BANKRUPTCY REFORM

PRINCIPALS AND GUIDELINES

by Joseph Pomykala

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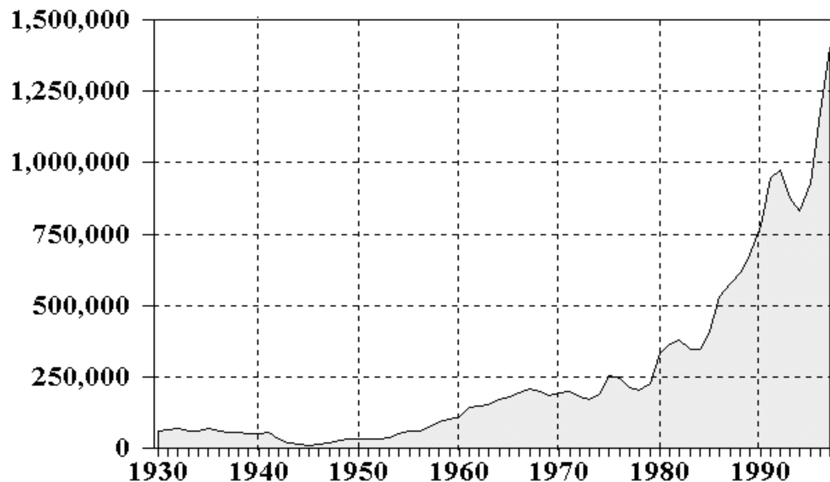
BANKRUPTCY FILINGS SKYROCKETED to yet another all-time record of 1,366,887—one filing for every seventy-six American households—during the year ending 30 September 1997 (see graph) a period of strong economic expansion. The bankruptcy rate now stands at six and one-half times the average annual rate of the 1970s. More filings occurred during the last *six months* than during the entire *decade* of the Great Depression. In the Bankruptcy Reform Act of 1994, Congress established a bipartisan National Bankruptcy Review Commission to redraft the nation's bankruptcy laws. Many of the Commission's recommendations, submitted to Congress in October 1997, would do little to alleviate the situation. The proposed legislation would increase debtors' entitlements and property they retain upon declaring bankruptcy. Rather than reform, these changes are welfare under another name, with creditors seemingly forced to foot the bill. Overall, these changes may actually increase the bankruptcy rate.



ORIGINS OF BANKRUPTCY

Bankruptcy jurisprudence dates back to ancient Roman law when debtors could be sold into slavery upon default. "Bankruptcy" has two etymological roots. "Banca rotta" in Latin means broken board as it was the custom in Medieval Italy for angry creditors to break the work benches of defaulting merchants (then solely eligible as bankrupts) over their heads. "Banqueroute" in French signified debtors on the lam (the route or road) who absconded without paying their debts and lived well off their ill-gotten gains. Bankruptcy was originally considered an act of debtor fraud. The discharge of debt was forbidden. Early laws against bankruptcy were in the collective interest of creditors and included the first provisions for pro rata sharing of the debtor's estate. First-come first-served rules that left late coming creditors with nothing were considered unfair.

Before the mid-19th century, bankruptcy was a crime. Creditors were plaintiffs accusing defendant debtors of committing an act of bankruptcy, usually absconding to avoid paying one’s debts. Voluntary debtor petitions to become bankrupt, now the norm, did not exist. Debtors convicted of certain acts of bankruptcy in England were felons subject to capital punishment. Colonial laws copied English jurisprudence. The Pennsylvania Bankruptcy Act of 1785 allowed the flogging of convicted bankrupts while nailed by the ear to the pillory, and afterwards the ear was cut off. In early colonial New York, bankrupts were branded on the thumb with a “T” for “thief.” Harsh punishments served as further incentives for bankrupts to avoid court proceedings against them.

England first introduced a limited opportunity for debtors to discharge their liabilities in 1705 to encourage bankrupts to appear and expose hidden property. It was also viewed as a temporary relief measure enacted during a depression. It contained an automatic repeal provision after three years, but it was repeatedly extended. Amendments allowing for a discharge were finally made permanent in 1796. A discharge certificate could only be issued if four-fifths of creditors, in number and value, approved; somewhat an extension of the creditors' election of trustees who liquidated the estate. Merchants and traders who "bought and sold" were the only classes eligible to become bankrupt. A minimum £100 debt had to be owed to enable a creditor to file a bankruptcy petition against a debtor.

In contrast with bankruptcy laws intended for creditor relief were insolvency laws for the relief of small debtors imprisoned on debt. Insolvency laws allowed debtors below a certain threshold of indebtedness, usually £100, to petition the court for their release from prison upon a voluntary assignment of their estate to creditors. Creditors could still pursue collection against future acquired property except for a few meager exemptions. Insolvency law was intended for relief from the notorious system of debtor prisons. Small debtors ineligible as bankrupts made up the majority of the prison population.

EARLY AMERICAN ENACTMENTS

Article I, Section 8, of the U.S. Constitution, gives the federal government the power to establish "uniform Laws on the subject of Bankruptcies throughout the United States." James Madison in promoting ratification of the Constitution, wrote in *Federalist Paper No. 42* (1788):

> The power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce, and will prevent so many frauds where the parties or their property may lie or be moved into different States that the expediency of it seems not likely to be drawn into question.

Bankruptcy was a national issue for Americans since eligible mercantile debtors found it easy to avoid paying debts by fleeing to different colonies, and later different states. That was in addition to the plethora of cross-Atlantic defaulted mercantile debt due to the Revolutionary War.

The first exercise of federal power under the 1800 Bankruptcy Act essentially copied the existing English statute. The death penalty for bankruptcy was replaced by a maximum of ten years imprisonment. (England later abolished the death penalty for bankruptcy in 1820.) Jeffersonian Democrats opposed the 1800 Act because it expanded the power of the federal courts, and because farmers and other nonmerchants were ineligible for the discharge. The Federalists enacted the law after a speculative panic in land and government debt. It was a liquidation procedure, initiated only by creditor(s) owed at least $1,000 (thirteen times the per capita income of $77), only merchants were eligible, and the discharge required two-thirds creditor approval.

The 1800 Act was repealed three and one-half years after its passage because it facilitated debtor fraud. Friends or family members could file a friendly bankruptcy petition against a debtor, fictitiously claim debts, share in the distribution, and vote to approve the discharge. The states retained authority over bankruptcy law unless the federal government acted to preempt the states.

The Bankruptcy Act of 1841 was a relief measure enacted in reaction to the most severe depression in American history to that date (after the Panic of 1837). The number of commercial failures was unprecedented during the depression. Banks suspended specie payments; some states defaulted on their debts; prices fell by 20 percent; struggling debtors pleaded for relief. All states banned imprisonment on debt, and most substantially increased property exemptions and enacted stay laws preventing the enforcement of debt contracts. The Supreme Court, in its 1819 ruling, *Sturges v. Crowninshield*, found that state laws which allowed the discharge of debts violated the Constitution by impairing the obligation of contracts. Yet the contract clause did not apply to federal legislation. The stage was set for debtor relief available only from Washington.

To gain electoral votes in several key states during the period of distress, the radical Whigs in the presidential campaign of 1840 proposed widening bankruptcy eligibility to include nonmercantile

classes, i.e. consumer debtors, and allowing voluntary debtor petitions. Prior attempts at such had been repeatedly defeated by members of Congress who considered these changes to be unconstitutional federal intrusions into state power. Voluntary petitioning by debtors and common (consumer) debtor eligibility were key attributes of insolvency law, a branch of law reserved by the states under the Tenth Amendment. The Whigs made good on their campaign promise with the 1841 Act; it contained relief for business debtors as well as new means for consumers to voluntarily discharge debts. Instead of requiring creditors to collectively approve the discharge, it became automatic unless a 50 percent majority of creditors in amount owed and number filed a written dissent.

Creditors complained of the odd turn of justice with the Act. Its voluntary provisions turned debtors into plaintiffs, and creditors into defendants. Bankruptcy was transformed from a creditor remedy against debtor fraud into a voluntary system where debtors could protect themselves from creditors and discharge debts. Leniency on debtors quickly turned into fraud and abuse. Debt obligations discharged under the Act amounted to 27 percent of GNP. The act quickly became unpopular and was repealed in 1843, a mere thirteen months after passage.

INDUSTRIAL ERA LAWS

Calls for new federal bankruptcy legislation followed the depression after the Panic of 1857. But legislation would wait until the depression following the Civil War. Geographical interests shaped the final bill pitting procreditor northern merchants against prodebtor southern farmers. Like the short-lived 1841 Act, the 1867 Act opened eligibility to all debtor classes and allowed voluntary petitioning. It restricted creditor voting for approval of the discharge to cases where the estate paid less than 50 cents on the dollar. And only a simple majority was needed for the discharge. A controversial part of 1867 Act incorporated state exemptions. Property retained by debtors had traditionally been meager - clothes and bedding plus tools of trade. Before becoming a state, Texas established generous homestead exemptions for real property to attract settlers. The exemptions were marketed to northern debtors seeking to shelter property.

During the aftermath of the Civil War and the time of the 1867 Act, most states in the prodebtor South and West substantially increased their exemption levels to prevent property from being conveyed to northern creditors. Mississippi allowed debtors to retain 240 acres of land plus $4,000 in personal property in 1865 when the annual per capita income was $250. Florida's Constitution of 1868 offered a 160 acre exemption.

Pressure mounted to repeal the Act, but a new financial panic in 1873 instead led to amendments for the relief of debtors. The 1874 Amendments abandoned the 50 cents on the dollar requirement applicable to involuntary cases where creditors had petitioned the debtor into bankruptcy, thereby preventing creditors from blocking the discharge in these cases. In voluntary cases, the voting majority was lowered to one-quarter by number and one-third in amount of creditors to approve the discharge, and only applicable when recovery was less than 30 cents on the dollar. The 1867 Act was repealed in 1878 amidst widespread fraud and dissatisfaction, and during a general economic rebound.

The 1880s saw pressure for bankruptcy reform from interstate creditor groups that wanted a uniform statute to replace a myriad of state debt collection laws. The depression following the Panic of 1893 was the second worst in the country's history; the stock market crashed; unemployment reached 18.4 percent. A plethora of default and bankruptcies followed. This led to passage of the 1898 Bankruptcy Act as a relief measure. Succeeding federal statutes have lasted to this day. Involuntary petitions against farmers and wage earners were banned. Creditor approval and other conditions for discharge access were fully removed, again ratcheting bankruptcy towards being a debtor entitlement.

Rather than repealing bankruptcy law during the recovery period, as had been the practice after past depressions, in 1903 Congress tried to solve problems caused by the law with amendments. For example, individuals could systematically incur debts they planned not to repay, declare bankruptcy and discharge debts an unlimited number of times with no time limits between bankruptcies. The 1903 Amendments prohibited serial discharges in voluntary cases if the debtor obtained one during the

prior six years. Unfortunately, debtors easily circumvented this restriction by having friends file involuntary petitions against them. The six year ban was extended to involuntary cases in 1926.

During the economic expansion of the 1920s, the bankruptcy rate quadrupled. Economic optimism led to risky ventures, and that meant individuals incurred more debt. Towards the decade's end, a presidential commission suggested that debtors should be made to pay some of their debts out of future income to limit growing abuse of the statute.

A flurry of debtor-friendly enactments transpired during the Great Depression further ratcheting bankruptcy into a social welfare program. Chapter XIII was introduced as an alternative to liquidation for consumer debtors. Under it, debtors retained possession of property, mainly residences, and offered creditors a three to five year payment plan during which a stay prevented lenders from enforcing liens. Reorganization was established for corporations under Chapter X, and a "temporary" version enacted for government municipalities under Chapter IX. The latter was ruled unconstitutional, but later, with President Franklin Roosevelt's appointees, the Supreme Court reversed the decision. Trustees elected by creditors to manage the estate were replaced with court appointees under corporate reorganization. Debtors in possession were left in control of small businesses under Chapter XI. Firms continued operations under both chapters and offered creditors a plan. The plan could be accepted by two-thirds in amount owed in Chapter X for corporations, but small businesses under Chapter XI used a weaker simple majority in both claim and number.

CONTEMPORARY CHANGES

The 1978 Bankruptcy Act was an oddity since it was not the outgrowth of an economic collapse. Prior law was held over in basic form and supplemented with added debtor benefits. Small and large business nonliquidating Chapters X and XI were merged into modern Chapter 11 reorganization with the more liberal attributes of Chapter X. Incumbent management rather than court appointed trustees were left in control of bankrupt companies. States were given the option of using a new federal set of property exemptions or of opting out and using their own.

The Act deliberately made Chapter 13 repayment plans for individual debtors more attractive than Chapter 7 liquidations. More types of debt were allowed to be discharged under Chapter 13's 'superdischarge' including those resulting from embezzlement and punitive damage awards. Instead of Chapter 13 being open to individuals under a certain income ceiling, it was made open to individuals with debts under certain dollar amounts. Creditors also lost the right to vote on Chapter 13 plans.

Chapter 12 was added in 1986 in reaction to the decade's farm crisis. Only family farmers were eligible for Chapter 12 relief. It mimicked Chapter 13's three to five year debt repayment plan. However, it differed in that it omitted Chapter 13's ban on modifying mortgage liens over the debtor's principal residence by allowing a 'knockdown' of farm mortgage principal. For example, if an original mortgage debt was $100,000 and an appraiser found the farm to be worth $60,000, the lender could be forced to accept a new mortgage with principal set at $60,000.

Over history, bankruptcy was slowly transformed from being a crime committed by debtors into a social welfare program. Major enactments typically occurred during depressions for debtor relief. Debtor benefits were ratcheted upwards during succeeding crises; broadening eligibility, increasing the level of exempt property retained by debtors, and allowing easier access to the discharge. The series of enactments ended up legalizing what the law first sought to prevent - the nonpayment of debt.

WHERE WE ARE

An automatic stay is put into effect upon a bankruptcy filing. It renders contracted property rights unenforceable. Lien property is unrecoverable during the stay. Wage garnishments and property attachments are halted; claims are frozen and do not accrue interest; the estate is created out of nonexempt property. Under Chapter 7 liquidation where 70 percent of all filings occur, the estate is sold by a court appointed trustee and remaining unpaid debts are discharged.

Consumer debtors file 96.2 percent of bankruptcies. Thirty-five states set the amount of exempt property retained by debtors. Bankrupts in the remaining states use the alternative federal

exemption list. Some debts are earmarked as nondischargeable such as for alimony, child support, taxes, and last minute credit card purchases for luxury goods incurred sixty days before filing. Select debts are prioritized for payment before others such as administrative expenses, wages due, taxes, alimony, and child support, among others. Debtors generally may only obtain a discharge once every six years.

Chapter 13 consumer debtors retain possession of property as an alternative to liquidation. They are required to submit a debt repayment plan conveying to creditors future disposable income that is not necessary to support the debtor and dependents. The plan lasts three to five years while the automatic stay remains in effect. Unsecured creditors must receive at least what they would under a hypothetical Chapter 7 liquidation with “value” determined by court testimony as opposed to actual market sales.

Debts and assets involved in Chapter 11 reorganizations of businesses total to more than all other types of bankruptcy combined. Incumbent management remains in control and ongoing operations continue while firm assets are protected from creditor suits. New interim financing, technically a loan to the estate during reorganization, can finance operations even if the firm runs at a loss, and must be paid back before older preexisting debts. Incumbent management, as "debtor in possession," has exclusivity for 120 days to propose a plan of reorganization to creditors, but in practice the time is typically extended for the duration of the case, often lasting for years. Plans usually reset the firm's capital structure and reassign property rights to claims and interests in the case. New securities are issued in various proportions to cancel old securities. Creditors are separated into similar classes, e.g. first mortgage bonds, subordinated unsecured debt, for the purpose of voting on the plan. Court confirmation requires each creditor class by one-half in number and two-thirds in claim amount to accept the plan. Stockholders also vote on the plan by two-thirds in amount.

Chapter 9, municipal bankruptcy, is designed for public subdivisions of a state, usually municipal utilities, government school and water districts, and cities. Its provisions generally copy those of Chapter 11.

THE BUSINESS OF BANKRUPTCY

Chapter 11 reorganization often protects inefficient businesses and results in the continued waste of resources. It also protects the managers and owners that led the company into bankruptcy who continue to draw lucrative salaries from the estate, and provides incentives encouraging them to take inappropriate risks or engage in further irresponsible action. If the company finally must shut down and be liquidated, as is more often the case, less value, if any, is left from which to pay back creditors.

For example, the net worth of Eastern Airlines was more than $1 billion when it filed for Chapter 11 bankruptcy in 1989 and proposed to pay creditors in full. It continued operating for twenty-two months under bankruptcy protection during which $1.6 billion evaporated in operating losses. Additionally, $100 million of the estate was consumed by legal fees. All monies that could have been used to pay unsecured creditors disappeared. Creditors petitioned the court to shut down the airline to stop the estate from consuming itself, but Judge Burton Lifland denied their requests partially on the basis that airline travelers would be disrupted around the Christmas holiday season.

Firms may gamble and take on new debts during reorganization to finance expected operational losses with the slim possibility of positive gains- heads: debtor wins, tails: creditors lose. In the Eastern Airlines case it was a gamble on a turnaround in ongoing operations. In Orange Country, California, the elected county treasurer, Robert Citron, gambled in high risk derivatives with a pooled municipal trust. It lost $2.5 billion. In 1994, the county declared bankruptcy under Chapter 9, the largest municipal bankruptcy thus far in history. It then offered creditors 72 cents on the dollar while residents voted against raising property taxes.

"Reorganization" is a misnomer. The rosy textbook Chapter 11 scenario taught in law schools with economically viable firms successfully emerging from bankruptcy under confirmed plans of reorganization with ongoing operations, rarely occurs. That is especially true for the less publicized small firms that make up the bulk of Chapter 11 filings. Rather, Chapter 11 is often a delay tactic to thwart creditors. The plan confirmation rate for initial Chapter 11 cases filed two to ten years

previously is a mere 4.2 percent. The other nearly 96 percent of these cases remain in regulatory limbo for years. The estate often dwindles due to continued losses from failed business operations and ongoing legal fees, and cases usually end up converting to liquidation under Chapter 7, or simply close when no assets are left to fund legal fees or proposed creditor payments. Moreover, of the few cases with reorganization plans confirmed by creditors, the plan default rate is 46.6 percent. Thus, only about 2 percent of Chapter 11 filings successfully result in a confirmed and executed plan of reorganization. Creditors receive nothing in 81.3 percent of initial Chapter 11 filing cases.

INSOLVENT EQUITY SHARING

A particular problem with Chapter 11 concerns the treatment of equity in the bankrupt enterprise. Under the "absolute priority rule," shareholders are supposed to be the last class to receive any payments from the estate. But in practice, shareholders typically obtain a slice of the estate pie even though debts owed to creditors remain unpaid. Professors Lynn LoPucki and William Whitford of the University of Wisconsin Law School, in a 1991 study, "Bargaining over Equity's Share in Bankruptcy Reorganization of Large Publicly Held Companies," found that 70 percent of confirmed plans of reorganization distributed value to the old stockholders of large bankrupt corporations that were also insolvent while debtholders recovered less than full claim. For example, under the 1985 reorganization plan for Dreco Energy, where incumbent management consisted of large shareholders, unsecured creditors recovered only 12 cents on each claim dollar. Yet equity owners extracted 58 percent of the value of the estate distributed to both unsecured creditors and equity. If the absolute priority rule was enforced, equity holders should have received nothing in that case.

LoPucki and Whitford's study documented only a single case out of forty-one where equity was frozen out of the distribution when unsecured creditors recovered more than 14 percent on their claims. Even in the solvency cases where creditors could have theoretically been paid in full, in more than half of these cases, creditors received only partial recovery. The only recourse for creditors in such cases is to vote against the plan and holdout for full payment. Attempting to enforce the absolute priority rule rarely works since it usually ends up in drawn-out court proceedings with a nonmarket "valuation" of the corporation's assets. The average time in reorganization proceedings is 2.1 years for large publicly traded corporations. Trying to enforce the absolute priority rule could add an extra year or more to the process, and during that time, most claims do not accrue interest and the estate continues to be depleted by ongoing and additional legal fees.

Businesses with an interstate presence often shop around for the area in which the firm will get the best bankruptcy deal. The Southern District of New York seems more lenient to corporate filers. Its judges are more likely to approve plans allowing for equity recoveries. Corporations often use their small subsidiaries to file there although main business operations are located in another judicial venue.

FEEDING ON THE ESTATE

Professionals such as lawyers, trustees, and accountants, are third parties that draw from the estate. They receive payment before any other creditors. There is little incentive for them to hurry cases pending in the system, but every reason for them to produce unnecessary litigation, delays, and thus fees. Former Senator Howard Metzenbaum (D-Ohio) on 17 June 1992 commented, "The increased number of bankruptcies has created literally a feeding frenzy for the attorneys, accountants, investment bankers, and other professionals who service the unraveling or the restructuring of a bankrupt debtor. ... . These professionals get paid first out of the bankrupt's estate, and all too often there is nothing or very little left to pay those the bankruptcy system is designed to protect."

Corporate reorganization is often viewed as a divide the pie game where lawyers play the pie cutters. These hired guns bargain over the plan and serve up slices of the estate to various creditor groups and equity holders who compete for bigger portions. But since the parties pay collectively for legal services out of the contended pie, a "split the check" problem occurs resulting in the estate incurring unnecessary legal fees due to transfer seeking. They are engaged in a negative sum game in which the pie shrinks as professional fees rise.

Trustees appointed by the court as guardians of the estate administer cases, investigate claims, collect and liquidate the estate, distribute payments, and register reports. Supposedly, they can only charge the estate for actual and necessary expenses. Further, compensation is capped by a decreasing graduated schedule based on a percentage of the payments received by creditors. But those limits are circumvented by the ability of trustees in their "fiduciary" capacity to hire their own law and accounting firms to work on cases they administer. Trustee self-referrals generate indirect income not subject to the fee cap through the firm in which the trustee holds an interest. This clear conflict of interest gives trustees an incentive to prolong cases and incur unnecessary administrative costs. Eighty percent of trustees reported they would not serve if self-referrals were prohibited.

There is little monitoring in the system. A 1994 General Accounting Office report, "Bankruptcy Administration Case Receipts Paid to Creditors and Professionals," estimated that to administer 1.2 million Chapter 7 cases during fiscal 1991 and 1992, a total of 166,153 hours of bankruptcy judges' time was expended. That amounts to an average of eight minutes and eighteen seconds per case. The U.S. Trustees Office of the Department of Justice is supposed to monitor trustee practices and investigate fraudulent activities of debtors. One U.S. Trustee is assigned to each of the 120 judicial districts. That is about five thousand cases per year for each U.S. Trustee to monitor. It is impossible for U.S. Trustees to monitor even a small portion of cases in any substantial detail.

FEEDING FRENZY

One lawyer in the 1991 bankruptcy case of Carter, Hawley & Hale billed for 27 hours of work he completed in one day. Administrative fees in LTV's seven year bankruptcy case which ended in 1993 totaled $270 million. Such included charges by a New York investment firm, Gruntal & Co., at $915.75 per hour just for preparing its bill. Administrative fees in the 1990 Federated Department Stores case cost the estate $120 million. The bill in Drexel Burnham Lambert's 1990 bankruptcy amounted to $100 million in less than two and one-half years.

Total administrative costs in Chapter 7 —professional fees borne by the estate, attorney fees borne by debtors themselves when there is no estate left, and court costs borne by taxpayers—amounted to a total of $1.894 billion during the two-year period of fiscal years 1991 and 1992. Creditors in these 1.2 million cases recovered $1.188 billion, pennies on the dollar, from $1.973 billion in case receipts. Thus it costs $1.59 per dollar distributed to creditors. The system's administrative costs borne by all parties total nearly the same as estates involved.

The "value" of property in bankruptcy cases is often determined by expert testimony, not markets. That often results in a battle of appraisers. Should estimated wholesale, retail, scrap, used, trade-in, replacement cost, or going concern value be used? Courts in various jurisdictions can adopt different rules. The 7th Federal Circuit adopted a "split the baby" approach by averaging wholesale and retail values.

Other undefined legal terms such as "fair rent" and "interest at the legal rate" also foster subjective interpretation by judges and wasteful litigation. Chapters 12 and 13 require that "disposable income" remaining after the "necessary maintenance" to support the debtor, his dependents, and business, be applied to fund creditor payments during a three to five year plan. Subjective interpretations in some courts permit private college tuition, piano lessons, birthday presents, and charitable tithing, as "necessary" and more deserving than creditors.

CONSUMER BANKRUPTCY CRISIS

Consumer bankruptcy is a system out of control; annual filings quickly approach one and one-half million. The question among economists is not why the bankruptcy rate is so high, but rather why it is so low. While only about 1 percent of households actually file for bankruptcy, 15 percent would financially benefit from filing. That figure increases to 17.5 percent if debtors act strategically by converting nonexempt property to exempt by paying off residential mortgages to take advantage of generous homestead exemptions. The figure increases to 22.6 percent if debtors also move to more expensive houses or states with higher allowed exemption levels.

Many debtors do not file because they do not know of the sweetheart deal until they seek legal

advice or speak with the growing number of friends and relatives who have used bankruptcy to remove their debts. Mortgage bankers sometimes recommend a quick Chapter 7 filing and discharge to lower debts to help applicants qualify for new housing loans and consummate a sale. The moral cost or stigma felt by those who stiff their creditors has also faded. Bankruptcy is no longer an embarrassment. It has become a smart financial decision. It is as easy for a lawyer to remove unwanted debts as a doctor to remove an unwanted cyst.

It is possible to retain substantial property while discharging debts. Florida's 160 acre homestead exemption allowed former corporate raider Paul Bilzerian to retain a $6 million mansion in Tampa, four stories high with eleven bedrooms and twenty bathrooms. Michael Buettner in the *Tampa Bay Business Journal* (15 July 1997) reports a Virginia case in which the owner of a failed mortgage company was allowed to keep his "one horse" under state law. His one horse was an $800,000 racehorse purchased just prior to filing. He writes, "Elsewhere, courts have upheld exemptions for mink coats and Rolex watches as 'clothing.' " Assets in Employee Retirement Income Security Act (ERISA) qualified plans are also sheltered against creditors under state and federal law while debts are discharged. O.J. Simpson walked on the criminal trial, but his $4.1 million in pension assets are protected against creditors of the $33.5 million damage award for the wrongful deaths of Nicole Simpson and Ronald Goldman. Despite his conviction in the civil trial, bankruptcy law would allow him to walk again fully discharging the civil judgement.

Chapter 7's title, "Liquidation" is a misnomer. In 96 percent of Chapter 7 cases there is no estate to liquidate and creditors receive nothing. In practice it is merely a procedure to remove unwanted debts.

Once the forbidden fruit is bitten, many bankrupts come back to discharge debts again after the six year bar has passed. Some debtors plan their bankruptcies, incur debts and spend monies recklessly without the intent to repay. Approximately 8.6 percent of filers have declared bankruptcy once before and 2.5 percent have declared three or more times.

Bankruptcy endows debtors the inalienable legal right to discharge debts without payment. Its nature invites abuse. A rarely used clause in the Code allows dismissal for "substantial abuse." Senator Charles Grassley (R-Iowa) who sits on the committee with jurisdiction over bankruptcy remarked on 16 September 1997 that this clause regrettably implied, "that it's okay to abuse the bankruptcy system somewhat, so long as you don't abuse it so much that the abuse becomes substantial."

In one 1996 case, Doctor Hashemi took his family on a six week European vacation costing $60,000. He charged it to his American Express card, and upon returning, promptly declared bankruptcy and asked for a discharge. In another 1996 case, Mr. Uddin, an unemployed New York waiter amassed $170,500 in unsecured debt over six months for airline tickets, consumer electronics, perfume, cosmetics, and gambling trips to Atlantic City where he lost $60,000. He obtained $50,000 in cash advances on his credit cards, claimed he lent such funds to a friend who defaulted and disappeared, and asked the bankruptcy court to absolve him of his debts.

Bankruptcy has evolved into a government sponsored social welfare program administered by the courts. One difference is that it is seemingly funded by expropriating tens of billions of dollars from creditors instead of through tax revenues. Another difference is that the relief offered debtors is not means tested. Many debtors could pay their debts but simply choose not to. But lenders understand and consider the risk of nonpayment. Thus debtors as a group pay up-front for the potential benefits of the discharge through higher interest rates and more stringent loan qualification requirements. Ironically, bankruptcy “protection” can hurt the group it is intended to protect.

EXEMPTIONS AND THE STATES

There is a clear need to lower the bankruptcy rate and halt growing abuse of the system in order to foster economic efficiency and improve credit markets. The National Bankruptcy Review Commission (NBRC) recommended fixing the amount of personal property debtors are allowed to retain at an aggregate value of $20,000 (or $40,000 for joint filers), plus $15,000 if not claiming a homestead exemption. It also recommends that

Congress bound a debtors' ability to utilize state set homestead exemptions with a $100,000 ceiling and $20,000 floor.

While a ceiling is needed to prevent clear cases of abuse in states that set homestead exemptions by extent allowing debtors to retain unlimited wealth, the NBRC recommendation is too generous. The number of affluent debtors is also small and the $100,000 ceiling would reduce the homestead exemption in only four states. The impact of the $20,000 floor would be sizable, increasing available homestead exemptions in thirty-seven states which now have a lower or no homestead exemption and where nearly 70 percent of all consumer filings occur. The NBRC proposal would not effect homestead exemptions in the ten remaining states.

Overall, the proposed floor would result in a significant increase in filings since increasing property retained by debtors makes bankruptcy a more attractive option. Exemption levels have influenced filings in the past. The Bankruptcy Reform Act of 22 October 1994 doubled the dollar value of most personal property and homestead exemptions used in the fifteen states that do not set their own exemption levels and the District of Columbia. Between 1994 and 1995, total bankruptcy filings increased 17 percent in the areas using the higher federal exemptions compared to only 10.4 percent in the opt-out states where exemption levels did not change.

Reducing benefits such as exemption levels and access to the discharge is the best way to limit bankruptcy filings and abuse. Ideally, the applicability of the bankruptcy statute to consumer debtors should be repealed consistent with the jurisprudence contemplated by Framers of the U.S. Constitution. Failing that, the federal government should reduce exemptions well below the NBRC recommended aggregate $120,000 ceiling, to less than $20,000 lump sum in combined real and personal property. The only nonmonetary capped exemption should be for prescribed health aids. Significant pension assets over a monetary or actuarial threshold should be included in the estate.

CONSUMER BANKRUPTCY REFORMS

Consumer debtor bankruptcies can be further discouraged through a series of reforms. A partial list of those reforms would include:

- The window of time prior to a bankruptcy filing during which last minute debts incurred are not dischargeable should be lengthened to ninety days and made applicable to all debt types. Currently, only extensions of credit card debt greater than $1,000 incurred for luxury goods and cash advances sixty days prior to bankruptcy are nondischargeable. The NBRC proposal would decrease this period to thirty days but widen applicability to credit card debts incurred for any items.
- The ban on repeat (serial) discharge should be lengthened to ten years and made applicable to all bankruptcy chapters. Currently, the ban on serial discharge is only applicable under Chapter 7 if a prior discharge was obtained within the last six years.
- Judicial authority should be expanded to allow the dismissal of cases for "substantial abuse" in any chapter on various statutory grounds. Those grounds could include the ability to repay using future income or if debts were incurred recklessly by gambling and consuming luxury expenses without the ability to repay. Creditors should also be allowed to petition the court for a hearing on such. Currently, only judges and U.S. Trustees can motion for a "substantial abuse" dismissal, and only in cases under Chapter 7.
- Chapter 13's vague definitions of "disposable income" and "necessary maintenance" should be replaced with a system garnishing a declining portion of the debtor's future income over a five year period and using that portion to repay unsecured creditors. A similar garnishment trust fund should be available for unsecured creditor recovery in Chapter 7 cases. Creditors should be allowed to vote on the debtor's proposed Chapter 13 plan.
- Debt minimums for bankruptcy should be reimposed thereby preventing small debtors from clogging the court system in attempts to get a few months of free rent or discharge a few thousand dollars.
- Consumer access to Chapter 7 liquidation should be further limited making it a privilege instead of a right. Legislation under consideration (S.1301, HR.2500) would deny access to the quick Chapter 7 discharge if a debtor's projected income was enough to pay at least 20 percent of unsecured debts. While a step in the right direction, these bills base

"projected income" on the debtors's income around the time of bankruptcy, thereby encouraging debtors to quit their jobs a few months before they declare Chapter 7. A better formula is needed, possibly based on average U.S. personal income rather than individual income, and subject to less judicial leeway and circumvention by debtors.

BUSINESS BANKRUPTCY REFORMS

Business bankruptcy under Chapter 11 is rarely successful. Access to it should thus be limited in order to weed out failed business operations, especially for small companies. Incumbent management should not be able to manipulate the system to buy time and extract value from creditors. The following suggestions would help:

●Plan filing deadlines should be accelerated, especially for small businesses. Creditors should be required to quickly approve continuing operations under incumbent management before a reorganization plan is filed. A strict time limit in Chapter 11 should be imposed.

●Creditors should be given the option of electing their own corporate governors of firms operating under Chapter 11. The system could be based on proxy votes by claim amount, similar to the traditional right to elect trustees under prior law, but more of a simple conveyance of stockholder voting rights over executive management. Leaving the debtor in control sometimes is akin to letting the fox watch the henhouse.

●The U.S. Trustee's role in monitoring cases, and funding and appointments for that purpose, should be increased.

●Panel trustees should be prohibited from hiring their own law and accounting firms to handle cases and having the estate pay the bill. Such blatant conflict of interest makes trustees part of the problem rather than the solution.

●Secured debts should be allowed to collect the collateral against which the debtor borrowed. When governments make it impossible for creditors to enforce contracts, such undermine the basic right of contract and facilitate the theft rather than protection of property. Bankruptcy should only provide for the pro rata treatment of unsecured debts.

●The absolute priority rule as a plan confirmation requirement should be strictly enforced. Property rights should be reassigned quickly to end drawn out court proceedings. That would be possible for large publicly traded corporations through an initial public offering of the estate in toto, as a substitute for reorganization proceedings, and using funds raised to pay off creditors. Such a process would save on administrative costs and court proceedings could take months rather than years.

●Market sales should be used whenever possible instead of testimony battles over "value."

CHAPTERS TO REPEAL

Chapter 12 gives special "privileges" to farmers. It was originally passed as a temporary and experimental chapter, and now it should be repealed. By forcing mortgage lenders to accept rewritten loans conveying more generous terms to bankrupts, Chapter 12 actually has discouraged lending to family farmers, thereby harming those the provision was supposed to help. A U.S. Department of Agriculture study indicated that Chapter 12 might have increased interest rates paid by "protected" farm borrowers by up to 1 percent.

Chapter 9 should be repealed as well. Municipal bankruptcy also began as a "temporary emergency" enactment that was later made permanent. The Framers of the Constitution inserted the contract clause specifically to prevent state governments from legally reneging on their debts. Allowing their subdivisions to do the same under bankruptcy law seems to blatantly violate the clause.

CONCLUSION

There is an urgent need for Congress to act expeditiously on the issue of bankruptcy. Reforms such as limiting eligibility, reducing property exemptions, and restricting the availability of the discharge, would substantially lower bankruptcy filings. Reform now, during good economic times, is especially imperative. If a recession occurs before reform measures are enacted, a sudden surge in bankruptcies would send a tremor through an already overburdened system. The repercussions, as in past episodes, could foster relief type legislation giving borrowers even more opportunities to renege on debts, thus fostering even higher bankruptcy rates, potentially to the point where bank failings and restricted credit would further the depth of an economic downturn.

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