-271 (Memorandum of Fox, J., dated Jan.7, 2002, attached hereto as Exhibit A).

8. The good faith efforts test does not require that the debtor show that she made payments during periods when she was unable to make payments. In re Buzoiu, (Memorandum of Raslavich, J., dated Oct.3, 2001, aff'd, McLaughlin, D.J. by Order dated Jan.28, 2002, both attached hereto as Exhibit B); In re Williams, 1999 Bankr. LEXIS 1541 (Bankr. E.D.Pa. 1999) and cases cited therein.

UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

IN RE:	:	**Bankruptcy No. 98-30182**
Evelyn Hatfield-Smith,	:	
	:	
Plaintiff/Debtor	:	**Adversary No. 00-863**
	:	
V.	:	
	:	
Michael Hershock, President,	:	
Pennsylvania Higher Education	:	
Assistance Agency,	:	
Defendant	:	

PLAINTIFF'S SUPPLEMENTAL MEMORANDUM OF LAW

INTRODUCTION

Plaintiff has previously submitted to this court a memorandum of law covering most of the legal issues raised by this case. The evidence at trial fully supported the arguments made in that memorandum. See Transcript and Exhibit References in attached. Proposed Findings of Fact. That evidence demonstrated that plaintiff does not have sufficient income to meet her basic needs, even without making payments on her student loans. It demonstrated that plaintiff is partially disabled and that her condition is, if anything, getting worse as she nears retirement age. It demonstrated that, despite attempting to better her situation throughout her life, plaintiff has never been able to earn more than her current wage. Moreover, it demonstrated that even if plaintiff's disability disappeared her income would not change appreciably. She would lose her workers' compensation income, which replaces the wages she has lost due to he being able to work only part time. Finally, the evidence demonstrated that plaintiff has made good faith efforts to pay her current and previous student loans.

No contrary evidence was introduced by defendant. Defendant offered no evidence that plaintiff earns more than she stated or that she is capable of earning higher wages than she ever earned before. Defendant offered no evidence to rebut the evidence that plaintiff is partially disabled.[1] Defendant offered no evidence that plaintiff has not made efforts to pay her student loans when she was able to do so.

This Memorandum will not repeat the arguments made in plaintiff's earlier memorandum, to which plaintiff refers the Court. Rather, it will address several issues raised by defendant at the trial which were not fully addressed in the prior memorandum.

I THE POVERTY LEVEL IS NOT A MINIMAL STANDARD OF LIVING.

In closing arguments, counsel for defendant argued that because plaintiff's loans are small, she can afford to make small payments on them. This argument assumes that plaintiff has some income which is not necessary for plaintiff to maintain a minimal standard of living. The evidence is to the contrary. Even without making student loan payments, plaintiff does not have

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[1] At the trial, plaintiff moved the admission into evidence of Exhibit P-4, a letter from plaintiff's physician that provided additional evidence of her disability. The court reserved ruling on the admissibility of the document. Although there is sufficient other evidence of her plaintiff's disability, Exhibit P-4 is admissible under Fed.R.Ev. 801(d)(2)(B) because defendant manifested an adoption of the statement by offering it in support of his summary judgment motion. The circumstances in this case are very similar to those in <u>In re Japanese Electronic Prods. Antitrust Litigation</u>, 723 F.2d 238, 300-301 (3d Cir. 1983), <u>reversed on other grounds</u>, 475 U.S. 574, 89 L. Ed. 2d 538, 106 S. Ct. 1348 (1986). In that case, a party manifested adoption of documents by referring to them in responses to interrogatories, thereby indicating that it intended the opposing party to rely on the truth of those documents. In this case, defendant included Exhibit P-4 in Exhibit 13 to its motion for summary judgment and referred to it in its Factual Allegation No.36 in connection with that motion, obviously intending that the Court rely upon the truth of the document.

sufficient funds for prescription pain medications, necessary repairs to her home and her car, adequate clothing and other basic needs. Even if her income were several thousand dollars greater, she would have no money to pay her student loans.

As discussed in plaintiff's summary judgment memorandum (pp.9-11), courts have regularly found debtors living well above the poverty level to be suffering undue hardship. See also In re Salinas, 258 B.R. 913 (Bankr.W.D.Wis. 2001)(poverty level is not test of minimal standard of living, citing Faish); In re Yapuncich. 266 B.R. 882 (Bankr.D.Mont. 2001)(debtor not required to live in substandard housing, citing Faish). This is not surprising, since the poverty level is generally regarded as an outmoded standard, which does not take into account the higher costs of living in urban areas. See Apgar, Standard of Living Eroding for Poor, Study Determines, 8 N.J. Law. 2641 (1999); Bernstein, Family Needs Far Exceed the Official Poverty Line; Study Lays Out Costs of Getting By in City, New York Times, September 13, 2000, Section B, p.1; The Living Wage Movement: Building a Political Link from Market Wages to Social Institutions, 34 Journal of Economic Issues 527 (2000). Many antipoverty programs recognize this fact by granting benefits to families above the poverty line. For example, the Low Income Home Energy Assistance Payments that the plaintiff receives are afforded to families with incomes up to 150% of the poverty level. 45 U.S.C. § 8624(b)(2)(B). Moreover, the court can take judicial notice of the fact that plaintiff's expenses are extremely modest in comparison to the costs of housing, transportation and other necessities in the Philadelphia area.

The circumstances of Ms. Smith are not dissimilar to those of the debtor in In re Buzoiu, supra, decided recently by Judge Raslavich and affirmed by the district court. That debtor had recently earned $8.50 per hour, more than Ms. Smith. Ms Buzoiu also was much younger and was not disabled. Like Ms. Smith, Ms. Buzoiu was far below the living standard of the debtor in Faish and could not make ends meet on her income; indeed, her expenses were below what the Court thought would be necessary. Also like Ms. Smith, and unlike the debtors in Faish and In re Brunner, 831 F.2d 395 (2d Cir.1987), Ms. Buzoiu was not a college graduate, and had only whatever minimal skills she might have picked up in for profit trade schools. Like Ms. Buzoiu, Ms. Smith has requested discharge of her loans only after years of trying to deal with the loans and pay them in good faith.

Another recent case with facts remarkably similar to those in this proceeding is In re Ford, 269 B.R. 673 (B.A.P. 8th Cir. 2001). The debtor in that case was 62 years old and also partially disabled. However, her income was $1338 per month, substantially more than that of Ms. Smith. The Bankruptcy Appellate Panel had no difficulty in finding that the evidence amply supported the trial court's conclusion that the debtor could not make student loan payments while paying reasonable living expenses.

Courts that have denied undue hardship discharges have done so in cases in which debtors earned, or could earn, substantially more than plaintiff in this case. In Faish, supra, for example, the debtor in 1993 earned $27,000 per year, lived in the lower cost central Pennsylvania area, and had one school-aged child. In In re Roberson, 999 F.2d 1132 (7th Cir. 1993), cited by the Faish court, the court found that the debtor, whose only dependent expense was $120/week in child support, would within a few years be able to resume earning over $30,000 per year, which he had previously earned before losing his driver's license. In In re Brightful, 267 F.3d 324 (3d Cir.2001), the Court of Appeals found that the debtor would within two years have no dependents and would be able to earn the full-time salary of a skilled legal secretary. The debtor in In re Brunner, 831 F.2d 395 (2d Cir. 1987), also relied upon by Faish, was similarly a single person with no dependents, a college degree and a good earning capacity that was likely to place her income above the self-sufficiency level. In In re Harmon, (Opinion attached to defendant's response to plaintiff's cross motion for summary judgment as Exhibit B) , Judge Raslavich denied an undue hardship discharge to a debtor who had earned $20,000 ten years earlier and showed no reason why she could not resume work in a similar position, which with inflation would presumably pay over $25,000, if she chose to do so.

In all of these cases in which an undue hardship discharge was denied, the debtors earned, or were likely to be able to earn, well over $20,000 per year. All were college graduates or had other job skills that would command higher wages. None resembled the plaintiff in this case, who has less than a 10th grade education, is 59 years old and disabled, and has never earned more than $7.40 per hour. This Court need not determine a bright line measure of a minimal standard of living in order to recognize that, wherever that line might be, plaintiff is far below it.

II PLAINTIFF'S ELIGIBILITY FOR VARIOUS REPAYMENT PROGRAMS DOES NOT PRECLUDE AND UNDUE HARDSHIP DISCHARGE

In closing arguments, defendant's counsel also argued that this proceeding is "premature" because plaintiff should instead apply for income-sensitive repayment programs offered by PHEAA and the Department of Education. This argument must fail for a number of reasons.

Primary among these reasons is that any repayment program that is available would require Ms. Smith to make some payments toward her student loans. Defendant's witness testified that, the repayment programs offered by PHEAA would require monthly payments of at least $59.77 at some point. (Tr.61) The Department of Education's Income Contingent Repayment Plan, available to a debtor who enter into a consolidation loan with the Department, requires debtors to make payments if their income is even a few dollars above the poverty level. 34 C.F.R. §209(a)(2) Thus, either of these programs would require plaintiff to make payments on her student loans, since her income is slightly above the poverty level, which is $8,860 for a family of one. 67 Fed. Reg. 6931-33 (2002). As discussed above, Ms. Smith cannot afford to make any payments, and could not afford to make any payments even if her income increased somewhat.

If Ms. Smith were to enter into any such payment arrangement and default, PHEAA could employ a range of draconian remedies against her. It could garnish her wages, student loans being virtually the only types of debts other than child support for which wage garnishment is available in Pennsylvania. 20 U.S.C. § 1095a The loan could be sent to a collection agency, which would be authorized to add collection fees. 34 C.F.R. § 682.410(b)(2). Once Ms. Smith begins receiving Social Security benefits, even a portion of those benefits might be seized. 31 U.S.C. § 3716. There is no statute of limitations on student loans. 20 U.S.C. § 1091a Moreover, even if plaintiff were able to make small payments under the Federal Income Contingent Program, interest would continue to accrue, and indeed it would be capitalized up to 10% of the loan. 34 C.F.R. § 685.209(c)(5) At the end of the repayment period, any portion of the loan not paid and therefore forgiven, which with interest accrual and capitalization could amount to many times the current balance, would result in deemed discharge of indebtedness income, potentially leaving Ms. Smith with a substantial tax debt she could not pay.

Thus, Defendant's argument that Plaintiff should be precluded from an undue hardship discharge under the good faith test is inconsistent with Faish and with the Bankruptcy Code. The law is clear in this circuit that undue hardship is determined not based on Department of Education regulations but rather based upon the Faish test. If a bankruptcy debtor cannot make any payments on student loans without undue hardship, the statute mandates that it be discharged. Defendant's argument simply ignores the fact plaintiff has not applied for payment arrangements because she is unable to make any payments on her loans and any repayment would impose undue hardship.

Moreover, based upon Defendant's argument, no debtor could ever obtain an undue hardship discharge, because alternative payment arrangements would always be available. Congress has not, in enacting various payment arrangements for student loans, repealed the undue hardship discharge provision in the Bankruptcy Code. Therefore, it cannot be the case that the availability of such arrangements, no matter how generous, renders it impossible to prove that payments on the loans would be an undue hardship. Otherwise, section 523(a)(8) would effectively be surplusage, read out of the statute. Courts should not interpret statutes in a way that renders them meaningless. As Judge Fox recently held in In re Newman, (Memorandum attached as Exhibit A), the existence of the income contingent repayment alternative does not preclude an undue hardship discharge and is simply a factor to take into consideration. (For example, a debtor might have a short-term inability to pay which would be alleviated by the income contingent repayment program until the debtor was able to make substantial payments.) See also In re Ford, supra (forbearance or deferment availability merely one factor to consider, and particularly unrealistic for an older debtor).

Finally, defendant's suggestion that plaintiff should have waited until a later time before bringing this action is disingenuous at best. Plaintiff filed her bankruptcy due to pressure from debts other than her student loans. Once in bankruptcy, she had a right to seek the student loan undue hardship discharge. If she were to follow defendant's suggestion and obtain a federal income-contingent consolidation loan, the Department of Education would argue that the debt was a postpetition debt and could not be discharged. See In re Clarke, 266 B.R. 301 (Bankr.E.D.Pa. 2001).[2] She might also have difficulty reopening her case to bring the issue before the Court, since some courts are reluctant to reopen cases for that purpose. See In re Newman, Memorandum of April 23, 2001, attached hereto as Exhibit C).

In analyzing "good faith" it is worth considering how it fits into the statutory language, especially since the statute does not contain the words "good faith" and the Third Circuit has never had occasion to apply it in a case.[3] The only possible statutory basis for this prong is the word "undue" in section 523(a)(8). In other words, the debt will not be discharged if hardships that would result from paying it are "due", ie. deserved by the debtor. This view is consistent with the Faish court's quotation from the Bankruptcy Commission Report, stating "the debtor may not willfully or negligently cause his own default, but rather his condition must result from 'factors beyond his reasonable control.'" 72 F.3d at 305. Certainly, Ms. Smith did not willfully or negligently cause her own default. It is clear that the circumstances preventing her from repaying more of her loans were beyond her reasonable control. See In re Brunner, 831 F.2d 395 (2d Cir.1987), adopting analysis of In re Brunner, 46 B.R. 752, 775 (S.D.N.Y. 1985); In re

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[2] Plaintiff does not believe Clarke was properly decided. See Collier on Bankruptcy ¶4007.03. However, that issue is not before this Court.

[3] In Faish the Court of Appeals applied the first prong of the test and in In re Brightful, 267 F.3d 324 (3d Cir. 2001) it applied the second prong of the test.

Buzoiu, slip op. P.10(attached hereto as Exhibit B).

CONCLUSION

In closing arguments, defendant's counsel argued that its defense of this action was based on a concern for "taxpayer dollars," so "the taxpayer isn't left having to pay for this."(Tr.107) This argument rings hollow in light of the fact that the money PHEAA has spent litigating this proceeding is undoubtedly many times the amount it could ever hope to collect from Ms. Smith. Ms. Smith easily meets the Faish test. Her education, her work history, her medical condition and her age together demonstrate that it is extremely unlikely that she will ever be in a position to repay her student loans without undue hardship. Ms. Smith's case is far more compelling than the cases of most debtors who have been granted undue hardship discharges. If Ms. Smith does not qualify for such a discharge, it is hard to imagine a debtor who would.

Respectfully submitted,

____

Henry J. Sommer
Attorney for Plaintiff

UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

In re: TAWANDALAIA NEWMAN	:	CHAPTER 7
Debtor.	:	BANKRUPTCY NO. 00-30784
TAWANDALAIA NEWMAN, Plaintiff	: :	
v.	:	
EDUCATIONAL CREDIT MANAGEMENT CORP, Defendant	: : :	ADVERSARY NO. 01-271

ORDER

AND NOW, this ________ day of ___________, 2001, defendant's motion for summary judgment is DENIED and summary judgment is GRANTED to plaintiff. Plaintiff's educational loans are declared dischargeable under 11 U.S.C. § 523(a)(8).

____
FOX, J

cc:

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UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

In re: TAWANDALAIA NEWMAN	:	CHAPTER 7
Debtor.	:	BANKRUPTCY NO. 00-30784
TAWANDALAIA NEWMAN, Plaintiff	: :	
v.	:	
EDUCATIONAL CREDIT MANAGEMENT CORP, Defendant	: : :	ADVERSARY NO. 01-271

PLAINTIFF'S RESPONSE TO DEFENDANT'S MOTION FOR SUMMARY JUDGMENT AND PLAINTIFF'S CROSS MOTION FOR SUMMARY JUDGMENT

Plaintiff responds to Defendant's Motion for Summary Judgment and hereby moves for summary judgment in favor of plaintiff. In support of her motion she avers:

1. There are no material facts in dispute in this proceeding.

2. Defendant is not entitled to summary judgment as a matter of law.

3. Plaintiff is entitled to summary judgment as a matter of law.

WHEREFORE, plaintiff requests that the defendant's motion for summary judgment be denied and that she be granted summary judgment declaring her student loans to be dischargeable.

HENRY J. SOMMER

Consumer Bankruptcy Assistance Project
1424 Chestnut Street
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(215) 242-8639

UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

In re: TAWANDALAIA NEWMAN	:	CHAPTER 7
Debtor.	:	BANKRUPTCY NO. 00-30784
TAWANDALAIA NEWMAN, Plaintiff	: :	
v.	:	
EDUCATIONAL CREDIT MANAGEMENT CORP, Defendant	: : :	ADVERSARY NO. 01-271

PLAINTIFF'S MEMORANDUM OF LAW IN OPPOSITION TO DEFENDANT'S MOTION FOR SUMMARY JUDGMENT AND IN SUPPORT OF PLAINTIFF'S CROSS MOTION FOR SUMMARY JUDGMENT

I INTRODUCTION

Plaintiff Tawadalaia Newman seeks, in this adversary proceeding, a judgment that her student loans are dischargeable under 11 U.S.C. § 523(a)(8) because repayment of those loans would cause her undue hardship. This court's determination of whether the undue hardship standard is met is guided by the decision of our Court of Appeals in In re Faish, 72 F.3d 298 (3d Cir. 1995). Defendant, relying on an incomplete statement of the facts, has filed a motion for summary judgment and argued that those facts warrant judgment in favor of Defendant.[1]

[1] In addition, some of the "facts" relied upon by Defendant should be disregarded. While plaintiff's statements in response to discovery may properly be considered by the Court, there is no declaration or affidavit authenticating Exhibits B and D to Defendant's motion. Unauthenticated documents and other documents not admissible into evidence may not be considered in deciding a summary judgment motion. F.R.Civ.P. 56(e), incorporated in Fed. R. Bankr. P. 7056. See First Nat'l Life Ins. v. California Pac. Life, 876 F.2d 877, 881 (11th Cir. 1989) (unauthenticated photocopies of out of state court proceedings were inadmissible evidence); Moore's Federal Practice ¶ 56.11[7][c].

As demonstrated below, and by the attached declarations, Defendant's version of the facts omits important facts. Indeed, Defendant's case is so weak that even the facts submitted by defendant do not support judgment in favor of Defendant. When the full factual record is examined, it reveals that plaintiff is an indigent single mother of 5 who is unable to make ends meet on her income, has struggled to remain out of default on her student loans, and will not see sufficient improvement in her situation to enable her to repay those loans. That factual record, which Defendant cannot dispute, provides ample basis for the Court to grant plaintiff's cross-motion for summary judgment.

II STANDARD FOR SUMMARY JUDGMENT

Defendant's motion for summary judgment appears to be based on a fundamental misunderstanding of Federal Rule of Bankruptcy Procedure 7056 and its counterpart, Federal Rule of Civil Procedure 56. Defendant seems to believe that in deciding a motion for summary judgment the Court can consider only discovery materials and pleadings. It is, of course, in a counteraffidavit or declaration that a party normally sets forth facts that complete the factual record, adding those facts which the original movant has failed to mention, as plaintiff has done here. It was not the duty of plaintiff to prove her case in the pleadings or in discovery, as Defendant seems to believe. Considering only the answers to Defendant's discovery inquiries and submissions would be like deciding the case based only on cross-examination and presentation of the defendant's case, with no direct examination or presentation of the plaintiff's case. When the full factual record is examined, including plaintiff's declaration, that record militates in favor of judgment for the plaintiff.

Defendant also apparently believes that under the summary judgment rule it may argue for factual findings that have no support in the record. As discussed below, Defendant asks this Court to draw inferences in its favor about plaintiff's ability to rebudget her scant income, about her ability to obtain much higher paying work, about her ability to have others pay the mortgage on her home, and about her good faith, which not only are not compelled by the evidentiary record but in fact are devoid of any support in that record. With respect to all these issues, the declarations submitted by plaintiff supply the relevant facts, facts very different than the assertions conjured up by Defendant.

III PLAINTIFF'S CURRENT INCOME DOES NOT SUPPORT EVEN A MINIMAL STANDARD OF LIVING

Defendant makes no argument that plaintiff does not meet the first prong of the Faish test – that she cannot currently repay the loans and at the same time maintain a minimal standard of living for herself and her dependents. Her annual income is below the federal poverty standard for a family of 6, which is $23,690. 66 Fed. Reg. 10695 (Feb. 16, 2001). Moreover, as detailed in the attached Declaration of Professor Mark Stern, the federal poverty standard greatly understates the cost of a minimal standard of living for a family in Philadelphia. Perhaps for this reason, the Court of Appeals in Faish held that a debtor need not live in "abject poverty" to meet this prong of the test. 72 F.3d at 305.

It is clear from her Declaration that Plaintiff cannot make ends meet with her income. (¶¶1, 2, 4) She amassed substantial debts prior to her bankruptcy case that she could not pay and that were discharged.(¶6) Since then she has incurred new debts that she cannot afford to pay.(Answer to Interrogatory No.8) She fell behind on her mortgage payments and was saved from foreclosure only by a state assistance program, which required additional payments on a new loan.(¶4) She is currently unable to pay another mortgage on her home arising from a home equity loan.(¶2) She has no financial cushion at all to deal with emergency expenses, home repairs or repairs to her car, which she needs to get to work, buy groceries, and transport her large family to doctors' appointments and on other necessary trips.(¶2) There are necessary expenses for her family that plaintiff simply cannot afford to pay.(¶2) Thus, plaintiff already suffers financial hardship due to her low income. By any measure, plaintiff is currently unable to maintain a minimal standard of living for herself and her children, even without making payments on her student loans.

IV PLAINTIFF'S CIRCUMSTANCES ARE NOT LIKELY TO IMPROVE

Plaintiff is a woman who has worked most of her life in addition to raising a family of five children, for a number of years, on her own. She continuously tried to better her position, by going to school, or by moving to jobs with better wages or more hours.(Newman Declaration ¶10; Answer to Interrogatory No.2) She has never earned more than $11.64 per hour and received that wage for only a few months in a temporary position in which she could not remain.(Newman Declaration ¶11) Except for that position and a temporary part-time position with the Bureau of the Census, her earnings have never significantly exceeded the $8 per hour she currently earns.(Answer to Interrogatory No.2)

As set forth in the Declaration of Mark Stern, plaintiff would have to earn approximately $4582 per month, over $50,000 per year, to achieve minimal self-sufficiency for her large family in Philadelphia.[2] (Stern Declaration ¶4) Defendant has not suggested that she can earn that amount or anything close to it. Despite the fact that Ms. Newman is young and employable, there is no hope that plaintiff's income will increase enough to enable her to maintain a minimal standard of living for her large family and also pay her loans.

As described in the Declaration of Professor Stern and its attachments, the Self-Sufficiency Standard is a much more accepted and realistic standard for a minimal standard of living than the outmoded poverty standard and is adjusted for the wide geographic variations in living costs. The Self-Sufficiency Standard (as opposed to the poverty standard) is also remarkably consistent with the leading cases on student loan discharges. In Faish, supra, for example, the debtor in 1993 earned $27,000 per year, lived in central Pennsylvania, and had one school-aged child. Even in 1998, the self-sufficiency standard for such a debtor was well below that amount for the Harrisburg-Lebanon-Carlisle MSA. In In re Roberson, 999 F.2d 1132 (7th Cir. 1993), cited by the Faish court, the court found that the debtor, whose only dependent expense was $120/week in child support, would within a few years be able to resume earning over $30,000 per year, which he had previously earned before losing his driver's license. In In re Brightful, 267 F.3d 324 (3d Cir.2001), the Court of Appeals found that the debtor would within two years have no dependents and would be able to earn the full-time salary of a skilled legal secretary, well above the self-sufficiency standard for one adult. The debtor in In re Brunner, 831 F.2d 395 (2d Cir. 1987), also relied upon by Faish, was similarly a single person with no

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[2] By way of comparison, under the "means test" proposals now pending in Congress, a Pennsylvania debtor with a family of 6 would not be subjected to the means test, designed to extract payments to unsecured creditors from debtors who supposedly can afford to pay some of their unsecured debts, unless that debtor had a gross income of approximately $70,000. See proposed new 11 U.S.C. § 707(b)(7), which would be added by H.R. 333 §102 (107th Cong.).

dependents, a college degree and a good earning capacity that was likely to place her income above the self-sufficiency level.

On the other hand, in In re Pena, 155 F.3d 1108 (9th Circuit 1998), the debtors' net income (for an adult couple) was $20,976, well above the poverty line. Even though one of the debtors' wages had increased twice during the course of the case, the Ninth Circuit found that "[c]learly, in these circumstances the Penas could not maintain a minimal standard of living and pay off student loans."155 F.3d at 1113. In In re Cheesman, 25 F.3d 356 (6th Cir. 1994) the Sixth Circuit affirmed the undue hardship discharge (with a temporary stay of the order) of debtors who had an income of $15,676 in 1991, even though one spouse was hoping for a promotion and the other was actively seeking employment, because their employment history did not indicate that the second spouse's employment would improve sufficiently to pay their loans.

Defendant offers several arguments in support of its claim that Ms. Newman will be able to pay her loans in the future. It first argues that four of Ms. Newman's children will attain majority in the next eleven years. While this is true, none of these children will attain majority in the next four years, and Ms. Newman will continue to have three dependent children for the next nine years. The self sufficiency standard for the family Plaintiff will have from six to eight years from now, in 1998 dollars, is $2464 per month, a wage of $14.00 per hour, (Stern Declaration ¶5) which is much more than Ms. Newman has ever earned and almost twice what she has earned in any job except for two brief temporary positions. There is no basis in the record for any conclusion, based upon the preponderance of the evidence, except the conclusion that Ms. Newman will not be likely to have the ability to repay her loans and maintain a minimal standard of living even after her family's size is reduced to four.[3] Moreover, Defendant cites no case which denies a student loan discharge based upon the prospect of reduced expenses so far in the future and plaintiff is not aware of any such case. Indeed, the Faish decision is quite clear that a debtor need only prove inability to pay "for a significant portion of the repayment period of the student loans." 72 F.3d at 305 (emphasis supplied). See also In re Brightful, 267 F.3d 324, __ (quoting In re Roberson, 999 F.2d 1132, 1137 (7th Cir. 1993) that test looks to whether debtor "will lack the ability to repay for several years").

Defendant next argues that Ms. Newman will be capable of working full time within the next three years without any costs of child care because her older children can care for the younger ones afer school and, presumably, during school vacations. It is, first of all, presumptuous and unrealistic for Defendant to assume that Ms. Newman's children should be required to give up after-school activities to be continuously available to provide childcare to enable Ms. Newman to repay her student loans. Her children did not incur the student loans. In any event, even if Ms. Newman were working full-time, her earned income at $8 per hour would be well under $20,000 per year, still below even the poverty level. She still would not have anything close to enough income to achieve self-sufficiency, which in three years would still require an income of over $43,000 in 1998 dollars (the self-sufficiency standard for an adult, two schoolage children and a teenager, augmented by $800 per month for two additional teenagers.)

It must also be remembered that a significant portion of Plaintiff's income consists of

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[3] Although the Third Circuit in In re Brightful, 267 F.3d 324 (3d Cir. 2001) did quote a bankruptcy court opinion speaking of a "certainty of hopelessness," it also stated it was applying the Faish test which looks to whether it is "likely" that the debtor's inability to pay will persist. Faish, 72 F.3d at 305. The Court gave no reason to believe that the normal preponderance of the evidence standard is to be discarded in favor of some other standard, such as "certainty."

benefits that are phased out as income increases and that other costs would rise as income increases. If her earned income did increase significantly, not only would her taxes be far higher but she would no longer receive food stamps, her mortgage payments to PHFA would increase, she would not be eligible for low income discounts on gas and electricity, her son would no longer receive SSI, and her family would no longer receive medical assistance.[4] (Newman Declaration ¶¶2-5) All of these benefits are afforded to her to bring her family closer to, but nowhere near, self-sufficiency. It has sometimes been noted that a family in this situation faces the equivalent of a marginal tax rate approaching 100% due to the loss, as income increases, of so many income-dependent benefits.

Lastly, Defendant argues that but for Ms. Newman's choice to "prioritize" her home mortgage and home equity debts she would be able to pay her student loans. However, this decision to prioritize her housing expenses (including a home equity loan used for home repairs) is expressly authorized by the Faish test. That test looks to whether a debtor can maintain a minimal standard of living and certainly that standard of living must include housing. The debtor's total payments on her mortgage loans, which she cannot even afford to make at present, along with her other housing related costs other than maintenance, are less than the cost of housing, based upon rent, for a family of four in the Self-Sufficiency Standard. (Stern Declaration ¶7) Thus, if Ms. Newman were renting, her housing expenses would be higher, and if she were not paying a portion of her rent, instead of not paying a home equity loan, she would have been evicted and her family would be homeless. Defendant has not suggested where she

[4] Ms Newman's current employer does not provide medical benefits. (Newman Declaration ¶2)

might live with her five children if she did not "prioritize" her mortgage payments. Defendant also suggests that other individuals should be paying the mortgage on Ms. Newman's home, but those individuals never were expected to make these payments, are not doing so, and will not do so. (Newman Declaration ¶¶7-8) Ms. Newman's former husband already provides support to her family, to the extent that he is able, in other ways.(Newman Declaration ¶8).

V PLAINTIFF HAS DEMONSTRATED GOOD FAITH

Finally, Defendant argues that plaintiff has not met the "good faith" prong of the Faish test. In analyzing "good faith" it is worth considering at the outset how it fits into the statutory language, especially since the statute does not contain the words "good faith" and the Third Circuit has never had occasion to apply it in a case.[5] The only possible statutory basis for this prong is the word "undue" in section 523(a)(8). In other words, the debt will not be discharged if hardships that would result from paying it are "due", ie. deserved by the debtor. This view is consistent with the Faish court's quotation from the Bankruptcy Commission Report, stating "the debtor may not willfully or negligently cause his own default, but rather his condition must result from 'factors beyond his reasonable control.'" 72 F.3d at 305.

Aside from repeating its arguments concerning Plaintiff's earning capacity and ability to have others pay the mortgages on her home, Defendant's principal argument on good faith is that Ms. Newman has not "taken advantage of" various payment arrangements available to her. There is no admissible evidence in the record of what these arrangements might be. However, as described in Defendant's brief, even the most liberal of these arrangements would require

[5] In Faish the Court of Appeals applied the first prong of the test and in In re Brightful, 267 F.3d 324 (3d Cir. 2001) it applied the second prong of the test.

payments if Ms. Newman's income rose even slightly above the poverty level, something she could not afford while at the same time maintaining a minimal standard of living for her family, as discussed above and in Professor Stern's Declaration. See also Newman Declaration ¶14

Defendant argues that under the income contingent repayment arrangements it believes would be available, Ms. Newman would not currently be obligated to make any payments. If this is the case, it is difficult to see how these arrangement have much to do with the Faish issue of good faith efforts to repay the loans. Ms Newman, as Defendant concedes, has in fact already consistently sought deferments and forbearance with respect to her payment obligations, to the extent that she is not even currently in default. (Newman Declaration ¶13) Defendant repeatedly granted those deferments on the basis of hardship, thereby agreeing that based on the income she received, which differs little from her current income, she could not afford to pay the loans. Ms. Newman has also made payments on her loan when she had any ability to do so, at all times trying in good faith to be responsible with respect to those loans.(Newman Declaration ¶13)

Thus, Defendant's argument that Plaintiff should be precluded from an undue hardship discharge under the good faith test is inconsistent with Faish and with the Bankruptcy Code. The law is clear in this circuit that undue hardship is determined not based on Department of Education regulations but rather based upon the Faish test. If a bankruptcy debtor cannot make any payments on student loans without undue hardship, the statute mandates that it be discharged. Defendant's argument simply ignores the fact plaintiff has not applied for payment arrangements because she is unable to make any payments on her loans and any repayment would impose undue hardship. (Newman Declaration ¶14)

Moreover, based upon Defendant's argument, no debtor could ever obtain an undue hardship discharge, because alternative payment arrangements would always be available. Congress has not, in enacting various payment arrangements for student loans, repealed the undue hardship discharge provision in the Bankruptcy Code. Therefore, it cannot be the case that the availability of such arrangements, no matter how generous, renders it impossible to prove that payments on the loan would be an undue hardship. Otherwise, section 523(a)(8) would effectively be surplusage, read out of the statute. Courts should not interpret statutes in a way that renders them meaningless.

CONCLUSION

It is hard to imagine a debtor who could have a better case than plaintiff for an undue hardship determination. She is a single mother of five young children whose income cannot support a minimal standard of living and who has no prospect of obtaining an income that will do so. Ms. Newman has worked all her life and attempted for years to deal with her student loans in good faith, struggling to make payments and seeking deferment after deferment. The plaintiff's motion for summary judgment should be granted.

Respectfully submitted,

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HENRY J. SOMMER

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CERTIFICATION OF SERVICE

I, HENRY J. SOMMER, hereby certify that the foregoing response to motion for summary judgment and cross motion for summary judgment was served on the date below, by first class mail, postage prepaid, upon:

Elizabeth F. Abrams
Reed Smith, LLP
2500 One Liberty Place
1650 Market Street
Philadelphia, PA 19103

HENRY J. SOMMER
Attorney for Plaintiff

DATE:

Excerpt from Consumer Bankruptcy Law and Practice (6th Ed. and 2002 Supp.)

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(617) 542-9595

ruptcy and then raise the discharge defensively in the applicable state or federal forum.[426]

If a bankruptcy court determination is desired, there is no time limit to commence an adversary proceeding to resolve the dischargeability issues. In fact, the applicable rule even speaks of allowing cases to be reopened in order to obtain determinations on issues related to dischargeability.[427]

14.4.3.8.1.2 Undue hardship test

The sole remaining exception to the nondischargeability of student loans is available when excepting the debt from discharge would cause the debtor or the debtor's dependents undue hardship. Courts have long struggled to define the term "undue hardship" found in section 523(a)(8). Although most of the published opinions on the subject agree that "undue" means more than the "garden variety" hardship that arises from the expense of future payments,[428] each judge seems to bring a unique set of values to the process of defining and implementing the applicable standard.

Several circuit courts of appeals have adopted a definition of undue hardship that employs a three-part test.[429] Under this test, undue hardship exists if:

- the debtor cannot maintain, based on current income and expenses, a 'minimal' standard of living for the debtor and the debtor's dependents if forced to repay the loans;
- additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and
- the debtor has made good faith efforts to repay the loans.

In general, low-income debtors are most likely to obtain a discharge under this test.[430] They should seek to have the court focus on their income and expenses as the basis for a determination of undue hardship. Certainly, any debtor who can demonstrate some personalized misfortune, disability or unique underprivilege should bring that factor to the attention of the court.[431] Similarly, every effort should be made to establish lack of job skills, lack of available jobs, disabilities and other factors which make it improbable that a low-income debtor will have better prospects in the future.[432] The test requiring a good faith effort to pay the loan does not require that repayment actually occurred, although it may require some effort to deal with the loan prior to bankruptcy.[433]

In evaluating student loans that were incurred for vocational school education, two additional considerations related to discharge are appropriate. First, the student's undue hardship argument may be strengthened if the student loan arose from a private vocational

426 *See, e.g.*, Indiana Univ. v. Canganelli, 501 N.E.2d 299 (Ill. App. Ct. 1986) (discharge can be raised as a defense to collection of student loans in postbankruptcy state court proceedings).

427 Fed. R. Bankr. P. 4007(b).

428 *E.g.*, Brunner v. New York State Higher Education Services, 831 F.2d 395 (2d Cir. 1987); In re Kopf, 245 B.R. 731 (Bankr. D. Me. 2000) (while "garden variety" hardship may not be sufficient, on the other extreme debtors should not be required to prove a "certainty of hopelessness" or "total incapacity").

429 In re Pena, 155 F.3d 1108 (9th Cir. 1998); In re Faish, 72 F.3d 298 (3d Cir. 1995), *cert. denied*, 518 U.S. 1009 (1996); Matter of Roberson, 999 F.2d 1132 (7th Cir. 1993); Cheesman v. Tennessee Student Assistance Corp., 25 F.3d 356 (6th Cir. 1994), *cert. denied*, 513 U.S. 1081 (1995); Brunner v. New York State Higher Education Services, 831 F.2d 395 (2d Cir. 1987).

430 In re Pena, 155 F.3d 1108 (9th Cir. 1998). *See also* In re Hornsby, 144 F.3d 433 (6th Cir. 1998) (debtors did not need to be at poverty level to show undue hardship).

431 *See, e.g.*, In re Cline, 248 B.R. 347 (B.A.P. 8th Cir. 2000) (single woman unable to increase income would need decades to repay $53,000 in loans); In re Johnson, 121 B.R. 91 (Bankr. N.D. Okla. 1990) (single mother of two not receiving support); In re Reilly, 118 B.R. 38 (Bankr. D. Md. 1990) (debtor was divorced mother of three whose ex-husband was incurably ill and therefore not contributing support); In re Zobel, 80 B.R. 950 (Bankr. N.D. Iowa 1986) (unemployed debtors who had made numerous unsuccessful attempts to find work); In re Wilcox, 57 B.R. 479 (Bankr. M.D. Ga. 1985) (debtor holding down subsistence job; wife suffering from crippling arthritis and confined to wheelchair); In re Dockery, 36 B.R. 41 (Bankr. D. Tenn. 1984) (debtor had suffered severe industrial injuries and several heart attacks); In re Diaz, 5 B.R. 253 (Bankr. W.D.N.Y. 1980) (divorced mother of four who had a series of illnesses, heart trouble, and alcoholic problem, need for future surgery, and a husband confined to a mental clinic presented "classic" hardship case); In re Bagley, 4 B.R. 248 (Bankr. D. Ariz. 1980) (debtor and husband lived on $560 per month earned by him as an Army private and had postpetition debts of over $4,000 for hospitalization of their baby); In re Fonzo, 1 B.R. 722 (Bankr. S.D.N.Y. 1979) (policeman-debtor had expenses exceeding income for himself, wife, and four children).

432 *E.g.*, In re Price, 25 B.R. 256, 258 (Bankr. W.D. Mo. 1982) (relevant considerations include "whether the education enabled or would enable the debtor to obtain substantially higher income"); Matter of Powelson, 25 B.R. 274 (Bankr. D. Neb. 1982) (vocational degree in hairstyling did not enhance debtor's job skills or employability). *See also* In re Pena, 207 B.R. 919 (B.A.P. 9th Cir. 1997), *aff'd* 155 F.3d 1108 (9th Cir. 1998) (debtors did not have to show "exceptional circumstances" to show they were unlikely to improve their financial situation in the future).

433 In re Coats, 214 B.R. 397 (Bankr. N.D. Okla. 1997); In re Hornsby, 201 B.R. 195 (Bankr. W.D. Tenn. 1995), *aff'd* 144 F.3d 433 (6th Cir. 1998); In re Maulin, 190 B.R. 153 (Bankr. W.D.N.Y. 1995).

school that closed down or defrauded the student. Not only do courts sense the unfairness involved in making a student repay a loan for a valueless education, but also the absence of acquired skills makes it less likely that the debtor will be able to obtain employment that could make possible future loan repayment.[434] In fact, under recent legislation, the debtor may be excused from paying the loan, even without a bankruptcy case.[435]

Evidence that a student obtained no benefit from their trade school education is relevant to the issue of whether the debtor will be able to pay in the future, because it suggests lack of skills necessary to obtain income for repayment.[436] It is also relevant to the debtor's payment history, because the debtor may not have had the ability to make any payments and because a valueless vocational school education is outside the Congressional concern about highly skilled professionals shedding loan obligations prior to a lucrative career.[437]

A further argument related to the dischargeability of trade school loans is that absent discharge, the debtor may be ineligible for future government educational loans.[438] If a discharge is not granted, a low-income student will not be able to go back to school, and will not be able to obtain a decent paying job, making repayment now or in the future an undue hardship.

Sometimes, even in fairly strong hardship cases, student loan creditors offer to take very low payments. While it could be argued that the court should only look to the payments actually due under the terms of the note, such offers of low payments can make it more difficult to assert that the loan, as modified by the creditor, presents a hardship. Perhaps not surprisingly, courts have been attracted to this method of compromising on the outcome of the case, sometimes finding no hardship solely because of the reduced-payments offer. In fact, a few have even devised other solutions short of complete nondischargeability in difficult cases, by reducing the term and/or amount of the loan.[439] The Sixth Circuit Court of Appeals approved a bankruptcy court's order ruling that a debtor's loans were dischargeable, but stayed enforcement of its order for eighteen months to see if the debtor's situation improved.[440] The authority for such actions without the creditor's consent is dubious, since this section of the statute, unlike others, does not use the phrase "to the extent" in describing whether a loan is dischargeable.[441]

In a similar vein, student loan creditors have argued in recent cases that there cannot be undue hardship because the Department of Education's regulations provide for payment relief in the form of Income Contingent Repayment Plans (ICRP).[442] Several courts have found the availability of these repayment plans relevant under the various hardship tests.[443] These courts fail to apply the statute as written, which affords the debtor an opportunity to obtain an absolute discharge, and fail to consider the student loan that the debtor actually has as

434 *See, e.g.*, In re Law, 159 B.R. 287 (Bankr. D.S.D. 1993) (repayment of $20,000 student loan for two and a half weeks of useless flight training would be undue hardship); In re Evans, 131 B.R. 372 (Bankr. S.D. Ohio 1991) (trade school education in word-processing did not put debtor in a position to repay her student loans); In re Correll, 105 B.R. 302 (Bankr. W.D. Pa. 1989) (student loan discharged where debtor received no benefit from the education); In re Carter, 29 B.R. 228 (Bankr. N.D. Ohio 1983) (loan discharged where debtor did not obtain a marketable skill); In re Love, 28 B.R. 475 (Bankr. S.D. Ind. 1983) (college education did not provide marketable skill); In re Price, 25 B.R. 256, 258 (Bankr. W.D. Mo. 1982) (relevant considerations include "whether the education enabled or would enable the debtor to obtain substantially higher income"); Matter of Powelson, 25 B.R. 274 (Bankr. D. Neb. 1982) (vocational degree in hairstyling did not enhance debtor's job skills or employability); In re Ford, 22 B.R. 442 (Bankr. W.D.N.Y. 1982) (court considered that debtor obtained little benefit from her education); In re Littell, 6 B.R. 85 (Bankr. D. Or. 1980) (whether the debtor benefitted economically from schooling should be a "substantial factor" in determining whether undue hardship exists).

435 *See* National Consumer Law Center, Unfair and Deceptive Acts and Practices § 11.4 (4th ed. 1997 and Supp.). This manual should be consulted for other nonbankruptcy student loan discharges available to debtors in addition to the closed school discharge, such as those based on the debtor's permanent and total disability and a school's false certification of the debtor's eligibility.

436 *E.g.*, Matter of Powelson, 25 B.R. 274 (Bankr. D. Neb. 1982).

437 In re Evans, 131 B.R. 372 (Bankr. S.D. Ohio 1991).

438 *See* National Consumer Law Center, Unfair and Deceptive Acts and Practices § 11.5 (4th ed. 1997 and Supp.).

439 In re Hornsby, 144 F.3d 433 (6th Cir. 1998) (partial discharge is permitted under court's equitable powers); In re Andresen, 232 B.R. 127 (B.A.P. 8th Cir. 1999) (discharging two of three student loans); In re Griffin, 197 B.R. 144 (Bankr. E.D. Okla. 1996) (discharging accrued interest and attorney fees on loans, but not principal); In re Hinkle, 200 B.R. 690 (Bankr. W.D. Wash. 1996) (discharging three out of six student loans); In re Littell, 6 B.R. 85 (Bankr. D. Or. 1980) (each debtor ordered to pay $10 per month for remainder of 5 year period after initial loan due date); In re Hemmen, 7 B.R. 63 (Bankr. N.D. Ala. 1980) (court conditioned discharge of loan on debtor using best efforts to find employment and paying any sums he received in excess of $3,600 per year after taxes toward student loan for remainder of five years after loan matured).

440 In re Cheesman, 25 F.3d 356 (6th Cir. 1994), *cert. denied*, 513 U.S. 1081.

441 In re Skaggs, 196 B.R. 865 (Bankr. W.D. Okla. 1996) (court's authority limited to determination whether entire debt is dischargeable).

442 *See* 20 U.S.C. 1078(m) and 1087a; 34 C.F.R. 685.209(a)(2)(i).

443 *See, e.g.*, In re Standfuss, 245 B.R. 356 (Bankr. E.D. Mo. 2000) ("flexibility of an ICRP plan considered in determining debtors' ability to repay student loan).

opposed to some modification of that loan.[444] If Congress had intended the payment programs to meet all hardship situations, it would have repealed the undue hardship provisions. It has not done so and has, in fact, amended them since these programs were enacted.

14.4.3.8.2 Procedure for dischargeability determination

A proceeding to determine dischargeability of a student loan may be brought at any time.[445] It usually must be commenced by a complaint pursuant to the adversary proceeding rules.[446] Because a state student loan creditor may argue that it is immune from suit under the Eleventh Amendment, it is often wise to name the head of the student loan agency as a defendant so that the suit may proceed under the principles of *Ex parte Young*.[447] The debtor has at least the burden of going forward with proof in such a case, but courts have differed regarding whether the debtor has the ultimate burden of proof, since in other dischargeability proceedings the creditor bears that burden.[448] Alternatively, at least if the student loan creditor does not object, the dischargeability of a student loan may be determined by a provision in the debtor's chapter 13 plan which, if the plan is confirmed, becomes binding upon the creditor.[449]

Although a debtor has the option of seeking a determination related to dischargeability in a nonbankruptcy forum after the bankruptcy is completed,[450] some state or nonbankruptcy federal courts may be unwilling to make a decision on what they perceive to be a bankruptcy issue especially if the open question is "undue hardship."[451] If the facts are favorable during the bankruptcy case, the better practice is to seek to have the issue decided in bankruptcy court prior to discharge.[452] If an unfavorable decision is received and circumstances subsequently change for the worse, dischargeability of student loan obligations generally may be relitigated by reopening a prior complaint or bringing a new proceeding even if the debtor's bankruptcy case has been closed.[453]

14.4.3.8.3 Raising defenses to student loan debts

If it is not likely that a student loan debt will be found dischargeable (and especially in chapter 13 if payments on the debt are going to be made), the debtor should consider whether there are defenses to the debt, particularly if there was a close relationship between the school and the lender. If possible, the debtor should consider bringing school-related defenses (e.g., breach of contract, warranty, fraud or unfair trade practice) to the proof of claim filed by the originating lender or guarantee agency.[454] A decision disallowing the claim based on a valid defense is as good or better than a decision that the loan is dischargeable.[455]

14.4.3.8.4 Special issues regarding student loans in chapter 13

In the past, because student loan debts were dischargeable upon completion of a chapter 13 plan, chapter 13 was an attractive option for those who sought to deal with student loan debt burdens. However, changes

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444 *See* In re Kopf, 245 B.R. 731 (Bankr. D. Me. 2000) (no matter how flexible or "humanely executed" such programs may be, they simply are not the equivalent of a discharge).

445 Fed. R. Bankr. P. 4007(b).

446 Fed. R. Bankr. P. 7001 *et seq.*

447 *See* § 13.3.2.2 *supra. See also* In re Innes, 184 F.3d 1275 (10th Cir. 1999), *cert. denied*, ___ U.S. ___, 120 S. Ct. 1530, 146 L. Ed. 2d 345 (2000) (state consented to litigation in federal court by signing participation agreement with U.S. Department of education agreeing to oppose dischargeability complaints); In re Phelps, 237 B.R. 527 (Bankr. D.R.I. 1999) (bankruptcy court's had jurisdiction to determine dischargeability notwithstanding Eleventh Amendment due to its jurisdiction over debtors and the estate); In re Muir, 239 B.R. 213 (Bankr. D. Mont. 1999) (loan guaranty agency failed to establish it was an arm of the state).

448 In re Fox, 163 B.R. 975 (Bankr. M.D. Pa. 1993) (debtor has burden of going forward but not burden of proof); In re Alliger, 78 B.R. (Bankr. E.D. Pa. 1987); In re Norman, 25 B.R. 545 (Bankr. S.D. Cal. 1982).

449 In re Andersen, 179 F.3d 1253 (10th Cir. 1999). *But see* note 459, *infra*.

450 11 U.S.C. § 523(c).

451 *See* Massachusetts Higher Education Assistance Corp. v. Taylor, 390 Mass. 755, 459 N.E.2d 807, Bankr. L. Rep. (CCH) ¶ 69,788 (1984) (implying that if undue hardship claim not raised in bankruptcy court it is waived).

452 Of course, if no decision is obtained in the bankruptcy court for some reason, debtors, in appropriate circumstances, should feel free to raise discharge on the basis of hardship in response to a later collection case. Alternatively, removal of the collection case to the bankruptcy court may be sought. 28 U.S.C. § 1452; Fed. R. Bankr. P. 9027. *See generally* § 13.4.1, *supra*.

453 11 U.S.C. § 350; Fed. R. Bankr. P. 4007(b); In re Sobh, 61 B.R. 576 (E.D. Mich. 1986). *See* In re Fisher, 223 B.R. 377 (Bankr. M.D. Fla. 1998) (debtor who had not sought discharge of student loan during bankruptcy could reopen case to seek undue hardship discharge in light of postbankruptcy accident which reduced her ability to repay).

454 *See* 10 NCLC REPORTS, *Deceptive Practices and Warranties Ed.* 29, (Sept/Oct 1991); National Consumer Law Center, Unfair and Deceptive Acts and Practices § 11.9 (4th ed. 1997 and Supp.). *See also* Tipton v. Secretary of Education, 768 F. Supp. 540 (S.D. W. Va. 1991).

455 To the extent the claim is disallowed, the debtor would have a binding judgment that the debt is not owed. Additionally, the creditor would not be entitled to any dividend available from the estate. Finally, attorneys fees might be available to counsel to the extent that a determination is based on unfair and deceptive acts or practices or another statute involving fee shifting.

in the law eliminated many of the advantages of the chapter 13 option. Code section 1328(a)(2) now incorporates section 523(a)(8) by reference so that student loans that would be nondischargeable in chapter 7 are now also nondischargeable in chapter 13.

Nevertheless, student loan issues continue to arise in chapter 13 cases that are filed for other reasons. Additionally, in some cases a chapter 13 plan may still provide advantages during the term of the plan, even if the debt is ultimately nondischargeable.

Given that amended section 1328(a) simply incorporates section 523(a)(8), issues of dischargeability of student loans in chapter 13 cases should be treated almost identically to those arising in chapter 7 cases. For example one court addressing dischargeability in chapter 13 determined undue hardship just as if the case had proceeded under chapter 7.[456] The mere fact that the debtor can afford chapter 13 plan payments should not be dispositive of the ability to pay a student loan.[457] In many cases those payments go almost entirely to secured creditors to ensure a debtor continued shelter, transportation to work or other necessities, or are made at great sacrifices that cannot be sustained beyond the plan period.

As in chapter 7, the debtor must affirmatively request a finding of undue hardship for the debt to be found dischargeable during the bankruptcy case. Although a plan provision might provide that confirmation of the plan will constitute a finding that undue hardship exists,[458] such provisions will probably be disfavored if a party objects.[459] A few courts have even sanctioned counsel for placing such provisions in plans,[460] although such decisions are contrary to both the concept of the chapter 13 plan as a proposal by the debtor which can include any provision not contrary to title 11[461] and the case law which has held that such provisions can be approved and binding. As discussed above, the procedure used in most cases for resolving questions related to dischargeability in bankruptcy is the one set out in Fed. R. Bankr. P. 4007 which provides for an adversary proceeding.

Since most chapter 13 cases continue for the three (or five) year length of the plan and because the nondischargeability of student loans can be raised at any time, careful considerations of timing should be brought to bear in order to ensure that the issues are heard when the debtor faces maximum financial pressures. However, some courts may take the position that no determination on dischargeability can be made until the end of the case.[462]

In a few districts, the chapter 13 standing trustee has taken the position that nondischargeable student loan debts must be fully paid in a chapter 13 bankruptcy plan. That position is incorrect. Even if a student loan is not dischargeable, it nevertheless remains an unsecured claim during the bankruptcy case (unless the creditor holds a nonavoided judgment lien), subject to those provisions of the Code applicable to unsecured debts.

For most cases, this means that during the bankruptcy plan, the student loan creditor is entitled to the greater of what it would receive under the best interests of the creditors test[463] or the ability to pay test[464] just like any other unsecured creditor.[465] Certainly, any arguments that a case must be dismissed because the debtor's filing was made in bad faith merely in order to improperly discharge student loans should be put to rest.[466]

Thus, the debtor can propose treatment of a student loan creditor during a bankruptcy plan that is no different than treatment of any other unsecured creditor.[467] The student loan creditor will not be entitled to additional regular payments outside the plan prior to the debtor's discharge.

However, if the student loan is nondischargeable, it is in the debtor's interest to make sure that as much of the loan as possible is paid during the bankruptcy. Frequently this means that the debtor wishes to propose a plan to separately classify the student loan and have it paid at a higher percentage than other unsecured debts.[468] Several judicial decisions have explicitly held that a separate classification in favor of a student loan

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456 In re Evans, 131 B.R. 372 (Bankr. S.D. Ohio 1991).

457 In re Goranson, 183 B.R. 52 (Bankr. W.D.N.Y. 1995) (income used for plan payments would not be available at end of plan, since major portion of payments was for car payments and other expenses that would continue after the plan).

458 In re Andersen, 179 F.3d 1253 (10th Cir. 1999). *See also* In re Pardee, 193 F.3d 1083 (9th Cir. 1999) (creditor bound by confirmed plan provision discharging postpetition interest on student loan).

459 In re Mammel, 221 B.R. 238 (Bankr. D. Iowa 1998); Matter of Key, 128 B.R. 742 (Bankr. S.D. Ohio 1991).

460 *E.g.*, In re Evans, 242 B.R. 407 (Bankr. S.D. Ohio 1999).

461 11 U.S.C. § 1322(b)(10).

462 *See, e.g.*, In re Cleveland, 89 B.R. 69 (B.A.P. 9th Cir. 1988) (decision on dischargeability of HEAL loan cannot be made until close of chapter 13 plan); In re Raisor, 180 B.R. 163 (Bankr. E.D. Tex. 1995) (dischargeability based upon undue hardship cannot be determined until end of plan).

463 11 U.S.C. § 1325(a)(4). *See* § 12.3.1, *supra*.

464 11 U.S.C. § 1325(b). *See* § 12.3.3, *supra*.

465 *See* In re Owens, 82 B.R. 960 (Bankr. N.D. Ill. 1988) (potentially nondischargeable HEAL loan may be treated like other unsecured debts during chapter 13); In re Gronski, 65 B.R. 932 (Bankr. E.D. Pa. 1986) (same).

466 Examples of such cases include: In re Stewart, 109 B.R. 998 (D. Kan. 1990); In re Makarchuk, 76 B.R. 919 (Bankr. N.D.N.Y. 1987). For other reasons, decisions requiring minimum payments to unsecured creditors beyond those required by the ability to pay or best interest of the creditors tests are obsolete. *See* Education Assistance Corp. v. Zellner, 827 F.2d 1222 (8th Cir. 1987); In re Owens, 82 B.R. 960 (Bankr. N.D. Ill. 1998). *See generally* § 12.3, *supra*.

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Since most chapter 13 cases continue for the three (or five) year length of the plan and because the nondischargeability of student loans can be raised at any time, careful considerations of timing should be brought to bear in order to ensure that the issues are heard when the debtor faces maximum financial pressures. However, some courts may take the position that no determination on dischargeability can be made until the end of the case.[462]

In a few districts, the chapter 13 standing trustee has taken the position that nondischargeable student loan debts must be fully paid in a chapter 13 bankruptcy plan. That position is incorrect. Even if a student loan is not dischargeable, it nevertheless remains an unsecured claim during the bankruptcy case (unless the creditor holds a nonavoided judgment lien), subject to those provisions of the Code applicable to unsecured debts.

For most cases, this means that during the bankruptcy plan, the student loan creditor is entitled to the greater of what it would receive under the best interests of the creditors test[463] or the ability to pay test[464] just like any other unsecured creditor.[465] Certainly, any arguments that a case must be dismissed because the debtor's filing was made in bad faith merely in order to improperly discharge student loans should be put to rest.[466]

Thus, the debtor can propose treatment of a student loan creditor during a bankruptcy plan that is no different than treatment of any other unsecured creditor.[467] The student loan creditor will not be entitled to additional regular payments outside the plan prior to the debtor's discharge.

However, if the student loan is nondischargeable, it is in the debtor's interest to make sure that as much of the loan as possible is paid during the bankruptcy. Frequently this means that the debtor wishes to propose a plan to separately classify the student loan and have it paid at a higher percentage than other unsecured debts.[468] Several judicial decisions have explicitly held that a separate classification in favor of a student loan

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461 11 U.S.C. § 1322(b)(10).

462 *See, e.g.,* In re Cleveland, 89 B.R. 69 (B.A.P. 9th Cir. 1988) (decision on dischargeability of HEAL loan cannot be made until close of chapter 13 plan); In re Raisor, 180 B.R. 163 (Bankr. E.D. Tex. 1995) (dischargeability based upon undue hardship cannot be determined until end of plan).

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464 11 U.S.C. § 1325(b). *See* § 12.3.3, *supra.*

465 *See* In re Owens, 82 B.R. 960 (Bankr. N.D. Ill. 1988) (potentially nondischargeable HEAL loan may be treated like other unsecured debts during chapter 13); In re Gronski, 65 B.R. 932 (Bankr. E.D. Pa. 1986) (same).

466 Examples of such cases include: In re Stewart, 109 B.R. 998 (D. Kan. 1990); In re Makarchuk, 76 B.R. 919 (Bankr. N.D.N.Y. 1987). For other reasons, decisions requiring minimum payments to unsecured creditors beyond those required by the ability to pay or best interest of the creditors tests are obsolete. *See* Education Assistance Corp. v. Zellner, 827 F.2d 1222 (8th Cir. 1987); In re Owens, 82 B.R. 960 (Bankr. N.D. Ill. 1998). *See generally* § 12.3, *supra.*

467 Some courts have held, however, that a nondischargeable student loan debt continues to accrue interest during the life of the plan. *See* note 410, *supra.*

468 *See generally* § 12.4, *supra.*

creditor does not "discriminate unfairly" within the meaning of 11 U.S.C. § 1322(b)(1).[469] At least one court has held that there is a reasonable basis for the separate classification both because the debt is nondischargeable and because absent payment the debtor may be unable to return to school to obtain a degree.[470] And even if separate classification is not permitted, the debtor has the absolute right to provide in the plan for a cure of all defaulted payments and maintenance of current payments under Code section 1322(b)(5) if the loan's last payment is after the plan's last payment.[471]

14.4.3.8.5 Health education assistance loans and other special loan programs

Congress created an additional student loan exception to discharge for certain student loans in the Omnibus Budget Reconciliation Act of 1981. Section 292f(g) of title 42, U.S. Code[472] provides that no bankruptcy discharge may be granted as to a Health Education Assistance Loan ("HEAL") within seven years after the date repayment is to begin. During this seven year period no hardship discharge is available for such loans.[473] Even after the seven years, the loan is dischargeable only if the bankruptcy court finds that denial of a discharge would be unconscionable.[474] This nondischargeability provision has been held to apply in chapter 13 as well as in chapter 7.[475] Because the provision contains language making discharge available after seven years based on unconscionability, a discharge should be possible in a chapter 13 case that is filed within seven years of the first repayment due date, if the discharge is not entered until after the seven-year period has expired.[476] Several courts have held that in the context of a chapter 13 plan, the student loan creditor can be treated like other unsecured creditors and that a determination as to discharge can only be made at the conclusion of the plan.[477] Moreover, based on the language of section 523(b), HEAL loans may be dischargeable in a second bankruptcy filing under the more lenient standards of section 523(a) if the prior case resulted in a discharge.[478]

As with section 523(a)(8), the provision making HEAL debts nondischargeable is self-executing. The burden is on the debtor to request and establish grounds for a court to find the loan dischargeable.[479] Courts have held that nondischarge of the loan would be unconscionable if it was "excessive, exorbitant," "lying outside the limits of what is reasonable or acceptable," "shockingly unfair, harsh, or unjust" or "outrageous."[480]

Several other health education programs have similar provisions which make debts arising in those programs nondischargeable.[481] Generally the operation of these provisions is similar to that of the HEAL provisions.

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469 In re Cox, 186 B.R. 744 (Bankr. N.D. Fla. 1995); In re Boggan, 125 B.R. 533 (Bankr. N.D. Ill. 1991); In re Freshley, 69 B.R. 96 (Bankr. N.D. Ga. 1987). Similarly, separate classification of nondischargeable debts for support arrearages have been allowed. *E.g.*, In re Leser, 939 F.2d 669 (8th Cir. 1991); In re Storberg, 94 B.R. 144 (Bankr. D. Minn. 1988); In re Davidson, 72 B.R. 384 (Bankr. D. Colo. 1987). *But see* In re Groves, 39 F.3d 212 (8th Cir. 1994) (affirming bankruptcy court's refusal to permit separate classification).

470 In re Freshley, 69 B.R. 96 (Bankr. N.D. Ga. 1987). See also § 12.4, *supra* for additional discussion of classification of claims.

471 In re Chandler, 210 B.R. 898 (Bankr. D.N.H. 1997); In re Sullivan, 195 B.R. 649 (Bankr. W.D. Tex. 1996); In re Benner, 156 B.R. 631 (Bankr. D. Minn. 1993).

472 This section replaces the former applicable provision, 42 U.S.C. § 294f(g).

473 In re Hampton, 47 B.R. 47 (Bankr. N.D. Ill. 1985). However, for bankruptcy cases commenced prior to the statute's amendment changing the five-year nondischargeability period to seven years, the five-year period is still applicable. In re Barrows, 159 B.R. 86 (Bankr. D.N.H. 1993).

474 42 U.S.C. § 292f(g).

475 Matter of Johnson, 787 F.2d 1179 (7th Cir. 1986).

476 In re Nelson, 183 B.R. 972 (Bankr. S.D. Fla. 1995) (also holding that under § 292f(g), the time period was not tolled during forbearance periods).

477 United States v. Lee, 89 B.R. 250 (N.D. Ga. 1987), *aff'd*, 853 F.2d 1547 (11th Cir. 1988) (debt is conditionally dischargeable during pendency of chapter 13 plan); In re Cleveland, 89 B.R. 69 (B.A.P. 9th Cir. 1988) (upon completion of chapter 13 plan, issue would be whether nondischarge of loan would be unconscionable); In re Battrell, 105 B.R. 65 (Bankr. D. Or. 1989); In re Owens, 82 B.R. 960 (Bankr. N.D. Ill. 1988). *See also* In re Gronski, 65 B.R. 932 (Bankr. E.D. Pa. 1986).

478 In re Tanski, 195 B.R. 408 (Bankr. E.D. Wis. 1996).

479 United States v. Wood, 925 F.2d 1580 (7th Cir. 1991). *See also* United States v. Erkard, 200 B.R. 152 (N.D. Ohio 1996) (United States, as guarantor of HEAL obligation must be made a party to dischargeability proceeding).

480 In re Rice, 78 F.3d 1144 (6th Cir. 1996) (nondischarge of HEAL obligation not unconscionable when debtor and his wife had $60,000 income and payment would not reduce family's income to anything close to poverty level); Matthews v. Pineo, 19 F.3d 121 (3d Cir.), *cert. denied*, 513 U.S. 820, 115 S. Ct. 82 (1994) (nondischarge not unconscionable when debtor chose to move to a small town and earn less than she could elsewhere as physician, rather than fulfill requirement of service in medically underserved area); In re Malloy, 155 B.R. 940 (E.D. Va. 1993) (nondischarge not unconscionable in case of debtor who was healthy, college educated and steadily employed); In re Nelson, 183 B.R. 972 (Bankr. S.D. Fla. 1995) (nondischarge would be unconscionable based on debtor's psychological and emotional health); Kline v. United States, 155 B.R. 762 (Bankr. W.D. Mo. 1993) (nondischarge would be unconscionable in view of debtor's chronic depression, anxiety and panic disorder).

481 In re Brown, 79 B.R. 789 (Bankr. N.D. Ill. 1987) (National Health Services Corp. Scholarship Program—42 U.S.C. § 254o(d)). *See also* 37 U.S.C. § 302g(e) (pertaining to refund obligations of military reservist physicians who receive special pay and who terminate their service early). Unlike HEAL loans, these provisions have not been amended to change the five year absolute bar on discharge to seven years.

14.4.3.8.1 Student loan dischargeability tests

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14.4.3.8.1.1 Former seven year test

Addition to notes 417, 418.

417 The official and Lawyers' Edition citations for denial of certiorari in the *Hiatt* case are 513 U.S. 1154, 130 L. Ed. 2d 1074.

418 The official and Lawyers' Edition citations for denial of certiorari in In re Woodcock are 516 U.S. 828, 133 L. Ed. 2d 52.

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14.4.3.8.1.2 Undue hardship test

Addition to note 429.

429 *But see* In re Crowley, 259 B.R. 361 (Bankr. W.D. Mo. 2001) (8th Circuit uses more flexible totality of circumstances test).

Add to text immediately before signal for note 430:

Generally speaking, debtors with incomes lower than $25,000 are found to be at a minimal standard of living.

Addition to note 430.

430 *See also* In re Cline, 248 B.R. 347 (B.A.P. 8th Cir. 2000) (single woman in good health who earned $25,000 and is unlikely to earn more granted discharge); In re Pena, 155 F.3d 1108 (9th Cir. 1998) (discharge granted to childless couple with income of $20,976); In re Nary, 253 B.R. 752 (N.D. Tex. 2000) (income of $48,000 for family of five, though 2.2 times poverty standard, would justify discharge based on family expenses if it could not be increased); In re Coulson, 253 B.R. 174 (W.D.N.C. 2000) (mother and two children with income of $23,975 could not repay loans); In re Ivory, 269 B.R. 890 (Bankr. N.D. Ala. 2001) (citing studies showing that income far higher than poverty level is needed for minimal standard of living).; In re Turretto, 255 B.R. 884 (Bankr. N.D. Cal. 2000) (debtor with one child in her care could not repay loans with income of over $25,000).

Add to text at end of sentence containing note 430:

, but debtors need not be at the poverty level to demonstrate undue hardship. Most debtors who have been denied an undue hardship discharge had incomes several times greater than the poverty level.[430.1]

430.1 *E.g.*, In re Roberson, 999 F.2d 1132 (7th Cir. 1993) (court found debtor could earn over $30,000).

Add to text after sentence containing note 432:

Debtors who do not demonstrate that they are not likely to earn significantly more in the future are often denied discharge of their loans.[432.1]

432.1 *E.g.*, Goulet v. Educational Credit Management Corp., 284 F.3d 773 (7th Cir. 2002) (record devoid of evidence that debtor's problems with alcoholism and a felony conviction prevented debtor from being gainfully employed); In re Rifino, 245 F.3d 1083 (9th Cir. 2001) (debtor had Masters degree and was already earning over $27,000 with additional increases likely); In re Brightful, 267 F.3d 324 (3d Cir. 2001) (debtor who did not introduce evidence showing why she could not use her skills as legal secretary to earn more income denied discharge of loan).

Addition to notes 433, 439, 441, 443.

433 In re Brown, 239 B.R. 204, 209 (S.D. Cal. 1999) and cases cite therein; In re Ivory, 269 B.R. 890 (Bankr. N.D. Ala. 2001) (no bad faith when debtor never had ability to repay loan); In re Turretto, 255 B.R. 884 (Bankr. N.D. Cal. 2000).

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439 In re Saxman, 263 B.R. 342 (W.D. Wash. 2001) (partial discharge).

441 In re Pincus, 280 B.R. 303 (Bankr. S.D.N.Y. 2001) (no language in § 523(a)(8) permits granting of partial discharge).

443 In re Wallace, 259 B.R. 170 (C.D. Cal. 2000) (remand for further proceedings on impact of ICRP; debtor's lack of diligence in pursing payment plans, even those presented for first time during discharge proceedings, may prove lack of good faith effort to repay the loans).

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Add to text following sentence containing note 444:

Other courts have recognized that placing a debtor in a twenty-five-year repayment plan that is not likely to pay off, or sometimes even reduce, the loan does not mitigate the undue hardship the loan would cause.[444.1] Payments must be made if the debtor's income is even slightly above poverty level, which still does not afford a minimal standard of living.[444.2] The income contingent repayment plan actually allows the loan balance to go up, with capitalization of some interest and does not prevent the discharge of a remaining balance after twenty-five years from being deemed taxable income to the debtor.[444.3]

444.1 In re Long, 271 B.R. 322 (B.A.P. 8th Cir. 2002).

444.2 *See* n.430, *supra*. *See also* In re Ford, 269 B.R. 673 (B.A.P. 8th Cir. 2001) (availability of ICRP is merely one factor considered in totality of circumstances test and not determinative in case where ICRP would result in 62-year-old woman with arthritic condition carrying large and increasing debt that would not be forgiven until she was 87 years old).

444.3 *See* 34 C.F.R § 685.209(c) (5); National Consumer Law Center, Student Loan Law § 8.2.2.6 (2d ed. 2002 and Supp.)

14.4.3.8.2 Procedure for dischargeability determination

Addition to notes 447, 450, 451.

447 *The official citation for denial of certiorari in In re Innes is*: 529 U.S. 1037. *Add*: *See also* In re Lees, 264 B.R. 884 (W.D. Tenn. 2001) (student loan agency was not arm of state entitled to immunity).

450 Standifer v. Alaska, 3 P.3d 925 (Alaska 2000) (debtor could move to vacate postbankruptcy default judgment on student loan to obtain determination of undue hardship dischargeability).

451 *See* In re Kapsin, 265 B.R. 778 (Bankr. N.D. Ohio 2001) (refusing to reopen case to consider changed circumstances alleged to cause undue hardship).

Add to text at the end of subsection:

A few courts have read section 523(a)(8) to provide that a student loan is not dischargeable unless a court has determined that it is dischargeable.[453.1] While, as a practical matter, student loan creditors will continue collection efforts absent such a determination, the language of section 523(a)(8) clearly provides that a loan is dischargeable if it meets the undue hardship test; it does not provide the loan is nondischargeable until a court finds otherwise. Like tax debts, student loans are either discharged or not discharged depending solely upon whether they fit the description in section 523(a).[453.2] Unlike the dischargeability provisions listed in section 523(c), there is no requirement that a proceeding be brought before the bankruptcy case is concluded.

453.1 *See, e.g.*, In re Janc, 251 B.R. 525 (Bankr. W.D. Mo. 2000) (erroneously holding that discharge of student loan not effective unless *and until* a court has determined undue hardship exists).

453.2 *See* Collier on Bankruptcy ¶ 4007.03.

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14.4.3.8.4 Special issues regarding student loans in chapter 13

Addition to note 458.

458 *But see* Banks v. Sallie Mae Servicing Corp., 299 F.3d 296 (4th Cir. 2002) (confirmed plan providing for discharge of postpetition interest violated student loan creditor's due process rights when creditor not served with adversary complaint and summons).

Add note 461.1 after the word "any time" in sentence before sentence containing note 462.

461.1 In re Ekenasi, 271 B.R. 256 (S.D. W. Va. 2002) (debtor need not wait until end of chapter 13 plan to bring dischargeability proceeding).

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Addition to note 471.

471 *Add at end of note*: *But see* In re Labib-Kiyarash, 271 B.R. 189 (B.A.P. 9th Cir. 2001) (use of § 1322(b)(5) subject to debtor showing that classification is fair under § 1322(b)(1)); In re Thibodeau, 248 B.R. 699 (Bankr. D. Mass. 2000).

14.4.3.8.5 Health education assistance loans and other special loan programs

Addition to note 480.

480 *See also* In re Ascue, 268 B.R. 739 (Bankr. W.D. Va. 2001) (partial discharge, eliminating $300,000 in interest on National Health Service Corps loan for debtor whose earnings were limited).

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14.4.3.9 Debts Incurred Through Drunk Driving—11 U.S.C. § 523(a)(9)

Add note 483.1 to end of sentence following sentence containing note 483.

483.1 *See* In re Longhenry, 246 B.R. 234 (Bankr. D. Md. 2000) (loss of consortium is a personal injury).

Addition to notes 488, 489.

488 *See also* In re Barnes, 266 B.R. 397 (B.A.P. 8th Cir. 2001) (discussing admissible evidence of intoxication).

ISSUES UNDER BANKRUPTCY MEANS TESTING

Hon. Eugene R. Wedoff
Chief U.S. Bankruptcy Judge
Northern District of Illinois at Chicago
Chicago, Illinois

SECTION G

ISSUES UNDER BANKRUPTCY MEANS TESTING

The H.R. 975 Means Test: Impact on Consumer Bankruptcy

1. Goal
2. Mechanism
3. Actual effect

1.The Goal of the Means Test

- "[If] repayment is possible by an individual . . . then he or she will be channeled into chapter 13 of the bankruptcy code which requires people to repay a portion of their debt as a precondition for limited debt cancellation. The bill does this by providing a means test to steer filers who can repay a portion of their debts away from chapter 7 bankruptcy." Remarks of Senator Charles Grassley, initiating floor debate on S. 420 (3/5/01).

2. The Mechanism of the Means Test

- **Fits into a new § 707(b) of the Code**
- Employs a 3-step abuse presumption
- Limits rebuttal of presumption
- Creates new duties for debtors' counsel and case trustees

2. The Mechanism of the Means Test

- Fits into a new § 707(b) of the Code (grounds for dismissal of a Chapter 7 case)

2. The Mechanism of the Means Test

- Fits into a new § 707(b) of the Code
  - "Abuse," not "substantial abuse"
  - Bad faith and "totality of circumstances" stated as grounds of abuse
  - General standing if debtor's income is above the median

Standing under the New §707(b)

	Debtor's income at or below applicable median	Debtor's income greater than applicable median
General grounds: bad faith, totality of circumstances	Judges, U.S. Trustee only (like current law)	All parties in interest
The means-test presumption of abuse	Nobody at all	All parties in interest

2. The Mechanism of the Means Test

- Fits into a new § 707(b) of the Code
  - "Abuse," not "substantial abuse"
  - Bad faith and "totality of circumstances" stated as grounds of abuse
  - General standing if debtor's income is above the median
  - Option of conversion to Chapter 13

2. The Mechanism of the Means Test

- Fits into a new § 707(b) of the Code
- **Employs a 3-step abuse presumption**
- Limits rebuttal of presumption
- Creates new duties for debtors' counsel and case trustees

2. The Mechanism of the Means Test

- The means test is designed to create a presumption that a Chapter 7 case is an abuse wherever the debtor appears to have sufficient income to pay substantial amounts of general unsecured debt. To determine whether the presumption applies, three steps are required.

2. The Mechanism of the Means Test

- The 3 steps:
  - 1. Calculate "current monthly income"
  - 2. Subtract allowed deductions
  - 3. Compare result to trigger points

2. The Mechanism of the Means Test

- The 3 steps:
  - 1. Calculate "current monthly income"
    - NOT the debtor's current income

2. The Mechanism of the Means Test

- The 3 steps:
  - 1. Calculate "current monthly income"
    - Debtor's 6-month average income But what 6 months?

2. The Mechanism of the Means Test

- The 3 steps:
  - 1. Calculate "current monthly income"
    - Debtor's 6-month average income
      If the debtor files a "schedule of current income"—
  The 6 calendar months preceding filing

2. The Mechanism of the Means Test

- The 3 steps:
  - 1. Calculate "current monthly income"
    - Debtor's 6-month average income
      Without filing a "schedule of current income"— "the 6-month period ending on the date on which current income is determined by the court"

2. The Mechanism of the Means Test

- The 3 steps:
  - 1. Calculate "current monthly income"
    - Debtor's 6-month average income
    - + regular contributions to expenses
    - - Social Security benefits
    - - victim payments (war crimes, international or domestic terrorism)

2. The Mechanism of the Means Test

- The 3 steps:
  - 1. Calculate "current monthly income"
    - Debtor's 6-month average income
    - + regular contributions to expenses
    - - Social Security benefits
    - - victim payments
    - = "current monthly income"

2. The Mechanism of the Means Test

- The 3 steps:
  - 2. Subtract allowed deductions:
    - Living expenses (IRS standards)
      - National (food, clothing, personal)
        an absolute allowance

2. The Mechanism of the Means Test

- The 3 steps:
  - 2. Subtract allowed deductions:
    - Living expenses (IRS standards)
      - National (food, clothing, personal)
      - Local (housing and transportation)
        only a cap on actual expenses?

2. The Mechanism of the Means Test

- The 3 steps:
  - 2. Subtract allowed deductions:
    - Living expenses (IRS standards)
      - National (food, clothing, personal)
      - Local (housing and transportation)
        "amounts specified under the . . . Local Standards"

2. The Mechanism of the Means Test

- The 3 steps:
  - 2. Subtract allowed deductions:
    - Living expenses (IRS standards)
      - National (food, clothing, personal)
      - Local (housing and transportation)
      - Other Necessary (misc. expenses)
        actual expenses, not "reasonable"

2. The Mechanism of the Means Test

- The 3 steps:
  - 2. Subtract allowed deductions:
    - Living expenses (IRS standards)
      - National (food, clothing, personal)
      - Local (housing and transportation)
      - Other Necessary (misc. expenses)
        but only in specified categories

2. The Mechanism of the Means Test

- The 3 steps:
  - 2. Subtract allowed deductions:
    - Living expenses (IRS standards)
      - National (food, clothing, personal)
      - Local (housing and transportation)
      - Other Necessary (misc. expenses)
      - Adjustments: + 5% food/clothing

2. The Mechanism of the Means Test

- The 3 steps:
  - 2. Subtract allowed deductions:
    - Living expenses (IRS standards)
      - National (food, clothing, personal)
      - Local (housing and transportation)
      - Other Necessary (misc. expenses)
      - Adjustments: + care of invalids

2. The Mechanism of the Means Test

- The 3 steps:
  - 2. Subtract allowed deductions:
    - Living expenses (IRS standards)
      - National (food, clothing, personal)
      - Local (housing and transportation)
      - Other Necessary (misc. expenses)
      - Adjustments: + heating costs

2. The Mechanism of the Means Test

- The 3 steps:
  - 2. Subtract allowed deductions:
    - Living expenses (IRS standards)
      - National (food, clothing, personal)
      - Local (housing and transportation)
      - Other Necessary (misc. expenses)
      - Adjustments: + domestic violence

2. The Mechanism of the Means Test

- The 3 steps:
  - 2. Subtract allowed deductions:
    - Living expenses (IRS standards)
      - National (food, clothing, personal)
      - Local (housing and transportation)
      - Other Necessary (misc. expenses)
      - Adjustments: + kids' education

2. The Mechanism of the Means Test

- The 3 steps:
  - 2. Subtract allowed deductions:
    - Living expenses (IRS standards)
      - National (food, clothing, personal)
      - Local (housing and transportation)
      - Other Necessary (misc. expenses)
      - Adjustments: *$125/kid<18/month*

2. The Mechanism of the Means Test

- The 3 steps:
  - 2. Subtract allowed deductions:
    - Living expenses (IRS standards)
      - National (food, clothing, personal)
      - Local (housing and transportation)
      - Other Necessary (misc. expenses)
      - Adjustments: - debt repayment

2. The Mechanism of the Means Test

- The 3 steps:
  - 2. Subtract allowed deductions:
    - Living expenses (IRS standards)
    - Secured debt (1/60 of 5-yr payments) *arreages only if critical property*

2. The Mechanism of the Means Test

- The 3 steps:
  - 2. Subtract allowed deductions:
    - Living expenses (IRS standards)
    - Secured debt (1/60 of 5-yr payments)
    - Priority debt (1/60 of 5-yr payments)
    - Charitable donations (up to 15% gross)
    - Ch. 13 fees (up to 10% of payments)

2. The Mechanism of the Means Test

- The 3 steps:
  - 2. Subtract allowed deductions:
    - Living expenses (IRS standards)
    - Secured debt (1/60 of 5-yr payments)
    - Priority debt (1/60 of 5-yr payments)
    - Charitable donations (up to 15% gross)
    - Ch. 13 fees—*counting mortgages?*

2. The Mechanism of the Means Test

- The 3 steps:
  - 3. Compare result to trigger points:
    - $166.67 or more, presumed abusive
    - $100 to $166.66, maybe presumed abusive— *if enough to pay 25% of general unsecured claims over 5 years (so, claims of $24 - 40,000)*

2. The Mechanism of the Means Test

- The 3 steps:
  - 3. Compare result to trigger points:
    - $166.67 or more, presumed abusive
    - $100 to $166.66, maybe presumed abusive
    - $99.99 or less, not presumed abusive

2. The Mechanism of the Means Test

- Fits into a new § 707(b) of the Code
- Employs a 3-step abuse presumption
- **Limits rebuttal of presumption**
- Creates new duties for debtors' counsel and case trustees

2. The Mechanism of the Means Test

- Limits rebuttal of presumption
  - Debtor must show "special circumstances that justify additional expenses or adjustments of current monthly income for which there is no reasonable alternative."

2. The Mechanism of the Means Test

- Limits rebuttal of presumption
  - Debtor must "itemize each additional expense or adjustment of income"

2. The Mechanism of the Means Test

- Limits rebuttal of presumption
  - Debtor must "provide documentation for such expense or adjustment to income and a detailed explanation of the special circumstances that make such expenses or adjustment to income necessary and reasonable."

2. The Mechanism of the Means Test

- Limits rebuttal of presumption
  - Debtor must "attest under oath to the accuracy of any information provided to demonstrate that additional expenses or adjustments to income are required."

2. The Mechanism of the Means Test

- Limits rebuttal of presumption
  - The additional expenses or adjustments to income must bring the debtor's income less deductions to below the applicable trigger point.

2. The Mechanism of the Means Test

- Fits into a new § 707(b) of the Code
- Employs a 3-step abuse presumption
- Limits rebuttal of presumption
- **Creates new duties for debtors' counsel and case trustees**

2. The Mechanism of the Means Test

- Creates new duties for debtors' counsel and case trustees

2. The Mechanism of the Means Test

- The debtor "shall include a statement of the debtor's current monthly income, and the calculations that determine whether a presumption arises under [under the means test, and] that shows how each such amount is calculated."

2. The Mechanism of the Means Test

- The debtor's attorney must certify the accuracy of the financial information provided by the debtor, subject to monetary penalties.

2. The Mechanism of the Means Test

- The UST must review all materials submitted by the debtor, and, within 10 days after the §341 meeting, file a statement with the court as to whether the debtor's case raises a presumption of abuse.
  - *This will be the case trustees' job.*

2. The Mechanism of the Means Test

- "[N]ot later than 5 days after receiving a statement under subparagraph (A), the court shall provide a copy of the [presumption] statement to all creditors."

2. The Mechanism of the Means Test

- If the presumption applies, and if the debtor's income is at or above the applicable median, then, within 30 days after filing the presumption statement, the UST must file either a §707(b) motion or a statement explaining why such a motion is not being filed.
  - *This will be the case trustees' job.*

2. The Mechanism of the Means Test

- No additional compensation for statements.
- No additional compensation for unsuccessful §707(b) motions.
- For successful §707(b) motions, payment from debtor's attorney only if Rule 9011 violation.
- Payment from debtor treated only if case proceeds in Chapter 13 (§ 1224 of Act), prorated over term of plan.

3.The Actual Effect of the Means Test

- Few cases of presumed abuse under the means test.
- New § 707(b) depending more on "totality of circumstances" than on the means test.
- Consumer bankruptcy more expensive for all participants.
- Chapter 7 trustees undercompensated.
- Greater power and responsibility for U.S. Trustee.

3.The Actual Effect of the Means Test

- Few cases of presumed abuse under the means test.
- New § 707(b) depending more on "totality of circumstances" than on the means test.
- Consumer bankruptcy more expensive for all participants.
- Chapter 7 trustees undercompensated.
- Greater power and responsibility for U.S. Trustee.
- "Disposable income" in Chapter 13 limited

Sample Application of § 707(b)(2) Means Test

Hypothetical debtor:

Head of household, annual household income $120,000 ("Current Monthly Income" is $10,000) married with 2 children, living in Wheaton, Illinois (moderately upscale Chicago suburb)

Assets: $500,000 home
One $35,000 automobile
One $20,000 automobile

Children attend private school

Deductions:

IRS Defined Costs

IRS National Standard (food, clothing, personal care, entertainment)	$ 1497		
5% extra for food and clothing	57		
IRS Local Standard housing	1941		
IRS Local Standard transportation ownership costs	756		
IRS Local Standard transportation operating costs	370		
Total IRS Defined Costs		$ 4621	
IRS Other Necessary Expenses			
Child care	500		
Taxes (income and property)	3000		
Health care	250		
Life insurance	250		
Total IRS Other Necessary Expenses		4000	
Chapter 13 expenses		355	10% of secured debt payment
Children's education		200	
Secured debt (mortgage)	2500	2000	offsets local standard
Secured debt (car loans)	1050	330	offsets local standard
TOTAL DEDUCTIONS		**$11506**	

SORRY COUNSEL, YOU SIGNED IT: ETHICS, RULE 9011, AND INADEQUATE FILINGS

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SECTION H

SORRY COUNSEL, YOU SIGNED IT: ETHICS, RULE 9011, AND INADEQUATE FILINGS

Sorry Counsel, You Signed It: Ethics, Rule 9011, and Inadequate Filings*

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I. Standards for Imposing Sanctions.

Bankruptcy Rule 9011 requires an attorney for a represented party to sign every paper filed in a bankruptcy case "except a list, schedule, or statement, or amendments thereto." Bankruptcy Rule 9011(a). The exception has led some courts to question whether the rule applies to a debtor's counsel when misrepresentations are made in the debtor's schedules and statement of affairs.[1] But subpart (b) of Rule 9011, as amended in 1997, provides for sanctions not only with respect to documents signed by an attorney, but also documents he "presents" by "filing" or "later advocating." Bankruptcy Rule 9011(b). Courts have relied on this language to hold counsel accountable for inaccuracies and misstatements in schedules.[2]

The pending Bankruptcy Reform Act and its predecessors over the past few years have included a "sense of Congress" that Rule 9011 should be amended to require all documents, including schedules, to be submitted only after the debtor or debtor's attorney has made a reasonable inquiry to verify the information.[3] That proposed legislation implies that Rule 9011 does not currently empower the court to sanction the debtor's counsel for misleading schedules.[4] To the extent Rule 9011 is inapplicable, however, some courts have employed their "catch all" powers under Bankruptcy Code § 105 and inherent authority of the court to sanction misconduct, including with respect to

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[1] See In re Ostas, 158 B.R. 312, 319 (N.D.N.Y. 1993); In re Palumbo Family Ltd. Partnership, 182 B.R. 447, 475-76 (Bankr. E.D. Va. 1995); In re Engel, 246 B.R. 734, 788-89 (Bankr. M.D. Pa. 2000).

[2] See In re Kelley, 255 B.R. 783 (Bankr. N.D. Ala. 2000)

[3] S.420 § 319; H.R. 333 § 319, as passed by the Senate and House of Representatives.

[4] Kelley, 255 B.R. at 786.

bankruptcy schedules.[5]

The standards for imposition of sanctions are different under Bankruptcy Rule 9011 and under Code § 105. Rule 9011 provides that all documents within its scope require the lawyer's certification of proper purpose, warranted by law or a non-frivolous argument for extension or reversal of the law, and evidentiary factual support. Bankruptcy Rule 9011(b).[6] Sanctions accordingly require only a showing of objectively unreasonable conduct, or alternatively, a subjective determination of an improper purpose.[7]

In contrast, sanctions may be imposed under the inherent power of the court and Code § 105 only upon a finding of "bad faith."[8] This concept "contemplates a state of mind affirmatively operating with furtive design or ill will,"[9] or a "defiling of the very temple of justice."[10]

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[5] See In re Rimsat, Ltd., 212 F.3d 1039, 1048 (7th Cir. 2000)(affirming sanction under § 105 and Rule 9011); In re Bryson, 131 F.3d 601, 603 (7th Cir. 1997)(§ 105 permits punishment of conduct Rule 9011 cannot reach); In re Rainbow Magazine, 77 F.3d 278, 284-85 (9th Cir. 1996)(same); In re Clark, 223 F.3d 859, 864 (8th Cir. 2000); Engel, 246 B.R. at 789; Kelley, 255 B.R. at 786;

[6] If specifically identified, a factual contention may be designated as likely to have evidentiary support after a reasonable opportunity for further investigation or discovery and a denial be reasonably based on a lack of information or belief. Bankruptcy Rule 9011(b)(3), (4).

[7] In re Collins, 250 B.R. 645, 661-62 (Bankr. N.D. Ill. 2000)(extensive citations); In re Mahendra, 131 F.3d 750, 759 (8th Cir. 1997) (objective determination of whether a party's conduct was reasonable under the circumstances); In re Marsch, 36 F.3d 825, 830 (9th Cir. 1994)(consider frivolousness and improper purpose on a sliding scale; the more compelling the showing as to one element, the less decisive need to show the other); Singer Furniture Acquisition Corp. v. SSMC, Inc., 254 B.R. 46, 59 (M.D. Fla. 2000) (need only show one of three alternatives: legally baseless, factually baseless, or improper purpose).

[8] Chambers v. NASCO, Inc., 501 U.S. 32, 44, 111 S.Ct. 2123, 2135 (1991). The finding need not be set forth explicitly in those "magic words", however. In re Rimsat, Ltd., 212 F.3d 1039, 1047 (7th Cir. 2000).

[9] Engel, 246 B.R. at 790, quoting BLACK'S LAW DICTIONARY 139 (6th ed. 1990).

[10] Goldin v. Bartholow, 166 F.3d 710, 722 (5th Cir. 1999); In re Smyth, 242 B.R. 352, 360-61 (W.D. Tex. 1999)(standard met by lie to court).

There are other sources for sanctions authority as well. Bankruptcy Rule 7037 sanctions failure to cooperate in discovery, and Bankruptcy Rule 7016 sanctions failure to comply with court scheduling and pretrial orders or cooperate in discovery and pretrial practice. 28 U.S.C. § 1927 also prohibits unreasonable and vexatious litigation.[11] Incompetent representation, not complying with the Bankruptcy Code and Rules, may also be sanctioned through denial of court approval of employment.[12] Obnoxious and abusive behavior toward opposing counsel, parties or the judge may likewise be sanctioned under Rule 9011 and the court's inherent authority.[13] The federal bankruptcy court must apply federal sanctions laws, however, not state counterparts.[14]

II. Ethical Obligations of Counsel for a Debtor Filing Documents.

Ethics rules are in accord with Rule 9011.[15] Ethically and legally, counsel can only advise the debtor, who makes the decisions.[16] But counsel exerts some or even

[11] See In re TCI Ltd., 769 F.2d 441 (7th Cir. 1985)(discussing Rule 9011 and 28 U.S.C. § 1927.

[12] In re Seeburg Products Corp., 215 B.R. 175 (Bankr. N.D. Ill. 1997).

[13] In re First City Bancorporation of Texas, Inc., 282 F.3d 864, 867 (5th Cir. 2002); In re 60 East 80th Street Equities, Inc., 218 F.3d 109, 116 (2d Cir. 2000) (bad faith and vexatiousness are evident from disparaging and unsubstantiated allegations impugning integrity of judge and trustee); In re Johnson, 236 B.R. 510, 519, 523 (D.D.C. 1999) (vituperative sanctions motion).

[14] In re Larry's Apartment, L.L.C., 249 F.3d 832, 837-38 (9th Cir. 2001).

[15] See Model Rule 3.1 (lawyer shall not bring or defend any action or assert or controvert an issue without non-frivolous basis for doing so including good faith argument for any position contrary to existing law); Model Rule 3.2 (make reasonable efforts to expedite litigation consistent with client interests); Model Rule 3.3 (lawyer shall not knowingly make false statement of material fact or law, fail to disclose material fact except as required by law, or fail to disclose legal authority in controlling jurisdiction); Model Rule 3.4 (lawyer shall not willfully obstruct another party's access to evidence; make a frivolous discovery request or fail to make reasonably diligent efforts to comply with proper discovery, allude to irrelevant material at trial, or obstruct others from giving relevant information to another party in most cases).

[16] Model Rule 1.2(a)("A lawyer shall abide by a client's decisions concerning the objectives of representation...."); Model Rule 1.4(b)("A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."); Model Rule 1.13(a)("A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents."); Bankruptcy Rule 9001(5). Hansen, Jones & Leta P.C. v. Segal, 220 B.R. 434 (D. Utah 1998); In re Rivers, 167 B.R. 288 (Bankr. N.D. Ga. 1994)(attorney may not make decisions for client, even if DIP is incompetent); see In re Sky Valley, Inc., 135 B.R.

considerable influence on bankruptcy strategy.[17] Counsel can and should develop "client control" through advising the client on the parameters of available alternatives and remedies, and not allowing a client to dictate activity in a case inconsistent with legal requirements.[18] Lawyers can and must take care to assure that representations to the court are accurate.[19]

Vigorous advocacy is ethical and appropriate in bankruptcy as in other cases, as long as it meets Rule 11 standards with a good faith basis for the facts and law asserted on positions taken for reasons other than harassment or delay. In Chapter 11 cases, good faith turns in part on whether reorganization is still possible.[20] Thus, acquiescing in and carrying out a client's "scorched earth" strategy or otherwise assisting insiders in actions detrimental to the estate and creditors, if it is shown that counsel knows reorganization is hopeless, likely would not meet the good faith standards of ethics and Bankruptcy Rule 9011.[21] Pursuing a plan that benefits insiders, at the considerable expense of the arms-length creditors, may also exceed the boundaries of good faith in some circumstances,

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925 (Bankr. N.D. Ga. 1992)(incumbent on DIP counsel to advise other DIP professionals of their responsibilities under Code and disclosures necessary to fulfill those responsibilities).

[17] In re SIDCO, Inc., 173 B.R. 194 (E.D. Cal. 1994); In re Brennan, 187 B.R. 135 (Bankr. D.N.J. 1995); In re Whitney Place Partners, 147 B.R. 619 (Bankr. N.D. Ga. 1992); In re Stamford Color Photo, Inc., 98 B.R. 135 (Bankr. D. Conn. 1989); In re Nephi Rubber Products Corp., 120 B.R. 477 (Bankr. N.D. Ill. 1990).

[18] In re Berg, 268 B.R. 250 (Bankr. D. Mont. 2001).

[19] In re Dreiling, 233 B.R. 848 (Bankr. D. Colo. 1999)(lawyer is officer of the court, and statements to the court are virtually made under oath).

[20] See Matter of Little Creek Development Co., 779 F.2d 1068 (5th Cir. 1986).

[21] See FE&B v. Charter Technologies, Inc., 57 F.3d 1215 (3d Cir. 1995); In re JLM, Inc., 210 B.R. 19 (2d Cir. BAP 1997); In re Marathon Home Loans, 101 B.R. 216, 222 (Bankr. E.D. Cal. 1989)(counsel for trustee wrongfully carrying out "scorched earth attrition" policy in Chapter 7 case; sanctions awarded under Rule 9011 even though each document objectively reasonable and not frivolous).

and be considered DIP self-dealing.[22] Acquiescing in DIP management self-dealing,[23] without any attempt at counseling and without full disclosure to the court and creditors of insider involvement in (and benefit from) transactions, is a breach of DIP counsel's duties.[24] Advocating a sale agreement with a "no shop" clause instead of seeking or entertaining other offers to maximize the estate's value, especially if the clause is not disclosed, violates fiduciary duties.[25]

A thorough analysis of the legal theories underpinning -- and delimiting -- the fiduciary duties of DIP counsel is found in Hansen, Jones & Leta, P.C. v. Segal.[26] The court explains that DIP counsel's client is the DIP, not the "estate," and identifies the duties counsel owes to the DIP and to the court. The court further explains why DIP counsel does not owe duties to the DIP client's beneficiaries, the equity holders and creditors who have conflicting interests. The court holds that estate interests are protected when the court focuses on whether DIP counsel breached counsel's fiduciary

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[22]In re Humble Place Joint Venture, 936 F.2d 814 (5th Cir. 1991); In re Kendavis Industries International, Inc., 91 B.R. 742 (Bankr. N.D. Tex. 1988); In re Downtown Investment Club III, 89 B.R. 59 (9th Cir. B.A.P. 1988); In re Global International Airways Corp., 82 B.R. 520 (Bankr. W.D. Mo. 1988); In re Golden Recipe Chicken, Inc., 109 B.R. 692 (Bankr. W.D. Pa. 1990)(DIP's counsel, using estate assets, secured release of shareholder's personal liability); In re Rusty Jones, Inc., 134 B.R. 321 (Bankr. N.D. Ill. 1991); In re Bonneville Pacific Corp., 147 B.R. 803 (Bankr. D. Utah 1992) rev'd. in part Hansen, Jones & Leta P.C. v. Segal, 220 B.R. 434 (D. Utah 1998).

[23]A DIP's attorney or other agent also may not purchase or self-deal in estate assets, even at a fair price. 18 U.S.C. § 154; In re Lowry Graphics, Inc., 86 B.R. 74 (Bankr. S.D. Tex. 1988); In re Q.P.S., Inc., 99 B.R. 843 (Bankr. W.D. Tenn. 1989)(DIP's accountant prohibited from buying estate car); In re Exennium, 23 B.R. 782 (9th Cir. BAP 1982), rev'd. on other grounds 715 F.2d 1401 (9th Cir. 1993)(former DIP counsel barred from purchasing lease from trustee after conversion).

[24]In re JLM, Inc., 210 B.R. 19 (2d Cir. BAP 1997)(explaining findings needed to justify fee denial on basis that services were not reasonably likely to benefit estate); In re Cent. Florida Metal Fabrication, Inc., 207 B.R. 742 (Bankr. N.D. Fla. 1997); In re Wilde Horse Enterprises, Inc., 136 B.R. 830 (Bankr. C.D. Cal. 1991); See In re Seeburg Products Corp., 215 B.R. 175 (Bankr. N.D. Ill. 1997)(attorney incompetently handled questionable chapter 11 case).

[25]In re Big Rivers Elec. Corp., 233 B.R. 768 (Bankr. W.D. Ky. 1999)

[26]220 B.R. 434 (D. Utah 1998).

duty to the client DIP, violated Code obligations or failed to provide services that benefit the estate (instead of insiders). The rights and powers vested in creditors and other parties in interest provide further protection. Another excellent analysis of DIP and DIP counsel fiduciary duties is set forth in In re Water's Edge Ltd. Partnership.[27]

III. Sanctionable Filings in Bankruptcy Cases

A. Serial Cases

Courts all over the country have found multiple filings to frustrate secured creditor foreclosure efforts to be sanctionable by orders prohibiting additional filings by the same debtor or a related debtor holding the collateral.[28] Bankruptcy Code § 349(a) authorized the court to dismiss a bankruptcy case with prejudice, and Code § 109(g) prohibits individual and family farmer repeat filings within 180 days of a case dismissal for either willful failure to abide by court orders, or a voluntary dismissal after a stay relief request. Code § 109(g) underscores Congress' distaste for bad faith serial filings, and the public policy in favor of sanctions for such abuses. It does not preclude comparable or more severe relief for debtors falling outside its express provisions.[29] The

[27] 251 B.R. 250 (Bankr. D. Mass. 2000); see also ICM Notes, Ltd. v. Andrews & Kurth, L.L.P., 278 B.R. 117 (S.D. Tex. 2002).

[28] See, e.g. In re Casse, 198 F.3d 327 (2d Cir. 1999) (4th bankruptcy [chapter 13] dismissed as void when filed after injunction; extensive citations of cases from all circuits); In re Jolly, 143 B.R. 383 (E.D. Va. 1992), aff'd. Jolly v. Great Western Bank, 45 F.3d 426 (4th Cir. 1994) (seven filings by debtor or related parties over three years to forestall foreclosure; dismissal with prejudice upheld); Matter of Mitan, 168 B.R. 326 (Bankr. E.D. Mich. 1994) (five chapter 11 and 13 cases; dismissal with prejudice); Terio v. Great Western Bank, 166 B.R. 213 (S.D.N.Y. 1994), aff'd, 52 F.3d 310 (2d Cir. 1995) (warning that future filings without court permission were prohibited and could warrant sanctions); In re Stathatos, 163 B.R. 83 (N.D. Tex. 1993) (injunction of any future filings for 24 months upheld, where debtor filed 3 chapter 13 cases to hinder evictions).

[29] Jolly, 143 B.R. at 386-87.

Code's broad grant of equitable power in § 105 has also been cited as authority for such prohibitions on re-filing of bankruptcy cases.[30]

Not every serial filing is wrongful. The United States Supreme Court has held a serial filing of chapter 7 and chapter 13 cases is not categorically foreclosed.[31] The test for a bad faith filing is "whether a debtor is attempting to unreasonably deter and harass creditors or attempting to effect a speedy, efficient reorganization on a feasible basis."[32]

It is incumbent on bankruptcy counsel to know the law on bad faith serial filings. Counsel may be sanctioned along with her client when the bankruptcy case is found to be a bad faith serial filing.[33] A lawyer is not excused by purportedly not knowing this aspect of bankruptcy law.[34] The lawyer must "closely inquire and determine the true intent and honesty of purpose of the debtor's new petition and financial capacity to consummate a plan and overcome the prior reasons for termination of the stay and/or dismissal".[35] Counsel should undertake the easy task of checking for previous bankruptcies via Pacer, instead of simply accepting the client's representations of no previous filings.

B. Otherwise Legally Unsupportable Cases

Serial cases are not the only ones that may be filed in bad faith. First-time filers, too, may proceed solely to delay a creditor with no realistic possibility of reorganizing a debtor under Chapter 11, or file merely to resolve a two-party dispute. Section 707(b) of

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[30] E.g. Casse, 198 F.3d at 336-39.

[31] Johnson v. Home State Bank, 111 S.Ct. 2150, 2156 (1991).

[32] Marsch, 36 F.3d at 828.

[33] In re Jones, 41 B.R. 263, 268 (Bankr. C.D. Cal. 1984)(sanctions against attorney who filed six petitions for sole purpose of delaying secured creditor)

[34] See In re Hutton Valley Farms, 251 B.R. 522, 524 (Bankr. W.D. Mo. 2000) (lawyer's claim that he was not familiar with "new debtor syndrome" cases not a defense to sanctions).

[35] In re McFarland, 17 B.R. 242, 245 (Bankr. N.D. Ga. 1982); Model Rule 1.2(d).

the Code specifically authorizes the court to dismiss petitions by consumer debtors that are considered a "substantial abuse" of Code provisions. Counsel are ethically obliged not to file such petitions, and may be sanctioned for doing so.[36]

- **The Debtor Cannot Reorganize.** A chapter 11 case may be filed by a corporation whose charter has been revoked. Under state law, the corporation continues as a "body corporate" only for the limited purpose of winding up its affairs.[37] A revoked corporation may be a debtor, but it is only eligible for liquidation.[38] The *Prism* court analyzed the various decisions addressing bankruptcies of corporations with revoked charters and the relevant state statutes on rights of dissolved entities. It concluded that "[t]he Bankruptcy Court is not empowered to continue a corporation's existence through reorganization as a going concern when state law dictates that it no longer exists. . . State law provides, however, that after revocation a corporation may continue to act to preserve and pursue assets and claims and settle liabilities, and accordingly the Debtor may liquidate under the Bankruptcy Code, either via a liquidating Chapter 11 plan or under Chapter 7."[39] The debtor also may be unable to reorganize as a practical matter, having

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[36] See In re Maurice, 69 F.3d 830 (7th Cir. 1995); In re Lederman Enterprises, Inc., 997 F.2d 1321 (10th Cir. 1993)(counsel fees disallowed for bad faith chapter 11); In re Coones Ranch, Inc., 7 F.3d 740 (8th Cir. 1993)(same); In re Rainbow Magazine, Inc., 136 B.R. 545, 554 (9th Cir. BAP 1992)(caselaw re sanctions allocated between client and counsel according to their relative culpability); In re Villa Madrid, 110 B.R. 919 (9th Cir. BAP 1990) (attorney who knew or should have known petition was being filed in bad faith is liable for sanctions); In re Start the Engines, Inc., 219 B.R. 264, 271-72 (Bankr. C.D. Cal. 1998)($10,000 sanctions against attorney and client, jointly and severally).

[37] E.g. Fidelity Metals Corp. v. Risley, 175 P.2d 592, 594 (Cal. App. 1946) (statute is "self executing law"); Porter v. Tempa Min. & Mill. Co., 93 P.2d 741, 745 (Nev. 1939) (upon revocation, corporation is dead for all purposes except that it has a right for a period of years after the date of forfeiture of its charter to dispose of its property).

[38] In re Prism Properties, Inc., 200 B.R. 43 (Bankr. D. Ariz. 1996).

[39] 200 B.R. at 47.

no employees or operations or likelihood of rehabilitation.[40]

Sanctions may be imposed under Rule 9011 on counsel filing a chapter 13 case when the chapter 13 debtor is ineligible to proceed with his or her plan.[41] The integrity of the chapter 13 system rests in the first instance with the debtors' bar, and courts expect them to make responsible judgments about eligibility of debtors before filing chapter 13 petitions, in compliance with Rule 9011. The fact that a chapter 13 debtor is unable to confirm a plan does not necessarily mean the case was filed or pursued in bad faith, however, especially if the debtor otherwise complies with all Code requirements.[42]

- **Case Filed for Improper Purpose.** A chapter 7 case may have no reasonable basis to proceed, just like a reorganization. The estate may have no assets to protect, or no need to discharge debts, and be filed merely to serve a non-economic motive, generally delaying a creditor.[43] A bankruptcy case may be filed simply to forum-shop when undesirable results are reached in state court.[44] Or a "new debtor" entity may be created in to file a bad faith case.[45]

- **Solvent Estate.** When an estate is solvent, DIP fiduciary duties may preclude a bankruptcy filing at all. Insolvency and inability to pay debts are not

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[40] In re Computer Dynamics, Inc., 252 B.R. 50, 61 (Bankr. E.D. Va. 1997); Singer Furniture Acquisition Corp. v. SSMC Inc. N.V., 254 B.R. 46, 52 (M.D. Fla. 2000).

[41] In re Smith, 234 B.R. 852 (Bankr. M.D. Ga. 1999); see also In re Jones, 41 B.R. 263 (Bankr. C.D. Cal. 1984).

[42] In re McNichols, 258 B.R. 892, 902 (Bankr. N.D. Ill. 2001).

[43] In re Primestone Investment Partners L.P., 272 B.R. 554 (D. Del. 2002) (totality of circumstances shows patently abusive case); In re Addon Corp., 231 B.R. 385, 389 (Bankr. N.D. Ga. 1999) (corporate debtor ineligible for discharge, no assets to protect, seeking only to delay eviction from terminated lease); In re Collins, 250 B.R. 645, 657 (Bankr. N.D. Ill. 2000); In re Hutton Valley Farms, 251 B.R. 522 (Bankr. W.D. Mo. 2000) (debtor formed just before filing to hold land and delay foreclosure).

[44] In re Singer Furniture Acquisition Corp., 261 B.R. 745, 750 (Bankr. M.D. Fla. 2001); In re Y.J. Sons & Co., Inc., 212 BR. 793 (D.N.J. 1997).

prerequisites for bankruptcy relief under the Code.[46] However, bankruptcy cannot be a mere tactical device for litigation leverage. If a solvent debtor is not suffering any adverse financial or operational effects, a bankruptcy petition may be deemed filed in bad faith, under chapter 11 or 7.[47] Even if the filing is proper, a solvent DIP may not use avoidance powers to obtain a windfall for the equity holders at the expense of the non-insider creditors.[48]

C. Inadequate Schedules

In addition to Bankruptcy Rule 9011 requirements, counsel is obligated both ethically and as an officer of the court not to file schedules and other disclosure documents he believes inaccurate.[49] Thus, courts have cautioned that before filing a petition, schedules, etc., it is incumbent upon counsel to "take all possible steps to assure himself that the information listed in his client's petition is correct . . . inquire as to amounts owed [secured by any assets] and to explain the requirements of full disclosure . . . ."[50] This means that a lawyer cannot simply accept his client's statement that he does

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[45] In re Guaranteed Retirement, 112 B.R. 263 (Bankr. N.D. Ill. 1990) (analyzing standards for determining when "new debtor" case is inappropriate).

[46] In re Stolrow's Inc., 84 B.R. 167, 171 (Bankr. 9th Cir. 1989).

[47] In re SGL Carbon Corp., 200 F.3d 154 (3d Cir. 1999); In re Smith, 257 B.R. 344 (Bankr. N.D. Ala. 2001); In re Collins, 250 B.R. 645, 657 (Bankr. N.D. Ill. 2000).

[48] Dunes Hotel Associates v. Hyatt Corp., 245 B.R. 492 (D. S.C. 2000).

[49] See § I, supra, regarding applicability of Rule 9011 to counsel with respect to schedules; Model Rules 1.2, 1.4, 8.4; In re Davila, 210 B.R. 727 (Bankr. S.D. Tex. 1996). The attorney likewise must take care not to file a disclosure statement overlooking known assets, or a plan counsel knows the debtor cannot fund. In re Ligon, 50 B.R. 127, 132 (Bankr. M.D. Tenn. 1985)(sanctions against attorney); In re Jones, 41 B.R. 263 (Bankr. C.D. Cal. 1984)(same, chapter 13); In re Bonneville Pacific Corp., 147 B.R. 803 (Bankr. D. Utah 1992) rev'd in part, Hansen, Jones & Leta v. Segal, 220 B.R. 434 (D. Utah 1998)(all fees ordered disgorged where DIP counsel found to have aided misconduct by insiders, and disclosure statement and plan were wholly irreconcilable with examiner's report, schedules and monthly reports). Counsel has also been sanctioned for misrepresentations in a final report, certifying that all administrative claims had been paid without verifying it. In re Kliegl Bros., 238 B.R. 531 (Bankr. E.D.N.Y. 1999).

[50] In re Engel, 246 B.R. 784, 791 (Bankr. W.D. Pa. 2000)(citing 1 NORTON BANKRUPTCY LAW & PRACTICE 2d § 27:25 at 27-76 (1998); In re Martinez, 22 B.R. 419, 421 (Bankr. D. N.M.

not know the value of an asset, but must ask follow-up questions.[51] Concepts such as "market value" entail legal judgments and the advice of experienced counsel.[52] Counsel must explain the matter to the extent necessary to permit the debtor client to make informed decisions about the information set forth in the schedules.[53]

Even if a lawyer is negligent in initially omitting an asset from schedules, he may be sanctioned if he has subsequent opportunities to review and correct them.[54] The obligation to correct errors in filed documents is a continuing duty.[55] A supervising attorney has a specific obligation to correct an assistant's failures, especially since a material error can support a conviction for bankruptcy fraud.[56] It is also critical that counsel not participate in deliberately scheduling assets for less than their known market value, or omitting creditors and claims.[57]

1982); In re Stebel, 54 B.R. 199 (Bankr. D. Vt. 1985). See In re Cossey, 172 B.R. 597 (Bankr. E.D. Ark. 1994)(counsel sanctioned for not fully disclosing insurance settlement on schedules). The lawyer cannot delegate schedule preparation entirely to a paralegal. In re Hessinger & Assoc., 192 B.R. 211 (N.D. Cal. 1996); In re Davila, 210 B.R. 727 (Bankr. S.D. Tex. 1996).

[51] In re Kelley, 255 B.R. 783, 785 (Bankr. N.D. Ala. 2000) (lawyer did not ask about value of a judgment, when a simple inquiry of the state court attorney would have elicited the judgment amount and the existence of $5,000 held in the attorney's trust account to pay it).

[52] In re Engel, 246 B.R. 784, 791 (Bankr. W.D. Pa. 2000) (citing Associates Commercial Corp. v. Rash, 520 U.S. 953, 117 S.Ct. 1879 (1997) on meaning of "value").

[53] Engel, 246 B.R. at 791 (citing Model Rule 1.4(b)).

[54] Engel, 246 B.R. at 790 (lawyer was asked for an opinion letter on impact of bankruptcy on debtor's ability to transfer unscheduled asset).

[55] Id.

[56] Engel, 246 B.R. at 784 (citing Model Rule 5.1(c)(2), 5.3 (c)(2)).

[57] Engel, 246 B.R. at 786-87 (belated attempt to schedule asset at negative book value day before selling for $50,000, and scheduling land at $58,000 despite awareness of $132,000 appraisal); In re Woodward, 229 B.R. 468, 472 (Bankr. N.D. Okla. 1999) (state litigation scheduled at $50,000 exemption limit, despite knowledge of $100,000 settlement offer); In re Moix-McNutt, 220 B.R. 631 (E.D. Ark. 1998)(attorney deliberately omitted creditor to conceal debtor's ineligibility for chapter 13). Knowingly filing false schedules also is criminal. 18 U.S.C. § 152; United States v. Webster, 125 F.3d 1024 (7th Cir. 1997)(aiding and abetting false schedules); United States v. Franklin, 837 F.Supp. 916 (N.D. Ill. 1993) (attorney advised client to shield assets through fake gambling scheme); Coughlan v. United States, 147 F.2d 233 (8th Cir.), cert. denied 325 U.S. 888, reh. denied 326 U.S. 805 (1945)(predecessor statute, concealing property by not listing or scheduling); Ruby v. United States, 61 F.2d 617 (6th Cir. 1932), cert. denied 288 U.S. 617

The duty to disclose assets on schedules includes disclosure of all potential causes of action.[58] That includes causes of action against the debtor's principals for negligence, mismanagement, and breach of fiduciary duty, when such a suit would be beneficial for the estate (albeit not the debtor's insiders).[59] Failure to disclose potential fraudulent transfer claims against insiders may be deemed a fraud on the court.[60]

While counsel has an obligation to encourage disclosure, the creditors should not have to pay more for an incompetent or deceptive debtor who thwarts disclosure, through shouldering increased counsel fees.[61] Courts have suggested guidelines for counsel working with debtors on disclosure to resolve this tension:

1. Explain the requirement of full, complete, accurate and honest disclosure of all information required of the debtor;

2. Ask probing and pertinent questions designed to elicit full, complete, accurate and honest disclosure from the debtor;

3. Check the debtor's responses in the petition, statements and schedules to be sure they are internally and externally consistent, and follow up if they are not; check readily available Pacer information for previous bankruptcies;

4. Demand of the client full, complete, accurate and honest disclosure of all information required by the debtor prior to the attorney's signature being placed upon the document, or before filing the client-signed document;

(1933)(same).

[58] Cusano v. Klein, 264 F.3d 936 (9th Cir. 2001)(list all causes of action that accrued prior to bankruptcy separately; "songrights" insufficient to schedule cause of action for prepetition royalties); In re Coastal Plains, Inc., 179 F.3d 197, 207-09 (5th Cir. 1999)(non-disclosure may judically estop estate from pursuing litigation); In re Guttman, 237 B.R. 643 (Bankr. E.D. Mich. 1999); In re Adeeb, 787 F.2d 1339 (9th Cir. 1986) (discharge denied unless full disclosure of fraudulent conveyance and recovery of property before filing).

[59] Louisiana World Exposition v. FDIC, 858 F.2d 233 (5th Cir. 1988); In re Microwave Products of America, Inc., 102 B.R. 666, 674 (Bankr. W.D. Tenn. 1989).

[60] In re R&R Associates of Hampton, 248 B.R. 1, 7-8 (Bankr. D. N.H. 2000).

[61] See In re Matthews, 154 B.R. 673 (Bankr. W.D. Tex. 1993); In re Huerta, 137 B.R. 356 (Bankr. C.D. Cal. 1992); In re Saturley, 131 B.R. 509 (Bankr. D. Me. 1991)(diligent and thorough effort to assist debtor in assembling, presenting and filing required date is part of counsel's job; expending large sums to test the accuracy and completeness through a title search is not appropriate).

5. Seek relief from the court of the client representation in the event that the attorney learns he has been misled by the client.[62]

The debtor's counsel should also take heed of objections and motions by creditors, which may disclose serious problems and concerns with the DIP's operations and representations to counsel.[63]

D. Compensation and Conflict Disclosures

There are far too many cases in which counsel have claimed to be disinterested when seeking court approval of employment as DIP counsel, without disclosing the ties of firm members to the debtor, its management, or the creditors. It is not for the DIP or its counsel to determine unilaterally whether a connection is relevant; the court is to review all connections and decide whether there are any disqualifying conflicts.[64] Disclosures must be sufficiently detailed to enable the court to understand the magnitude of the connections and potential conflicts, and must be strictly accurate.[65] An employment

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[62] In re Matthews, 154 B.R. at 680 and In re Huerta, 137 B.R. at 379:

[63] In re Alderson, 114 B.R. 672, 680 (Bankr. D. S.D. 1990)(duty of DIP counsel to ascertain and present debtor's true financial condition).

[64] Rome v. Braunstein, 19 F.3d 54 (1st Cir. 1994); In re Hathaway Ranch Partnership, 116 B.R. 208, 219 (Bankr. C.D. Cal. 1990); Matter of Arlan's Department Stores, 615 F.2d 925, 932 (2d Cir. 1979); Halbert v. Yousif, 225 B.R. 336 (E.D. Mich. 1998).

[65] In re Park-Helena Corp., 63 F.3d 877 (9th Cir. 1995) cert. denied, 116 S. Ct. 712 (1996)(failure to provide details of retainer payment; strict compliance with disclosure rules required); In re Cook, 223 B.R. 782 (10th Cir. BAP 1998)(creditor representation disclosed, but not contingency fee agreement); In re LSS Supply, Inc., 247 B.R. 280 (Bankr. D. Ariz. 2000)(failure to disclose connections with corporate insiders and control and multiple capacities of insiders with debtor); In re Filene's Basement, Inc., 239 B.R. 845 (Bankr. D. Mass. 1999)(accounting firm's prior representation and Chinese Wall disclosed, but not identity of parties, nature of litigation, or other facts alerting court of potential problem); In re Filene's Basement, Inc., 239 B.R. 850 (Bankr. D. Mass. 1999)(law firm's description of litigation and extent of attorney-client relationship with creditor misleading); In re Granite Partners, L.P., 219 B.R. 22 (Bankr. S.D.N.Y. 1998)(extent of representation and client restrictions not disclosed); In re Southmark Corp., 181 B.R. 291 (Bankr. N.D. Tex. 1995) (affidavit disclosed fact of prior services for creditor unrelated to debtor but not type of services or substantial compensation by creditor); In re Brennan, 187 B.R. 135 (Bankr. D.N.J. 1995)(description of types of information needed); In re Amdura Corp., 139 B.R. 963 (Bankr. D. Colo. 1992)(disclosure of creditor as client insufficient due to not disclosing magnitude of relationship); but see In re Missouri Mining, Inc., 186 B.R. 946 (Bankr. W.D. Mo. 1995)

application with full disclosure must be made for each professional firm employed; undisclosed subcontracting is impermissible.[66] Disclosure through the schedules and statement of affairs, an exhibit to the petition, testimony at the first meeting of creditors, or monthly operating report entries is inadequate. The court has no duty to search the file and ferret out information on conflicts.[67]

Disclosure is an ongoing responsibility. If potential conflicts arise after the initial application and disclosure, they should be brought to the court's attention promptly.[68]

Full disclosure of all aspects of fee arrangements is also required.[69] Even if an attorney limits her representation to prepetition advice or even petition preparation alone, a Rule 2016 statement must be filed.[70] The absence of full disclosure of fee payment arrangements in a chapter 13 case means the client's plan disclosures are likewise erroneous, impairing the client and creating a conflict.[71] Complete disclosure of

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(attorney promptly corrected erroneous disclosures and was not sanctioned); In re CIC Investment Corp., 175 B.R. 52 (9th Cir. BAP 1994) (court may excuse failure to disclose).

[66] In re United Companies Financial Corp., 241 B.R. 521 (Bankr. D.Del. 1999); In re Gulf Coast Orthopedic Center, 243 B.R. 135 (Bankr. M.D. Fla. 1999).

[67] Halbert v. Yousif, 225 B.R. 336, 351 (E.D. Mich. 1998); In re Smitty's Truck Stop, Inc., 210 B.R. 844, 849 (10th Cir. BAP 1997)..

[68] In re Lewis, 113 F.3d 1040, 1044-45 (9th Cir. 1997); In re Granite Partners, L.P., 219 B.R. 22 (Bankr. S.D.N.Y. 1998)(later-arising facts bearing on disinterestedness and adverse interest); In re Sauer, 222 B.R. 604 (8th Cir. BAP 1998); In re TJN, Inc., 194 B.R. 400 (Bankr. D.S.C. 1996)(disclose additional compensation received); In re Cropper Company, 35 B.R. 625 (Bankr.M.D. Ga. 1983)(after appointment, DIP began doing business with entity owned in part by associate in firm of DIP's attorney); In re Wingspread Corp., 152 B.R. 861 (Bankr. S.D.N.Y. 1993)(postpetition bank merger resulted in DIP counsel suing one subsidiary of bank while representing another).

[69] In re Kisseberth, 273 F.3d 714, 720-21 (6th Cir. 2001); In re Independent Engineering Co., Inc., 197 F.3d 13, 16-17 (1st Cir. 1999); In re Downs, 103 F.3d 472 (6th Cir. 1996); In re Park-Helena Corp., 63 F.3d 877, 880-81 (9th Cir. 1995) cert. denied, 116 S. Ct. 712 (1996)(strict compliance); In re Pierce, 809 F.2d 1356 (8th Cir. 1987); In re Arlans Departments Stores, Inc., 615 F.2d 925 (2d Cir. 1979).

[70] In re Fraga, 210 B.R. 812, 822 (9th Cir. BAP 1997); In re Basham, 208 B.R. 926, 932-33 (9th Cir. BAP 1997).

[71] In re Davila, 210 B.R. 727 (Bankr. S.D. Tex. 1996); see In re Bell, 212 B.R. 654, 657 (Bankr. E.D.Cal. 1997)(fee disclosure important in chapter 13 cases since court does not approve

prepetition payments "in connection with" and "in contemplation of" bankruptcy must be disclosed, in addition to disclosure of retainer arrangements.[72]

Rule 9011 applies to employment applications and affidavits. Thus, attorneys are obliged to inquire into and analyze the factual and legal elements of every document signed and filed.[73] A half-hearted inquiry into conflicts among firm members is inadequate. It is counsel's responsibility to ensure complete disclosure.[74] Special counsel cannot simply rely on the DIP's primary bankruptcy counsel to handle necessary filings.[75] Committee counsel may be sanctioned like debtor's counsel for inadequate disclosures.[76] A secured creditor's counsel may likewise be sanctioned for misrepresenting fee arrangements when seeking fees as part of a secured claim under Code § 506(b).[77]

The most common consequence of non-disinterestedness or inadequate fee disclosure is fee denial or disgorgement of interim payments, but termination of the

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debtor's counsel's employment); see also In re Beesley, 212 B.R. 4 (Bankr. D. Me. 1997)(sanctioning chapter 7 attorney for charging in excess of written fee agreement).

[72] In re Keller Financial Services of Florida, Inc., 248 B.R. 859 (Bankr. M.D. Fla. 2000)(extensive analysis of § 329). Payments by the debtor's spouse must be disclosed as well. In re Greco, 246 B.R. 226 (Bankr. E.D. Pa. 2000).

[73] In re Pierce, 809 F.2d 1356 (8th Cir. 1987) (applying Rule 9011 to erroneous application to employ counsel); In re Dreiling, 233 B.R. 848, 870 (Bankr. D. Colo. 1999)(fundamental premise of our judicial system is that attorneys are officers of the court; when they address a judge it is virtually made under oath); Model Rule 3.1 and comment.

[74] See In re Thrifty Oil Co., 205 B.R. 1009, 1014 (Bankr. S.D. Cal. 1997) (accounting firm's conflict check inadequate); In re Perry, 194 B.R. 875 (E.D. Cal. 1996)(trustee's attorney failed to conflict check purchaser of estate assets -- represented by own firm); In re Michigan General Corp., 78 B.R. 479, 482 (Bankr. N.D. Tex. 1987)("Unfortunately, the burdens of the Bankruptcy Code are not met by a white heart. Negligence does not excuse the failure to disclose a possible conflict of interests.").

[75] In re Crook, 79 B.R. 475, 478-79 (9th Cir. BAP 1987). On the other hand, general bankruptcy counsel has been sanctioned for failure to disclose lack of disinterestedness of other estate professionals. Matter of CF Holding Corp., 164 B.R. 799, 808 (Bankr. D. Conn. 1994).

[76] In re Carlton House of Brockton, 1996 Bankr. LEXIS 170, 28 BCD 777 (Bankr. D. Mass. 1996)(creditors' committee counsel suspended from bankruptcy practice for one year due to false representations of disinterestedness).

representation is not infrequent, and sanctions have extended to suspension from practice, disbarment, and even criminal convictions for blatant non-disclosure violations.[78] The court may disqualify counsel from representing the DIP based upon an objective standard, evaluating the facts of each case, regardless of the integrity or intent of the attorney.[79] An evidentiary hearing is not required before a court requires disgorgement of fees on grounds of disqualification.[80]

E. Frivolous and Bad Faith Adversary Litigation

In addition to administrative filings, adversary litigation is rife with sanctions rulings, from frivolous adversary proceeding complaints[81] to bad faith objections,[82] frivolous motions and appeals,[83] and failing to cooperate with discovery requests.[84] Burdensome, unnecessary discovery requests may likewise be deemed sanctionable.[85] And counsel for the debtor all too often acquiesces in his client's request to list all claims

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[77] In re 1095 Commonwealth Corp., 236 B.R. 530, 534 (D. Mass. 1999).

[78] See United States v. Gellene, 182 F.3d 578 (7th Cir. 1999)(criminal conviction affirmed); In re Gellene, 676 N.Y.S.2d 161 (N.Y. App. Div. 1998)(disbarment); People v. Mills, 923 P.2d 116 (Colo. 1996)(attorney suspended from practice 60 days for failure to disclose and obtain bankruptcy court approval for attorneys' fees charged and collected).

[79] In re Roger J. Au & Son, Inc., 65 B.R. 322, 336 (Bankr. N.D. Ohio 1984), aff'd 64 B.R. 600 (N.D. Ohio 1986)(court does not render a moral judgment on the conduct of the attorneys, but requires their disqualification); In re Martin, 817 F.2d 175, 181 (1st Cir. 1987); In re Gray, 64 B.R. 505 (Bankr. E.D. Mich. 1986).

[80] In re Land, 943 F.2d 1265, 1267 (10th Cir. 1991); In re Kendavis Industries International, Inc., 91 B.R. 742 (Bankr. N.D. Tex. 1988).

[81] FE & B v. Charter Technologies, Inc., 57 F.3d 1215 (3d Cir. 1995)In re Peoro, 793 F.2d 1048 (9th Cir. 1986); In re TCI, Ltd., 769 F.2d 441 (7th Cir. 1985); In re Excello Press, Inc., 967 F.2d 1109 (7th Cir. 1992)(before pursuing preference action, counsel ordinarily should examine whether any obvious defenses bar case, but no *per se* rule).

[82] In re Arkansas Communities, Inc., 827 F.2d 1219 (8th Cir. 1987); In re Edmonds, 110 B.R. 38 (D. Kan. 1989).

[83] In re 60 East 80th Street Equities, Inc., 218 F.3d 109 (2nd Cir. 2000)(frivolous appeal); In re Eisen, 14 F.3d 469 (9th Cir. 1994).

[84] In re Dubrowsky, 206 B.R. 30 (Bankr. E.D.N.Y. 1997); In re Bernard, 85 B.R. 864, 865 (Bankr. D. Colo. 1988).

[85] In re Rimsat, Ltd., 212 F.3d 1039 (7th Cir. 2000) (deposition taken in unproductive and harassing manner).

as disputed on the schedules, or file blanket objections to claims, which creditors may not dispute only because economically infeasible to do so. Strategies designed to make opponents capitulate because litigation is prohibitively expensive may result in sanctions against counsel as well as adverse consequences to clients.[86] Irresponsibly drafted and inflammatory language in pleadings may show their improper, sanctionable purpose.[87]

Counsel may also be sanctioned under Rule 9011 for pursuing or agreeing to reaffirmation agreements without having first ensured that the debtor is informed as to the legal effects and consequences of the reaffirmation, and verified that the reaffirmation will not impose an undue hardship.[88]

IV. Reacting to Client Misconduct

What should counsel do when she learns that her client has lied or her client asks her to lie or otherwise circumvent bankruptcy law restrictions? Rather than carrying out client directions exceeding good faith boundaries, the debtor's attorney has ethical obligations to counsel her client with respect to its fiduciary duties.[89] As stated in the comment to Model Rule of Professional Conduct 1.6, "The lawyer is part of a judicial

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[86] See In re St. Johnsbury Trucking Co., Inc., 184 B.R. 446, 458 (Bankr. D. Vt. 1995), motion for stay denied, Winthrop, Stimson v. St. Johnsbury Co., 186 B.R. 53 (D. Vt. 1995); In re French Bourekas, Inc., 175 B.R. 517, 522 (Bankr. S.D.N.Y. 1994), sanctions order, 183 B.R. 695 (Bankr. S.D.N.Y. 1995); In re Marathon Home Loans, 101 B.R. 216, 222 (Bankr. S.D. Cal. 1989) (sanctioning harassment in the form of "a procedural war of scorched-earth attrition," even though each "motion or paper may be objectively reasonable and, thus, not frivolous"). See also In re Hensley, 249 B.R. 318 (Bankr. W.D. Okla. 2000)(intentionally including language in chapter 13 plans in hope that creditors will fail to object and be bound by res judicata violates counsel's ethical obligations).

[87] In re Computer Dynamics, Inc., 252 B.R. 50, 61 (Bankr. E.D. Va. 1997).

[88] In re Melendez, 235 B.R. 173 (Bankr. D. Mass. 1999); In re Vargas, 257 B.R. 157 (Bankr. D. N.J. 2001).

[89] CFTC v. Weintraub, 471 U.S. 343, 355, 105 S. Ct. 1986, 1994 (1985); Pepper v. Litton, 308 U.S. 295, 306 (1939); In re Perez, 30 F.3d 1209 (9th Cir. 1994); Hansen, Jones & Leta P.C. v. Segal, 220 B.R. 434 (D. Utah 1998); In re JLM, Inc., 210 B.R. 19 (2d Cir. BAP 1997); In re Consupak, Inc., 87 B.R. 529, 549 (Bankr. N.D. Ill. 1988).

system charged with upholding the law. One of the lawyer's functions is to advise clients so that they avoid any violation of the law in the proper exercise of their rights."[90]

If the operating head of the DIP entity fails to act in compliance with the DIP's fiduciary responsibilities, the lawyer may have to refer the matter higher up the chain of command to the chief executive officer or board of directors. The lawyer is to consider the seriousness of any illegality and its consequences in deciding what to do within the organization, however, and is to minimize any disruption to the entity and the risk of revealing information to outsiders.[91] If a lawyer "develops material doubts about whether a proposed course of action in fact serves the estate's interests, he must seek to persuade his client to take a different course or, failing that, resign."[92] DIP counsel may in some cases be obligated to bring the DIP's breaches of fiduciary duty to the attention of the court.[93]

Thus, counsel is to urge the DIP to meet its fiduciary duties to creditors, but is to abide by the client's decisions as long as there is a nonfrivolous basis for doing so.[94] If

[90] In re Whitney Place Partners, 123 B.R. 117, 124 (Bankr. N.D. Ga. 1992); See also Model Rule 2.1 ("In representing a client, a lawyer shall exercise independent professional judgment and render candid advice."); Model Rule 1.2(e)(When a lawyer knows that a client expects assistance not permitted by the Rules of Professional Conduct or other law, the lawyer shall consult with the client regarding the relevant limitations on the lawyer's conduct.").

[91] Model Rule 1.13.

[92] In re Perez, 30 F.3d 1209, 1219 (9th Cir. 1994); In re Berg, 268 B.R. 250, 262 (Bankr. D. Mont. 2001); In re Start the Engines, Inc., 219 B.R. 264, 271 (Bankr. C.D. Cal. 1998). In the terminology of the Model Rules, if a client is insistent on an action that "is clearly a violation of law and is likely to result in substantial injury to the organization," the lawyer may withdraw. Model Rule 1.13; see also Model Rule 1.16; but see In re SIDCO, Inc., 173 B.R. 194, 196 (E.D. Cal. 1994)(DIP attorney's fiduciary duty is to DIP client, not creditors and shareholders whose interests may be adverse to DIP).

[93] In re JLM, Inc., 210 B.R. 19, 26 (2d Cir. BAP 1997); In re Brennan, 187 B.R. 135 (Bankr. D.N.J. 1995)(in serious cases such as conversion of estate property, the professionals will sometimes be obligated to report the debtor's breach to others); Model Rule 1.6 Comment; ABA Formal Opinion 92-366 (August 8, 1992)(duty of "noisy withdrawal" from representation).

[94] Model Rules 1.2, 1.13, 2.1, 3.1.

the attorney and client disagree, it is not the attorney's prerogative to act on her own as she believes best for the estate, but rather to refrain from filing bad faith or frivolous pleadings, and to withdraw if the high standards for withdrawal are met. If the attorney fails to appropriately counsel the client and carries out an abusive client strategy, her fees may well be subject to attack—refunds of previously allowed interim payments have been mandated where the court has found unethical conduct.[95]

The attorney is to explain legal requirements to the extent reasonably necessary to permit the client to make informed decisions.[96] But the lawyer may not follow client instructions if they would operate to defraud,[97] and may not knowingly make or affirm a false statement of material fact or law to others or fail to disclose a material fact necessary to avoid defrauding others.[98] A disclosure statement, motion to approve a settlement or sale, or the like may well entail an evaluation of facts and law for use by third persons often unrepresented themselves. Counsel is to disclose any limitations on information used in making the valuation, and not state or imply that the lawyer is disinterested rather than the advocate of her DIP client.[99]

Despite her diligence, an attorney nonetheless may discover that her client has committed perjury on his schedules and statement of affairs by concealing assets or asset transfers, or deliberately omitting creditors or misrepresenting important facts. Counsel

[95] See, e.g., In re Humble Place Joint Venture, 936 F.2d 814, 819 (5th Cir. 1991); In re Gregory, 214 B.R. 570, 576 (S.D. Tex. 1997).

[96] Model Rule 1.4(b).

[97] Model Rules 1.2, 8.4.

[98] Model Rule 4.1. Disclosure may be prohibited by the obligation to preserve client confidences set forth in Model Rule 1.6. In that case counsel must withdraw instead of countenancing an improper course of action. Model Rule 1.16(b). See In re Wilde Horse Enterprises, Inc., 136 B.R. 830, 840 (Bankr. C.D. Cal. 1991).

[99] Model Rules 2.3, 4.3 and official comments.

also may learn that the client has lied in testimony, or misrepresented facts to the attorney that were the basis of positions taken on his behalf. The attorney must preserve client confidences, but not to the extent of implicitly sanctioning illegality.[100] Counsel may not further the illegal purpose, including by suggestions of concealment, nor may counsel continue assisting in conduct discovered to be criminal or fraudulent.[101] The client must be warned that he may forfeit his discharge, be liable under the bankruptcy crimes statute and criminal perjury statute, and that a trustee will likely be appointed if not already serving.[102] The client must also be warned that the attorney-client privilege does not protect criminal plotting or statements made to counsel about it, and that counsel may be obliged to turn over all books and records.[103]

The client should be counseled to rectify the situation as much as possible, such as by supplemental filings mailed to affected parties.[104] If the client is unwilling to do so, the attorney must withdraw and, if necessary to remedy the situation or the attorney

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[100] Model Rules 1.6, 3.3; see United States v. Cherek, 734 F.2d 1248, 1252-53 (7th Cir. 1984) cert. denied 105 S. Ct. 2016 (1984)(criminal liability under 18 U.S.C. § 152; debtor required to disclose existence of assets even if debtor's ownership status is questionable); United States v. Kaldenberg, 429 F.2d 161 (9th Cir. 1970) cert. denied 400 U.S. 929 (1970)(debtor convicted of failure to report rentals from estate property).

[101] Model Rule 1.2. See U.S. v. Goodstein, 883 F.2d 1362, 1371 (7th Cir. 1989)(lawyer guilty of bankruptcy fraud for role in unauthorized postpetition transfers); U.S. v. Dolan, 120 F.3d 856 (8th Cir. 1997)(counsel guilty of bankruptcy fraud, conspiracy, aiding and abetting client's bankruptcy fraud); U.S. v. Rosen, 130 F.3d 5 (1st Cir. 1997)(counsel guilty of mail fraud in deceiving bankruptcy court with undisclosed side deal in connection with estate asset sale).

[102] 11 U.S.C. § 727; 18 U.S.C. §§ 152, 1621; 11 U.S.C. § 1104(a)(1); In re Olson, 916 F.2d 481, 484 (8th Cir. 1990)(denial discharge for failure to disclose interest in asset nominally owned by spouse and of questionable value on schedules); In re Calder, 907 F.2d 953, 955 (10th Cir. 1990)(denial discharge for failures to disclose assets on schedules); United States v. Ellis, 50 F.3d 519 (7th Cir.) cert. denied, 516 U.S. 849 (1995) (conviction for false statement about prior bankruptcies on petition).

[103] Model Rules 1.6(c), 3.3; United States v. Ballard, 779 F.2d 287, 292-93 (5th Cir.) cert. denied, 106 S.Ct. 1519 (1986); 11 U.S.C. § 542(e).

[104] Model Rule 3.3 Comment; see Model Rule 1.13(b) regarding procedures when the client is an organization; Bankruptcy Rule 1009.

cannot withdraw, he may have to reveal the misrepresentations to the court.[105] Counsel may withdraw or disaffirm any document, which would probably be deemed necessary to remedy the filing of a misleading document with his signature, such as a disclosure statement, and perhaps also to remedy the filing of fraudulent schedules and statements of affairs signed by the client.[106]

Client failures to communicate or otherwise cooperate with counsel, insistence on pursuing an objective the lawyer considers improper, or client conduct which renders effective representation unreasonably difficult may also warrant a court request for withdrawal.[107] It may also become clear that there are insufficient unencumbered assets to pay counsel, making the representation unreasonably financially burdensome. Although the ethical rules authorize a request for withdrawal in such circumstances, it may not be allowed.[108] In the event of withdrawal, counsel must take reasonable steps to protect the client's interests, such as giving the client notice and an opportunity to employ other counsel, turning over the client's papers and property, and refunding unearned retainers.[109]

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[105] Model Rules 1.6, 1.16, 3.3; In re Gregory, 214 B.R. 570, 576 (S.D. Tex. 1997)(duty to disclose client defalcation); In re Swansea Consolidated Resources, Inc., 155 B.R. 28, 38 n. 14 (Bankr. D. R.I. 1993)(as an officer of the court, DIP counsel "had absolutely no choice but to disclose" unauthorized diversion of $64,000 of DIP funds to a foreign bank); see also In re Brennan, 187 B.R. 135 (Bankr. D.N.J. 1995)(in serious cases such as conversion of estate property, the professionals will sometimes be obligated to report the debtor's breach to others).

[106] Model Rule 1.6 Comment; see In re Saturley, 131 B.R. 509, 519 (Bankr. D. Me. 1991)(inform trustee that schedules are incomplete if concerns about client's candor, to prompt trustee investigation); In re Matthews, 154 B.R. 673, 680-81 (Bankr. W.D. Tex. 1993)(same; alert U.S. Trustee, court, or another interested party that schedules are incomplete or inaccurate; failure to withdraw contributed to debtor's dishonesty by not setting up early alarm that something was amiss); ABA Formal Opinion 92-366 (Aug. 8, 1992)(ethical obligation of "noisy withdrawal").

[107] Model Rule 1.16; In re Alderson, 114 B.R. 672, 680-81 (Bankr. D. S.D. 1990).

[108] Model Rule 1.16; In re Meyers, 120 B.R. 751, 752 (Bankr. S.D.N.Y. 1990) and cases cited therein.

[109] Model Rule 1.16(d). The court may order turnover of the attorney's files regardless of any charging lien rights. 11 U.S.C. § 542(e).

V. Procedures for Obtaining Sanctions.

Until the 1997 modification of Rule 9011, upon any violation the court was required to impose an appropriate sanction; it exercised discretion only in deciding what sanction was appropriate under the circumstances.[110] Now, sanctions are discretionary, and there is a safe harbor procedure for serving a sanctions motion and giving an opportunity to withdraw the offensive document before filing the motion.[111] The safe harbor does not apply to the filing of a bankruptcy petition, however, given its immediate and serious consequences.[112] Otherwise, it is a mandatory requirement for a Rule 9011 sanctions motion.[113]

Sanctions generally take the form of attorneys' fees awards to opponents; in some cases attorneys and clients have been held jointly liable for the opponent's fees and doubled costs, or additional monetary amounts.[114] Rule 9011 now includes a provision on the nature and limitations of sanctions. A sanction imposed for violation of that rule is to be limited to what is sufficient to deter repetition of the conduct by the one sanctioned or others similarly situated. It may consist of non-monetary directives, a court penalty, or

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[110] In re Gioioso, 979 F.2d 956, 960 (3d Cir. 1992)(the concurrence discusses whether bankruptcy courts also have inherent power to sanction misconduct under Chambers v. NASCO, 111 S.Ct. 2123 (1991)). Changes to Federal Rule of Civil Procedure 11 are not incorporated by reference in Bankruptcy Rule 9011. In re Dubrowsky, 206 B.R. 30, 35 (Bankr. E.D.N.Y. 1997).

[111] Rule 9011(c). There is no safe harbor for filing a bankruptcy petition violating rule 9011 standards, however. Id. See In re Russ, 187 F.3d 978, 981 (8th Cir. 1999) (omissions from schedules so serious that bankruptcy court sanctions would have been upheld, but court did not abuse discretion in denying sanctions either).

[112] Rule 9011(c)(1)(A); In re Collins, 250 B.R. 645 (Bankr. N.D. Ill. 2000).

[113] In re McNichols, 258 B.R. 892, 902 (Bankr. N.D. Ill. 2001).

[114] FE&B v. Charter Technologies, Inc., 57 F.3d 1215 (3d Cir. 1995) (disallowance of all fees); Dreamlite Holdings Ltd. v. Kraser, 890 F.2d 1147 (Fed. Cir. 1989)(refusing to accept further filings on behalf of clients or their attorney until award of fees and double costs paid in full and satisfactory proof furnished to court); In re Salter & Co., Ltd., 99 B.R. 327 (E.D. La. 1989)(fees and double costs); In re Beugen, 99 B.R. 961 (9th Cir. BAP 1989)(same); In re Start the Engines, Inc., 219 B.R. 264 (Bankr. C.D. Cal. 1998)($100,000 awarded against attorney and client, jointly and severally).

an order to pay reasonable attorneys' fees and costs incurred as a direct result of the violation.[115] Sanctions may also include disgorgement of retainers or interim fees previously awarded to DIP counsel.[116] A chapter 7 attorney may likewise be precluded from recovering compensation for a petition filed in bad faith.[117] Sanctions under other authority than Rule 9011, including the inherent power of the court, may be stiffer, as described in section I, *infra*.

The party seeking sanctions has a duty to mitigate its damages by using reasonable efforts to resolve disputes by inexpensive means, but need not take actions that would impair its rights.[118] The sanctioned attorney and affected parties may stipulate to a settlement; the court may approve it or may impose more draconian sanctions.[119] The court imposing sanctions is to consider the ability to pay of the sanctioned party or attorney, but only if limited ability to pay is raised in a timely manner.[120]

Counsel is entitled to a meaningful opportunity to explain his conduct before sanctions are awarded, generally but not necessarily at a "show cause" hearing.[121] An evidentiary hearing is not required, however. An opportunity to respond by brief or oral

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[115] Bankruptcy Rule 9011(c)(2).

[116] In re Kendavis Industries International, Inc., 91 B.R. 742 (Bankr. N.D. Tex. 1988).

[117] In re Addon Corp., 231 B.R. 385, 391 (Bankr. N.D. Ga. 1999).

[118] In re Film Ventures Intern., Inc., 89 B.R. 80, 86 (9th Cir. BAP 1988).

[119] In re Smith, 257 B.R. 344, 353 (Bankr. N.D. Ala. 2001).

[120] In re Y.J. Sons & Co., Inc., 212 B.R. 793, 806-07 (D. N.J. 1997).

[121] Bankruptcy Rule 9011(c); Goldin v. Bartholow, 166 F.3d 710, 722 (5th Cir. 1999) (court's mention of cost-shifting was insufficient notice of personal liability for sanctions); In re Stein, 127 F.3d 292, 295 (2nd Cir. 1997) (notice and opportunity to be heard, but not full evidentiary hearing); In re Big Rapids Mall Associates, 98 F.3d 926, 929-30 (6th Cir. 1996)(briefs with opportunity for affidavits sufficient); FE&B v. Charter Technologies, Inc., 57 F.3d 1215 (3d Cir. 1995) (sanction motion was sufficient notice of conduct at issue). The explanation presented may justify a reversal of an initial inclination to award sanctions. In re Whitney Place Partners, 123 B.R. 117 (Bankr. N.D. Ga. 1992)(sanctions directed and OSC set); 147 B.R. 619 (Bankr. N.D. Ga. 1992)(evidence showed errors to be the result of counsel's lack of bankruptcy expertise; sanctions not imposed).

argument may suffice.[122] A sanctions award must specify how the fees and expenses were calculated, and how they were caused by the conduct of the parties sanctioned, so the appellate court has sufficient basis to review the decision.[123] Adequate notice is important before any sanctions hearing, but especially important if the severe sanction of disbarment from the bankruptcy court is to be considered.[124] The prerequisites of adequate notice are (1) the fact that sanctions are under consideration, (2) the reasons why (*i.e.* the conduct alleged to be sanctionable), and (3) the form of sanctions under consideration, generally including the legal rule on which sanctions will be based.[125] If inadequate notice is given, the error may be cured by an immediate stay of the results and a scheduled reconsideration hearing.[126]

Rule 11 motions for sanctions, like all other motions, must be filed in good faith. Rule 11 does not mandate punishment just because an adversary's theory is rejected at trial, and is not intended to "kill an attorney's enthusiasm or creativity."[127] Courts generally evaluate whether an objectively reasonable basis for the attorney's contentions was asserted, in deciding on sanctions requests, even if the attorney ultimately lost on the

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[122] In re 60 East 80th Street Equities, Inc., 218 F.3d 109, 117 (2nd Cir. 2000); In re Mahendra, 131 F.3d 750, 760 (8th Cir. 1997) (notice and opportunity to respond re sanctions on appeal); see In re Rimsat, Ltd., 212 F.3d 1039, 1046 (7th Cir. 2000) (court may cite perceptions of general litigation strategy as background and context for sanctions ruling without providing particularized notice).

[123] In re Gioioso, 979 F.2d 956 (3d Cir. 1992); In re Lane, 991 F.2d 105 (4th Cir. 1993)(factors to be considered in determining sanctions); In re Rainbow Magazine, Inc., 136 B.R. 545 (9th Cir. BAP 1992); In re Omega Trust, 110 B.R. 665 (Bankr. S.D.N.Y. 1990), aff'd in part, remanded in part, 120 B.R. 265 (S.D.N.Y. 1990)(detailed discussion of Rule 9011 types of sanctions and factors that may be considered in determining which sanctions to impose).

[124] In re Engel, 246 B.R. 784 (Bankr. M.D. Pa. 2000); In re MPM Enterprises, Inc., 231 B.R. 500, 505 (E.D.N.Y. 1999).

[125] Engel, 246 B.R. at 794 (citing authorities); In re Highgate Equities, Ltd., 279 F.3d 148, 152 (2nd Cir. 2002); FE&B v. Charter Technologies, Inc., 57 F.3d 1215 (3d Cir. 1995) (notice of 9011 sanctions sufficient to impose sanctions for same conduct under inherent power of court).

[126] In re Hancock, 192 F.3d 1083, 1086 (7th Cir. 1999).

merits.[128] Sanctions may not be imposed against counsel merely because the court finds the client's testimony not credible, or objects to the form of a respectful communication.[129] But a sanctions motion that is itself replete with vituperation and abuse will not be tolerated, even if it asserts a colorable claim.[130] Mitigating and aggravating factors bearing on the type of sanctions to impose include the degree of willfulness involved, the person's expertise and prior history and ability to pay, the nature and extent of prejudice and expense suffered by the offended person, and burdens on the court system.[131]

VI. Collateral Consequences – at the Bar and in the Prison

Other possible sanctions include a reprimand, reference to bar disciplinary authorities, an order precluding the introduction of evidence or litigation of certain issues, default judgment or dismissal, injunctive relief limiting future access to the courts to a party or attorney, or mandatory legal education, generally in the areas of bankruptcy and legal ethics.[132]

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[127] In re Oak Grove Village, Ltd., 90 B.R. 246, 249 (Bankr. W.D. Tex. 1988).

[128] In re Hall's Motor Transit Co., 889 F.2d 520, 523 (3d Cir. 1989) (FRAP 38); Matter of McGuirt, 879 F.2d 182, 184 (5th Cir. 1989) (same); Sea Harvest Corp. v. Riviera Land Co., 868 F.2d 1077 (9th Cir. 1989); Dreamlite Holdings Ltd. v. Kraser, 890 F.2d 1147 (Fed. Cir. 1989); White v. General Motors, 908 F.2d at 680; but see In re Marathon Home Loans, 101 B.R. 216, 222 (Bankr. S.D. Cal. 1989)(each filing not frivolous, but sanctionable as part of persistent pattern of abusive litigation activity).

[129] In re Big Rapids Mall Associates, 98 F.3d 926, 930-31 (6th Cir. 1996); In re Highgate Equities, Ltd., 279 F.3d 148, 154-44 (2nd Cir. 2002) (letter).

[130] In re Johnson, 236 B.R. 510, 519, 523 (D.D.C. 1999).

[131] In re Omega Trust, 110 B.R. 665, 673-74 (Bankr. S.D.N.Y. 1990) (extensive list of mitigating and aggravating factors, and supporting citations).

[132] Omega Trust, 110 B.R. at 673-74 (citing numerous cases, and a list of alternative sanctions); see also In re Placid Oil Co., 158 B.R. 404 (N.D. Tex. 1993)(fee disgorgement and disbarment for violation of court orders); In re Maurice, 167 B.R. 114, 128 (Bankr. N.D. Ill. 1994) (complete 16 hours of CLE in bankruptcy and 8 hours in legal ethics); In re Pearson, 108 B.R. 804 (Bankr. S.D. Fla. 1989) (9 hours bankruptcy and 3 hours ethics CLE).

Several courts have imposed sanctions in the form of suspension or disbarment from practice in the bankruptcy court.[133] Pro hac vice status may likewise be revoked.[134] The suspension may last only until sanctions are fully paid, but may last for years.[135] The suspension may even be permanent until and unless a reapplication is accepted.[136] The bankruptcy court or appellate court may refer its sanctions determination to the state professional disciplinary authority, commencing a state disciplinary process.[137] While counsel may introduce mitigating evidence bearing on appropriate punishment at the state hearing, either applicable state rules or the doctrine of offensive non-mutual collateral estoppel may prevent the lawyer from re-litigating the facts or law relating to sanctioned

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[133] In re Moix-McNutt, 220 B.R. 631, 637 (E.D. Ark. 1998) (citing cases); In re MPM Enterprises, Inc., 231 B.R. 500, 504 (E.D.N.Y. 1999) (citing cases); See In re Smith, 257 B.R. 344, 353 (Bankr. N.D. Ala. 2001)(any further sanctionable conduct will result in suspension of practice before the bankruptcy court); In re Brantley, 84 B.R. 508, 510 (Bankr. S.D. Ohio 1988) (same, from repeated defects in schedules); see Landscape Properties,Inc. v. Whisenhunt, 127 F.3d 678, 685 (8th Cir. 1997) (district court considering bankruptcy sanctions appeal referred matter to other district judges to determine whether disciplinary actions should be taken against appellant attorney).

[134] In re Rimsat, Ltd., 212 F.3d 1039, 1043 (7th Cir. 2000); D.H. Overmyer Co., Inc. v. Robson, 750 F.2d 31, 33 (6th Cir. 1984).

[135] In re Maurice, 73 F.3d 124, 126 (7th Cir. 1995)(suspension from all federal courts in circuit pending compliance with sanctions payment); In re 60 East 80th St. Equities, Inc., 218 B.3d 109, 120 (2d Cir. 2000)(suspension until sanctions paid); In re Hancock, 192 F.3d 1083, 1086 (7th Cir. 1999) (same); Moix-McNutt, 220 B.R. at 637 (4 years); In re Heard, 106 B.R. 481, 484 (Bankr. N.D. Ohio 1989)(1 year); In re Nesom, 76 B.R. 101, 102 (Bankr. N.D. Tex. 1987) (60 days); In re Assaf, 119 B.R. 465, 467 (E.D. Pa. 1990)(until fees paid); In re Woodward, 229 B.R. 468, 476-77 (Bankr. N.D. Okla. 1999)(OSC to consider suspension, plus immediate suspension if disgorgement order not met); In re Carlton House of Brockton, Inc., 28 BCD 777 (Bankr. D. Mass. 1996) (1 year).

[136] In re Statmore, 176 B.R. 512, 515 (D. Neb. 1984)(court will consider lifting suspension upon proof of payments); In re Lowe, 18 B.R. 26, 27 (Bankr. N.D. Ga. 1982) (permanent suspension pending further order of the court).

[137] In re Maurice, 167 B.R. 114 (Bankr. N.D. Ill. 1994); In re 60 East 80th St. Equities, Inc., 218 F.3d 109, 121 (2d Cir. 2000); In re Clark, 223 F.3d 859, 865 (8th Cir. 2000);In re Davila, 210 B.R. 727 (Bankr. S.D. Tex. 1996).

conduct.[138] A state supreme court's suspension or disbarment typically results in the same discipline being imposed in the federal courts where the attorney practices.[139]

Worse still, sanctionable activity may warrant a criminal conviction. The lawyer enabling false and misleading schedules to be filed may be convicted of aiding and abetting the fraudulent concealment of property from the bankruptcy trustee.[140] If so, status as an attorney may warrant a sentence enhancement.[141] Filing a false and misleading Rule 2014/2016 statement of disinterestedness, and confirming it in court, may result in conviction on counts of bankruptcy fraud and perjury.[142] Failing to obey a court sanctions order may be deemed criminal contempt.[143] The bankruptcy court or district or circuit court on appeal of a bankruptcy order may refer its disciplinary decision to the United States Attorney to consider prosecution.[144]

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[138] E.g. Mississippi Bar v. Shah, 749 So.2d 1047, 1048-50 (Miss. 1999); In re Caranchini, 160 F.3d 420, 422 (8th Cir. 1998).
[139] Caranchini, 160 F.3d at 424.
[140] United States v. Webster, 125 F.3d 1024, 1028 (7th Cir. 1997), cert. denied, 522 U.S. 1051 (1998); United States v. Dolan, 120 F.3d 856 (8th Cir. 1997); United States v. Cherek, 734 F.2d 1248, 1254 (7th Cir. 1984), cert. denied, 471 U.S. 1014 (1985); United States v. Franklin, 837 F.Supp. 916 (N.D. Ill. 1993) (plea to obstructing justice).
[141] Webster, 125 F.3d at 1036
[142] United States v. Gellene, 182 F.3d 578 (7th Cir. 1998)
[143] In re Maurice, 69 F.3d 830, 834 (7th Cir. 1995).
[144] Maurice, 69 F.3d at 834; In re Ludwick, 185 B.R. 238, 247 (Bankr. W.D. Mich. 1995).

BANKRUPTCY LEGISLATION

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SECTION I

BANKRUPTCY LEGISLATION

8-6-02

Major effects of the consumer bankruptcy provisions of the 2002 Bankruptcy Legislation (H.R. 333 Conference Report)

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On July 25, 2002, the House and Senate conferees on H.R. 333 reached agreement on a conference report, resolving differences between versions of the legislation as passed in the two houses. The following summary sets out the major areas of consumer bankruptcy law impacted by the conference report, with references to the sections of the report that effect the changes.

Chapter 7

1. *New § 707(b)—means testing; Conference Report* § 102(a)-(d)

Section 707(b) of the Bankruptcy Code is amended to provide for dismissal of Chapter 7 cases or (with the debtor's consent) conversion to Chapter 13, upon a finding of abuse. Abuse can be found in one of two ways: first, through an unrebutted presumption of abuse, arising under a new means test; and second, on general grounds, including bad faith, determined under the totality of the circumstances.

Standing. Any party in interest, including the U.S. trustee or bankruptcy administrator, as well as a judge, may invoke the means-test presumption, but only as to debtors whose income exceeds a defined state median. For debtors whose income does not exceed the defined median, abuse can only be found on general grounds, and only the judge, U.S. Trustee or bankruptcy administrator may raise the issue. This standing scheme can be summarized in a table:

	Debtor's income at or below the applicable median	*Debtor's income above the applicable median*
The means-test presumption	No one has standing.	All parties in interest have standing.
General grounds of abuse	Only judges, U.S. Trustees, and bankruptcy administrators have standing.	All parties in interest have standing.

Presumption of abuse under the means test. The means test is designed to determine the extent of a debtor's ability to repay general unsecured claims. It has three elements: (a) a definition of "current monthly income," measuring the total income a debtor is presumed to have available; (b) a list of allowed deductions from current monthly income, for purposes of support and repayment of higher priority debt; and (c) defined "trigger points," at which the income remaining after the allowed deductions would result in the presumption of abuse.

(a) "Current monthly income" is a monthly average of all the income received by the debtor (including regular contributions to household expenses made by other persons, but excluding Social Security benefits) during a defined six-month period. If the debtor files schedules with the bankruptcy petition, the six-month period ends with the last day of the calendar month preceding the filing. Thus, if schedules were filed with a bankruptcy petition in March, current monthly income would be the average monthly income received by the debtor during the preceding September through February. But if schedules are not filed with the petition, then the six-month period ends on the date that the court determines "current monthly income."

(b). The deductions from current monthly income allowed under the means test can be categorized as follows: (1) allowances set by the Internal Revenue Service (in the context of negotiating repayment of delinquent tax obligations)—on a national basis for food, clothing, personal care, and entertainment (the "National Collection Standards") (with an increase of up to 5% of the food and clothing allowance, if demonstrated to be reasonable and necessary), and on a regional basis and for transportation and housing (the "Local Collection Standards"), except that any portion of the allowances under National and Local Standards reflecting repayment of debt is not to be counted; (2) the actual expenses of the debtor in categories recognized by the IRS but as to which no specific allowance has been set ("Other Necessary Expenses"); (3) expenses for protection from family violence; (4) continued contributions to care of nondependent family members, including children and grandchildren; (5) actual expenses of administering a Chapter 13 plan, as determined by the Executive Office for United States Trustees; (6) expenses for grade and high school (up to $1500 annually, per minor child), if the debtor documents both the reasonableness and necessity for such expenses, and that the expenses are not covered by the applicable IRS standards; (7) additional home energy costs, documented as reasonable and necessary and not covered by the IRS Local Standards; (8) 1/60th of all secured debt that will become due in the five years after filing (and all past due debt secured by property necessary for support of the debtor and the debtor's dependents); (9) 1/60th of all priority debt; and (10) (as provided for under current § 707(b)) continued contributions to tax-exempt charities, up to 15% of gross income.

(c) There are two distinct trigger points for the presumption of abuse: (1) if the debtor has at least $166.67 in current monthly income available after the allowed deductions, abuse is presumed regardless of the amount of the debtor's general unsecured debt, and (2) if the debtor has at least $100 of such income, abuse is presumed if the income is sufficient to pay at least 25% of the debtor's general unsecured debt over five years. Thus, a debtor with less than $100 in monthly income after allowed deductions would never be subject to a presumption of abuse; if the debtor had income after deduction in the amount of exactly $100, there would be a presumption of abuse if the debtor's general unsecured debt was $24,000 or less; a debtor with $150 in monthly income after deductions would be subject to the presumption with general unsecured debt of $36,000 or less; and a debtor with income of $166.67 or more after deductions would be subject to the presumption regardless of how much unsecured debt was owed.

To rebut the presumption, a debtor would have to swear to and document "special circumstances" that would decrease income or increase expenses so as to bring the debtor's income after expenses below the trigger points.

General grounds for abuse. The other basis for a finding of abuse, applicable where the presumption does not apply or has been rebutted, is that the debtor filed the petition in bad faith or that the totality of the debtor's financial circumstances indicates abuse. The U.S. trustee, bankruptcy administrator or judge can assert this basis for finding abuse in any case; creditors are limited to asserting it in cases where the debtor's income is above the defined state median.

Procedure. Debtors are required to file a statement as to the calculation under the means test in all cases: the court is required to serve this statement on creditors; and, if the presumption applied, the U.S. trustee is required to file either a motion under § 707(b) or a statement explaining why the motion was not being filed.

2. *Sanctions imposed on debtor's counsel.*

• *Conference Report* § 102(a)(2)

Section 707(b) is amended to add a new subparagraph (4)(A) allowing the court to award costs and fees to a trustee who successfully pursues a § 707(b) motion, payable by debtor's counsel, if it finds that the Chapter 7 filing violated Fed. R. Bankr. P. 9011; a new subparagraph (4)(B) specifying that if the court finds any violation of Rule 9011 by the debtor's attorney, it may award a civil penalty against the attorney, payable to the trustee, U.S. trustee, or bankruptcy administrator; and a new subparagraph (4)(C) providing that the signature of a debtor's attorney on a petition constitutes a certification that "the attorney has no knowledge after an inquiry that the information in the schedules filed with [the] petition is incorrect."

• *Conference Report* § 227(a)

Debtors' counsel are subject to loss of fees, damages, injunctive remedies, and imposition of costs for any failure to meet new disclosure and record-keeping requirements.

• *Conference Report* § 319

A sense of Congress is set out, stating that Fed. R. Bankr. P. 9011 should be amended to include a requirement that all documents submitted by a debtor either to the court or a trustee, specifically including schedules, be subject to a reasonable inquiry by the debtor or the debtor's counsel to verify that the information contained in the document is well grounded in fact and warranted by law.

3. *Support priority.*

• *Conference Report* § 212

Family support obligations of the debtor would have the first priority in distribution, subject to the expenses of a trustee in administering assets that might otherwise be used to pay the support obligations.

4. *Reaffirmations.*

• *Conference Report* § 203

In addition to the provisions of current law, (1) a reaffirmation agreement is not effective unless the debtor received an extensive set of disclosures, and (2) the court may disapprove reaffirmation agreements with creditors other than credit unions if a statement filed by the debtor indicated that the debtor did not have sufficient funds to make the agreed upon payments. A hearing on this issue is required to be concluded prior to the time a discharge is entered, and there is no deadline for filing a reaffirmation agreement. Creditors are allowed to receive payments prior to the filing of a reaffirmation agreement, and under agreements "which the creditor believes in good faith to be effective." The disclosure requirements are met if "given in good faith."

5. *Redemption.*

• *Conference Report* § 304, 327

Redemption requires full payment of the amount of the allowed secured claim at the time of the redemption, with the claim based on the retail replacement price of the collateral.

6. *Ride-through.*

• *Conference Report* §§ 304-05

A debtor's option to retain collateral without redemption or reaffirmation by making contract payments, recognized by some courts, is eliminated. Failure to redeem or reaffirm results in termination of the automatic stay without motion.

7. *Trustee compensation.*

• *Conference Report* § 407

Section 330 is amended to provide that the compensation to Chapter 7 trustees would not be based on the factors applicable to other professionals, but would be a commission, based on § 326.

• *Conference Report* § 1224

If a Chapter 7 trustee is awarded compensation for services in connection with a § 707(b) motion, and the debtor is later in a Chapter 13 case (due to conversion or refiling after dismissal), any of the § 707(b) compensation remaining unpaid is to be paid during the Chapter 13 case, according to a limiting formula.

8. *Nonsubordination of property tax liens to family support claims.*

• *Conference Report* § 701

Section 724(b) of the Bankruptcy Code currently allows a Chapter 7 trustee to pay family support obligations from funds that would otherwise be used to satisfy a property tax lien, with the tax lien being subordinated to other liens on the affected property. This type of subordination is eliminated, so that if the debtor owed both property taxes (secured by a lien on the debtor's property) and support obligations, the proceeds of any sale of the property will be used to pay the taxes before the support obligations.

Chapter 13

1. *Secured claims: stripdown, adequate protection, valuation.*

• § *Conference Report* 306, both bills.

Stripdown of secured claims to the value of the collateral under § 506(a) is limited. Purchase money security interests in motor vehicles purchased within 910 days of the bankruptcy filing (two days less than 2-1/2 years), could not be stripped down, and stripdown is unavailable as to all other secured debts incurred within one year of bankruptcy.

• *Conference Report* § 327

Where stripdown is available, the collateral must be valued at replacement (retail) cost.

• *Conference Report* § 309(c)

Chapter 13 plans would have to provide for payment of secured claims in equal installments, at least sufficient to provide adequate protection, and, prior to confirmation, the debtor would have to make the adequate protection payments directly to the secured creditor, deduct the adequate payments from the preconfirmation plan payments made to the trustee, and give proof of the adequate protection payments to the trustee. The amount required to be paid for preconfirmation adequate protection is not clearly defined, and might be either the amount called for by the plan or the amount due under the contract. Preconfirmation payments on personal property leases (primarily auto leases) would have to be paid directly to the lessor, with proof given to the trustee.

2. *Disposable income*

• *Conference Report* §102(h)

The best efforts test of § 1325(b) currently requires Chapter 13 plans (if objected to by the trustee or an unsecured creditor) to either pay unsecured claims in full with interest or else provide that all of the debtor's disposable income will be contributed to the plan for a minimum period of three years. Under the new legislation, for Chapter 13 debtors whose income is more than the defined median, "disposable income" for purposes of the best efforts test is to be calculated under the means test for the presumption of abuse under § 707(b).

3. *Plan length*

• *Conference Report* § 318

For debtors whose income is equal to or greater than the applicable median, the "best efforts" test, in the absence of full payment, requires a five-year plan.

4. *Superdischarge*

• *Conference Report* §§ 314, 707

The list of debts excepted from a Chapter 13 discharge under current § 1328(a) is expanded to include debts defined by § 523(a)(1)(B) and (C) [unfiled, late-filed, and fraudulent tax returns], (a)(2) [fraud, including credit card misuse], (a)(3) [failure to notify creditors of the bankruptcy in time to allow assertion of claims], (a)(4) [embezzlement, breach of fiduciary duty], and—insofar as personal injury or wrongful death is concerned—(a)(6). However, where § 523(a)(6) provides that "willful *and* malicious" injury gives rise to nondischargeable debts in Chapter 7 and 11 cases, the revised § 1328(a)(4) would except debts arising from "willful *or* malicious" injury.

5. Timing of confirmation hearing

• *Conference Report* § 317

Confirmation hearings may not take place until at least 20 days after the 341 meeting, unless the court determines that it would be in the best interests of creditors and the estate to hold an earlier confirmation hearing and there is no objection. The confirmation hearing is required to be conducted no later than 45 days after the conclusion of the 341 meeting.

Chapter 11

Individual Chapter 11 cases.

• *Conference Report* § 321

Individual Chapter 11 debtors will receive a discharge only after completion of their plans; a best efforts test (5-year minimum contribution of disposable income) is applicable on the objection of any unsecured creditor; and the post-petition earnings of the debtor are property of the estate.

General

1. *Successive discharges.*

• *Conference Report* § 312

A Chapter 7 debtor will be subject to denial of discharge under § 727 if the debtor received a Chapter 7 or 11 discharge in a case filed within 8 years of the filing of the pending case. A Chapter 13 debtor will be denied discharge if the debtor received a discharge (a) in a case under Chapter 7, 11, or 12, filed within four years of the pending case filing, or (b) in a prior Chapter 13 case filed within two years of the pending case filing.

2. *Tax returns, other required filings.*

• *Conference Report* § 315(b)

Section 521 is amended to provide that, unless the court orders otherwise, individual debtors must file, together with their schedules,"copies of all payment advices or other evidence of payment received within 60 days before the filing of the petition, by the debtor from any employer of the debtor," as well as "a statement of the amount of monthly net income, itemized to show how the amount is calculated" and " a statement disclosing any reasonably anticipated increase in income or expenditures over the 12-month period following the date of the filing of the petition."

Each debtor must also provide to the trustee, and to any creditor making a timely request, at least seven days prior to the 341 meeting, a copy of the federal income tax return or transcript of the return (the debtor's choice), for the period for which the return was most recently due. Each individual debtor in a case under Chapter 7, 11, and 13, must also, on request of a party in interest or the judge, file with the court copies of federal income tax returns (or transcripts of the returns) that become due while the case is pending or were past due for the three-year period prior to filing. The filed returns are to be available to any party in interest, with the debtor's privacy protected by regulations to be adopted by the Director of the Administrative Office.

At the request of any party in interest, the debtor in a Chapter 13 case must file a financial statement annually, under penalty of perjury, showing "income and expenditures of the debtor during the tax year . . . most recently concluded . . . and monthly income of the debtor." The annual statement must also show "how income, expenditures, and monthly income are calculated."

• *Conference Report* § 716

A new § 1308 requires Chapter 13 debtors to file any tax returns past due for the four years preceding the bankruptcy filing within specified times following the 341 meeting.

3. *Audits*

• *Conference Report* § 603

Audits are required (1) of all information provided by the debtors in at least 0.4% of individual Chapter 7 and 13 cases, randomly selected, and (2) of any schedules of income and expenses "which reflect greater than average variances from the statistical norm of the district in which the schedules were filed if those variances occur by reason of higher income or higher expenses than the statistical norm of the district in which the schedules were filed." The audits are to be conducted by certified or licensed public accountants in accordance with generally accepted auditing standards, or under regulations adopted by the Attorney General (and the Judicial Conference in areas served by bankruptcy administrators), within two years of enactment of the legislation,

4. *Credit counseling and debtor education.*

• *Conference Report* §106(a)

Individuals will be ineligible for relief under any chapter of the Code unless, within 180 days of their bankruptcy filing, they received credit counseling—through a service approved by the United States trustee or bankruptcy administrator—that includes, at a minimum, a briefing on the opportunities for credit counseling and assistance in performing an initial budget analysis. The required counseling may be provided by telephone or the internet. Exceptions would be made (1) for districts in which adequate services were unavailable and (2) for debtors with exigent circumstances requiring filing before the counseling could be obtained within five days after the debtor requested it (in which case the debtor would be required to complete the counseling within 30 days after the bankruptcy filing). The debtor is required to file a certificate from the creditor counselor describing the services provided, and file any debt repayment plan developed with the counselor.

• *Conference Report* §§105, 106(b)

Pilot educational programs for debtor financial management would be tested in six judicial districts over an 18-month period, and thereafter evaluated for effectiveness and cost. At the same time, all Chapter 7 debtors would be subject to denial of discharge under § 727, and Chapter 13 debtors would not be granted a discharge, if they failed to complete an instructional course concerning personal management, unless the United States trustee or bankruptcy administrator determined that approved courses were inadequate. Telephone and internet courses would be permissible "if effective".

5. *Automatic stay.*

• *Conference Report* § 302

If a Chapter 7, 11, or 13 case is filed within one year of the dismissal of an earlier case (other than a Chapter 11 or 13 case filed after a § 707(b) dismissal), the automatic stay in the second case terminates 30 days after the filing, unless a party in interest demonstrates that the second case was filed in good faith with respect to the creditor sought to be stayed. And if a second repeat filing takes place within the one-year period, the automatic stay does not go into effect, although a party in interest may obtain imposition of the stay by demonstrating that the third filing is in good faith with respect to the creditor sought to be stayed.

• *Conference Report* § 303

"In rem" relief from the automatic stay is authorized—in cases of multiple bankruptcy filings involving the same property, the court may issue an order of relief from the automatic stay as to the property, which order, if properly recorded, is binding on all owners of the property for two years from the date of entry. A party in interest may file a request for imposition of the stay within 30 days of a subsequent case filing, and the court may impose the stay only if the party demonstrates that the case was filed in good faith as to the creditors sought to be stayed.

• *Conference Report* § 311

Two new exceptions from the automatic stay are established for landlords seeking to evict tenants. The first, § 362(b)(22) allows the continuance of any eviction proceeding in which the landlord obtained a judgment of possession prior to the filing of the bankruptcy petition. The second, § 362(b)(23) deals with evictions based on "endangerment" of the rented property or "illegal use of controlled substances" on the property. Paragraph (b)(23) would except the eviction proceeding from the stay if (a) it was commenced before the filing of the bankruptcy case, or (b) if the endangerment or illegal use occurred within the 30 days before the bankruptcy filing. In either situation, the landlord would be required to file with the court and serve on the debtor a certificate setting out the facts giving rise to the exception. The debtor would be able to contest the applicability of the new exceptions. As to (b)(22), the debtor would be able to keep the stay in effect by showing that applicable nonbankruptcy law allowed the lease to remain in effect upon the debtor's cure of the default that was the basis of the eviction order, and by paying the cure amount within 30 days of the bankruptcy filing. As to (b)(23), the debtor may contest the assertions in the landlord's certificate, and the court is required to conduct a hearing within 10 days "to determine if the situation giving rise to the lessor's certification . . . existed or has been remedied."

6. *Notice to creditors.*

• *Conference Report* § 315(a)

Notice to a creditor will not be effective (for purposes of enforcing the automatic stay) unless served at an address filed by the creditor with the court or at an address stated in two communications from the creditor to the debtor within 90 days of the filing of the bankruptcy case, unless the notice was "brought to the attention of the creditor," which is defined as meaning receipt by a person designated to receive bankruptcy notices.

7. *Exemptions.*

• *Conference Report* § 307

Debtors must have had a domicile in the state of their bankruptcy filing for 730 days before filing in order to claim the exemption law of that state. Otherwise, the applicable exemption law is that of the place of domicile for the majority of the 180-day period preceding the 730 days before filing (that is, between 2 and 2-1/2 years before the filing).

• *Conference Report* § 308

The value of a debtor's homestead, for purposes of a homestead exemption, is reduced to the extent of any addition to the value of the homestead on account of a disposition of nonexempt property made by the debtor—with intent to hinder, delay, or defraud creditors—during the 10 years prior to the bankruptcy filing.

• *Conference Report* § 322

Value in excess of $125,000 added to the homestead during the 1215-days (about 3 years, 4 months) preceding the bankruptcy filing is deducted from the exemption unless it was transferred from another homestead in the same state. An absolute $125,000 homestead cap applies if either (a) the court determines that the debtor has been convicted of a felony demonstrating that the filing of the case was an abuse of the provision of the Bankruptcy Code, or (b) the debtor owes a debt arising from a violation of federal or state securities laws, fiduciary fraud, racketeering, or crimes or intentional torts that caused serious bodily injury or death "in the preceding 5 years."

• *Conference Report* § 323

Employee contributions to ERISA-qualified plans are exempted from the estate.

• *Conference Report* § 224

All tax-exempt retirement accounts are deductible, with a $1 million cap for IRAs.

8. *Bankruptcy appeals.*

• *Conference Report* § 1233.

The circuit courts of appeal are given discretion to accept bankruptcy appeals without an intermediate appellate decision if the bankruptcy court, the district court, the Bankruptcy Appellate Panel, or the parties to the appeal acting jointly certify that direct appeal is necessary to resolve a matter or issue of importance.

9. *Effective date.*

• *Conference Report* § 1401

The changes made by the legislation are generally effective only with respect to cases filed after its effective date, 180 days after the date of enactment, except that the limitations on homestead exemptions set out in §§ 308 and 322 become effective upon enactment.

2002 Bankruptcy Reform Legislation (H.R. 333 Conference Report)
Table of Major Consumer Effects

Impact Area	Issue	Section	Details
Chapter 7	Means testing	102	Test uses average monthly income (over 6 months) less (1) IRS collection standards, with up to 5% increase in food and clothing, but without debt repayment; (2) expenses for protection from family violence; (3) continued contributions to care of nondependent family members; (4) actual expenses of administering a Chapter 13 plan, as determined by the EOUST; (5) expenses for grade and high school (up to $1500 annually, per minor child), with documentation of need; (6) additional documented home energy costs; (7) 1/60th of all secured debt due in the five years after filing (and past due on property necessary for support); (8) 1/60th of all priority debt; and (9) [current law] continued charitable contributions, up to 15% of gross income. Presumes abuse (1) if at least $100, but less than $166.67, and enough to pay at least 25% of general unsecured debt over 5 years or (2) if greater than or equal to $166.67. Presumption overcome only by a showing of unavoidable special circumstances, detailed and sworn to by debtor. Debtor must file calculations as to presumption. UST must file a statement regarding presumption; court must serve on creditors. UST must file a motion or statement in all presumption cases where income exceeds a defined median. Median income limits all invocation of the presumption and limits general standing (for bad faith).
	Sanctions on debtors' counsel	102, 319	Fees for trustee's § 707(b) motion may shift to debtor's counsel if bankruptcy filing found to violate Rule 9011. Rule 9011 to include schedules: requires certification of no knowledge, after inquiry, of inaccuracy in schedules; violation by counsel allows payment of civil penalty.
	Support priority	212	Claims for support made first priority, subject to the expenses of a trustee administering assets "otherwise available to pay such claims."
	Reaffirmation	203	Extensive disclosure statement (with broad safe harbors for creditors); hardship hearings required in certain cases, must conclude before discharge.
	Redemption	304, 327	Requires full payment of secured claim, valued at retail, at the time of redemption, within 45 days "after the first meeting of creditors."
	"Ride-through"	304, 305	"Ride-through" alternative to reaffirmation under 521(2) is eliminated—failure to redeem or reaffirm terminates the stay without creditor motion.
Chapter 13 (***see also*** Tax returns, ***infra***)	Secured claims: stripdown, adequate protection; valuation	306, 309(c), 327	No § 506(a) stripdown for motor vehicle loans incurred within 2-1/2 years of bankruptcy or for other secured debts incurred within 1 year. Preconfirmation adequate protection payments must be made directly by debtor to creditor, with proof to the trustee. Plan payments must be in equal amounts sufficient for adequate protection. Retail value must be used in all individual Chapter 7 and 13 cases in determining § 506(a) valuations.
	Disposable income	102(h)	"Disposable income" is generally defined, and for debtors with more than median income, is determined according to the § 707(b) means test.
	Length of plan	318	For debtors with more than median income, a 5-year minimum plan is required unless full payment is made in less time.
	Superdischarge	314, 707	No superdischarge for § 523(a)(1)(B)(C), (2), (3), (4), or debts arising from "willful *or* malicious" personal injury or wrongful death.

Chapter 11	Individuals	321	If any unsecured creditor objects, a 5-year best efforts test applies; estate definition, plan modification, and discharge treated as in Chapter 13.
General	Successive discharge	312	No discharge is allowed in Chapter 13 if a prior discharge was entered in (a) any Chapter 7, 11, or 12 case filed within 4 years of the pending filing or (b) any Chapter 13 case filed within 2 years of the pending filing. Section 727(a)(8), giving grounds for an objection to discharge in Chapter 7 or 11 after the filing of a prior Chapter 7/11 in which a discharge was entered, is extended to 8 years .
	Tax returns and other required filings	315(b)	A copy of the debtor's federal tax return or transcript for the tax year before bankruptcy must be given to the trustee and any requesting creditor within 7 days of the § 341 meeting; otherwise the case must be dismissed unless debtor shows circumstances beyond the debtor's control. Section 521 filings must include a "net income" calculation and pay stubs for 60 days before bankruptcy. On request of any party in interest, the debtor must file current tax returns and (in Chapter 13) an annual budget.
	Audits	603	Audits must be conducted of a random minimum 0.4% of all consumer filings and of all schedules "reflecting greater than average variance" from district norms, under GAAS by independent certified or licensed public accountants or under regulations of the Attorney General (adopted within 2 years of enactment of the legislation).
	Credit counseling; debtor education	105, 106	Credit counseling (approved by the U.S. trustee) is a § 109 eligibility requirement; there is 5-day exigency exception; phone or internet counseling may be approved. Completion of a debtor education program approved by the U.S. trustee is a condition for discharge in Chapter 13; failure to complete such a program is grounds for denying discharge in Chapter 7; pilot programs concurrent with mandatory.
	Automatic stay	302, 303, 305, 311	The automatic stay terminates after 30 days in a first repeat filing within one year; no automatic stay comes into effect in a second repeat filing in a year (but the court may order otherwise on a showing of good faith). 2-year ***in rem*** stay relief is available. New stay exceptions are added for cases filed by ineligible debtors, and for certain residential lease evictions (subject to rebuttal by debtors).
	Notice to creditors	315(a)	Creditors must be served at addresses filed with the court or listed on two communications to debtor within 90 days before case filing.
	Exemptions	307, 308, 322, 323, 224	730-day residency is required for state exemptions; homestead exemption reduced by a 10-year exclusion of value fraudulently added to the homestead; $125,000 cap is placed on value added to the homestead during the 1215 days (3 yrs, 4 mos.) preceding bankruptcy, unless from a prior homestead in the same state; an absolute $125,000 homestead cap is imposed if the debtor has been convicted of a felony showing abuse or if the debtor owes a debt arising from securities law violations, fiduciary fraud, racketeering, or intentional or reckless physical harm. ERISA contributions are excluded from the estate., and a new general exemption is created for tax-exempt retirement funds, with a $1million cap for IRAs.
	Bankruptcy appeals	1233	Bankruptcy court decisions may be directly appealed to the circuit court if authorized by the circuit on certification by any lower court or all parties.
	Effective date	1401	The legislative is generally effective 180 days after enactment and inapplicable to cases filed before the effective date—with an exception for the new homestead limits, which are effective upon enactment.

A PROPOSAL FOR MORE EFFECTIVE BANKRUPTCY REFORM
By A. Thomas Small and Eugene R. Wedoff

Introduction

This Proposal addresses the goals of bankruptcy reform advanced in the last several sessions of Congress and most recently incorporated in the Conference Report on H.R. 333 in the 107th Congress. The Proposal furthers the principal objective of the reform legislation—to curb bankruptcy abuse—by expanding the scope of the legislation, by making bankruptcy relief more difficult for the most likely abusers, and by eliminating unproductive and costly administrative procedures so that judicial resources may be better focused on cases involving real abuses.

The Proposal is set out in 15 separate recommendations, followed by a summary table. The recommendations for individual bankruptcy cases (1) make the reform provisions applicable to *all* debtors, rather than limiting them to debtors with primarily consumer debts, (2) expand the criteria for determining abuse to include both ability to pay and the amount of property exempted, (3) expose the most likely abusers to increased scrutiny, and (4) maintain incentives for debtors to choose repayment of their debts through a Chapter 13 plan. The recommendations for business bankruptcy are consistent with the objective of expediting the confirmation process, reducing costs for both debtors and creditors, and providing increased oversight.

The Proposal is limited to those areas with the greatest impact on the bankruptcy system, and does not address all of the provisions of the Conference Report. The failure to comment on a particular section of the Conference Report reflects neither support of nor disagreement with that section.

Proponents

A. Thomas Small has been a United States Bankruptcy Judge for the Eastern District of North Carolina for 20 years and served a 7-year term as Chief Judge from 1992 to 1999. His involvement with bankruptcy reform began in the early 1980s. As an attorney in the Legal Division of First Union National Bank and as a representative of the American Bankers Association and the National Coalition for Bankruptcy Reform, Judge Small participated in hearings on bankruptcy abuse conducted by Senator Robert Dole, Chair of the Senate Judiciary Committee's Subcommittee on Courts, and by Representative Peter Rodino, Chair of the House Judiciary Committee. These reform efforts led to significant amendments to the Bankruptcy Code, including the addition of § 707(b) and amendments to § 523 to discourage the "loading up" of pre-bankruptcy debt. In 1985, Judge Small, along with Judge Thomas M. Moore (B.J., E.D.N.C.) testified before a joint Senate committee chaired by Senators Charles Grassley and John East regarding agricultural bankruptcies. Together with Judge Keith Lundin (B.J., M.D. Tenn.), Sam Gerdano (majority counsel for the Senate Judiciary's Subcommittee), and Vince Lavoi (legislative aid to Rep. Mike Synar), Judges Small and Moore drafted Chapter 12, which became part of the Bankruptcy Code in 1986. In 1987, Judge Small developed a fast track procedure for handling small business Chapter 11 cases. These procedures have been adopted in many districts and are the basis of many of the present small business provisions in the Bankruptcy Code and in the Conference Report.

Judge Small is chair of the Advisory Committee on Bankruptcy Rules of the United States Judicial Conference, was a member of the Long Range Planning Committee of the United States Judicial Conference from 1991 to 1996, and was a member of the Board of the Federal

Judicial Center from 1997 to 2001. He was president of the National Conference of Bankruptcy Judges (2000-2001), served on the Board of the American Bankruptcy Institute from 1989 to 1995, and currently is on the Board of the American College of Bankruptcy.

Eugene R. Wedoff is the Chief Bankruptcy Judge for the Northern District of Illinois, in Chicago. He has been serving as a bankruptcy judge in that district for 15 years. After graduating from the College and Law School of the University of Chicago, Judge Wedoff became a partner and member of the Executive Committee at the Chicago law firm of Jenner & Block, specializing in the defense of businesses and individuals in complex civil litigation. Judge Wedoff is presently presiding over the bankruptcy of United Airlines and its related entities.

In 1997, Judge Wedoff became co-chair of the Consumer Bankruptcy Committee of the American Bankruptcy Institute. In that capacity, he has prepared analyses of the bankruptcy reform legislation presented in the last several terms of Congress, and testified concerning the legislation before the House Subcommittee on Commercial & Administrative Law. For his work in this area, Judge Wedoff received a special award from the ABI in 1998. Judge Wedoff also has engaged in discussions regarding bankruptcy reform as a participant in the Annual Bankruptcy Conferences sponsored by Visa USA, and has been a member of the Visa Bankruptcy Roundtable. An advocate of the Chapter 13 bankruptcy system, Judge Wedoff drafted the model Chapter 13 plan now used in the Northern District of Illinois and introduced that District's model retention agreement, which sets out the duties owed by debtors' attorneys to their clients.

Judge Wedoff is the author of the chapter on professional employment in Queenan, Hendel and Hillinger, *Chapter 11 Theory and Practice* (LRP Publications, 1994), and has served as an associate editor of The American Bankruptcy Law Journal. He is a director of the American Bankruptcy Institute, a member of the Board of Governors of the National Conference of Bankruptcy Judges, and a Fellow of the American College of Bankruptcy.

The Proposal

1. Section 707(b), abuse, means testing

Proposal

1) Change "substantial abuse" to "abuse" in § 707(b) [same as Conference Report ("CR") § 102(a)(2)].

2) Remove the presumption in favor of the debtor's choice of relief in § 707(b) [same as CR § 102(a)(2)].

3) Expand the scope of § 707(b) to include *all* individual debtors, not just those with "primarily consumer debts" [new, modifies CR § 102(a)(2)].

4) Expand the criteria for § 707(b) "abuse" to include (1) the ability to repay general unsecured debt at a rate of at least $150 monthly, and (2) the totality of the debtor's circumstances, with specific reference to the extent of exemptions claimed by the debtor and to the intent of the debtor to reject a personal services contract [new, modifies CR § 102(a)(2)].

5) Clarify income measurement for purposes of § 707(b) to require that the determination of abuse be based on the debtor's earning capacity, considering both the debtor's income at the time of filing and the debtor's income for the preceding calendar year [continues approach of CR § 102(a)(2) by considering past earning history, but eliminates difficulties caused by 6-month averaging].

6) Permit creditors to file motions to dismiss under § 707(b) if the debtor's current or prior year income exceeds the applicable state median [expands CR approach in § 102(a)(2)].

7) Determine debtor's expenses on an actual and necessary basis, without application of IRS standards [new, modifies CR § 102(a)(2)].

8) Provide for a study of the effect of employing IRS standards or other measures of appropriate living expenses in determining abuse under § 707(b) [same as CR § 103(b), but with the study preceding the use of IRS standards].

9) In cases where the debtor's gross income exceeds 150% of the applicable state median,

   a. require debtors to file schedules detailing each item of personal property with a fair market value exceeding $500, and to provide copies of the prior three years' income tax returns or transcripts to the trustee within 7 days of the § 341 creditors' meeting;

   b. require that the U.S. trustee (or bankruptcy administrator) file either a motion to dismiss under § 707(b) or a statement explaining why no motion was filed;

   c. if no motion under § 707(b) is filed by the U.S. trustee or bankruptcy administrator, require the clerk (i) to provide creditors with a copy of the statement explaining why no motion was filed and (ii) to notify creditors of their right to file such a motion;

   d. authorize the court—on a showing by the trustee, U.S. trustee or bankruptcy administrator of cause to question the accuracy of the debtor's schedules—to order an audit of the debtor's schedules by an auditor approved by the U.S. trustee or bankruptcy administrator, with the costs of the audit paid by the debtor

   [modifies procedures of CR § 102(a)(2) to apply in most cases in which abuse is likely].

Comment

Perhaps the most important change proposed in the Conference Report is its "needs-based" approach to Chapter 7 relief. This approach is designed to limit Chapter 7 relief to debtors who genuinely need it, because their income is not sufficient to pay both their living expenses and their debts. The Conference Report effectuates needs-based Chapter 7 relief through amendments to § 707(b) of the Code. Section 707(b) currently allows dismissal of Chapter 7 cases for "substantial abuse," with the understanding that it would be a substantial abuse for a debtor to seek an immediate discharge in Chapter 7 if the debtor could repay debts from current income, under Chapter 13 if necessary. However, § 707(b) has had limited impact—for several reasons: (1) only judges and the U.S. trustee or bankruptcy administrator have standing to bring a § 707(b) motion; (2) the provision is limited to debtors with primarily consumer debts; (3) it contains no definition or description of "substantial abuse"; and (4) it includes a presumption that the debtor has properly chosen to proceed in Chapter 7.

The Conference Report amends § 707(b) to accord standing to all parties in interest if the debtor's average monthly income over a six-month period exceeds a defined state median; it allows dismissal for simple "abuse" rather than "substantial abuse"; it describes abuse as involving the totality of the debtor's financial situation; it eliminates the presumption in favor of the debtor's choice of Chapter 7; and it creates a new presumption: that abuse exists in any case where the debtor's average monthly income over six months—less deductions for living expenses and payment of secured and priority debt—exceeds defined "trigger points." For purposes of this presumption, the debtor's expenses are based, in part, on standards developed by the IRS for negotiating payment of tax liabilities from delinquent taxpayers.

The Conference Report's approach is problematic in two respects. First, it continues the current limitation of § 707(b) to debtors with primarily consumer debts, with the effect of excluding from its scope wealthy debtors with substantial business liabilities. Second, its presumption of abuse is complex, and creates substantial difficulties in calculating both income and allowable expenses. Six-month income averaging produces skewed results for debtors with seasonal employment, and fails to take into consideration recent changes in employment. Moreover, the IRS collection standards for expense allowance, which are complex in their own right, were not created for use in bankruptcy, and so the Conference Report contains numerous provisions modifying or supplementing them (for example, one provision requires that the IRS standards be adjusted to eliminate any expense attributable to secured debt repayment, since such payments are allowed as a separate deduction). As a result, the presumption is difficult to apply and subject to manipulation. It also imposes substantial costs on all debtors, regardless of their ability to pay debts, as well as on trustees and the court in administering the presumption.

To achieve the goal of needs-based Chapter 7 more effectively, the Proposal suggests retaining the overall modifications to § 707(b) set out in the Conference Report as follows: (1) changing "substantial abuse" to simple "abuse"; (2) removing the presumption in favor of the debtor's choice of Chapter 7 relief; (3) defining "abuse" to include consideration of the debtor's ability to pay general unsecured debt at a defined level; (4) considering the debtor's past earnings in determining ability to pay; and (5) extending standing to creditors and case trustees where the debtor's income exceeds the applicable state median. However, the Proposal would delay application of a presumption of abuse until the completion of a study of the potential use of IRS collection standards for this purpose, as directed by § 103(b) of the Conference Report.

At the same time, the Proposal suggests the following additional provisions to make § 707(b), as amended, more effective:

• Remove the "primarily consumer debt" limitation, so that § 707(b) is applicable to all individual Chapter 7 debtors.

• Allow the expanded standing for parties in interest to be based on the debtor's prior year's gross income, as well as on current income.

• Create a single, clear "trigger point" of $150 (adjusted for inflation), at which available monthly income to pay general unsecured debts will constitute abuse of Chapter 7. The trigger points for the presumption of the Conference Report range from $100 per month to $166.67 per month, depending on the total amount of general unsecured debt. This range creates complexity, and provides incentive for debtors to increase their debt prior to bankruptcy so as to avoid a finding of abuse.

• Specify that, in calculating the amount of income the debtor has available to pay general unsecured debt, the debtor's actual earning capacity be used, determined by the debtor's earnings history as well as the debtor's current earnings. Specify further that the expenses claimed by the debtor must be the debtor's actual expenses, in amounts reasonably necessary to provide for the maintenance or support of the debtor and the debtor's dependents.

• Clarify that the "totality of the circumstances" may lead to a finding of abuse even where the debtor has not been shown to have ability to repay debt above the trigger point, and that, in this regard, the court may consider the extent of the exemptions claimed by the debtor as well as bad faith and the intent by the debtor to reject a personal services contract.

• Create a set of procedures for the filings most likely to be found abusive: namely, those of debtors with income exceeding 150% of the applicable state median. These procedures would require the debtor to provide more detailed schedules, would require specific consideration of § 707(b) by the U.S. trustee or bankruptcy administrator, and would provide additional notice to creditors, allowing them to file a § 707(b) motion if the U.S. trustee or bankruptcy administrator declines to do so. Additionally, where there are grounds for believing that there are material misstatements in schedules filed by a debtor with income exceeding 150% of the applicable median, the court would be authorized to order an audit of the schedules, at the debtor's expense.

2. Random audits; attorney liability for accuracy of schedules

Proposal

1) Provide for random audits of all individual debtors, conducted by auditors approved by the U.S. trustee or bankruptcy administrator; provide for the cost of such audits to be borne by the U.S. trustee system unless a willful, material misstatement is established; in case of such a misstatement, provide for the audit cost to be assessed against the debtor [consistent with, but expanding on CR § 603].

2) Eliminate increased liability for debtor's counsel beyond that currently required by Rule 9011, FRBP [omits additional liability provided in CR §§ 102(a), 319].

Comment

Random audits. In order for the bankruptcy system to operate fairly, it is essential that the information provided by debtors in their schedules be accurate. To achieve greater accuracy the Conference Report provides for random audits of not less than one in every 250 cases of individual debtors (0.4%). If the cost is $1500 for each audit, and individual bankruptcy cases continue to be filed at the current rate (1.5 million annually), the total annual cost to audit 0.4% of the cases would be $9 million. The Conference Report does not address payment of the costs of these audits.

Random audits have the potential to be very effective in encouraging accuracy by debtors. At the same time, the question of payment for the audits must be addressed. Most Chapter 7 debtors have no assets available to pay the costs of an audit. Chapter 13 debtors often are required to devote nearly all of their debt repayment to priority and secured indebtedness, which must be paid in full, leaving little for payment of general unsecured claims. A requirement that such debtors bear the cost of an audit would be very difficult to enforce, and likely cause the failure of many Chapter 13 plans. Thus, as a general rule, the costs of the audits should be borne by the U.S. trustee system, with funding provided to that system for this purpose. On the other hand, where a random audit reveals a willful, material misstatement by the debtor, it is appropriate for the audit costs to be assessed against the debtor; the imposition of such costs will serve as an additional incentive for accuracy.

Attorney liability. The burden of full and accurate disclosure in bankruptcy schedules is properly placed on the debtor. With the addition of random audits, there should be no need for the enhanced liability that the Conference Report would impose on debtors' attorneys to investigate the accuracy of schedules. Requiring such investigation would increase the cost of legal representation and interfere with the attorney-client relationship.

3. Conditions precedent for relief (credit counseling, financial documentation, education)

1) Require credit counseling as a condition of eligibility for individual Chapter 7 debtors [same as CR § 106(a), but limited to Chapter 7].

2) Require debtors to produce proof of earnings to the trustee, prior to the § 341 creditors meeting, rather than filing the documentation with the court; provide that if the debtor fails to produce information required under § 521 of the Code, the court must dismiss the case on motion of a party in interest, unless (a) the debtor demonstrates that the failure was due to circumstances beyond the debtor's control or (b) the trustee establishes grounds for seeking a denial of discharge or administering the estate for the benefit of creditors [modifies CR §§ 315(b) and 316].

3) Commence a program of mandatory debtor education only after consideration of a study of the effectiveness of various educational methods [retains CR § 105; defers CR § 106(b)].

Comment

Credit counseling. Section 106(a) of the Conference Report requires that each individual debtor obtain a briefing from a credit counseling agency as a condition of eligibility for bankruptcy filing. The briefing would inform the debtor of the opportunities for credit counseling and assist the debtor in performing a budget analysis. Such a briefing could be helpful to Chapter 7 debtors. A Chapter 7 debtor may not have carefully considered the possibility of paying creditors over time through available income, and a limited delay in filing the case to allow for a credit counseling briefing is unlikely to cause significant difficulties, since Chapter 7 is not generally used to prevent foreclosures or repossessions.

In contrast, credit counseling briefings are not likely to be helpful in Chapter 13. A Chapter 13 debtor must propose a budgeted repayment plan as part of the bankruptcy process, and so any budgeting work done with a credit counselor would be duplicative, adding unnecessary expense. Moreover, Chapter 13 debtors frequently approach their attorneys shortly before a foreclosure sale or repossession, with a need to file the bankruptcy immediately if the threatened action is to be avoided. Any delay required to obtain counseling could cause the loss of property essential to the debtor's success in reorganizing under Chapter 13. (While the Conference Report does provide an exception for filing in emergencies, it requires the debtor to establish that credit counseling services were unavailable for five days, and so the exception would not apply in situations where the attorney is contacted within five days of a threatened foreclosure or repossession.) Limiting the credit counseling requirement to Chapter 7 debtors would provide maximum value, limit unnecessary expense, and provide a valuable incentive for debtors to file under Chapter 13.

Financial documentation/dismissal for failure to produce. Section 521 of the Code sets out the duties of debtors, including the duty to file schedules. Section 315(b) of the Conference Report imposes several additional duties on individual debtors, including a duty to file with the court "copies of all payment advices or other evidence of payment received within 60 days before the filing." Such payment advices are likely to include identifying information of a personal nature (including social security numbers) that would be difficult for the court to protect from disclosure. For tax returns filed prior to the bankruptcy, § 315(b) provides that the debtor is not required to file the information with the court, but to provide it to the trustee at least seven days before the creditors' meeting. By treating payment advices in the same way, the problems of protecting privacy can be avoided.

Sections 315(b) and 316 of the Conference Report set out a complex set of rules for dismissal of individual bankruptcy cases in situations where the debtor fails to submit required financial information. In some situations, dismissal is required automatically, without notice to the debtor. In others, dismissal is required unless there is a showing of good faith on the debtor's part, or a showing that circumstances beyond the debtor's control prevented timely production of the documents. Automatic dismissal is problematic, in that neither the debtor nor the trustee may be aware of any deficiency in providing required information; and, dismissal in the absence of a showing of good faith by the debtor may prevent a trustee from seeking a denial of the debtor's discharge or the recovery of avoidable transfers. It is preferable to require a motion for dismissal based on the debtor's failure to provide required information, and to allow denial of the motion if the debtor shows the existence of circumstances beyond the debtor's control, or the trustee shows good cause to continue administering the case for the benefit of creditors.

Debtor education. Section 105 of the Conference Report establishes a pilot educational program, in six judicial districts, designed to help individuals better manage their finances. The program would be studied by the Executive Office for United States Trustees, and would be followed by a report to Congress by the director of that office. The program, study, and report would be of great value. A number of educational programs already have been developed, primarily in the context of Chapter 13, and knowledge of their effectiveness would be very helpful to Congress in determining what type of educational program would be most effective in bankruptcy. For example, it might be determined that educational programs are much more effective in Chapter 13, where debtors are in contact with the bankruptcy process for an extended period of time, than they are in Chapter 7, where the debtor is generally involved in bankruptcy for only a few weeks.

In contrast to § 105, § 106(b) of the Conference Report mandates debtor education in both Chapter 7 and Chapter 13 cases, on penalty of a loss of the bankruptcy discharge. It is premature to require completion of the educational programs before the results of the study. If it is determined, for example, that educational programs are not effective in Chapter 7, requiring completion of such programs will unnecessarily expend both the time and financial resources of debtors with limited income. Moreover, allowing completion of the study before mandating education will allow any mandated course of study to be based on the best available curriculum.

4. Reaffirmation agreements

Proposal

1) Conduct a study to determine extent of any abuse and need for legislation [same as CR § 205].

2) Defer modifying reaffirmation procedures until completion of the study [defers extensive and confusing reaffirmation requirements in CR § 203].

Comment

Under present law counsel must certify that reaffirmation agreements (other than agreements involving a consumer debt secured by real property) do not impose an undue hardship on the debtor or a dependent of the debtor and that the agreement is in the debtor's best interest. 11 U.S.C. § 524(c)(6). If the debtor is not represented by an attorney in connection with the reaffirmation agreement, the court must hold a hearing at which it informs the debtor of the effect of the agreement and finds that the agreement (other than an agreement involving a debt secured by real property) does not impose an undue hardship on the debtor or a dependent and is in the debtor's best interest. 11 U.S.C. § 524(d). These requirements—attorney certification and court approval for agreements involving pro se debtors—may be adequate to protect the interests of debtors. The protections provided by the Conference Report are cumbersome and should not be enacted until the study has been completed and a need for the additional protections has been established.

5. Serial filers; relief from stay

Proposal

1) Provide that, in a second bankruptcy case filed by a debtor within a one year period, the court shall enter an order terminating the automatic stay 30 days after the second petition is filed, without the need for a motion, unless prior to the expiration of 30 days the debtor demonstrates that the second case was filed in good faith or unless a trustee demonstrates the potential to administer particular assets for the benefit of the estate [consistent with CR § 302 except that an order is required].

2) Provide that, upon a third bankruptcy filing by a debtor within a one year period, the court shall immediately enter an order terminating the automatic stay, without the need for a motion, except that the stay may be reinstated by the court if the debtor demonstrates that the third case was filed in good faith or if a trustee demonstrates the potential to administer particular assets for the benefit of the estate [consistent with CR § 302 except that an order is required].

3) Provide in § 362(d) of the Code that, with respect to all personal property securing consumer debts in Chapter 7 cases, the court shall enter an order terminating the stay, upon motion, if there has been no redemption or reaffirmation with respect to the property within 45 days of the date first set for the first meeting of creditors, unless the trustee establishes that the property at issue is of consequential value or benefit to the estate, in which case the court shall order appropriate adequate protection of the moving party's interest [consistent with CR § 304-05 except that an order on motion is required].

4) Provide in § 362(d) of the Code that, with respect to all personal property subject to an unexpired lease in an individual Chapter 7 case, the court shall enter an order terminating the stay, upon motion, if there has been no assumption of the lease within 45 days of the date first set for the first meeting of creditors, unless the trustee establishes that the lease at issue is of consequential value or benefit to the estate, in which case the court shall order appropriate adequate protection of the moving party's interest [consistent with CR § 305 except that an order on motion is required].

5) Provide in § 362(d) of the Code that, in Chapter 11 cases of small business debtors, the court shall enter an order terminating the stay, upon motion, if in a prior small business case of the debtor (or of an entity that the debtor acquired) an order of dismissal or an order confirming a plan was entered less than two years prior to the order of relief in the pending case, unless the debtor shows (a) that the pending case was an involuntary one, filed without collusion with the debtor, or (b) that the need for filing the pending case arose from unforeseeable circumstances beyond the control of the debtor, and that a non-liquidating plan is probable [consistent with CR § 441(2) except that an order on motion is required].

Comment

It is not uncommon for debtors to frustrate collection efforts of secured creditors by filing bad faith bankruptcy cases. That is unfair to the creditors and relief from the stay should be promptly granted in these cases, without unnecessary cost to the creditors, unless good grounds are shown for the stay remaining in effect. The Conference Report provides in several sections for automatic non-application of the stay (with the stay either not going into effect, or terminating automatically, without motion) in situations deemed to be potentially abusive. In each of these situations, the stay would be effective if the debtor or a trustee makes a specified showing of good faith. The problem with this approach is the uncertainty of whether or not the stay is applicable—that is, whether the predicates for non-application of the stay have occurred—and there is potential for confusion if the applicability of the automatic stay is required to be adjudicated in state court. Accordingly, it would be preferable for the circumstances set out in the Conference Report to be additional grounds mandating relief from the stay through an order of the bankruptcy court. This will ensure that questions regarding the grounds for relief are adjudicated in a forum with experience in the application of the laws in question, and that any dispute over the application of the law is addressed in the federal appellate process. Specifically:

Repeat filings by individual debtors. Section 302 of the Conference Report provides that the stay should automatically terminate after 30 days if there is a second filing by an individual debtor within one year, and not be applicable at all if there are more than two filings, unless the debtor takes action to show good faith. In addition to the problem of requiring state courts to determine any dispute as to whether these provisions are effective, § 302 does not provide an opportunity for a trustee to show that property in the estate has equity that could be used to pay debts other than that of the secured creditor seeking to proceed against the property outside of the bankruptcy. The recommendation would require the bankruptcy court to enter an order terminating the stay without motion or request of the creditor if the debtor or trustee does not make the appropriate showing; state courts could then rely on an order of the bankruptcy court in allowing actions against the debtor's property to proceed.

Redemption or reaffirmation. With respect to personal property that is collateral or subject to a lease, §§ 304 and 305 of the Conference Report provide for automatic termination of the stay if the property is not subject to redemption or reaffirmation by an individual debtor within a specified 45-day period. The recommendation is for the court to enter an order terminating the stay if the debtor does not redeem or reaffirm a secured debt, or assume a lease, within the 45-day period. A motion would be required in these situations, since a reaffirmation agreement may not be of record. The motion would allow the trustee to present evidence of equity to the court, so as to allow the trustee to sell the property or assume the lease in question for the benefit of the estate.

Repeat filings by small business debtors. Section 441(2) of the Conference Report provides for non-application of the automatic stay in situations of repeat filings of small business Chapter 11 cases. Here, especially, there are likely to be questions as to whether the grounds for non-application apply. For example, § 441(2) provides that an entity that acquires "substantially all of the assets or business" of a small business debtor under a confirmed plan would not get the benefit of the automatic stay in its own small business bankruptcy for a two-year period after the order of confirmation in the original case, unless it showed that the acquisition was in good faith and not for the purposes of avoiding application of the automatic stay limitation. This provision is subject to considerable potential dispute—both as to the question of whether "all or substantially all" of the business was acquired, and whether the acquisition was in good faith. It is better to allow these matters to be resolved in the bankruptcy court, with appeal through the federal courts, rather than in state court. This, again, can be accomplished by mandating that relief from the stay shall be granted on motion on the grounds set forth in § 441(2).

6. Notice to creditors

Proposal

> Continue current law pending adoption of procedures for electronic filing and notice [omits CR § 315(a)].

Comment

Section 315(a) of the Conference Report sets out a new program for providing notice to creditors, requiring that they be served at a preferred address, which may be on file with the court generally, on file with the court in a particular case, or listed in the two most recent pieces of correspondence sent to the debtor within the 90 days preceding the bankruptcy filing, unless the creditor was prohibited from communicating with the debtor during that period, in which case the required address would be the one used on correspondence sent to the debtor prior to the 90-day period. If the preferred address is not used, the debtor or trustee would have the burden of showing that notice was actually received by the creditor's designated office in order for certain enforcement actions to be taken against the creditor.

The Administrative Office of the United States Courts is currently in the midst of a transition to electronic filing for the federal judiciary, in which bankruptcy courts are taking the lead. Participants in the electronic filing program will be able to receive electronic notice of filings, via the Internet, almost as soon as the filing takes place. This system offers possibilities for effective notice, on a nationwide basis, that can avoid the uncertainty and potential for litigation involved in the program set out in § 315(a). Accordingly, it is proposed that the current law on noticing be continued pending the adoption and implementation of electronic filing.

7. Time between discharges

Proposal

> Retain current law regarding the effect of prior bankruptcy discharges on the ability of the debtor to obtain a discharge in Chapter 13 [modifies CR § 312].

Comment

Section 312 of the Conference Report changes current law regarding the effect of prior bankruptcy cases on the ability of an individual to obtain a discharge in a pending case. Under current law (§ 727(a)(8)), a Chapter 7 debtor is subject to denial of discharge if the debtor obtained a discharge in a Chapter 7 or 11 case filed within six years of the pending case. The Conference Report extends this time to eight years—a change not affected by this Proposal.

However, § 312 also creates, for the first time, a limitation on the ability of a Chapter 13 debtor to obtain a discharge, by providing that a discharge will not be granted in Chapter 13 if the debtor obtained a discharge in a Chapter 7, 11, or 12 case filed within four years of the pending case, or in a Chapter 13 case filed within two years of the pending case. This provision has the effect of denying any possibility of a bankruptcy discharge, for four years, to an individual who has obtained a Chapter 7 discharge.

For an individual who is again in financial distress after obtaining a Chapter 7 discharge, Chapter 13 may be the most effective means for financial restructuring. Since the discharge could only be granted if the debtor devotes all disposable income to plan payments for a minimum of three years (or pays 100% of all claims), Chapter 13 may well create a framework of financial responsibility that will prevent further difficulties.

The principal problem of allowing a debtor to file Chapter 13 shortly after a Chapter 7 case is concluded has to do with the so-called "Chapter 20" abuse—in which debtors who could have addressed all of their debt in Chapter 13 instead file Chapter 7 cases, obtain a discharge of their unsecured debt, and then pursue Chapter 13 only to deal with the remaining secured debt. This type of abuse is dealt with by current law requiring that Chapter 13 cases be filed in good faith (a requirement confirmed by CR § 102(g)), and by new limitations on the effect of the automatic stay included in the Conference Report, as discussed above in Recommendation 5. Denying a discharge to a debtor in the "Chapter 20" situation would have no impact in any event, because the Chapter 13 debtor would already have received a discharge in the prior Chapter 7 case, and would be using the Chapter 13 only to restructure nondischargeable secured debt.

8. Dischargeability

Proposal

1) Create a new ground for nondischargeability under § 523(a) dealing specifically with misuse of credit card obligations, and provide that the new ground for nondischargeability is not applicable to a discharge under § 1328(a) of the Code [modifies CR § 314(b)].

2) Remove § 523(a)(1)(B) from the categories of nondischargeable tax debt as to which a discharge under § 1328(a) does not apply [modifies CR § 707].

Comment

In the area of the dischargeability of debt, the Conference Report makes a substantial change in current law, largely eliminating the "superdischarge" feature of Chapter 13. Under current law, a full Chapter 13 discharge, as provided for by § 1328(a), applies to a number of debts that are nondischargeable under other chapters of the Code, including the following:

- § 523(a)(1)(B) and (C) (debts arising from late-filed and fraudulent tax returns),

- § 523 (a)(2) (debts incurred through fraud),

- § 523 (a)(3) (debts held by creditors who received inadequate notice of the bankruptcy filing),

- (a)(4) (debts for embezzlement and breach of fiduciary duty), and

- (a)(6) (debts from willful and malicious personal injuries or wrongful death).

Except for willful injuries to property, all of these debts would no longer be dischargeable in Chapter 13. While most of these changes in the law would have a relatively small impact on the overall operation of the Chapter 13 process, two of the changes would make Chapter 13 much less effective, and so are proposed to be modified here. Specifically, the Proposal recommends retaining the superdischarge as to credit card misuse and tax debt arising from late-filed returns.

Credit card misuse. Credit card misuse is the most commonly encountered form of nondischargeable debt in Chapter 7. Debts arising from credit card misuse are currently excepted from discharge under the fraud exception of § 523(a)(2). However, the application of this provision to credit card misuse has been problematic, since there is no actual contact between the debtor and the credit issuer at the time the credit card is used. For that reason, the traditional fraud elements of misrepresentation by the debtor and reasonable reliance by the creditor have been difficult to define. Creation of a new ground for nondischargeability, dealing specifically with credit card misuse, would resolve a number of conflicting approaches under the current law. Debts incurred with a credit card would be nondischargeable if, at the time of the transaction in question, the debtor intended to file a bankruptcy case or otherwise did not intend to repay the debt. Misrepresentation and reliance would not be relevant, and the presumption of § 523(a)(2)(C) (as amended by § 310 of the Conference Report) would be fully applicable.

The discharge under § 1328(a) should continue to apply to credit card misuse. This element of the Chapter 13 superdischarge is significant in any situation where a debtor has incurred questionable credit card debt. Under current law, such a debtor has a significant incentive to file under Chapter 13. Even though the debtor may have a colorable defense to a dischargeability complaint in Chapter 7, and even though Chapter 13 would require the debtor to complete a minimum three-year plan (or pay all debts in full) in order to obtain the discharge, the debtor would still likely choose Chapter 13, since that choice would avoid the expense of litigating the question of dischargeability, and offer the debtor a certain discharge if the plan is completed. If debts from misuse of credit cards are not dischargeable in Chapter 13, the incentive is reversed, with the debtor better off filing under Chapter 7. Chapter 7 would provide an immediate discharge of all other obligations and allow the debtor to use post-filing earnings to pay only the questionable credit card debt, while Chapter 13 would require the debtor to make partial payment of all unsecured debts, only to have the balance of the credit card debt still owing at the end of the plan.

Tax debt. The superdischarge should also continue to apply to tax debt arising from late-filed returns. Virtually all such debt is within the priority established by current § 507(a)(8), and so would have to be paid in full in any Chapter 13 plan under current § 1322(a)(2). However, making a debt nondischargeable, in addition to its status as a priority debt, has the effect of continuing interest and penalties. For late tax obligations, interest and penalties can be significant. Since the debt must be paid in full, the continuation of interest and penalties may make completion of a Chapter 13 plan impossible for many debtors with late filed claims, and again, give these debtors a substantial incentive to file under Chapter 7 rather than Chapter 13. This recommendation would not affect the provision of the Conference Report denying a discharge under § 1328(a) to fraudulently incurred tax debt.

9. Treatment of secured debt in Chapter 13

Proposal

1) Continue current law allowing a Chapter 13 plan to bifurcate a claim secured by property other than residential real estate, with the secured portion of the claim accorded the replacement value of the collateral under § 506(a) of the Code, but provide in addition that the holder of a purchase money security interest in personal property acquired by the debtor within one year prior to the bankruptcy filing may elect to require the debtor to surrender the collateral [modifying CR § 306].

2) Continue current law allowing § 506(a) valuation to vary according to the purpose for which the valuation is made [omits CR § 327].

3) Clarify that holders of secured claims treated by a Chapter 13 plan must credit payments made under the plan consistent with the plan provisions [redrafting CR § 202].

4) Require preconfirmation adequate protection payments (in the amounts proposed by the plan) to be made by the Chapter 13 trustee from payments made by the debtor to the trustee [modifying CR § 309].

Comment

Bifurcation. Section 306 of the Conference Report changes the current treatment of secured debt in Chapter 13. Under current law, all claims secured by property other than the debtor's homestead are subject to bifurcation (or "strip down") under § 506(a) of the Code. That is, the "secured" portion of the claim, required to be paid in full unless the debtor chooses to surrender the collateral, is measured by the value of the collateral; to the extent that this value is less than the full amount of the claim, the debtor is allowed to treat the balance of the claim as unsecured. Section 309 would eliminate such bifurcation for any motor vehicle loan incurred within two and a half years of the bankruptcy filing, and any secured debt incurred within one year of the filing. Thus, if a Chapter 13 debtor wished to keep the collateral securing such a loan, the debtor would be required to pay the full amount of the outstanding debt, even though the collateral might be worth much less than that amount. There is no apparent reason for favoring secured debt in this way. The diversion of funds from unsecured debt would be in excess of the actual value of the collateral and thus would compensate the secured creditor in excess of what that creditor would receive if it repossessed and sold its collateral. The goal of discouraging debtors from purchasing items on credit shortly before filing bankruptcy can be advanced more effectively by the recommended alternative of allowing the creditor to require surrender of such items.

Valuation. Under current § 506(a), the value of a secured claim, for purposes of the bifurcation discussed above is determined "in light of the purpose of the valuation and of the proposed disposition or use of such property." Section 327 of the Conference Report would change this flexible approach to valuation so as require that, in cases of individual debtors in Chapter 7 and Chapter 13, valuation of secured claims would always be determined "on the replacement value of such property as of the date of filing the petition, without deduction for costs of sale or marketing." Secured claims must be valued in many different contexts in individual bankruptcy cases—from determining how much a Chapter 13 debtor must pay in installments to retain collateral throughout a plan, to how much a Chapter 7 debtor must pay in a lump sum to redeem collateral, to how much a creditor must reduce its claim when collateral is surrendered. The current law, allowing for accommodation of these different circumstances, should be retained.

Allocation of payments. Section 202 of the Conference Report adds a new subsection (i) to § 524 of the Code, which provides that a mortgage holder (or other creditor) whose claim is treated by a Chapter 13 plan must credit payments received under the plan in the manner that the plan requires; so that allocating plan payments to prepetition debt or late charges (and then attempting to collect additional sums from the debtor after the plan concludes) would be a violation of the discharge injunction. However, the language of section 202 is confusing and may unduly limit the impact of the provision:

> The willful failure of a creditor to credit payments received under a plan confirmed under this title, unless the order confirming the plan is revoked, the plan is in default, or the creditor has not received payments required to be made under the plan in the manner required by the plan (including crediting the amounts required under the plan), shall constitute a violation of an injunction under subsection (a)(2) if the act of the creditor to collect and failure to credit payments in the manner required by the plan caused material injury to the debtor.

The following language would more clearly and generally require crediting of plan payments according to the plan:

> Unless the order confirming a plan under this title is revoked, or the case in which the plan was filed is dismissed, or payments are not transmitted to the creditor in the manner required by the plan, the failure of a creditor to credit payments made pursuant to the plan in the manner required by the plan, and any act of the creditor to collect payments inconsistent with the treatment of the creditor's claim under the plan, shall constitute a violation of an injunction under subsection (a)(2).

Preconfirmation adequate protection. Under current law, a Chapter 13 debtor is required to make full plan payments to the trustee prior to confirmation, but the trustee is directed not to distribute payments to creditors until the plan is confirmed. This situation makes it difficult for preconfirmation adequate protection payments to be made to secured creditors, and for preconfirmation lease payments to be made to lessors, whenever the Chapter 13 plan calls for these payments to be made by the trustee. Section 309(c) of the Conference Report deals with the need for preconfirmation payments, by requiring the debtor to deduct adequate protection and lease payments from the amounts otherwise payable to the trustee prior to confirmation, and send the deducted funds directly to the creditor. This approach will cause confusion: debtors will be unsure of the amounts required to be sent to the trustee, questions will arise as to whether the payments required to be sent to creditors were in fact sent by the debtor, and confirmation will likely be delayed. These problems can be avoided by retaining the requirement that the debtor submit full preconfirmation plan payments to the trustee, while directing the trustee to make adequate protection and lease payments prior to confirmation.

10. Miscellaneous Chapter 13 matters

Proposal

1) The minimum term of a Chapter 13 plan, in the absence of full payment, should be extended to five years only for (a) those debtors whose income exceeds 150% of the applicable state median, and (b) those debtors who have converted their cases to Chapter 13 from Chapter 7 after the filing a motion under § 707(b) [modifies CR § 318].

2) A Chapter 13 debtor should be required to file post-petition tax returns and amended budgets only if ordered by the court, either on its own motion or on the motion of any party in interest, based on a likelihood that the debtor's income or expenses will materially change [modifies CR § 315(b)].

3) Chapter 13 trustees should be allowed to charge a separate, lower percentage fee for payment of current mortgage obligations and other large debt payments [new, amends current 28 U.S.C. § 586(e)(1)(B)].

Comment

Minimum plan term. Under current law, the minimum term for a Chapter 13 plan that does not pay all claims in full is three years. Section 318 of the Conference Report would extend this term to five years for all debtors with income over the applicable state median. For many debtors with more than median income, there will remain a choice between filing under Chapter 7 and Chapter 13, and the five-year minimum plan term will be a significant incentive to choose Chapter 7, with its immediate discharge, rather than Chapter 13. The extended plan term should be reserved for those debtors who are most likely to be able to address their financial difficulties outside of bankruptcy (those earning more than 150% of the applicable median), and those whose Chapter 7 filings are subject to a finding of abuse under § 707(b). The latter provision would create an incentive for debtors with a potential ability to repay to file under Chapter 13 in the first instance.

Tax returns and budgets. Section 315(b) of the Conference Report imposes on Chapter 13 debtors the obligation to file with the court, if requested by the court or any party in interest, copies of all post-petition tax returns and annual budgets for the duration of the debtor's case. The tax returns are to be subject to regulations that will allow creditor access to the filings while protecting the privacy of the debtors. This provision is likely to impose substantial administrative burdens on the courts, both in connection with maintaining files in a semi-restricted form, and in enforcing the debtors' obligations. It can be anticipated that many Chapter 13 debtors who are current in plan payments will fail to file requested tax returns or budgets, leading to enforcement motions that generate expense for all parties involved and for the court. Chapter 13 plans that would otherwise have successfully completed payments to creditors may fail because of the debtor's delay in responding to such motions. Rather than create an absolute right to the filing of post-petition tax returns and budgets, it would be preferable to require these filings only in cases where it appears likely that the debtor's financial condition will change materially (for example, debtors with a temporary medical condition, or temporarily depressed employment). In this way, the resources of the court and the parties can be devoted to enforcing disclosure requirements in cases where they are likely to be significant.

Trustees fees. In many Chapter 13 cases, the most effective way to ensure that the debtor completes the plan is by deducting plan payments from the debtor's wages, pursuant to § 1325(c) of the Code. If all of the payments required by the plan are deducted, the debtor is no longer tempted to divert resources that should be used for debt payment to current consumption. However, the effectiveness of a wage deduction is lost if the debtor is responsible for making certain debt payments under the plan. Since those payments cannot be deducted from the wages, the debtor may still choose not to make the debt payment.

Frequently, Chapter 13 plans provide that the debtor, rather than the Chapter 13 trustee, will make current mortgage payments The principle reason for this provision is that the current mortgage payment is generally the largest debt payment made, and Chapter 13 trustees are required to charge a percentage fee on every payment they make, up to 10%, pursuant to 28 U.S.C. § 586(e)(1)(B). The Attorney General has interpreted § 586(e)(1)(B) as requiring that a *uniform* percentage fee be charged on all payments. Thus, if a particular Chapter 13 trustee charges a fee of 8% on payments made by the trustee, that fee would be added to mortgage payments made by the trustee, while payments made directly by the debtor would incur no additional fee. It would greatly benefit the Chapter 13 system if trustees were allowed to charge lower percentage fees for current mortgage payments or other large monthly payments, so as to encourage debtors to allow all debt payments to be made through the trustee and to allow for fully effective wage deduction orders.

11. Bankruptcy administrator

Proposal

> Give the bankruptcy administrators in North Carolina and Alabama the same rights, duties and obligations as U.S. trustees [§§ 232, 405, 416, 439, 1104].

Comment

In North Carolina and Alabama, bankruptcy administrators perform the administrative functions that are performed in other jurisdictions by U.S. trustees. Some provisions of the Conference Report affecting bankruptcy administration refer only to U.S. trustees. These provisions should be amended to apply to bankruptcy administrators as well.

12. Individual Chapter 11 debtors

Proposal

> Omit Conference Report § 321, which would impose Chapter 13-type requirements on individual debtors in Chapter 11.

Comment

Under Conference Report § 321, individuals in Chapter 11 are to be treated more like individuals in Chapter 13. Property of the estate would include postpetition earnings. If an unsecured creditor objects to confirmation, the debtor must pay all disposable income as defined in § 1325(b)(2) for five years, or pay the claim in full. The debtor does not receive a discharge until all payments have been made under the plan. A creditor may request modification of a plan at any time before completion of the plan. These proposed changes, which apply to all individuals in Chapter 11 cases, are substantial changes that have not been exposed to public debate.

The provisions are based on Chapter 13 provisions that do not fit well with Chapter 11 concepts. In Chapter 13 an unsecured creditor can insist that a debtor commit all disposable income to a plan for three years. That makes sense in Chapter 13 where creditors do not vote. But in Chapter 11 creditors do vote, and a single creditor should not be able to defeat a plan by objecting. Also, a single creditor could request modification of a plan. The ramifications of delaying a discharge in a Chapter 11 case have not been sufficiently studied.

All of these proposed changes should be omitted until they have been studied and exposed to public debate. If the Chapter 13-type requirements are included at all, they should be placed in § 1129(b).

13. Small business provisions

Proposal

1) Change the definition of small business debtor to be consistent with present § 101(51C) of the Bankruptcy Code [retains the $2 million aggregate debt limit of CR § 432, but eliminates unworkable provisions of the definition].

2) Permit flexibility with respect to disclosure statements [same as CR §§ 431, 433].

3) Permit conditional approval of disclosure statements [same as CR § 431].

4) Permit combined disclosure statement and confirmation hearings [same as CR § 431].

5) Establish uniform reporting requirements for small businesses, with uniform forms proposed by the Advisory Committee on Bankruptcy Rules [same as CR §§ 434 and 435].

6) Provide that the debtor must file (rather than "append") a balance sheet and statement of operations together with its petition; delete tax returns from the filing requirement [modifies CR § 436].

7) Require status conferences "necessary to further the expeditious and economical resolution of the case"; change section title to "status conference" [modifies CR § 440 only to make its title consistent with the substantive provision].

8) Retain the 120-day exclusivity period for plan filing by the debtor [modifies the 180-day period of CR § 437].

9) Require the debtor to file a plan and disclosure statement within 120 days of the order for relief, with extensions for cause possible up to 300 days after the order for relief; allow further extensions of the filing deadline only upon a showing by the debtor of extraordinary circumstances and a strong likelihood that a confirmable plan will be proposed within the further extension [modifies CR § 437].

10) Omit the requirement that a plan be confirmed within 45 days of filing [modifies CR § 438].

11) Require termination of the automatic stay in defined situations of repeat filings, as set out in Recommendation 5 [consistent with CR § 441(2) except that an order on motion is required].

12) Conduct a study to determine why small businesses become debtors and the best way for these small businesses to reorganize [same as CR § 443].

Comment

Under current law, special, optional treatment is provided under Chapter 11 for a "small business." The Conference Report alters the definition of small business and makes the special treatment mandatory. As a whole, the changes are helpful, but several present difficulties.

Definition. Consistent with current law, Section 432 of the Conference Report defines a "small business debtor" as a business with not more than $2 million in aggregate debt, but then adds qualifications (1) that affiliates of the debtor, also involved in bankruptcy proceedings, are to be included with the debtor in calculating the amount of debt, and (2) that cases in which the U.S. trustee has appointed a creditor's committee are excluded from the definition unless the court determines that the committee is "not sufficiently active and representative to provide effective oversight of the debtor." The $2 million limit properly includes most Chapter 11 debtors; however, the language regarding affiliates of the debtor is awkward and may exclude affiliated entities that are truly separate businesses from being small business debtors. Also, the presence of an active creditor's committee should not preclude small business treatment (and, in any event, there would be considerable uncertainty as to whether the small business provisions applied, since the court could make a determination that a committee was insufficiently active at any time). The references to affiliates and to committees should be eliminated, retaining the substance of the current definition of small business.

Flexible disclosure statement requirements. Conference Report § 431 amends Bankruptcy Code § 1125(a)(1) to list factors that the court should consider when approving a disclosure statement and amends Bankruptcy Code § 1125(f) to give the court, in small business cases, the flexibility to dispense with a disclosure statement and to approve form disclosure statements. Both amendments improve the operation of Chapter 11 in small business cases.

Conditional approval of disclosure statement; combined hearing on disclosure statement and confirmation. Conference Report § 431 amends § 1125 of the Bankruptcy Code to give the court in small business cases the flexibility (1) to approve disclosure statements conditionally and (2) to combine the hearing on adequacy of the disclosure statement with the confirmation hearing. For many years, a number of bankruptcy courts have successfully utilized these practices, and the Code is improved by express statutory provision allowing it.

Uniform reporting requirements; reporting rules and forms. Conference Report § 434 requires small business debtors to file specific reports, to match projections with actual cash disbursements, to certify compliance with their reports and with the Federal Rules of Bankruptcy Procedure, and to explain how noncompliance will be cured. Conference Report § 435 directs the Advisory Committee on Bankruptcy Rules to propose rules and forms and provides that the reporting requirements shall take effect 60 days after the rules are prescribed. These reports are already required in most jurisdictions by U.S. trustees or bankruptcy administrators. Some of the terms used in the Conference Report are somewhat vague (e.g., "such other matters as are in the best interest of the debtor and creditors"), but these requirements can be made specific through the Rules process.

Duties of the small business debtor. Conference Report § 436 requires small business debtors to "append" to their bankruptcy petitions their most recent balance sheet, statement of operations, cash-flow statement, and Federal income tax return. Senior management must attend meetings, scheduling conferences, and meetings of creditors unless the court, upon a finding of extraordinary and compelling circumstances, waives attendance. The debtor must timely file all schedules (subject to a maximum extension of 30 days absent extraordinary and compelling circumstances), maintain customary insurance, timely file tax returns, and pay current taxes. Most courts already impose most of these duties and require these documents. However, not all of these documents, especially the tax return, should be made part of the public record. The term "append" is not applicable to electronic filing and should be deleted.

Duties of the U.S. trustee. Conference Report § 439 expands the duties of the U.S. trustee in small business cases to include conducting an initial interview, investigating viability, asking about the debtor's plan, developing a scheduling order, verifying the filing of tax returns, and monitoring activities to ascertain inability to confirm a plan. If the trustee finds material grounds for relief under § 1112, the trustee shall apply promptly after making that finding to the court for relief. U. S. trustees and bankruptcy administrators are already performing many of these functions. It should be noted that the provision requiring the U.S. trustee to move for dismissal or conversion applies to all Chapter 11 cases, not just to small business cases.

Scheduling conferences. Conference Report § 440 amends § 105(d) of the Bankruptcy Code to make status conferences mandatory, providing that the court "shall hold such status conferences as are necessary to further the expeditious and economical resolution of the case." This provision applies to all Chapter 11 cases. Many courts now hold status conferences. There are no guidelines as to who should attend, but this would be left to the Bankruptcy Rules. Courts should have flexibility in designing the type of status conference that works best in the district and in the particular case. The title of this Conference Report section is "Scheduling Conferences" and should be changed to "Status Conferences."

Exclusivity in small business cases. Conference Report § 437 provides that in a small business case the debtor has the exclusive right to file a plan for 180 days after the order for relief, unless the time is extended or reduced for cause. Obtaining an extension of the 180-day period is appropriately difficult, with the debtor required to "demonstrate by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable period of time." Furthermore, in situations where exclusivity is to be extended, a new deadline must be imposed, and the order must be signed before expiration of the first deadline. Presently all Chapter 11 debtors have a 120-day period of exclusivity that may be extended "for cause." Small business cases should move quickly, and the exclusivity period should not be longer than in regular Chapter 11 cases. However, requiring an extension order to be signed prior to the expiration of the deadline penalizes a debtor for delays caused by a court. The period of exclusivity should remain at 120 days, and the requirement that the order must be signed prior to expiration of the deadline should be omitted.

Deadline for plan filing. Conference Report § 437 provides that a small business debtor must file a plan not later than 300 days after the order for relief. There is no provision for reducing the 300-day period and it may only be extended in the same manner as extending the 180-day period of exclusivity. In most small business chapter 11 cases a plan should be filed well before 300 days. If 300 days is the limit, it may become the standard. The limit should be 120 days with extensions for "cause" up to a 300-day maximum. In order for an extension beyond 300 days to be granted, the debtor would be required to "demonstrate by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable period of time."

Confirmation deadline. Conference Report § 438 provides that in a small business case the court shall confirm a plan that meets the confirmation requirements "not later than 45 days" after the plan is filed, unless the time for confirmation is extended in the same manner for extending the 120-day period of exclusivity and the 300-day period to file a plan. The 45-day time limit for confirming a plan is not realistic and should be omitted. A 45-day limit works well in Chapter 12 where there is no disclosure statement requirement, no voting,, and the confirmation hearing is held on expedited notice. Rule 3017 of the Federal Rules of Bankruptcy Procedure requires 25 days notice for the disclosure statement hearing and 25 days notice for the confirmation hearing. Combining the two hearings is discretionary, and if the two hearings are not combined it would be impossible to meet the 45-day limit. The experience in the Eastern District of North Carolina, where the hearings are almost always combined, is that the hearings are held about 50 days after the plan is filed.

Small business serial filers. See Recommendation 5, above.

Small business study. Conference Report § 443 provides that the Small Business Administration is to conduct a 2-year study to learn why small businesses become debtors and the best way for these small businesses to reorganize. This is an excellent idea.

14. Expanded grounds for dismissal

Proposal

1) Give the court discretion with respect to dismissal in Bankruptcy Code § 1112, by retaining the "may" dismiss in the Code and omitting the "shall" dismiss in the Conference Report [modifies CR § 442].

2) Expand the "for cause" list in Bankruptcy Code § 1112 [same as CR § 442].

3) Omit the 30-day time limit for commencing a hearing on a motion to dismiss and omit the 15-day limit on deciding such a motion [modifies CR § 442].

Comment

Conference Report § 442 amends § 1112 of the Bankruptcy Code to provide that the court "shall" convert or dismiss a Chapter 11 case if the movant establishes cause "absent unusual circumstances specifically identified by the court that establish that the requested conversion or dismissal is not in the best interests of creditors and the estate." "Cause" is defined to include matters such as gross mismanagement, failure to maintain insurance, unauthorized use of cash collateral, failure to file a report, failure to appear for examination, failure to pay taxes or file tax returns, failure to file a plan on time, failure to effectuate substantial consummation of a plan, material default under a plan and failure to pay domestic support obligations. The court can excuse such conduct if the debtor establishes that "there is a reasonable likelihood that a plan will be confirmed within the applicable time frames" and 1) there is a "reasonable justification" for the act or omission and 2) there will be a cure of the act or omission within "a reasonable period fixed by the court." As an alternative to conversion or dismissal, the court may appoint a trustee or examiner. Conference Report § 442 further requires the court to commence a hearing under § 1112 not later than 30 days after the filing of the motion and to decide the motion not later than 15 days after commencement of the hearing. These time limits may be extended for "compelling circumstances."

These provisions, although contained in the small business section of the Conference Report, apply to all Chapter 11 cases. The Conference Report makes conversion or dismissal mandatory by changing "may" to "shall." Conversion or dismissal may be avoided in "unusual circumstances specifically identified by the court," but it would be better to leave conversion or dismissal to the court's discretion and to retain the word "may" rather than "shall." Conversion or dismissal may also be avoided by having a confirmation-type hearing at which the debtor must show "reasonable justification" for the act or omission (frequently there is no justification) and a cure within a reasonable period of time (sometimes there is no cure), and must also show a reasonable likelihood that a plan will be confirmed within the established time limit. It is important to make the debtor accountable for improper activities and omissions. However, every case is different, and the court should have the discretion to convert or dismiss without having to conduct an elaborate and expensive hearing. The 30-day time period for holding a hearing and the 15-day time limit for deciding the issue are too restrictive and should be omitted.

15. Requirement to describe tax consequences

Proposal

Omit the requirement in Conference Report § 717 that Chapter 11 debtors include in the disclosure statement a description of the tax consequences of the plan [modifies CR § 717].

Comment

Conference Report § 717 amends § 1125(a)(1) of the Bankruptcy Code to require that a disclosure statement include "a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case." This requirement is not realistic. A debtor will not know the tax consequences to its creditors, and any tax opinion would be costly and speculative at best.

Table of Proposed Revisions to H.R. 333 Conference Report

Sec. No.	Issue	Present Content	Proposed Treatment
101	Consent to conversion in 707(b)	Allows consensual conversion to Ch. 12 or 13 as an alternative to dismissal	Retain
102	Means testing	Complex presumption of abuse based on IRS collection standards; enhanced scheduling and noticing requirements for all debtors; enhanced liability for debtors' counsel	Amend: Means test based on gross income; safe harbor under median; creditor standing to file § 707(b) motions above median; enhanced scrutiny above defined level (150% of median); omit enhanced attorney liability
103	IRS standards amendment and study	Sense of Congress that standards may be altered; EOUST study ordered	Retain study; omit sense of Congress pending study on use of IRS standards
105	Pilot educational program	18-month test of educational programs in six districts, followed by report of Director of EOUST to Congress	Retain
106	Credit counseling; mandatory debtor education	Credit counseling an eligibility requirement, education required for all consumer debtors.	Amend to make credit counseling required only in chapter 7; defer mandatory education pending results of pilot program
107	Schedules for Chapter 13 expenses	Part of the formula for calculating means-test deductions	Omit pending results of study on use of IRS standards
202	Failure to credit plan payments; ride-through contacts for home mortgages	Some failures to credit plan payments made a violation of discharge injunction; request for payment in lieu of foreclosure not a violation	Amend to clarify provision regarding failure to credit plan payments
203	Reaffirmation	Extensive disclosure requirement with broad safe harbors for creditors);	Omit subject to completion of study
302	Stay exceptions for serial filings	30-day termination of stay in first refiling within a year; no stay in second refiling unless required showings made	Amend to provide for order terminating stay
304	Stay for personal property collateral	Stay terminated if no redemption or reaffirmation in 45 days after first meeting; no installment redemption	Amend to provide for order terminating stay
305	Stay for personal property and leases	Similar to 304 of the Act, as above, but with conflicting terms	Amend to add leases to procedure under § 304
306	Secured debt in Chapter 13	(1) Requires lien retention until debt paid in full or discharge granted; (2) 2-1/2 year anti-stripdown for car loans; (3) 1 year anti-stripdown for all other secured debt; (4) principal residence defined.	Amend to provide that a creditor with a pmsi not more than one year old may require return of collateral
309	Chapter 13 secured claims	(1) secured claim not reduced on conversion to Ch 7; (2) procedures for debtors to assume personal property leases; (3) adequate protection payments, including preconfirmation payments directly by the debtor; (4) proof of insurance required from debtor	Amend to provide for preconfirmation adequate protection payments to be made by the Chapter 13 trustee from payments made to the trustee by the debtor
312	Extended time between discharges	727(a) extended to 8 years; no discharge in 13 if prior discharge in a 7, 11, or 12 filed within 4 years or a 13 filed within 2 years	Amend to retain current law regarding Chapter 13 discharge

314	New ground for nondischarge-ability; superdischarge	(a) Debts incurred to pay non-federal taxes excepted from discharge; (b) superdischarge eliminated for 523(a)(2) and (4) and for personal injuries	Amend to create new ground for credit card nondischargeability, subject to Chapter 13 superdischarge
315	Notice to creditors	(a) Complex notice system with burden on debtor to show effective notice; (b) new document production requirements for debtors, including pay stubs, tax returns, and annual budgets	Omit notice provisions pending adoption of electronic filing procedures; provide for wage information to be provided to trustee prior to creditors meeting
316	Automatic dismissal for inadequate filings	Failure to file results in dismissal without motion, deadline only extended once	Amend to require entry of order on motion; allow trustee objection for avoidance actions or 727 action
318	Term of Chapter 13 plan	5 yrs for debtors over the median income level	Amend: 5 years for debtors with income more than 150% of median or who pursue Chapter 13 after a 707(b) motion
321	Individual Chapter 11 cases	Generally imposes Chapter 13 rules	Omit
327	§ 506(a) valuation	Requires retail value in Ch 7/13 individual cases	Omit
431	Flexible Rules for disclosure statement and plan	List of factors when considering disclosure statement; flexibility in approving disclosure statement; approval of form disclosure statements; conditional approval of disclosure statements; combining hearings on disclosure statement and confirmation of plan	Retain
432	Definition	$2 million in aggregate debt (includes debtor affiliates but excludes debtor affiliates with more than $2 million in debt) where creditors' committee has not been appointed or committee is not sufficiently active	Omit references to affiliates and committees; keep present definition in § 101(51C)
433	Standard form disclosure statement and plan	Bankruptcy Rules Committee to propose standard forms for disclosure statements and plans	Retain
434	Uniform reporting requirements	Small business debtors must file reports and certify compliance with reports and Bankruptcy Rules	Retain
435	Uniform rules and forms	Bankruptcy Rules Committee to propose forms for reports	Retain
436	Debtor duties in small business cases	Small business debtors must "append" most recent balance sheet, statement of operations, cash flow, and income tax statement to petition; senior management must attend meetings and conferences; must file schedules on time, maintain insurance. file tax returns and pay current taxes	Retain most provisions; delete "append;" do not make income tax return part of public record; delete "extraordinary and compelling circumstances" standard

437	Plan filing and confirmation deadlines	Small business debtor has 180-day period of exclusivity; debtor must file a plan not later than 300 days after the order for relief; deadlines may not be extended unless debtor can demonstrate by a pre-ponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable period of time	Amend to provide 120-day exclusivity period, extendable for cause; small business debtor must file plan within 90 days of order for relief, but time may be extended for cause; court may not extend time beyond 300 days unless the debtor makes specified showing
438	Plan confirmation deadline	Court shall confirm a plan not later than 45 days after it is filed	Omit
439	UST duties	Expands duties of UST in small business cases, including verifying filing of tax returns	Retain
440	Scheduling conference	Court shall hold such status conferences as are necessary to further the expeditious and economical resolution of the case	Retain, except change caption to "Status Conferences"
441	Serial filer provisions	Automatic stay does not apply with respect to certain serial filing small business debtors	Retain, except require order terminating the stay on motion
442	Expanded grounds for dismissal or conversion	Court "shall" convert or dismiss "absent unusual circumstances" upon showing of cause; cause is defined	Modify to give court more discretion as to whether to convert or dismiss
443	Small business study	Small Business Administration to study causes of small business filings and to determine best way for small business debtors to reorganize	Retain
603	Audits	Audits must be conducted of a random minimum 0.4% of all consumer filings and of all schedules "reflecting greater than average variance" from district norms, under GAAS by independent certified or licensed public accountants or under regulations of the Attorney General (adopted within 2 years of enactment of the legislation); 18 month delay in effect	Amend: audits charged only to those in "enhanced scrutiny" class; all audits should be conducted pursuant to EOUST regulations, by employees or contractors of EOUST; regulations within 18 months; effective 6 months thereafter
707	Superdischarge	523(a)(1)(B) (unfilled or late filed taxes) and (C) (fraudulently filed taxes) made nondischargeable in Ch 13	Amend: remove only § 523(a)(1)(C) tax debts from the superdischarge of § 1328(a)