Federal Cases

Federal Statutes

Other Authorities

DEBATE

RESOLVED: THE 1978 BANKRUPTCY CODE HAS BEEN A SUCCESS

RALPH BRUBAKER*
KENNETH N. KLEE**

Prof. Margaret Howard: Welcome to our bankruptcy debate this morning. Let me begin by introducing our debaters. Ken Klee graduated from Stanford with his undergraduate degree and received his JD from Harvard. He was Associate Counsel to the Committee on the Judiciary of the U.S. House of Representatives where he was one of the principal drafters of the 1978 Bankruptcy Code. Ken had

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been in full time practice until 1997 when he joined the faculty of UCLA Law School as a full time member, having previously taught there on a part time basis.

Ralph Brubaker has his BS, his MBA, and his JD from the University of Illinois and has been a member of the Emory faculty since 1995.

We have two topics today that we are going to take separately. The first resolution is "Resolved: The 1978 Bankruptcy Code Has Been a Success for Business Bankruptcies." The affirmative will have fifteen minutes. The negative will have twenty minutes. The affirmative will then have five minutes of rebuttal. And time will be strictly kept. [Laughter]

I have been asked to make the following statement. The positions taken by the debaters are for purposes of advocacy only [laughter] and should not be attributed to them personally or to their clients. [Laughter]

So if any client, opposing party, or adversary counsel hears anything that generates a reaction of either horror or glee, then you surely misunderstood what was said. [Laughter]

Or if you have it on tape, then why can't you take a joke? [Laughter]

And besides, any resemblance either of these persons bears to the real Ken or Ralph is purely coincidental. [Laughter] [Applause]

Prof. Ralph Brubaker: It's a pleasure to be here. Thank you very much, Margaret. And it's an honor to be debating Ken Klee, for whom I have so much admiration and respect. But I find myself in the odd position today of being the champion of the work product of my antagonist. But as one of the people in this room, who shall remain nameless, remarked to me (Bruce Markell), if nothing else, it will be so nice to hear Ken Klee admit he was wrong for once. [Laughter]

A lot of my points are going to echo things we heard yesterday, which simply reinforce my case on the success of the Bankruptcy Code.

Perhaps the best indication of the success of business bankruptcies under the Code is not what happens *in* bankruptcy, but what happens *outside* bankruptcy. In a market-based economy that prizes deregulation, that prizes competition, that heavily relies upon debt financing, financial distress and failure are an inevitable feature of our economy. So a reliable system for dealing with a business's financial distress is vital to the proper functioning of our economy. In particular, studies have found that differences in legal systems across countries are significant in explaining the relative size, breadth, and valuation of countries' capital markets. And one measure of the successful contribution of our business bankruptcy system to general economic health lies in the fact that there are, in fact, *a lot* of business bankruptcies in this country. The system is actually used.

There's a recent paper from the World Bank that studied the relationship between the *use* of business bankruptcy systems of thirty-five countries and overall economic development.[1] And what they found is that higher levels of usage of a country's business bankruptcy system are strongly associated with a higher GDP per capita and greater efficiency in the judicial system. And the United States, not surprisingly, has one of the very highest rates of usage of its business bankruptcy system—filings as a percentage of all businesses in the country. And the world, in general, considers the U.S. bankruptcy system, and chapter 11 in particular, to be *the* standard benchmark for a successful business bankruptcy system and *the* model for design and reform of their own business bankruptcy systems.

Business bankruptcy under the Bankruptcy Code, of course, is largely synonymous with chapter 11, because nearly all businesses of any significant size file under chapter 11. So the vast majority of all business assets and debts in bankruptcy are handled by chapter 11. And in judging the success of chapter 11, it's appropriate to focus on large companies, because just the few very largest cases comprise the bulk of the assets, debts, distributions, and employees in chapter 11.[2] And those cases are the cases where the conventional function of preserving viable operating businesses and preserving going concern value is most compelling. And chapter 11 has clearly been successful in doing so.

Once again, I think it's appropriate, in judging the success of chapter 11, to focus primarily not on what happens *in* chapter 11, but what happens *outside* chapter 11. The preferred means of responding to financial distress and default is a negotiated resolution, without resort to bankruptcy. And at least half the time, those negotiations produce a successful, consensual, out-of-court deal with very low direct and indirect costs that deplete the value of the firm.[3]

The chapter 11 regime is integral to fostering and facilitating those workouts, because chapter 11 cures the holdout and free rider problems that plague out-of-court workouts—problems that would be much more of a stumbling block to out-of-court workouts in the absence of chapter 11. And in fact, the rise of prepackaged and pre-negotiated chapter 11s actually produces the phenomenon of creditors preferring chapter 11 over an out-of-court workout, even with the added cost that chapter 11 brings, precisely because a confirmed chapter 11 plan will bind all creditors.[4]

In assessing the success of chapter 11, I think it's also helpful to keep in mind that the cases that don't restructure out of court, and end up in a traditional chapter 11, tend to be the "hard" cases—the cases where the debtors have more complex capital structures, have relatively less bank debt, have a relatively higher number of

[1] Stijn Claessens & Leora F. Klapper, *Bankruptcy Around the World: Explanations of its Relative Use* (July 2002), *available at* http://www.worldbank.org/research/bios/lklapper/Bankruptcy_Claessens&Klapper.pdf (last visited Apr. 6, 2004).

[2] *See generally* Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 AM. BANKR. L.J. 499 (1999); Ed Flynn, Administrative Office of the United States Courts, Statistical Analysis of Chapter 11 (Oct. 1989) (unpublished manuscript, on file with author).

[3] *See* Karen H. Wruck, *Financial Distress, Reorganization and Organizational Efficiency,* 27 J. FIN. ECON. 419 (1990).

[4] *See* Elizabeth Tashjian et al., *Prepacks: An Empirical Analysis of Prepackaged Bankruptcies*, 40 J. FIN. ECON. 135 (1996).

smaller creditors (like trade creditors), and have relatively more contingent or disputed debt (like tort debts).[5] Well, unless we're to simply write off those debtors as not worth saving, we must offer a restructuring system that stays creditor collection and that can bind dissenters to a restructuring plan.

Comment [RB1]: Note: the word "Study" was misspelled in the Gilson citation, and the volume number was incorrectly cited as "26" rather than "27".

And once again, the need for and success of chapter 11 in that regard lies in its *use* by large companies to restructure, which has seen more than a tenfold increase in the last twenty-five years. And these large companies nearly always confirm a plan of reorganization or do a sale without a plan.[6] So given that large companies do choose to restructure in chapter 11, and we must have a system like chapter 11 for those debtors, thereafter it's simply a question of execution. And while we could debate endlessly about various aspects of the chapter 11 system, none of it seems to rise above the level of details and tinkering. And none of it seems to undermine the proposition that chapter 11 has been an extremely successful restructuring device for large debtors who, again, account for a large majority of the assets, debts, employees, and distributions in the system.

Comment [RB2]: Note: I changed the "last visited" date in the WebBRD cite, and added a "hereinafter" reference.

The primary challenges to that proposition have been speed and cost. The argument has gone, "It takes way too long to confirm plans in chapter 11," with dire predictions of staggering direct and indirect costs multiplying as the chapter 11 proceedings drag on. Of course, the only problem with that story is just that—it's a story. And it's not really true anymore and may never have been true with respect to at least half of that story.

With respect to speed, once again, it's helpful to remember that it's the "hard" cases that tend to end up in chapter 11. And even the "easy" cases that restructure out of court take time. And the chapter 11 process for large debtors has become extremely expeditious, and now compares very favorably to the time to restructure out of court.

One study put the average time to do a non-bankruptcy workout at fifteen months,[7] and another study put the average time to negotiate, file, and confirm a prepackaged or pre-negotiated chapter 11 plan at twenty-two months.[8] Well, for large chapter 11 cases that have been concluded in the last five years, even when we take out prepacks and pre-negotiated cases, which are now about thirty percent of all cases, the average time to a sale or confirmation is only sixteen months.[9] And when you tack on the average time negotiating pre-petition of eight months,[10] you get total time for resolution of only twenty-four months, which is very, very comparable to that of prepackaged and pre-negotiated cases at twenty-two months. So there seems to be very little substance to the "chapter 11 takes too long" argument anymore.

Comment [RB3]: Note: I deleted the *See* signal from the Gilson cite.

Comment [RB4]: Note: I deleted the *See* signal from the Tashjian cite.

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[5] *See* Stuart C. Gilson et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315 (1990).

[6] *See* WEBBRD: LYNN M. LOPUCKI'S BANKRUPTCY RESEARCH DATABASE, *at* http://lopucki.law.ucla.edu/ (last visited Oct. 5, 2003) [hereinafter LOPUCKI WEBBRD].

[7] Gilson et al., *supra* note 5.

[8] Tashjian et al., *supra* note 4.

[9] *See* LOPUCKI WEBBRD, *supra* note 6.

[10] *See* Gilson et al., *supra* note 5.

And the "chapter 11 costs too much" argument also seems overdone. The direct costs of chapter 11 for large debtors have always been quite modest as compared to the total value of the firms being reorganized. And a very recent study by LoPucki and Doherty shows that the direct costs of chapter 11 in large cases, on average, are only about two percent of the debtor's assets.[11] So the more important cost question is indirect costs and the supposition that just being in chapter 11 has all sorts of adverse effects on the debtor's business that deplete the value of the firm.

Well, when we move outside the realm of supposition and anecdotal evidence from this case or that case or the Eastern Airlines case, those who make their livings isolating and measuring such things have had a very hard time establishing the existence of *any* substantial indirect costs from chapter 11, even during the 1980s. For example, one massive study compared the productivity of the plants of chapter 11 firms with their industry counterparts, using an extremely large sample—thousands of plants.[12] And they found *no* evidence of significant declines in productivity while these firms were in chapter 11 and little evidence that chapter 11 had any adverse effect on these firms' asset deployment decisions about whether to close or sell particular plants.

Comment [RB5]: Note: I deleted the *See* signal from the Maksimovic cite.

And another study directly measured changes in firm value during the period firms were restructuring, focusing solely upon the effect of financial distress and restructuring, or in other words, over-leveraging only.[13] And after weeding out changes due to adverse shocks to the firms' businesses (or economic distress) and focusing solely upon financial distress and restructuring, they found that, on average, there were no statistically significant declines in firm value while these firms were restructuring. In fact, they found frequent indications of indirect benefits from things like management turnover, cost cutting, and improved operations. And in instances where there were indications of indirect costs—attributable to things like supplier and customer problems, distressed asset sales, slashing R&D expenses—those tend to be concentrated in the period *before* the firm filed chapter 11. So the chapter 11 actually helped them fix those problems.

Comment [RB6]: Note: I deleted the *See* signal from the Andrade cite and inserted a space in the citation before the number "1443".

So while popular accounts of chapter 11 have tended to portray it as an incredibly inefficient, incredibly cumbersome, incredibly expensive restructuring process, on the whole, the direct and indirect costs of restructuring in chapter 11 for large debtors appear to be quite low. And chapter 11 seems to be a very efficient and expeditious restructuring process for large firms.

The other major attack on the success of chapter 11 for large firms is a charge of too much recidivism, citing to the number of firms that confirm a plan and then subsequently restructure again through another chapter 11 filing or a subsequent out-of-court workout, with the implication being that even if chapter 11 allows

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[11] Lynn M. LoPucki & Joseph W. Doherty, *The Determinants of Professional Fees in Large Bankruptcy Reorganization Cases*, 1 J. EMPIRICAL L. STUD. 111 (2004).

[12] Vojislav Maksimovic & Gordon Phillips, *Asset Efficiency and Reallocation Decisions of Bankrupt Firms*, 53 J. FIN. 1495 (1998).

[13] Gregor Andrade & Steven N. Kaplan, *How Costly Is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions That Became Distressed*, 53 J. FIN. 1443 (1998).

companies time to fix various operating problems, it's not doing as good a job fixing over-leveraging problems. "Companies are coming out of chapter 11 with too big a debt burden."

Especially as compared with industry averages for leverage ratios, reorganized companies do tend to have much more debt. That phenomenon, though, is not limited to restructurings in chapter 11. There's a very interesting 1997 study by Stuart Gilson[14] that showed there are various obstacles to reducing debt levels once a firm experiences financial distress—obstacles that have nothing to do with bankruptcy law: taxes, the preferences of creditors, resistance to asset sales, etc . . . and debt levels are even *higher* after an out-of-court workout. Even more importantly, the variables that are statistically significant in explaining why debt levels remain high after an out-of-court workout disappear in chapter 11 reorganizations, implying that the high debt levels we see for companies coming out of chapter 11 are high because those are the debt levels that maximize the value of those firms, for example, because the disciplining effect that debt has on management may be much more important once a firm has already experienced financial distress—more important than it is for firms that haven't already experienced financial distress.

And that explanation, that the optimal capital structure for those firms is one that contains more debt, makes a lot of sense given that these confirmed plans are almost always consensual plans. And the major players who sign off on the plan presumably are aware of the likelihood and costs of a future restructuring that's associated with the higher debt levels, and the effect that has on the value of the reorganized company, and the effect that has on the value of the securities they're receiving under the plan. But nonetheless, they want the firm carrying more debt than is typical in the firm's industry.

It's also somewhat misleading to focus solely on those firms at the very bottom of the distribution. When you look at the entire distribution of firms reorganizing in chapter 11, the returns to claimants look quite good. For example, a study of the postbankruptcy cash flows of reorganized firms by Alderson and Betker[15] . . . . [Time Called] Okay. [Laughter]

Comment [RB7]: Note: I deleted the *See* signal from the Alderson cite.

Prof. Kenneth N. Klee: It's an honor and a privilege to debate Ralph Brubaker. I have never debated anyone who has acknowledged he had a BS Degree. [Laughter]

Ralph told you several things, but he didn't tell you anything about success. He didn't define success for you. He didn't tell you whether it was percentage of plans confirmed, percentage returned to creditors. So it's hard to debate someone who hasn't really defined his topic. But I can tell you that we ought to look at success on two levels, the theoretical level and the practical level.

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[14] Stuart C. Gilson, *Transactions Costs and Capital Structure Choice: Evidence from Financially Distressed Firms*, 52 J. FIN. 161 (1997).

[15] Michael J. Alderson & Brian L. Betker, *Assessing Post-Bankruptcy Performance: An Analysis of Reorganized Firms' Cash Flows*, 28 FIN. MGMT., Summer 1999, at 68.

First of all, as a matter of theory, it's indisputable that the Bankruptcy Code has been unsuccessful with respect to business bankruptcies because as a matter of theory, the Bankruptcy Code was never adopted. Now the reason that was the case, is if we assume that congressmen and their constituents acting with perfect information would only want to maximize their own utility, then we can assume that since only approximately a seventh of those constituents, if they're individuals and far less than that if they're businesses, ten thousand cases a year, is all we have go bankrupt, the vast majority of them are solvent. They're not bankrupt.

And from their perspective, what does bankruptcy do? Bankruptcy distorts state law entitlements. It distorts the rights of secured creditors. It penalizes efficient businesses by preserving sick businesses and hampering the competitive nature of our capitalistic system. That being the case, there is no rational reason why any member of Congress or any constituent would support the enactment of a Business Bankruptcy Code that would dispute and disrupt those state law rights. Since the Bankruptcy Code was never enacted for business bankruptcy, it can hardly be successful. But even if you look at this aside from a theoretical proposition and consider it in practice, the Bankruptcy Code has been a disappointing failure in practice for most small, medium sized, and yes, even large businesses.

Now, it's not surprising that my opponent focused on the large cases where there are successful confirmation rates in the handful of cases where this occurs. Of the ten thousand cases that are filed under chapter 11 on average in the last three years, a tenth of those are for individuals. They're not business cases at all. It can hardly be said to be successful to have a chapter that's called "Business Reorganization" apply in cases where we don't have businesses.

Now, the Supreme Court might reach that result in *Toibb v. Radloff*,[16] but that doesn't mean that the law is a success when it allows individuals to skirt the other chapters of the Bankruptcy Code for which the law was designed. With respect to the businesses that do file, they break down into three or four different categories.

And I'd like to start with one that is particularly suspect: Single-asset real estate cases. For single-asset real estate cases, chapter 11 is simply an inefficient illusion. Most judges, and I see some judges in the room, despise single-asset real estate cases because they're simply an effort to delay the inevitable foreclosure on the property that the mortgagee bargained for as a matter of state law rights. All bankruptcy does in this regard is to interfere with that bargain and create inefficiencies. And you, the American taxpayers, and I wind up paying for this. Most judges who have these cases, and don't dismiss them out of hand, put them on a very short leash.

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I submit to you that society would be better off barring single-asset real estate cases from eligibility for chapter 11 and just permitting the lender to foreclose or to strike a deal with the debtor out of court. After all, there's nothing that prevents the

16 501 U.S. 157, 166 (1991) (holding plain language of Bankruptcy Code allows individuals not engaged in business to reorganize under chapter 11).

lender and the borrower from getting together to restructure debt on a single-asset real estate property.

Commentators have argued that the ability of the mortgagee to foreclose on his or her collateral in an inexpensive and expeditious manner is a key element of the bargain between the borrower and the lender that determines a market interest rate. Since lenders never know who's going to go bankrupt, the presence of chapter 11 raises mortgage rates for all of us. This inefficient intrusion on state law contract rights and remedies underscores the failure of chapter 11 in single asset real estate cases.

But beyond that, consider chapter 11 in the context of small business cases. For most small business cases (and that's defined in the Bankruptcy Code in which the aggregate non-contingent liquidated secured and unsecured debts at the date of the petition are two million dollars or less),[17] chapter 11 is far too expensive to constitute a meaningful alternative.

The LoPucki study that was cited by my opponent putting chapter 11 costs at two percent of assets applies only in large public company cases.[18] That's Professor LoPucki's universe. It has no application whatsoever in the small chapter 11 case that is the mainstream of Middle America.

Comment [RB8]: Note: I changed the *supra* reference number in the LoPucki citation.

We know, based on studies, that these small business cases comprise over eighty percent of the chapter 11 cases filed. And they can barely sustain the costs of paying a debtor's lawyer's retainer, much less to sustain the administrative costs and professionals. For these small businesses, an out of court workout would be far more attractive. And before federal bankruptcy laws imposed a cumbersome legal apparatus financed at taxpayer expense, debtors and creditors, in fact, did work matters out of court through a general assignment for the benefit of creditors or through a consensual extension or composition agreement.

My opponent cannot sustain his burden of showing that chapter 11 should trump these state law rights and remedies in small business cases. Creditor representation in small business cases is almost nonexistent because there is no creditor's committee in most of these cases. The entire premise of chapter 11 is that judges will resolve disputes, and that creditors, through the formation of creditor's committees, will oversee the operation of the debtor-in-possession to make sure that chapter 11 functions efficiently.

Nothing could be further from the truth. Studies report that the United States Trustee has trouble forming and constituting creditor's committees in small business cases. That's why the statute was amended to enact section 1102(a)(3) to allow the court to dispense with the requirement of even putting the U.S. Trustee through the effort in these cases.[19]

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[17] *See* 11 U.S.C. § 101(51C) (defining small business).
[18] *See* LoPucki & Doherty, *supra* note 11.
[19] *See* 11 U.S.C. § 1102(a)(3) (2002) ("On request of a party in interest in a case in which the debtor is a small business and for cause, the court may order that a committee of creditors not be appointed.").

So what do we have? We have a vacuum in these small cases that allows the debtor to run amok. It has forced some judges back into the process to try to oversee the business and thereby lose their impartiality as dispute resolvers.

It is extremely difficult for debtors in small business cases to obtain debtor-in-possession financing. The expenses and fees alone of the debtor-in-possession financer would choke or be beyond the means of most small business debtors. These points are significant because these small business cases comprise over eighty percent of the chapter 11 cases, eighty percent of the cases that we are financing as taxpayers. If chapter 11 doesn't work in over eighty percent of the cases, it must be a failure. But it just gets worse.

Chapter 11 is also something that doesn't work for medium-sized cases. In the past three years, between ten and eleven thousand chapter 11 cases have been filed each year.[20] And we've established that ten percent of those are consumer cases. Less than two thousand of these cases are medium and large cases, and most of them can't afford adequate representation. Some of the judges in the audience know about the *pro se* chapter 11 cases they see.

Now you can't have that for a corporation. But you don't get a very good quality lawyer if you can't afford to pay the outrageous legal rates that are being charged these days by chapter 11 lawyers. Why I know one lawyer in New York who charges nine hundred and seventy-five dollars an hour and many in New York who charge in the high seven hundred dollar an hour range. There's no way that a medium sized chapter 11 case can pay this type of fee. There's also no creditor's committee in most medium sized chapter 11 cases. And debtor-in-possession financing is difficult to obtain there too.

Chapter 11 fails to cure business problems in medium sized chapter 11 cases because incompetent management is left in possession, and almost no case results in the appointment of an independent trustee or even an examiner to investigate this incompetent management. In other cases, outmoded products hinder the prospects for rehabilitation. And the cases just wind up liquidating. That can hardly be said to be a success just because you confirm a chapter 11 plan that provides for liquidation when chapter 7 was the route Congress prescribed for liquidation to begin with. Medium cases also have a mis erable confirmation rate.

Society would be better off auctioning off these assets and letting the market determine if the business should survive. Wasting taxpayer resources to have judges preside over the potential reorganization of less than two thousand cases a year is a poor investment and unwarranted infringement on state law rights.

Now that leaves us with the handful of large cases that my opponent used as his sole justification for the benefits of chapter 11. Chapter 11, though, also does not work for large cases. Most of the literature that's written and many of the experiences of the people in this room concern the few hundred cases a year where

[20] Statistics on bankruptcy filings are available at http://www.uscourts.gov/bnkrpctystats/statistics.htm#fiscal (las t visited Apr. 7, 2004).

almost all the dollars are. The scent of money is not lost on the attorneys, the accountants, the investment bankers and other professionals.

But contrary to what my opponent says, the cost of chapter 11 is enormous. In Enron, the professional fees are accruing at one million dollars a day.[21] Think about that. And even if we throw out Enron and some of the super-large cases as aberrational, and the costs are only two percent of assets, in a two billion dollar case, two percent is twenty million dollars. That's a lot to pay in the way of professional fees.

Taxpayers are subsidizing chapter 11 to the detriment of better-managed solvent companies. Some of these solvent companies have gone to Congress to complain about this. Our capitalist system is hamstrung. When the weak are subsidized at the expense of the strong, it is only through the failure of the weak and the survival of the fittest that America can remain strong. Indeed, liquidation through a prompt auction would properly provide for an efficient reallocation of capital and labor resources. Instead, chapter 11 panders to weak managers who make poor business decisions and run businesses incompetently. To coin a phrase, "is this any way to run an airline?" [Laughter]

Judges frequently confirm plans for large chapter 11 cases that are unfeasible and result in repeat filings. My opponent argues that because these plans are consensual, they must be good. The same argument was made to extol the virtues of equity receiverships in which secured creditors and managers routinely got together and made deals to squeeze out the trade creditors and the public security holders. Chapter 11 assumed that courts would determine feasibility to protect the public interests. The rash of repeat filings, particularly in jurisdictions that race to the bottom to attract chapter 11 business, is a testament to the failure of chapter 11.

Management continues to extract large, private benefits in the form of retention pay or bonuses that are not tied to performance. Cases are legion in the bankruptcy press and mainstream media about the large benefits paid to managers while creditors get only cents on the dollars in these cases.

Even the legislated cap on trustees has been avoided. In how many chapter 11 cases do you see a trustee? You don't. Why? Because a trustee's compensation is capped. But an examiner with expanded powers, where the court has read in the ability to hire professionals, there is no cap on those fees. Or how about a chief restructuring officer? Page through chapter 11 and find out where that one is. The chief restructuring officer comes into these cases and gets huge success fees. Based on what? Confirmation of a chapter 11 plan, a plan that rehabilitates the business? Oh, no. It could be a plan providing for the sale of assets. Hello. That's what could happen if we didn't have chapter 11. Why are we paying some chief restructuring officer a success fee? This has gotten so far out of hand that legislation is currently pending in front of Congress to remedy these abuses.

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[21] *See, e.g.*, David Barboza, *Lawyer Proves a Thorn for Enron's Partners*, N.Y. TIMES, Sept. 21, 2002, at C1 (noting one Atlanta law firm is billing Enron about three million dollars per month).

And of course, the forum shopping, no argument about the success of chapter 11 would be complete without discussing the forum shopping. It does make it very successful for those communities where twenty-five percent of the office space is staffed by bankruptcy lawyers. [Laughter]

But for the rest of the country, the presence of forum shopping undermines the confidence and the fairness of our federal judicial system.

The race to the bottom by courts to compete for chapter 11 business is well known. And those within the system defend it. Those outside revile it. Legislation to remedy this problem passed the House but was killed in the Senate by a Senator who recognized the importance of chapter 11 bankruptcy to the business economy of his particular state.[22]

Only in America would someone have the temerity to call a law that allows for this forum shopping a success. We would be less hypocritical to simply allow the debtor's lawyer to pick the jurisdiction in which he or she wants to file the case or allow judges to bid for cases. [Laughter]

We could do that. And some would contend, by the way, that the current law does just that by allowing the judges to adopt guidelines about what they will or won't approve for debtor-in-possession financing or in certain first day orders. No data supports the contention that chapter 11 is beneficial or needed.

Learned commentators suggest that our free market system would function more efficiently if the assets of troubled companies were sold or auctioned rather than tied up in a court administered chapter 11 process.[23] Even in the absence of chapter 11, out of court workouts would continue to occur. For example, banks, insurance companies and other debtors that are ineligible to file chapter 11 have been able to accomplish out of court restructurings. How have they been able to do it without chapter 11? Because ladies and gentlemen, chapter 11 is simply unnecessary. It costs too much. It's inefficient. And the fact that we're all part of it looking at it from the inside doesn't mean that it's justified. Think about this: Suppose we were a convention of biologists or environmentalists and our mission in life was to save certain endangered species like a leech or a barnacle. [Laughter]

It would be very important to us to preserve this species and not make it extinct. But that doesn't mean that it would be in the public interest or in the national interest to continue this process. [Laughter]

If you stand back and step away from the prospect of, "Oh my God, what would I do tomorrow if there were no chapter 11?" and ask yourself from a societal perspective, is this something we should support, you can only reach the conclusion that something has gone wrong.

Comment [RB9]: Note: I italicized the title in the LoPucki citation.

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[22] *See* Robert K. Rassmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 NW. U. L. REV. 1357, 1381 (2000) (providing responses from Senators William Roth and Joseph Biden vowing to protect status quo and availability of reorganization in Delaware).

[23] *See, e.g*, Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 600 (1993)(noting expeditious auction of assets as most frequently suggested alternative to chapter 11).

The most liberal Congress in the Twentieth Century, the Ninety-third Congress, passed a law that was premised on rehabilitating sick businesses based on the undocumented assumption that the reallocation of capital and labor resources that would take place if the business were allowed to liquidate would be devastating to our society and would be avoided if only we could have a chapter 11 system that would allow these businesses to rehabilitate in a court supervised system where the judge was a arbiter of disputes.

No consideration was given to the effect on competition of preserving these inefficient businesses. No consideration was given to preserving these businesses not just once but two times or three times. And how many Continental Airlines or TWAs or Pan Ams or LTV's does it take to keep going in? My gosh, we even have a restaurant chain that's gone in now for the second time. Restaurants!

Are the jobs going to be lost if we have liquidations? Of course not. People in this country are going to continue to work, or at least the people in India will continue to work for these companies. [Laughter]

Yet we're taking federal tax dollars that could be used to provide for drugs for the elderly or education or cancer research. And we're diverting those dollars to support a federal court system to have a chapter 11 reorganization structure to protect two hundred large companies.

And I tell you, we might think that's a success, but I'm not sure anybody else will. Thank you.

Prof. Ralph Brubaker: I'm glad that Ken mentioned competition in the airline industry, in particular, because I routinely fly to D.C. from Atlanta roundtrip for a couple of hundred bucks. And I imagine you couldn't do that in 1978.

He mentions the mandatory auction proposal of learned commentators. Learned commentators have proposed so many alternatives to chapter 11 that it's hard to keep track of them all. Mandatory auction is the simplest. But given the recent reductions of both the time and cost of chapter 11 proceedings, it's not clear that mandatory auctions would provide further significant decreases. For example, LoPucki and Whitford found that even in cases where the decision to sell is made very quickly, the time to sell, on average, takes over twelve months.[24] And there are various circumstances that can make an "internal reorganization" superior to a sale to a third party, in terms of maximizing the value that's available for distribution to the claimants. And it seems much better to leave it to the parties to decide whether, when, and which assets should be sold in lieu of an internal reorganization, instead of imposing, from on high, that we sell every time.

Indeed, I've always considered the greatest virtue of chapter 11 to be its tremendous flexibility. And making auction of a debtor firm mandatory seems particularly unnecessary given that asset sales have always been a significant aspect of large-firm reorganizations. Especially recently, chapter 11 practice has evolved,

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[24] Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 761 n.294 (1993).

on its own, into a means for, primarily, expeditious sale of the business of a financially distressed firm—in nearly half of all large-firm cases.[25]

And mandatory auction has a big problem in smaller cases. And that is that management, who would invariably lose their jobs in the sale of the business, would be loathe to ever file the bankruptcy case. One of the more prominent sources of indirect costs of financial distress is undue delay in addressing the financial difficulties, and mandatory auctions would simply exacerbate that particular problem.

With respect to single-asset real estate cases, the function of bankruptcy in a single-asset real estate case is to facilitate negotiations regarding a restructuring of the debtor's mortgage debt. And the fact that many cases are ultimately dismissed and do not confirm a plan really tells us nothing about the Code's success in facilitating those restructuring negotiations. In fact, dismissal is precisely what you would expect once the debtor and mortgagee have struck a deal. You'd expect confirmation proceedings to occur only when they *don't* reach a deal. And probably the biggest obstacle to fruitful negotiations in that context is not the Bankruptcy Code, but rather is the Supreme Court's repeated failure to tell us whether there's a new value exception to the absolute priority rule. And these cases can't delay forever. Nearly all of them—a very high percentage of them—are subject to the interest requirement; now they do have to pay pendency interest.[26]

Well, what about the mass of smaller firms that constitute the overwhelming majority of bankruptcy filings, just in terms of sheer number of cases? Well, with respect to the very smallest debtors, to ask how well chapter 11 works in reorganizing those businesses seems to ask the wrong question, because more of these businesses file under chapter 13 than under chapter 11.[27] And chapter 11 in these cases seems to serve the same sort of role as it does for single-asset real estate debtors. It's facilitating negotiations with key creditors for what Douglas Baird has called "human capital" businesses, where the most valuable assets can't really be sold anyway, because they're bound up with the talents of the owner-manager.[28] So the chapter 11 case is invariably converted or dismissed, but it nonetheless gives the owner-manager a chance to work things out. And that seems to be a perfectly appropriate function for chapter 11 to serve: a safety net for entrepreneurs to facilitate and encourage entrepreneurial activities.

Comment [RB10]: Note: I have no page reference for the Baird cite and will need for you to fill that in, when available.

And with respect to medium-sized businesses, the inability to successfully restructure most of these businesses has nothing whatsoever to do with chapter 11 and has everything to do with the fact that they're just not viable businesses. Chapter 11 can't fix the business that's not viable. So with respect to these cases, chapter 11 essentially functions as a sorting device. So the best measure of success in these cases is how well it performs that sorting function, with the primary

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[25] *See* LOPUCKI WEBBRD, *supra* note 6.
[26] *See* Warren & Westbrook, *supra* note 2.
[27] *See id.*
[28] *See* Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69 (2004).

concern being that allowing nonviable businesses to continue operating too long imposes all sorts of costs on both the court and creditors.

The good news in that regard is that the same trend of steadily decreasing case-processing times that we've seen in the large cases over the 1990s has been a more generalized phenomenon.[29] And for businesses that are shut down in chapter 11, as we heard yesterday, there's evidence that most of them shut down within the first few months of filing. They don't linger forever.

There seems to be a desire by many to just impose some drop-dead dates that are going to force the liquidation to occur at this time—can't delay one minute longer. But any sort of system like that would have costs of its own. And Douglas Baird and Edward Morrison have a beautiful paper that nicely demonstrates that the flexibility to postpone the shutdown decision has value in its own right, which they formally model using so-called "real options" or optimal stopping theory.[30] But the message is not only will the drop-dead date, if we impose it, be irrelevant in most cases given what the bankruptcy courts are already doing, but those sorts of rigid constraints can also force the shutdown decision to occur too early. Thank you very much. [Applause]

Prof. Margaret Howard: Thank you. Our next proposition will be "Resolved: The 1978 Bankruptcy Code Has Been a Success for Consumer Bankruptcies." Again, time will be strictly observed.

Prof. Ralph Brubaker: Okay, I'll take this side again. [Laughter]

When I told one of my colleagues I was going to debate the success of the Bankruptcy Code, his response was, "Over a million-and-a-half bankruptcies per year . . . . It looks like it's been *extremely* successful." And although his flip remark goes against the grain of the story with a lot more play these days—that the steadily increasing numbers of bankruptcy filings is conclusive proof that the bankruptcy system is failing—I think he actually hit the nail on the head. As is the case with business bankruptcies, the need for and success of the consumer bankruptcy system is confirmed by its use. And it's being used for precisely the purpose for which it was intended.

Our unique consumer bankruptcy system is a direct by-product of our unique approach to socioeconomic issues in general. The American ethos of maximizing the economic opportunities of businesses and individuals, with maximum flexibility and minimal interference from the government, necessarily brings increased risk for both businesses and individuals. And an economy that's dependent upon robust consumer spending that's increasingly fueled by largely unregulated consumer credit simply magnifies the financial risks for individual consumers.

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[29] *See* Gordon Bermant & Ed Flynn, *Outcomes of Chapter 11 Cases: U.S. Trustee Database Sheds New Light on Old Questions*, AM. BANKR. INST. J., Feb. 1998, at 8.

[30] Douglas G. Baird & Edward R. Morrison, *Bankruptcy Decision Making*, 17 J. L. ECON. & ORG. 356 (2001).

Our system *permits* financial failure by consumers. Financial failure is inescapable. The availability of a discharge of indebtedness in bankruptcy, then, is simply a recognition of the reality of financial failure *and* that it would do little good for anyone—debtors, creditors, society in general—to have hopeless insolvents subjected to indeterminate peonage to their creditors. That, in fact, there's great social utility in affording hopeless insolvents, in the words of Justice Sutherland, "a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."[31]

Comment [RB11]: Note: I deleted the word "creates" here.

That's the intended function of our consumer bankruptcy system, and that's precisely what our consumer bankruptcy system does—provides debt relief for hopeless insolvents. And the financial picture of those who resort to bankruptcy bears that out.[32]

Comment [RB12]: Note: I added a full citation to all authors of "The Fragile Middle Class" because the latter two are the most well known amongst bankruptcy professionals.

The national median family income is more than two times greater than the median family income of those filing bankruptcy. Ninety percent of bankruptcy debtors have incomes below the national median, and a third of the bankruptcy debtors have incomes below the poverty level. There is no general trend of relatively affluent debtors flocking to the bankruptcy courts for an easy escape from their debts. In fact, the income levels of bankruptcy debtors has steadily declined since enactment of the Bankruptcy Code.

Those very low income levels for bankruptcy debtors are coupled with staggeringly high debt levels in comparison. On average, bankruptcy debtors have total debt that is three times greater than their annual income. And even more tellingly, when you take out mortgage debt and focus solely upon short-term debt, the average bankruptcy debtor has short-term debts that are one-and-a-half times greater than their annual income—a level of short-term debt clearly beyond any reasonable capacity to repay, without even considering the substantial interest obligations that will continue to accrue on that debt.

And that same dire mismatch between income and short-term debts has remained constant for bankruptcy's debtors since the enactment of the Bankruptcy Code. The point at which bankruptcy debtors file bankruptcy has not changed. People tend to file bankruptcy when their short-term debts are one-and-a-half times greater than their annual income. And there are lots of aggravating circumstances that help explain how bankruptcy debtors get themselves into the position where their short-terms debts, on average, are one-and-a-half times greater than their annual income: job problems, medical problems, family problems, which I'll say a little bit more about in a minute. But chief among them, of course, is consumer credit and especially credit card debt.

It's no mystery whatsoever why consumer bankruptcy filings now exceed 1.6 million per year, and it really has nothing to do with the Bankruptcy Code. Bankruptcy filings are simply a reflection of the level of consumer debt

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[31] Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).

[32] *See generally* TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT (2000) (providing extensive data on finances of bankruptcy debtors and contributing causes of their financial difficulties).

outstanding, virtually a mirror-image reflection. And the steady increase in personal bankruptcy filings is not, by any means, a recent phenomenon, confined to the twenty-five year reign of the Bankruptcy Code. The rate of bankruptcy filings per capita has been on a long-term, steady, upward trend ever since World War II, increasing in both good times and bad, and especially in good times of economic expansion. And that increase tracks the steady expansion in the availability of consumer credit in the post-War period, which has, no doubt, been a good thing for consumers, homeowners, and the economy in general. But increased levels of consumer debt, not surprisingly, increase default risk for consumers, which inevitably increases bankruptcy filings.

And the increased risk that accompanies these increased debt levels is intensified by a number of common causes contributing to the financial downfall of bankruptcy debtors. In particular, employment difficulties play a role in over two-thirds of all bankruptcy filings. The unemployment rate among bankruptcy debtors is three to four times greater than that of Americans in general. And even more bankruptcy debtors have experienced substantial interruption in their incomes *before* filing—for example, from a period of unemployment during a transition between jobs after a layoff, or have backslid into a lower paying job or backslid into part-time work. And self-employed entrepreneurs are nearly three times more likely to end up in personal bankruptcy than are typical wage earners. None of these latter phenomena show up in the reported unemployment statistics, but their effects upon bankruptcy debtors are unmistakable, even during periods of relatively low unemployment rates.

The tremendous flexibility that businesses now have in quickly adjusting the size of their workforces is a great boon to corporate productivity, profits, the economy in general, *and* for employees' opportunities in an increasingly mobile workforce. But the inevitable displacements that accompany that flexible workforce place definite financial strains on workers that are manifest amongst debtors filing bankruptcy.

Closely related to job problems' contribution to debtors' financial problems are medical problems, which play a role in nearly half of all bankruptcy filings.[33] And in most of those cases, the illness or injury also had an adverse job or income effect. There's a substantial overlap among medical problems and job problems for debtors filing bankruptcy, with nearly forty percent of all debtors filing bankruptcy in 1999 experiencing both job problems and medical problems. The reduced income that accompanies illness or injury is, of course, often accompanied with increased debts, especially among the ranks of the growing uninsured and underinsured. So illness or injury makes individuals particularly susceptible to financial problems that can push them into bankruptcy.

And also among the most common contributors to the financial strain of bankruptcy debtors is the big "D": Divorce. For some time, scholars have noted the

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[33] *See* Melissa B. Jacoby, Teresa A. Sullivan & Elizabeth Warren, *Rethinking the Debates over Health Care Financing: Evidence from the Bankruptcy Courts*, 76 N.Y.U. L. REV. 375, 377 (2001).

association between divorce rates and bankruptcy rates. Increased family instability leads to increased financial instability, and vice versa, with each exacerbating the other and landing lots of debtors in bankruptcy.

The divorced and separated are two to three times more likely to end up in bankruptcy than others, and over sixty percent of single debtors in bankruptcy are currently divorced or separated. As a result, the consumer bankruptcy system is integral to sorting out the competing financial demands of ex-spouses and their dependants. And ultimately, it's the consumer bankruptcy system that is the means by which we vindicate the critical societal interest in *enforcing* support obligations, by permitting the overburdened ex-spouse to discharge all *other* debts and, thereby, free up their future income to pay ongoing support obligations. And yesterday, we heard from Elizabeth Warren that there is an increased risk of bankruptcy for those with children, which I could also give you some personal anecdotes about. [Laughter]

The consumer bankruptcy system is where we see the fallout from these other problems: job problems, medical problems, family problems. But again, the necessary predicate is debt. Overburdening consumer debt is why we have 1.6 million bankruptcies per year. Study after study confirms the extremely strong statistical correlation between consumer debt levels and consumer bankruptcy filings. In the period since enactment of the Bankruptcy Code, Bob Lawless found that "the correlations are almost perfect"—in the ninety-six to ninety-eight percent range.[34]

Comment [RB13]: Note: I deleted an extra space here.

Comment [RB14]: Note: I changed both the "last modified" and "last visited" dates in the Lawless cite.

And when the Congressional Budget Office plotted consumers' debt-to-income ratios against per capita bankruptcy filing rates for the period 1948 to 1999,[35] when I looked at the CBO graph wearing these ten-year-old glasses that I'm too cheap to replace—although I may have to because one of the nose pads actually fell off yesterday—but when I look at the CBO graph with these glasses, I don't even see two lines. I see one line headed straight up from 1948 to 1999—the bankruptcy filing rate increasing lockstep with increases in consumers' debt-to-income ratios.

Comment [RB15]: Note: I added an "available at" to the CBO cite.

Since enactment of the Code, increases in consumer debt levels have been primarily attributable to an exponential increase in the volume of credit card debt, beginning about 1982 with the effective deregulation of credit card interest rates, which instantly turned credit card lending into an extremely profitable business, which prospered from increasing volume even in the face of steadily rising delinquencies, defaults, and charge-offs. And that dynamic is evident in consumer bankruptcy filings. Vastly increased credit card debts is one of the most distinctive features of debtors filing bankruptcy in the 1990s—owing so much credit card debt at the median that it would take an entire month's income just to keep up with the annual interest charges.

[34] Robert M. Lawless, *The Relationship Between Nonbusiness Bankruptcy Filings and Various Basic Measures of Consumer Debt*, *at* http://www.law.unlv.edu/faculty/rlawless/busbkr/filings.htm (last modified Aug. 12, 2002) (last visited Sept. 5, 2003).

[35] CONGRESSIONAL BUDGET OFFICE, PERSONAL BANKRUPTCY: A LITERATURE REVIEW 8 (Sept. 2000), *available at* ftp://ftp.cbo.gov/24xx/doc2421/Bankruptcy.pdf.

And I'm not here to beat up on the credit card companies because, again, I think that the ready availability of consumer credit, on balance, is a very good thing. But it has definitely contributed to the increasing numbers of overburdened consumers who seek relief in bankruptcy. And it exacerbates all of these other contributing factors, like job problems, medical problems, and family problems.

The economic prosperity of the 1990s, with increased consumer spending was largely *financed* consumer spending. Household income levels in the 1990s remained essentially stagnant, but debt levels rose. So the credit card lenders' mock surprise and outrage over increased bankruptcy filing rates is a little hard to take given that the increase in bankruptcy filings is an entirely predictable phenomenon that they had to see coming. It is an inevitable corollary to increasing consumer debt burdens, which the credit card lenders are very, very anxious for us all to incur. And restricting the availability of a bankruptcy discharge would likely do *nothing* to reduce consumers' debt burdens and is likely to actually have the opposite effect of *increasing* the volume of consumer lending and ultimately *increasing* the number of bankruptcy filings.

The other thing that we can do to stop the bankruptcy filings, I guess, is repeal the Bankruptcy Code with respect to consumer debtors, in the name of reducing bankruptcy filings. But bankruptcy filings are a symptom. Bankruptcy filings are not the disease. Bankruptcy law can't cure the disease, but it can provide a much-needed palliative for the afflicted.

So I return to where I started. The Bankruptcy Code is a magnificent success in consumer bankruptcy cases. It is doing exactly what it was intended to do—relieving hopeless insolvents from their debts. Bankruptcy filings are increasing because the number of hopeless insolvents in need of relief is increasing, in direct proportion to increasing consumer debt. [Applause]

Prof. Kenneth N. Klee: Well this time we heard a definition of success. Success is equated to use. So I suppose if every citizen in the country filed bankruptcy, then it would be the most successful of all. That can't possibly be a measure for determining the success or failure of the consumer bankruptcy system. There are aspects of the consumer bankruptcy system and consumer bankruptcy policy that we could talk about, and that would be an interesting debate. But our debate is about the success or failure of the 1978 Bankruptcy Code as it relates to consumer bankruptcy.

How do we account for the staggering increase in consumer bankruptcy filing in the face of what has been an unprecedented period of prosperity? How do we account for that? Well, there are explanations that have been offered that my opponent has not suggested, and I will go through some of them with you to try to shed some light on the topic.

But first I want to get the statistics out on the table and talk about not just where we are now, but where we've been in terms of numbers. Yes, 1.6 million consumers filing for bankruptcy this year, the last twelve months ending June 30. This is a ten percent increase over the 1.47 million who filed cases in the previous twelve-month period.[36]

Now saying that success is measured by the number of people who use the bankruptcy system is sort of like saying the success of the hospital is determined by the bed count. That might be true in terms of the financial health of the hospital, but it doesn't say a whole lot for the financial health of society as a whole. And a full bankruptcy court, I think we all could agree, reflects poorly on society's financial health. To me this is not success. This is failure.

Consumers continue to file chapter 7 at an alarming rate rather than filing chapter 13. If they file chapter 13, they could repay their creditors a portion of the debts owed. For example, just the other day a judge in the Central District of Illinois held that a debtor who could afford to pay sixty-nine cents on the dollar to his unsecured creditors could proceed under chapter 7 rather than having to file a chapter 13 case.[37] In the twelve-month period ending June 30, 2002, consumers filed 1.2 million chapter 7 petitions. Also a ten percent increase over the previous twelve-month period. By the same token only 473,000 chapter 13 petitions were filed. And the rate of increase in chapter 7 cases was nearly fifty percent higher than the rate of increase in chapter 13 filings during the same time. And this trend is not a flash in the pan. Over the past ten years, consumer bankruptcy filings have doubled even though the numbers of consumers have not. This is exposed contractual opportunism on the part of consumer debtors, and it imposes a burden on all of us. At the very least, the law should require consumer debtors to spend three to five years repaying their debts. My opponent says this is peonage. But it is not indeterminate peonage. It is fair price to extract for the privilege of receiving a discharge, something the Supreme Court has recognized is not a fundamental Constitutional right,[38] but rather is something that can be conferred by Congress and by society as a benefit.

In other civilized countries, such as Australia, just such a law has been adopted. And I think we would do well to follow the lead of some of the other countries around the world that require the debtors to do something on their part to repay creditors.

Increased filings have also strained judicial resources. The average caseload per judge has skyrocketed. And the amount of time judges devote to particular chapter 7 cases has decreased. It is only fair to infer that the quality of justice dispensed in these cases also has diminished. That is not success. That is failure. The return to creditors in consumer bankruptcy cases continues to plummet. Overwhelmingly, these cases are no-asset cases in which unsecured creditors receive absolutely nothing. This undermines the basic premise on which consumer bankruptcy has been based since 1841 when the debtor's discharge was instituted.

[36] These statistics and others can be accessed at http://www.uscourts.gov/bnkrpctystats/statistics.htm#march (last visited Apr. 7, 2004).

[37] *See In re* Daubman, No. 02-85018, 2003 Bankr. LEXIS 1132 (Bankr. C.D. Ill. Sept. 2, 2003).

[38] *See* United States v. Kras, 409 U.S. 434, 445–47 (1973) ("There is no Constitutional right to obtain a discharge of one's debts in bankruptcy.").

Prior to that time, as you know, bankruptcy was a device to recover assets for creditors. But to encourage consumer debtors to go ahead and bring forth their assets for distribution, the discharge was granted by creditors as part of a fundamental bargain: You deliver your nonexempt assets, distribute them to your creditors, and you'll get a discharge, a fresh start. The premise for that bargain no longer exists today.

Today the debtor surrenders nothing and gets his or her discharge in exchange. The system has been turned on its head.

Although some of the consumers who file chapter 7 are poor but honest debtors who indeed deserve a fresh start, there is an enormous amount of abuse that pollutes the consumer bankruptcy system. And my opponent simply ignores this abuse. Now, abuse can be measured in two ways. First, there are dishonest debtors who file bankruptcy and intentionally fail to list their assets and their creditors and their proper identification. They list false identification largely to overcome the automatic one hundred eighty day bar of section 109(g) of the Code on sequential filing of consumer bankruptcy cases.[39]

Many of these debtors are repeat offenders. They file to get the automatic stay. The case is dismissed. They file again. It's not legal to file again. They file again anyway. We've even had a circuit say that on such a re-filing the automatic stay doesn't come into play,[40] plainly at odds with the language of the statute but done out of desperation to stop this problem.

In the Central District of California, false identification and false social security numbers are so common that the Office of United States Trustee has formed a special debtor identification program to deal with the abuse. And the problem is not confined to the Central District of California. A national U.S. Trustee sponsored debtor identification study found in the first six months of 2001 that one percent of all consumer cases have debtor identification problems.[41] So one percent of 1.6 million is sixteen thousand cases on today's numbers.

Apart from identity abuse, debtors routinely fail to accurately list their assets and their creditors on their schedules.

Bear in mind while my opponent rightly says that one third of bankruptcy debtors have income below the poverty line, two thirds are going to have income above the poverty line. Where are their assets? How can ninety percent of the cases be no asset cases? The Office of U.S. Trustee has disclosed in its *2001 Annual Report of Significant Accomplishments* that in the seven years from 1994 to 2000, in which two hundred thousand chapter 7 asset cases were closed, only $10.5

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[39] *See* 11 U.S.C. 109(g) (2002); *see also* Harriet Thomas Ivy, Note, *Means Testing Under the Bankruptcy Reform Act of 1999: A Flawed Means to a Questionable End*, 17 BANKR. DEV. J. 221, 233–34 (2000) (discussing abusive chapter 7 filings).

[40] Umali v. Dhanani (*In re* Umali), 345 F.3d 818 (9th Cir. 2003) (declaring stay void when petition refiled during 180-day bar period).

[41] Press Release, U.S. Department of Justice, Executive Office for U.S. Trustee, Office of Research and Planning, Personal Bankruptcy Filers Will Be Required to Show Proof of I.D., Based on Results of Pilot Study (Jan. 3, 2002) *at* http://www.usdoj.gov/ust/press/pr20020103.htm (indicating pilot program found inaccurate names or social security numbers in about one percent of pilot cases).

billion was collected in those cases. And of this, $3 billion went to secured creditors; $3.4 billion went to trustees and professionals.[42] That's quite a little more than two percent of the asset value. By my reckoning, it's somewhere like thirty-three percent of the asset value. And only $2.5 billion went to general unsecured creditors with the balance going to priority claims.

Of the money collected, only 3,179 cases accounted for $5.91 billion of those assets, or over fifty percent of the total. And most of these asset cases were filed under another chapter and converted to chapter 7. Thus, in the vast majority of the cases, chapter 7 has lost its moorings and failed to return anything to unsecured creditors. And in the few asset cases where a return is made, the secured creditors and administrative claimants take the lion's share of the distribution.

There's a second way to measure abuse. There are immoral debtors who can afford to repay their creditors over time but who choose to opt for a quick fix by taking an immediate discharge in chapter 7. Studies have shown, even recent books have shown, that the abuse rate ranges between three and ten percent of the cases. That may not sound like a lot. But with 1.6 million cases a year we're talking about between fifty thousand and a hundred and sixty thousand abusive filings every year.

There's also systemic abuse by unscrupulous petition preparers who prey on unsuspecting debtors and by debtors who use false social security numbers. In the Central District of California, for example, the Office of United States Trustee has an entire periodic newsletter that is dedicated to the topic of consumer bankruptcy abuse. This newsletter is called *The Watchdog*.[43] *The Watchdog* typically ranges from between nine to fifteen pages in length. I recommend it to those of you who think that abuse doesn't exist or exists only in theory.

Among these abuses, *The Watchdog* reports several instances of petition preparer abuse by check kiting, overcharging, nondisclosure, predated petitions, and the unauthorized practice of law. In one issue alone, five separate petition preparers were enjoined by different bankruptcy judges based on their abuse of the law.[44]

Systemically, we're doing practically nothing to deter debtor abuse. During the 1990s, for example, the United States Trustee program reports only 1,168 fraud convictions in ten years ranging from a low of 70 convictions in 1990 to a high of 182 in 1998. While the efforts of the United States Trustees are laudable, it is plain that criminal deterrents simply don't work to deter abuse in the bankruptcy system.

Civil enforcement to deal with abuse is more promising. Each year hundreds of abusive filings are dismissed for substantial abuse. For example, the United States Trustee reports in 2001 that it filed 1,950 substantial abuse motions of which 660 were granted and 600 more resulted in voluntary conversions to chapter 13. Other cases resulted in settlements relating to abuse. Although the United States Trustee

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[42] *See* U.S. TRUSTEE, 2001 ANNUAL REPORT OF SIGNIFICANT ACCOMPLISHMENTS 46, 47, *available* at http://www.usdoj.gov/ust/press/annualreport/ar2001.pdf (last visited Apr. 7, 2004).

[43] Recent publications of *The Watchdog* are available at www.usdoj.gov/ust/r16/watchdog.htm (last visited Apr. 7, 2004).

[44] *See id*. Various issues, which are available online, discuss cases brought against Bankruptcy Petition Preparers.

is to be applauded for ferreting out abuse in about five thousand cases, one can only imagine the thousands of cases in which abuse occurs and goes undetected.

Based on our academic studies, in 2003 anywhere from fifty thousand to a hundred and sixty thousand cases are abusive. And that's only based on an ability to repay definition of abuse, not based on identity abuse or failure to schedule assets or creditors. Providing a remedy in only three to ten percent of these cases is unacceptable and underscores the failure of the 1978 Bankruptcy Code to provide a fair and honest consumer bankruptcy system.

The 1978 Bankruptcy Code, however, has also proved to be a failure for poor but honest debtors. The quality of the debtor's fresh start has deteriorated steadily and significantly since 1978. In 1978, there were only nine exceptions to discharge codified in title 11. Today there are eighteen exceptions to discharge, double the number codified, and many more codified outside of title 11 in other areas of the United States Code.[45] And if the pending legislation in Congress is enacted, the exceptions to discharge will mushroom even more. Thus even for the poor but honest debtor, the Bankruptcy Code is a failure and gives the debtor much less than a fresh start.

So where are we? We're paying our tax dollars to set up a federal court system to perform a social work function. There's nothing being done in the time judges spend on chapter 7 cases that couldn't be done by an administrative agency, or if the Constitution were amended, handled at the State level. [Laughter]

The national policy of just saying to anyone "go ahead, take your free pass, just write off your debts," is not something that marks a successful system. Indeed, some books that argue that debtors should act strategically encourage debtors to finish dealing with their doctors and running up the medical bills or finish dealing with the unemployment problems and getting a new job before filing for bankruptcy to maximize the effect of the discharge in bankruptcy. We have lost our markers. We have lost our moorings. Where is the social norm that people who can repay their debts should repay their debts? Where are the moral values? What is the societal impact? Now people say that there's no such thing as a decline in stigma; but it can't be denied that in a small town where someone borrows from his or her neighbor, and they know that if they stiff the neighbor, it is going to be talked about in church or synagogue or at town meetings where they have to look the neighbor in the eye. It is different than when you don't pay one of the banks that send you the pre-approved credit card form in the mail.

I want to say a little bit about some of these statistics that my opponent has thrown at you in an effort to convince you that this consumer bankruptcy system is all wonderful and abuses should be blamed on the credit card companies who should know better. It is true that there is a correlation between the volume of consumer credit and bankruptcy filing rates. But correlation does not mean

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[45] Exceptions to discharge are available in chapters 7, 11, 12, and 13 of title 11 of the United States Code. Further exceptions to discharge can be found outside of title 11 in title 42. *See, e.g.*, 42 U.S.C. § 292f(g) (2002) (setting forth conditions for discharge of debt in bankruptcy).

causation. None of the studies that have been done have used control groups. None of the studies that have been done establish causation. They simply assume that because there is a correlation there is causat ion. Sort of like when the best economy in the world has the most chapter 11 filings then chapter 11 must be good for healthy economies. We heard that argument in the previous debate. It didn't work then. It doesn't work now.

Let me tell you somethin g else that we heard. We talked about the debt to income ratio and the chart in debt to income ratio that tracks, with a bit of a lag, to predict bankruptcy filings. Well, debt to income ratio might have some correlation. But again, it doesn't mean that there's causation. Debt is a long-term obligation. Income is a short-term measurement. Where is the measurement of assets and liabilities, the more traditional means by which solvency is determined? Nobody talks about the assets that these debtors have that they could use to liquidate to repay these debts. They just talk about their income. Let's get a complete picture instead of talking about measuring apples and oranges.

Third, nobody forces these debtors to borrow this money. People get offers in the mail to go ahead and visit gaming casinos. They get offers in the mail to go on cruises. It doesn't mean they go ahead and do it. If they get an offer in the mail to get a credit card, it doesn't mean they have to use it. What happened to responsibility for consumer debtors? When are we going to hold these people accountable for doing what they do, because it's noted in modern books that bankers take these things into account when they set the rates. They take into account that people might default. But if that's so, then if fewer people went through bankruptcy and got rid of their debts, rates would come down for all of us. [Laughter] We all, [laughter] I almost did it.[46] [Laughter]

We all pay the price of the unscrupulous deadbeats who borrow the money and fail to repay their debts in a responsible fashion. No one is arguing for repeal of the 1978 Bankruptcy Code for Consumer Bankruptcy Law except putting it in a social agency might not be a bad idea. But we should have reform. And we should have reform that takes account of the abuse that is occurring and that limits bankruptcy to poor but honest debtors for which the system was designed.

I commend to your reading a document that is being prepared and will shortly be published by the Director of the Office of Policy Planning of the Federal Trade Commission called *Why so Many Bankruptcies and What to do About it, An Economic Analysis of Consumer Bankruptcy Law and Bankruptcy Reform*.[47] This thoughtful study that runs over a hundred and ten pages authored by Todd Zwyicki has a penetrating analysis of the statistical causes of consumer bankruptcy and of the validity of the statistical arguments that have been offered to you by my opponent. I commend it to your reading. Thank you for your attention. [Applause]

[46] Professor Klee almost made it through the debate with a straight face advocating many positions with which he has strong personal disagreement.

[47] Todd J. Zywicki, *Why so Many Bankruptcies and What to do About it, An Economic Analys is of Consumer Bankruptcy Law and Bankruptcy Reform*, George Mason Law and Economics Research Paper No. 03-46 (2003), *at* http://ssrn.com/abstract_id=454121 (last visited Apr. 7, 2004).

Prof. Ralph Brubaker: I also have an income above the poverty level. And I keep looking for my assets too. And I'm not seeming to find them. [Laughter]

And bankruptcy debtors have even more of a problem with that than I do. There are very few that have any assets that exceed their debts. It's a distribution that is clearly in the insolvent range. Only the very, very outer tail has any assets at all, and the creditors, of course, get them.

And yes, there is abuse in the system, which is inevitable. Perfect justice is not attainable on this earth. And there are always those who are going to work the system to obtain undue advantage, regardless of what the system looks like. The best that we can do is try to minimize the abuse to the greatest extent practicable, while maintaining the overriding purpose and function of the system as a whole. There is no systematic evidence of increasing abuse of the system. The evidence indicates that filing rates are climbing for other reasons.

The problem with these sensationalized claims of abuse from folks such as my opponent is that they focus upon the relatively infrequent exceptions. And that's being used to try to dramatically rework the entire system in a way that would change its fundamental purpose and function as applied to the more typical case, so that the bankruptcy system will no longer provide effective debt relief for overburdened debtors, but rather will be transformed into a rather blunt, somewhat arbitrary, very cumbersome, herding, sorting, and steering system, designed to ensure that as many debtors as possible do remain in indeterminate peonage to their creditors—essentially turning the fresh start function on its head.

The primary kind of abuse that's driving these sorts of proposals—that chapter 7 debtors are given a free pass on debts that they can clearly afford to repay—is clearly the exception and not the norm. By all estimates, the relative numbers of such debtors are small. For example, the Congressional Budget Office concluded, "The findings of all the studies suggest that a small percentage of people may be avoiding debts that they could afford to repay."[48]

Comment [RB16]: Note: I changed the *supra* reference number in the CBO cite.

Current means testing proposals to try to get at that abuse, or purportedly to try to get at that abuse, by a very small percentage of "can pay" debtors—probably less than five percent of chapter 7 debtors[49]—would impose substantial additional administrative burdens on all debtors and on the system as a whole. And doing what the current legislation would do—erect a fairly mechanical, formulaic screening of debtors filing chapter 7—presents its own opportunities for gamesmanship and working the system for undue advantage. And those debtors with the propensity for such abuse will, no doubt, find lots of ways to avoid being caught in these means-testing screens.

[48] CONGRESSIONAL BUDGET OFFICE, *supra* note 35, at 29.

[49] *See* Marianne B. Culhane & Michaela M. White, *Taking the New Consumer Bankruptcy Model for a Test Drive: Means-Testing Real Chapter 7 Debtors*, 7 AM. BANKR. INST. L. REV. 27 (1999); Ed Flynn & Gordon Bermant, *Estimating Means-Tested Chapter 13 Case Yields From Current Chapter 13 Performance*, AM. BANKR. INST. J., June 2000, at 22.

And the predictable effect of increasing the complexity and cost of filing chapter 7 for all debtors, especially in terms of attorneys' fees and the availability of people who will actually do consumer bankruptcy work, is that "can't pay" debtors—clearly "can't pay" debtors—will be deterred from seeking bankruptcy relief. Many more chapter 7 cases will be filed *pro se* and with the assistance of these abusive petition preparers that are all over the place. And more and more debtors will be steered into chapter 13, which seems particularly inappropriate given chapter 13's very low success rates, with only about a third of all chapter 13 debtors actually completing their plans and receiving a discharge. In fact, there seems to be far *too much* steering of debtors into chapter 13 already, to attempt infeasible repayment plans that often leave them in a much worse position than had they never filed chapter 13 in the first place, which looks to me like indeterminate peonage of debtors.

And what do we hope to achieve with this sort of administrative superstructure that would formalize and enforce this more grand-scale steering of debtors? More creditor repayment, which we're led to believe will decrease the cost of credit for everyone. But it's far from clear that the increased creditor repayment would ever result in any significant decrease in the cost of consumer credit, especially in the form of a lowering of credit card interest rates, which have been particularly unresponsive to even significant long-term declines in the issuers' biggest expense item, their cost of funds.

And the predicate for any decrease in the cost of credit is even more doubtful. It seems very unlikely that creditors are actually going to receive significant additional repayments under these proposed means-testing regimes, especially given the very low repayments that unsecured creditors already receive in chapter 13. Thank you very much.

Prof. Margaret Howard: I reiterate that the positions taken by the debaters are for purposes of advocacy only. And if you think you heard Ken Klee say anything suggesting that lawyers charge too much, you surely misunderstood. [Laughter]

[A brief question and answer section with the audience has been edited out of the transcript]

Please join me in thanking our debaters. [Applause]