

MUSINGS DURING A SYMPOSIUM AFTERNOON

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I. INTRODUCTION

Professor-Judge Ayer's insightful analysis¹ into ways of looking at Chapter 11² is intended to set our bankruptcy musings in more productive directions. It set my thoughts upon an inquiry regarding the shortcomings of the current "law and economics"³ view of reorganization that dominated the first afternoon of this Symposium. There is no doubt that assessing bankruptcy law solely by the degree to which it meets the goals of fair distribution to creditors provides a focused way of looking at bankruptcy, a wonderfully simple backdrop for teaching bankruptcy to law students, and a "land of milk and honey" for creditors. The questions that pervaded my thoughts while I was listening to the presentations at the Symposium were, "Is it an accurate statement of current American bankruptcy law?" and, if not, "Would it be appropriate to adopt as the sole or primary principle of American bankruptcy law?"

I believe that the answer to each of these questions is a resounding "no." In this brief musing I will describe one of the many bases for concluding that when one tracks through current American bankruptcy law, she finds that there is a series of principles that overshadow the law and economics principles. I will then compare the process by which bankruptcy law is

* First, a bit about this observer because it impacts upon my observations. I am a Midwestern bankruptcy and creditors' rights lawyer and part-time Article 9 and bankruptcy law teacher. I have noticed that nearly all of the reorganization literature focuses on a very few very large reorganization cases; although we have a few very large cases here in the Midwest, and representation of our clients takes us to the Coasts for large cases periodically, my practice consists primarily of medium-sized and smaller cases.

1. John D. Ayer, *Through Chapter 11 With Gun or Camera, But Probably Not Both: A Field Guide*, 72 WASH. U. L.Q. 883 (1994).

2. 11 U.S.C. §§ 1101-1174 (1988).

3. For a sample of recent work in this school, see Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439 (1992); Douglas G. Baird, *A World Without Bankruptcy*, LAW & CONTEMP. PROBS., Spring 1987, at 173; James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Law and the Elementary Economics of Loss Distribution*, 26 GA. L. REV. 439 (1992); Donald R. Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law*, 71 TEX. L. REV. 541 (1993); Robert K. Rasmussen, *The Ex Ante Effects of Bankruptcy Reform on Investment Incentives*, 72 WASH. U. L.Q. 1159 (1994).

made in the United States with the process by which Article 9 of the Uniform Commercial Code is made, to show that bankruptcy is an area in which Congress must strike a balance more toward the middle of the political spectrum than the law and economics people would choose.

II. THE CURRENT LAW: THE DOCTRINE OF SECOND CHANCE

American bankruptcy law provides most types of debtors with a "second chance." To look at bankruptcy only from the creditors' point of view is to dismiss this central ingredient. The question for Congress has been how to structure that second chance so that it is meaningful to the debtor, but also fair to creditors and to other parties that are affected. This doctrine of second chance applies to individual debtors in Chapter 7 and to all types of eligible debtors in Chapters 9, 11, 12, and 13. A society has many choices for dealing with those that do not pay their debts. It could cane them, it could put them in prison, it could put a star on their foreheads, or it could establish rules for giving them a second chance as Congress has done.

Chapter 7 is an effort to balance the chance for an individual to have a fresh start with the interests of creditors to make certain that it is not a head start.

For example:

1. State and federal exemptions⁴ are determinations of what and how much a Chapter 7 debtor that wants a discharge may keep.
2. The discharge of unsecured debt⁵ and the ability to preserve postpetition income and property are the weapons for a fresh start.
3. The provisions that establish nondischargeable debts⁶ define those unsecured obligations that, for a variety of reasons, we are unwilling to allow to be discharged.
4. The rules regarding secured claims⁷ are an effort to balance the property rights of a secured creditor against the second chance opportunity, and the rights of unsecured creditors to share in any "equity" that may exist in the property.

Chapter 13 is about a fresh start or a second chance for those who wish

4. The Bankruptcy Code includes a compromise that establishes an alternative federal set of exemptions which could be used in place of the state exemptions, but allows any state to "opt out" of the federal exemptions and provide that only the state exemptions would apply. 11 U.S.C. § 522 (1988).

5. 11 U.S.C. § 524 (1988).

6. 11 U.S.C. § 523 (1988).

7. 11 U.S.C. §§ 362, 506 (1988).

to pay a portion of their debts over time, and for those who want a discharge but need special rules to help them keep their cars⁸ and homes⁹ while they are discharging unsecured obligations; the cost of these extras is that the debtors must promise to pay disposable income to unsecured creditors for the three-to-five-year duration of the plan.¹⁰ This balancing of the opportunities to keep a car and a home along with the right to discharge certain debts that would not be dischargeable in Chapter 7 against the very limited payments from disposable income to unsecured creditors has been a subject of much political debate.¹¹ The rule that the debtor cannot restructure a debt secured solely by a lien on her principal residence¹² is a special limit on the ability of the debtor to restructure secured debt that represents a balancing of political and philosophical interests.

Americans protect their farmers in very bad times,¹³ and Chapter 12¹⁴ is a second chance for "family farmers" that combines most of the advantages of Chapter 13 with several key advantages of Chapter 11, such as the right to restructure long-term debt. In 1986, as a result of a glut of agricultural credit defaults for which Chapter 11 did not appear to be an effective antidote, Congress passed Chapter 12. During the remainder of the agricultural recession,¹⁵ Chapter 12 had the very positive effect of

8. Pursuant to 11 U.S.C. § 1322(b) in a Chapter 13 case, the debtor may restructure obligations secured by a car over the term of the plan. 11 U.S.C. § 1322(b) (1988).

9. Pursuant to 11 U.S.C. § 1322(b)(2), the debtor is limited in the degree to which it can restructure a claim that is secured solely by the debtor's principal residence. 11 U.S.C. § 1322(b)(2) (1988). The debtor may cure its default by paying the arrearage in installments over the term of the plan (or in some jurisdictions, over a shorter period of months). 11 U.S.C. § 1322(b)(5) (1988). The remaining portion of the obligations may not, however, be impaired without the consent of the holder of that claim.

10. 11 U.S.C. § 1325(b)(1)(B) (1988).

11. During the early 1980s, there were dozens of cases and a great deal of law review literature which addressed the concept of low percentage plans. See, e.g., *Deans v. O'Donnell*, 692 F.2d 968, 969-72 (4th Cir. 1982); *Barnes v. Whelan*, 689 F.2d 193, 198-200 (D.C. Cir. 1982); *In re Rimgale*, 669 F.2d 426, 431-33 (7th Cir. 1982); Lynn M. LoPucki, *Encouraging Repayment Under Chapter 13 of the Bankruptcy Code*, 18 HARV. J. ON LEGIS. 348 (1981); Conrad K. Cyr, *The Chapter 13 "Good Faith" Tempest: An Analysis and Proposal For Change*, 55 AM. BANKR. L.J. 271 (1981).

12. See *supra* note 9.

13. For example, during the Great Depression, Congress enacted the Frazier-Lemke Act. For a historical review, see John C. Anderson & Rex D. Rainach, *Farmer Reorganizations Under the New Bankruptcy Code*, 28 LOY. L. REV. 439, 444-51 (1982).

14. 11 U.S.C. §§ 1201-1231 (1988).

15. Chapter 11 was too cumbersome and expensive for any but the largest farm cases. Melanie Fisher, Note, *Disposable Income Determination: Challenges in the Chapter 12 Family Farmer Context*, 19 J. CORP. L. 713, 717-18 (1993); MERRITT S. DIETZ, JR. & JOHN W. AMES, A NEW CHAPTER IN

reducing costs and creating great predictability against which dozens of cases could be settled for every one that was filed. The procedural simplicity¹⁶ and the very short timelines reduced the court time and the expenses of all parties for those cases that were filed. Congress abolished such creditor protections as the absolute priority rule,¹⁷ § 1111(b),¹⁸ and the right to vote on the plan¹⁹ in return for the quicker processing of the case. In addition, Congress granted interested parties the right to require the debtor to devote its "projected disposable income" to payment of unsecured claims for the three-to-five-year duration of the plan.²⁰

Chapter 11's second chance is primarily for businesses.²¹ Congress has chosen to make this opportunity available to businesses of every size—those that are closely held and those with widely dispersed ownership. In defining this opportunity, Congress was required to balance the chance for a fresh start against the interests of creditors and others.²² It fashioned a number of protections for secured and unsecured creditors. Subject to these protections, a business in financial trouble may restructure

BANKRUPTCY LAW: CHAPTER 12 AND THE FAMILY FARMER 5 (1987).

16. Among the procedural simplifications of Chapter 12 were the requirement of § 1221 that a plan be filed within 90 days after the Chapter 12 order for relief is entered and the requirement of § 1224 that the hearing on confirmation of the plan be concluded not later than 45 days after the filing of the plan. There is no requirement of a separate disclosure statement hearing and creditors do not vote upon the plan. 11 U.S.C. §§ 1221, 1224 (1988).

17. 11 U.S.C. § 1129(b) (1988).

18. Section 1111(b) provides the undersecured creditor with an alternative for sharing in upside appreciation of its claim by forgoing its opportunity to have the undersecured portion of its claim share in the distribution to holders of unsecured claims. 11 U.S.C. § 1111(b) (1988).

19. Section 1126 provides that a class is deemed to have accepted the treatment provided for in the plan, if the plan is accepted by a simple majority by number of the members of the class that vote and if the assenting members hold claims that constitute two-thirds of the total of claims of those members that vote upon the plan. 11 U.S.C. § 1126 (1988).

20. Section 1225(b)(1)(B) actually says "projected" disposable income. 11 U.S.C. § 1225(b)(1)(B) (1988). Other issues that have arisen with regard to this provision are:

- a. May a farmer keep a reserve from year one through the subsequent years of the plan?
- b. If the answer is yes, then must any reserve that exists at the time of discharge be distributed among creditors or may the farmer-debtor keep it?
- c. How shall the decision be made about the purchase of capital equipment?
- d. What is the appropriate procedure for objecting to the way the debtor has spent her money?
- e. Is it projected net disposable income or actual net disposable income?

21. In *Toibb v. Radloff*, the United States Supreme Court held that individuals not engaged in business are not prohibited from filing and pursuing a Chapter 11 reorganization. 501 U.S. 157, 166 (1991).

22. For an excellent statement of the proposition that various interests of third parties should be taken into account, see Karen Gross, *Taking Community Interests Into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031 (1994).

the debts of creditors and other interestholders against their opposition.

These limits include:

1. For unsecured creditors:

a. The best interests of creditors test.²³ If any single creditor objects, then the plan may not be confirmed if the unsecured creditors are receiving less in the Chapter 11 plan than they would receive upon a Chapter 7 liquidation.

b. The absolute priority rule.²⁴ If a class of unsecured creditors rejects the plan, then the plan may not be confirmed unless classes lower in interest than unsecured creditors do not receive or keep any property under the plan. In some jurisdictions, the courts have recognized the new value exception to this rule.

2. For secured creditors:

a. The rule of adequate protection.²⁵ During the pendency of the case, the secured creditor is entitled to receive adequate protection. For example, if its secured claim is in danger of being diminished then it must be provided protection against the diminution.

b. Fair and equitable treatment.²⁶ At confirmation, the secured creditor must be treated in a nondiscriminatory manner and the secured portion of its claim must be treated by giving either the present value of that claim over time or the indubitable equivalent of that claim.

3. The protection against multiple modifications of a confirmed Chapter 11 plan.²⁷

This photographic exhibit of American bankruptcy law is intended to demonstrate that the doctrine of second chance is a central principle of Chapters 7, 11, 12, and 13 and, thus, of American bankruptcy law, and that it is at least as important, if not more important, than the principles espoused by the law and economics people. Because the law and economics proponents relegate it so completely, their analysis fails as an accurate statement of American bankruptcy law.

23. 11 U.S.C. § 1129(a)(7) (1988).

24. 11 U.S.C. § 1129(b) (1988).

25. 11 U.S.C. § 361 (1988).

26. 11 U.S.C. § 1129(b)(1) (1988).

27. The rules for postconfirmation modification in Chapter 11 are much more restrictive than in Chapters 12 or 13. Section 1127 limits that opportunity to the time period before there is substantial consummation of the plan. 11 U.S.C. § 1127 (1988). Although various courts have recognized that there is no absolute bar regarding successive cases involving Chapter 11, 12, or 13, the standards adopted for a serial Chapter 11 filing that would not be dismissed after confirmation are extremely narrow. For Chapters 12 and 13, the rules for modifications and successive cases are much less restrictive. *See* 11 U.S.C. §§ 1229, 1329 (1988).

III. FUNDAMENTAL PRINCIPLES OF AMERICAN BANKRUPTCY LAW

We now turn to observe what values American bankruptcy law should include and what the relative balance among them should be. If we contrast the route that bankruptcy legislation takes to become law in the United States with the route for legislation governing security interests in personal property, we identify a basic fallacy in the law and economics model. When Congress considers bankruptcy legislation, the process is complex, not only technically and legally, but politically and philosophically as well. For example, when Congress considers the proposed Chapter 10, it is required to choose whether to give smaller businesses the special benefits it gave to farmers, including the elimination of the absolute priority rule and substitution of the "disposable income" requirement, or whether simply to shorten the process for them in Chapter 11 and keep in place the requirement that they cannot keep their property unless the unsecured creditors vote in favor of their plan. This is primarily a political or philosophical decision that requires balancing the opportunity for a second chance for this group against the losses that would be sustained by their creditors under each of the alternatives.

When it enacted Chapter 13 in 1978,²⁸ Congress balanced the various rights it gave and limitations it placed on Chapter 13 debtors and creditors. In numerous other examples throughout the Bankruptcy Code, Congress sought to create a concept of second chance that would be meaningful without taking too much away from creditors.

It is useful to compare this process with the legislative history of Article 9 of the Uniform Commercial Code. Article 9 was drafted and amended by a group that was intent on expanding the ability of borrowers to give and creditors to take effective security interests in nearly all types of non-real estate collateral. They operated under the belief that enhancement of secured credit was in the public interest.²⁹ Currently, an official drafting committee is considering a new set of amendments to Article 9 and will likely deliver them to the governing bodies within the next year or two.³⁰

28. See H.R. REP. NO. 595, 95th Cong., 1st Sess. 116-73 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6076-134; S. REP. NO. 989, 95th Cong., 2d Sess. 12-13 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5798-99.

29. See U.C.C. § 9-101 cmt. (1972).

30. Amelia H. Boss & Stephen C. Veltri, *Introduction to the Uniform Commercial Code Survey: A Plea for Cooperation*, 48 BUS. LAW. 583 (1993); William M. Burke et al., *Interim Report on the Activities of the Article 9 Study Committee*, 46 BUS. LAW 1883 (1991).

There is no doubt that the central purpose of those drafters and amenders is to make it easier for the secured lenders to defeat the claims of unsecured creditors, later lien creditors, and most of all the trustee in bankruptcy. Because we give to the secured creditors and their representatives the job of writing the legislation that guarantees them their priority,³¹ a "law and economics only" analysis of Article 9 is accurate and instructive. They have a single goal, and their job is to write legislation that reflects that goal. Although I believe that the Article 9 legislative process should be more evenhanded, my point here is that it is less important that it be evenhanded than that the bankruptcy legislative process be evenhanded.

Whereas the major effect of the Bankruptcy Code is on the interests of many individual human beings in their capacities as users of credit or owners of closely held businesses, Article 9 is mostly about the balancing of interests among various types of creditors. If the secured creditor wins, in most cases it is not the debtor that loses, but rather the other creditors that lose. The pot rarely goes back to the debtor. The central purpose of Article 9 is to decide which creditor gets what. A central purpose of the Bankruptcy Code is to decide how much the debtor gets to keep and the extent to which the debtor is freed of prepetition obligations in order to have a second chance.

Because this Symposium and most of the law and economics literature is aimed at Chapter 11, it is important to focus specifically on the balancing that this chapter requires of Congress. Since so much of the dialogue on this issue revolves around very large cases, I will address small and medium-sized cases. Individual owners of businesses or of interests in closely held corporations or partnerships are the most sympathetic beneficiaries of Chapter 11's second chance. As the ownership is spread more widely, the opportunity for a second chance translates into the

31. Robert E. Scott & Thomas H. Jackson, *The Politics of Article 9*, 80 VA. L. REV. (forthcoming 1994). Indeed, one of the most knowledgeable presenters at this Symposium proposed amending Article 9 to provide that any creditor who tried to be secured, but failed to comply with some technical requirement, would nevertheless defeat the trustee in bankruptcy even if it failed to meet the requirements of Article 9. When courts, law teachers, or others seek to interpret Article 9, they can understand this single central purpose. Amendments to Article 9 must be approved by the American Law Institute, The National Conference of Commissioners on Uniform State Laws, and the various state legislatures; yet based on recent history, none of them is likely to balance the interests of unsecured creditors or to make an independent determination as to whether the goal of Article 9 is one to which they subscribe. The primary exceptions to this analysis of Article 9 are the "consumer protection" provisions. These pertain primarily to the default provisions as they apply to security interests in consumer goods.

realization on a passive investment, and as it becomes more remote, the doctrine of second chance becomes less persuasive and is less of the type of value that Congress would seek to protect. When the Bankruptcy Code made Chapter 11 reorganization more feasible for smaller and more closely held businesses, it enhanced the opportunity for the most sympathetic beneficiaries of a second chance through use of Chapter 11.³² Under the Bankruptcy Act provisions analogous to Chapter 11, reorganization was practical only for the large, publicly held corporations and, thus, the required balancing of these interests was different.

Many of the same principles that drive Congress to protect the interests of individuals in Chapters 7, 13, and even 12 are at work in giving the small and medium-sized Chapter 11 debtor a real opportunity at a second chance. A philosophy that focuses solely on the rights and interests of creditors in these types of cases is inconsistent with the principles behind those chapters.

The contrast between the nature of Article 9 and its legislative process on the one hand, and the nature of the Bankruptcy Code and its legislative process on the other hand, demonstrates why it is appropriate that American bankruptcy law reflect the value of a second chance equally or more highly than the value of creditors' ownership and control of the debtor's assets with regard to small and medium-size Chapter 11 cases.

I have taken Professor-Judge Ayer's instructions to heart and I have used my camera on a trip through the Bankruptcy Code. It has led me to examine the political tradeoffs that currently define the limits of the doctrine of second chance and the ingredients that go into defining them. On this basis I conclude that although the law and economics types offer criteria that should be among the gauges for determining how the bankruptcy process is working and ought to work, it is not only unrealistic, but actually destructive, to use their criteria as the sole gauge.

32. Professor Gross, in her article in this Symposium, discusses the interests of various third parties that may merit consideration. Gross, *supra* note 22.