S. HRG. 100-1067

THE AMERICAN BANKRUPTCY INSTITUTE SURVEY

HEARING

BEFORE THE

SUBCOMMITTEE ON
COURTS AND ADMINISTRATIVE PRACTICE

OF THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

ON

S. 1626, S. 1358, S. 1863, and S. 2279

BILLS PERTAINING TO TITLE 11 OF THE UNITED STATES CODE, THE BANKRUPTCY CODE

JUNE 10, 1988

Serial No. J-100-75

Printed for the use of the Committee on the Judiciary



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THE AMERICAN BANKRUPTCY INSTITUTE SURVEY

FRIDAY, JUNE 10, 1988

U.S. SENATE,
SUBCOMMITTEE ON COURTS AND ADMINISTRATIVE PRACTICE,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:07 a.m., in room SD-226, Dirksen Senate Office Building, Hon. Howell Heflin (chairman of the subcommittee) presiding.

Also present: Senators DeConcini and Grassley.

Senator HEFLIN. This hearing will come to order.

Rather than take time to read my opening statement, I am going to place it in the record. We have a real time problem. We are discussing the death penalty in drug-related cases on the Senate floor and we have a lot of witnesses scheduled for today's hearing.

[The prepared statement of Senator Heflin follows:]

STATEMENT OF SENATOR HOWELL HEFLIN
BEFORE THE SUBCOMMITTEE ON COURTS AND ADMINISTRATIVE PRACTICE
JUNE 10, 1988

I WOULD LIKE TO WELCOME MY COLLEAGUES AND THE WITNESSES TO TODAY'S HEARING OF THE SUBCOMMITTEE ON COURTS AND ADMINISTRATIVE PRACTICE. TODAY WE WILL HEAR TESTIMONY ON SEVERAL BILLS PENDING BEFORE THIS SUBCOMMITTEE CONCERNING BANKRUPTCY ISSUES.

BANKRUPTCY IS A SMALL PART OF THE JURISDICTION OF THIS SUBCOMMITTEE, BUT IT IS A VERY IMPORTANT PART. THE MEMBERS OF THIS SUBCOMMITTEE AND THE JUDICIARY COMMITTEE HAVE BEEN VERY INVOLVED IN THE REVISIONS TO THE BANKRUPTCY CODE IN THE PAST 10 YEARS. OFTENTIMES LEGISLATION IS IN RESPONSE TO A CRISIS THAT HAS ARISEN IN THE BANKRUPTCY SYSTEM AND WE DO NOT HAVE THE OPPORTUNITY TO DETERMINE THE IMPACT OF PARTICULAR LEGISLATION ON THE BANKRUPTCY SYSTEM AS A WHOLE. I BELIEVE THAT THE TESTIMONY OF THE MEMBERS OF THE AMERICAN BANKRUPTCY INSTITUTE, WHICH CONDUCTED A SURVEY ON THE IMPACT OF THE 1984 AMENDMENTS, UNDERSCORES THE NEED NOT ONLY TO ENACT LEGISLATION, BUT TO SEE HOW THAT LEGISLATION IS EFFECTUATED.

IN ADDITION TO THE TESTIMONY FROM THE AMERICAN BANKRUPTCY INSTITUTE WE WILL CONSIDER LEGISLATION WHICH CONCERNS

(1) LICENSING OF INTELLECTUAL PROPERTY RIGHTS AND SPECIFICALLY HOW THOSE RIGHTS ARE TREATED IN BANKRUPTCY;

(2) THE TREATMENT OF NONCOLLUSIVE FORECLOSURE SALES UNDER SECTIONS 548 AND 547 OF THE BANKRUPTCY CODE;

(3) THE ABILITY OF MUNICIPALITIES TO RE-ADJUST THEIR DEBT UNDER THE PROTECTIONS OF THE BANKRUPTCY CODE WITHOUT JEOPARDIZING THEIR ABILITY FOR FUTURE CREDIT, AND

(4) THE INTERACTION OF FINANCIAL ARRANGEMENTS AND THE BANKRUPTCY LAWS, PARTICULARLY IN THE AREA OF SWAP AGREEMENTS.

EACH OF THESE BILLS RESPONDS TO A SPECIFIC PROBLEM IN BANKRUPTCY, AND IN ADDRESSING THESE PROBLEMS, WE NEED TO UNDERSTAND HOW WE AFFECT THE BALANCE OF EQUITIES IN THE SYSTEM AS A WHOLE.

WE HAVE AN AMBITIOUS SCHEDULE, SO I WOULD ASK THAT EACH WITNESS LIMIT HIS OR HER TESTIMONY TO 5 MINUTES. I WOULD ALSO LIKE TO TAKE THIS OPPORTUNITY TO THANK THE MEMBERS OF THE ABI AND THE NATIONAL BANKRUPTCY CONFERENCE WHO CONTINUALLY OFFER THEIR ASSISTANCE AND EXPTERTISE IN THE FIELD OF BANKRUPTCY.

WELCOME AND LETS BEGIN.

Senator HEFLIN. Because of the time factor and the number of witnesses testifying, we will use a timer. Each witness will be allocated 5 minutes. When the red light comes on, please conclude your testimony. Your written statements will be submitted to the record in their entirety.

I would suggest that you summarize your statements because we have 14 witnesses. So with that in mind, we will start with panel No. 1, Professor Gross, the Honorable Alexander Paskay, and Mr. Charles M. Tatelbaum, who will come forward to testify on the ABI Survey.

Professor Gross, if you would start.

THE AMERICAN BANKRUPTCY INSTITUTE SURVEY

STATEMENT OF A PANEL CONSISTING OF PROF. KAREN GROSS, NEW YORK LAW SCHOOL, NEW YORK, NY; HON. ALEXANDER L. PASKAY, CHIEF BANKRUPTCY JUDGE, MIDDLE DISTRICT OF FLORIDA, TAMPA, FL; AND CHARLES M. TATELBAUM, KASS, HODGES & MASSARI, TAMPA, FL

STATEMENT OF KAREN GROSS

Ms. GROSS. Mr. Chairman, my name is Karen Gross, and I am an associate professor of law at New York Law School. I appear before you today as the reporter for a study that was undertaken by the American Bankruptcy Institute, the results of which were released in July 1987 in a 106-page monograph.

In 1986, the American Bankruptcy Institute sponsored a study which was designed to look at the effect and effectiveness of certain of the 1984 amendments to the Bankruptcy Code. The study was perceptual in nature and investigated four specific areas of change: the consumer credit amendments, jurisdiction, preferences and the automatic stay.

Some of my copanelists will speak about specific findings. I would like to mention something about the study's methodology and themes and then offer some projections based on our findings.

The study was done in conjunction with the Survey Research Center at the University of Maryland and involved telephonic interviews of over 1,000 people involved in the day-to-day process of the bankruptcy system—lawyers, bankruptcy judges, estate administrators and U.S. trustees. We had a remarkable response rate of 86 percent. We had participants from all areas of the country, involved in all types of cases, with varying levels of experience and practicing in different-size law firms. We had cross-tabulation tables that allowed us to see how bankruptcy practice was being handled across the country. Each respondent was interviewed based on a 60-question survey instrument. The results were reported at a 95-percent confidence level with an error factor of plus or minus 3.1 percent. Some of the observations and themes I see emerging from the study are as follows:

First, the 1984 amendments that we studied did not have a dramatic impact. In fact, what is startling is that 42 percent of the respondents thought that the amendments had had no effect. What that suggests to me is that there is a marked difference between

enacting legislation and effectuating legislation, and perhaps we ought to be focusing more of our attention on effectuation.

Second, that there is a lack of consensus revealed about what the problems in the bankruptcy system are. In fact, the study suggests that, in some instances, the problems were perhaps not as severe as had been perceived. Different parties in the bankruptcy system have markedly different views and perceptions about what is happening and what the problems are. This raises a corollary issue; namely, that some of the changes to the Bankruptcy Code did not produce the intended results. As the study reveals, there are specific examples where one can identify this happening.

Third, the legislative changes that were made to the code were not always implemented, and there was acquiescence in that noncompliance by other parties in the bankruptcy system. For example, 50 percent of the respondents did not comply with a statutory mandate that stay hearings be commenced within 30 days. The study indicates that this result is not related directly to levels of abuse; it is not related to new case filings per judge.

What this suggests, then, is that there is no quick fix to some of the bankruptcy problems. Simply adding judges or nationalizing the U.S. trustee program may not cure some of the problems in the bankruptcy system.

Last, I see emerging the fact that bankruptcy law is practiced very differently in different parts of the country. There is a lack of uniformity in both practice and implementation. That makes problem-solving very difficult in the bankruptcy area.

You pick it up in regional differences, for example, by looking at perceptions of abuse. In some circuits, the perception of abuse is much greater than in other areas circuits. Noncompliance is perceived to be much greater in some areas of the country than others.

Where that leads me, simply stated, is I think there is great significance in terms of what can be gained from empirical data. Empirical data forces us to see the system as it operates, not as we think it operates and not as we want it to operate. It allows us to see whether some of our underlying premises of the system are accurate and then to see what solutions will work—once we see the problem. An example that could have been helped, I think, by some empirical study is what is now H.R. 2969, relating to retirees.

Senator HEFLIN. I am sorry. If you can, summarize in about 30 seconds.

Ms. GROSS. I think that that bill, dealing with retirees, would have been helped by understanding what is happening or could happen in terms of how people view Bankruptcy Code section 1113 (dealing with collective bargaining agreements) and proposed section 1114.

Let me conclude by saying that empirical data may not be the be-all and end-all in terms of bankruptcy legislation. However, it is one very important addition to the process of enacting legislative change.

Thank you.

[The prepared statement of Ms. Gross follows:]

Hearing before the
Subcommittee on Courts and Administrative Practice
Committee on the Judiciary
United States Senate
June 10, 1988

Statement of Professor Karen Gross
New York Law School
regarding American Bankruptcy Institute Study
of the 1984 Amendments to the Bankruptcy Code

Address: New York Law School
57 Worth Street, Room B-303
New York, N.Y. 10013
Phone: (212) 431-2154
(212) 431-2140

Statement of Professor Karen Gross
New York Law School, New York, New York

Mr. Chairman and Members of the Committee:

My name is Karen Gross, and since 1984, I have been an Associate Professor of Law at the New York Law School where I concentrate my teaching, research and writing in the field of debtors' and creditors' rights. I serve on the Board of Directors of the American Bankruptcy Institute. Prior to teaching, I was engaged for seven years in private law practice in the bankruptcy field at Weil, Gotshal and Manges in New York and Arvey, Hodes, Costello and Burman in Chicago, respectively.

I appear before you today to testify as the Reporter for a study undertaken by the American Bankruptcy Institute ("ABI") in 1986-1987. The opinions which I am expressing today do not necessarily reflect the policies or views of ABI.

Importance of the American Bankruptcy Institute Study

In 1986, ABI, which is a not-for-profit organization of 2,000 members based in Washington, D.C., undertook a national study designed to look at the effect and effectiveness of certain of the 1984 Amendments to the Bankruptcy Code. The study was conducted under the aegis of an ABI subcommittee chaired by Judge George C. Paine, II, Chief Judge, United States Bankruptcy Judge for the Middle District of Tennessee. Charles M. Tatelbaum served as Evaluator and, as indicated above, I served as the Reporter. The subcommittee worked in conjunction with the Survey Research Center of the University of Maryland, which provided social science expertise. The results of this study were published in a 106 page monograph released by ABI in July 1987 titled Perception and Reality: Survey on Selected Provisions of the 1984 Amendments to the Bankruptcy Code (the "ABI Report").

The ABI study makes an important contribution to the bankruptcy field[1] and is of particular relevance to Congress as it proceeds to review the existing bankruptcy system and evaluate changes thereto. The study demonstrates the type of

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[1] There have been remarkably few empirical studies in bankruptcy to date and the bulk of the existing work has focussed on consumer bankruptcy issues. Moreover, at least one study (the Purdue University study) has been the subject of considerable controversy. See Sullivan, Warren and Westbrook, "Limiting Access to Bankruptcy Discharge: An Analysis of Creditors' Data," 1983 Wis. L. R. 1091.

current perceptual data that can be elicited through empirical research and the usefulness of that information in making legislative change.[2] As bankruptcy filing rates continue to rise, it seems inevitable that new issues and problems will present themselves under the bankruptcy laws. Therefore, studies which give us guidance into what is happening and what could happen in the future not only timely but necessary.

An Overview of the Study's Methodology

The ABI study involved the telephonic interview[3] of over 1000 individuals involved in the bankruptcy process, namely bankruptcy judges, estate administrators,[4] United States Trustees and lawyers with bankruptcy expertise (collectively, the "respondents"). Looking at the respondents, 74% of the then sitting Bankruptcy Judges were interviewed while 78% of the United States Trustees and 87% of the Estate Administrators, respectively, were interviewed. Seven hundred and fifty-one (751) lawyers specializing in bankruptcy were interviewed.[5] Based on

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[2] See Sullivan, Warren and Westbrook, "The Use of Empirical Data in Formulating Bankruptcy Policy," 50 Law & Contemp. Prob. 195 (1987).

[3] The data obtained from the telephonic interviews was coded into the Computer Assisted Survey Execution System, a statistical computer program utilized by the Survey Research Center of the University of Maryland for data collection. The data was tabulated utilizing the internationally recognized program known as the Statistical Package for Social Sciences.

[4] The major portion of telephonic interviewing in the study was conducted before passage of the nationwide United States Trustee program in 1986. (See Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554.) Hence, estate administrators were still active participants in the bankruptcy process in the non-pilot districts.

[5] There are certain difficulties in establishing which lawyers have bankruptcy expertise as the field of bankruptcy is a recognized specialty in only a handful of states. Moreover, there was a desire to obtain lawyers who represented the myriad of interests in bankruptcy, practiced in diverse geographical areas and in firms of varying sizes.

the number of completed interviews, there was a remarkably high response rate of 86% for the Survey.

The respondents had offices in every state except Hawaii. An effort was made to insure that, among the respondents, there was involvement in cases[6] under Chapters 7, 11 and 13 and varying levels of experience. The lawyer respondents were drawn from firms of all sizes and these lawyers represented individual debtors, corporate debtors, unsecured creditors, secured creditors and trustees. In other words, the respondents represented a cross-sampling of those involved in the bankruptcy process on a day-to-day basis.[7]

The respondents were questioned, utilizing an approximately 60 question survey instrument, about FOUR specific areas of change brought about by the 1984 amendments to the Bankruptcy Code: the consumer credit amendments, the automatic stay, jurisdiction and preferences.[8] These particular substantive topics were selected to provide data useful to the many different constituencies involved the bankruptcy process. Following accepted statistical procedure, the probability level (P Value) of less than or equal to .05 was selected as the test of significant association. Thus, results of the study are reported at a 95% confidence level, with an error factor of +/- 3.1%.

Considerations in Thinking about the Data

In looking at the results of the ABI study, several factors must be considered. First, the study deals with the respondents' PERCEPTIONS of what happened as a consequence of the 1984 Amendments. It is possible that these perceptions do NOT mirror

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[6] Chapter 12, passed as part of the 1986 amendments to the Bankruptcy Code, was not operative during the bulk of the telephonic interviewing and hence, respondent involvement in this particular chapter was not considered in the study.

[7] It would have been possible, albeit difficult, to interview still others in the bankruptcy process (i.e. actual debtors and creditors rather than their representatives). Although such added perspectives would have been helpful, it was hoped that lawyers speak, at least to some extent, for the views of their respective clients.

[8] A more detailed discussion of these changes appears in the ABI Report at p. 2.

reality, although hard data establishing that reality may not be readily available or in some instances, would be impossible to obtain.[9] However, even if ultimately determined to diverge from reality, perceptions still provide important insight into what the participants in the bankruptcy process believe is happening and as such, are accurate reflections of what people with day-to-day experience in the bankruptcy process think about the issues they were questioned about. One can perhaps speculate that, at least in some instances, perception may become reality.

Second, utilizing cross-tabulation tables, the results of the study are reported on a circuit by circuit basis. This breakdown provides insights into the differing ways bankruptcy law appears to be practiced across the country. However, it is possible that had the results been broken down nationally by DISTRICT rather than by CIRCUIT, the results may have been different.[10] In the future, with a larger sample (to preserve anonymity), district by district analysis would be possible and productive.

Third, the data generated does not provide EXPLANATIONS for results. Rather, it reveals what the respondents perceived in response to the given questions. The explanations are plentiful, and some of them may diffuse what initially may appear to be "odd" or "dramatic" results. Whatever the explanations for the results, one has to distinguish between what the data SHOWS and interpretations of what the data shows. The report issued by ABI does not purport to provide the explanations---it serves to report the data.

Summary of Emerging Themes from the ABI Study

Rather that repeating the many findings of the ABI study, some of which are being addressed by my co-panelists and all of which can be found in the report itself, let me use this opportunity instead to identify certain more general themes I see

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[9] Actual case files would not reveal, for example, whether preference litigation was no pursued as vigorously after the passage of the 1984 amendments. Case files would reveal the number of cases litigated or settled, not the number of debtors or trustees who elected not to pursue actions in the first instance. Obviously, both types of data would be useful.

[10] This is because a given circuit encompasses a large and frequently diverse geographic area. Thus, for example, the results of an entire circuit could be affected (skewed?) by a very large city with an active bankruptcy practice.

emerging from the data. These themes are preliminary in nature and, as other studies are conducted, can be further elaborated.

It is fair to say that the ABI study reveals, as perceived by the respondents, that the bankruptcy system as a whole is operating well. However, the study indicates that the 1984 amendments were not perceived to have had a dramatic impact.[1] Overall, 42% of the respondents thought that the 1984 amendments had had NO EFFECT. What this reveals to me is that there is a difference between ENACTING and EFFECTUATING legislative change. Phrased differently, our primary focus is frequently on getting legislation passed rather than looking at whether it accomplishes its desired goals once passed. Therefore, the study suggests that we broaden our inquiry and look at the process of "enacting" legislative change to include the effectuation of the changes sought.

The ABI study reveals a lack of consensus on and understanding of the problems that were being fixed by the 1984 amendments to the Bankruptcy Code. For example, while Section 707(b) was added to curb individual debtor abuse of the bankruptcy laws, it is not clear exactly what abuse this section addresses nor for that matter whether individual debtor abuse is, in fact, a significant problem. Part of this difficulty stems from the realization that differing constituencies in the bankruptcy process have very different perceptions of the bankruptcy system. As the study indicates, on many issues, the differing categories of respondents had markedly different views on the same issues.

Concerns over understanding the underlying problem give rise to a corollary issue, namely the need for an understanding of the consequences of the changes made. Thus, for example, changes to the jurisdictional system, designed to correct its constitutional infirmities, did not necessarily operate as intended. The study reveals that there is considerably more appellate review of core matters than non-core matters. This suggests that the constitutional infirmity may be cured on paper but not in practice.

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[1] Some will argue that it is not surprising that there was not a dramatic impact as at least some of the amendments (i.e. the consumer credit amendments) were drafted knowing there would be no dramatic impact. Rather, it is argued, the amendments were designed to quiet lobbying groups. However, if one posits that legislative change is enacted to do just that---change the status quo, then it is startling, at least to this professor, that legislation seemingly designed to make change, does not accomplish that end.

The ABI study suggests that even when curative legislation is added, it is not always implemented. To the extent that there are unequivocal statutory mandates which are not complied with by the judges and there is acquiescence in such non-compliance by the parties involved, there is a problem in the bankruptcy system which legislative change alone does not cure. For example, the ABI study reveals that, in the context of commencing hearings in respect of the automatic stay, approximately 50% of the respondents perceived there was some degree of non-compliance with statutory mandates.

Although the ABI study did not probe all possible explanations for statutory non-compliance, the available data[12] suggests that there is not a correlation between levels of perceived abuse and levels of perceived non-compliance. The number of new case filings per judge also does not correlate to levels of non-compliance. What this says to me, as a preliminary matter, is that there is no "quick fix" to the problem. Simply adding new judges, nationalizing the United States Trustee program or amending the existing Code may not solve the problem of non-compliance.[13]

The ABI study also reveals what may have been sensed by many experientially, namely that bankruptcy law is practiced very differently in different parts of the country. Implementation of

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[12] The ABI Report utilized data prepared by the Administrative Office of the United States Courts. Although data from the Administrative Office has been criticized, it did provide the only readily available data-base for making the indicated calculations which are recognized to be exploratory in nature. See Sullivan, Warren and Westbrook, "Folklore and Facts: A Preliminary Report from the Consumer Bankruptcy Project," 60 Am. Bankr. L. J. 293 (1986), forthcoming in book form titled As We Forgive Our Debtors, Oxford University Press, 1988.

[13] The issue of non-compliance can be seen in a broader context. For example, in the studies conducted of Chapter 11, there is evidence that the check and balance system is not operating in that creditors are not exercising all the statutorily prescribed options. Thus, for example, creditors' committees, one of the primary creditor checks, are not even formed in some smaller cases. See generally LoPucki, "The Debtor in Full Control---Systems Failure Under Chapter 11 of the Bankruptcy Code," 57 Am. Bankr. L.. J. 99 (1983)(First Installment); 57 Am. Bankr. L. J. 247 (1983)(Second Installment); Curtin, Gross and Togut, "Debtors-Out-of-Control: A Look at Chapter 11's Check and Balance System," forthcoming 1987 Ann. Survey Bankruptcy Law.

new provisions is varied and the degree of non-compliance with statutory mandates differs in different areas of the country. There is, then, a lack of uniformity NOT in the laws as drafted but the laws as implemented.

Projections

The ABI study demonstrates the type of data that can be generated over a relatively short time frame. It would have been useful, for example, for Congress to have had information on how aspects of Chapter 13 were operating (e.g. section 1325(b)) before enacting Chapter 12---which took virtually verbatim sections from Chapter 13.

Similarly, it would have been productive for Congress to have had access to the differing views of the categories of respondents. Thus, before implementing the nationwide United States Trustee program, it would have been of assistance to see whether the perceptions of the pilot trustees were shared by the other categories of respondents. Similarly, it would have been useful to observe that the Sixth Circuit, the only circuit without a pilot program, had the least perceived abuse and non-compliance of any circuit in the country. At a minimum, this would have raised questions about the way in which the nationwide program should be structured to serve as an effective mechanism for rooting out abuse and increasing statutory compliance.

Congress is currently considering legislation which would most certainly benefit from empirical data, namely the treatment of retirees. The legislation currently being considered (the creation of Section 1114 and an amendment to existing Section 1113) is patterned after Section 1113, which was added to the Bankruptcy Code in 1984. However, there is a clear lack of judicial consensus on how the existing section should be applied.[14] Moreover, there has not been, to my knowledge, any systematic empirical evaluation of how those involved in the bankruptcy process believe the issues involving retirees should be handled or what they believe the impact of the proposed legislation will be on the reorganization process.[15] Nor has

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[14] Compare, for example, the approach of the court in In re Wheeling-Pittsburgh Steel Corp., 791 F.2d 1074 (3rd Cir. 1986) with In re Carey Transportation Inc., 816 F.2d 82 (2nd Cir. 1987).

[15] Empirical study differs from statements and testimony of individuals and groups as studies are designed to produce, in accordance with accepted methods of social science,

there been an effort to evaluate the overall economic impact of the proposed legislation. Certainly, given the seriousness and magnitude of the problem for all parties involved, some empirical work should be considered.

Conclusions

The type of data generated by the ABI study, while considered "soft" data, can yield important insights into the bankruptcy process.[16] It reveals that making change in the bankruptcy system is not a simple matter---there are too many constituencies with too many views to be easily resolved. In addition, there are difficulties in implementing whatever changes are enacted. Care should be taken in enacting piecemeal changes to a system that many believe is operating well as a whole.

Through empirical data, conducted by non-partisan groups, Congress can gain a better understanding of the problems to be solved, the possible solutions and the ways in which these solutions can be implemented. Studies also provide an ongoing data base from which to assess what is happening in the bankruptcy system on a go-forward basis. It permits comparisons over time and suggests avenues to pursue in the future.

The availability of empirical data is not a be-all end all proposition. However, it is one type of important information that should have a place in the process of enacting change in the bankruptcy system. At a minimum, it will shed additional light on resolving complex and ever-growing issues in the bankruptcy system.

I appreciate having the opportunity to appear before you and ask that my written presentation, as well as the ABI Report, be made a part of the record.

"statistically significant data." This is not to say that other information is unimportant or without merit. Rather, it is the composite of all types of information that is useful.

[16] "Soft" data refers to perceptual data and can be contrasted with "hard" data, which involves information generated from actual filings (i.e. case files). There is certainly room for both types of data and both are sorely needed.

STATEMENT OF HON. ALEXANDER L. PASKAY

Judge PASKAY. Judge Heflin, my name is Alexander L. Paskay. I am the chief bankruptcy judge for the Middle District of Florida, serving on the bench since 1963. I am holding court in Tampa, Orlando, and Fort Myers, FL.

I was assigned to make brief remarks on the impact of the 1984 amendments on two areas of the 1984 legislation. First, jurisdiction, and the second, the clarification of the automatic stay provision of the Bankruptcy Code, section 362.

Concerning the jurisdictional aspect or the changes brought about by Congress' reaction to the decision of the Supreme Court in *Northern Pipeline* v. *Marathon,* we all know it has been totally restructured. It was initially perceived and anticipated by some that it would bring total chaos in the system and actually the system would come to a halt. That did not pan out at all.

The survey clearly indicates that the system functions. The fact of the matter is, generally speaking, business is as usual and there is hardly any change between the functioning of the bankruptcy court system post-1984 and pre-Marathon method of operation.

However, there are two areas which I would like to briefly mention, which create some problems and generate, in my judgment, unnecessary and extended litigation. One is a subject matter dealing with a right to a trial by jury in a bankruptcy court. While the survey does not take a position on this proposition, whether or not there should be a right to a trial by jury, as the Code and the Judicial Code are now structured, it appears that the only right to a trial by jury is currently that which involves tort actions, specifically personal injury torts, and wrongful death claims which shall be tried by the district court.

There are numerous cases on each side of the coin, holding the pro and the con. The fact of the matter is there are two cases pending before the Supreme Court right now where the right to a trial by jury is challenged. One of them would be in the *Harbour* case, 840 F.2d 1165 (4th Cir. 1988) (cert. filed 4/25/88), which petition for cert. has been filed recently. And also In re Chase & Sanborn Corporation, 835 F.2d 1341 (11th Cir. 1988) (cert. filed 4/18/88).

It would be very helpful if Congress would give serious consideration to clarify this position, that there should or should not be a right to a jury trial in bankruptcy cases.

The second area deals with a very bothersome area, the power of a bankruptcy judge to utilize civil contempt power to enforce obedience of lawful orders entered by the bankruptcy judge. The ninth circuit, in the *Sequoia Auto Brokers* case, 827 F.2d 1281 (9th Cir. 1987), Judge Wiggins decided that because Congress eliminated section 28 U.S.C. 1481, which dealt with this problem albeit not directly, from that it followed that currently there is no power by a bankruptcy judge to utilize civil contempt powers to enforce compliance with any lawful order entered by a bankruptcy judge.

To compound the problem, the recently amended Bankruptcy Rule 9020 specifically deals with this problem and authorizes the bankruptcy judge to determine that somebody committed contempt. Although the word "punish" is stricken, "determine" really means in practice that unless the contemptor is objecting to the de-

termination, the order of contempt entered by the bankruptcy judge is final and the same legal effect as the order entered by the district court.

It would be very helpful to clarify this problem also, because it is anomalous indeed, in my judgment, that the debtor could be protected during the pendency of the case by the sanction power granted by Congress in section 362, yet after the debtor receives the discharge, the very bankruptcy judge who issued the discharge is powerless to protect or vindicate the rights of that debtor, if those rights are violated post-discharge.

Section 362 is an area which creates a lot of problems and the survey clearly indicates a very substantial disobedience.

Senator HEFLIN. Judge, I believe you are familiar with time requirements, so if you will, summarize in about 30 seconds.

Judge PASKAY. Basically, the rigid time frame commanded by 362 is too strong and, at times, for good reasons, should be more flexible and extended. Thank you, Judge.

[The prepared statement of Judge Paskay follows:]

TESTIMONY AND PRESENTATION OF
ALEXANDER L. PASKAY, CHIEF BANKRUPTCY JUDGE
MIDDLE DISTRICT OF FLORIDA
ON BEHALF OF THE AMERICAN BANKRUPTCY INSTITUTE

Mr. Chairman, Members of the Committee:

INTRODUCTION

My name is Alexander L. Paskay, and I am the Chief Bankruptcy Judge for the Middle District of Florida. I have served on the Bankruptcy Bench continuously since 1963. My headquarters are located in Tampa. I am also holding Court in Orlando and Ft. Myers Division of the Middle District.

I want to thank the Committee for giving me the opportunity to appear before you and the opportunity to state some observations on the effect of the Bankruptcy Amendment and Federal Judgeship Act of 1984 (BAFJA), Pub. L. 98-353, as revealed by the recently conducted survey by the American Bankruptcy Institute (A.B.I).

In addition to being a Bankruptcy Judge, I serve as a member of the Board of Directors of the A.B.I. The views I am expressing are not necessarily of the Institute but based on my personal experience as an acting Bankruptcy Judge.

IMPACT OF THE 1984 AMENDMENTS ON JURSIDICTION

In response to the decision of the Supreme Court in Northern Pipeline Construction v. Marathon Pipe Line Co., 102 S. Ct. 2858, 73 L. Ed. 2d 598 (1982) Congress completely restructured the Bankruptcy System in 1984 by enacting BAFJA. In so doing the original jurisdictional Section of 28 U.S.C. commencing with

§1471 which governed jurisdiction of Bankruptcy Courts since October 1, 1979, was replaced in toto by 28 U.S.C. §1334(a)(b) and (c). These Sections initially give original and exclusive jurisdiction of all cases filed under Title 11 and original but not exclusive jurisdiction over all civil proceedings arising under Title 11 or arising in or related to a case under Title 11. The debate surrounding the creation of the court system raised highly charged questions. Some observed that what was created was "complex and convoluted." King, "Jursidiction and Procedure Under the Bankruptcy Amendments of 1984," 38 Vand. L. Rev. 675(1985); It was also feared that the alternative to Article III status would shuttle cases between courts...would invite endless litigation over jurisdictional issues, would delay and disrupt the operations of debtors and creditors, and might ultimately be found unconstitutional. Taylor, "Business and the Law: Bitter Dispute on Bankruptcy," The New York Times, July 24, 1984, Sec. D, p.2, col. 1.

The questions in the Survey on these changes were designed to elicit whether the projections about the new system came to pass. What the Survey reveals is that the system did not come to a halt as a consequence of these changes. The bankruptcy system has proceeded with little substantive effect as a result of the 1984 Amendments. However, the Survey also reveals that the system is not functioning to the extent some of the proponents anticipated it could, thence some of the changes mandated for constitutional law reasons are not really according the

protections that may be needed. Thus the system is operating, although with perhaps some constitutional infirmities.

When asked whether the amount of time spent both in and out of court determining which court had jurisdiction to hear a particular matter or case had increased as a consequence of the 1984 Amendments, 54% of the Respondents indicated that more time was being spent, with 31% of the Respondents indicating that the same amount of time was being expended. When asked whether the time period in which cases are closed or confirmed increased as a consequence of the jurisdictional changes, 53% of the Respondents reported no change while 35% of the Respondents reported an increase in time. When asked whether more time was spent reaching the merits of cases as a consequence of the jurisdictional changes, 39% of the Respondents indicated the same amount of time was expended while 48% of the Respondents indicated that more time was being spent. When asked whether the dollar amount of distribution to creditors was affected by the jurisdictional changes, 66% of the Respondents perceived no change while 24% of the Respondents perceived a decrease in distributions.

When asked whether the 1984 Amendments created fewer or more problems than those which existed under the pre-1978 jurisdictional system (with summary and plenary jurisdiction), 43% of the Respondents believed there were more problems before 1978 than there were under the 1984 Amendments. Only 24% of the Respondents thought there were more problems under the 1984

Amendments. When asked whether more time was expended on jurisdictional issues under the pre-1978 system or under the 1984 Amendments, 40% of the Respondents thought more time was spent pre-1978. Only 30% of the Respondents thought more time was spent post 1984. These answers did not vary depending on the category of Respondents, with the exception of the United States Trustee Respondents who perceived that more time was spent post-1984.

The distinction between "core" and "non-core" proceedings generated controversy on several fronts. First, the question arose whether the definition of "core" proceedings was adequate and workable? Second, what happens at the appellate stage where the higher courts have the right to review findings in non-core proceedings de novo while core proceedings are reviewed by the clearly erroneous or an abuse of discretion standard?

When asked whether the definition of "core proceeding" was over or under inclusive, 50% of the Respondents thought it was about right and 32% of the Respondents thought it was under inclusive. When asked whether more time was spent reviewing final orders of core matter or recommendations on non-core matters, 53% of the Respondents perceived the level of review to be the same. However, a striking 38% of the Respondents thought there was more review of final orders than there was of recommendations in non-core matters.

There are three additional changes brought about the by 1984 Amendments, albeit neither of them specifically covered by the

survey but all of them in my judgment are important and warrant a brief mention and recommendation for consideration by Congress.

RIGHT TO JURY TRIAL

The previous jurisdictional section included §1480 entitled "Jury Trials" and §1481 entitled "Powers of the Bankruptcy Court." The 1984 Amendment deals with this subject in 28 U.S.C. 1411. This Section now provides that the right to a trial by jury of an individual available under a non bankruptcy law with regard to personal injury and wrongful death tort actions is unaffected. This Section coupled with §157(a)(5) seems to indicate there is no right to a trial by jury in the Bankruptcy Court at all except in actions for personal injury or wrongful death tort actions and then by virtue of §157(b)(5), such actions shall be tried in the District Court in which the bankruptcy case is pending or in the District Court in the District in which the claim arose as determined by the District Court in which the bankruptcy case is pending. As a result of this change there is a great deal of doubt existing today whether or not a Bankruptcy Judge may or may not conduct jury trials. This uncertainty is greatly enhanced by a recent amendment of the Bankruptcy Rules which became effective August 1, 1987, which completely eliminated previous Bankruptcy Rule 9015 which set forth the procedure for the conduct of jury trials in the Bankruptcy Courts. In light of this development it is not surprising that courts in general are divided on this issue and the decisions dealing with the right to trial by jury in the Bankruptcy Court

are not by any means unanimous. There are several which held that there is never a right to trial by jury in the Bankruptcy Court. In re Kenneth W. Proehl, 12 B.C.D. 321 (W.D. Va. 1984); In re I.A. Durbin, Inc., 14 B.C.D. 1267 (S.D. Fla. 1986); In re Smith-Douglas, Inc., 12 B.C.D. 426 (E.D. N.C. 1984); 43, B.R. 616 (Bkrtcy. N.C. 1985); In re American Energy, 50 B.R. 175 (Bkrtcy. N.D. 1985); In re Morse Electric Co., Inc., 47 B.R. 234 (Bkrtcy. Ind. 1985).

On the other hand there are cases which upheld the right to trial by jury in the Bankruptcy Court. In re Lombard-Wall, Inc., 48 B.R. 9896 (S.D. N.Y. 1985); In re James B. Blackman, 13 B.C.D. 1013 (Bkrtcy. D.C. 1985); In re Baldwin-United Corp., 12 B.C.D. 913 (S.D. Oh. 1985); In re Rodgers & Sons, Inc., 48 B.R. 683 (Bkrtcy. E.D. Okla. 1985); In re Bokum Resources Corp., 13 B.C.D. 11 (Bkrtcy. N.M. 1985); In re O.P.M. Leasing Services, Inc., 13 B.C.D. 114 (S.D. N.Y. 1985); 48 B.R. 824 (S.D. N.Y. 1985); In re Sarah Ferlina Fe Fowler Guenther, 15 B.C.D. 63 (Bkrtcy. Co. 1986); In re Price-Watson Co., 15 B.C.D. 72 (S.D. Tx. 1986); In re Kenval Marketing Corp., 15 B.C.D. 725 (E.D. Pa. 1986); In re John D. McCormick, 15 B.C.D. 743 (D.C. N.Y. 1986).

There is currently pending before the Supreme Court a petition for certiorari in the case of In re Harbour, 840 F.2d 1165 (4th Cir. 1988) (cert filed 4/25/88) which involves the question of whether or not a Bankruptcy Judge has or does not have a right to conduct a jury trial in an action by the Trustee who seeks to recover a preference and a fraudulent transfer under

§547 and §548 of the Bankruptcy Code. See also In re Chase & Sanborn Corp., 835 F.2d 1341 (11th Cir. 1988) (cert filed 4/18/88)

While all agree that the Bankruptcy Court may not, or at least should not, conduct a jury trial in a non core proceeding unless there is consent by the parties, it is unclear whether such right exists absent consent in a core proceeding, notable in actions to recover preferences under §547 actions by Trustee to recover fraudulent transfers under §548 or under §544(b) all of which are clearly defined to be pure "core" proceedings by 28 U.S.C. 157(b)(2)(F) (H) and (K).

EFFECT OF THE AMENDMENT ON THE CIVIL CONTEMPT POWER OF THE BANKRUPTCY COURTS

As noted §1481 of 28 U.S.C. entitled "Powers of Bankruptcy Court" was also eliminated by the 1984 Amendment and not replaced by BAFJA. Based on this change the Court of Appeals for the Ninth Circuit in the case of Sequoia Auto Brokers, Ltd., 827 F. 2d 1281 (9th Cir. 1987), concluded that Bankruptcy Judges no longer have any contempt power notwithstanding of the fact that §105 of the Bankruptcy Code was amended in 1986 by the enactment of the Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, Pub.L. 99-554, Title II, §203, Oct. 27, 1986, 100 Stat. 3097. This amendment provides that Subsection (c) of this Section shall not be interpreted to exclude Bankruptcy Judges from the operation of this Section with authorizes the Court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of

this title." It appears from the foregoing that this amendment recognized, even though only by implication, that Bankruptcy Courts have civil contempt power in order to enable them to enforce their valid orders and judgments. Moreover the Amended Bankruptcy Rule 9020 which is now in effect after having been approved by the Supreme Court and by Congress clearly and specifically indicates that the Bankruptcy Judge may determine civil contempt and absence an objection to the determination of the order on contempt entered by the Bankruptcy Judge, the order has the same force and effect as an order entered by the District Court. As I noted in my memorandum opinion in the case of In the Matter of Miller, 81 B.R. 669 (Bkrtcy. M.D. Fla. 1988), copy of which is attached to my written statement, it is anomalous indeed that the debtor whose rights are violated by an entity during the pendency of the case because of a willful violation of the automatic stay, may be vindicated by a Bankruptcy Judge through imposition of sanctions pursuant to §362(h) of the Bankruptcy Code but the Bankruptcy Judge is powerless to vindicate the rights of a discharged debtor when a creditor is in direct violation of the permanent injunction imposed by §524(a)(2) by continuing to pursue the debtor in an attempt to collect a prepetition debt which had been discharged. It is very difficult indeed to accept conceptually the proposition that a Bankruptcy Judge has the power to grant the discharge if there is a general reference, which is usually the case, but it has no power to protect the rights flowing from the

very discharge granted to the debtor.

PROCEDURE TO DETERMINE DISCHARGEABILITY OF DEBTS

Although the Amendment did not specifically deal with this problem, the operation of the procedure to determine dischargeability of debts merits a mention. §157 of 28 U.S.C., subclause 157(b)(I) provides that the determination as to the dischargeability of a particular debt is a "core" proceeding. Prior to the enactment of the Code §17(a)(3) of the Bankruptcy Act of 1898 provided that after the Court determined that the debt is non-dischargeable the Court was directed to proceed and determine all remaining issues, render judgments and make such orders which were necessary for the enforcement of the order. This Section is not reenacted by the Code and is not part of §523(c) of the Bankruptcy Code which deals with procedure to determine dischargeability of debt under §523(a)(2)(4) and (6). §523(d) of the Bankruptcy Code contains no reference to the procedure to be followed after the Bankruptcy Judge determined the non-dischargeability character of the liability. Neither is there any similar provision under §157 which deals generally with the procedures before the Bankruptcy Judge, thus it appears that the Bankruptcy Judge is now powerless to enter a money judgment after having determined that a particular obligation is non-dischargeable. As a result, after the Bankruptcy Judge has determined that the debt is non-dischargeable the parties are required to go back to the State Court and file a new suit in order to obtain a judgment on the liability unless there was a

judgment entered on the obligation prior to the commencement of the bankruptcy case. This bifurcated procedure is hardly conducive to the effective administration of justice and without doubt presents an undue burden on litigants and substantial additional costs. Moreover, in most instances debtors do not have the funds to defend the second action in State Court. For this reason in the majority of the cases, the money judgments entered by State Courts are by default which, of course, usually include awards for costs and attorney's fees, the amount of which at times is exorbitant since no one is there to oppose it.

While it might be argued that the Bankruptcy Court has no jurisdiction to enter a money judgment on state law claim such jurisdiction could be sustained on a doctrine of pendent jurisdiction enunciated by the Supreme Court in Hurn v. Oursler, 289 U.S. 238, 77 L.Ed. 1149 (1933). Applying this principle I suggest that inasmuch as the Bankruptcy Court has jurisdiction to determine the character of the liability which is clearly a core matter, §157(b)(2)(i), it should have the power to complete the matter as it was done prior to 1979 and enter a money judgment on the liability which has been determine to be non-dischargeable. Section 17(a)(5) of the Bankruptcy Act of 1898 preserved the right to try by jury where such rights existed. A similar provision could be enacted in order to avoid any constitutional problems. Under these circumstances I see no difficulty why the Bankruptcy Judge could not try the damage aspect of the proceeding. The fact that the Bankruptcy Judge is

not an Article III Judge should not present any constitutional problems. Non-Article III Judges, i.e. State Court Judges, have been and are conducting jury trials since the foundation of the Republic. Thus if one accepts the pendent jurisdictional approach a provision similar to the previous §17(a)(5) of the Bankruptcy Act of 1898 could be utilized to avoid the unnecessary duplication of judicial labor and in turn also to assure that the right to jury trial if exists is preserved.

THE AUTOMATIC STAY

Section 362(a) of BAFJA also amended §362. The Amendment is actually referred to as a clarification now provides that if the initial hearing held under §362 was a preliminary as distinguished from a final hearing, the final hearing has to be commenced within 30 days after the conclusion of the preliminary hearing. This Amendment also provides that if the initial hearing, whether preliminary or final, is not commenced within 30 days from the date the request was made for relief from the stay, it is terminated as a matter of law. As a further implementation of this rigid time frame the Bankruptcy Rule 4000(b) now requires that unless a Court denies the relief from the stay within 30 days after the final hearing is commenced the stay expires unless specifically extended by the Court and the stay expires 30 days after the final hearing is commenced unless prior to that time the Court denies the motion for relief from the stay. .

The survey questionnaire on this issue was designed to probe whether Respondents believe that there is a judicial compliance

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with the prescribed statutory mandates and with the mandate of Bankruptcy Rule 4001(b). When asked whether preliminary or final hearings are commenced within 30 days after relief is requested, only 52% of the Respondents indicated that such a hearing was held "almost all the time". If there were full compliance with the statutory mandate, the response to this question would have been that 100% of the responses were "almost all the time." Eleven percent (11%) of the Respondents indicated that such a hearing was "hardly ever" commenced within 30 days and another 15% of the Respondents indicated that such a hearing was commenced "some of the time." There were 23% of the Respondents who indicated that such hearings were commenced "most of the time." The survey further indicates that, overall, there is a considerable amount of non-compliance with the statutory mandates of this Section.

In addition to requiring that a hearing be held, the Code mandates that the stay be terminated if such a hearing is not commenced. When asked if judges permit the stay to remain in effect even though no hearing has been held, 42% of the Respondents indicated "hardly ever." That leaves 59% of the Respondents who responded that the stay remained in effect, notwithstanding the statutory mandate indicating that the stay was effectively terminated, at least some of the time. Twenty-two percent (22%) of the Respondents indicated that the stay was permitted to remain in effect "almost all the time," a degree of non-compliance even greater than that seen in the prior question.

There is one possibility which may be kept in mind in respect to this question is that some judges are extending the stay pursuant to §105 of the Code. Therefore the Respondents would not be responding that there is a violation of a statutory mandate. There has been considerable controversy over the use of "105 Orders" to circumvent clearly prescribed statutory timetables set forth in §362.

When asked whether, as mandated by statute, judges are commencing final hearings within thirty days after conclusion of the preliminary hearing, 47% of the Respondents indicated that such hearings are commenced "almost all of the time." Ten percent (10%) of the Respondents thought such hearings were "hardly ever" commenced within the statutorily prescribed time period.

When asked whether courts are deciding issues involving relief from the stay within 30 days after conclusion of the final hearing, 48% of the Respondents indicated that such decisions are rendered "almost all the time." Only 7% of the Respondents indicated that such decisions are "hardly ever" rendered in the designated time period. Not unlike the other questions in this section, there is a broad disparity in the amount of reported compliance on a circuit by circuit basis.

There is no agreement as to the real reason for non-compliance. One possible correlation appears to be to the extent of non-compliance with the size of the caseload. In my experience this is not really the case. As a general

proposition, motions for relief from the stay are rarely or seldom filed in Chapter 7 liquidation cases and not in significant number in Chapter 13 cases. In my view, non compliance occurs mostly in districts with a large volume of Chapter 11 cases. For instance in my own district for the first 6 months of this year there were as many as 295 motions for relief from the automatic stay filed in March, and the low of 202 in January, or an average of 231 motions for relief per month. Considering an average of 20 actual working days per month in order to comply with the requirement of the statute that would require to conduct 60 preliminary hearings on these motions per week or 12 motions per day. It should be evident from the foregoing that it is impossible to conduct any meaningful preliminary hearings with witnesses and to handle any other business which arises in a currently pending caseload of 3,500 cases, which until recently was in excess of 7000 cases until I received help with the appointment of an additional judge for the Middle District of Florida, serving in the Tampa Division. For this reason, although I schedule hearings within 30 days, I do not permit the presentation of any live testimony and under this procedure, and the stay is either extended or terminated based solely on the submission of affidavits and documentary evidence. To further compound the problem in my district and I am certain in many other districts, where the judge is required to hold court in locations other than the headquarters of the court, it is impossible to comply with the 30 day requirement for the

following reasons. I am required to hold court in Ft. Myers once a month. If there is a motion filed seeking relief from the automatic stay within 20 days before my scheduled court date in Ft. Myers, inasmuch as the calendar is already filled and there is no room to schedule any additional hearings it is impossible for me to consider the motion for relief within the 30 day requirement unless I make a special trip to Ft. Myers and schedule a hearing to consider the matter. In this situation I am also guilty of non-compliance because in order to preserve the rights of the parties, I am compelled to extend the automatic stay or possibly terminate the stay without any hearing based just on the moving papers in order to assure that the mere passage of time does not trigger the self-destruct provision of the section. In these instances, I have no choice but to extend the automatic stay on the moving papers and reschedule either a preliminary or a final evidentiary hearing later than the period mandated by §362(e) of the Code. It is my suggestion that there should be greater leaway and flexibility in the section by permitting a Bankruptcy Judge, based on specific findings of cause, to schedule the preliminary hearing within 45 days and not within 30 days as now required from the date of the initial request. I think this would solve the problem and would not cause any undue delay and prejudice to the moving party and would avoid creating a lot of difficulties which we are currently encountering with the operation of this section.

One persisting question is why, if there is such a level of

non-compliance, are lawyers not doing anything about it? For example, why are secured creditor lawyers not treating the stay as expired and proceeding to foreclosure since they have a statutory right to do so, absent a Section 105 Order? Why are such lawyers not seeking mandatory writs from the District Courts or withdrawals of the initial reference to the Bankruptcy Judges? Moreover, why are the United States Trustees, empowered to oversee the administration of bankruptcy matters, not able to secure greater levels of judicial compliance? Certainly the United States Trustees could assert that their program lacks the staff and fiscal resources to enforce the Code provisions since the establishment of the nation wide U.S. Trustee System by the 1986 legislation. It is too early to tell the effectiveness of the U.S. Trustee program as it relates to the compliance with the mandate of the Code. It also remains to be seen whether or not as a result of the Supreme Court's decision in In re Timbers of Inwood Forest Associates, Ltd., 108 S.Ct. 626, 98 L.Ed. 2d 740 (1988), which reinstated the Fifth Circuit Panel decision dated July 9, 1986, 808 F.2d 363 (5th Cir. 1987)(en banc), would center the attention of the Bankruptcy Judges on the importance of a strict compliance with the mandate of §362 of the Code.

Thank you for permitting me to make these comments and if you have any questions, I am more than pleased to answer them.

STATEMENT OF CHARLES M. TATELBAUM

Mr. TATELBAUM. Mr. Chairman, Senator DeConcini, I am Charles Tatelbaum, a practicing attorney from Tampa, FL, and I am testifying on behalf of the American Bankruptcy Institute, serving as the editor of its publications and an evaluator for the survey.

According to the survey, the consumer credit amendments, which were the much heralded part of the 1984 amendments, did not have a dramatic effect on consumer bankruptcy cases or the perceived abuses within the bankruptcy system that caused the legislation. The survey pointed out that a fair amount of statutory noncompliance with the 1984 amendments, and this noncompliance may have a direct effect on the public and the bar's and the bench's perception that the consumer credit amendments are not effective.

This proves that the problem goes beyond the consumer credit amendments to problems inherent within the application of the Bankruptcy Code and the lack of its consistent application.

A majority of the respondents to the survey reported that distributions were unchanged as a result of the 1984 amendments, yet less than a majority thought things were better for creditors. This demonstrates that while the improvements were perceived for creditors, these improvements have not translated into money, which is the ultimate bottom line indicator for creditor success.

While the consumer credit amendments were pending before Congress, it was stated that the abuse of the system came primarily from consumer debtors, while the survey discloses that the perceived abuses go well beyond these individuals, and that individual debtor abuse may not be at the heart of the perceived problem of the abuse of the bankruptcy system, but it may go into chapter 11 and other business cases.

Two-thirds of the respondents thought that there was no change in chapter 7 filings as a result of the consumer credit amendments. Indeed, 22 percent thought that the filings had increased. The perception of a majority of the respondents was that the consumer credit amendments of 1984 did not have the intended result of encouraging the increased use of chapter 13.

Since the use of chapter 13 cases varies widely, it appears that where it was used extensively prior to the amendments, it is still being used. And where it was not used, it is not.

Referring to section 707(b), it appears that because the statute required the judge to be the impetus to find abuse and to dismiss the case, that, too, was not working because a vast majority of the respondents said that section 707(b) is hardly ever being used by judges in dismissing abusive bankruptcy cases.

Chapter 13 was amended, in section 1325, to require debtors to dedicate all of their net disposable income toward the plan in order to get confirmation. This was to eliminate the perception of abuse with the zero-percent plans, or minimal plans. The survey found that the system is not being used, that lawyers are getting around the system by creating inflation budgets, so that the net disposable income does not have to be used and, in fact, there is a perception that a great number of judges around the country are simply con-

firming the plans without complying with the law of the net disposable income.

Questions exist with respect to the effectiveness of the amendments to do the things that were intended. The survey points out that the need for extensive prior study, similar to the ABI survey, in order to make certain that legislative change is needed and that the proposed legislation will, in fact, effect the changes that are intended.

The survey points out that additional studies are needed in certain areas beyond the issues that were raised. The areas which may need to be studied include the nature and extent of the bankruptcy system as a whole; chapter 11 and the much perceived and heralded abuses there, whether they exist and how they can be changed if they do; a review of the operation of the newly enacted U.S. Trustee Program that is going to end some of these abuses, and whether or not there is bankruptcy judge compliance with the statutes, the reasons for noncompliance, and how Congress can mandate the compliance.

The survey also indicates a need for a better and more efficient method of monitoring judicial compliance and the need for legislation to ensure this compliance.

Mr. Chairman, as you know as a former judge, it is important that the judges comply.

Senator HEFLIN. Please summarize.

Mr. TATELBAUM. Nothing is perfect. It is interesting to note that 73 percent of the respondents ranked the system as good to excellent and less than 1 percent think the overall system is very poor. It is working and we would respectfully suggest that survey methods be used as a tool to assist in future legislative process.

I would ask that all of our written reports be included in the record, including the ABI survey.

[The prepared statement of Mr. Tatelbaum follows:]

SENATE SUBCOMMITTEE ON COURT AND ADMINISTRATIVE PRACTICE

COMMITTEE ON THE JUDICIARY
HEARING ON THE ABI SURVEY
"PERCEPTION AND REALITY"
JUNE 10, 1988

PREPARED STATEMENT OF CHARLES M. TATELBAUM REGARDING THE ABI SURVEY

**TESTIMONY AND PRESENTATION OF
CHARLES M. TATELBAUM OF TAMPA, FLORIDA
ON BEHALF OF THE AMERICAN BANKRUPTCY INSTITUTE**

Mr. Chairman, Members of the Committee:

INTRODUCTION

I am Charles M. Tatelbaum, a practicing attorney from Tampa, Florida, with the law firm of Kass, Hodges & Massari and I am testifying today on behalf of the American Bankruptcy Institute ("ABI") where I am a member of the Board of Directors and I am the Editor of the American Bankruptcy Institute Newsletter. I served as Evaluator of the ABI Survey. I have been practicing bankruptcy law for 22 years, having previously practiced in the Baltimore-Washington area. I also served as an instructor in creditors rights at the University of Maryland School of Law for seven years.

It must be kept in mind that one of the prime focuses of the ABI Survey ("The Survey") was to review the perceptions of those surveyed, which perceptions may be as important as or more important than the reality of the situation. When the bench, the bar, the business community or the public in general do not have confidence in either the statutes created by the legislative process or the judicial system, a problem exists, whether or not there is any fault to be ascribed. The ABI felt it important to review certain aspects of the 1984 Amendments to the Bankruptcy Code in order to further assist with the legislative process by determining the perceptions of how "the system works". Some of the subjective views contained in this presentation must of necessity, be my own as they present opinions based upon the data contained in The Survey.

My portion of the presentation deals with the results of The Survey concerning the consumer credit amendments that were enacted in 1984, as well as the change to the section of the Bankruptcy Code (547) dealing with exceptions to preferences.

CONSUMER CREDIT AMENDMENTS

The consumer credit amendments are contained in Subtitle A of Title III of Pub.L.No.98-353 (and will be referred to as the "Consumer Credit Amendments") provide an example in which both the effect and the effectiveness of certain of the 1984 Amendments were measured by The Survey. This is an instance where a substantial lobbying effort was initiated by the consumer finance industry to correct what was perceived to be and in fact acknowledged by many to be debtor abuse. Additionally, at the time that the legislation was under consideration, there was considerable media attention given to the perceived abuses, and the fact that the Consumer Credit Amendments would curtail this perceived individual debtor abuse. Additionally, cases involving individual debtors constitute the vast majority of the number of cases filed in the bankruptcy courts throughout the U. S. While the individual dollar volume of a consumer case in no way compares to the dollar volume of the highly publicized chapter 11 cases, the effect of consumer cases on the consumer finance industry may be even greater.

According to The Survey, the Consumer Credit Amendments did not have a dramatic effect on consumer bankruptcy cases and the perceived abuses within the bankruptcy system. Additionally, The Survey pointed out a fair amount of statutory non-compliance with the 1984 Amendments, which non-compliance may have had a direct effect on the perception of the effectiveness of the Consumer Credit Amendments. This proves that the problem goes beyond the Consumer Credit Amendments to problems inherent in the application of the Code and any lack of its consistent application.

The Survey reviewed the effectiveness of the Consumer Credit Amendments by two standards. Fifty-seven percent (57%) of the Respondents reported that distributions were unchanged as a result of the 1984 amendments, yet 48% of the Respondents thoughts things were better for creditors. This demonstrates that while there were improvements perceived for creditors, these improvements had not translated into money, which is the ultimate indicator of creditor success.

Since the initiative for the Consumer Credit Amendments came primarily from the perception of individual debtor abuse in bankruptcy cases, The Survey attempted to measure the extent of the perceived abuse as well as the effect of the 1984 Amendments on this abuse. The Survey indicated that 19% of the Respondents perceived a "significant" amount of abuse while 38% perceived a "moderate" amount of abuse in the consumer cases. Thus, 57% of the Respondents felt that there was at least a moderate amount of abuse. Looking at it on the other side, 48% of the Respondents perceived "negligible" abuse of the Consumer Credit Amendments, while The Survey showed that when the bankruptcy process as a whole is reviewed, only 2% of the Respondents thought there was no abuse. While the Consumer Credit Amendments were pending before Congress it was stated that the abuse of the system came primarily from the consumer debtors, while The Survey discloses that the perceived abuses go well beyond individuals, and that individual debtor abuse may not be at the heart of the perceived problem of abuse of the bankruptcy system.

The Survey also attempted to view the issue of the increase in bankruptcy filings. Sixty-six percent (66%) of the Respondents thought that there was no change in Chapter 7 filings as a result of the Consumer Credit Amendments. Indeed, 22% of the Respondents thought the filings had increased. A major impetus for the enactment of the Consumer Credit Amendments was the attempt to stem the growing tide of filings and to encourage more

individuals to reorganize than to liquidate. In response to the question as to whether Chapter 13 cases had increased as a result of the Consumer Credit Amendments, 53% of the Respondents thought that there was no change, and 35% thought that there had been an increase. These statistics demonstrate that the perception of a majority of the Respondents is that the Consumer Credit Amendments did not have the intended result of encouraging the increased usage of Chapter 13. Since the use of Chapter 13 cases varies widely with districts, it is believed that where Chapter 13 cases were popular prior to the Consumer Credit Amendments, they continue to be popular, and where they had not had substantial use, the amendments did little to change the practice. As noted in The Survey, the statistics from the Administrative Office of the United States Courts show that the actual filings in reality came close to the perceptions of the Respondents.

Referring to specific substantive amendments, one was the change Section 707(b) which provided that the bankruptcy judge, on his own motion, could dismiss a case if the judge found substantial abuse. The provision stated that no outside party in interest could bring the perceived abuse to the judges' attention, but the judges had to "find it on their own". With respect to Section 707(b), only 3% of the Respondents indicated that the issue was being raised often while 44% stated that the issue was <u>never</u> raised. In response to the question whether the courts were conducting significant reviews under Section 707(b), 67% stated that negligible review was being conducted while only 8% perceived significant review. With respect to this area, 19% of the Respondents perceived significant debtor abuse. It thus seems that the courts were not acting or able to act consistent with the statute at the time they were the only ones charged with the responsibility to do so. It should be noted that in 1986, Section 707(b) was amended to permit the U. S. Trustee to raise the issue of abuse and seek the dismissal. While The Survey could not report on the 1986 Amendments, there is a feeling amongst the bar that the 1986 amendment has done little to change

the perceptions and practice that existed at the time of The Survey. Here, too, there is a perception of the lack of "judicial compliance" since 48% of the Respondents indicated that there were no Section 707(b) hearings even being held. As will be noted elsewhere in the ABI presentation, this may stem from the delegation of the review responsibility to the bankruptcy judges, when the judges did not have the time nor the opportunity to conduct a review of chapter 7 filings unless an adversary proceeding existed.

Chapter 13 was amended with a change in Section 1325(b) that mandated the use of the debtor's net disposable income towards the plan in order to achieve confirmation. This was heralded as a method by which 0% or minimal distribution plans would be eliminated, and the distribution to creditors substantially increased. When asked if the Consumer Credit Amendments increased the number of Chapter 13 plans that were confirmed, 58% perceived no change in the number of confirmations, with there being a even balance among the remainder of the Respondents as to whether there was an increase or decrease. Likewise, in response to the question as to whether more Chapter 13 plans were being carried out by debtors in accordance with their original terms, 64% responded that there was no change, and the balance again was split between those who felt there was an increase and a decrease. It is interesting to note that 52% of the Respondents thought that distributions had increased. Thus, while a majority of the Respondents felt that confirmations and effectuations had not changed, the distributions to creditors as a consequence of the amendment were increasing.

An area of contention has been the ability of debtors to effect the confirmation of a plan which provides for little or no distribution to unsecured creditors. Forty-five percent (45%) of the Respondents perceived no change in the number of these plans as a result of the amendment to Section 1325(b) while 41% thought that such plans had decreased. It should be noted that nothing

in Section 1325(b) precludes such plans, but instead, debtors are merely required to commit all of their disposable income to the plan payments, which should help to eliminate these plans.

When asked whether the courts were "complying" with the statutory mandate in the manner of confirming the Chapter 13 plans, 24% of the Respondents indicated that plans were being confirmed without this dedication of income "almost all" or "most of the time". On the other side, 31% of the Respondents indicated that plans were "hardly ever" confirmed without disposable income being applied.

CONSUMER CREDIT AMENDMENT EXPLANATIONS

The responses appear to indicate that there is judicial non-compliance of statutory mandates with respect to Sections 707(b) and 1325(b). In comparing these statistics to the judicial case loads, there is no correlation between non-compliance and heavy case loads. The one correlation that can be observed is between the distribution to creditors as a percentage of the ratio of assets to liabilities, and the rate on non-compliance. There appears to be greater non-compliance in the districts where there is a smaller distribution to creditors. The totality of The Survey on the Consumer Credit Amendments when viewed in the light of the problems that were to be addressed reveals that certain problems exist, but the solutions may not just be those utilized to date, at least in part because the problem is only beginning to be understood. A more detailed study of the problem must be undertaken in order to determine the methodology for reaching the solutions by legislative means. Over burdening the courts with tasks which cannot be performed does nothing to solve the problems, but may in fact exacerbate them and taint the perception of many. As The Survey points out, detailed study of the problem as well as the proposed solution is a necessary precondition to effective legislative enactments.

PREFERENCE ACTIONS

The 1984 Amendments changed Section 547(c)(2) by deleting what was known as the "45 day rule", which amendment had the effect of assisting creditors who dealt with a debtor in the ordinary course of business prior to bankruptcy. As a result of the change, a creditor who received a payment from a debtor in the ordinary course of business and according to terms within the 90 day period prior to bankruptcy would be excepted from the provisions dealing with voidable preferences. This change had been universally supported by the credit industry, especially the commercial paper banking industry. Surprisingly to many, The Survey indicated that the changes in procedures as a result of the 1984 Amendments did not materialize in a major change in the practice.

Forty-three percent (43%) of the Respondents stated that there was no change in the level of pursuit of preference recoveries, with the balance being evenly split between increases and decreases. With respect to the issue of preference litigation, 44% believed there had been no change in the amount of litigation, with the balance being almost evenly split between an increase and a decrease. It is interesting to note that 36% of the lawyer Respondents in small firms thought the amount of litigation had increased, but only 19% of the lawyer Respondents in large firms thought there had been an increase. On the other side, 39% of the lawyer Respondents in large firms thought litigation had decreased, while only 21% of those in small firms shared this perspective. This difference can be understood when viewing the different types of cases handled by the different sized firms.

With respect to creditor success in preference litigation as a result of the 1984 Amendments, 39% of the Respondents thought that creditors were more successful, while 46% of the Respondents perceived no change in creditor success. These results may be

considered in light of other results which indicate that only cases that are more certain of success are being litigated by the trustees in order to achieve a recovery.

It was anticipated that the amendment would create additional litigation focusing on the meaning of "ordinary course of business". Indeed, 50% of the Respondents indicated that there had been an increase in litigation, yet the intended results have not materialized.

CONCLUSIONS

As noted above, it is somewhat surprising to state that the amendment to Section 547(c)(2) did not have the effect that was anticipated. This further points out the need for prior study for additional changes to the avoidance sections, and in the process of changing the Bankruptcy Code itself.

As will be noted throughout the presentation in reviewing The Survey, questions exist with respect to the effectiveness of the 1984 Amendments to do those things which were intended. The Survey points out the need for extensive prior study similar to The Survey in order to make sure of the legislative need for change, and if the proposed legislation will affect that change intended. Absent this, the risk is run that new legislation will not be effective to solve a problem, and in fact, a problem may not even exist.

In order to "combat" unpopular changes, creative ideas are being employed to circumvent the intent of the legislation. In order to comply with the new mandates of Section 1325, debtors and their attorneys are creating "imaginary budgets", so that inordinate expenses will be approved by the court to permit less than all of one's net disposable income being dedicated to

creditors under the plan. Likewise, the provisions of Section 707(b) are simply ignored, so that there is a lack of effective compliance.

The Survey points out that additional studies are needed in certain areas based upon the issues raised. The areas which need to be studied include the nature and extent of abuse in the bankruptcy system as a whole, the operation of the U. S. Trustee program and compliance by bankruptcy judges with other statutory mandates created by the Bankruptcy Code. Before other and further changes to the Bankruptcy Code are made, a serious and conscious effort should be made to study the areas contemplated for change in an objective and non-partisian manner. As the Respondents' responses indicate, there were changes that did not achieve what the proponents of the legislation desire. Some suggestions for improvement should have been, and apparently were not, carefully considered before the 1984 Amendments were enacted.

The Survey also indicates a need for a better and more efficient method of monitoring judicial compliance, and the need for legislation to ensure such compliance. To require the bankruptcy judges to do things that cannot be done because of case load and other factors, is to frustrate the system. Likewise, to permit some judges to fail to comply with the Code for no reason creates a lack of confidence in the system.

Nothing is perfect. It is interesting to note that 73% of the Respondents rank the current bankruptcy system as good to excellent and less than 1% of the Respondents rank the system as very poor. Obviously, the system is working. The Survey, though, points out the need for study and consideration prior to the enactment of additional and further legislation.

Senator HEFLIN. Without objection, so entered.

I will submit written questions to each of you and I would appreciate a response as soon as you possibly can.

Senator DeConcini, do you have an opening statement or questions?

Senator DECONCINI. Mr. Chairman, I want to thank you for holding these hearings. You have taken a great leadership role as chairman of the Courts subcommittee and, although it is late in the session this year, I am truly hopeful that after these hearings we can move quickly toward a markup. I appreciate your interest and the time you have put into this.

I look forward to hearing the testimony this morning. I have a Foreign Operations subcommittee also marking up this morning, so I will not be able to stay for the entire hearing.

I do have some questions of the judge and the witnesses on this panel that I will submit and ask them for their response. I will forego asking any questions at this time.

Thank you, Mr. Chairman.

Senator HEFLIN. Thank you.

[Panel members subsequently submitted the following material:]

Responses of Professor Karen Gross
New York Law School
to questions regarding Testimony of June 10, 1988
on the American Bankruptcy Institute Study
before the
Subcommittee on Courts and Administrative Practice
Committee on the Judiciary
United States Senate

Address: 57 Worth Street, Room B-303
New York, New York 10013

Phone: (212) 431-2140

As of 8/25/88: Cardozo Law School
55 Fifth Avenue
New York, New York 10003

(212) 790-0269

Question from Senator DeConcini:

You stated that there are problems in the bankruptcy system that legislative change alone cannot cure. What do you think needs to be done and what role should Congress play in correcting the problems?

Response:

First, let me focus on the perception of many respondents in the American Bankruptcy Institute Survey that Congressional changes (as part of the 1984 Amendments to the Bankruptcy Code) were not always implemented. I think this reveals an important but frequently unstated observation, namely that there is a vast difference between enacting and effectuating legislative change. For example, to the extent Bankruptcy Judges do not implement changes enacted by Congress and there is acquiescence in that non-compliance by the other participants in the bankruptcy process, then problems may not be in the legislation itself.

I believe there must be an assessment as to WHY there is such non-implementation---which frequently takes the form of non-compliance with statutory mandates. It is only recently that we have even documented perceptions of non-compliance and hence, we are still not clear as to the reasons for its existence. Is it because the applicable legislation change was not an appropriate or workable change in practice? Was it perhaps even recognized that the new legislation might not be fully utilized and yet it was the only feasible solution under the circumstances? Is it because the Bankruptcy Judges do not have the time or inclination to adopt the new legislation? Moreover, why are the other parties in the bankruptcy process (i.e. lawyers) acquiescing in this non-compliance? Are these attorneys fearful of taking action in view of repeated appearances in the same forum? Why is non-compliance more prevalent in certain areas of the country?

What should be done about the non-compliance hinges, in large part, on the responses to these questions. The addition of the United States Trustee program may assist in furthering compliance, assuming the program has adequate funding to allocate resources to this aspect of bankruptcy practice and an ability not just to spot the non-compliance but to act upon it effectively.

In terms of Congressional action regarding non-compliance, I think there should be ongoing monitoring and study of compliance with statutory mandates so that there can be frequent public disclosure of what is happening in the bankruptcy system based on district by district comparisons. Peer pressure, through public release of reports, may help to self-police the system. In fact, it is now two years since the data was collected by the American

Bankruptcy Institute and the time for a follow-up study, using many of the same questions, is upon us.

There are problems, other than non-compliance, which also cannot be directly cured by legislative change. For example, there are perceptions of abuse of the bankruptcy process and yet existing provisions of the Bankruptcy Code and other titles are not brought to bear on the situation. Extreme abuse might, for instance, be alleviated to some extent by increased utilization of the Bankruptcy Crimes provisions housed in Title 18. Part of the under-utilization of Title 18 may be caused by the failure of Bankruptcy Judges to refer criminal acts to the United States Attorney under 18 U.S.C. sec. 3057, although there does not appear to be any published data on this. Further, United States Attorneys have not been exactly eager to prosecute bankruptcy crimes as they have never been a high priority. Perhaps the crimes sections themselves need further evaluation and possible revamping. The United States Trustee program now has the ability to notify the United States Attorney of Title 18 crimes and to assist in prosecuting if so requested. (28 U.S.C. sec. 586(a)(3)(F). This is an area that merits further attention and study.

What all of this suggests to me is that before we amend the Bankruptcy Code again, we should look at what it and other titles contain and try to encourage and foster a utilization of existing law. If these laws are then found not to work, we can again consider remedial legislation.

Question from Senator Thurmond:

The Survey indicates a finding of abuse in Chapter 11 cases with debtors utilizing chapter 11 for purposes of delay rather than reorganization. Do you believe this is a legitimate concern, and if so, how could this problem be resolved?

Response:

In a word, yes. The American Bankruptcy study suggests that the real "abuse" of the bankruptcy system MAY be in Chapter 11. I share the respondents' concern about the operation of this chapter. I believe it is legitimate to suggest that in SOME types of Chapter 11 cases, neither reorganization nor maximization of assets for creditors (through a liquidating Chapter 11) are the primary consequences of the filing. In some instances, delay and maximizing recovery for owner/managers may be the principle result of the Chapter 11 filing.

Unfortunately, there have been remarkably few studies of the operation of Chapter 11, and it is incumbent upon us to move quickly to look at Chapter 11 in light of its growing use. As expressed in a forthcoming article in the 1987 Annual Survey of Bankruptcy Law (a copy of which I will send to you upon publication), Messrs. Curtin and Togut and I noted that Chapter 11 does not appear to be operating effectively in some "small" Chapter 11 cases. (The definition of "small" v. "large" cases is complicated and requires further elaboration in that a small case in a metropolitan area may be a large case in other parts of the country.) For instance, it seems that creditors' committees--the primary creditor monitoring device in Chapter 11---are not functioning in the small cases and in some cases, a committee is not even formed!

I sense that the amalgam of old Chapters X, XI and XII into a single reorganization chapter---current Chapter 11---may have produced some of the problems. There is a marked difference in how cases of varying sizes are and should be handled. The amount of time, energy and legal expertise that is brought to bear appears to be directly proportional to the dollar values involved. It may be that "smaller" Chapter 11 cases do not require the resources of a "larger" Chapter 11 case. However, if there is no creditor activity and no effective monitoring, then one of the underlying premises of all Chapter 11 cases---namely an effective check and balance system---is in jeopardy.

In terms of "solving" this problem, I think we should first identify what the problem is and get a better sense of how Chapter 11's OF ALL SIZES are operating. In this vein, we should look a host of as yet unprobed issues: amount and cost of attorney and other professionals' time; creditor committee formation and function; plan development and effectuation; and disclosure. We should look at what the nationwide United States Trustee program is doing in Chapter 11 cases and whether its guidelines are appropriate for all types of Chapter 11 cases. Moreover, we should consider the time allocation within the United States Trustee offices. Should the United States Trustee allocate large blocks of time to the bigger Chapter 11 cases where there is active creditor involvement or should they focus their attention on the less visible, smaller cases with little or no creditor participation? In which type of case is the "creditor body" better served?

Armed with this data, we can then evaluate whether aspects of Chapter 11 should be modified to deal with the large or small case. For example, should we change the creditor committee mechanism in "small" cases? Should we handle disclosure differently in large and small cases? Should debtors be required to indicate whether they intend to liquidate in Chapter 11 and what they anticipate creditors will receive as a distribution?

I have been serving on a American Bar Association task force that was formed as part of the Chapter 11 Business Bankruptcy Committee specifically to look at abuse in Chapter 11. This task force is only the beginning. My experience in practice, my conversations with practitioners and my reading of the case law and scholarly literature suggests that it is time attention was paid to Chapter 11. While these cases do not account for the largest NUMBER of filings, they do account for the greatest DOLLARS and therefore deserve our attention before the problems exacerbate.

Question from Senator Heflin (No. 2):

How can future studies be helpful to this Committee?

Response:

Studies can be helpful in a variety of ways. As a threshold matter, there are a variety of types of studies that should be pursued, namely those involving "hard" and "soft" data. Hard data studies might focus, for example, on actual case filings while soft data studies would focus on perceptions. These studies should be conducted on a district by district basis (or representative districts) and an effort should be made to address the perceptions not only of the professionals but actual debtors, creditors and trustees.

One of the important features of the American Bankruptcy Institute study, a soft data study, is that it can provide information within a relatively short time frame. Unlike hard data studies which are extremely costly and time-consuming, perceptual studies can reveal data that is current at a reasonable cost. Both types are, in my assessment, necessary although one type of study may be more suitable than another in a given situation.

There is a great deal of information that can be garnered from studies. First, they can assist us in determining whether some of our underlying assumptions about bankruptcy are correct. For example, if we want to curb filing rates, will restricting exemptions be an effective approach? Second, it will give us insight into what is actually happening in the bankruptcy system. For example, it will reveal whether the legislative changes passed by Congress have been implemented. Third, it will allow the participants in the bankruptcy process to reveal how they believe the system is operating and how it should be

operating. Fourth, ongoing studies will supply a data base that can be used for comparative purposes. This will allow significant ongoing monitoring of the bankruptcy system and allow us to better assess when and if changes are needed.

Question from Senator Heflin (No. 6):

What do you consider to be the most significant finding of the study?

Response:

I suspect that everyone who looks at the study will find something different as the "most" significant finding. To me, what is most significant about the study is what it tells us about the MYTHS *we* have about how bankruptcy law is practiced. To date, most of our insights into the practice have been largely anecdotal or based on a reading of published decisions. Most significant among these myths is that bankruptcy law is practiced very differently in different parts of the country and that the competing interests have differing perceptions about what is happening in the bankruptcy system. These perceptual and geographic differences have appeared to make change in the bankruptcy system problematic.

The American Bankruptcy Institute study suggests that indeed, the respondents believe bankruptcy law is practiced very differently in different parts of the country. Moreover, in some instances, debtor lawyers think very differently from creditor lawyers (i.e. regarding the consumer creditor amendments.) The categories of respondents (lawyers, judges, United States Trustees and Estate Administrators) also think differently about the system in many instances.

These differences suggest to me that an external "reality" of the bankruptcy system is hard to come by. These findings should caution us about making change in the bankruptcy system without a full and complete understanding of who is seeking the change, how it will impact on the other parties in the bankruptcy process and whether a particular problem is regional or national in nature. Phrased differently, verification of the myths serves to emphasize the difficulties of implementing change in bankruptcy.

Question from Senator Heflin (No. 7):

Did the ABI Survey "reach" debtors, not simply attorneys who represent debtors?

Response:

No, the ABI study did not interview debtors, creditors or trustees. Rather, the study was designed to interview only their representatives. In many instances, the issues the study addressed were too specific and "legalistic" to be answered by non-lawyers.

However, this is not to suggest that there is no merit in interviewing a representative sample of debtors, creditors and trustees. In fact, such a study could yield important (and heretofore unavailable information) about the bankruptcy system. Given the significant number of filings nationally and the impact bankruptcy has on our economy and family life, investigation of those actually involved is important indeed. Certainly in the consumer area, where literally hundreds of thousands of individuals are involved either directly or indirectly in the bankruptcy process, it is extremely relevant to probe their views.

Unfortunately, to yield statistically significant data, a study of these categories of respondents would be more time-consuming and costly than the study conducted by ABI. In fact, a comparison of the results of the representatives of debtors, creditors and trustees with these individuals themselves would be informative in and of itself.

Question from Senator Heflin (No. 10):

How should Congress use the results of the ABI Survey in enacting new bankruptcy legislation?

Response:

First, I think the study cautions us about making piecemeal bankruptcy change in the future and suggests that we would be

well served by studying the problems at hand and the Bankruptcy Code as applied by those with day-to-day experience before enacting further change.

Second, the study suggests that we look at the effectuation of legislative change and better monitor what is happening in the bankruptcy system. Enacting legislation is not productive if the legislation is not implemented.

Third, the study suggests that we look more closely at the operation of Chapter 11 as the respondents perceive abuse in the bankruptcy system which does not appear, contrary to the perceptions of many, to be keyed to individual debtor abuse.

Fourth, the study reveals concerns about how the nationwide United States Trustee program will operate in practice. Given this concern, Congress should develop appropriate mechanisms to evaluate this program so that, if necessary, changes can be made.

Last, the study provides a heretofore unavailable data base that we can use to develop a ongoing look at the bankruptcy system. We can begin to look at whether practice is changing, whether practice remains different in different parts of the country and whether perceptions of the system are altering.

United States Bankruptcy Court
Middle District of Florida
4921 Memorial Highway, Suite 250
Tampa, Florida 33634

Alexander L. Paskay
Chief Bankruptcy Judge

Phone: (813) 228-2261

June 27, 1988

The Honorable Howell Heflin
United States Senate
The Subcommittee on Courts and
Administrative Practice
Senate Judiciary Committee
223 Hart Senate Office Building
Washington, D.C. 20510

Dear Judge Heflin:

First, let me thank you for the opportunity to appear before your Committee and present my views on certain sections of the Bankruptcy Code which in my judgment merit a reconsideration. Answering specifically the questions you posed, I would like to state the following:

Civil Contempt Powers of Bankruptcy Judges

As you recall, the Ninth Circuit Court of Appeals in the case of Sequoia Auto Brokers, Ltd., Inc., 827 F.2d 1281 (9th Cir. 1987), concluded that the bankruptcy judges do not have civil contempt power. Judge Wiggins, speaking for the court, arrived at this conclusion first because 28 U.S.C. 1481 was not carried over by BAFJA into the amended version ultimately enacted which now deals with the jurisdiction of bankruptcy courts. Wiggins also concluded that bankruptcy judges do not have an inherent contempt power nor does §105 of the Code furnish acceptable authority to exercise such power. As a result of this decision, the issue has been extensively litigated.

It is my opinion that in order to eliminate needless litigation on this issue, it would be advisable for Congress to specifically deal with this matter. In my judgment, this can easily be accomplished by simple amendment of 28 U.S.C 157(b), the section which describes and identifies "core" proceedings in which the bankruptcy court has the power to enter final binding judgments and orders. This could be accomplished by an additional subclause which should read as follows: "Proceedings to enforce the civil contempt or appropriate orders and judgments, subject only to review under §158 of the Judicial Code, 28 U.S.C., provided, however, that the bankruptcy judge may not order any incarceration as punishment for contempt. As an alternative suggestion to deal with this matter, a short amendment of §105 of the Bankruptcy Code would also solve this problem.

Stay Litigation--Compliance with §362(e)

As the Survey reveals, there is a very significant non-compliance with the time frame mandated by §362(e) of the Code. It is my view that this problem can be solved by amending §362(e) to permit more flexibility and to allow the bankruptcy judge to extend the automatic stay for "cause" and schedule the preliminary hearing within 60 days rather than the 30 days which is now required by law.

As I have indicated in my written submission, the current time frame mandated by Congress is too rigid and too inflexible, and its self-destruct provision creates a major problem which in my judgment merits a reconsideration. The principal reasons for non-compliance are twofold. First, in districts where the judge is required to hold court in more than one place, it is almost impossible to comply with the requirements of the Code and hold a preliminary hearing on the motion within 30 days from the date the Motion was filed. For instance, if the motion for relief from the automatic stay is filed two weeks or a week before the scheduled court date in a location other than the headquarters of the Court, it is impossible to schedule a preliminary hearing within the 30 days required by §362(e) because the calendar is already full and since the next court date on that location is usually outside the 30 days, the motion cannot be and will not be considered within the time frame unless the court makes a special trip to hear one single motion. In the alternative the Court has no choice but to compel the attorneys to travel a long distance to attend the hearings scheduled at the headquarter location of the court. In such situations, courts generally enter an order without a hearing extending the automatic stay in order to prevent an expiration of the automatic stay called for by §362(e).

Second, there is another problem with the rigid time frame of this Section which is related to the conversion of a Chapter 11 case to a Chapter 7 liquidation case. If the motion to lift the stay is filed ten days or less prior to the entry of the order of conversion, it cannot be handled until the real party of interest, i.e., the interim Trustee, is appointed pursuant to §701 of the Code who is served with the motion and given an opportunity to respond to the motion. None of this can be accomplished within 30 days. As the result, the stay is terminated unless the court enters an ex parte order extending the automatic stay. The termination of the stay frequently causes a very substantial harm to the general estate in cases where the property involved represents a substantial value to the general unsecured creditors, and which is disposed of by the secured party before the Trustee is heard on the matter and which is usually lost by the time the Trustee is able to assume the administration of the Chapter 7 case. I suggest that the Section should be amended to provide for more flexibility and permit the judge for cause to extend the automatic stay under similar instances described and schedule a preliminary hearing within 60 days rather than the 30 which are now required by law. As an alternative solution, I suggest that upon conversion the automatic stay should be automatically extended for 30 more days from the date of conversion in order to enable any interim Trustee to look into the matter and take a position on behalf of the estate.

Lack of Interest to Enforce Compliance
by Attorneys and by U. S. Trustee

While attorneys understandably should be more aggressive in insisting on full compliance with the time frame of §362, as a general proposition they do not want to rock the boat, except in instances where the lifting of stay is required to prevent irreparable harm. For this reason, attorneys seldom if ever insist on invoking the self-destruct provision of §362. Next, based on my experience, it is my view that the U.S. Trustees have little or no interest in enforcing the time requirements of the Code and seldom, if ever, participate actively in stay litigations. In a Chapter 11 case, the U.S. Trustees currently focus their attention on the administrative aspect of the Chapter 11 case and consider stay litigation to be

a private matter between the moving party and the Debtor-in-Possession. In my view, there is nothing really Congress could do to motivate private attorneys or the U.S. Trustees to insist on full compliance with the mandate of the Code; however, I do believe, as I indicated earlier, a readjustment of the time frame of §362 would certainly produce a more realistic result and would produce a substantial compliance than that which has been revealed by the survey.

Impact of 1984 Amendments on Fresh Start Concept

Prior to the enactment of the Code, §17c(3) of the Bankruptcy Act of 1898 provided that once the bankruptcy court determined that the debt involved is nondischargeable, the court was directed to proceed to determine the remaining issues and render judgment and make such orders as were necessary, unless the amount of the liability of a debtor has been already determined by the entry of the final judgment by a non-bankruptcy tribunal prior to the commencement of a case. The corresponding section of the Code dealing with this subject is §523(c) which, however, does not include a similar provision. The net result of this change is that in dischargeability disputes the court is limited to considering the character of the liability but cannot enter a judgment determining the amount of the liability, and unless there was a pre-filing judgment entered, the litigants, that is the moving party and the debtor, have to litigate that issue after discharge in a non-bankruptcy forum.

Debtors as a general rule not having any funds do not defend such post-petition lawsuits under the assumption that the discharge granted to them prevents any further action by a creditor, but more importantly because they just do not want to spend any more for attorney fees which are needed to litigate the issue in a state court. If that occurs, the plaintiff who obtained the determination in the bankruptcy court that the debt is nondischargeable will obtain a default judgment in a state court which at times includes an award of enormous attorney fees and costs, which is frequently double what the liability should have been, had the matter been determined with the debtor's participation in the bankruptcy court. I do not see any difficulty in readopting the language of §17c(3) of the Act of 1898 and directing the bankruptcy court to proceed to determine all remaining issues involving, of course, the amount of the liability of the debtor to the prevailing creditors after the court has resolved the dischargeability in favor of the creditor.

The vast majority of discharge litigation centers around §523(a)(2)(A) which provides that debts incurred by a debtor by obtaining money, property or services by false pretenses, or by fraudulent representations, or by actual fraud are nondischargeable. When this issue is raised, it always involves a loan transaction where the amount of liability is fixed and would not present any problem for the bankruptcy judge to enter a money judgment based on the amount established by the documents submitted in the adversary proceeding as evidence.

Thank you for your consideration of the points of my remarks, and I would like to express again my thanks for the opportunity to appear again before your Committee.

Very truly yours,

ALEXANDER L. PASKAY
Chief Bankruptcy Judge

Thomas Avrutis
Jeffrey S. Brinsn
Larry M Foyle
Edward P. Gerace, P.A
John M. "Jack" Hodges
Michael Kass
Domenic L. Massari, III
Thomas K. Scarrino, Jr.
James M. Shuler
Gilbert M. Singer
Larry E. Solomon
Neil C. Spector
Charles M. Tatelbaum

KASS, HODGES & MASSARI
Tampa-Sarasota-Ft.Myers-Orlando
Centre Square
1505 N. Florida Avenue
P.O Box 800
TAMPA, FLORIDA 33601
(813) 229-0900
Telecopier (813) 229-3323
Telex (WU) 514246
KASS LAW

In reply address firm at
P.O. Box 800
Tampa Florida 33601

June 29, 1988

The Honorable Howell Heflin
The United States Senate
The Subcommittee on Courts and
Administrative Practice
Senate Judiciary Committee
223 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Heflin:

I am enclosing the responses to the questions of yourself, Senator DeConcini and Senator Thurman which were presented to the participants of the hearings held in conjunction with the American Bankruptcy Institute Survey. We attempted to coordinate our answers so as to eliminate duplication in the responses.

I would like to take this opportunity to thank you and the subcommittee's staff for the assistance provided myself and the other participants in preparing for the testimony, and in working to respond to these questions.

Judge Paskay, Professor Gross and I will be happy to respond to any additional questions that any of the committee members or staff may have.

Very truly yours,

KASS, HODGES & MASSARI

Charles M. Tatelbaum

CMT:dm
Enclosures

RESPONSES FROM CHARLES M. TATELBAUM, TAMPA, FLORIDA ON BEHALF OF THE AMERICAN BANKRUPTCY INSTITUTE TO QUESTIONS FROM SENATOR HEFLIN FOR PANEL ON AMERICAN BANKRUPTCY INSTITUTE SURVEY

(Mr. Tatelbaum will only respond to those questions directed to him by Senator Heflin, as well as questions which were "undirected" to which he has an applicable response. Judge Paskay and Professor Gross will also respond to these "undirected" questions.)

4. QUESTION: DID THE SURVEY SHOW THAT THE 1984 AMENDMENTS ARE WORKING? IS THE BANKRUPTCY SYSTEM ITSELF WORKING?

ANSWER: The Survey dealt with specific 1984 Amendments to the Bankruptcy Code. With respect to a number of these, the Survey disclosed that the perception of the Respondents was that the amendments were not "working", or certainly were not working as well as expected. Additionally, the 1984 Amendments created some additional problems not envisioned when the amendments were enacted, which reflect negatively upon the perception as to whether or not the amendments are working.

Specifically, Section 707(b) is not working. (In 1986 an additional amendment to this section was enacted, and this response will not deal with the 1986 Amendment.) This section prescribes that a bankruptcy judge may, on his own motion, dismiss a bankruptcy case if his review of the file discloses substantial abuse. The Bankruptcy Reform Act of 1978 places the bankruptcy judge in the role of arbiter of disputes, eliminating the prior role of the bankruptcy judge/referee as an administrator and arbiter. As a result, the bankruptcy judge does not and should not review a bankruptcy file unless an

adversary dispute is before the judge. As a result, the judge never has the opportunity of reviewing the file. If creditors who do review the file call an abuse to the judge's attention, the judge is precluded from dismissing the case under Section 707(b) because the abuse was not "discovered" by the bankruptcy judge. As a result, this amendment "does not work".

Section 1325 was amended in 1984 to provide that all of the net disposable income of a Chapter 13 debtor must be dedicated to the payment of the creditors under the plan. This was enacted so as to attempt to eliminate perceived abuses with Chapter 13. The Survey results show that the Respondents perceive that the statute is being circumvented either by judicial noncompliance or "creative budgets" to the end and effect that all of the net disposable income is not being used to pay creditors, and zero percent or minimal plans are being confirmed.

There are other instances relating to the 1984 Amendments that show they are not "working". By this I mean that the Congressional intent is not being carried out to the extent expected when the statute was enacted.

As to whether the system itself is working, undoubtedly the vast majority of the Respondents say it is. There is equally no question that it could be improved, and in fact, the majority of the Respondents believe that there is at least a moderate abuse of the system. Considering the number of cases that are filed each year and which remain pending plus the billions of dollars that remain at risk, the system is working well.

5. QUESTION: HOW REPRESENTATIVE DO YOU BELIEVE THE STUDY IS OF THE VIEWS OF THE ENTIRE BANKRUPTCY COMMUNITY?

ANSWER: I believe that the study is as representative as one can be if debtors themselves are excluded (see the answer to question 7). The Respondents comprise bankruptcy judges, U. S. Trustees, estate administrators and attorneys. Within the attorney category, the Respondents were selected at random from several lists which comprised attorneys from large and small firms, those who represented debtors and those who represented creditors, various other subcategories which helped the study be as representative as possible. Each of the four different groups of Respondents views the system from a different perspective, and this was input into the ultimate results.

RESPONSES FROM CHARLES M. TATELBAUM, TAMPA, FLORIDA
ON BEHALF OF THE AMERICAN BANKRUPTCY INSTITUTE
TO QUESTIONS FROM SENATOR DeCONCINI FOR PANEL ON
AMERICAN BANKRUPTCY INSTITUTE SURVEY

1. QUESTION: AS YOU COMMENTED ON, THE SURVEY REVEALED THAT A LARGE PERCENTAGE OF THOSE SURVEYED PERCEIVED A GREAT DEAL OF ABUSE STILL EXISTS IN THE BANKRUPTCY SYSTEM. WHAT WOULD YOU SUGGEST BE DONE TO CURTAIL THIS ABUSE?

ANSWER: The Survey dealt with perceptions, many of which constitute the reality. First, I believe that further studies should be undertaken to determine the extent of abuse that does in fact exist. If the abuse is not as great as perceived, major reform need not be undertaken. If, however, the perception equals the reality, further studies should be initiated which focus on the areas of the most significant abuse. In the past, the areas of the most abuse or the abuse involving the greatest amount of creditor dollars was not necessarily dealt with when the Bankruptcy Code was being amended. Once the areas of abuse can be isolated, the methodology for curtailing the abuse may be developed.

With any proposed legislation to cure abuse, careful consideration needs to be given as to whether the suggested change will accomplish the ends intended, and also as to whether or not the proposed amendments will have any "side effects". As was noted in ABI's written testimony, the Survey revealed that in a number of instances not only did the 1984 Amendments not

accomplish what was intended, but also there were other "side effects" which further interfered with the effective administration of the bankruptcy system and the Bankruptcy Code.

To the extent that the perceived abuse is permitted to continue because of judicial noncompliance, the judicial noncompliance must be found, and steps taken to eliminate it. Effective monitoring systems of judicial compliance must be adopted, as attorneys will not permit themselves to be placed in the position of "blowing the whistle" on a judge where the attorney must appear before the judge on a regular basis.

2. QUESTION: YOU ALSO STATE THAT THE SURVEY REVEALED THE INEFFECTIVENESS OF THE '84 AMENDMENTS AND THAT ADDITIONAL STUDIES SHOULD BE DONE BEFORE ANY FURTHER LEGISLATION IS ENACTED. DOES THE ABI INTEND TO FOLLOW UP ON THIS SURVEY TO TARGET PARTICULAR PROBLEM AREAS AND TO FOCUS MORE ON HOW THEY MIGHT BE CORRECTED?

ANSWER: The ABI has not yet formulated its plans for a follow up to the Survey. The reviews of the Survey have been extremely positive, and the Survey has been very well received. Funding for surveys is difficult to obtain, especially for a multi-disciplined apolitical organization such as the American Bankruptcy Institute. Assuming funding would not be a problem, the ABI intends to effect follow up surveys in such a manner as would be helpful and other similar Congressional committees. The ABI would hope that this committee could have substantial input as to the areas of study which would be the most effective.

3. QUESTION: DID THE CONSUMER CREDIT AMENDMENTS OF 1984 HAVE THE EFFECT OF CURTAILING CONSUMER RELATED FILINGS? IF NOT, WHY DIDN'T FILINGS GO DOWN?

ANSWER: The Survey disclosed that the Respondents perceived that the 1984 Amendments did not have any dramatic effect on reducing the number of filings. Many extraneous factors have contributed to increased filings such as the nature of the economy, the regional problems dealing with energy, the permissiveness of consumer credit grantors in extending credit and the like. The Survey did point out, though, that many of the 1984 Amendments that were intended to curtail the filings simply had no major effect.

The Survey did not focus on why the filings did not go down. It is my opinion that although well intended, the 1984 Amendments did not fully deal with the problems at hand, but attempted to apply a "band-aid" approach to the situation. The requirement that the clerk of court notify all potential debtors of the availability of Chapter 13 simply does nothing. As was discussed in ABI's written presentation, the bankruptcy judges are unable to independently review files for abuse under Section 707(b). Debtors are not encouraged to file Chapter 13s, nor discouraged from filing Chapter 7s. If it is determined from a policy position that changes need to be made to encourage the curtailing of Chapter 7 filings or bankruptcy filings in general, studies need to be undertaken to determine the most effective way of doing this. In so doing, the entire Bankruptcy Code must be reviewed, not just a particular section.

4. QUESTION: THE PRIMARY PURPOSE OF YOUR SURVEY WAS TO REVIEW THE IMPACT OF THE 1984 CONSUMER RELATED AMENDMENTS, HOWEVER, YOU ALSO RECEIVED DATA ON THE PERCEPTIONS PEOPLE HAVE ABOUT CHAPTER 11, THE REORGANIZATION CHAPTER MOST USED BY BUSINESS. HOW DO YOU

FEEL CHAPTER 11 IS WORKING? WHAT PERCENTAGE OF CASES FILED IN CHAPTER 11 EVER HAVE PLANS CONFIRMED? HOW MANY OF THOSE FINALLY MAKE IT? WHAT IS THE TYPICAL PAYOUT TO CREDITORS IN A CHAPTER 11 CASE? SHOULD CHAPTER 11 BE THE SUBJECT OF A SEPARATE SURVEY?

ANSWER: The Survey clearly demonstrated that the Respondents believe that the perception is that chapter 11 is not working, certainly not working as well as it should. As with any system, chapter 11 procedure can always be improved. Since perceptions and reality may differ, it would be important to have additional studies to determine if chapter 11 proceedings are really working throughout the United States, and if not, which areas need the most immediate and extensive attention.

While I do not have the exact figures at hand concerning chapter 11 cases, the perception of the Respondents to the Survey as well as my own perceptions based upon my travels throughout the United States is that a very large percentage of cases filed in chapter 11 never have a plan confirmed. Some of these cases should never have been filed in the first place. Some have been filed in chapter 11 only because of the inability of chapters 12 and 13 because of dollar limitations. A large number of chapter 11 cases are "eleventh hour" real estate cases, where the bankruptcy proceeding is initiated to stay a foreclosure sale with no real hope of a reorganization. These "single asset" bankruptcy cases have very little likelihood of any success.

There is a perception at the amalgamation of the Chapters X, XI and XII from the Bankruptcy Act have not produced a smooth,

unified and effective method for dealing with corporate and other reorganizations. The procedures are cumbersome, time consuming and expensive. Creditor apathy is growing, and the majority of creditors simply give up because of their feeling of ineffectiveness. There is a perception that the attorneys are the only ones who receive a distribution. It is perceived that the typical payout to unsecured creditors is minimal.

The ABI Survey as well as my own observations clearly demonstrate that a study should be done of the effect and effectiveness of chapter 11. This will be the only way to determine how well (or poorly) the system is working, and how best to repair it.

RESPONSES FROM CHARLES M. TATELBAUM, TAMPA, FLORIDA ON BEHALF OF THE AMERICAN BANKRUPTCY INSTITUTE TO QUESTIONS FROM SENATOR THURMOND FOR PANEL ON AMERICAN BANKRUPTCY INSTITUTE SURVEY

1. QUESTION: THE BANKRUPTCY CODE PROVIDES THAT A CREDITOR WHO RECEIVES PAYMENT WITHIN THE LAST 90 DAYS BEFORE A BANKRUPTCY FILING CAN DEFEND AGAINST A PREFERENCE RECOVERY ACTION BROUGHT BY A TRUSTEE IF THE CREDITOR CAN ESTABLISH THAT THE PAYMENT WAS MADE IN THE ORDINARY COURSE OF BUSINESS. PRIOR TO THE 1984 AMENDMENTS, THIS DEFENSE COULD BE USED ONLY IF THE PAYMENT TO THE CREDITOR WAS MADE 45 DAYS AFTER THE DEBT WAS INCURRED BY THE DEBTOR. HAS ELIMINATION OF THE 45 DAY TEST REDUCED THE AMOUNT OF PREFERENCE LITIGATION?

ANSWER: The Survey indicated that the amount of litigation has not been curtailed. The Survey did indicate that the focus of the litigation has changed so that the major issue is now the interpretation of the term "ordinary course of business" which is contained in the 1984 Amendment to the preference section (Section 547). I personally believe that trustees are making less claims for preference than in the past, but that issues are being raised which require litigation for resolution. While there appeared to be no question that the amendments needed to be made in 1984 to the preference section, the methodology employed may have created additional problems not contemplated at the time of the enactment of the statute.

2. QUESTION: CONGRESS ENACTED A PROVISION IN 1984 AUTHORIZING BANKRUPTCY JUDGES TO REVIEW INDIVIDUAL DEBTOR FILINGS FOR ABUSE. NEARLY 3/4THS OF THE BANKRUPTCY JUDGES RESPONDING TO THE SURVEY AGREED THAT THERE WAS "NEGLIGIBLE" REVIEW OF DEBTOR FILINGS BY BANKRUPTCY JUDGES. COULD YOU EXPLAIN THE RELUCTANCE BY JUDGES TO REVIEW DEBTOR FILINGS FOR ABUSE?

ANSWER: The 1984 Amendment to Section 707(b) required the

bankruptcy judge to review the bankruptcy filings on the judge's own motion, and if an abuse was found, the judge then becomes the moving party for the dismissal. The role of the bankruptcy judge is that of the arbiter of disputes, rather than as an administrator under the Bankruptcy Act. Bankruptcy judges do not have the opportunity of reviewing files unless a dispute arises. The work load and the role of the judge precludes an addition to the review of chapter 7 filings for abuse. Unfortunately, the 1984 Amendments precluded a creditor from bringing the abuse to the judge's attention. Creditors are best able to review the files and call to the court's attention the abuse. Unfortunately, if a creditor calls the abuse to the attention of the judge, the judge may not act on it.

Another basis for the reluctance of judges to effect the review is the "glitch" in the system created by Section 707(b). If, for example, a bankruptcy judge were to find substantial abuse on his own, bring the matter on for hearing and ultimately dismiss the case, if the debtor appealed a unique problem arises. The debtor is the appealing party or appellant, but who is the appellee? Is the judge required to file a brief and argue the appeal to justify the dismissal? Is the U. S. Attorney required to then represent the bankruptcy judge in the conduct of the appeal? Is the bankruptcy judge's role then being changed to an advocate on appeal? It is this uncertainty of the appellate procedure that has created a major problem.

It is believed that the appointment of new bankruptcy judges

following 1984's Amendments will permit the judges more time to spend on case administration. However, the perception among judges is that the current provisions of Section 707(b), even as modified by the 1986 Amendments, simply does not work.

PERCEPTION AND REALITY:

AMERICAN BANKRUPTCY INSTITUTE RELEASES RESULTS OF SURVEY EXAMINING IMPACT OF SELECTED 1984 AMENDMENTS TO THE BANKRUPTCY CODE

The American Bankruptcy Institute has completed a national survey involving more than 1,000 participants which examined the operation and impact of selected 1984 amendments to the United States Bankruptcy Code. The Survey sought the views of bankruptcy judges, United States Trustees, private lawyers, and estate administrators to determine how certain sections of the 1984 amendments affected the jurisdictional and substantive operation of the bankruptcy system.

The American Bankruptcy Institute is a Washington-based membership organization concerned with the operation of the bankruptcy system. Its membership of 2,000 individuals includes lawyers, judges, trustees, bankers, accountants, credit managers, legislators and academics interested in bankruptcy matters. Senator Dennis DeConcini of Arizona serves as honorary chairman of the ABI. The Survey was conducted by ABI with supervision from the Survey Research Center of the University of Maryland and the Survey Research Division of ATC International, Inc. ("SURRES").

The results of the Survey show that the bankruptcy experts interviewed agree that many of the 1984 amendments either have not been implemented by the bankruptcy courts, or have not had the impact intended by Congress or the amendments' proponents. Among the findings of the Survey are the following:

- The respondents to the Survey generally found the bankruptcy system to be operating well. Nearly three-fourths rated the bankruptcy system as "good to excellent" while approximately one-fourth rated the system as "fair to poor".
- There is a widespread lack of compliance by the bankruptcy courts with statutory deadlines established by Congress. One of the 1984 amendments requires bankruptcy courts to commence hearings on motions to terminate the automatic stay within thirty days after the filing of these motions. But the Survey found that this statutory mandate was met in the Second Circuit only 33% of the time, and in the Eighth Circuit only 38% of the time. (See attached chart.)
- Similarly, although the 1984 amendments require the bankruptcy courts to terminate the automatic stay if the hearing is not commenced within the thirty day period, 22% of those responding to the Survey said that the stay was not terminated in that circumstance as required by statute.
- The degree of compliance with all statutory mandates studied varies greatly in different parts of the country, with the most compliance occurring in the First, Fourth, Sixth, and Eleventh Circuits, and the least in the Second, Third

and Seventh Circuits.

- Neither the attorneys practicing in the bankruptcy courts nor the United States Trustees are challenging the failure by the courts to meet statutory mandates. This failure may result from the fact that the attorneys themselves are on the opposite side of these issues in other cases or from a recognition that the mandates cannot be met in many circumstances.
- There is a perception of "great" abuse in the bankruptcy system, according to 21% of the respondents, and significant variation by locale in this perception, with 30% of the respondents in the Ninth Circuit agreeing with this conclusion.
- Although Congress enacted numerous amendments to the consumer bankruptcy provisions of the Bankruptcy Code in 1984, these amendments did not have a dramatic effect in eliminating perceived debtor abuse of the bankruptcy system. Only 22% of the respondents agreed that the 1984 amendments had effectively dealt with individual abuse in the bankruptcy system.
- Congress enacted a new provision in 1984 authorizing bankruptcy judges to review individual debtor filings for abuse. Nearly three-fourths of the bankruptcy judges responding to the Survey agreed that there was in fact "negligible" review of debtor filings by bankruptcy judges.
- A majority of the respondents agreed that the amendments to Chapter 13 governing "wage earner plans" did lead to increased distributions under such plans. On the other hand, nearly 25% of the respondents reported that the bankruptcy courts were not enforcing the statutory provision requiring debtors under these plans to commit all projected disposable income to repay creditors.
- Although the principal impetus to the 1984 amendments was a reform of the jurisdiction of the bankruptcy court system, nearly 40% of the respondents said that the appellate review provisions of the 1984 amendments were not operating as contemplated by Congress.
- The Survey recommends follow-up evaluations of the United States Trustee system and the potential abuse of the bankruptcy system. It recommends that Congress review such studies before enacting additional amendments to the Bankruptcy Code. The Survey also recommends a more careful monitoring of the compliance by the courts with statutory mandates.

I. THE CONDUCT OF THE SURVEY

The American Bankruptcy Institute initiated the Survey in 1986 for the purpose of determining the impact of certain of the 1984 amendments to the Bankruptcy Code. The Survey interviewed a cross-section of four groups of individuals who are principally involved in the operation of the federal bankruptcy system. A random sample of 94% of the 226 bankruptcy judges was selected for interviews. All 18 of the United States Trustees and Assistant United States Trustees, and all 85 Estate Administrators were included as

potential respondents. Using various lists of lawyers practicing bankruptcy law, a random selection of 977 bankruptcy practitioners was also compiled. (See attached table.)

After various initial contacts, a final list of 1,165 potential respondents was prepared. Of this total, 1,005 or 86% were interviewed using a survey questionnaire developed jointly by a steering committee of ABI and SURRES. This response rate was far above the response rate of 70% expected in surveys of this nature.

The Survey questionnaire contained questions about the bankruptcy process and four substantive areas affected by the 1984 bankruptcy amendments. These four areas concerned (1) jurisdictional changes, which were intended by Congress to respond to the United States Supreme Court's decision in 1982 invalidating the then-existing bankruptcy court system; (2) consumer credit amendments, enacted largely in response to the suggestions of the consumer credit industry to reduce perceived abuses of the bankruptcy system by individual debtors; (3) changes to the bankruptcy preference section, enacted to reduce the ability of bankruptcy trustees to recover payments made to creditors in the last months before a bankruptcy filing; and (4) amendments to the automatic stay provision of the Bankruptcy Code (which forbids actions by creditors to collect debts or repossess collateral from debtors), intended to require more timely hearings when creditors seek relief from the stay to commence collection actions.

The Survey also collected substantial background information from each respondent. This information includes the respondent's current position, years of experience in the bankruptcy system, type of practice (whether principally devoted to representation of debtors, creditors or bankruptcy trustees), size of law firm, and judicial circuit of principal practice. Much of this background information was cross-tabulated with responses to the substantive questions.

In respect of all conclusions reported in the Survey, there is a sampling error of plus or minus 3.1% at a 95% level of confidence.

II. SURVEY RESULTS

A. Background Information

The results of the Survey provide numerous insights into the background of those involved in the bankruptcy system. The Survey shows that the average experience in the bankruptcy system for current bankruptcy judges is 17 years and for lawyers is 11 years. The average experience for those in the United States Trustee offices and for estate administrators is 7 years and 6 years, respectively. This means that the last two groups, who are the "watch dogs" responsible for monitoring the operation of the bankruptcy system, have significantly less experience than those whose actions they are reviewing.

The Survey found that among the lawyer respondents, 34% of their work was debtor related, 35% of their work was secured creditor related, 17% of their work was unsecured creditor related, and 13% of their work was trustee related. The lawyer respondents spent more time on Chapter 11 cases, as did those in the United States Trustee offices, than did the bankruptcy judges or estate administrators. The judges and estate administrators reported spending more time on Chapter 13 cases. The Survey also found a correlation between firm size and type of practice, with creditor lawyers generally practicing in medium and large firms, while debtor lawyers generally practice in small firms principally handling

Chapter 7 liquidation cases and Chapter 13 wage earner plans.

B. Operation of the Bankruptcy System

A significant group of bankruptcy judges found that the 1984 amendments had made the bankruptcy system operate worse than it had previously. This view was held by 31% of the bankruptcy judges, but by only 20% of the lawyer respondents. But the predictions of many that the jurisdictional amendments would paralyze the bankruptcy system have not been borne out, with only 11% of the respondents reporting that their practice had changed substantially.

Another key set of findings concerned perceptions as related to type of practice and locale. The Survey found that so-called creditor and debtor lawyers often shared similar perspectives about the operation of the bankruptcy system. There were not significant variations in the groups' views about the operation of the automatic stay, compliance with statutory mandates, or the changes to the jurisdictional provisions of the Bankruptcy Code. The Survey concludes that the fact that lawyers often represent different groups on different cases may lead to a decrease in partisanship in the lawyers' views about the bankruptcy system. Another key finding concerns the variation in perception depending on the locale of the respondent. There are dramatic differences in the perception of the operation of the bankruptcy system in different parts of the country. This is true not only among lawyer respondents but also among the bankruptcy judges. Thus, 46% of the bankruptcy judges in the Second Circuit rated the system as good to excellent, as did 92% in the Sixth Circuit.

C. Amendments Concerning the Automatic Stay

The first of the four substantive areas discussed in the Survey concerned compliance with provisions in the 1984 amendments affecting the operation of the automatic stay. The automatic stay prohibits creditor action to collect debts owed by, or repossess collateral in the possession of, the debtor as of the time of the bankruptcy filing. A creditor seeking to take action to collect such debts must first move for relief from the stay, which can be granted by the bankruptcy court following notice and hearing.

The Bankruptcy Code provides that an initial hearing on a creditor's motion for relief must be commenced within thirty days of the filing of the motion and that the stay can be continued in effect by the Court pending a final hearing. In response to creditor contentions that the bankruptcy courts were delaying ruling on requests for relief, the 1984 amendments mandate that the final hearing on the creditor's motion must be commenced within thirty days after the conclusion of the preliminary hearing.

The Survey sought to determine whether the bankruptcy courts were complying with these statutory mandates. Approximately one-half of the respondents reported that the initial hearing was commenced "almost always" within the thirty day statutory period. The statutory mandates were met either "hardly ever" or only "some of the time" according to 26% of the respondents, with another 23% reporting that the hearing was timely commenced "most of the time." Thus, the statutory hearing periods were not met, at least on some occasions, according to one-half of the respondents.

There was a clear difference in perception among the types of respondents. While 45% of the lawyer respondents reported that timely hearings were commenced all or nearly

all of the time, 70% of the judge respondents so reported. Similarly, while 13% of the lawyer respondents reported that timely hearings were hardly ever held, only 2% of the judge respondents so reported. There were significant variations by circuit, with the Fourth, Sixth, and Eleventh Circuits having the highest degree of compliance, and the Second and Eighth Circuits having the lowest. In the Second Circuit, for example, only one-quarter of the lawyers reported that timely hearings were held "almost all the time."

The respondents reported a similar failure to comply with the mandate to terminate the stay if the hearing is not timely commenced. The stay continued notwithstanding the failure to hold a hearing almost all the time reported 22% of the respondents; only 42% said that this "hardly ever" happened. The most compliance with this mandate was in the Fourth, Sixth, Tenth and Eleventh Circuits, while the least compliance was in the First, Second and Third.

The Survey found substantial agreement that the 1984 amendments did not have the desired effect of accelerating the final hearings on creditor motions. When asked whether the amendments had increased the frequency with which courts commence final hearings on creditor motions, 61% of the respondents said there was no change while 36% said there was an increase.

The Survey sought to determine whether the failure to comply with the statutory mandates was correlated with the caseload per judge among the circuits. The Survey found no correlation between the number of new case filings per judge by circuit and the Survey results concerning the failure to comply with the statutory mandates.

D. Amendments Concerning Recovery of Preferences

One provision of the 1984 amendments that was clearly intended to benefit creditors was the deletion of the so-called forty-five day rule. The Bankruptcy Code provides that a creditor who receives a payment within the last ninety days before a bankruptcy filing can defend against a preference recovery action brought by a trustee if the creditor can establish that the payment was made in the ordinary course of the debtor's business.

Until the 1984 amendments, the Bankruptcy Code provided that this defense could be used only if the payment to the creditor was made within forty-five days after the debt was incurred by the debtor. Creditor lawyers representing commercial paper lenders objected to the forty-five day test, contending that repayment of commercial paper debt could be an ordinary course payment even though made more than forty-five days after the initial loan. Congress agreed with this argument and deleted the forty-five day test as part of the 1984 amendments.

There was significant litigation before 1984 on the method for determining when a debt was incurred and when it was repaid. Thus, it could be expected that the elimination of the forty-five day test would reduce the amount of preference litigation since the timing issue was no longer a subject of dispute. But the Survey found no agreement on this proposition, with the respondents evenly divided as to whether the preference amendment had led to more or less litigation. But the lawyer respondents agreed, more than other respondents, that creditors were more successful in defending against preference actions since the 1984 amendments and that there were more settlements of such actions since the enactment of the amendments. Finally, while elimination of the forty-five day test could be expected to result in more liberal credit policies, most respondents perceived no change,

and of those who perceived change, the majority thought credit policies had become less liberal.

E. Amendments to the Consumer Credit Provisions

The consumer credit industry was a major force behind many of the 1984 amendments, contending that changes were needed to prevent individual debtors from misusing the bankruptcy system. Changes were enacted in 1984 both to allow bankruptcy judges to review Chapter 7 filings for substantial abuse and to require that Chapter 13 plans dedicate all projected disposable income to repay unsecured creditors who object to the debtor's plan.

The Survey concludes that the consumer credit amendments did not have a dramatic effect on the perceived abuses of the system. While 37% of the respondents reported increased distributions to creditors, 57% reported no change in the amount of distributions. Even after the amendments, about 57% of the respondents reported "moderate" or "significant" abuse of the system by individual debtors. (See attached chart.) Perhaps not surprisingly, creditors' lawyers reported more abuse than did debtor lawyers, and judges more often reported "negligible" abuse than did the lawyer respondents. The United States Trustee respondents reported more abuse than any other category. Only 22% of all respondents rated the 1984 amendments as having a "good" or "excellent" impact in reducing abuse by individual debtors.

The Survey found widespread agreement that, while the 1984 amendments gave the bankruptcy courts the statutory authority to review Chapter 7 filings for abuse, the bankruptcy judges were not utilizing that power. Two-thirds of the respondents said that the judges were not generally reviewing these filings. The judges themselves agreed with this conclusion, with 72% of the judges reporting "negligible" review of filings for abuse. There is a wide disparity by circuits, with 70% of the respondents in the Seventh Circuit reporting that "no" such hearings were held, while less that 30% of those in the Fourth Circuit reported "no" hearings having been held.

The amendments requiring increased payments under Chapter 13 plans appear to have been more successful. More than half the respondents said that Chapter 13 plan distributions had increased, and nearly three-quarters of these reported that parties sometimes were relying on the 1984 amendments to require increased distributions. But about 45% reported no change in the number of "zero payment" plans being confirmed and nearly a quarter of the respondents reported that bankruptcy courts were confirming plans without compliance with the statutory mandate that the plan commit all disposable income to the repayment of creditors.

F. Amendments to the Jurisdictional Provisions

The need to respond to the Supreme Court's 1982 decision in *Northern Pipeline Co. v. Marathon Pipeline Co.* was one of the principal forces behind the 1984 amendments. Congress was then faced with the need either to grant bankruptcy judges Article III status or to restrict the jurisdiction of the bankruptcy courts and increase the supervision by the district courts. Congress opted for the latter alternative and imposed limitations on the jurisdiction of the bankruptcy courts to decide certain issues.

The 1984 amendments divided the issues before bankruptcy courts into "core" and

"non-core" proceedings. Core proceedings include most of the traditional valuation, exemption and discharge issues faced by bankruptcy courts; non-core proceedings generally include non-bankruptcy law matters, such as certain state law lawsuits brought by a debtor or a trustee. The 1984 amendments provide that bankruptcy courts can issue only proposed decisions in non-core proceedings, with the final decision to be made by a district court. Bankruptcy courts can issue final orders only in core proceedings, with such orders subject to review on appeal using a "clearly erroneous" standard of review with respect to findings of fact.

Opponents of the 1984 amendments to the jurisdictional provisions predicted that the provisions would wreak havoc with the bankruptcy system and would be unworkable. These predictions have not been borne out according to the Survey. Many respondents acknowledged that there is now more time devoted to jurisdictional questions and that it now takes longer to reach the merits of issues. But the Survey also found that the time devoted to jurisdictional disputes appears to be decreasing as participants in the system become more familiar with the 1984 amendments. The definition of core proceedings was rated as "good" by 50% of the respondents, with 32% finding the definition to be underinclusive.

A more disturbing finding in the Survey is that 38% of the respondents said that the district courts devoted more time to reviewing final orders in core proceedings than they devoted to reviewing recommended decisions in non-core proceedings. One of the principal goals of the 1984 amendments was to ensure that district courts entered the final orders in non-core proceedings, since those proceedings were of the type found by the Supreme Court not to be within the traditional jurisdiction of the bankruptcy courts. On the other hand, the Bankruptcy Rules provide that the review of findings of fact in core proceedings is to be by a clearly erroneous standard. If the district courts are devoting less attention to reviewing recommendations in non-core proceedings than they are to final orders in core proceedings, yet another of the statutory mandates of the 1984 amendments is being ignored.

III. PROJECTIONS CONCERNING 1986 AMENDMENTS

The Survey concentrated on the impact of selected provisions of the 1984 amendments. While the Survey was in progress, Congress enacted additional amendments in 1986. These amendments included the provision of additional bankruptcy court judgeships, a virtual nationwide expansion of the pilot United States Trustee program, an amendment to Section 707(b) allowing the United States Trustee to seek bankruptcy court review of individual debtor petitions, and the enactment of Chapter 12 which is concerned with family farmer bankruptcies.

The results of the Survey permit certain projections about the likely impact of the 1986 amendments. For example, the Survey results concerning the lack of compliance with statutory mandates indicate that the addition of 52 bankruptcy court judgeships will not necessarily result in greater compliance with statutory mandates. This conclusion is based on the lack of correlation by circuit between new caseload per judge and compliance with statutory mandates.

Another projection derived from the Survey results is that the expansion of the United States Trustee system is likely to result in a more prosecutorial approach to per-

ceived abuse of the bankruptcy system. The responses by the United States Trustees indicated more concern with fraud and abuse than was expressed by other respondents. The United States Trustees adopted a far more prosecutorial approach than did the estate administrators in office in non-pilot districts. Thus, the expansion of the United States Trustee program should lead to a more aggressive approach toward alleged fraud and abuse. The Survey suggests a follow-up report after the expansion of the United States Trustee program to see if the program is effective in reducing perceived abuse and fraud.

The Survey raises additional questions about the amendments enacted in 1986. While Congress amended Section 707(b) to allow United States Trustees to seek bankruptcy court review of individual debtor filings for substantial abuse, the Survey shows that United States Trustees devote little time to Chapter 7 issues, so there is some question whether the amendment will have any positive impact. Similarly, Congress modeled Chapter 12 on many of the provisions of Chapter 13, including the provision of Section 1325(b) requiring dedication of all projected disposable income to repay unsecured creditors. But the Survey reported that 44% of the respondents said that Section 1325(b) had not resulted in increased distributions to creditors. Had Congress had the Survey results before enacting Chapter 12, it may have taken a different approach instead of following the approach of Section 1325(b).

IV. GENERAL CONCLUSIONS

The Survey reaches a number of general conclusions about the bankruptcy system, those participating in it, and the effect of the 1984 amendments. Some of the conclusions are set forth at the beginning of this Summary. Among the other conclusions are:

1. There is significant non-compliance with various statutory mandates enacted by Congress. The degree of non-compliance varies significantly by Circuit, with the least non-compliance found in the First, Fourth, Sixth and Eleventh Circuits and the most non-compliance found in the Second, Third and Seventh Circuits.
2. The variation by Circuit in the degree of compliance and in the method of case administration may lead to significant forum shopping by creditors and by debtors alike. If this occurs, the administration of the bankruptcy system will become less effective than it is today.
3. There is a perception of a significant amount of abuse in the bankruptcy system. This perception varies greatly by region, with the greatest abuse found in the Fifth, Ninth and Eleventh Circuits. The perception of abuse varies significantly between judges and lawyers, and by the experience of the lawyer-respondents.
4. Some of the respondents also indicated a perception of significant abuse in Chapter 11 cases, with debtors utilizing Chapter 11 for the purpose of delay rather than reorganizing. Other respondents also reported a perception of a hiding of assets and the undervaluation of assets. These factors should be considered by the new nationwide United States Trustee system.

end

WEDNESDAY, JULY 22, 198. The Washington Post

BUSINESS

Study Finds Major Flaws in Nation's Bankruptcy Syster

By Michael Abramowitz
Washington Post Staff Writer

A sweeping new study of the nation's bankruptcy system has found major problems in the administration of bankruptcy cases, from judges who ignore parts of the law to companies and individuals who abuse the system.

Although the bankruptcy system is working reasonably well on a day-to-day basis, it faces a serious loss of credibility if the flaws are not corrected, according to bankruptcy judges and lawyers associated with the study released yesterday.

The most serious problem identified in the study, according to the experts, is the failure of many judges to follow the congressional mandate to protect the interest of creditors. Congress in part changed the bankruptcy law in 1984 because of a perception that debtors were treated too leniently, but the study indicated that either the new rules are not being followed or have not had their intended effect.

"In some areas of the country, the judges are not doing what they are supposed to be doing," said George C. Paine, federal bankruptcy judge in Nashville and one of the overseers of the survey of more than 1,000 judges, trustees and other lawyers involved with bankruptcy cases.

Experts cited the sheer crush of bankruptcy filings in recent years as one of the prime reasons judges are not always complying with federal bankruptcy rules. Unusually stringent provisions of the bankruptcy code, including requirements that hearings start within a certain length of time, were also cited as reasons for noncompliance.

The survey also indicated that lawyers are not willing to challenge judges who ignore the law. This problem is exacerbated, experts said, because bankruptcy are a relatively small part gal community and often time and time again before judges.

Whatever the reasons compliance, bankruptcy law Congress needs to rethink its recent efforts to add new ments to the system, or more resources and judges.

Sen. Dennis DeConcini one of the Senate's leading ties on bankruptcy, said he prised at the extent of [no ance]" shown in the survey.

See BANKRUPT, F2, Co

Study Finds Flaws in Bankruptcy System

BANKRUPT, From F1

a little too early to tell what changes we need," he said, adding that he expects hearings to be called on the matter.

The survey released yesterday was carried out during the past year by the American Bankruptcy Institute, a group of professionals involved in bankruptcy matters. It comes amid a staggering increase in the volume and complexity of bankruptcy cases around the nation that experts say has resulted from the economic distress in some parts of the country as well as the growing use of the bankruptcy code as a business reorganization device.

According to figures released with the study yesterday, a record 477,843 individuals and businesses filed for bankruptcy in the year ended June 30, 1986, and throughout the first nine months of the current fiscal year, 411,309 bankruptcies have been reported.

The study was primarily intended to assess the effectiveness of the 1984 amendments to the bankruptcy code, but it also highlighted several broader trends. Among the key findings:

- There is a significant degree of noncompliance by judges with various legal requirements of the code, although this varies greatly by judicial circuit. For instance, Congress in 1984 required bankruptcy courts to schedule hearings within 30 days when creditors seek to lift the bankruptcy code's automatic prohibition against their efforts to collect their debts or seize collateral. However, about one-half the survey respondents said the deadlines were not met on at least some occasions, while one-quarter said they were hardly ever met.
- There is "considerable perceived abuse of the bankruptcy process." Virtually all the bankruptcy professionals surveyed perceived some abuse, while 21 percent perceived a "great deal of abuse." Respondents differed widely on the nature of the abuses, but among the problems cited were individuals hiding assets from creditors or understating their worth.

A large group of respondents, the survey showed, believe that many companies are abusing the system by filing under Chapter 11 with no intention of reorganizing, but only to delay business failures. Under Chapter 11 of the federal bankruptcy code, debtors are temporarily protected from creditors while devising a plan of reorganization.

- The 1984 changes enacted by Congress that were studied by the institute did not dramatically change the bankruptcy system. Only 37 percent of the respondents thought the system was better as a result of the changes, while 42 percent perceived no changes.

The changes were designed to prevent individual debtors from abusing the system.

The Washington Times

PAGE C8 / *WEDNESDAY, JULY 22, 1987*

Bankruptcy law changes not always implemented

By David R Sands
THE WASHINGTON TIMES

Virginia and Maryland came out well, but a new survey of bankruptcy lawyers, judges and trust officers released yesterday found substantial dissatisfaction nationwide with the U S bankrupcty system

The survey, conducted by the *American Bankruptcy Institute as part* of its two-day annual convention here, reported "significant non-compliance" with many key provisions of the 1984 amendments to the United States Bankruptcy Code in such areas as expedited hearings and abuse of bankruptcy filings

"*The most important finding* [of the survey] is that amendments to the bankruptcy code intended to have a dramatic impact on the system did not cause that impact," said Karen Gross, head of the study and a bankruptcy professor at N York Law School

"It *showed the amendments have* be ineffective in achieving their goals," s said. "There is generally judicial n compliance with congressional ma dates The law is not having an impa because it is not being implemented."

The ABI survey polled more than 1,0 professionals in the industry, includi 74 percent of all bankruptcy cou judges, and more than 750 lawyers wor ing in the field. Survey results we broken down by federal court circuits

In contrast to the national trend in t survey, the 4th Circuit, which incluc Maryland, Virginia, West Virginia, Nor Carolina and South Carolina, scored w in compliance with the 1984 changes the law

Local bankruptcy courts were parti

see SURVEY, *page C10*

SURVEY

From page C7

larly effective, according to the survey, in implementing so-called Section 707(b) reviews, under which US trustees now have the power to seek dismissal of individual bankruptcy filings for substantial abuse of the process.

Results for the District of Columbia, which constitutes the 12th Circuit, were not broken out in the report.

The 4th Circuit ranked with the 1st, 6th, and 11th circuits in complying with the 1984 changes to the bankruptcy code, while the 2nd, 3rd and 7th circuits had the worst records concerning the new laws, the survey found.

"It's not surprising the 4th Circuit came out well, at least from my experience," said William J Perlstein, a Washington lawyer who helped author the survey's summary

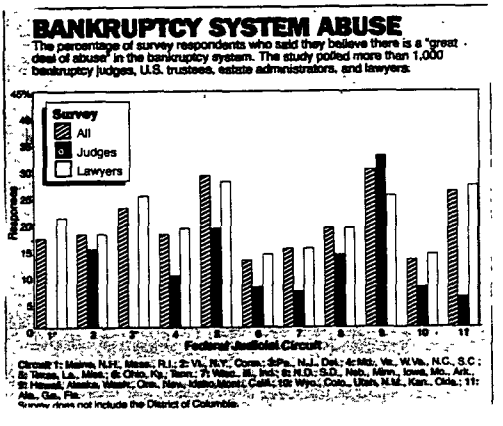
"Even with the heavy dockets all the judges have, there's much more respecting of deadlines here than you have in Texas or California," he said.

In the 2nd Circuit, which includes New York City, survey respondents said courts were meeting a congressionally mandated deadline to commence hearings on terminating automatic stay motions within 30 days in only one third of all bankruptcy cases.

*Some bankruptcy lawyers yester-*day expressed general dissatisfaction with the 1984 reforms of the Bankruptcy Code, saying Congress had tried to fix a system that wasn't broken and hadn't allocated the resources to do the job right

Byron Cordero, a bankruptcy *manager with Chase Manhattan* Bank N.A., said Congress "has not provided enough bodies" in the U.S. Trustee's Office to cope with the number of bankruptcy filings on the dockets in the greater New York area

American Bankruptcy Institute *officials stressed that the survey* was not a hard data polling, but a reflection of attitudes among professionals on how the current bankruptcy system is working



American Bankruptcy Institute

Perception and Reality:

American Bankruptcy Institute Survey on Selected Provisions of the 1984 Amendments to the Bankruptcy Code



Study Conducted By

The Steering Committee of the American Bankruptcy Institute

The Honorable George C. Paine, II, Chair;

Professor Karen Gross, Reporter;

and Charles M. Tatelbaum, Evaluator

In conjunction with

The Survey Research Center of the University of Maryland and

The Survey Research Division of ATC International, Inc.

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American Bankruptcy Institute . 107 Second Street, NE . Post Office Box 2187 . Washington, DC 20013-2187
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PREFACE

When the Steering Committee commenced its work over one year ago, many of us did not realize the magnitude of the task we were about to undertake. The Steering Committee has been ever so ably assisted by the Survey Research Center of the University of Maryland, which walked with us every step of the way. They not only made sure we "did things right" but they did so with patience, thoughtfulness and remarkable insight. We consider ourselves fortunate to have had them with us as part of the project.

The ability to undertake this Survey required, above all else, the vision of the American Bankruptcy Institute, with its firm commitment to exploring and gathering information about the bankruptcy process. The Institute's leadership, through Harry D. Dixon, Richard A. Gitlin and L. E. Creel, has done much more than insure that the requisite funding, not an insubstantial sum, was available for the Survey. ABI's leaders have given generously of their time and insight in the hope that the Survey will be a significant contribution to bankruptcy scholarship. ABI's leadership has allowed the Steering Committee to proceed with complete freedom and independence and has delegated full responsibility for the execution of the Survey to the Committee. This commitment reflects the strength and quality of the individuals with primary responsibility for ABI's operation, and we hope that the Steering Committee has discharged its responsibility with an equal commitment to quality and concern for the enhancement of information available about the bankruptcy process.

The Survey required a great deal of time and effort from a number of individuals, and the Steering Committee would like to extend its thanks to all of you. In particular, the Steering Committee thanks G. Timothy Leighton, ABI's Executive Director, whose constant availability, wisdom and level-headed approach throughout the project assisted us immeasurably. Thanks is also given to Craig Taschner, New York Law School class of 1987, for his careful research assistance and to the New York Law School faculty secretaries for their patience, care and untiring efforts in preparing the manuscript.

G.C.P.
K.G.
C.M.T.

Perception and Reality:
Survey on Selected Provisions of the
1984 Amendments to the Bankruptcy Code

Section I

INTRODUCTION

In 1986, the American Bankruptcy Institute ("ABI"), a not-for-profit, non-partisan organization which serves as a national clearinghouse for information and developments in bankruptcy[1], undertook a national survey (the "Survey") on certain sections of the 1984 amendments to the Bankruptcy Code.[2] The 1984 Amendments both added to and amended provisions of the Bankruptcy Code as well as Title 28 of the United States Code.[3] Since over one hundred and seventy-five changes were made,[4] they could not all be effectively studied in a single survey.[5] Therefore, four specific areas of change were selected for study by the Steering Committee appointed by the Institute to oversee the Survey (the "Steering

1. The American Bankruptcy Institute was founded in 1982 and its membership of approximately 2,000 includes lawyers, judges, trustees, bankers, accountants, credit managers, legislators and academics interested in bankruptcy matters. Through its varied membership, the Institute serves to establish a network for thoughtful and timely consideration of the issues confronting the many participants in the bankruptcy process. ABI does not represent any particular interest group within the bankruptcy process but rather seeks to promote interdisciplinary study and evaluation of the bankruptcy system.

2. These amendments form a part of The Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98. Stat. 333 (codified as amended in scattered sections of 11 U.S.C. and 28 U.S.C.). The 1984 Amendments are hereinafter referred to as the "1984 Amendments" or the "Amendments". This report utilizes the term "Bankruptcy Code" and the "Code" interchangeably to signify the Bankruptcy Reform Act of 1978, Pub. L. No. 95-595, 92 Stat. 2549 (codified at 11 U.S.C. §§ 101-151326), as amended by the 1984 Amendments. It should be noted that the Bankruptcy Code was further amended in 1986 with the passage and signing into law of the Bankruptcy Judges, United States Trustees and Family Farmer Bankurptcy Act of 1986, Pub. L. No. 99-554, 1986 U.S. Code. Cong. & Admin. News (100 Stat. ___). The 1986 amendments are hereinafter referred to interchangeably as the "Bankruptcy Act of 1986" and the "1986 Amendments".

3. The 1984 Amendments are divided into four titles. Title I deals with bankruptcy jurisdiction and procedure and contains amendments to Title 28 of the United States Code. Title II deals with judgeships, also amending Title 28. Title III is divided into ten subtitles, all of which contain amendments to Title 11. Subtitle A contains the Consumer Credit Amendments; Subtitle B contains the Amendments relating to Grain Storage Facility Bankruptcies; Subtitle C contains the Leasehold Management Amendments; Subtitle D contains amendments to Section 523 relating to Discharge of Indebtedness by Persons Driving While Intoxicated; Subtitle E relates to the Salary and Expense Fund; Subtitle F deals with amendments regarding Repurchase Agreements; Subtitle G contains amendments to Section 365 for Timeshare Consumers; Subtitle H contains Miscellaneous Amendments to Title 11; Subtitle J refers to Collective Bargaining Agreements; and Subtitle K contains miscellaneous provisions including effective dates.

4. For a section by section analysis of the 1984 Amendments, see "Bankruptcy Amendments and Federal Judgeship Act of 1984: Law and Explanation," Commerce Clearing House, Inc., July 1984.

5. SURRES (*see infra*, note 13) advised the Steering Committee (*see infra*, note 6) that the optimum interview length was thirty minutes. SURRES and the Steering Committee determined, after pre-testing of the Survey Questionnaire, that only four substantive areas could be tested effectively.

Committee"),[6] namely, the changes to the automatic stay provision,[7] the deletion of the "forty-five day rule" relating to preference recoveries,[8] the consumer credit amendments,[9] and the jurisdictional changes.[10] These topics were chosen principally because a number of

6. The Steering Committee consists of twelve (12) individuals drawn from varied backgrounds and experience to help insure that the Survey was conducted in a non-partisan manner. The Steering Committee members are as follows: **Howard J. Beck, Jr.**, formerly Clerk of the United States Bankruptcy Court, Roanoke, Virginia, now associated with Glenn, Flippin, Feldmann & Darby, Roanoke, Virginia; **Thomas D. Drennan**, President of Wells Fargo Business Credit, Lewisville, Texas; **Jean K. FitzSimon**, formerly Senior Attorney-Advisor, United States Department of Justice, Washington, DC, now associated with Meyer, Hendricks, Victor, Osborn & Maledon, Phoenix, Arizona; Professor **Dale Beck Furnish**, Arizona State College of Law, Tempe, Arizona; **Leonard Gilbert**, a shareholder of Carlton Fields Ward Emmanuel Smith & Cutler, Tampa, Florida; Professor **Karen Gross**, New York Law School, New York, New York; The Honorable **George C. Paine, II**, Chief Judge, United States Bankruptcy Court for the Middle District of Tennessee in Nashville; **Louis P. Rochkind**, partner with Jaffe, Snider, Raitt and Heuer, Detroit, Michigan; **Thomas A. Rose**, Deputy General Counsel, Federal Deposit Insurance Corporation, Washington, DC; **Daniel Scouler**, Manager of the Reorganization and Insolvency Section, Arthur Young and Company, New York, New York; **Charles M. Tatelbaum**, partner with Kass, Hodges and Massari, Tampa, Florida; and **David B. Ward**, Senior Vice President for Government Relations, Beneficial Management Corporation, Peapack, New Jersey. All members of the Steering Committee also serve as Directors of ABI. Steering Committee members have acted in their personal capacity and the interpretations and conclusions contained in this report do not necessarily reflect the views of their respective organizations and institutions.

Judge Paine chaired the Steering Committee. Professor Gross served as the Reporter for the Survey. G. Timothy Leighton, ABI's Executive Director, served as the project director. Judge Paine, Professor Gross and Mr. Tatelbaum served throughout the project as the subcommittee with primary responsibility for drafting the Survey Questionnaire, overseeing the data collection, analyzing the data ultimately produced and drafting this report.

7. Subtitle H of Title III of Pub. L. No. 98-353 (captioned Miscellaneous Amendments to Title 11) amended Section 362(e) of the Code to insure that hearings in respect of relief from the stay are commenced within 30 days after request for such relief and that if the initial hearing is a preliminary hearing, the final hearing is to be commenced within 30 days after conclusion of the preliminary hearing. For a fuller discussion of the changes to the automatic stay provision, see Miller and Bienenstock, "Bankruptcy Restructuring Promises Few Reforms," Legal Times, July 30, 1984; Bienenstock, *Bankruptcy Reorganization* 144-9 (1987). Surprisingly, this change has received less publicity than some of the other of the 1984 Amendments. *See* Riesenfeld, "Forward to Symposium on Bankruptcy," 38 Vand. L. Rev. 665, 670 (1985).

8. Subtitle H of Title III of Pub. L. No. 98-353 (captioned Miscellaneous Amendments to Title 11) amended Section 547 (c) (2) of the Code by deleting the reference therein to debt incurred within 45 days. The deletion of this time period means that a trustee could not seek to avoid an otherwise preferential transfer if such a transfer was made in payment of a debt incurred in the ordinary course of the debtor's and the creditor's respective business or financial affairs in accordance with ordinary business terms. For a fuller discussion of the meaning of the deletion of the forty-five day rule, see Countryman, "The Concept of a Voidable Preference in Bankruptcy," 38 Vand. L. Rev. 713 (1985).

9. The consumer credit amendments are contained in Subtitle A of Title III of Pub. L. No. 98-353 (collectively, the "Consumer Credit Amendments"). These amendments, among other things, added Sections 707 (b) and 1325 (b) to the Code. Section 707 (b) permits the court to dismiss an individual debtor's Chapter 7 case if his debts are primarily consumer debts and such individual is substantially abusing the provisions of Chapter 7. Section 1325 (b) requires that the debtor contribute all of his projected disposable income to his plan if creditors are not being paid in full and object to the Chapter 13 plan as proposed by the debtor. For a fuller discussion of the Consumer Credit Amendments, see Morris, "Substantive Consumer Bankruptcy Reform in the Bankruptcy Amendments Act of 1984," 27 Wm & Mary L. Rev. 91 (1985); Breitowitz, "New Developments in Consumer Bankruptcies: Chapter 7 Dismissal on the Basis of Substantial Abuse," 59 Am. Bankr. L. J. 327 (1985) Part I; 60 Am. Bankr. L. J. 33 (1986) Part II; Gross, "Preserving a Fresh Start for the Individual Debtor: The Case for Narrow Construction of the Consumer Credit Amendments," 135 U. Pa. L. Rev. 59 (1986).

10. The jurisdictional changes constitute Title I of The Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333. The jurisdictional changes were a response to the United States Supreme Court decision in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982) which held that the bankruptcy court system under the Code was unconstitutional. Title I contained a number of changes including limitations on what particular matters bankruptcy court judges can hear and decide with finality and expanding the situations in which the bankruptcy court must abstain. For a fuller discussion of the jurisdictional changes, see Miller and Bienenstock, "Bankruptcy Restructuring Promises Few Reforms," Legal Times, July 30, 1984 at 30; Bienenstock, *supra* note 7; King, "Jurisdiction and Procedure Under the Bankruptcy Amendments of 1984," 38 Vand. L. Rev. 675 (1985).

the constituencies involved in the bankruptcy process had an interest in the impact of these changes. Several more generalized topics were also chosen, in large part to develop an understanding of the perception of the bankruptcy system as a whole before and after the 1984 Amendments.

The selected topics formed the basis of an approximately sixty (60) question survey instrument consisting primarily of closed-ended questions[11] (the "Survey Questionnaire")[12] which was jointly developed by the Steering Committee and the Survey Research Center of the University of Maryland and the Survey Research Division of ATC International, Inc. (collectively, "SURRES").[13] The Survey Questionnaire also contained a script for the interviewers to maximize standardization.[14] SURRES successfully pre-tested the Survey Questionnaire in August 1986 on twelve randomly selected individuals involved in the bankruptcy process who were representative of those who would ultimately be surveyed.[15]

Following completion of the pre-test, SURRES randomly selected 1293 potential respondents from across the United States, all of whom were involved in the bankruptcy process, to participate in an approximately 30 minute telephonic interview based on the Survey Questionnaire.[16] This group consisted of United States Bankruptcy Judges, United States Trustees, Estate Administrators and lawyers. From this group of potential respondents, 1005 interviews were conducted by trained interviewers over a six month period spanning from August 1986 to January 1987.[17] All data obtained from the interviews was coded into the Computer Assisted Survey Execution System ("CASES"), a statistical computer program utilized by SURRES for data collection. Based on the number of completed interviews, there was an approximate response rate of 86% for the Survey,[18] far above the ex-

11. Closed ended questions are defined as "those to which the respondent must choose between fixed alternative answers ..." Jones, *Research Methods in the Social and Behavioral Sciences* 151 (1985). For a discussion of some of the advantages of closed ended questions, *see* Jones at 151-154. The Survey Questionnaire contained approximately six open-ended questions, defined as those questions which can be answered in any way the respondent chooses. *See* Jones at 151-154. *See also* Vinson and Anthony, *Social Science Research Methods for Litigation*, 75-77 (1985).

12. The Survey Questionnaire is appended to this report as Appendix A.

13. SURRES is a non-partisan survey research center based in Calverton, Maryland. It employs 12 full-time professionals, inclusive of members of the faculty of the University of Maryland and has a part-time staff of some 35 individuals who serve as interviewers and coders. SURRES develops, conducts and evaluates statistical research projects and since its inception in 1984 has been involved with approximately 35 survey research projects. These include projects for federal government agencies, Maryland state government agencies and firms in the private sector. SURRES has been involved in a broad range of survey projects utilizing telephonic interviewing, personal interviews and mailed questionnaires. During the term of the Survey, SURRES has acted as the program manager. Ted Langevin, the director of SURRES, served as the project officer for the Survey.

14. *See* Jones, *supra* note 11, at 142-3.

15. For a fuller discussion of the methodology employed in the Survey, see Section II herein. For a brief discussion of the significance of pre-testing, *see* Jones, *supra* note 11, at 154.

16. For a more detailed discussion of the selection of respondents, see Section II of this report discussing methodology. Of the 1005 respondents interviewed, 166 were United States Bankruptcy Judges, 751 were lawyers, 14 were United States Trustees, 74 were Estate Administrators. In terms of percentages, approximately 17% of the Respondents were judges, 75% were lawyers, 1% were United States Trustees and 7% were Estate Administrators.

17. For a more complete discussion of the training process for the interviewers, see Section II herein discussing methodology.

pected response rate of 70% anticipated in surveys of this nature.

The data collected from the completed interviews of the respondents (the "Respondents") was tabulated in January 1987 utilizing the internationally recognized computer program known as the Statistical Package for Social Sciences ("SPSS").[19] As more fully described in Section II of this report captioned "Methodology", a number of cross tabulation tables were utilized to assist in the evaluation of the data. All the data produced was then analyzed and evaluated by the drafting subcommittee of the Steering Committee[20] and SURRES in the Spring of 1987. This report reflects the results of that analysis and evaluation. In respect of all conclusions reported, there is a sampling error of plus or minus 3.1% at a ninety-five percent (95%) level of confidence.[21]

The Survey was designed to achieve a number of goals. First and foremost, it was intended to study both the **effect** and **effectiveness** of the 1984 Amendments selected for study and to suggest, wherever possible, explanations for the results observed. The need for this type of study was exemplified by the significant amount of media attention the Amendments received at or around the time of their enactment[22] and ongoing speculation and debate among the various constituencies in the bankruptcy process on how the Amendments have effected and do effect the bankruptcy system.[23] The issue of "effectiveness" is more difficult to assess as, at least at one level, the "effectiveness" of the Amendments may well hinge on what particular constituency is responding to the question asked. However, to the extent one can glean the purpose and function of the Amendments from the legislative history surrounding their enactment,[24] it is possible to evaluate more objectively whether and to what extent the Amendments have achieved their purported goals.

18. For a further discussion of the response rate and the refusal rate, see Section II of the report discussing methodology.

19. *See* Vinson and Anthony, *supra* note 11 at 214-5.

20. *See supra* note 6.

21. For a more complete discussion, see Section II dealing with the methodology employed in the Survey.

22. At the time of the passage of the 1984 Amendments, there was a fair amount of media attention given to these changes. *See* Rose, "Bankruptcy Bill Augers Precious Little Reform," Legal Times, July 30, 1984, at 23; "Something for Everybody in the New Bankruptcy Law," Business Week, July 16, 1984, at 27; "Bankruptcy Bill Approved by Congress Includes Reforms of Consumer Code," Washington Financial Reports, July 9, 1984, at 34; Taylor, "Business and The Law: Bitter Dispute on Bankruptcy," The New York Times, July 24, 1984, at 2, col. 1; "A Further Bankruptcy Mess," The New York Times, July 17, 1984, at 20, col. 1; Scherschel, "Going Broke? What the New Bankruptcy Laws Mean to You," U.S. News and World Report, July 19, 1984, at 115; Lieberman, "Bankruptcy Bill Gives Protection to Creditors," American Banker, July 6, 1984, at 1.

23. There have been a plethora of articles on the 1984 Amendments, some of which deal with the amendments as a whole while others address specific amendments. These articles have appeared in the law reviews, trade journals and the public press. A sampling of the available literature follows. Barkley, "The Amended Bankruptcy Code," 88 Credit and Fin. Man. 14 (1986); Chatz and Schumm, "1984 Code Amendments -- Fresh From the Anvil," 89 Com. L. J. 317 (1984); King, "Jurisdiction and Procedure Under the Bankruptcy Amendments of 1984," 38 Vand. L. Rev. 675 (1985); Miller and Bienenstock, "Bankruptcy Restructuring Offers Few Reforms," Legal Times, July 30, 1984, at 30; Gross, "Recent Bankruptcy Developments," 88 Credit and Fin. Man. 9 (1986); Note, "Rejection of Collective Bargaining Agreements in Chapter 11 Reorganizations: The Need for Informed Judicial Decisions," 134 U. Pa. L. Rev. 1235 (1986).

24. There is actually very little "official" legislative history accompanying the 1984 Amendments. The Amendments were passed without an official report from either the House or the Senate. Statements were made on the floors of the House and Senate on the date of passage of the Amendments, namely June 29, 1984. *See e.g.*, 130 Cong. Rec. H7489-7500, S8887-8900 (daily ed. June 29, 1984); 130 Cong. Rec. S7615-25 (daily ed. June 19, 1984). However, dating back to 1979, there were hearings on various proposed amendments and these

The Survey was also designed to fill a gap in existing bankruptcy scholarship and is unique among those studies which have been completed. First, there have been perilously few studies in bankruptcy to date.[25] Second, most of the existing studies have focussed on consumer bankruptcies[26] and hence, there has been little attention given to the issues of interest to those involved in Chapter 11 cases.[27] Third, the vast majority of the studies conducted has focussed on actual case filings, rather than personal interviews.[28] Therefore, the data obtained does not tend to reveal how the participants in the bankruptcy process perceive its operation. Fourth, because the vast majority of the studies is based on case files, by the time the data is reported, there has been a considerable time lag. This has produced data which is dated.[29] Lastly, at least one of the existing studies has received substantial criticism for partisanship and flaws in methodology, thereby tainting the significance of the results obtained therein.[30]

hearings, while not "legislative history," do provide some insight into the rationale underlying the proposals that were being advocated by those testifying. *See e.g. Hearings before the Senate Subcommittee on Courts of the Committee of the Judiciary*, 97th Cong., 1st Sess., on the Bankruptcy Reform Act of 1978, April 3 and 6, 1981; *Hearings Before the Senate Committee on the Judiciary*, 97th Cong., 2nd Sess., on the Bankruptcy Reform Act of 1978, July 22 and 23, 1982; *Hearing Before the Senate Subcommittee on Courts of the Committee of the Judiciary*, 98th Cong., on *Northern Pipeline Co. v. Marathon Pipe Line Co.* Decision, Consumer Credit Amendments, Agricultural Produce Bailment Amendments, Repurchase Agreement Code Amendments, Shopping Center Tenancy Amendments, and Timeshare Agreements Amendments, January 24, 1983; *Hearing Before the Senate Committee on the Judiciary*, 98th Cong., 1st Sess., on S.333 and S.445, April 6, 1983. There is also proposed legislation and floor statements made by various Representatives and Senators at the time of introduction of either new bills or amendments to existing bills. *See*, e.g. 130 Cong. Rec. S6081-82, S6107, S6122, S6127 (daily ed. May 27, 1984); 130 Cong. Rec. H1796-1854, H1809 (daily ed. March 21, 1984); S. Rep. No. 65, 98th Cong., 1st Sess. (1983); S. 3023, 96th Cong., 2nd. Sess. (1980).

25. The following is a sample of the studies that have been done to date in bankruptcy: Stanley and Girth, *Bankruptcy: Problem, Process, Reform*, The Brookings Institution (1971) (the "Brookings Study"); Shuchman, "Little Bankruptcies in New England," 56 Bost. Univ. L. Rev. 685 (1976); Purdue University Credit Research Center, Consumer Bankruptcy Study (1981), reprinted *Hearings Before the Subcomm. on Courts of the Senate Comm. on the Judiciary*, 97th Cong., 1st Sess. at 23 (the "Purdue Study"); Shuchman and Rhorer, "Personal Bankruptcy Data for Opt-Out Hearings and Other Purposes," 56 Am. Bankr. L. J. 1 (1982); LoPucki, "The Debtor in Full Control -- System's Failure under Chapter 11 of the Bankruptcy Code," 57 Am. Bankr. L. J. 99 (1983); Shuchman, "The Average Bankrupt: A Description and Analysis of 753 Personal Bankruptcy Filings in Nine States," 88 Com. L. J. 288 (1983); Woodward and Woodward, "Exemptions as an Incentive to Voluntary Bankruptcy: An Empirical Study," 88 Com. L. J. 309 (1983); Shepard, "Personal Failures and the Bankruptcy Act of 1978," 27 J. Law and Econ. 419 (1984); Boyes and Faith, "Some Effects of the Bankruptcy Reform Act of 1978," 29 J. Law and Econ. 139 (1986); Sullivan, Warren and Westbrook, "Folklore and Facts: A Preliminary Report from the Consumer Bankruptcy Project," 60 Am. Bankr. L. J. 293 (1986), forthcoming in book form titled *As We Forgive Our Debtors*, Oxford University Press (1987).

26. *Id.*

27. Lynn LoPucki's article on Chapter 11 cases noted *supra* note 25 is the obvious exception.

28. The key exceptions to this are the Brookings and Purdue Studies. In the Brookings Study, approximately 1,100 persons were interviewed, including United States District Court Judges, Referees, Trustees and Receivers, attorneys, employers, welfare authorities, appraisers, accountants, business and consumer debtors and state court judges. *See* Brookings Study, *supra* note 25, at 219-226. There was also interviewing of the general population. In the Purdue Study, debtors were also interviewed. In both studies, concerns can be raised about the soundness of the data produced in these interviews. *See* Sullivan, Warren and Westbrook, "Folklore and Facts: A Preliminary Report from the Consumer Bankruptcy Project," *supra* note 25, at 313.

The Sullivan, Warren and Westbrook Consumer Bankruptcy Study did supplement its hard data case file study with personal interviews of Bankruptcy Judges and Clerks. Attorneys "specializing" in consumer bankruptcies were also interviewed. It appears that these interviews were not designed to serve as a free-standing basis of analysis. Professor LoPucki also filled in gaps in his study through interviews.

29. This is not to say that the data obtained from the study of case files is lacking in utility. There is a substantial wealth of information that can be so garnered. The Consumer Bankruptcy Study conducted by Sullivan, Warren and Westbrook was based on cases on file in 1981. Since that year, the Code has undergone major amendments on two separate occasions, including the passage of the Consumer Credit Amendments

The Survey addresses these concerns. First, the amendments selected for study appeal to a broad constituency, and several of them deal with issues arising in Chapter 11 cases. The Survey has also produced current data which, given the frequency with which the Code have been amended and the constant flurry of proposed legislation to amend the Code further,[31] is of great significance. There has also been a concerted and conscious effort to avoid charges of partisanship. This has been accomplished by the retention of the services of SURRES which served to insure that, to the extent possible, the Survey Questionnaire was bias-neutral and the entire survey was conducted in a statistically sound manner. Lastly, through the use of interviews, as distinguished from actual case files, the Survey has been able to elicit perceptions of the participants in the bankruptcy process.

The Survey is not, and does not profess to be, a **hard data** study[32] on the effect and the effectiveness of the 1984 Amendments. The purpose of this study is to elicit how the 1984 Amendments are functioning by the individuals who confront their application on virtually a daily basis; it is, then, an **attitudinal** study.[33] Certainly, some of the subject areas covered by the Survey could be evaluated from the perspective of existing case files; other information would not be apparent from a study of the actual case files.[34]

One of the downsides of a hard data study is the considerable time and cost involved. One of the risks of an attitudinal study is that hard data may ultimately reveal that some of the perceptions of the Respondents in the Survey were not, in fact, "correct" reflections of what was happening in the bankruptcy process. However, the perceptions of the Respondents are "correct" in the sense that they are the Respondents' actual perceptions. Therefore, perceptions of the bankruptcy process reveal something that hard data does not reveal, namely how the participants who deal with bankruptcy on virtually a daily basis believe the system is functioning. It is not difficult to hypothesize that perception of the system may well affect how it functions and therefore, perceptions of the bankruptcy process

which form a part of the 1984 Amendments. Therefore, the data collected in the Consumer Bankruptcy Project does not address the impact of the 1984 Amendments although the study is being released substantially after the passage of these amendments.

30. The study most frequently criticized is the Purdue Study, *supra* note 24. *See* Sullivan, Warren and Westbrook, "Limiting Access to Bankruptcy Discharge: An Analysis of the Creditors' Data," 1983 Wis. L. Rev. 1091 (1983); Sullivan, Warren and Westbrook, "Rejoinder: Limiting Access to Bankruptcy Discharge," 1984 Wis. L. Rev. 1087 (1984).

31. Recent examples of legislation introduced in the 100th Congress include Senate Bill 548, S2236 Cong. Rec. (daily ed. Feb. 19, 1987) sponsored by Senator Howard Metzenbaum to accord retirees of their now financially troubled former employer greater protections and some 34 other bills in the Senate and House of Representatives, as of June 30, 1987.

32. A hard data study would involve the analysis of actual case files and hence would provide results based on existing data.

33. *See* Vinson and Anthony, *supra* note 11, at 44-45.

34. For example, a study of actual case files would reveal how many preference actions have been filed. The case file would not necessarily reveal the number of potential preference actions that were not pursued in the first instance as a consequence of the change to Section 547. A study of case files would reveal how many motions to dismiss are brought by the court under Section 707(b). The case file would not reveal, however, the extent to which the court is evaluating the files to make the assessment of whether a motion under Section 707(b) should be brought in the first instance.

This is not to say that the hard data should not be obtained. In fact, there is an increasing movement to expand the amount of data that is collected and therefore distributed about the bankruptcy process. The federal agency currently charged with the responsibility of reporting bankruptcy data is the Administrative Office of the U.S. Courts (hereinafter termed the "Administrative Office" or "AO". There has been criticism of the AO, both in terms of what data is available and as to the data which does exist, the method of categorizing and reporting same. *See* Sullivan, Warren and Westbrook, "Folklore and Facts: A

could certainly affect the hard data.[35]

Optimally, the results of both types of studies would be available for review. However, bankruptcy scholarship has not yet progressed that far. The Survey provides a major step in the evaluation the 1984 Amendments and the bankruptcy process generally, without in any way undermining the need for other, further and more detailed studies about the matters covered by the Survey and a host of other topics in the bankruptcy arena.[36]

It is fair to say that the Survey elicited information that went far beyond both the selected 1984 Amendments which were studied and the expectations of the Steering Committee.[37] The Survey has produced an overwhelming amount of significant current data on the state of bankruptcy law generally, information that has not been available to date. The Survey, as the report indicates, has been able to substantiate hypothesized but unsubstantiated observations about bankruptcy practice.[38] It has also produced data which destroy some pre-conceived notions about how lawyers involved in the bankruptcy process perceive the system.[39] It has revealed that courts are not complying with provisions of the Code, some of which antedate the 1984 Amendments, and the degrees of statutory compliance vary dramatically from circuit to circuit.[40] It has also established a data base on bankruptcy practice which can serve as the foundation for further follow-up studies. It has allowed for projections to be made about how certain of the 1986 Amendments will function in practice, particularly the virtually nationwide United States Trustee Program.

The final goal of the Survey was to open the avenue for productive dialogue among the participants in the bankruptcy process about how the 1984 Amendments are functioning and how the bankruptcy system as a whole is operating. The Survey was intended to allow the various constituencies to consider together the ways in which the process can be improved. To that end, the Survey has raised a number of questions and concerns about the 1984 Amendments selected for study. It has pointed out other areas which are in need of study. It has also challenged a reevaluation of certain basic assumptions in bankruptcy and has forced a rethinking of some of the choices that are made in how to proceed in

Preliminary Report from the Consumer Bankruptcy Project," *supra* note 17. It should be noted that since the only "official" data on bankruptcy is collected by the Administrative Office, certain of their statistics have been used to assist in explaining some of the data produced by the Survey. Moreover, the Administrative Office permitted us to review other data not generally released. Our utilization of the data from the Administrative Office has been to assist in probing possible explanations of some of the general results of the Survey. AO's data is, therefore, only being employed for limited purposes, without any assurance as to the full accuracy thereof.

35. The converse may also be true. If one were able to know what is happening, that could well affect how one perceives the system in operation.

36. Section X of the report indicates the other areas of study suggested by the Respondents. As indicated therein, it covers a panoply of areas.

37. *See* Sections III, IX and X of the report.

38. For a fuller discussion, see Section III, captioned "Demographics". It should also be noted that the Survey has produced data that indicates that the mandates contained in the Code are not always being followed. For a fuller discussion of this issue, see Sections IV, V, VII and X.

39. For a fuller discussion, see Section IV of the report which indicates, among other things, that not all debtor lawyers and creditor lawyers have differing perspectives on the bankruptcy process based on the parties whom they represent most frequently.

40. *See* Sections IV, V and VII of the report.

bankruptcy cases. If the Survey has raised awareness of what is going on and allowed the participants in the process to think more clearly about the bankruptcy system, both practically and theoretically, then it will have made a substantial contribution to the bankruptcy field.

To these ends, the report on the Survey is divided into ten sections. Following this introduction, Section II describes the methodology of the Survey. Section III details the demographics of the Respondents. Section IV reports the results of the more generalized questions in the Survey Questionnaire. Sections V, VI, VII and VIII deal, respectively, with the specific areas of change selected for study. Section IX contains speculations on the potential impact of the 1986 Amendments on the bankruptcy process, including the virtually nationwide United States Trustee program. Section X contains conclusions and recommendations.

With this, as with all studies, there are certain caveats that must be kept in mind in reading this report. An effort has been made to write as complete a report as was feasible. However, the Survey generated over a thousand pages of data, not all of which are reported. Moreover, the report does not contain all the data that would be relevant to interpreting the effect and effectiveness of the 1984 Amendments studied in that it principally addresses the data generated by the Survey Questionnaire.

Lastly, the report does not explain many of the questions the data raises. While an effort has been made to provide explanations for some of the results, the report is not, and does not profess to be, a conclusive analysis of the 1984 Amendments.[41] It is, however, what could manageably be reported at this time. As other and further analysis of the data is obtained and additional studies conducted, both by ABI and others, further insights will no doubt be garnered.

This report is the first major step in evaluating the 1984 Amendments. It sets the stage for other and further studies and demands that a hard look at the existing bankruptcy system be given before it is amended again.

41. *See* Vinson and Anthony, *supra* note 11, at 45-46 wherein the authors caution about the use (and misuse) of numbers.

Section II

METHODOLOGY

This Section of the report, which details the methodology employed in the Survey, is divided into four units. First, there is a discussion of the selection of the Respondents. Thereafter, the intricacies of the Survey Questionnaire are described. Next, the interviewing process is detailed. Lastly, there is a description of the approaches utilized to evaluate the data base. This last section contains descriptions of the variables used for purposes of preparing cross tabulation tables, the uses of such cross tabulation tables in analyzing the data, the creation and use of means tables, and lastly, a discussion of the statistical significance of the data and other reporting techniques.

Selection of Respondents

At the onset of the Survey, the Steering Committee determined that a broad spectrum of participants in the bankruptcy process should be interviewed in connection with the Survey. Four distinct categories were selected: United States Bankruptcy Judges, United States Trustees, Estate Administrators and lawyers dealing primarily with bankruptcy matters. These categories were selected because everyone within them dealt with bankruptcy matters on virtually a daily basis and all had substantially more than passing familiarity with the Code and the 1984 Amendments.

Within the category "Lawyers", the Steering Committee wanted to insure, to the extent possible, that this group in the aggregate represented the spectrum of interests in the bankruptcy process, namely lawyers who represented debtors, secured creditors, unsecured creditors and trustees. Moreover, there was a desire to have a pool of lawyer respondents with aggregate experience in practice under Chapters 7, 11 and 13.

The Steering Committee and SURRES recognized that there were certainly other persons involved in the bankruptcy process who could be interviewed. First, in addition to the bankruptcy judges, other federal and state judges could have been selected as respondents. However, while these individuals may have had experience with federal bankruptcy issues from time to time, the vast majority of their work was spent on non-bankruptcy matters. Since the major focus of the study was on particular amendments to the Code, this group of individuals would not, in all likelihood, have the requisite familiarity with the subject matter of the Survey.

Consideration was also given to interviewing non-lawyer participants in the bankruptcy process. This category of individuals would have included actual debtors and creditors as well as non-lawyer trustees. These individuals were excluded from the respondent pool for several reasons. First, it would have been difficult to locate a representative group drawn from a nationwide sample that would have willingly participated in the Survey. While it would not have been difficult to ascertain a listing of at least some of the non-lawyer trustees, there would have been considerable problems finding a comprehensive na-

tional list of debtors (individual and business, in Chapters 7, 11 and 13) and creditors (secured and unsecured in Chapters 7, 11 and 13) which would have been representative of those who had filed or were involved in pending cases. Among the creditor group, it would have been possible, through various trade organizations, to develop lists of at least some of the major creditors involved in bankruptcy. However, no such lists exist for debtors. There was also concern that, even to the extent these individuals could be located, they would not be willing to participate in the Survey.

The concerns went beyond locating a representative sample. The Survey focusses on specific amendments to the Code and calls for respondents familiar with at least some of the selected Code provisions. While non-lawyers would, in many instances, be quite familiar with the subject areas being surveyed, their knowledge would not necessarily entail a detailed understanding of the statutory provisions addressed. Moreover, the Survey sought responses from individuals with more than one experience in the bankruptcy system as those with multiple experiences would be better able to assess the overall bankruptcy process more effectively.

Moreover, there was every expectation that the lawyers selected could, at least in some sense, speak for their respective clients in terms of how the 1984 Amendments are operating. Although lawyers may not share all of the views of their clients, the lawyer representing a given client at least has some ability to assess how that client is faring under the Amendments. It is recognized that not all lawyers representing trustees, some of whom may themselves act as trustees, will always respond to questions as a non-lawyer trustee would. Nor would a lawyer who principally represents debtors always respond as a non-lawyer debtor would. However, since the Survey was designed to look at the 1984 Amendments in practice, in terms of how they are functioning on a day to day basis, the lawyers involved in these matters, who are trained to read and apply statutes, seemed best suited to the task.

Last but not least, given the economic realities of conducting surveys and the quest for statistically meaningful data, the sample[42] of one thousand respondents could not be divided into small subdivisions as this would render any effort to analyze the subdivisions meaningless. Should additional funding become available in the future, the Survey Questionnaire could be rewritten so that non-lawyers could be interviewed and the results from any project could be compared to those reflected in this report.

Following selection of the general categories of respondents, SURRES proceeded to determine how the respondents would be chosen within each group. SURRES performed this task in a manner which insured that all respondents were randomly selected. How the specific respondents within each of the selected categories were chosen varied from group to group. At the time of the selection of the sample, there were 226 United States Bankruptcy Judges. From a complete listing of such Judges, every tenth name on that list was omitted and the remaining names (213 in all) constituted the sample of United States Bankruptcy Judges. From the complete list of the United States Trustees (7 United States Trustees and 11 Assistant United States Trustees), all were selected as potential respondents due to the small number of individuals involved in this category. From the complete list of estate administrators in office as of May 1985 (85 were listed), all were selected as

42 "Sample" may be defined as "[a] subset of the element of a population, chosen for study with the hope that what is found to be true of the sample will be true for the population." Jones, *Research Methods in the Behavioral Sciences*, 375 (1985).

potential respondents, again because of the small size of the overall group.

The selection of the lawyers was a more complicated process since there is no complete listing of lawyers who practice bankruptcy law. Moreover, since there is no definition of "bankruptcy" as a specialty, it was difficult to ascertain from existing listings the extent of the bankruptcy experience of those listed. SURRES utilized a combination of five lists to select the sample of lawyers: (1) an initial listing of bankruptcy practitioners prepared by Professor Lynn LoPucki (the "LoPucki List")[43]; (2) 1986 Membership List of the Commercial Law League of America ("CLLA List"); (3) 1986 American Bar Association Consumer Bankruptcy Membership Committee List ("ABA List"); (4) Membership List of the National Bankruptcy Conference ("NBC List"); and (5) the listing contained in Chapter 4 of the book *Best Lawyers in America* entitled "Creditors' and Debtors' Rights" ("Best List").[44]

The LoPucki List served as the primary source for respondents for several reasons. First, it contained a large number of names from across the country (3580) of individuals who Professor LoPucki had determined were in some manner connected to the bankruptcy process. Moreover, there was no charge to individuals included on the LoPucki List, and it was not connected with any partisan or non-partisan organization such as a state or local bar or trade association. The CLLA List (containing, after cross-checking with the other lists, 4396 names) and the ABA List (containing, after cross-checking with the other lists, 183 names) both required membership in the requisite organizations in order to be listed. The CLLA List also contained non-lawyers and "collection" lawyers, whose primary practice was based in state courts. The NBC List contained the names of 44 bankruptcy lawyers and as such was not sufficiently extensive to form the nucleus of the study. Moreover, the NBC List is known to contain highly experienced bankruptcy professionals, and hence is not representative of the bankruptcy bar. The Best List, containing two hundred names, was based on its authors' interviews of attorneys around the country to assess those lawyers most prominent in their field. As such, it tended to represent only experienced practitioners. All lists, other than the LoPucki List, contained some element of pre-selection, whether through membership, election or experience level. Therefore, while the names thereon could form part of the sample selected, it was believed that they were not sufficiently "unbiased" to reflect a representative sample of the lawyers involved in bankruptcy matters across the United States.

SURRES compared the LoPucki list with all the other lists and the other lists with each other and deleted from those other lists any name that appeared in more than one list. SURRES used a sampling interval[45] of five for the LoPucki list. A sampling interval of twenty was used for the other lists. Through this selection process, 977 names of lawyers were randomly selected.

Through this process, 1293 individuals were selected. All of these individuals received a personalized letter on ABI letterhead from Judge George C. Paine, II, the Chair of the

43. This list is currently available in published form, although the published edition contains names not available at the time the Survey was undertaken. *See* LoPucki, *Directory of Bankruptcy Attorneys* (Prentice Hall 1986). The LoPucki List, unlike some of the other lists, contained names, addresses and telephone numbers, which facilitated locating potential respondents. Professor LoPucki utilized a variety of techniques to determine if those listed were in fact "bankruptcy lawyers," including telephone calls to individuals listed.

44. Naifeh and Smith, *The Best Lawyers in America*, (Seaview/Putnam 1983).

45. "Sampling Interval" is defined as "[i]f all the elements in a population are arranged in a list and you decide to take every nth element as your sample, then n is your sampling interval. Jones, *supra* note 2, at 375.

Steering Committee, requesting participation in the Survey. The text of this letter was reviewed by SURRES to insure that it would not bias any of the Survey results. From the total sample, 128 names were deleted as these individuals indicated, when called telephonically, that they no longer did the type of work which had originally placed them on a particular list (i.e. an individual was no longer a Bankruptcy Judge). From the remaining sample of 1165, 1005 interviews were completed. This yields an overall response rate of 86%, well above that anticipated for a Survey of this kind. There were 124 individuals who refused to participate in the Survey, yielding a refusal base of 1129 individuals (1005 completes plus 124 refusals) and an overall refusal rate of 11% (124 refusals/1129 refusal base). The high response rate and the low refusal rate indicate a remarkable willingness on the part of individuals to participate in the Survey and demonstrates that the topics in the Survey are of substantial interest. There was some variation in the response and refusal rates, respectively, of the four categories of Respondents, as reflected in Table 1, which summarizes the selection of the sample.

TABLE 1

SAMPLE SELECTION RESULTS (BY CATEGORY)

	Judges	U.S. Trustees	Estate Administrators	Lawyers	All
TOTAL NAMES ON LISTS	226	18	85	8403	8732
NUMBER OF NAMES (randomly selected)	213	18	85	977	1293
NAMES OUT OF SAMPLE	20	0	5	103	128
RESPONSE BASE	193	18	80	874	1165
COMPLETE INTERVIEWS	166	14	74	751	1005
RESPONSE RATE (%)	86%	78%	93%	86%	86%
REFUSALS	22	3	6	93	124
NO ANSWERS AND CALL BACKS	5	1	0	30	36
REFUSAL BASE	188	17	80	844	1129
REFUSAL RATE (%)	12%	18%	8%	11%	11%

Of the sample of 1005 respondents, lawyers represented 75% of the sample, United States Bankruptcy Judges represented 17% of the sample, Estate Administrators represented 7% of the sample and the United States Trustees represented 1% of the sample.[46]

46. All places to the right of the decimal point are rounded to the nearest whole percent for reporting purposes in the Survey. Point five is rounded upward.

These percentages were not designed to be exact reflections of the relative ratios these categories bear to each other in actuality. However, they are generally reflective of the bankruptcy process in that there were, at the time of the Survey, significantly more lawyers than any other category, and the number of Bankruptcy Judges was more than twice the combined number of United States Trustees and Estate Administrators.

For purposes of the subsequent analyses of the data base, it is also significant that of the total pool of 226 United States Bankruptcy Judges, 166 were interviewed. As such, 74% of the Bankruptcy Judges in the country then on the bench were interviewed. From a total pool of 18 United States Trustees, 14 were interviewed. Hence, 78% of the United States Trustees were interviewed. Lastly, from the 85 Estate Administrators, 74 were interviewed. Hence, 87% of all the Estate Administrators in the country were interviewed.

As discussed in more detail in Section III on Demographics, the selection of the sample was effective in obtaining Respondents from virtually every state of the union and, with respect to the lawyers, the Respondents had participated in varied chapters under the Code, represented varied clients within the bankruptcy process and came from a wide range of firm sizes. In sum, the Respondents represented the wide range of participants in the bankruptcy process.

The Survey Questionnaire

The Survey Questionnaire was developed jointly by the Steering Committee and SURRES. All aspects of the Survey Questionnaire were reviewed to maximize the likelihood that the questions would generate statistically significant information. Once the initial questions were formulated, SURRES created the necessary computer program, including the script for the interviewers, so that the Survey instrument could produce data that could be collected on CASES. The Survey Questionnaire was pre-tested successfully in August 1986.

The Survey Questionnaire is structured as follows. First, there is a short standardized introduction read by the interviewer and three general closed-ended questions about the bankruptcy process.[47] Thereafter, there are four substantive units, each representing one of the 1984 Amendments selected for study. The first substantive unit deals with the jurisdictional changes and contains 13 questions of which 12 are closed-ended and one is open-ended.[48] One of the closed-ended questions contains a follow-up question that is open-ended.[49] The second substantive unit deals with the Consumer Credit Amendments and contains 22 questions of which 20 are closed-ended questions.[50] One question contains a closed-ended follow-up question if a certain response is made to the initial question.[51] This follow-up question is included in the count of the total number of questions. The third substantive unit deals with the changes to the preference section and contains 11 questions of

47. *See* Appendix A, Questions A1-A3. This report references questions based on the letter and number designation appearing in the left hand column of the Survey Questionnaire (which is appended as Appendix A). This should assist readers in locating the question referenced.

48. *See* Appendix A, Questions B1-B13. Question B13 is the open-ended question.

49. *See* Appendix A, Question B8.

50. *See* Appendix A, Questions C1-C21.

51. *See* Appendix A, C17a and C17b.

which 10 are closed-ended and one is open-ended.[52] There is one closed-ended question that contains an open-ended follow-up.[53] The fourth unit deals with the automatic stay and contains 9 questions of which 8 are closed-ended and one is open-ended.[54] At the conclusion of these substantive units, there is a general closed-ended question about abuse in the bankruptcy process[55] and then a series of 16 questions designed to elicit information necessary for the development of the demographics of the Survey.[56] There is one final open-ended question asking the Respondents about other surveys they would like to see conducted.[57]

The ordering of the substantive units within the Survey Questionnaire was designed to take into account the nature of the attitudes of the Respondents generally. Jurisdiction, the most complex unit, appeared first, when the Respondents were more alert. The second unit on the Consumer Credit Amendments contained the greatest number of questions and hence appeared relatively early in the interview so that there was consistent attention paid to it. The selection of the order is not, however, a reflection of the relative importance of the substantive units.

The general questions at the outset of the Survey Questionnaire were considered warm-up questions and were worded so as not to affect or prejudice the Respondents' responses to the questions asked during the balance of the interview. The last substantive question of the Survey Questionnaire dealing with abuse was fraught with more bias and therefore appeared after all the other questions were answered.

Each question within the Survey Questionnaire was assigned a code name ("code name"). The frequencies of the responses for each question were tabulated after all the interviews were completed. As discussed more fully later in this Section, additional code names were developed so that cross tabulation tables could be run on the data obtained. The responses to the open-ended questions were printed out by the computer but were not computer tabulated to, for example, pick up similar responses. Evaluation of the open-ended data was completed, however, based on a reading and manual tabulation thereof.

The Interviewing Process

All interviews of Respondents were conducted by SURRES trained interviewers. Sixteen individuals were assigned to interview the Respondents. All interviewers received a minimum of four hours training on the Survey Questionnaire as well as hands on training at the computer terminal. A majority of the interviewers had previously done work for SURRES and hence were familiar with the telephonic interviewing process. The vast majority of the interviewers were undergraduate and graduate students at the University of Maryland and the balance were individuals employed by SURRES as independent contractors. The dyad or dialogue method was used to train interviewers to handle specific interviewing

52. *See* Appendix A, Questions D1-D9. Question D9 is the open-ended question.

53. *See* Appendix A, Question D5.

54. *See* Appendix A, Questions E1-E8. Question E8 is the open-ended question.

55. *See* Appendix A, Question F1.

56. *See* Appendix A, Question F2-F9.

57. *See* Appendix A, Question F10.

problems and questions asked by the Respondents.

To facilitate interviewing, all interviewers obtained a general description of the Survey, a brief overview of the bankruptcy process and a bankruptcy lexicon containing approximately 21 terms. The lexicon was provided for two purposes: first, to assist the interviewers in being able to understand the Survey Questionnaire itself and second, to enable interviewers to capture in type, in short readable form, the responses to the open-ended questions.

All interviews were scheduled to the convenience of the Respondents. The interviewers were instructed to exercise maximum flexibility in scheduling interviews and if necessary, rescheduling interviews. As many as 16 telephone calls were made to each Respondent (or staff) before the actual interview was conducted. In several instances, the Respondent had to interrupt the interview and in all these instances, the interview was rescheduled for completion at a later date. The vast majority of the interviews were conducted during business hours although evening interviews were scheduled if requested by the Respondent. None of the interviewers reported any difficulties in conducting the interviews and neither SURRES nor ABI received any complaints from any of the Respondents.

The interviews took place over a six month period spanning from August 1986 through early January 1987.[58] The interviews were conducted over a six month span for several reasons. First, this expanse of time allowed the interviewers to schedule and reschedule interviews as needed, thereby increasing the number of Respondents who completed the Survey Questionnaire. Second, the Respondents were contacted in waves due to the process of timing the letter they received from Judge Paine[59] with the call the interviewers made thereafter.

In addition to recording the results of all interviews into the computer programs, all interviewers maintained call record sheets indicating the number of calls made to reach a Respondent, instructions regarding callbacks and any other relevant information necessary to compete the interviews. Any problems with the interview, once completed, were also reflected on these sheets. These call record sheets were constantly reviewed by the interviewing supervisors.

Data Evaluation

At the same time that the interviewing process was underway, the drafting subcommittee and SURRES formulated the manner in which the data could be evaluated. It was determined that all questions in the Survey Questionnaire would be cross tabulated based on the following variables, which will be more fully described: (1) category of Respondent ("Type");[60] (2) circuit in which the Respondent was located ("Circuit"); (3) number of years

58. During the summer and fall of 1986, Congress was considering legislation to amend the Code once again, and on October 27, 1986, the President signed the 1986 Amendments into law. The Survey was not designed to evaluate whether the responses varied based on whether a Respondent was interviewed before or after passage of the 1986 Amendments. In the future, it may be worth evaluating whether the passage of the 1986 Amendments affected the Respondents' views of the 1984 Amendments.

59. *Supra* note 45 and accompanying text.

60. This is the terminology reflected in the computer program. Within the report, types of Respondents are referenced as "categories" of Respondents in order to distinguish the four categories of general Respondents from the specific types of Lawyer Respondents in the Survey, who are termed "types" within the report.

in bankruptcy related work ("Years"); (4) type of Lawyer ("Work"); and (5) size of the firm in which the lawyer practiced ("Size").

"Type" is defined as the four general categories of respondents in the sample, namely, United States Bankruptcy Judges, United States Trustees, Estate Administrators and lawyers (hereinafter referred to as the "_____ Respondents", respectively). By looking at all the questions based on the category of Respondent, it has been possible to determine whether the view of Judges, for example, differs from that of lawyers. This breakdown became all the more significant in view of the fact that the 1986 Amendments established a virtually nationwide United States Trustee system. Because the data allowed comparisons of how United States Trustees and Estate Administrators, respectively, responded to the questions, certain projections can be made about how the system will operate when there are only United States Trustees.

"Circuits" is defined as the twelve[61] judicial districts in the federal court system as all Respondents indicated the circuit in which they worked. This variable enables the evaluation of the data on a circuit by circuit basis to determine if there are differences in the responses in various parts of the country.[62] To the extent that a Lawyer Respondent indicated practice in more than one circuit, the Respondent was asked to choose the circuit in which the most work was conducted. A map reflecting the states within each judicial circuit appears as Appendix B and can be detached from the report for easy reference.

"Years" is a variable designed to elicit the experience level of the Respondents. The Respondents were divided into four categories based on the number of years of *bankruptcy related* experience they had had. In other words, this variable might, but would not necessarily, correlate to the number of years an individual was in practice. For example, an individual may have been in practice for ten years of which only the last two were bankruptcy related. The experience levels were broken down as follows: less than three years; three to eight years; nine to twelve years; and more than twelve years.

The rationale for these particular categories is, in part, that those with less than three years of practice as of the date of the Survey had *not* practiced under the pre-*Marathon* system and hence had only had experience under the Emergency Rule. Those who had been involved between three and eight years had had experience under the Code, both pre- and post-*Marathon*. Those who had been involved for nine to twelve years had had experience both under the Bankruptcy Act, the precursor to the Code and the Code, in its pre- and post-*Marathon* states. Lastly, the group with more than twelve years of experience had had considerable experience under the Act as well as the Code. Through this particular grouping, an effort was made to evaluate, particularly in the area of the jurisdictional changes, whether a Respondent's experience level affected perceptions of the system.

The variable "Work" defines the nature of the practice of the Lawyer Respondents. While there is no precise definition of a "debtor's lawyer" or a "creditor's lawyer", these terms are, in fact, used by those involved in the bankruptcy process. The Survey defined a debtor's lawyer as any lawyer who spent fifty percent or more time representing debtors.

61. There are officially thirteen judicial circuits, twelve generally by region and the specialized Federal Circuit. This report does not address the Federal Circuit.

62. As noted earlier, while there were Respondents in the Twelfth Circuit, this group was too small to produce statistically significant data. Hence, the results from the Twelfth Circuit have not been reported.

Similarly, a creditor lawyer was defined as any lawyer who spent fifty percent or more time representing either secured or unsecured creditors. A trustee lawyer was defined as anyone spending more than fifty percent of the time representing trustees. By so defining the lawyers, certain Lawyer Respondents did not fit within any of these categories. For example, a Lawyer Respondent whose time was spent equally divided between representation of debtors, creditors and trustees would not be included in a specific category, though their responses would appear under the variable Type. Accordingly, there was a smaller sample when the cross tabulation tables based on Lawyer Type were evaluated compared to the number of Lawyer Respondents appearing in the cross tabulation tables revealing the categories of Respondents.

The purpose of evaluating the data in light of the nature of the Lawyer Respondents' work was to determine if there is any correlation between whom a lawyer represents and the response to a given question or series of questions. In other words, the purpose was to detect and determine the extent to which perspective of the bankruptcy process is effected by whom the Lawyer Respondent represents.

The fifth variable constructed was "Size" which is designed to categorize the size of the firms in which the Lawyer Respondents practiced. The firm sizes were broken down as follows: small (between 1 and 10 lawyers); medium (between 11 and 50 lawyers) and large (more than 50 lawyers). It should be noted that there is some variation across the country in terms of what is considered a small, medium or large firm. For example, in a rural community, a firm of 25 lawyers might be considered large where that same size firm in a large metropolis would be considered relatively small. However, the indicated breakdowns are designed to take into account a nationwide perspective on the issue of firm sizes.

The rationale of this variable was to determine if there was any distinction in the Lawyer Respondents' perceptions based on the size of the firms in which they practiced. Are certain attitudes, for example, more prevalent in big firms? Are certain interests more frequently represented by small firms?

Two of these five variables were also cross tabulated together, namely Type and Circuit. The purpose of this cross tabulation was to determine if there was any pattern among Respondents of a particular Type in a particular Circuit compared to other Respondents of the same Type in different Circuits. Moreover, this cross tabulation allowed an evaluation of whether Respondents of a different Type within the same Circuit felt similarly about the given issue.

One new code name, termed "Mandate" within the database, was created. This code name was designed to combine the responses to all the questions in the Survey Questionnaire that dealt with statutory mandates[63] and to determine therefrom an overall sense of compliance with provisions of the Bankruptcy Code. The following five questions were combined to achieve this code name:[64]

63. Statutory mandates include, as more fully described in Section IV, compliance with the Federal Rules of Bankruptcy Procedure.

64. *See* Appendix A, Questions C18, E1, E2, E3, and E6.

(1) When creditors object, do courts confirm Chapter 13 plans without debtors committing all of their disposable income?

1.	Almost all of the time	4.	Never
2.	Most of the time	5.	Hardly ever
3.	Some of the time	6.	Na-ref[65]

(2) In proceedings seeking relief from the automatic stay, are preliminary or final hearings commenced within 30 days?

1.	Almost all of the time	4.	Never
2.	Most of the time	5.	Hardly ever
3.	Some of the time	6.	Na-ref

(3) In general, are judges commencing final hearings within 30 days as prescribed by the statute?

1.	Almost all of the time	4.	Never
2.	Most of the time	5.	Hardly ever
3.	Some of the time	6.	Na-ref

(4) In general, are judges permitting the automatic stay to remain in effect without the consent of the parties beyond the 30-day period as prescribed by the statute?

1.	Almost all of the time	4.	Never
2.	Most of the time	5.	Hardly ever
3.	Some of the time	6.	Na-ref

(5) Following the conclusion of a final hearing seeking relief from the automatic stay, are courts deciding issues presented at such final hearing within 30 days?

1.	Almost all of the time	4.	Never
2.	Most of the time	5.	Hardly ever
3.	Some of the time	6.	Na-ref

Over nine hundred tables were generated in respect of these cross tabulations. Obviously, not all of these tables are contained in this report. However, wherever possible, the questions have been evaluated from the standpoint of all the cross tabulations run on that question to see whether and what patterns emerge. This report has only included reference to tables when same have yielded data deemed relevant to the report. Certainly some of the unreported data might become important in the future in the context of a different report.

An example of the analytic process is useful so that the balance of the data in the report can be better understood. Consider the last substantive question of the Survey Questionnaire:

> • Some people have suggested that there is abuse of the federal bankruptcy system while others have said that no abuse exists. In your opinion, do you believe there is no abuse, a little abuse or a great deal of abuse?[66]

65. These abbreviations stand for "Not Applicable" and "Refused".

66. *See* Appendix A, Question F1.

There are tabulations revealing the frequency with which all of the Respondents answers fell within the indicated categories – a great deal, a little or none (*i.e.* _X_% of the Respondents thought there is no abuse). These general frequencies can then be looked at more fully based on the variables. First, consider the variable "Type". The cross tabulation tables based on this variable in the context of the indicated question on abuse will reveal whether one category of the Respondent group thinks there is more abuse relative to the other members of the same category than another category. Phrased differently, of the Respondents who perceived "no abuse", do the Lawyer Respondents have a greater percentage of their responses indicating this or are more Judge Respondents indicating there is no abuse?

The responses can also be cross tabulated based on the circuit in which the Respondent is located, utilizing the variable "Circuit". Hence, it is possible to determine whether the perception that there is a great deal of abuse is more prevalent in one circuit versus another. Cross tabulation tables were also run on the combination of the two variables, "Type" and "Circuit", to determine whether variations in responses within a circuit correlated to the category of Respondent. Similarly, cross tabulation tables utilizing the variable "Work" reveal whether there are differing perceptions of abuse among the Debtor Lawyer Respondents, the Creditor Lawyer Respondents and the Trustee Lawyer Respondents. Looking at the variables "Years" and "Size", it is possible to determine if perceptions of abuse are correlated to level of experience or the size of the firm in which a Lawyer Respondent practiced.

All of the cross tabulation tables allow a look at the data that is not evident from the frequencies themselves. It is through these tables that a fuller insight into the bankruptcy process is revealed in that patterns among Respondents within a given circuit or of a particular type or category can be followed. It is these overall trends that form a part of the impact of this study in that this sort of data reveals more than information about the 1984 Amendments selected for study. It reveals information about how bankruptcy law is practiced.

Means Tables

In addition to the frequencies and cross tabulation tables, various means tables were also generated. These means tables were produced to reveal more particularized data about the sample. For example, means tables were created to determine the percentage of work that was done under the various chapters of the Code by the four categories of Respondents (i.e. percentage of individual Chapter 7 work, percentage of business Chapter 7 work). Means tables were also generated to determine, among other things: (1) the percentage of the Lawyer Respondents' work that was debtor related, secured creditor related, unsecured creditor related and trustee related, respectively; (2) the sizes of the Lawyer Respondents' firms; (3) the type of clients principally represented by the small, medium and large firms, respectively; (4) the type of cases handled by the small, medium and large firms, respectively; (5) the years of experience for each of the categories of Respondents; and (6) the type of work done by those with varying levels of experience. The results of the means tables are reflected in Section III of this report on Demographics.

Statistical Significance and Reporting

Following accepted statistical procedure, the probability level (P Value) of less than or equal to .05 has been selected as the test of significant association: that is, an association among variables is accepted as real (significant) only if it could have occurred by chance fewer than 5 times out of 100. At these levels, the results obtained are not as likely to be attributed to randomness and are likely to represent differences attributable to some other factor. As noted in Section I, there is an error factor of plus or minus 3.1% at a 95% level of confidence in respect of all responses reported. Phrased differently, theoretically, in 19 cases out of 20, the results based on the sample will differ by no more than 3.1% in either direction from what would have been obtained through interviews of all participants in the bankruptcy process.

The report specifically notes the data which is statistically significant at a level of .05 or less. Data for which the P Value is greater than .05 have been reported in some instances, but only for descriptive purposes. P Values in excess of .05 do not mean that the data is meaningless. Rather, it indicates, depending on the size of the P Value, that the results reported are not statistically significant at the level of significance chosen for this Survey.

All frequencies are reported based on their adjusted level. This means that all responses in the categories "not applicable" and "refused" are excluded from the frequency calculations. However, when the size of the category "not applicable" and "refused" is greater than that appearing in the majority of the responses, it has been noted in the report. All percentages are reported rounded to the nearest whole percent, with the number 5 being rounded upward. No results appear in respect of the Twelfth Circuit specifically in that the number of Respondents in this circuit was too few to produce meaningful results. Similarly, the responses of the United States Trustees on a circuit by circuit basis, as distinguished from in the aggregate, have not been reported due to the small number of United States Trustees in relation to the number of circuits.

With this understanding of the methodology employed in conducting the Survey and evaluating the Survey data, it is possible to begin the detailed discussion of the results of the Survey.

Section III

DEMOGRAPHICS

The Survey revealed substantial demographic data about the Respondents. To the extent that the Respondents are a representative sample of the participants in the bankruptcy process,[67] this demographic data reveals insights about the participants in the bankruptcy process generally. As will be demonstrated, some of the hypotheses about how bankruptcy law is practiced are confirmed by the Survey. Information is also developed about the experience levels of the participants and suggests some new avenues for inquiry into the bankruptcy system.

The Sample

The Respondents to the Survey had offices in every state except Hawaii. The largest number of Respondents had offices located in California (9%), Florida (4%), Illinois (4%), Michigan (3%), New York (6%), Ohio (5%), Pennsylvania (5%) and Texas (8%). The other states had representation of less than three percent. The percentage breakdown by judicial circuit[68] of where the Respondents were chiefly involved[69] in bankruptcy matters is as follows:[70]

First	2%
Second	8%
Third	8%

67. *See* Section II on Methodology discussing the selection of the sample and the quest to obtain broad-based representation of those involved in the bankruptcy process. The demographic data itself reveals the breadth of the participation of the Respondents in the process and hence confirms the adequacy of the sample obtained.

68. *See* Appendix B for a map of the states within each circuit. For the convenience of the reader in reading this section of the report, the following is a listing of the states located within each circuit:

First: ME, MA, NH, RI, PR	Second: CT, NY, VT
Third: DE, NJ, PA, VI	Fourth: MD, NC, SC, VA, WV
Fifth: LA, MS, TX	Sixth: KY, MI, OH, TN
Seventh: IL, IN, WI	Eighth: AR, IA, MN, MO, NE, ND, SD
Ninth: AK, AZ, CA, HI, ID, MT, NV, OR, WA, GU, NMI	Tenth: CO, KS, NM, OK, UT, WY
Eleventh: AL, FL, GA	Twelfth: DC.

69. The Respondents were requested to list only one circuit, even though their work might take them to more than one circuit. Hence, the responses represent the principal circuit in which the Respondent is involved in bankruptcy matters.

70. All percentages reflect adjusted frequencies to take into account 1.5% of the respondents who either did not know or refused to answer. Due to the small percentages of responses from the Twelfth Circuit and those who said they were involved in multiple circuits, results from these categories are not being reported when circuit by circuit responses are referenced in the report.

Fourth	9%
Fifth	11%
Sixth	12%
Seventh	9%
Eighth	7%
Ninth	18%
Tenth	6%
Eleventh	9%
Twelfth	less than 1%
Multiple	1%

The Lawyer Respondents and United States Trustee Respondents indicated that they were, on average, involved in matters that took them to more than one judicial district. The Lawyer Respondents practiced in 3 Districts on average, while the United States Trustees worked in 2 judicial districts.[71]

Among all the Respondents, there was involvement in all categories of cases under the Code.[72] Business Chapter 7 cases accounted for 16% of all work, individual Chapter 7 cases accounted for 27% of all work, Chapter 11 cases accounted for 43% of all work and Chapter 13 cases accounted for 13% of the work. The percentage of work not fitting within any of these categories accounted for 1% of the responses.

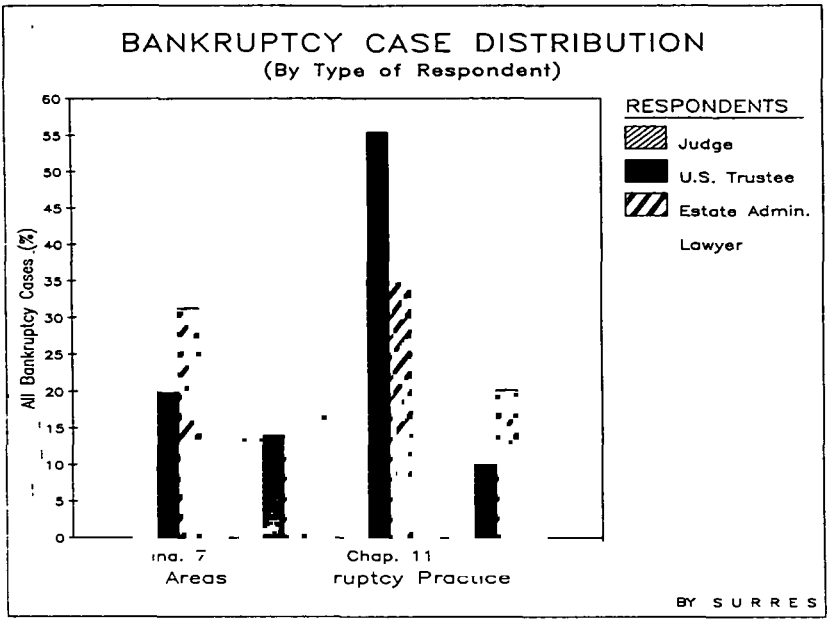
Within all categories of Respondents, the most time was expended on Chapter 11 cases, although Lawyer Respondents and United States Trustee Respondents spent more of their respective time on Chapter 11 than did the Judge Respondents and Estate Administrator Respondents. The Judge Respondents and Estate Administrator Respondents spent more of their respective time on Chapter 13 cases than did Lawyer Respondents and U.S. Trustee Respondents. All categories of Respondents expended approximately the same amount of time dealing with business Chapter 7 cases but United States Trustee Respondents and Lawyer Respondents expended less time than the other categories of Respondents on individual Chapter 7 cases.

The following chart summarizes the case distribution among the categories of Respondents.

71. The Respondents' answers to questions reveal, then, insights based on practice in more than one locale.

72. This breakdown would be changed by the 1986 Amendments, in that a percentage of the Respondents' work, at least in some areas of the country, would be Chapter 12 cases. Chapter 12 cases could account for at least a portion of the category "other". The category "other" could also include cases under Chapter 9.

CHART 1



One observation that can be made is that there seems to be a pairing between the amount of time the Judge Respondents and Estate Administrator Respondents spent on the one hand and United States Trustee Respondents and Lawyer Respondents on the other hand. One possible explanation is that Estate Administrators work closely with the Judges and hence the amount of time they each spend on a matter is parallel. Although United States Trustees do not work together with lawyers in the same way, United States Trustees may be overseeing the cases in which there is more lawyer activity and hence, there is a direct correlation between the amount of time expended by these two categories of Respondents.

The average level of bankruptcy law experience among the Respondents was 12 years. Among the categories of Respondents, the average level of experience for the Judge Respondents was 17 years, for the United States Trustee Respondents was 7 years, for the Estate Administrator Respondents was 6 years and for the Lawyer Respondents was 11 years. This disparity in the levels of experience is of particular note in view of the fact that

the United States Trustees are empowered to oversee the bankruptcy process. In this sense, individuals with considerably less experience than those they are overseeing are performing the policing power. One has to wonder whether this disparity in experience levels accounts for at least some of the discontent about the operation of the pilot United States Trustee System.[73]

The Lawyer Respondents divided their time between representation of debtors, unsecured creditors, secured creditors and trustees. The category "other" comprised only a small percentage of the Lawyer Respondents' work.[74] Among the Lawyer Respondents, 34% of their work was debtor related, 35% of their work was secured creditor related, 17% of their work was unsecured creditor related and 13% of their work was trustee related.[75] Less than one percent of the Lawyer Respondents had work that fell into unlisted categories. As the following chart indicates, the Lawyer Respondents had a broad cross-section of clients. If the two categories of creditor interests are coupled, Lawyer Respondents did creditor related work approximately 53% of the time. Similarly, if debtor and trustee interests are coupled,[76] 47% of the Lawyer Respondents were involved in debtor and trustee related work. This almost 50-50 split suggests that the Lawyer Respondents were not overwhelmingly pro-creditor nor pro-debtor.[77]

(Chart 2 on next page.)

73. *See* Section IX on the potential applications of the data obtained in the Survey. The 1986 Amendments, establishing a nationwide United States Trustee System, obviously do not speak to the age of the United States Trustees to be appointed. However, perhaps years of experience should be an important criterion to consider, as the individuals that the Trustees are monitoring have years of experience averaging 12 years compared to the average United States Trustee in the pilot programs whose years of experience averaged almost half that (7 years).

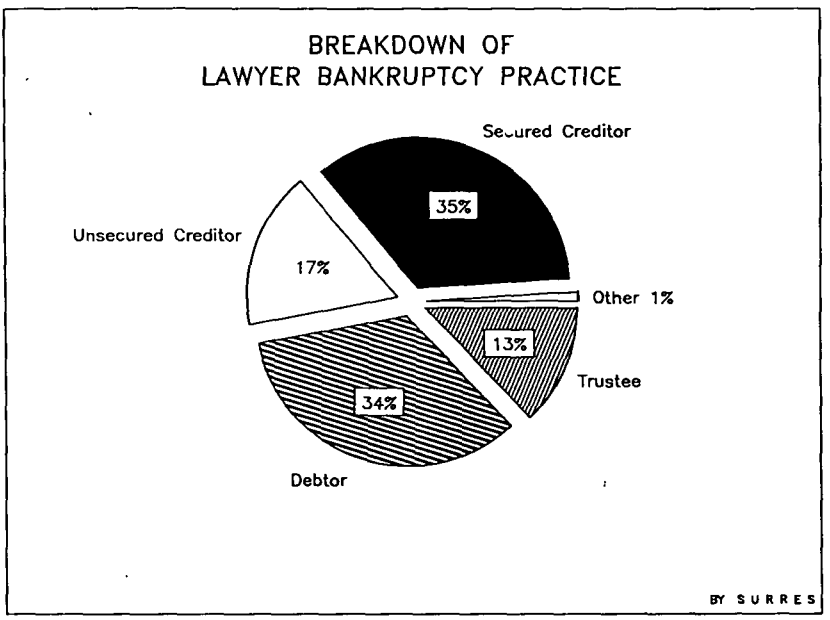
74. The category "other" could include the representation of equity holders.

75. It is possible to presume that, when a Lawyer Respondent indicated the work was "debtor related," the work involved actually representing a debtor under the Code. Similarly, if a Lawyer Respondent's work was "secured creditor related", it is possible to assume that the Lawyer Respondent represented secured creditors in the designated amount.

76. Since the debtor in a Chapter 11 case stands in the shoes of a trustee in a Chapter 7 case, the interests of debtors and trustees in certain contexts are not that different *from the standpoint of exercising powers under the Code.* Therefore, this coupling is not one of individuals with completely antithetical interests.

77. This presumes that to the extent one represents creditors overwhelmingly, one is more likely to be creditor oriented. Similarly, to the extent one represents primarily debtors, one is likely to be debtor oriented.

CHART 2



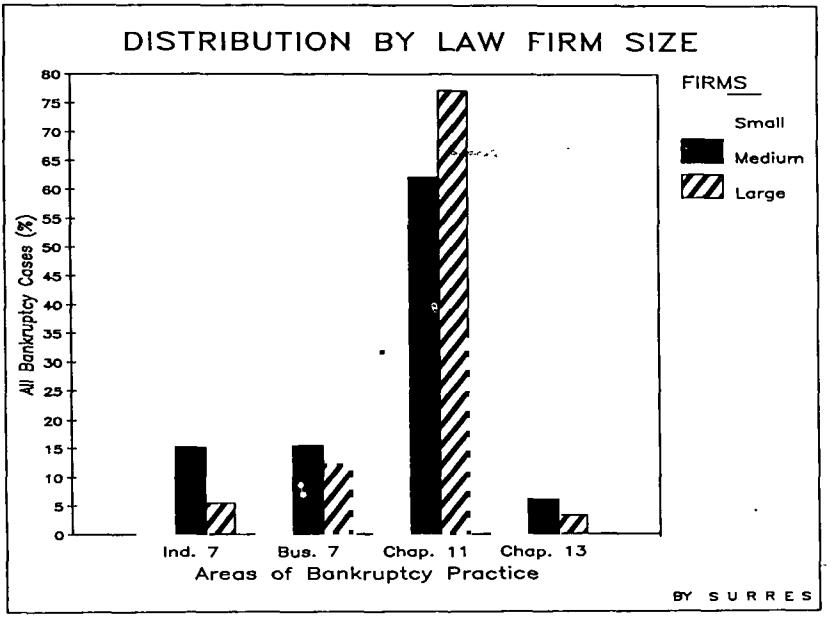
The Lawyer Respondents' firms varied dramatically from a low of one lawyer to a high of 650 lawyers. The average firm size for the Lawyer Respondents was 29 lawyers. Among the small firms, the average number of lawyers was 4. Among the medium firms, the average number of lawyers was 23, and among the large firms, the average number of lawyers was 142.

The size of the Law Firm had a direct correlation to the type of work conducted in that firm, thereby establishing a correlation between the size of the firm in which the Lawyer Respondent practices and the nature of that practice. Secured creditor work was handled primarily by medium and large firms. Only 27% of the work in a small firm was secured creditor related while 49% and 51% of the work of medium and large firms, respectively, was secured creditor related. On the other hand, small firms handled significantly more of the debtor related work than medium and large firms. In a small firm, 40% of the work was debtor related while medium and large firms only had 24% and 23%, respectively, of debtor related work. Trustee representation was handled, not unlike debtor related work, more by small than large firms, with medium firms falling somewhere in-be-

tween. Nearly seven percent of the large firm bankruptcy work was trustee related while 15% of the small firm work was trustee related. Ten percent (10%) of the medium size firm work was trustee related. Unsecured creditor work was evenly divided among the three firm sizes, accounting for between 17% and 20% of the work.

In terms of concentration on particular chapters of the Code, the small firms handled considerably more of the individual Chapter 7 and Chapter 13 work represented in the Survey than did the medium and large firms, respectively. Small firms handled 35% of the individual Chapter 7 cases while large firms handled only 6% of such cases. Conversely, Chapter 11 work represented in the Survey was principally handled by the large firms, with medium firms following thereafter and small firms handling less than one-half that handled by the large firms. There was not much difference in terms of firm size regarding business Chapter 7 cases. The following chart summarizes these findings:

CHART 3



From this data, it is possible to establish a correlation between size of firm and nature of practice and client representation. For example, a lawyer that principally represents debtors is more likely to be in a small firm and involved in Chapter 7 and 13 cases whereas a

lawyer that primarily represents secured creditors is likely to be in a large firm dealing with Chapter 11 cases. These observations comport with the frequently hypothesized statement that "big firms" represent the "monied interests." If one can generalize by suggesting that secured creditors are more fiscally sound than the debtors who seek relief under the Code, then the frequently asserted claims about the nature of large firm clients is substantiated by the Survey, at least in the bankruptcy context.

Similarly, it is suggested that individuals are frequently represented by small firms, a hypothesis also borne out by the Survey. One possible explanation of this phenomena in bankruptcy is that individuals may be more likely to seek representation of lawyers in small firms since lawyer advertising for clients seeking relief from indebtedness is popular at least in certain areas of the country. It appears, at least superficially, that the lawyers advertising are in small firms. Another possible explanation for this phenomena is that it is perceived by individuals (and is often true) that the costs in small firms are lower, an attractive element for the individual debtor seeking representation. A small firm may also offer the individual debtor more of a one-to-one atmosphere whereas the same individual might be intimidated by a large firm. Conversely, the large corporate client (*i.e.* secured creditor), familiar and comfortable with a "corporate" environment, is more likely to choose a large firm, a result also borne out by the Survey.

In terms of the level of the Lawyer Respondents' experience and the nature of said Respondents' practice, there are some correlations that can be drawn. Lawyers with fewer years experience were less involved with trustee related work. There does not appear to be any significant correlation between experience levels and representation of debtors and unsecured creditors. However, the less experienced lawyers appeared to do secured creditor work more frequently, in fact considerably more than those with more than twelve or more years of experience.

At first blush it seems anomalous that the lawyers with less experience were more involved in secured creditor related work. However, there were only 13 Lawyer Respondents in the Survey with fewer than three years of experience. Of those 13 designated, five (5) were in a large firm, one (1) was in a medium firm and seven (7) were in a small firm. Since larger firms represented more secured creditors than do smaller firms, there is at least a partial explanation of why the lawyers with lesser experience were more involved in secured creditor work. Perhaps another explanation is that even in smaller firms, when secured creditor work is done, there are sufficient fees generated to support the learning of a less experienced lawyer. This hypothesis is supported by the observation that years in bankruptcy practice did not seem to correlate substantially in terms of the nature of practice. The levels of experience did not suggest, for example, that less experienced lawyers were more involved in individual Chapter 7 cases while experienced lawyers were more involved in business Chapter 7 cases. If anything, somewhat fewer experienced lawyers were involved in Chapter 11 cases. Perhaps this is related to the fact that younger lawyers represented secured creditors more frequently and secured creditor work is more predominant in Chapter 11.

With this background of the Respondents in mind, the report now turns to the more substantive results of the Survey Questionnaire, beginning with an overview that examines the results of the general questions in the Survey and the conclusions which may be drawn therefrom.

Section IV

AN OVERVIEW OF THE RESPONSES

Although the Survey was designed primarily to look at selected sections of the 1984 Amendments, it revealed a significant amount of more generalized data of interest to the participants in the bankruptcy process in light of the introductory and ending questions in the Survey Questionnaire[78] and the overall patterns that can be established by looking at all the data collected.[79] This data reveals information both on how the bankruptcy process is operating and whether it operates according to some of our expectations.

Rating the Bankruptcy System

As a threshold matter, a vast majority of the Respondents (73%) rated the current bankruptcy system as good to excellent. Eighty-five percent (85%) of these responses fell into the category "good" while the balance of the responses were in the category "excellent". Less than 1% of the Respondents thought the bankruptcy system was very poor, leaving 26% of the Respondents who believed the system was fair to poor.

There was statistically significant variation in responses among the Circuits,[80] with the Fifth Circuit feeling the least positive about the system[81] and the Sixth Circuit feeling the most positive.[82] Only four of the Circuits (2nd, 4th, 5th and 9th) had any responses in the category "very poor" and none of these responses exceeded 2% of the total responses in that circuit. There was little differentiation among the circuits in respect of those Respondents who ranked the system as "poor" (the range was from 0% to 5% of the responses), except in the First Circuit in which 13% of the Respondents ranked the system as poor.

Among the categories of Respondents, while not statistically significant at a .05 level,

78. *See* Appendix A, Questions A1, A2, A3 and F1.

79. Because of the cross tabulation tables that were prepared (*see* Section II on Methodology), it is possible to track the responses of the Respondents based on, for example, their category (i.e. Judge, U.S. Trustee, Estate Administrator and Lawyer), location of work (i.e. circuit), type of practice (debtor related, creditor related, trustee related), size of firm (small, medium and large) and level of experience (less than 3 years, 3 to 8 years, 9 to 12 years, more than 12 years).

80. This is statistically significant at a P Value level of less than or equal to .05.

81. In the Fifth Circuit, only 60% of the Respondents ranked the system "good" to "excellent".

82. In the Sixth Circuit, 84% of the Respondents ranked the system as "good" to "excellent". This response is of particular interest in that the Sixth Circuit is the only circuit in which the pilot United States Trustee Program was *not* operating in any district within the Circuit. *See* Section IX on Projections under the 1986 Amendments.

the United States Trustee Respondents ranked the system "excellent" 29% of the time while the Lawyer Respondents only ranked the system "excellent" 8% of the time. However, when the categories "good" and "excellent" are combined, there were virtually no differences between the categories of Respondents. What is statistically significant is that among the Lawyer Respondents, there was not a marked distinction between the Debtor, Creditor and Trustee Lawyer Respondents, with each of these types assessing the system similarly.[83] Consistent with their view of the overall system, the United States Trustee Respondents did not have any responses in the categories "poor" and "very poor", unlike the other categories of Respondents, each of whose responses to these combined categories was around 5%. These results are summarized in the following table:

TABLE 2[84]

RATING THE CURRENT BANKRUPTCY SYSTEM
(BY CATEGORY AND LAWYER TYPE)

	Judge	U.S. Trustee	Estate Admin.	All Lawyers	Creditor Lawyer	Debtor Lawyer	Trustee Lawyer
EXCELLENT	15%	29%	17%	8%	5%	13%	9%
GOOD	59%	43%	54%	65%	64%	66%	61%
FAIR	21%	29%	24%	23%	25%	20%	28%
POOR	4%	0%	4%	4%	5%	2%	2%
VERY POOR	1%	0%	1%	1%	1%	1%	0%
TOTAL NO. OF RESPONDENTS	164	14	72	750	358	174	54

Among the Judge Respondents, however, there were marked and statistically significant differences in their respective ratings of the bankruptcy system.[85] Of the Judge Respondents in the Sixth Circuit, 92% ranked the system as "good" to "excellent" whereas only 46% of the Judge Respondents in the Second Circuit considered the system "good" to "excellent". In four circuits (3rd, 5th, 7th and 8th), none of the Judge Respondents considered the bankruptcy system either "poor" or "very poor". We note that while not statistically significant at a .05 level and considering the small number of Respondents in each cell, the Estate Administrator Respondents in the Sixth Circuit paralleled the Judge

83. This is statistically significant at P Value level of less than or equal to .05.

84. The breakdown by category of Respondent has a P Value of .1. The breakdown by type of Lawyer Respondent has a P Value of less than or equal to .05.

85. This is statistically significant at P Value level of less than or equal to .05.

Respondents' responses, indicating that 100% of such Respondents ranked the system "good".[86] However, unlike the Judge Respondents in the Second Circuit, 100% of the Estate Administrator Respondents in the Second Circuit ranked the system "good" to "excellent".

Effect of the 1984 Amendments

When asked whether the 1984 Amendments as a whole made the bankruptcy system better or worse or had no effect on it,[87] 42% of the Respondents thought that the system was about the same.

Thirty-seven percent (37%) of the Respondents thought the system was better while 21% of the Respondents thought it had made the system worse. Among the categories of Respondents, it is statistically significant that 31% of the Judge Respondents thought the 1984 Amendments had made the system worse while only 7% and 12%, respectively, of the United States Trustee Respondents and Estate Administrator Respondents shared that perspective.[88] Of the Lawyer Respondents, 20% thought the Amendments had made the system worse. For descriptive purposes only, Creditor Lawyer Respondents thought the system was made better more frequently than Debtor Lawyer Respondents or Trustee Lawyer Respondents, although the differential in responses is not substantial.[89] The size of the firm in which the Lawyer Respondents practiced did make a sizable difference, with 43% and 41%, respectively, of those in the small and medium firms feeling that the system was better while only 26% of the Lawyer Respondents in the large firms had this response.[90]

Among the circuits and while not statistically significant at a .05 level, the Respondents in the Second Circuit thought the system was better less frequently than any other circuits, with the Eleventh and Sixth Circuits, respectively, responding that the system was better the most frequently. Again, while not statistically significant at a .05 level and considering the small number of Respondents in each cell, there is a considerable range among the categories of Respondents on a circuit by circuit basis. For example, in respect of making the system better, only 8% of the Judge Respondents in the Second Circuit so responded while 39% of the Judge Respondents in the Tenth Circuit thought the 1984 Amendments had improved the system. Similarly, 32% of the Lawyer Respondents in the First Circuit thought the 1984 Amendments had made the system worse while only 13% of the Lawyer Respondents in the Sixth Circuit thought the system was worse.

86. The responses in the Sixth Circuit did reflect some differences in that none of the Estate Administrator Respondents ranked the system "excellent" while 12.5% of the Judge Respondents did.

87. *See* Appendix A, Question A2.

88. This is statistically significant at a P Value level of less than or equal to .05.

89. Creditor Lawyer Respondents thought the system was better in 43% of the responses while Debtor Lawyer Respondents and Trustee Lawyer Respondents thought the system was better in 34% and 33%, respectively, of the responses.

90. This is statistically significant at P Value level of less than or equal to .05.

The Changes in Practice

When asked whether practice had changed since the passage of the 1984 Amendments,[91] 69% of the Respondents felt that practice had changed somewhat. Only 11% of the Respondents felt that practice had changed substantially while 20% of the Respondents did not think practice had changed at all. For descriptive purposes, it is observed that, with the exception of the United States Trustee Respondents, the other categories of Respondents generally had the same responses.[92] Nor was there a differentiation among the categories of Lawyer Respondents. There were differing responses among the circuits at a statistically significant level, with 25% of the Respondents in the Tenth Circuit indicating that practice had changed substantially while only 4% of the Respondents in the First Circuit felt there was a substantial change in practice.[93]

Abuse of the System

The last substantive question of the Survey Questionnaire[94] probed the extent to which the Respondents believed there was abuse of the federal bankruptcy system.[95] Twenty one percent (21%) of the Respondents thought there was a "great deal" of abuse and 77% of the Respondents thought there was a "little" abuse. Only 2% of the Respondents thought there was *no* abuse of the federal bankruptcy system.[96] Stated differently, 98% of the Respondents thought there was at least a little abuse of the federal bankruptcy system. It should be noted that a possible correlation exists between the 21% of Respondents who felt there is a great deal of abuse, and the 73% of Respondents who felt that the bankruptcy system could be rated as good or excellent, assuming the non-existence of a great deal of abuse constitutes a system rated as good or excellent.

91. *See* Appendix A, Question A3.

92. The United States Trustee Respondents saw less change than any of the other categories of Respondents.

93. This is statistically significant at a P Value level of less than or equal to .05.

94. *See* Appendix A, Question F1.

95. This question did follow the substantive questioning, one section of which also addressed the abuse issues, albeit in a different context. (*See* Section VII on the Consumer Credit Amendments and Appendix A. Questions C2, C3 and C12.) Accordingly, the responses to this Question could have been biased, at least to some extent, by the prior lines of questioning, particularly the connection between abuse and the Consumer Credit Amendments. Other of the amendments selected for study also could have affected the responses to this Question and had other of the 1984 Amendments *not* covered by the Survey been brought to mind (i.e. the creation of Section 1113 dealing with collective bargaining agreements in Chapter 11 cases), the responses might have been different.

96. The amount of abuse in the category a "little" abuse may be somewhat understated in that a number of the Respondents to the open-ended question probing what type of abuse was present (*see* Appendix A, Question F1) indicated that had the category been "moderate" as distinguished from "little", they would have selected the category "moderate". Questions C2 and C3 dealing with abuse, *infra* note 219 and accompanying text, did utilize the category "moderate". Accordingly, the category a "little" abuse includes those who thought there was "moderate" but not a "great deal" of abuse.

Among the categories of Respondents, it is statistically significant that the United States Trustee Respondents thought there was a "great deal" of abuse more frequently than the other categories of Respondents.[97] Of the Judge Respondents, 15% believed there was a "great deal" of abuse"; Lawyer Respondents believed there was a "great deal" of abuse in 21% of the responses; Estate Administrator Respondents believed there was a "great deal" of abuse in 34% of the responses. Of the United States Trustee Respondents, 50% believed there was a great deal of abuse. This distinction is particularly interesting in view of the earlier observation that the United States Trustee Respondents ranked the bankruptcy system as "excellent" more frequently than any of the other categories of Respondents.[98]

Among the types of Lawyer Respondents, there are statistically significant differences in the responses. Creditor Lawyer Respondents thought there was a great deal of abuse more frequently than the Debtor Lawyer Respondents.[99] Twenty nine percent (29%) of the Creditor Lawyer Respondents thought there was a "great deal" of abuse while only 8% of the Debtor Lawyer Respondents shared that view. The Trustee Lawyer Respondents thought there was a great deal of abuse with almost the same frequency as the Creditor Lawyer Respondents. However, when the categories a "great deal" and a "little" abuse are combined, there is very little variation among the types of Lawyer Respondents.

The experience level of the Respondents had a dramatic impact of their perception of the amount of abuse of the federal bankruptcy system.[100] Respondents with less than three years experience thought that there was a great deal of abuse in 41% of the responses while 18% of the Respondents with more than twelve years of experience thought there was a great deal of abuse. While not statistically significant, there was no correlation between the amount of abuse and the size of the Lawyer Respondents' firms.

There were distinct and statistically significant differences in the perceptions of abuse in the circuits.[101] The greatest abuse was felt in the Fifth, Ninth and Eleventh Circuits while the least amount of a "great deal" of abuse was felt in the Sixth and Tenth Circuits. We note that while not statistically significant at a .05 level and considering the small number of Respondents in each cell, these disparities become more pronounced when the amount of abuse is further broken down by the categories of Respondents within each circuit. In two circuits (1st and 3rd), the Judge Respondents did not perceive a "great deal" of abuse at all. This must be contrasted with the Ninth Circuit, where the Judge Respondents believed that there was a great deal of abuse in 38% of their responses. Among the Lawyer Respondents, a great deal of abuse was sensed more frequently in the Third, Fifth, Ninth and Eleventh Circuits, although the range of the lawyer responses is not as dramatic as in

97. This is statistically significant at a P Value level of less than or equal to .05.

98. *Supra* note 84.

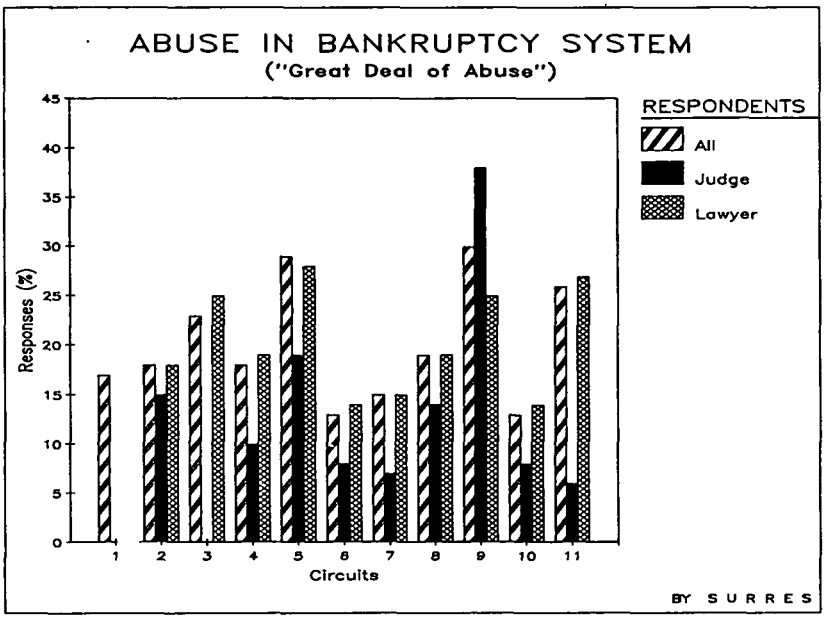
99. This is statistically significant at a P Value level of less than or equal to .05.

100. This is statistically significant at a P Value level of less than or equal to .05.

101. This is statistically significant at a P Value level of less than or equal to .05.

the context of the Judge Respondents (the range of the lawyers' responses was from a low of 14% to a high of 29%). The following chart breaks down the responses that there was a great deal of abuse into certain of the respondent categories on a circuit by circuit basis.[102]

CHART 4[103]



Explanations to Explore

In assessing why there is so much abuse, one factor that must be considered is that the question involving abuse does not define the term "abuse". Abuse of the bankruptcy system can mean a variety of different things. For example, some Respondents may believe that debtors are abusing *current* provisions of the Code; other Respondents may believe the current provisions of the Code are not being abused but that a system which entertains the results permitted by the current Code provisions is abusive. Therefore, the fact that the Respondents perceive abuse does not indicate what that abuse is, and what constitutes the

102. While the chart reveals the combined totals of all categories of Respondents, it does not break-out the responses of the United States Trustee Respondents and the Estate Administrator Respondents.

103. The breakdown by circuits has a P Value level of less than or equal to .05. The breakdown by Judge Respondents in the circuits has a P Value of .08. The breakdown by Lawyer Respondents in the circuits has a P Value of .36.

Respondents' sense of abuse could be quite variable.

In seeking to evaluate why there is more perceived abuse in some circuits than others (the response a "great deal" appeared more frequently in the 5th, 9th and 11th circuits), the first possible correlation to check is the increase in case load over the past year to determine if the quantum of increase of cases correlates to the amount of abuse. The data needed to make this assessment is published by the Administrative Office of the United States Courts (the "AO"). Some of the methodology employed by the AO in gathering its statistics has been challenged and hence is subject to some controversy.[104] However, the statistics produced by the AO are the only ones available and are then utilized for testing various hypotheses in the Survey, with the full understanding that other and further analyses need to be completed before any hypothesis can be proven with a degree of certainty. Moreover, the AO has supplied ABI with additional information, not generally published, which, while providing important contributions, has not been independently verified.

The statistics published by the AO reveal that the greatest percentage increase in filings for the year ending June 1986 is in the 5th Circuit,[105] reflecting the linkage suggested. The percentage increase in the 10th Circuit is the second highest.[106] However, the percentage increase in the 9th Circuit does not rank it among the highest. Of the 12 circuits, the 9th Circuit had the 6th highest percentage change. This suggests, that at least in the 9th Circuit, abuse is correlated to something more than percentage case load increase. Moreover, since circuits with a greater percentage increase than the 9th Circuit are not showing the level of abuse reflected in the responses of the Respondents in that circuit, something other than case load increase must determine whether abuse is felt.

Another possible correlation to evaluate is between the new case filings on a per judge basis per circuit and the level of abuse. This number has been calculated by dividing the number of judges in a given circuit with the total number of new filings in that circuit, based on the statistics published by the AO. These calculations do not, however, present a complete picture of what is happening in the bankruptcy system. First, the number of judges utilized in the calculation reflects the total *available* judgeships and not the *actual* number of judges sitting during the year June 1985 to June 1986. Therefore, vacancies, of either long or short duration, have not been considered, and this could materially alter the results. In addition, within each circuit, some districts are busier than others. While some of the statistics produced by the AO are published on a district by district basis, the Survey does not breakdown responses by judicial district. Accordingly, a district by district analysis has not been made with respect to this and all the other calculations made. The per judge case load of new filings by district could present something quite different from what is currently revealed. These caveats notwithstanding, it is worth at least a preliminary look to see if any possible correlations exist.

104. The soundness of these statistics has been challenged by Sullivan, Warren and Westbrook *supra* note 30.

105. The statistics published by the AO and appearing in the January 22, 1987 of News and Comment, published by CRR Publishing Company at A10-14, reflect a 50% increase in filings for the year ended June 1986 compared to the year ended June 1985.

106. The increase, as reflected in the statistics published by the AO, is 42% for the year ending June 1986 over the prior year ending June 1985.

The new case filings per judge is highest in the Ninth Circuit. High case loads per judge are also revealed in the Fifth and Seventh Circuits. The case loads in the Tenth and Eleventh Circuits, respectively, follow closely on the heels of the Seventh Circuit. The Seventh and Tenth Circuits, which do not reveal a great deal of abuse, seem to be at odds with a pattern established in the other circuits, namely, that the level of new filings per judge affects the level of abuse.

Several other factors can be evaluated, namely, pending adversary proceedings per judge and new non-business filings per judge, all with the concerns about calculations mentioned above. The highest number of pending adversary proceedings on a per judge basis appear in the Fifth and Ninth Circuits. The greatest number of new non-business filings appear in the Fifth, Seventh, Ninth and Eleventh Circuits. The Eleventh Circuit, which has high levels of perceived abuse, does *not* have a high number of adversary proceedings per judge. In addition, the Sixth Circuit, which demonstrates less abuse than the other circuits, has the fifth highest non-business new case filings.

What these correlations suggest is that high numbers of new filings, pending adversary proceedings and new non-business filings are factors contributing to the level of perceived abuse. However, it is also apparent that these are not the sole factors contributing to abuse in that some circuits reveal high numbers in these categories without a corresponding high level of abuse. This reveals that something other than per judge new case load, adversary proceedings and non-business filings are a factor contributing to the perception of abuse.

Another possible correlation exists between the type of new cases filed (Chapters 7, 11 or 13, respectively) and the extent of abuse. With the caveats noted earlier, there does not seem to be a direct correlation between the percentage that the total number of Chapter 13 cases filed bear to the total number of new filings in a circuit and abuse.[107] Nor does there appear to be a significant correlation between abuse and the number of new non-business Chapter 13 filings in relation to all new non-business filings. There also does not appear to be a relationship between the amount of abuse and the ratio of new non-business filings to overall new filings.

There does appear to be some correlation between the value of assets in bankruptcy cases disposed of in the year ending December 31, 1986 and the amount of abuse.[108] These calculations are based on figures supplied by the AO. The data is troubling for several reasons. First, the data relates to cases disposed of as of December 1986. The Respondents were, in all likelihood, focussing not only on recently closed cases but on current pending cases in answering the questions asked. In addition, a number of cases with significant assets and liabilities have not been closed to date, including Johns Manville, A.H. Robins, LTV and Texaco. The closure of these cases would significantly affect the figures utilized. However, as with the other data, it is still valuable to see if any correlations can be observed, as it provides at least a starting point for future analysis.

The circuits with the largest value of assets in cases disposed of were the Fifth, Sixth, Ninth and Eleventh Circuits. The clear anomaly is the Sixth Circuit, in which the Respon-

107. This is based on the statistics supplied by AO, *supra* note 104 and accompanying text.

108. These statistics were supplied by AO and are not regularly published. This correlation is only a rough estimate since the data supplied by AO relates to cases disposed of whereas the Respondents were dealing with current cases, as well as insights into older cases. This time lag could affect the comparisons.

dents felt there was not a great deal of abuse. The anomaly of the Sixth Circuit is eliminated if the total value of assets is evaluated on the basis of the total number of cases which were disposed of in a given circuit, a more meaningful measurement. The asset values on a per case basis are highest in the Fifth, Ninth and Eleventh Circuits. On a per case basis, the asset value per case disposed of in the Sixth Circuit is substantially lower. In absolute terms, there is no correlation between the amount of liabilities by circuit for cases disposed of at year-end 1986 and the circuits registering a "great deal" of abuse. However, when comparing the ratio of assets to liabilities by circuit for cases disposed of at year-end, the circuits with the highest average per dollar payout (1st, 5th, 9th and 11th circuits) have among the highest levels of abuse, the First Circuit being the anomaly.

Lastly, again based on statistics supplied by the AO and with the caveats previously noted, there does not seem to be any correlation between high administrative costs and the level of abuse.[109] The costs of administration on a per case basis range from a high of approximately $730 in the Second Circuit to a low of approximately $338 in the Eighth Circuit.[110] The costs of administration in the Fifth, Ninth and Eleventh Circuits were approximately $365, $395 and $675, respectively, per case. In the Sixth Circuit, where the Respondents did not perceive a great deal of abuse, the average administrative costs per case were approximately $495.

As previously observed, abuse of the bankruptcy process is not a simple term to define and it is helpful at this point to note the specific areas in which the Respondents perceived the abuse. Those Respondents who felt that there was a great deal of abuse of the federal bankruptcy system (Question F1) were asked to describe what the abuse was. A large number of the Respondents felt that the "great deal of abuse" consisted of the hiding, dissipating, undervaluing or exemption of assets.[111] A similarly large group felt that Chapter 11 was being used as a delay tactic while the debtor operates the business and dissipates the assets with no intent whatsoever of reorganizing.[112] A somewhat smaller group felt that the delay was a factor in Chapter 13, with minimal payments to creditors and the subsequent receipt of the Chapter 13 "super discharge." These responses suggest that abuse of the system may be something other than that which was originally addressed in the 1984 Amendments.

With these responses to the general questions in the Survey in mind, it is now possible to draw some general observations about the effect and effectiveness of the 1984 Amendments.

General Perceptions

From any perspective, the responses to this general series of questions reveal that the Respondents did not believe that the 1984 Amendments fundamentally changed the system. Even though approximately 80% of the Respondents thought the 1984 Amendments

109. The cost of administration per case in each circuit for cases disposed of at December 31, 1986 was supplied by AO.

110. *Id.*

111. *See* Section II on Methodology.

112. This is the topic of a survey conducted by a task force of the Business Bnakruptcy Committee of the American Bar Association due to be released in 1987-1988.

changed practice, apparently the changes did not result in improvements in the system at a rate anywhere approaching the rate of change. This suggests that while a number of changes were made, they did not have an overwhelming effect on the substantive outcome under the system. Moreover, there were few Respondents who believed there was no abuse of the bankruptcy system and one fifth of the Respondents thought there was a "great deal" of abuse.

Certainly, when new legislation is passed, there is the hope that it will improve the state of things; if not, there is no purpose in making the changes in the first instance. There has certainly been sufficient time since the passage of the Amendments to evaluate at least the initial effects of these Amendments.[113] Therefore, the observation that the majority of the Respondents saw no change in the system and a constant presence of at least some degree of abuse suggests that the overriding goal of these amendments, as with almost any statutory scheme, has not been achieved.

Moreover, special interest groups that would have hoped to see significant changes in various aspects of the Code as a consequence of the 1984 Amendments are not seeing these changes.[114] The Consumer Credit Amendments, for example, reflect overall the least amount of change. Creditor Lawyer Respondents see more abuse of the bankruptcy system than do Debtor Lawyer Respondents, suggesting that the Consumer Credit Amendments did not eradicate perceived abuses of the system. Additionally, other groups in the bankruptcy process that disliked aspects of the 1984 Amendments are not seeing the dramatic collapse of the system they might have wanted to demonstrate the inappropriateness of the changes.[115] The jurisdictional changes, for example, reveal the greatest amount of change, but neither that level of change nor the concomitant results are dramatic. In sum, then, the 1984 Amendments were neither as good as some special interest groups would have liked nor as bad as other participants in the process anticipated.

Altering Our Hypotheses

One of the more startling and significant features of the responses to the Survey is that they do not always run along "party lines". Debtor Lawyer Respondents do not always

113. Certainly, follow-up studies are warranted to see if the initial observations remain true over the long-haul.

114. For example, the Consumer Credit Industry (which is defined for these purposes as those groups that pursued added protections in the Code to eradicate perceived abuses of individual debtors who did not repay their unsecured credit card and loan obligations) would have hoped that the bankruptcy system was considerably better as a consequence of the 1984 Amendments. However, in the ratings of the bankruptcy system, Creditor Lawyer Respondents are not responding that the system is better. This suggests that the Consumer Credit Amendments did not achieve what they were designed to achieve. *See* Section VII on the Consumer Credit Amendments.

115. For example, the Lawyer Respondents and Judge respondents, many of whom favored the creation of Article III Bankruptcy Courts, hoped and perhaps anticipated that the 1984 Amendments would create substantial jurisdictional problems such that the entire bankruptcy process would be jeopardized. While it appears that practice may have changed, the overall effect on the system does not seem to be dramatic. *See* Section VIII on the jurisdictional changes.

think differently from Creditor Lawyer Respondents. In responding to the questions in the Survey Questionnaire involving the automatic stay, statutory compliance and jurisdiction, these two groups shared similar perspectives. One possible explanation is that the Lawyer Respondents were able, at least in some areas, to see the system objectively rather than through the perspective of their clients' interests.[116] Another explanation is that while a Lawyer Respondent was defined as a "debtor", "creditor" or "trustee" lawyer, this did not preclude the Lawyer Respondent from representing other interests, albeit in smaller proportions. Therefore, Debtor Lawyer Respondents could be taking creditor interests into account in responding, thereby curtailing the partisanship factor themselves.

Lawyer Respondents in small firms do not always think differently from Lawyer Respondents in large firms. In responding to questions on the automatic stay, statutory mandates and the Consumer Credit Amendments, there were no significant differences in responses based on the size of the Respondents' firm.[117] This vitiates, at least in part, the longstanding myths about big firm mentality.

The Survey does reveal important differences in other areas, however. The four categories of Respondents frequently think differently about the questions asked. Moreover, there are dramatic differences among the circuits, something which has frequently been perceived by those in practice and can be observed in a reading of the growing number of contradictory bankruptcy court decisions. Lawyers with less than three years experience are responding differently to the questions asked, suggesting that experience levels are a factor in determining responses.

The Sections that follow detail the responses to the specific 1984 Amendments studied. These Sections cannot and do not always explain the responses. However, the results at least open the doors to asking the right questions and suggest some avenues to pursue in seeking to find the seemingly illusive answers.

116. These two groups did have differing responses to the questions on the Consumer Credit Amendments and preference recoveries. *See* Sections VI and VII, respectively.

117. Firm size does appear to impact on the responses to the questions involving jurisdiction and preference recoveries. *See* Section VI and VIII, respectively.

Section V

THE AUTOMATIC STAY

In the 1984 Amendments, Section 362 was "clarified" to provide that if the initial hearing held under Section 362 was a preliminary, as distinguished from a final, hearing, then the final hearing was required to be commenced within 30 days after the conclusion of the preliminary hearing.[118] The 1984 Amendments also clarify that if the initial hearing (whether preliminary or final) is not commenced within 30 days, the stay is terminated.[119] Bankruptcy Rule 4001(b) adds that unless the court denies the relief from the stay within 30 days after the final hearing is commenced, the stay expires, unless specifically extended by the court.[120]

This unit of the Survey Questionnaire is designed to probe whether the Respondents believe that there is judicial compliance with the prescribed statutory mandates and rules. This is accomplished by breaking down the relief from stay process into distinct questions.[121] A new variable was created that combines all the questions in the Survey dealing with compliance to determine overall patterns of compliance with statutory mandates.[122] Although four of the five questions within the recoded variable are contained in this Sec-

118. Prior to the passage of the Code, there was a sense that there were delays in obtaining relief from the stay, to the prejudice of creditors. (*See* House Report No. 95-595, 95th Cong., 1st. Sess. 1977.) While the Code clarified this matter to some extent, as expressed by Miller and Cook in their treatise *A Practical Guide to the Bankruptcy Reform Act*, "Although Section 362(e) does require the final hearing be 'commenced' within 30 days from the preliminary hearing, it fails to set a deadline for the completion of the hearing or for the decision. Even if the court were to complete the final hearing promptly, it may still reserve decision for several months and continue the stay in effect during that period."

Bankruptcy Rule 4001(b) provides that the stay terminates 30 days after commencement of the final hearing unless the court denies the request for relief.

119. Section 362(e) contemplates that if the initial hearing is a preliminary hearing, it must not only be commenced but must also be concluded within 30 days after the request for relief from the stay.

120. This is tantamount to saying that the judge must both conclude the hearing and decide the request for relief within 30 days after the final hearing is commenced.

121. *See* Appendix A, Questions E1-E6.

122. The term "statutory mandate" is being utilized in the broad sense to include compliance not only with provisions of the Code itself but the Rules promulgated to effectuate the Code. While the Bankruptcy Rules do not carry the weight of the provisions of the Code itself, in that they are designed to be procedural as distinguished from substantive, they form a significant part of bankruptcy practice. Bankruptcy Rule 1001 states that "These rules shall be construed to secure the expeditious and economical administration of every case under the Code and the just, speedy, and inexpensive determination of every proceeding therein." Since the purpose of Rule 4001(b) was to promote speedy determinations, compliance with its terms is important to the effectiveness of Section 362.

tion, the results of the combined responses to the overall issue of statutory compliance will be addressed in Section X of this report.[123]

This unit of the Survey Questionnaire reveals that there was a considerable amount of non-compliance with statutory mandates. Not surprisingly, while the Judge Respondents acknowledged non-compliance, the level of acknowledged non-compliance was less than the quantum of non-compliance perceived by the Lawyer Respondents. Moreover, while non-compliance existed in every circuit, the amount of non-compliance with statutory mandates varied quite dramatically from circuit to circuit.

Commencing Hearings Within 30 Days

When asked whether preliminary or final hearings[124] are commenced within 30 days after relief is requested,[125] only 52% of the Respondents indicated that such a hearing was held "almost all the time". If there were full compliance with the statutory mandate, the response to this question would have been that 100% of the responses were "almost all the time". Eleven percent (11%) of the Respondents indicated that such a hearing was "hardly ever" commenced within 30 days and another 15% of the Respondents indicated that such a hearing was commenced "some of the time". There were 23% of the Respondents who indicated that such hearings were commenced "most of the time".

The responses to this question varied dramatically if the Respondents are broken in categories.[126] Of the Judge Respondents, 70% thought there was compliance "almost all the time" while only 45% of the Lawyer Respondents shared that perspective. The responses of the Estate Administrator Respondents were similar to that of the Judge Respondents (75%) while the responses of the United States Trustee Respondents were similar to that of the Lawyer Respondents (43%).

At the other end of the spectrum, 13% of the Lawyer Respondents thought the hearing was hardly ever commenced within the statutorily mandated 30 day period while only 2% of the Judge Respondents and 3% of the Estate Administrator Respondents shared that view. None of the United States Trustee Respondents answered that there was hardly ever compliance.

There are also dramatic and statistically significant disparities among the circuits.[127]

123. Section II on Methodology, *supra* at 64, describes the newly created code. The one question that did not appear in the series of questions on Section 362 involves the Consumer Credit Amendments and compliance with Section 1325(b) of the Code (which requires that Chapter 13 debtors who are not paying their creditors in full contribute all of their projected disposable income over the subsequent three years to plan payments). Although the subject area is different, the determination of whether there is compliance with this express statutory provision is similar to that evaluated in the context of Section 362 and the accompanying Bankruptcy Rule. However, for a fuller understanding of the combined variable, the section on the Consumer Credit Amendments should be evaluated.

124. The preliminary and final hearings can be consolidated into a single hearing at the discretion of the judge. Whether the initial hearing is preliminary or final, it must be commenced within 30 days after relief is requested. Therefore, to comply with the statutory mandate, the response to the Question should be "almost all the time".

125. *See* Appendix A, Question E1.

126. This is statistically significant at a P Value level of less than or equal to .05.

127. This is statistically significant at a P Value level of less than or equal to .05.

In answering whether there was compliance almost all the time, three circuits (4th, 6th and 11th) indicated such compliance between 61% to 64% of the time. This contrasts with the Second and Eighth Circuits where compliance "almost all the time" appeared in 33% and 38%, respectively, of the responses. There is less variation among the circuits if the responses "almost all the time" and "most of the time" are combined. The Fourth, Sixth and Eleventh Circuits still show the greatest levels of compliance. The Second Circuit continues to show the least level of compliance. The Eighth Circuit rises to the middle of the pack when the totals are combined, and the First and Third Circuits lag behind.

Even greater disparity can be seen when the responses are cross tabulated both by category of Respondent and Circuit. While not statistically significant at a .05 level and while there were few Judge Respondents in each cell, the range of responses of the Judge Respondents as to whether there was compliance "almost all the time" is astounding. In the First Circuit, 100% of the Judge Respondents thought there was compliance almost all the time while only 31% of the Judge Respondents in the Second Circuit shared this perspective. In the other circuits, the responses among the Judge Respondents ranged from a high of 90% to a low of 56%.

Among the Lawyer Respondents who believed there was statutory compliance "almost all the time", it is statistically significant that there was less range in the responses.[128] Lawyer Respondents in the Sixth and Eleventh Circuits thought there was such compliance 55% and 58% of the time, respectively, while Lawyer Respondents in the Second Circuit shared this view in only 26% of the responses.[129] Among the other circuits, the range of Lawyer responses that there was compliance with the statutory mandate almost all of the time was from a high of 51% in the Fourth Circuit to a low of 33% in the Eighth Circuit.

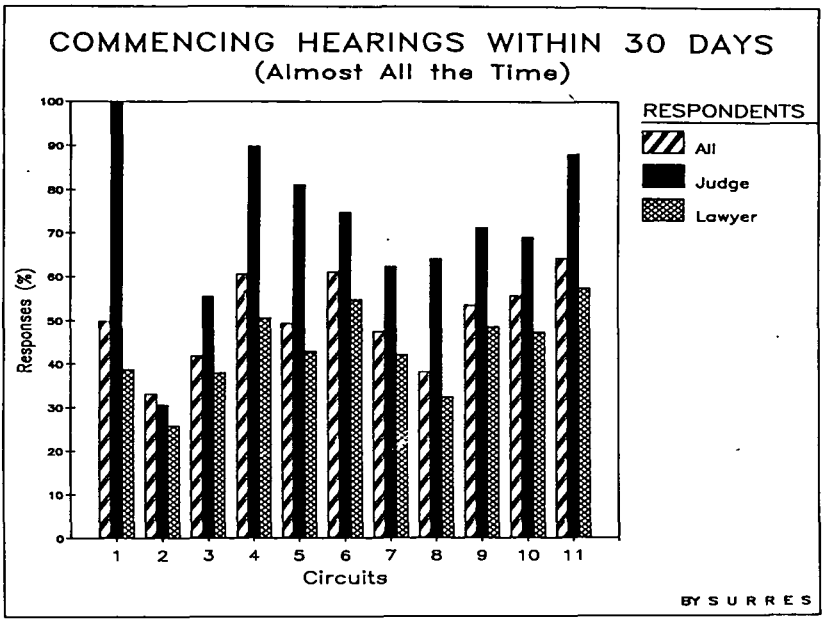
What is equally revealing is a comparison of the results among the Judge Respondents and Lawyer Respondents by circuit to determine if these two groups have similar perceptions of what is transpiring in their respective circuits. The least disparity of responses can be seen in the Second Circuit, a circuit with the lowest level of compliance. In that circuit, the Judge Respondents perceived there was compliance "almost all of the time" in 31% of the responses while the Lawyer Respondents thought there was such compliance in 26% of the responses. Contrast this with the First Circuit where the greatest disparity can be seen. In that circuit, 100% of the Judge Respondents thought there was compliance "almost all of the time" while only 39% of the Lawyer Respondents shared that perspective. The circuits, other than the First, showing the greatest differential in responses,[130] were the Fourth and Fifth Circuits. The following chart demonstrates the responses of the Judge Respondents and Lawyer Respondents, each compared to the other, on a circuit by circuit basis.

128. This is statistically significant at a P Value level of less than or equal to .05.

129. This is statistically significant at a P Value level of less than or equal to .05.

130. As noted, *supra* 127 and accompanying text, the Judge Respondents always thought there was more compliance than the Lawyer Respondents and hence the differential is always running in the same direction.

CHART 5[131]



One possible conclusion that can be drawn is that while the level of non-compliance was greatest in the Second Circuit, there was agreement that there was non-compliance among the Judge Respondents and Lawyer Respondents. Where wide disparities in responses are observed, such as in the First, Fourth and Fifth Circuits, there may well be some tension between the Lawyers practicing in those circuits and the Judges sitting there. It is plausible, though, that the Judge Respondents may not be aware of the amount of non-compliance if, for example, a clerk is maintaining the docket and scheduling matters. In addition, some of the disparity may be attributable to the fact that the lawyers may be reaching agreements to continue a matter without the court being aware of any such accords, although that would *not* account for the Lawyer Respondents' sensing non-compliance. When a marked disparity is noted, it would seem that the Lawyer Respondents' viewpoint has more credibility than that of the Judge Respondents who are under a statutory duty to comply and hence are less likely to admit to non-compliance as it would reflect poorly on them.

131. The breakdowns by circuits and by Lawyer Respondents in the circuits have a P Value of less than or equal to .05. The breakdown of the Judge Respondents in the circuits has a P Value of .09.

At least at this juncture, there does not appear to be a direct correlation between compliance with this statutory mandate and perceptions about abuse, except in respect of the Sixth Circuit where the responses correlate, namely, where there is a high level of compliance, there is a lesser degree of perceived abuse. However, the circuits demonstrating the highest degree of abuse (5th, 9th and 11th Circuits) do not reflect the greatest degree of non-compliance. In fact, non-compliance is greatest in the Second Circuit which is not among the circuits registering a high level of abuse. This suggests that the abuse the Respondents are sensing is something more than judicial non-compliance with statutory mandates.

Among the most startling aspects of the responses in respect of commencing a hearing is what they do *not* show. When asked about commencing a hearing, there were no appreciable differences in the responses of the Debtor Lawyer Respondents, Creditor Lawyer Respondents and Trustee Lawyer Respondents. Nor did the firm size in which the Lawyer Respondents practiced affect the responses. Experience level also did not effect the responses. The only factor that played a role was the category of Respondent and the geographic local. This strongly suggests that the Lawyer Respondents answered objectively and without partisanship rather than supplying, consciously or unconsciously, a response that would be more beneficial to their respective clients' interests.[132] Moreover, it suggests more reliability in their responses than those of the Judge Respondents in terms of accurately assessing the degree of non-compliance.

Stay Termination

In addition to requiring that a hearing be held, the Code mandates that the stay be terminated if such a hearing is not commenced.[133] When asked if judges permit the stay to remain in effect even though no hearing has been held,[134] 42% of the Respondents indi-

132. Debtor Lawyer Respondents, if answering with only their clients' interests in mind, might indicate that there was substantial compliance so that there would not be a move afoot to lift the stay more than it was already being lifted. This is not to suggest that such Debtor Lawyer Respondents would have impure motives but rather that one's perspective can be affected by the interests one represents most frequently.

133. *Supra* note 119.

134. *See* Appendix A, Question E2. To comport with the statutory mandate, the responses should have been "hardly ever".

cated "hardly ever". That leaves 59% of the Respondents who responded that the stay remained in effect, notwithstanding the statutory mandate indicating that the stay was effectively terminated, at least some of the time.[135] Twenty-two percent (22%) of the Respondents indicated that the stay was permitted to remain in effect "almost all the time", a degree of non-compliance even greater than that seen in the prior question.[136]

This question produced similar differentiations between the circuits.[137] The responses indicating the most compliance ranged from a high of 55% in the Eleventh Circuit to a low of 26% in the Third Circuit. High levels of compliance were also observed in the Fourth, Sixth and Tenth Circuits.[138] Lower compliance was seen in the First and Second Circuits.[139] When the categories reflecting the least compliance are combined ("almost all the time" and "most of the time"), the greatest level of non-compliance appears in the Third and Eighth Circuits and the least level of non-compliance is found in the Sixth, Tenth and Eleventh Circuits.

While not statistically significant at a .05 level and considering the small number of Respondents in each cell, for descriptive purposes only, there was more marked distinctions in the responses when they are evaluated both by Circuit and Respondent. The responses of the Judge Respondents varied from a high of 71% indicating that they hardly ever let the stay remain in effect (7th Circuit) to a low of 25% in the Third Circuit. The next lowest response was 42% in the Second Circuit, suggesting that the Judge Respondents in the Third Circuit have views quite different from their compatriots in other Circuits.

For descriptive purposes, it can be seen that among the Lawyer Respondents, there is a difference in their responses to Question E2, but these differences do not correlate to the size of the Lawyer Respondent's firm. The responses to the category "hardly ever" (which designates the most compliance) ranged from a high of 52% of the responses in the Eleventh Circuit to a low of 24% of the responses in the Third Circuit. When the Judge Respondent responses are compared to those of the Lawyer Respondents, it again demonstrates, as indicated in Question E1, that in all of the Circuits except the Third and Eighth, the Lawyer Respondents perceive more non-compliance than do the Judge Respondents. Since it is a mandate placed upon the Judges, it is not surprising that they perceive more compliance than the Lawyer Respondents.

135. One possibility to keep in mind in respect to this Question is that some judges may be extending the stay pursuant to Section 105 of the Code and hence the Respondents would not be responding that there is a violation of a statutory mandate. There has been considerable controversy over the use of "105 Orders" to circumvent clearly prescribed statutory timetables.

136. There were 73 missing cases in this question (E2) compared to 27 such cases in the prior question (E1) which might account for some of the differences. Moreover, this Question required a response in the reverse order than the prior Question. In other words, the response indicating compliance in Question E1 was "almost all of the time" where that same response to Question E2 demonstrated the least compliance, the most compliance being designated by the response "hardly ever". This juxtaposition may have confused some Respondents.

137. This is statistically significant at a P Value level of less than or equal to .05.

138. In Question E1, high compliance was observed in the Fourth, Sixth and Eleventhth Circuits.

139. In Question E1, the Second Circuit demonstrated the least compliance, with the Eighth Circuit following just behind. In response to Question E2, the Eighth Circuit responses within the category "hardly ever" were 39% compared to the Second Circuit Responses of 37%, not an appreciable difference.

Commencing Final Hearing

When asked whether, as mandated by statute, judges are commencing final hearings within thirty days after conclusion of the preliminary hearing,[140] 47% of the Respondents indicated that such hearings were commenced "almost all of the time". Ten percent (10%) of the Respondents thought such hearings were "hardly ever" commenced within the statutorily prescribed time period.

For descriptive purposes, on a circuit by circuit basis, the responses have similar variations to those indicated in respect of Questions E1 and E2. The highest level of compliance appears in the First, Sixth, Tenth and Eleventh Circuits. The least compliance is noted in the Second and Third Circuits. Among the Judge Respondents in each circuit, there are dramatic differences in the responses. For example, in the Tenth and Eleventh Circuits, responses of "almost all the time" exceeded 80% while in the Second and Third Circuits, responses to that same category were 25% and 22% respectively. Among the Lawyer Respondents, there was also a range of responses, but without the dramatic variations present among the Judge Respondents. In each of the First and Eleventh Circuits, 53% of the responses of the Lawyer Respondents indicated "almost all the time". This can be compared to the responses in the same category of 33% and 31% for the Lawyer Respondents in the Second and Seventh Circuits, respectively. There does not appear to be any correlation between these responses depending on the type of Lawyer Respondent, nor does firm size appear to affect responses. Again, while not statistically significant at a .05 level, there is a marked difference between the Judge Respondents' and the Lawyer Respondents' respective answers to the same question in the same circuit except in the Second, Third and Ninth Circuits. In the Second and Third Circuit, the Respondents in these categories agree that there is not a great deal of compliance with statutory mandates. In the Ninth Circuit, the Judge Respondents and Lawyer Respondents also agreed that there was non-compliance to the same degree, but in this instance, there is a higher level of perceived compliance than in the Second and Third Circuits.

Court Determinations

When asked whether courts are deciding issues involving relief from the stay within 30 days after conclusion of the final hearing,[141] 48% of the Respondents indicated that such decisions are rendered "almost all the time". Only 7% of the Respondents indicated that such decisions are "hardly ever" rendered in the designated time period. Not unlike the other questions in this section, there is a broad disparity in the amount of reported com-

140. *See* Appendix A, Question E3.

141. *See* Appendix A, Question E6. The question actually contemplates that it could take even more time than that provided for in Bankruptcy Rule 4001(b). Rule 4001 mandates that the decision be rendered within thirty days after the final hearing is commenced. The question references measuring the thirty day period from the point of *conclusion* as distinguished from *commencement* of the final hearing. Therefore, the time period for compliance is even less than that suggested by the question. Accordingly, if there is substantial non-compliance in response to the question as drafted, there will be even less compliance with Rule 4001 which requires the rendering of a decision sooner.

pliance on a circuit by circuit basis.[142] Decisions are rendered more frequently within the designated time period in the Fourth and Sixth Circuits. Such decisions are rendered less frequently in the Second, Third and Seventh Circuits. When the responses "almost all the time" and "most of the time" are combined, some of the spread between the responses diminishes. However, there is cumulatively still the least compliance in the Second, Third and Seventh Circuits and the greatest amount of compliance in the First and Sixth Circuits. The following table summarizes these findings:

TABLE 3[143]

DECISIONS WITHIN 30 DAYS
(BY CIRCUIT)

	1st	2nd	3rd	4th	5th	6th	7th	8th	9th	10th	11th
ALMOST ALL THE TIME	55%	38%	34%	61%	45%	57%	30%	50%	50%	49%	54%
MOST OF THE TIME	30%	34%	33%	21%	32%	29%	36%	31%	31%	29%	19%
SOME OF THE TIME	10%	17%	17%	11%	18%	11%	20%	13%	15%	19%	23%
HARDLY EVER	5%	11%	17%	6%	6%	3%	14%	6%	4%	3%	3%
TOTAL NO. OF RESPONDENTS	20	71	77	80	110	114	84	64	166	59	90

Among the Judge Respondents broken down by circuit, while not statistically significant at a .05 level, there was again a range of compliance but it was not as pronounced as that apparent in Questions E1, E2 and E3. The range of responses are between a low of 54% of the responses in the Tenth Circuit to a high of 90% of the responses in the Fourth Circuit. Among the Lawyer Respondents, there are also fewer variations than in the previous question, although there is still a fair range of responses. Of the Lawyer Respondents indicating decisions within the designated time period "almost all of the time",[144] only 20% of the Lawyer Respondents in the Seventh Circuit shared this perspective while 54% of the Lawyer Respondents in the Fourth Circuit shared this viewpoint. The type of Lawyer Respondent and the size of the firm in which the Respondent practiced did not appear to affect the responses. Again, as with the other questions in this section, there are quite distinct differences in the responses of the Judge Respondents and the Lawyer Respondents.[145] However, unlike the other questions wherein the Judge Respondents and Lawyer

142. This is statistically significant at a P Value level of less than or equal to .05.

143. This breakdown has a P Value of less than or equal to .05.

144. This is statistically significant at a P Value level of less than or equal to .05.

145. This is statistically significant at a P Value level of less than or equal to .05.

Respondents shared similar responses[146], in this question there are consistent disparities except in the Tenth Circuit wherein both the Judge Respondents and Lawyer Respondents both perceived approximately the same level of response to "almost all the time." Interestingly, in the Second and Third Circuits, which had similar perceptions about the degree of non-compliance, these categories had differing observations about the issuance of court decisions.

Effect of the 1984 Amendments

In responding to whether the 1984 Amendments affected the frequency of commencing final hearings,[147] 61% of the Respondents thought there was no change as a consequence of the Amendments, although 36% of the Respondents did see an increase. When asked whether the 1984 Amendments made things better for creditors,[148] 48% of the Respondents thought there was no change while 46% thought the Amendments had made things better for creditors. The responses to these two questions did vary based on categories of Respondents.[149] The Judge Respondents believed more often than the other Respondents that there was no difference in the frequency of hearings while the Lawyer Respondents perceived that there were hearings being held more frequently. Similarly, the Judge Respondents thought that the Amendments had made no difference to creditors more frequently than did the Lawyer Respondents.

Among the Lawyer Respondents, there were no disparities in how they viewed the frequency of the hearings but they did view the effect of the Amendments quite differently.[150] In response to whether there were more hearings as a consequence of the 1984 Amendments, 35%, 38% and 36% of the Creditor Lawyer Respondents, Debtor Lawyer Respondents and Trustee Lawyer Respondents, respectively, thought that there was an increase in the frequency of hearings. In looking at whether the 1984 Amendments made things better for creditors, only 40% of the Creditor Lawyer Respondents shared this perspective while 51% of the Debtor Lawyer Respondents and 65% of the Trustee Lawyer Respondents believed the creditors' position had been bettered. Looking at the question from the reverse perspective, in other words, whether the 1984 Amendments made things better or worse for debtors,[151] there is, although not statistically significant, less of a differentiation in responses based on the type of Lawyer Respondent. For example, 30% of the Creditor Lawyer Respondents thought things were worse for debtors while "only" 41% of the Debtor Lawyer Respondents and 40% of the Trustee Lawyer Respondents thought things were worse for debtors. One possible explanation for this difference is that Creditor Lawyer Respondents do not see the improvement in their clients' positions that others see since they want to see even more improvement. Perhaps partisanship does not effect how one views the actual operation of the system but calculating improvements affecting one's

146. *Supra* notes 129, 139 and 140, and accompanying text.

147. *See* Appendix A, Question E4.

148. *See* Appendix A, Question E7(b).

149. This is statistically significant at a P Value level of less than or equal to .05.

150. This is statistically significant at a P Value level of less than or equal to .05.

151. *See* Appendix A, Question E7(a).

client's interests does impact on responses. It is also possible that the Debtor Lawyer Respondents believe things are better for creditors than they actually are.

What remains somewhat puzzling about Question E7(b) is why Creditor Lawyer Respondents see improvement as a consequence of the 1984 Amendments and yet perceive in Questions E1, E2, E3 and E5 that there is a substantial amount of non-compliance with statutory mandates and the frequency of hearings has not improved dramatically. One possible explanation is that the Creditor Lawyer Respondents are revealing some bias in their responses in that they still do not believe things are as good as they should be—from their vantage point. Another explanation is that while there is still major non-compliance, there is less non-compliance than there was before. The increase in the frequency of hearings (35% increase based on the responses of the Creditor Lawyer Respondents) parallels the perceived improvement in the creditors' position as a consequence of the Amendments (40% of the Creditor Lawyer Respondents thought the Amendments were an improvement for creditors). However, the flip-side of the equation does not work as well. Thirty eight percent (38%) of the Debtor Lawyer Respondents perceived that hearings had increased as a consequence of the 1984 Amendments and yet 51% of the Debtor Lawyer Respondents thought things were better for creditors.[152] Perhaps this reveals that Debtor Lawyer Respondents think things are better for creditors even though the Debtor Lawyers themselves recognize that the actual improvement is not that great. Another possible explanation is that the benefits for creditors as a consequence of the 1984 Amendments to Section 362 go beyond the increased frequency of hearings into more intangible variables such as the increased leverage and negotiating ability that speedier hearings may promote.

Explanations for Non-Compliance

As noted in respect of the findings regarding abuse,[153] one possible correlation is that the amount of compliance is related to case load. If found, this would show that there is better compliance with statutory mandates where there is a smaller case load and conversely that a large case load leads to non-compliance. As noted in Section IV of the report, the calculations necessary to make these comparisons are problematic; however, at present, they represent the only available data and hence are worth considering as a first step in the explanation process.

At least as to the aspects of non-compliance addressed in this section of the report, correlations between new case filings per judge per circuit and non-compliance cannot be established.[154] The circuits with the greatest compliance (4th, 6th and 11th) do not have

152. The Trustee Lawyer Respondents thought things were even better for creditors than did the Debtor Lawyer Respondents. Again, the responses of the Trustee Lawyer Respondents are similar to those of the Debtor Lawyer Respondents.

153. *Supra* note 104 and accompanying text.

154. *See* Section VII on the Consumer Credit Amendments, *infra* note 282, wherein a correlation between case load and compliance is discussed.

the smallest case loads on a per judge basis,[155] but rather appear in the middle of the pack. The smallest case loads are observed in the First, Second and Third Circuits, of which the Second and Third Circuits have the highest degree of non-compliance.[156] The circuits with the greatest number of new filings per judge (5th and 9th Circuits) do not have the highest degrees of non-compliance. This suggests that something other than case load is affecting the degree of statutory non-compliance. One possible explanation for this is that the Second Circuit has a high number of large business cases. Therefore, while the Second Circuit may not, in volume, have a large number of cases, the cases which it does have involve complex and time-consuming issues. The lack of a direct correlation also suggests that increasing Bankruptcy Judgeships, as was accomplished in the 1986 Amendments, may not lead to greater statutory compliance, at least in respect of stay issues.[157]

There may be some correlation between compliance and the ratio of assets to liabilities in cases disposed of in 1986.[158] The smallest percentage dividend to creditors on an overall case basis appears in the Second, Third, Seventh and Eighth Circuits. (The 1st, 9th and 11th Circuits have the highest levels of payout per case.) This suggests that there is less statutory compliance where there is less distribution to creditors. The circuits with the greatest compliance (4th, 6th and 11th Circuits) have higher, although not consistently the highest, levels of payout. Again, this suggests that non-compliance may be related to low distributions but compliance is composed of more than higher distributions to creditors, particularly since the circuits with the highest distributions (with the exception of the Eleventh Circuit which has the highest per creditor payout and among the highest compliance levels) to creditors do not have substantially high levels of compliance (5th and 9th Circuits).

There does not appear to be a correlation between administrative costs[159] and compliance. The circuits with high compliance do not consistently have the lowest nor the highest administrative costs. The circuits with the least compliance reveal no consistent pattern in terms of highest or lowest administrative costs. There does not appear to be a pattern among the circuits, then, based on the costs of administration.

One persisting question is why, if there is such a level of non-compliance, are lawyers not doing anything about it? For example, why are secured creditor lawyers not treating the stay as expired and proceeding to foreclosure since they have a statutory right to do so,

155. *See supra* note 104 and accompanying text for the difficulties in determining the case load per Judge and some of the potential inaccuracies in the figures represented which could affect the results.

156. The First Circuit generally shows high degrees of compliance although without the consistency of the other circuits.

157. *See* Section IX on Projections.

158. *See supra* note 104 and accompanying text for the methodology of determining these statistics and the difficulties inherent therein.

159. *See* Section IV titled Overview, *supra* note 104 and accompanying text, for a discussion of how these statistics were determined and some problems in their calculation that could lead to interpretive difficulties.

absent a Section 105 Order? Why are such lawyers not seeking mandatory writs from the District Courts or withdrawals of the initial reference to the Bankruptcy Judges? Moreover, why are the United States Trustees, empowered to oversee the administration of bankruptcy matters, not able to secure greater levels of judicial compliance? Certainly the United States Trustees could assert that their program lacked the staff and fiscal resources to enforce the Code provisions and that the program was only "pilot" in nature and hence not designed to be effective on a national scale. However, this argument pales in view of the high degree of compliance in the Sixth Circuit where no pilot programs were in force. Moreover, it is possible that the United States Trustee Respondents who perceived abuse, but were not effectively remedying it, were providing a justification for the creation of the nationwide United States Trustee program. Given the advent of the nationwide United States Trustee Program,[160] it is worth probing why, on a district by district basis, the pilot program did not achieve better results, at least to the extent the Survey reveals non-compliance in circuits in which the programs were operating.[161] Additionally, concern is raised as to whether the nationwide United States Trustee system will increase the degree of judicial compliance and decrease lawyer acquiescence.

Last but not least, compliance with Section 362(e) has become the focus of increased attention in light of the Fifth Circuit's decision in *In re Timbers of Inwood Forest Associates, Ltd.* (dated Jan. 9, 1987)[162] which reinstated the Fifth Circuit Panel decision dated July 9, 1986 and as to which the United States Supreme Court has granted certiorari.[163] The Fifth Circuit Panel, in denying an undersecured creditor lost opportunity costs, premised its decision in part on the availability of other forms of creditor relief under the Code to avoid delays. In this regard, the Panel noted the importance of existing Code provisions in preventing delay in the secured creditor obtaining protections as a consequence of a filing. The key provision cited was Section 362(e) which the court observed was Congress' response to delay in cases, and it provides "assurance that requests for relief from the stay will be considered in a timely manner."[164] The majority opinion in the Fifth Circuit observed that while lost opportunity costs appeared as one way to solve the delay in cases, the best way was for the bankruptcy courts to exercise "early and ongoing judicial management of Chapter 11 cases...", stating that "...it is incumbent upon the bankruptcy judge to effectuate the provisions of the Bankruptcy Code...".[165]

The failure of the bankruptcy courts to act expeditiously gave rise then to the movement for lost opportunity costs and the increasing number of appellate decisions. Without compliance with existing Code provisions, there will be further judicial interpretations and perhaps unnecessary and ill-advised legislative action.

160. *See* Section IX on Projections.

161. As discussed earlier, *supra* note 106, the Survey results are not broken down by district which would have better enabled a comparison of the pilot and non-pilot districts. *See* Section X on Conclusions and Recommendations.

162. 808 F.2d 363 (5th Cir. 1987) (en banc), reinstating 793 F.2d 1380 (1986), petition for cert., No. 86-1602), cert. granted, 481 U.S. ___ (May 26, 1987).

163. *Id.*

164. *Id.* at 540.

165. *Id.*

Section VI

PREFERENCE PROVISIONS

The 1984 Amendments changed Section 547(c)(2) by deleting the 45 day rule.[166] As a consequence, it is no longer necessary for courts to consider whether debt, as to which a payment[167] was made, was incurred within 45 days of such payment.[168] There has been considerable debate over the avowed purpose of deleting the 45 day rule. It has been alleged that the original intent behind the deletion of the rule was to assist commercial paper lenders who had asserted that the inclusion of the 45 day rule made virtually all payments and roll-overs on commercial paper preferential.[169] Since there was substantial litigation prior to the 1984 Amendments concerning the way in which the 45 days were calculated,[170] it has been asserted that the 1984 Amendments make it easier for creditors to retain payments since the timing mechanism for fitting within the exception has been deleted.[171]

The Survey reveals that the operation of the preference exception to the Code contained in Section 547(c)(2) has not changed dramatically as a consequence of the 1984 Amendments. However, unlike the responses to the Survey question on the stay, the answers to the preference questions do present differences among the types of Lawyer

166. *Supra* note 8.

167. In defining a preference, the Code utilizes the broader based term "transfer" which, as defined in Section 101(50), encompasses payment. It could also include a host of other types of transactions including the creation and perfection of a security interest or distribution of property. Professor Countryman, in his article "The Concept of Voidable Preferences in Bankruptcy", 38 Vand. L. Rev. 713, 775 (1985) questions the justification for this distinction.

168. Countryman, *supra* note 2, at 770-772.

169. Countryman, *supra* note 2, at 770-772. A host of other interest groups hopped on the bandwagon and asserted that the 45 day rule did not comport with business realities. *Id.* at 771. *See* also Bienenstock, *supra* note 7, at 392-394.

170. *Id.* at 770, 773.

171. *See*, e.g. Gross, "Recent Developments", Credit & Financial Management, May 1986, at 10.

Respondents and the size of the firms in which the Lawyer Respondents practice. Like the responses to the stay questions, there are sizable differences in the responses based on the category of Respondent and the circuit in which the Respondent is located.

Pursuing Recoveries

When asked whether debtors-in-possession and trustees were pursuing the recovery of preferences, whether in or out of court, less frequently,[172] 43% of the Respondents indicated no change in the level of pursuit of preference recoveries. Of the remaining Respondents, an almost even number thought the pursuit of preference recoveries had increased and decreased. When the question was rephrased to focus on the amount of preference litigation,[173] the responses did not vary. Virtually an even number of the Respondents thought the amount of preference litigation had increased and decreased, leaving 44% of the Respondents who believed that there had been no change in the amount of such litigation.

There were some distinctions between the categories of Respondents.[174] In response to Question D1,[175] the Judge Respondents and United States Trustee Respondents thought things had remained the same more frequently than did the other categories of Respondents. The Lawyer Respondents thought things had remained the same less frequently than the other categories of Respondents and were evenly divided as to whether the pursuit of preferences had increased or decreased. The widest differentiation appeared in the responses of the Judge Respondents, 25% of whom thought the pursuit of preference recoveries had decreased while only 17% of whom thought there had been an increase.

In response to Question D2,[176] and while not statistically significant, there was less variation among the Judge Respondents, who like all other categories of Respondents, except the United States Trustee Respondents, thought there was an equal amount of increase and decrease in preference litigation. One possible explanation is that of the Judge Respondents who believed that there has been some change,[177] they believed there was a decrease in the pursuit of preferences although no real diminution in preference litigation.

For descriptive purposes, overall among the Lawyer Respondents, there was an even spread among those who thought there was no change, those who thought there was an increase and those who thought there was a decrease in the pursuit of preference recoveries.

172. *See* Appendix A, Question D1. The theory of this question was that with deletion of the 45 day rule, more transfers will fit within the 547(c)(2) exception. Therefore, at least in theory, there will be fewer preference recoveries.

173. *See* Appendix A, Question D2. This question, as distinguished from Question D1 which focussed on both formal and informal mechanisms for seeking recovery of preferences, was directed at the actual amount of litigation. The theory behind the two questions was to see if there was still an effort to recover preferences but that the bulk of that effort was now taking place outside of court, through settlement or negotiation, discussed *infra* note 180 and accompanying text.

174. This is statistically significant at a P Value level of less than or equal to .05.

175. *Supra* note 172.

176. *Supra* note 173.

177. In Questions D1 and D2, 58% and 53%, respectively, of the Judge Respondents thought there was no change at all.

Concerning the amount of preference litigation, the Creditor Lawyer Respondents and Debtor Lawyer Respondents thought things had remained the same more than the Trustee Lawyer Respondents, and the Trustee Lawyer Respondents were equally divided as to what had happened as a consequence of the changes to Section 547(c)(2).

However, there was a dramatic and statistically significant difference in the responses of the Lawyer Respondents to Question D2 based on firm size.[178] While there was no substantial difference between the percentage of Lawyer Respondents in small firms and large firms who thought the amount of litigation had remained the same, 36% of the Lawyer Respondents in small firms thought the amount of litigation had *increased* while only 19% of the Lawyer Respondents in large firms thought that there had been an increase. Conversely, 39% of the Lawyer Respondents in large firms thought that litigation had decreased while only 21% of the Lawyer Respondents in small firms shared this perspective. In all instances, Lawyer Respondents in medium firms sided more closely with the Lawyer Respondents in large firms. This data is summarized in the following table:

TABLE 4[179]

AMOUNT OF PREFERENCE LITIGATION
(BY FIRM SIZE)

	Small Firm	Medium Firm	Large Firm	Row Total
INCREASED	36%	25%	19%	31%
DECREASED	21%	40%	39%	28%
REMAINED THE SAME	43%	36%	43%	41%
TOTAL NO. OF RESPONDENTS	453	154	108	715

On a circuit by circuit basis, most of the Respondents thought there was no change. As a descriptive matter, among the Respondents who did perceive a change, the Respondents in the First and Second Circuits thought litigation had decreased more than in the other circuits. This is reinforced by looking at the responses of the Lawyer Respondents on a circuit by circuit basis. Again, among the Lawyer Respondents who believed there was a change, more Lawyer Respondents in the First and Second Circuits thought there was a decrease in litigation than in the other circuits.

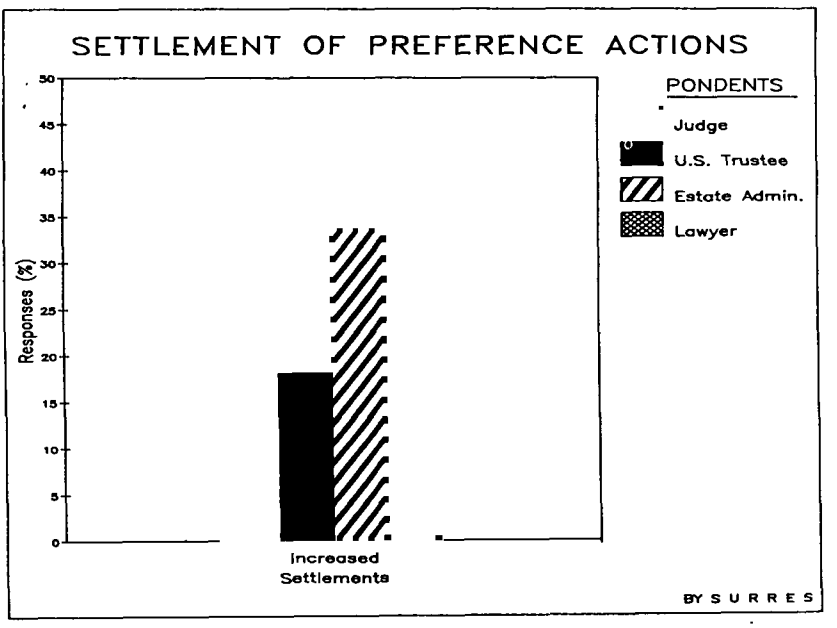
178. This is statistically significant at a P Value level of less than or equal to .05.

179. The breakdown by firm size has a P Value of less than or equal to .05.

Settlement

When asked whether the litigation that was brought was settled more frequently,[180] 51% of the Respondents thought there was no change from before the 1984 Amendments. However, 42% of the Respondents thought settlements had increased while only 7% of the Respondents thought settlements had decreased. Among the categories of Respondents,[181] the Lawyer Respondents thought matters were settled more frequently than did the other categories of Respondents.[182] These results are summarized in the following chart:

CHART 6[183]



180. *See* Appendix A, Question D5.

181. This is statistically significant at a P Value level of less than or equal to .05.

182. The responses of the United States Trustee Respondents were quite different from the other categories of Respondents. Eighty-two percent of these Respondents thought things had remained the same and the balance thought settlement had increased.

183. The breakdown by Respondent categories has a P Value of less than or equal to .05.

55

While not statistically significant at a .05 level and considering the small number of Respondents in each cell, there was some variation among the circuits with 35% of the Lawyer Respondents in the Eleventh Circuit perceiving more settlements and 55% of the Lawyer Respondents in the Second Circuit sharing that perspective. There were no real variations based on firm size. However, there was more, although not statistically significant, variation among the types of Lawyer Respondents. Only 45% of the Creditor Lawyer Respondents thought the amount of settlement had remained the same while 55% of the Debtor Lawyer Respondents thought things had remained the same. Fifty percent (50%) of the Creditor Lawyer Respondents thought settlements had increased while only 38% of the Debtor Lawyer Respondents shared this viewpoint.

Creditor Success

When asked whether the proportion of creditors defending litigation are more successful than prior to the passage of the 1984 Amendments,[184] 46% of the Respondents perceived no change in creditor success while 39% of the Respondents thought creditors were more successful. There was a statistically significant disparity in the Judge Respondent and Lawyer Respondent answers.[185] Only 25% of the Judge Respondents thought creditors were more successful in defending litigation while 44% of the Lawyer Respondents shared this perspective. The responses of the United States Trustee Respondents were similar to those of the Lawyer Respondents while the responses of the Estate Administrator Respondents were similar to the Judge Respondents. It appears, while not statistically significant at a .05 level, that Respondents in the First and Second Circuit perceived a greater percentage of creditor success in litigation than in other circuits. Type of Lawyer Respondent did not affect answers appreciably. Firm size did, on the other hand, have a statistically significant impact on the responses.[186] Of responses of Lawyer Respondents in large firms, 62% thought creditor success had increased while only 36% of the Lawyer Respondents in small firms shared this perspective. Medium firms fell closely in line with large firms in terms of responses to this question. These results are summarized in the following table:

184. *See* Appendix A, Question D3.

185. This is statistically significant at a P Value level of less than or equal to .05.

186. This is statistically significant at a P Value level of less than or equal to .05. It is odd that no correlation exists between this cross tabulation and that dealing with types of Lawyer Respondents. As revealed in Section III on Demographics, large firms tend to represent the creditor interests. Therefore, if large firms are more successful in obtaining creditor success, the Lawyer Respondents in large firms (i.e. Creditor Lawyer Respondents) should share that perspective -- which they *do not*. Perhaps the lawyers in large firms are not seeing their own success as clearly as others do.

TABLE 5[187]

CREDITOR SUCCESS IN PREFERENCE LITIGATION (BY FIRM SIZE)

	Small Firm	Medium Firm	Large Firm	Row Total
INCREASED	36%	57%	62%	44%
DECREASED	19%	12%	9%	16%
REMAINED THE SAME	45%	31%	30%	40%
TOTAL NO. OF RESPONDENTS	419	147	102	668

The responses to this question are particularly valuable when compared to the previous questions in this section. There is less litigation in the First and Second Circuits,[188] and this decrease is sensed primarily by the medium and large firms.[189] Yet, the medium and large firms report greater creditor success in litigating. As demonstrated in Section II, medium and large firms overwhelmingly represent creditors.[190] There appear to be a number of Respondents from large firms in the First and Second Circuits (Boston and New York City) that have among the largest law firms in the country.[191] One possible explanation for the increased success among medium and large firms is that they are only litigating the cases in which they perceive they will be successful while other firms are not making the same threshold analysis. Another factor to consider is that the cost and expense of retaining a medium or large firm and litigating a preference matter to conclusion requires that a cost benefit analysis be pursued such that many preference actions are never brought

187. The breakdown by firm size has a P Value of less than or equal to .05.

188. *Supra* note 173.

189. *Supra* note 178.

190. *Supra* note 77 and accompanying text.

191. Large firms are also prevalent in Chicago and Los Angeles, located in the Seventh and Ninth Circuits, respectively.

in the first instance.[192] Perhaps there is a correlation between the size of the case, and correspondingly the size of a creditor's alleged preference, and the pursuit of preference recoveries and the success in litigation. Phrased differently, medium and large firms in the First and Second Circuits are involved more frequently in Chapter 11 cases and their clients have potentially large exposure, all of which militates in favor of litigating only when the chance of success is worth the incremental costs thereof.[193]

Focus of the Litigation

When asked whether the proportion of litigation focussing on the meaning of "ordinary course of business" had increased as a consequence of the 1984 Amendments,[194] 50% of the Respondents responded affirmatively while 43% of the Respondents thought there was no change. Although the differential between those who saw an increase and those who saw no change is not substantial, it is the first question in the preference section[195] wherein the Respondents saw change more frequently than no change.

Not surprisingly, among the categories of Respondents,[196] the Lawyer Respondents felt this focus on "ordinary course of business" more strongly than the other categories of Respondents, with 56% of the Lawyer Respondents noting an increase while only 36% of the Judge Respondents shared this perspective. Although the type of Lawyer Respondent did not affect the responses, the size of the Lawyer Respondents' firms did affect the responses.[197] Of the Lawyer Respondents in large firms, 72% believed there had been an increased focus on "ordinary course of business" while only 48% of the Lawyer Respondents in small firms shared this perspective. These results are summarized in the following table:

192. Oddly, the size of the Lawyer Respondents' firm does not appear to correlate to settlements, and it would seem that similar cost-benefit analyses would arise in the settlement context as well.

193. This would seem to be a matter of concern for all creditors, however, even if the scale is smaller.

194. *See* Appendix A, Question D4. The presence of the term "ordinary course of business" antedates the 1984 Amendments. However, the bulk of the pre-1984 preference litigation focussed on the applicability of Section 547(c)(2) based on the 45 day rule. Many creditors could not even begin to focus on the issue of "ordinary course of business" since the debt as to which payment had been made was not incurred within 45 days. Therefore, it was hypothesized that the deletion of the 45 day rule should increase the focus on the meaning of "ordinary course of business".

195. It is noteworthy in terms of all the 1984 Amendments wherein the majority of the responses were "remained the same" or "had no effect".

196. This is statistically significant at a P Value level of less than or equal to .05.

197. This is statistically significant at a P Value level of less than or equal to .05.

TABLE 6[198]

FOCUS ON TERM "ORDINARY COURSE OF BUSINESS"
(BY CATEGORY AND FIRM SIZE)

	Judge	Lawyer	Small Firm	Medium Firm	Large Firm
INCREASED	36%	56%	48%	69%	72%
DECREASED	3%	7%	7%	6%	8%
REMAINED THE SAME	61%	37%	45%	26%	21%
TOTAL NO. OF RESPONDENTS	154	674	422	143	106

If the responses to this question are considered in light of the prior questions, it is possible to draw a correlation between the firms demonstrating the greatest success and those focussing on the term "ordinary course of business". Such firms' success may be attributable to a number of other factors, but the possibility of the above correlation is interesting to note. There are indications that lawyers in medium and large firms, where the focus of the case will be on ordinary course of business, are more likely to produce a favorable result.

When asked whether creditors' credit policies have become more liberal as a consequence of the 1984 Amendments,[199] 71% of the Respondents stated that there had been no change in credit policies as a consequence of the changes to Section 547(c)(2). Of all Respondents, 22% thought the credit policies were *less* liberal.[200] Although the Creditor Lawyer Respondents would seem best suited to respond, their views were no different than those of the other categories of Lawyer Respondents, the majority of whom felt that credit policies had not changed and to the extent that they had, they had become less liberal. Interestingly, among the firms, the Lawyer Respondents in the large firms thought credit policies had been made *more* liberal more frequently than the other sizes of firms, although

198. The breakdown by category of Respondent and firm size has a P Value of less than or equal to .05.

199. *See* Appendix A, Question D8. The question was designed to elicit whether, since the new focus of Section 547(c)(2) may have been on "ordinary course of business", that creditors could expand the range of their ordinary course of business by creating more liberal credit terms. Phrased differently, if a creditor had very liberal credit policies, more payments received would be within its ordinary course and hence non-avoidable. *See* Gross, "Recent Developments", Credit & Financial Management, May 1986, at 10.

200. This question had the highest number of missing responses in this unit, attributable perhaps to the fact that many of the Respondents felt they did not know what had happened to credit policies. Among the Respondents, the group most likely to have an insight into this question was the Creditor Lawyer Respondents, although not all such lawyers would be sufficiently familiar with their client's business practices to respond.

the majority of the Lawyer Respondents in large firms did not perceive any change in credit policy.[201]

One conclusion that can be drawn is that creditors appear to be considering more than the possibility of bankruptcy when they determine credit risk. In other words, the ability to avoid disgorging funds in a bankruptcy context is not a primary focus of those extending credit, who may instead be focussing on the credit-worthiness of the customer. This focus leads to an anomaly. The less credit-worthy the customer, the more likely the creditor is to extend conservative credit terms. It is this very customer, however, that has the greatest likelihood of becoming a debtor under the Code where the more liberal the credit terms, the more likely a transfer will be in the ordinary course and hence non-avoidable. Certainly, a balancing needs to be done, but the Survey reveals that creditors may be hurting rather than helping themselves when they determine credit policy for less credit-worthy enterprises.[202]

Who benefitted

When asked whether the amendments to Section 547(c)(2) made things better for commercial paper lenders,[203] 67% of the Respondents thought they had made no difference, while 13% of the Respondents thought that it had made things worse. While not statistically significant at a .05 level and considering the small number of Respondents in each cell, when the responses are evaluated on a circuit by circuit basis, 37% of the Respondents in the Second Circuit thought that changes had benefitted commercial paper lender compared to 22% or less in the other circuits. This observation is reinforced by looking at the responses of the Respondents by category within each circuit. By a substantial margin, the Judge Respondents in the Second Circuit thought the changes were better for commercial paper lenders than the Judge Respondents in other Circuits, although it is difficult to ascertain the extent to which the Judge Respondents would be aware of effects on commer-

201. This is statistically significnt at a P Value level of less than or equal to .05.

202. Recent case law has not taken an altogether expansive view of "ordinary course of business" which diminishes the impact of the more liberal credit policy approach suggested by the findings of the Survey. Increased utilization of liberal credit policies only makes sense if courts construe the "ordinary course of business" to include recent changes in business practices with a troubled company as part of the new "ordinary course". *See* Countryman, *supra* note 2 at 774-5; *In re Bourgeois*, CCH Bankr. L.R. 71,054 (Bankr. W.D. La. 1986).

203. *See* Appendix A, Question D7(c). As noted earlier, assisting commerical paper lenders was one of the primary motivating forces behind this amendment to the Code. Therefore, if the amendment achieved its goal, this group should have felt that its position was substantially improved as a consequence of the 1984 Amendments.

cial paper lenders. The differentiation is more marked in the responses of the Lawyer Respondents, where, in the Second Circuit, 40% thought the changes made things better for commercial paper lenders while only 14% of the Lawyer Respondents in the Eighth Circuit shared this view.

For descriptive purposes, it is noteworthy that the size of the Lawyer Respondents' firms also affected the responses. Of the Lawyer Respondents in large firms, 32% believed the changes had made things better for commercial paper lenders while only 19% of the Lawyer Respondents in small firms were of a similar view. Conversely, more of the Lawyer Respondents in small firms thought the changes were worse for the commercial paper lender than did the Lawyer Respondents in large firms.

When asked if the dollar distribution to unsecured creditors increased as a consequence of the changes to Section 547(c)(2),[204] 58% of the Respondents saw no change while 23% of the Respondents thought the dollar amount distributed had diminished.[205] There were some sizable disparities, while not statistically significant at a .05 level, in the responses among the types of Lawyer Respondents with Trustee Lawyer Respondents sensing the greatest diminution in assets available for distribution to unsecured creditors. The size of the Lawyer Respondents' firms demonstrated statistically significant differences.[206] Among the small firms, 23% of the Lawyer Respondents thought distributions to unsecured creditors had increased while only 10% of the Lawyer Respondents in large firms shared that perspective. This corresponds to the earlier question which revealed greater creditor success in medium and large firms,[207] thereby suggesting a diminution not an increase in the rate of overall distribution to unsecured creditors.

Conclusions

It is fair to say that the amendment to Section 547(c)(2) did not have the effect that was anticipated. If anything, it has done little to change the status quo, particularly of those the amendment was expressly designed to assist. Once again the Second Circuit stands out from all the other circuits, in this instance in establishing creditor success in seeking to retain payments made to them. As suggested by Section X of the Report, further study is needed of the Second Circuit, the changes to the preference section and the process of change of existing Code provisions.

204. *See* Appendix A, Question D6. In theory, if fewer transfers are avoidable, the pool of assets available for distribution to unsecured creditors will be smaller and unsecured creditor distributions will diminish. While it is true that the amount of money a single unsecured creditor may obtain may be increased (because he will not have to turn over preferential payments), the creditor body as a whole will have diminished payments as a consequence, unless, of course, every creditor received a preferential payment in which event there will be no diminution of the pool on a pro-rata basis.

205. It may be too early to determine the effect on unsecured creditors since the 1984 Amendments had only been in effect approximately two years at the time of this Survey. Many Chapter 11 cases filed in this two year period would not have had plans of reorganization confirmed at the time the Survey was undertaken and hence it would be difficult to ascertain overall distribution comparisons.

206. This is statistically significant at a P Value level of less than or equal to .05.

207. *Supra* note 187.

Section VII

CONSUMER CREDIT AMENDMENTS

The Consumer Credit Amendments[208] selected for study in the Survey present an example of an instance in which both the effect and the effectiveness of certain of the 1984 Amendments can be measured. The Consumer Credit Industry[209] lobbied for these amendments in an effort to eradicate *perceived* debtor abuse.[210] At least some of the legislators supporting the legislation acknowledged this perceived problem in statements before the House and the Senate. Moreover, considerable media attention was focussed on the perception that the Consumer Credit Amendments would curtail individual debtor abuse.[211] Legislators also expressed the desire to reduce the costs and burdens bankruptcy brought to bear on middle class America.[212] Therefore, effectiveness, at least from the perspective of the Consumer Credit Industry, can be evaluated. The effect of the Consumer Credit Amendments selected for study can also be evaluated.

It can be safely stated that, based on the Survey, the selected Consumer Credit Amendments did not have a dramatic effect. In response to a number of the questions, the

208. *Supra* note 9.

209. *Supra* note 114.

210. *Supra* note 9.

211. *See* Molotsky, "New Bankruptcy Law Tougher on Consumers", The New York Times, June 29, 1984, at 35, col. 1. As expressed therein, "The changes in the bankruptcy code that Congress approved today include some provisions that will make it more difficult for consumers to have their debts erased, a circumstance that its proponents say is good for creditors and borrowers alike."

212. *Id. See also supra* note 24.

Respondents reported no change. While there is some evidence that the Amendments improved the position of creditors,[213] they did not eradicate debtor abuse or markedly increase the distributions made to creditors. Some of this is attributable to the observations reflected by the Survey that the Amendments are not functioning as was originally intended or hoped.[214] Some of the lack of both effect and effectiveness (if viewed from the perspective of the Consumer Credit Industry which promoted the amendments) may, however, have nothing to do with the Amendments *per se*.[215] As the Survey reveals, there is a fair amount of statutory non-compliance, a part of which is revealed in the application of the Consumer Credit Amendments. The problem, then, goes beyond the Consumer Credit Amendments to problems inherent in the application of the Code and the lack of its consistent application.

Overall Effectiveness

When asked whether the Consumer Credit Amendments increased the dollar amount of distributions to creditors,[216] 57% of the Respondents reported that distributions were unchanged, with 37% of the Respondents indicating that dollar distributions had increased. When asked whether the Consumer Credit Amendments had made things better for creditors,[217] 33% of the Respondents thought the Amendments had had no effect while 48% of the Respondents thought things were better for creditors. Twenty percent (20%) of the Respondents believed things were either equal for both debtors and creditors or better for debtors. What these two questions reveal, side by side, is that even to the extent improvements were perceived for creditors, they did not translate into money, which should

213. *Infra* note 264 and accompanying text.

214. *Infra* note 245 and accompanying text.

215. Additional possible explanations abound, including the hypothesis that the Amendments fixed something that did not need to be fixed, at least to the extent it was "fixed". Therefore, since the problems were never as great as perceived, the "solution" will not have the dramatic results its proponents wished. This is part of the ongoing debate concerning the extent of individual debtor abuse and the definition of that abuse. *See* Sullivan, Warren and Westbrook, *supra* note 25; Gross, *supra* note 9; Ayer, "How to Think About Bankruptcy Ethics," 60 Am. Bankr. L. J. 355 (1986).

216. *See* Appeudix A, Question C1. This question looks at the heart of the Amendments which, at the bottom line, were designed to maximize payments to creditors. The theory was that individuals capable of repaying their creditors were being relieved of indebtedness through a variety of channels (liquidating rather than reorganizing, expansive discharge in both Chapter 7 and more importantly Chapter 13, over-generous exemptions) and that if these avenues were shut off, distributions would increase. Phrased differently, the Consumer Credit Industry was not seeking just to establish a "moral" principle that individuals should repay debts. They were trying to increase their recoveries from troubled individuals.

217. *See* Appendix A, Question C20.

be the ultimate indicia of creditor success.

The above responses are of increased interest when it is observed that there were not dramatic differences in the responses of the Creditor Lawyer Respondents and Debtor Lawyer Respondents.[218] This suggests that both the creditor and debtor representatives perceive the lack of dramatic success of the Consumer Credit Amendments.

How Much Abuse is There?

When asked whether the current amount of individual debtor abuse was significant,[219] 19% of the Respondents perceived a "significant" amount of abuse, 38% of the Respondents perceived "moderate" abuse and 43% of the Respondents perceived "negligible" abuse. These responses are particularly revealing when compared to the overall question of abuse in the bankruptcy system addressed in Section IV.[220] If the category "no abuse" is comparable to "negligible",[221] then only 2% of the Respondents thought there was no abuse of the bankruptcy process while 43% of the Respondents thought there was negligible abuse of the bankruptcy process by individual debtors. This strongly suggests that the perceived abuses of the bankruptcy process go well beyond individuals and that individual abuse may not be at the heart of the perceived problem of abuse of the bankruptcy system.

Looking at the perceived amount of abuse based on the categories of Respondents,[222] the United States Trustees felt there was significantly more abuse than any of the other categories of Respondents. The Judge Respondents, Estate Administrator Respondents and Lawyer Respondents perceived a "significant" amount of individual debtor abuse in 14%, 27% and 19% of the responses, respectively, while the United States Trustee Respondents perceived significant abuse in 43% of the responses. The dramatic differences in perceptions of abuse by the United States Trustee Respondents and the other Respondents is eliminated if the responses to the categories "significant" and "moderate" are combined. In other words, while the United States Trustee Respondents perceive the greatest amount of "significant" abuse, they do not see more overall abuse than the other categories of Respondents. These results are summarized in the following chart:

218. The Trustee Lawyer Respondents thought that the dollar distribution to creditors had increased more than did the other categories of Lawyer Respondents.

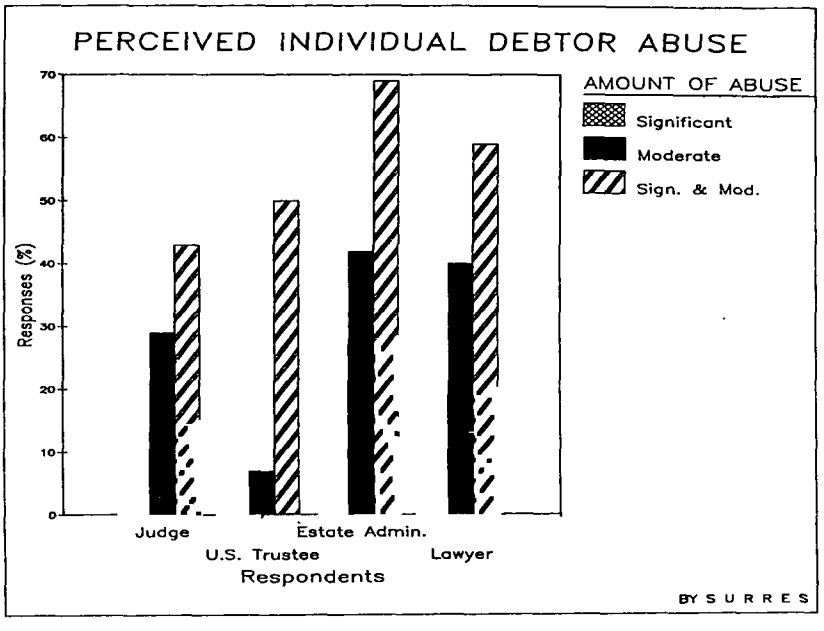
219. *See* Appendix A, Question C2. The question was designed to work in tandem with Question C3. The current question deals with whether abuse exists. Question C3 tries to capture whether, if there is abuse, the court is aware of its existence. This is significant in that if there is abuse which goes unnoticed, then the problem raised by Question C2 is compounded. There is *abuse* and it is *unnoticed* and hence unattended to.

220. *Supra* note 95 and accompanying text.

221. Negligible could include "some" or "a little" abuse. If viewed in this fashion, the category "no abuse" could be smaller in respect to individual debtors.

222. This is statistically significant at a P Value level of less than or equal to .05.

CHART 7[223]



The United States Trustee Respondents' perceptions of abuse can be viewed from several vantage points. First, if there is a lot of abuse, then the United States Trustee program, particularly on a national level, is not only justified but absolutely necessary. However, if United States Trustees are empowered to oversee cases, and then curtail abuse, they are not accomplishing that which they are supposed to do in that substantial abuse still exists and is recognized as existing by the United States Trustees. An additional explanation may be that the level of bankruptcy experience of the United States Trustee Respondents compared to the other Respondents is appreciably smaller,[224] and those with less knowledge and experience about the bankruptcy process perceive more abuse in the

223. The breakdown by category of Respondent has a P Value of less than or equal to .05.

224. *See* Section III on Demographics.

system -- abuse which may, but does not necessarily, exist.

The responses perceiving "significant" abuse varied from circuit to circuit,[225] with a high of 27% in the Ninth Circuit, the same circuit registering high abuse levels in the general abuse question,[226] to a low of 12% in the Fourth Circuit. The Sixth Circuit also demonstrated, as in the general question of abuse, low levels of "significant" abuse. While not statistically significant at a .05 level and considering the small number of Respondents in each cell, it is noteworthy that looked at by Respondent category and circuit, the Judge Respondents had a wide spectrum of views. Thirty-two percent (32%) of the Judge Respondents in the Ninth Circuit perceived substantial abuse by individual debtors while zero percent of the Judge Respondents in the Third and Sixth Circuits shared this perspective. Interestingly, there are similarly high levels of abuse perceived among the Judge Respondents in the Second, Fifth and Ninth Circuits with respect to the instant question as there was with the prior question on general abuse.

Looking at the issue from the perspective of "negligible" rather than "significant" abuse, it is statistically significant that the Lawyer Respondents thought there was more overall abuse than did the Judge Respondents with 51% of the Judge Respondents perceiving negligible abuse with only 41% of the Lawyer Respondents sharing that viewpoint.[227] As a descriptive matter, among the Judge Respondents, the amount of negligible abuse on a circuit by circuit basis ranged from a high of 75% of the responses in the First Circuit indicated a small amount of abuse among individual debtors to a low of 36% of the responses in the Ninth Circuit. Again, as a descriptive matter, among the Lawyer Respondents, the range of those who perceived "negligible" abuse was narrower, from a high of 55% in the Second Circuit to a low of 31% in the Sixth Circuit.

Unlike some of the other areas surveyed,[228] there were statistically significant differences in the responses of the types of Lawyer Respondents. The Creditor Lawyer Respondents perceived 28% "significant" abuse while the Trustee Lawyers and Debtor Lawyers perceived only 19% and 7%, respectively. Looking at it from the other side, only 29% of the Creditor Lawyer Respondents perceived negligible abuse by individual debtors while 41% and 58% of the Trustee Lawyer Respondents and Debtor Lawyer Respondents, respectively, perceived negligible abuse.

While there were no appreciable differences based on firm size of the Lawyer Respondents, the level of experience of the Respondents of all categories affected responses, with the Respondents with the least experience perceiving the greatest amount of abuse.[229] Of the Respondents with fewer than three years of bankruptcy experience, it is statistically significant that only 10% believed there was negligible abuse while the Respondents with more than twelve years of experience perceived there was negligible abuse in 51% of the responses. This suggests that perceptions about abuse may be correlated to

225. This is statistically significant at a P Value level of less than or equal to .05.

226. *Supra* note 103.

227. This is statistically significant at a P Value level of less than or equal to .05.

228. *Supra* notes 132, 144, and 200.

229. This is statistically significant at a P Value level of less than or equal to .05.

both the client interests of the Lawyer Respondent and the experience level of the same Respondent. These results are summarized in the following table:

TABLE 7 [230]

AMOUNT OF ABUSE BY INDIVIDUAL DEBTORS
(BY EXPERIENCE LEVEL)

	Less Than 3 Years	3-8 Years	9-12 Years	More Than 12 Years	Row Total
SIGNIFICANT	52%	21%	15%	16%	19%
MODERATE	38%	42%	37%	33%	38%
NEGLIGIBLE	10%	37%	49%	51%	43%
TOTAL NO. OF RESPONDENTS	21	417	204	305	947

There are several possible explanations for why the less experienced Respondents may perceive more abuse. First, these Respondents may not have the requisite experience to know what is or is not abuse. What seems abusive to them may not seen abusive to the more experienced individual. For example, a less experienced person may consider it an abuse that individuals can liquidate rather than reorganize, thereby objecting to the concept of the "fresh start". The more experienced individual, while perhaps not agreeing with the policy, may accept it as part and parcel of the system. Similarly, a less experienced individual may be "offended" by the breathing space accorded the debtor by the automatic stay while the more experienced individual accepts it as a major aspect of the bankruptcy process. In other words, there are certain "inequities" peculiar to the bankruptcy system that may seem abusive to the neophyte. Moreover, increased sophistication and experience with the practicalities of the system may be necessary to evaluate it effectively. On the other hand, one could argue that the perceptions of the less experienced participants are more accurate and objective, as those with more experience are jaded by the system and more willing to accept what happens within it.

One other possible explanation is that the less experienced individual is closer to the law school experience where the focus is on the problems not the strengths of a system. Thus, law students operate from a negative premise in all areas of the law and look for the flaws and the difficulties. It is only with years in practice that they move from a more "ivory tower approach" to one grounded in the realities of the system, when idealism is supplanted by realism.

230. The breakdown by experience level has a P Value of less than or equal to .05.

When asked whether the amount of abuse as to which the court is unaware is significant,[231] the responses of the Respondents did not vary from those given in response to the amount of abuse generally, which suggests that the court is aware of the abuse that exists. However, when the responses are broken down by categories of Respondents,[232] the Judge Respondents thought there was less "significant" abuse as to which they were unaware than the other categories of Respondents, although the responses in these categories did not differ significantly from those in respect of the prior question. The other cross tabulations parallel those which were present in respect of the previous question on the amount of individual debtor abuse. This suggests, whether or not the court acts upon it, that Judge Respondents were aware of abuse, although they perceived less abuse overall than the other categories of Respondents.

When asked the overall degree of effectiveness of the Consumer Credit Amendments in dealing with individuals' abuse,[233] a startling 21% of the Respondents indicated that the Amendments had had no effect in dealing with such abuse. Only 22% of the Respondents thought that the Amendments had proved "excellent" to "good" in dealing with abuse while 21% of the Respondents thought the results were "poor" to "very poor". With the exception of the United States Trustee Respondents, all other categories of Respondents felt similarly about the effectiveness of the Consumer Credit Amendments. Moreover, for descriptive purposes, while there was some variation among the Lawyer Respondents, their answers quite consistently demonstrated that the Consumer Credit Amendments were not an overwhelming success in dealing with individual debtor abuse. This suggests that the abuse that is bothering the Respondents is something other than that which is addressed by the Consumer Credit Amendments.[234]

Changes in Case Filings and Conversions

When asked whether the Consumer Credit Amendments affected the number of Chapter 7 filings,[235] 66% of the Respondents thought there was no change, while 22% of the Respondents thought filings had *increased*. Only 12% of the Respondents thought Chap-

231. *See* Appendix A, Question C3.

232. This is statistically significant at a P Value level of less than or equal to .05.

233. *See* Appendix A, Question C19.

234. This observation is reinforced by the responses to the open-ended questions. *See* Section X on Conclusions and Recommendations.

235. *See* Appendix A, Question C4.

ter 7 filings had decreased. This is particularly startling since one of the avowed purposes of the Consumer Credit Amendments was to stem the growing tide of filings and to encourage more individuals to reorganize rather than liquidate.[236] When asked whether the number of Chapter 13 cases had increased as a consequence of the Consumer Credit Amendments,[237] 53% of the Respondents thought there was no change in the number of filings while 35% of the Respondents thought such filings had increased. This shows more promise in terms of the Amendments achieving their purported goal although the majority of the Respondents perceived no change. When asked whether there has been any change in the number of cases converted from Chapter 7 to Chapter 13,[238] 68% of the Respondents perceived no change, while 23% of the Respondents perceived an increase. It is statistically significant that over 40% of the Respondents in the Fourth, Fifth, Sixth and Eleventh Circuits perceived increases in Chapter 13 filings compared with less than 25% of the Respondents sharing this perspective in the Second, Third, Seventh and Eighth Circuits.

When asked whether the Consumer Credit Amendments had increased the number of individuals electing not to seek relief under the federal bankruptcy laws,[239] 68% of the Lawyer Respondents perceived no change. Thirty-two percent (32%) of the Lawyer Respondents thought fewer individuals were electing to opt-out of the federal system, responses borne out in part by the statistics revealing increased filings.[240]

Looking at the data[241] supplied by the Administrative Office of the United States Courts,[242] both Chapter 7 and Chapter 13 filings have increased since the passage of the Consumer Credit Amendments. From 1984 to 1985, Chapter 7 filings increased from 232,778 to 244,647, representing approximately a 5% increase. Chapter 13 filings increased from 91,480 to 98,452 during the same period, representing approximately an 8% increase. The increases from 1985-1986 are more dramatic. Chapter 7 filings increased from 244,647 to 332,675, representing an increase of approximately 36%. Chapter 13 filings increased from 98,452 to 120,726, an increase of approximately 23%. There are no figures available on rates of conversion.

236. See Gross, *supra* note 9, for a possible explanation of why the Consumer Credit Amendments may have had a reverse effect from that desired by the Consumer Credit Industry.

237. *See* Appendix A, Question C5.

238. *See* Appendix A, Question C6.

239. *See* Appendix A, Question C7. The theory behind this question is that if attorneys are advising their individual clients of their options in view of the 1984 Amendments, there may be debtors who choose not to file at all. These might be individuals, for instance, whose Chapter 7 case might be dismissed as an abuse of the provisions of Chapter 7 under Section 707(b) and who do not want to commit their disposable income to payment of creditors under a Chapter 13 plan as required by Section 1325(b). Such individuals might elect to stay outside the federal bankruptcy system and leave creditors to pursue their often costly and time-consuming state law collection measures. *See* Gross, *supra* note 9.

240. *Infra* note 241 and accompanying text.

241. This is an example of an instance where hard data is available, at least in part. Data on the number of filings since the passage of the Consumer Credit Amendments is available. However, the hard data does not reveal the whys; it only reveals the numbers. The questions addressing filing levels are looking to see whether the Consumer Credit Amendments have had any effect on filing rates, given that a whole host of other variables could affect filing levels. For example, a major economic depression in certain parts of the country could affect filings and hence any increases would not be attributable to the Consumer Credit Amendments.

242. *Supra* note 104.

The actual filing figures suggest that the perceptions of the Respondents mirror reality. The Consumer Credit Amendments did not cause, overall, a decrease in the rate of filings. The perception of 22% of the Respondents who believed Chapter 7 filings had increased as a consequence of the Consumer Credit Amendments may also have hit upon something. The dramatic upswing in filings since 1984 suggests, however, that something else must be going on with individuals. It demonstrates that the effort to curb filings by correcting abuses may have been misguided; the level of filings may have little, if anything, to do with perceived abuse. If this is the case, then one of the underlying premises upon which the Consumer Credit Amendments were based is now shown to be incomplete at best and perhaps inaccurate. There certainly is room for further analysis and investigation.

The Survey results reinforce observations made in the context of exemptions where it has been asserted that generous exemptions have encouraged individuals to file for relief. While the data is not complete on this area of the law, recent studies have demonstrated that such a correlation does not necessarily exist.[243] To the extent that this is verifiable, we have to rethink the basis upon which we choose to amend the federal bankruptcy laws. Perhaps we are also proceeding with the cart before the horse. This Survey demonstrates, as graphically illustrated by the responses to this series of questions, that more empirical data should be ascertained *before* changes are made. This does not guarantee that the amendments that are made will be a perfect solution. It does suggest that they will be based on more than hypothesis and conjecture.[244]

Section 707(b)

When asked whether courts are raising issues under Section 707(b),[245] only 3% of the Respondents indicated that the issue was being raised often. Forty-four percent (44%) of the Respondents indicated that the issue was *never* raised. While there was some variation among the categories of Respondents, they basically agreed that Section 707(b) was not

243. *Supra* note 25. *See* also Woodward and Woodward, "Exemptions as an Incentive to Voluntary Bankruptcy: An Empirical Study," 88 Com. L. J. 309 (1983).

244. The Consumer Credit Industry can quite rightly suggest that the Consumer Credit Amendments were not introduced without a study. However, as noted *supra* note 30, the Purdue Study was the subject of considerable criticism well before the passage of the 1984 Amendments. What is needed is more impartial, nonpartisan studies which are the cooperative effort of all of the participants in the bankruptcy process. *See* Section X on Conclusions and Recommendations.

245. *See* Appendix A, Question C10. Section 707(b) was changed by the 1986 Amendments to provide that now, in addition to the court, the United States Trustee can seek dismissal of the case of an individual with primarily consumer debts for substantial abuse. For a further discussion of the effects of this change, see Section IX on Projections.

being raised by courts with frequency. It is statistically significant that, in some circuits, Section 707(b) issues were raised more frequently than in others.[246] For example, 65% of the Respondents in the First Circuit indicated that issues under Section 707(b) are never raised compared to 20% of the Respondents in the Fourth Circuit who shared this view. Surprisingly, while there was some differentiation among the responses of the types of Lawyer Respondents, it was not as pronounced as in other aspects of the Survey.[247] Of the Creditor Lawyer Respondents, 41% thought that Section 707(b) was never raised while 50% and 52% of the Debtor Lawyer Respondents and Trustee Lawyer Respondents shared this perspective. If anything, one would have supposed that the Creditor Lawyer Respondents, who would want to see considerable action under Section 707(b), thought it was used more frequently than the other categories of Respondents. This runs contrary to the other positions taken by Creditor Lawyer Respondents where they thought their clients' interests were less benefitted than did the other types of Lawyer Respondents.[248]

When asked if courts were conducting significant Section 707(b) review,[249] 67% of the Respondents indicated that negligible review was being conducted and 8% of the Respondents perceived significant review. This is particularly noteworthy in view of the previous response that 19% of the Respondents perceived significant debtor abuse.[250] While a portion of that abuse could be based on cases under chapters of the Code other than Chapter 7, at least a portion of that abuse is probably tied to Chapter 7 cases, indicating that court review is necessary if the abuse is to be eradicated. It is also possible that the abuse in Chapter 7 is not of the kind that would give rise to dismissal under Section 707(b), as, for example, in the situation where the debtor's debts were not primarily consumer obligations. This might account for the higher level of abuse and the lower level of review. It still seems, however, that courts were not acting when they were the only entity charged with the responsibility to do so. It is also interesting to note that the absence of review is similar

246. This is statistically significant at a P Value level of less than or equal to .05.

247. See e.g., *supra* note 99.

248. See e.g., *supra* note 205.

249. *See* Appendix A, Question C11. The theory behind this question was to demonstrate that since only the court could raise Section 707(b) issues, the only way in which it would have access to the information necessary to make any assessment of whether an action under Section 707(b) would rest would be to review the file. Some information could be elicited in open court but it is probable that a review of case filings would be necessary in many instances. Therefore, if courts were doing little review, that could account for the lack of the effectiveness of Section 707(b). If, on the other hand, courts were conducting significant review and then were not pursuing actions, that would suggest that they are not finding the abuse that the Consumer Credit Industry perceived was there. As observed, *supra* note 245, some of this problem is alleviated by the 1986 Amendments which permit the United States Trustee to bring an action under Section 707(b). However, at some point, determinations will have to be made to evaluate how much Section 707(b) review they are doing since, to date, they have focussed their attention primarily on Chapter 11 cases. *See supra* note 72 and accompanying text.

250. *Supra* note 219.

to the level of non-compliance with statutory mandates discussed earlier.[251]

It is statistically significant that the Judge Respondents thought they conducted negligible review more frequently than did the Estate Administrator Respondents and the Lawyer Respondents.[252] Since the Judge Respondents are in the best position to evaluate whether or not they look at cases to determine issues under Section 707(b), it is telling that 72% of them perceived negligible review. This contrasts with the other responses dealing with non-compliance in that there, the Lawyer Respondents perceived more abuse than did the Judge Respondents.[253] Two explanations are readily apparent. First, judicial review of cases for 707(b) purposes is not required by statute.[254] Second, judges may be indicating that for a host of possible reasons, including their respective case loads, they cannot conduct Section 707(b) reviews, revealing that the Section is not working, at least as intended by its proponents.

The amount of review by circuit reveals that there was more review in some circuits than others.[255] There are also differences in the responses when they are evaluated by circuit and type of Respondent. For example, while not statistically significant at a .05 level and considering the small number of Respondents in each cell, 50% of the Judge Respondents in the Sixth Circuit believed there was negligible Section 707(b) review while over 80% of the Judge Respondents in each of the Second, Seventh, Eighth, Tenth and Eleventh Circuits thought there was negligible review. Among the Lawyer Respondents, it is statistically significant that 44% thought there was negligible review in the Fourth Circuit while 88% thought there was negligible review in the Seventh Circuit.[256] There was virtually no differentiation based on the type of Lawyer Respondent.[257]

Among the actions pursued under Section 707(b), 23% of the debtors have not been successful in defending such actions based on asking the Respondents whether debtors were successful in convincing the court that they had not abused the provisions of Code.[258] Only 14% of the Respondents indicated that debtors were successful a significant number of times. This suggests that when Section 707(b) actions are pursued, the court is likely to have the case dismissed.[259] These responses did not vary based on the type of Lawyer Respondent although there are variations among the Lawyer Respondents in the various

251. *Supra* note 125 and accompanying text.

252. This is statistically significant at a P Value level of less than or equal to .05.

253. *Supra* note 131 and accompanying text.

254. Note the differences in the phraseology of the questions. Moreover, Question C11 was not included in the variable coupling all the questions on mandate.

255. This is statistically significant at a P Value level of less than or equal to .05.

256. This is statistically significant at a P Value level of less than or equal to .05.

257. This is statistically significant at a P Value level of less than or equal to .05.

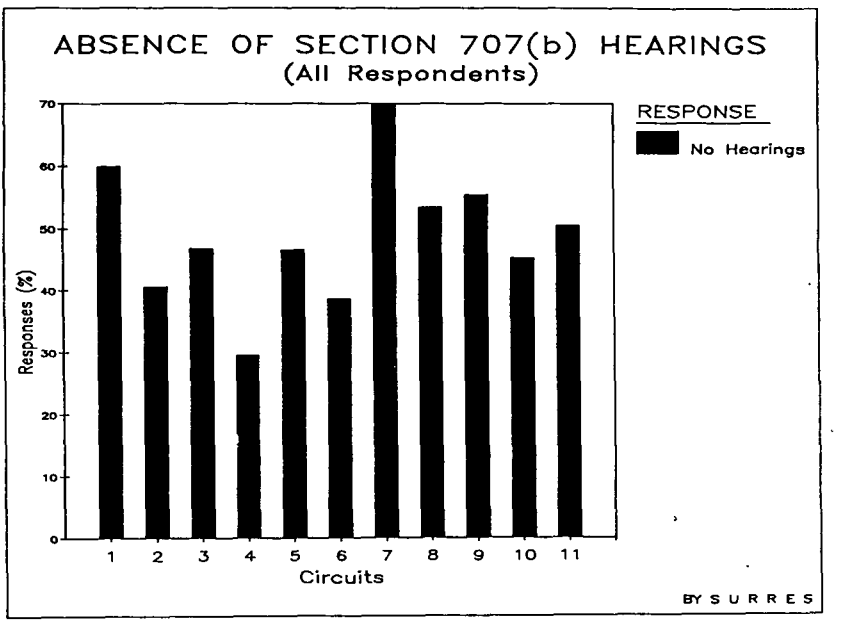
258. *See* Appendix A, Question C12.

259. The actual published decisions in the area suggest debtors are even less successful than the Survey suggests. However, the Survey takes into account unpublished decisions as well. *See* Gross, *supra* note 9.

circuits,[260] with 9% of the Lawyer Respondents in the First Circuit indicating negligible debtor success while 31% of the Lawyer Respondents in the Fourth Circuit thought there was negligible debtor success.

In response to this question, there was a category of response which stated "there have been no Section 707(b) hearings". Forty eight percent (48%) of the Respondents indicated that there were no Section 707(b) hearings. Therefore, while it is possible to discuss what happens when the hearings are held, these observations pale in view of the fact that hearings were frequently not even held in the first instance. There appears to be a marked disparity among the circuits as to those which hold Section 707(b) hearings and those which do not.[261] As revealed in the following chart, the fewest Section 707(b) hearings are conducted in the Seventh Circuit and the most are conducted in the Fourth Circuit.

CHART 8[262]



260. This is statistically significant at a P Value level of less than or equal to .05.

261. This is statistically significant at a P Value level of less than or equal to .05.

262. The breakdown by circuits has a P Value of less than or equal to .05.

What remains to be explained is why there was greater Section 707(b) review in some parts of the country while in others the hearings were not held in the first instance. This question will be considered in conjunction with the issues on Chapter 13.[263]

Chapter 13 and Section 1325(b)

When asked whether the Consumer Credit Amendments increased the number of Chapter 13 plans that were confirmed,[264] 58% of the Respondents perceived no change in Chapter 13 confirmations. The balance of the Respondents split between those who perceived an increase and those who perceived a decrease. When asked whether more Chapter 13 plans were being carried out by debtors in accordance with their original terms,[265] 64% of the Respondents stated that there was no change. The balance of the Respondents split their answers between those who thought there was an increase in successful plans and those who thought there was a decrease in success. When asked whether Section 1325(b) has had an effect on the distributions to creditors,[266] 44% of the Respondents thought there was no change. However, 52% of the Respondents thought distributions had increased. Therefore, even though overall Chapter 13 filings, plan confirmations and plan effectuations were not changed, the dollar distributions to creditors as a consequence of Section 1325(b) were increasing. To the Consumer Credit Industry, this is some evidence that the Amendments improved their position, albeit not to the extent they would have desired.

The sense that Section 1325(b) was increasing distributions was felt by all categories of Respondents in approximately the same proportions. There was, however, while not statistically significant at a .05 level, some variation among the circuits, with only 39% of the Respondents in the Seventh Circuit sensing an increase while 60% of the Respondents in the Sixth Circuit shared this perspective. While circuits varied, there was little difference in the percentage of Lawyer Respondents of the differing types who thought that there were increased distributions. This reinforces that the Amendments *did* improve the position of creditors.

263. *Infra* note 282 and accompanying text.

264. *See* Appendix A, Question C8. The question was designed to probe whether the incentive in the legislation that more cases be filed under Chapter 13 led to increased confirmations. If the only thing that increased was filings, which as demonstrated did not itself happen to the extent anticipated and hoped by the Consumer Credit Industry, then the changes were not successful as success would be measured by confirmations and distributions under Chapter 13 plans. *Infra* note 269. The instant question was also designed to determine whether individuals may have been "scared off" by the requirements that they contribute all of their disposable income to plan payments and hence, while they filed Chapter 13 cases, did not proceed to confirmation.

265. *See* Appendix A, Question C9. This question probes whether the new standard contained in Section 1325(b) regarding projected disposable income is operating to increase plan success. In other words, is there the disposable income that is projected and is it being applied to plan payments or are plans being modified or cases dismissed for failure to carry out the terms of the plan?

266. *See* Appendix A, Question C17(a). This question gets to the heart of the success of the Consumer Credit Amendments which is whether the distribution to creditors is increasing. All the changes are for naught in the eyes of the Consumer Credit Industry if distributions do not increase.

When those Respondents who thought there was an increase in distributions as a consequence of Section 1325(b) were asked if the section was being raised as an issue to increase distributions,[267] 72% of the Respondents indicated "sometimes", while only 2% of the Respondents indicated "never". Among the Lawyer Respondents, there were not substantial differences in the responses although, for descriptive purposes, Creditor Lawyer Respondents thought the issue was raised "often" more frequently than did the other types of Lawyer Respondents.

A similar issue was presented when the Respondents were asked whether Section 1325(b) had improved the amount of plan payments by increasing pre-confirmation negotiations,[268] 54% of the Respondents indicated no change while 45% of the Respondents perceived an increase. Among the Lawyer Respondents, there were no appreciable differences between the Creditor Lawyer Respondents and the Debtor Lawyer Respondents, suggesting that the Section seemingly increased communications between these two "competing" interests.

Zero and Minimal Repayment Plans

When asked whether Section 1325(b) had led to a decrease in the number of minimal or zero repayment plans,[269] 45% of the Respondents perceived no change while 41% of the Respondents thought such plans had decreased.[270] There were more Judge Respondents than any of the other categories of Respondent who believed there was no change.[271] Of those who perceived a decrease in such plans, the Estate Administrator Respondents and Lawyer Respondents had the highest percentage of responses.[272] Among the Lawyer Respondents, while not statistically significant at a .05 level, the Creditor Lawyer Respondents thought such plans had decreased more than any other type of Lawyer Respondent. Perhaps what is most startling is that 14% of the Respondents thought the number of zero or minimal repayment plans had *increased*, the opposite result from that intended. These results are summarized in the following table:

267. *See* Appendix A, Question C17(b). The purpose of this follow-up question was to determine if Section 1325(b) was a valuable and useful strategic tool, increasing distributions in part by virtue of its very existence.

268. *See* Appendix A, Question C15.

269. *See* Appendix A, Question C16. At the heart of the complaints of the Consumer Credit Industry was the belief that courts were permitting debtors to confirm plans with no distributions while the debtors were capable of repaying out of future income. The pre-1984 case law had focussed on the meaning of "good faith" in Section 1325(a)(3). *See* Gross, *supra* note 9. One of the avowed purposes of Section 1325(b) was to curtail zero or minimal repayment plans by requiring debtors to commit all of their disposable income to plan payments. Therefore, at least part of the success of this change can be measured by the reductions in zero or minimal plans. Hard data should ultimately be available on this issue to the extent the Administrative Office for US Courts releases data on the payments in Chapter 13 cases.

270. There were a number of missing responses in respect to this question (239).

271. This is statistically significant at a P Value level of less than or equal to .05.

272. This is statistically significant at a P Value level of less than or equal to .05.

TABLE 8[273]

NUMBER OF MINIMAL OR ZERO REPAYMENT PLANS
(BY CATEGORY)

	Judge	US Trustee	Estate Admin	Lawyer	Row Total
INCREASED	14%	30%	3%	15%	14%
DECREASED	30%	30%	52%	42%	41%
REMAINED THE SAME	56%	40%	45%	43%	45%
TOTAL NO. OF RESPONDENTS	151	10	69	536	766

Additional possible explanations abound, including the hypothesis that the Amendments fixed something that did not need to be fixed, at least to the extent it was "fixed". Therefore, since the problems were never as great as perceived, the "solution" will not have the dramatic results its proponents wished. This is part of the ongoing debate concerning the extent of individual debtor abuse and the definition of that abuse. *See* Sullivan, Warren and Westbrook, *supra* note 25; Gross, *supra* note 9; Ayer, "How to Think About Bankruptcy Ethics," 60 Am. Bankr. L. J. 355 (1986).

Perhaps one explanation for the increase in such plans is that nothing in Section 1325(b) precludes such plans. While debtors are required to commit all of their disposable income to plan payments, the Code is silent as to what transpires if there is no disposable income. One has to assume that debtors with no disposable income are still permitted to seek relief under Chapter 13. Therefore, the Consumer Credit Amendments only eliminate such plans to the extent there is disposable income. There may not be as great a number of debtors with disposable income as originally perceived.[274] Another possible explanation is backlash. It is possible that courts are interpreting the term disposable income narrowly by permitting debtors to retain significant sums as what is reasonably necessary to support

273. The breakdown by category of Respondent has a P Value of less than or equal to .05.

274. *Supra* notes 9 and 25.

themselves and their dependents. Although the published case law is not taking this approach,[275] it is a possible underlying theme in courts' approaches to this issue.

Statutory Mandate

When asked whether courts are confirming a debtor's Chapter 13 plan without all disposable income committed to plan payments when creditors object,[276] only 8% of the Respondents indicated "never" while 24% of the Respondents indicated that plans are being confirmed without this income "almost all" or "most of the time".[277] Thirty-one percent (31%) of the Respondents indicated that plans were "hardly ever" confirmed without disposable income being applied. There was a sharp and statistically significant division in the categories of Respondents.[278] Among the Judge Respondents, 20% perceived that plans were "never" being confirmed without disposable income while 15% of the Judge Respondents admitted that plans were confirmed without such income "almost all" or "most of the time".[279]

Of the Lawyer Respondents, only 5% thought plans were "never" confirmed without disposable income, leaving 95% of the Lawyer Respondents who thought there were at least some instances in which plans were not being confirmed with utilization of a debtor's disposable income. Over 67% of the Lawyer Respondents thought that disposable income was not applied either "some", "most" or "almost all" of the time.

While there is some variation among the circuits, it is not nearly as dramatic as that revealed in other aspects of the Survey addressing compliance with statutory mandates.[280] Looking at the responses on the basis of category of Respondent in each circuit, there are variations among the Judge Respondents, although not statistically significant at a .05 level. Of the Judge Respondents,[281] 67% of such Respondents in the First Circuit perceived that plans were confirmed without disposable income and over creditor objections "almost all the time". In the Sixth Circuit, there were zero responses in this category. However, surprisingly, there are no substantial variations among the Lawyer Respondents.

Among the Lawyer Respondents, while not statistically significant at a .05 level, there was striking similarity among the responses reflecting compliance "almost all" and "most" of

275. Gross, *supra* note 9.

276. *See* Appendix A, Question C18. This question probes the issue of compliance with statutory mandates addressed earlier in Section V on the Automatic Stay. This question is included in the new variable developed to look at overall statutory compliance. *See* Section II on Methodology. The statute, notwithstanding one case (*In re Otero*, 48 Bankr. 704 (Bankr. E.D. Va. 1985)) which is criticized by Gross, *supra* note 9, mandates that all of the debtor's projected disposable income be applied to plan payments. Although there is latitude in interpreting the term "disposable income", the requirement that it be applied, howsoever it is defined, is not debatable. Of course, a very narrow construction of "disposable income" makes the requirement less harsh on the debtor.

277. These two categories were combined to achieve the indicated percentage.

278. This is statistically significant at a P Value level of less than or equal to .05.

279. Again, these two categories were combined to reflect the indicated percentage.

280. *Supra* note 124 and accompanying text.

281. The P Value for this cross tabulation is .0638.

the time. There was a greater range of responses falling into the categories "some" and "hardly ever". Among the types of Lawyer Respondents, the Creditor Lawyer Respondents and Trustee Lawyer Respondents perceived that more plans were being confirmed without disposable income than did the Debtor Lawyer Respondents. However, even among the Debtor Lawyer Respondents, only 27% believed there was compliance "almost all" and "most" of the time, suggesting that there was major non-compliance nationally. There was almost no variation in responses based on firm size and experience level.

Possible Explanations

Whether in the form of non-compliance with a statutory mandate or failure to review cases and conduct hearings under Section 707(b), there is a pattern of judicial non-compliance. Subject to the caveats detailed earlier in terms of calculating possible correlations,[282] the circuits with the most compliance (4th and 6th) do not have the smallest number of new case filings per judge. Similarly, the circuits with the least compliance (2nd, 3rd and 7th) do not have the highest number of new filings on a per judge basis. There do not appear to be correlations between the number of Chapter 7 cases or Chapter 13 cases filed and the rate of non-compliance. The one correlation that can be observed is between the distribution to creditors, as a percentage of the ratio of assets to liabilities, and the rate of non-compliance. There appears to be greater non-compliance in the districts in which there is a smaller distribution to creditors. What this suggests, at a minimum, is the addition of new Judgeships based on case load will not necessarily create greater statutory compliance. Moreover, the circuits reflecting the greatest abuse are not necessarily those revealing the greatest non-compliance with the Code. Therefore, the solutions to these two problems may be different and perhaps more complex than previously contemplated. As recent studies have revealed in the exemption area,[283] there are a myriad of reasons why individuals seek relief under the Code. Therefore, the concept that filings could be curtailed simply by limiting exemptions is misguided; other factors, quite apart from exemptions are governing filings. Similarly, what the Survey reveals is that certain problems exist but the solutions may not just be those utilized to date, at least in part because we are only beginning to understand the problem. Adequate solutions will have to await a detailed analysis of the problem.

282. *Supra* note 104 and accompanying text.

283. *Supra* note 243.

SECTION VIII

JURISDICTION AND PROCEDURE

The jurisdictional and procedural changes effected by the 1984 Amendments were a direct response to the United States Supreme Court's decision in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*[284] and hence an effort to create a bankruptcy court system that would satisfy the constitutional standards. The debate surrounding the creation of the court system raised other highly charged questions about the quality of the existing bankruptcy judges and the nature of the bankruptcy process. Some observed that what was created was "complex and convoluted".[285] As expressed in the media at the time of passage of the 1984 Amendments, "the more complex bankruptcy-court system may require some bankruptcy firms and their clients to press their claims in several different courts -- a sure prescription for longer and costlier legal battles."[286] As further observed, "The alternative [to Article III status] of shuttling cases between courts ... would invite endless litigation over jurisdictional issues, would delay and disrupt the operations of debtors and creditors, and might ultimately be found unconstitutional."[287]

The questions in the Survey on these changes were designed to elicit whether the

284. 458 U.S. 50 (1982), discussed *supra* note 10.

285. King, "Jurisdiction and Procedure Under the Bankruptcy Amendments of 1984", 38 Vand. L. Rev. 675 (1985); Bienenstock, *supra* note 7.

286. Scherschel, "Going Broke: What the New Bankruptcy Law Means to You", U.S. News and World Report, July 16, 1984 at 115.

287. Taylor, "Business and the Law: Bitter Dispute on Bankruptcy", The New York Times, July 24, 1984, Sec. D, p. 2, col. 1.

projections about the new system came to pass. What the Survey reveals is that the system did not come to a halt as a consequence of these changes. The bankruptcy system has proceeded with little substantive effect as a result of the 1984 Amendments. Phrased differently, the system survived what most predicted would be a full scale assault. However, the Survey also reveals that the system is not functioning as at least some of the proponents anticipated that it would and hence some of the changes mandated for constitutional law reasons are not according the protections that may be needed. The system is operating, then, but perhaps with constitutional law infirmities.

What Happened in Practice?

When asked whether the amount of time spent both in and out of court determining which court had jurisdiction to hear a particular matter or case had increased as a consequence of the 1984 Amendments,[288] 54% of the Respondents indicated that more time was being spent, with 31% of the Respondents indicating that the same amount of time was being expended. When asked whether the time period in which cases are closed or confirmed increased as a consequence of the jurisdictional changes,[289] 53% of the Respondents reported no change while 35% of the Respondents reported an increase in time. When asked whether more time was spent reaching the merits of cases as a consequence of the jurisdictional changes,[290] 39% of the Respondents indicated the same amount of time was expended while 48% of the Respondents indicated that more time was being spent. When asked whether the dollar amount of distribution to creditors was affected by the jurisdictional changes,[291] 66% of the Respondents perceived no change while 24% of the Respondents perceived a decrease in distributions.

288. *See* Appendix A, Question B1. The Respondents were asked to compare the 1984 changes with the time period antedating *Marathon* since changes had to be made after *Marathon* to respond to constitutional infirmities. The theory of the questions in this area was to measure time spent under the Code, as enacted in 1978, which presented a system with the most expansive jurisdiction of the bankruptcy court, with the system created by the 1984 Amendments, which presented a system with most restrictive jurisdiction. Although hard data, assuming it is collected and released, would address issues involving jurisdictional matters before the courts, *it would not reveal out-of-court decision-making*. The time spent by attorneys in out-of-court negotiations could well exceed that spent in litigation and, howsoever much time is spent, it is relevant in assessing the "cost" of the 1984 Amendments in that clients pay for their representatives' time, whether in or out of court.

289. *See* Appendix A, Question B3. The theory of this question is that "costs" to participants in the bankruptcy process can be measured in several ways. To creditors, a goal of a case under any chapter is speed. In other words, given the time value of money, creditors want cases closed (i.e. liquidations) or confirmed (i.e. Chapters 11 and 13) promptly, so distributions can be made. Even if jurisdictional issues are taking more time, if that does not cost money, the time expenditure has less of an effect.

290. *See* Appendix A, Question B4. The rationale behind this question is that if a lot of time is expended before the merits are ever even reached, then there is a "wasted" cost in the sense that time is spent litigating where to litigate and the merits become secondary. This type of procedural delay can be utilized for strategic purposes, affecting the rights of debtors and creditors alike. Spending time figuring out where to litigate is a more sensitive issue than outside of the bankruptcy context in that there are generally insufficient assets in the first place and debtors would be spending what little money they have on issues that do not go to the merits. Similarly, creditors who are already owed sums will be spending good money figuring out where to begin chasing after what is owed, a seemingly unnecessary expenditure of funds.

291. *See* Appendix A, Question B5. This question goes to the heart of the matter, namely whether the changes are ultimately affecting the amount of monies creditors receive. To the extent the jurisdictional changes are decreasing distributions, they may be succeeding as a matter of constitutional law but failing as a matter of bankruptcy law.

Among the categories of Respondents, it is statistically significant that the Judge Respondents and United States Trustee Respondents perceived greater time expenditures than did the Lawyer Respondents and Estate Administrator Respondents.[292] More Judge Respondents thought distributions to creditors had decreased. There were wide, and in most instances, statistically significant disparities among the circuits, with more time being spent on jurisdictional matters in some circuits than others.[293] For example, over 60% of the Respondents in the First, Second, Fifth and Tenth Circuits, respectively, perceived that more time was being spent in and out of court deciding which state or federal court was the best forum in which to bring a matter.[294] However, only 43% of the Respondents in each of the Third and Eleventh Circuits shared that perspective.[295] Similarly, 61% and 65%, respectively, of the Respondents in the First and Tenth Circuits thought there had been an increase in reaching the merits of cases while only 35% and 37%, respectively, of the Respondents in the Fourth and Eleventh Circuits shared this perspective.[296] These results are summarized in the following table:

TABLE 9[297]

TIME PERIOD TO REACH THE MERITS (BY CIRCUIT)

	1st	2nd	3rd	4th	5th	6th	7th	8th	9th	10th	11th
INCREASED	61%	49%	40%	35%	52%	43%	52%	45%	51%	65%	37%
DECREASED	0%	14%	14%	8%	16%	17%	11%	9%	13%	5%	20%
REMAINED THE SAME	39%	36%	46%	57%	32%	40%	36%	45%	36%	30%	43%
TOTAL NO. OF RESPONSES	23	77	80	84	111	116	88	64	165	60	90

The disparities among the circuits has more significance if evaluated in the context of Question B5, which looks at whether the increased expenditure of time decreased distributions to creditors.[298] While not statistically significant at a .05 level, in the First Circuit, 46% of the Respondents perceived such a decrease while only 11% of the Respondents in

292. This is statistically significant at a P Value level of less than or equal to .05.
293. This is statistically significant at a P Value level of less than or equal to .05.
294. This is statistically significant at a P Value level of less than or equal to .05.
295. This is statistically significant at a P Value level of less than or equal to .05.
296. This is statistically significant at a P Value level of less than or equal to .05.
297. The breakdown by circuit has a P Value of less than or equal to .05.
298. *Supra* note 291.

the Third Circuit shared this perspective. These results are summarized in the following table:

TABLE 10[299]

DOLLAR AMOUNT OF DISTRIBUTION TO CREDITORS (BY CIRCUIT)

	1st	2nd	3rd	4th	5th	6th	7th	8th	9th	10th	11th
INCREASED	5%	7%	10%	17%	8%	11%	11%	0%	12%	9%	13%
DECREASED	46%	18%	11%	18%	27%	23%	25%	35%	25%	33%	23%
REMAINED THE SAME	50%	75%	79%	65%	64%	66%	64%	65%	64%	58%	64%
TOTAL NO. OF RESPONDENTS	22	68	72	72	95	109	83	57	154	55	86

While there is not substantial variation among the responses of the Lawyer Respondents, firm size did affect the expenditure of time in a statistically significant manner.[300] It is statistically significant that medium and large firms spent more time on jurisdictional matters than did smaller firms. For example, 44% of the Respondents in small firms thought the time in or out of court had increased while 59% and 65% of medium and large firms, respectively, shared this perspective. However, this disparity did not translate into a variation in the dollar amount distributed to creditors.

Perhaps at least a portion of the explanation for why additional time has been spent without the corresponding decrease in distributions to creditors appears in the responses to Question B12.[301] When asked whether more time was spent on jurisdiction initially following the passage of the 1984 Amendments or in the time thereafter, 60% of the Respondents indicated that more time was spent initially while 12% of the Respondents believed more time was spent now. There was some statistically significant variation among the categories of Respondents with 50% of the Judge Respondents indicating that they spent more time initially and 61% of the Lawyer Respondents taking the same position.[302] While there were some variations among the types of Lawyer Respondents which were not statistically significant at a .05 level, a greater and statistically significant disparity is seen among the law firms. Small and medium firms spent more time initially than did large firms.[303] Large firms were spending more time now than medium and small firms. One possible explanation is that larger firms are perhaps utilizing the jurisdictional changes for strategic

299. The breakdown by circuits has a P Value of .09.

300. This is statistically significant at a P Value level of less than or equal to .05.

301. *See* Appendix A, Question B12.

302. This is statistically significant at a P Value level of less than or equal to .05.

303. This is statistically significant at a P Value level of less than or equal to .05.

purposes more frequently than other firms. Another possible explanation is that small and medium firms thought that jurisdictional matters were a big issue but once the system settled down, it became a "non-issue", and things proceeded much as they had before. Another possible explanation related to learning time, suggesting that the initial time expenditure by everyone was significant but that once familiar with the changes, there was not a lot to be done. If the latter explanation has merit, then the reason dollar distributions have not decreased in direct proportion to time spent is that the time was spent early on whereas distributions occurred much later in the learning curve. Therefore, distributions were not effected. One other possibility that merits study is that it is too early to tell whether distributions have gone down, particularly in cases under Chapters 11 and 13. The 1984 Amendments have been in place for two years, and many reorganization cases filed after their introduction have not yielded payments. Therefore, it is impossible to ascertain whether the economic consequences are material.

A Hark-Back to Summary and Plenary Jurisdiction

When asked whether the 1984 Amendments created fewer or more problems than those which existed under the pre-1978 jurisdictional system (with summary and plenary jurisdiction),[304] 43% of the Respondents believed there were more problems before 1978 than there were under the 1984 Amendments. Only 24% of the Respondents thought there were more problems under the 1984 Amendments. When asked whether more time was expended on jurisdictional issues under the pre-1978 system or under the 1984 Amendments,[305] 40% of the Respondents thought more time was spent pre-1978. Only 30% of the Respondents thought more time was spent post 1984. These answers did not vary depending on the category of Respondent, except in respect of the United States Trustee Respondents who perceived, for descriptive purposes only, more time was spent post-1984 than any other category of Respondent with fewer problems.

Among the types of Lawyer Respondents, the Trustee Lawyer Respondents thought the level of problems was greater under the pre-1978 law but there were no dramatic differences in perceptions in respect of the time spent on jurisdictional matters among these Respondents. Firm size did reveal statistically significant differences, with the Lawyer Respondents in large firms sensing more problems under the pre-1978 law than did the Lawyer Respondents in medium and small firms.[306] Only 38% of the Lawyer Respondents in small firms thought there were more problems under the summary and plenary system while 53% of the Lawyer Respondents in large firms thought there were more problems pre-1978. One possible explanation is that most of the litigating under the pre-1978 law involved cases under Chapters X, XI and XII, the former reorganization chapters. Since it is likely that larger firms were more involved in reorganization cases than smaller firms, if the demographics revealed herein have reflected a longstanding pattern,[307] they would have spent more time litigating jurisdictional matters. It is also possible that since large firms are more likely to represent secured creditors, these interests may have the time and money to litigate about where to litigate more frequently than those in smaller firms, thereby increas-

304. *See* Appendix A, Question B10.

305. *See* Appendix A, Question B11.

306. This is statistically significant at a P Value level of less than or equal to .05.

307. *Supra* note 77 and accompanying text.

ing litigation by large firms.

The level of experience did not dramatically affect the responses, although the less experienced Respondents perceived more problems pre-1978 than did those who actually had practiced under the pre-1978 law, but these differences were not statistically significant at a .05 level, and there were a small number of Respondents with less than three years experience. Again, while not statistically significant at a .05 level, the less experienced Respondents also perceived more time being spent pre-1978 than did the other Respondents. It is possible that the less experienced individual was more persuaded by what was said about the difficulties of practice under pre-1978 law than was actually the case, perception masking reality.

Core and Non-Core

To distinguish between matters which could be heard with finality by the bankruptcy court without requiring an Article III court and those which could not be heard with finality and required an Article III forum, Congress devised a system of "core" and "non-core" proceedings.[308] This distinction has generated controversy on several fronts. First, is the definition of "core" proceedings adequate and workable? Second, what happens at the appellate stage where the higher courts have the right to review findings in non-core proceedings *de novo* while core proceedings are reviewed on the basis of the clearly erroneous or an abuse of discretion standard? If, for example, everything is treated as a "core" proceeding, then the distinction is not achieving the goal of distinguishing what matters should and should not be heard with finality by the bankruptcy court. Similarly, if appellate courts are according more review to final orders in core matters than to findings in non-core matters, the appellate process designed to insure review by an Article III court is not functioning as it should.

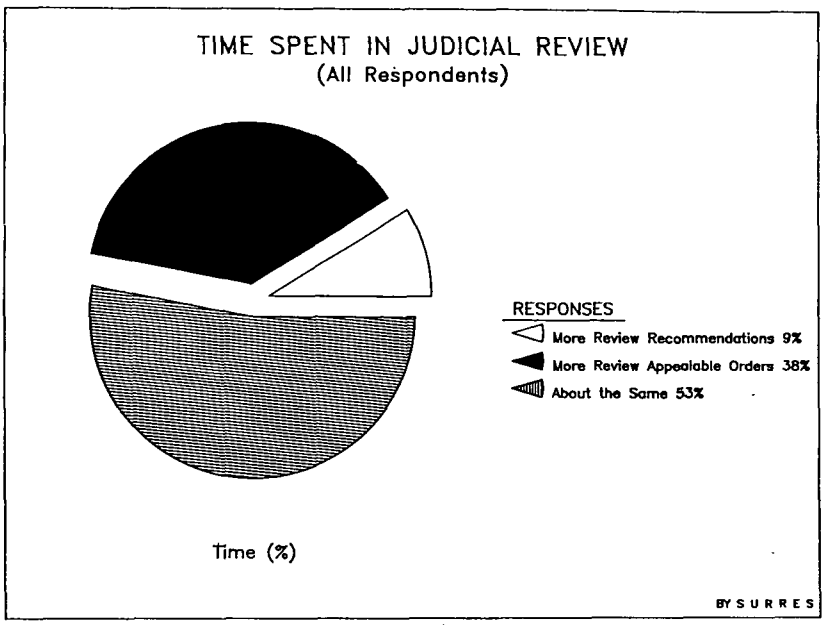
When asked whether the definition of "core proceeding" was over or under inclusive,[309] 50% of the Respondents thought it was about right and 32% of the Respondents thought it was under-inclusive. When asked whether more time was spent reviewing final orders of core matters or recommendations on non-core matters,[310] 53% of the Respondents perceived the level of review to be the same. However, a striking 38% of the Respondents thought there was more review of final orders than there was of recommendations in non-core matters. This data is summarized in the following chart:

308. For a fuller discussion, *see* King, *supra* note 10.

309. *See* Appendix A, Question B8.

310. *See* Appendix A, Question B9.

CHART 9[311]



It is statistically significant that the Judge Respondents perceived greater appellate review of final orders in 52% of the responses while 35% of the Lawyer Respondents shared this perspective.[312] Fifty-seven percent (57%) of the Lawyer Respondents perceived that the same level of review was received.[313]

This suggests that if a lawyer is seeking to maximize judicial review, the issue of core/non-core should not be litigated in the first instance if the other side wants to treat a matter as a core matter. If the results of the Survey are accurate, then there is an increased likelihood of more review on appeal of a final order than could be obtained by review of recommendations by the higher court. The results also suggest that in a number of instances, parties are not obtaining Article III review to the extent contemplated. While the jurisdictional system may be functioning, in that its seeming "complexity" did not bring the system to a halt, it is not accomplishing its avowed purpose.

311. P Values did not need to be calculated in respect to this chart.

312. This is statistically significant at a P Value level of less than or equal to .05.

313. This is statistically significant at a P Value level of less than or equal to .05.

Section IX

PROJECTIONS

Although the Survey was not designed to study the 1986 Amendments, certain of the responses regarding the 1984 Amendments provide indicators of how the 1986 Amendments will function. Four of the 1986 Amendments are particularly noteworthy: the creation of additional judgeships,[314] the establishment of a virtually nationwide United States Trustee Program,[315] the amendment to Section 707(b)[316] and the creation of new Chapter 12,[317] particularly Section 1225(b).[318]

Additional Judgeships

The 1986 Amendments created 52 additional bankruptcy judgeships, with the greatest number of such judgeships in California, Georgia, Illinois and Texas. In terms of circuits, the greatest increases in bankruptcy judgeships occurred in the Fifth, Seventh, Ninth and Eleventh Circuits. As with other amendments to the Code, there is no definitive legislative

314. Pub. L. 99-554, § 101, 100 Stat. ___ (codified as amended at 28 U.S.C. § 152(a)(2)).

315. Pub. L. 99-554, §§ 111-117, 201-231, 100 Stat. ___ (codified as amended in scattered sections of 11 U.S.C. and 28 U.S.C.).

316. Pub. L. 99-554, § 219, 100 Stat. ___ (codified as amended at 11 U.S.C. § 707(b)). The lead-in language to Section 707(b), as amended by the 1986 Amendments, provides, "After notice and a hearing, the court, on its own motion or *on a motion by the United States trustee but ...*" (emphasis indicates the language added by the 1986 Amendments).

317. Pub. L. No. 99-554, §§ 251-257, 100 Stat. ___ (codified as amended at 11 U.S.C. §§ 1201-1231).

318. Pub. L. No. 99-554, § 255, 100 Stat. ___ (codified as amended at 11 U.S.C. § 1225(b)). Section 1225(b) parallels Section 1325(b), *supra* note 264.

history on the creation of these additional judgeships.[319] However, as expressed by Representative Edwards, the creation of the additional judgeships was a response to the burgeoning bankruptcy case-load,[320] and "[a]n appropriate and limited response to the excessive demands on bankruptcy judges in a number of Federal judicial districts has been the objective of both bodies."[321]

Assuming the theory behind the creation of additional judgeships is to facilitate case administration that has been faltering, in part due to increased filings,[322] then there may be some surprise when the effects of the additional judgeships are measured. As the responses in the Survey indicate,[323] there is not a direct correlation between case load and compliance with statutory mandates.[324] In other words, adding additional bankruptcy judges will not necessarily result in increased compliance with statutory mandates. While there is greater compliance in the First Circuit, which has a new small case load per judge, there is not a corresponding lack of compliance in the circuits with the highest new case load.[325] Thus, one possible consequence of the creation of the additional judgeships is increased compliance in those circuits in which judgeships are added but continuing non-compliance in other circuits which do not have high case loads on a per judge basis.[326]

There do appear to be increased perceptions of abuse in certain circuits, namely the Fifth, Ninth and Eleventh Circuits.[327] The increased judgeships appear in these circuits, suggesting that the perceptions of abuse in these circuits may decrease. However, the circuits with the highest new case loads do not necessarily have the highest perceptions of abuse.[328] The Survey reveals that circuits with less abuse perceived also have high case-loads.[329] This suggests that perceptions of abuse may correlate to case load but decreased case load will

319. The Joint Explanatory Statement of the Committee of Conference does not specifically address the creation of additional judgeships. *See* Cong. Rec. H8986, 8998-9, Oct. 2, 1986).

320. *Id.* at 9000.

321. *Id. See also* the additional comments of Representatives Moorhead and Dannemeyer (at 9001-2) on the need for additional judgeships in selected parts of the country.

322. According to the Administrative Office, filings have increased 31% for the year ending June 30, 1986 over the prior year.

323. *Supra* notes 154 and 276.

324. For a fuller discussion of the issue of statutory compliance, see Section V on the Automatic Stay, Section VII on the Consumer Credit Amendments and Section X on Conclusions and Recommendations.

325. *Supra* notes 154 and 276 and accompanying text.

326. The Second and Third Circuits are examples of this. *See supra* note 154.

327. *Supra* notes 101 and 225.

328. *Supra* notes 105 and 282 and accompanying text.

329. *Supra* notes 106 and 282 and accompanying text.

not necessarily diminish the perceptions of abuse.

The Survey suggests, then, that statutory compliance and diminished abuse are more complicated than it first appears. There are certainly a number of justifications for creating additional bankruptcy judgeships, justifications that go well beyond the scope of the Survey. However, the addition of judges is not a panacea; just because there are more judges does not mean the bankruptcy system will operate better. Phrased differently, it is not only the quantity of bankruptcy judges that is relevant, it is quality as well. Therefore, if the goal to be achieved is to eliminate statutory non-compliance and abuse, then increasing judgeships is not enough. More study is needed to see what will correct these ills.

Nationwide United States Trustee Program

In 1978, Congress established a pilot United States Trustee Program,[330] and a report on the program was to be made by January 1984.[331] If the program did not continue on a nationwide basis, it would have expired by its own terms in September 1986.[332] There was considerable controversy surrounding the establishment of a nationwide United States Trustee Program.[333] At the time of the enactment of the nationwide system in 1986, several Representatives remarked that the new system would promote the goals of the Code and "act as watch dogs against fraud."[334] The new system can assist in "uncovering abuses."[335] According to Representative Moorhead, "A nationwide program offers ... increased success in preventing fraud and abuse in the bankruptcy system."[336]

Looking at the responses of the United States Trustees in the Survey, it is clear that they perceived more "wrong" with the bankruptcy system than any other category of Respondent. The United States Trustee Respondents perceived more abuse than the other Respondents.[337] They believed the court was unaware of such abuse more frequently.[338] The United States Trustee Respondents thought the Consumer Credit Amendments were not working effectively and perceived that they did little to improve the system.[339] The United States Trustee Respondents perceived less compliance with statutory mandates than the other categories of Respondents.

These responses suggest that the United States Trustees in the pilot program were

330. 11 U.S.C. §§ 11501-151326. This Chapter was repealed in its entirety by Pub. L. No. 99-554.

331. *See* Transition Provisions to the Code, Title IV, Pub. L. No. 98-598, § 408.

332. *Id.*

333. *See* Greiman, "An Overview of the United States Trustee Pilot System," 1984 Ann. Surv. Bankr. L. 133.

334. Statement of Representative Edwards, Congressional Record, Oct. 2, 1986; H9000.

335. *Id.*

336. Congressional Record, Oct. 2, 1986, H9001.

337. *Supra* notes 97 and 222.

338. *Supra* note 232.

339. *Supra* note 233.

most concerned about the level of abuse under the Code and the amount of judicial non-compliance with statutory mandates. This reflects a prosecutorial approach to the bankruptcy system, namely an effort to correct apparent wrongs committed within the system. In seeking to promote the establishment of a nationwide system, it is probable that those involved in the pilot program focussed on what they perceived was wrong with the system, thereby creating a need for the United States Trustee program on an ongoing basis.[340] Phrased differently, one has to wonder whether the responses of the United States Trustee Respondents were true indicators of the current state of the bankruptcy system or orchestrated responses necessary to insure that the nationwide United States Trustee program became a reality.

To the extent that the eradication of abuse was an avowed purpose of the nationwide United States Trustee program, the nationwide system will focus on the high levels of perceived abuse. If statutory non-compliance is also perceived by the United States Trustees as an abuse,[341] then eradication of this situation may also be a function of the nationwide system. It is not possible to tell whether the United States Trustees who are appointed will have a similar approach to those in office during the pilot program. However, if they do, then it is fair to say that the nationwide program will try to root out the problems perceived in the system. Certainly eradication of "real" abuse is a worthwhile goal. What is particularly noteworthy is that the program may be geared to eradicate something that is not nearly as severe or as clearly defined as the United States Trustees, who will be pursuing its eradication, perceive. In other words, there is now a nationwide system that may be focussing at least some of its attention in the wrong place.

Two features are striking. First, the United States Trustee Respondents did not have the same approach in many instances as the Estate Administrator Respondents, the individuals who performed the administrative functions in bankruptcy matters not covered by the pilot districts. The Estate Administrator Respondents answered questions in a manner more similar to the Judge Respondents and the Lawyer Respondents than the United States Trustee Respondents. The Estate Administrator Respondents did not perceive the same levels of abuse and non-compliance as did the United States Trustee Respondents. The Estate Administrators had less of a prosecutorial approach.

This suggests several things. It is possible that the extent to which the United States Trustee Respondents perceived problems represents an exaggeration, in part to justify the existence of their program. This hypothesis is reinforced by the fact that the United States Trustee Respondents, when asked to rate the overall bankruptcy system, did not think it was poor or very poor.[342] Moreover, the United States Trustee Respondents thought the system was "excellent" more frequently than any other category[343] of Respondent. It is hard to reconcile that the United States Trustee Respondents believe the system is better than the other categories of Respondents and yet see more problems with its operation. On the other hand, it is possible that the Estate Administrator responses reflect any real or im-

340. *Infra* note 342.

341. The responses reveal that abuse is something other than statutory non-compliance. See *supra note* 282.

342. *Supra* note 84.

343. The P Value for this cross tabulation is .1016.

agined control that the bankruptcy judges may exercise over them, and hence do not reveal the extent of actual abuse in the system.

Moreover, and very importantly, when there are no longer Estate Administrators, except in Alabama and North Carolina,[344] there will be an increased perception of abuse and statutory non-compliance. The bankruptcy administration may, then, take on more of a "prosecutorial" approach. If the disparity in levels of experience of the United States Trustee Respondents and the other categories of Respondents[345] is carried onward with the new United States Trustees, then any problems resulting from this disparity will be magnified. Not unlike other federal agencies where those watching are less experienced than those being watched, the bankruptcy "watchdog" will be less experienced than those who are being watched. As noted earlier, the average bankruptcy experience level of the United States Trustee Respondents was 7 years while the average experience level of the Lawyer Respondents and Judge Respondents was 11 and 17 years, respectively.

The second striking feature is that while the United States Trustee Respondents perceived more problems with the system, they were not able, apparently, to stop the situations from continuing. This may be because the pilot program lacked the resources and clout necessary to effectuate its goals. However, if the role of the United States Trustee system is to curtail abuse, then the circuits with United States Trustees should have had *decreased* abuse and *decreased* non-compliance. Since the Survey results were tabulated according to circuits and the United States Trustee program was in place in only 18 districts, it was not possible to ascertain whether, within a given circuit, problems were less significant when the United States Trustee program was in place. However, the Sixth Circuit, *which had no pilot program in place*, had the greatest levels of compliance and the least abuse. One has to wonder what will happen to perceptions in the Sixth Circuit once the United States Trustee program is in force nationwide. The Survey suggests that, at a minimum, we have cause to be wary over whether the system eradicates abuse and non-compliance or merely perceives its existence.

The unique position of the Sixth Circuit within the Survey suggests that it is an excellent place to begin a follow-up study on the nationwide United States Trustee System. Further, since two states will still be operating under the Estate Administrator system, there is a limited control group in existence. Therefore, another study could be constructed, as a follow-up to the Survey, to evaluate what is actually happening under the nationwide United States Trustee system. Given the time that will be needed to phase in the study on a national level, that study may still be far off.

One further observation needs to be made. As noted in Section II, the 1986 Amendments were in the process of being drafted and passed while the Survey was being conducted. To the extent that the Respondents believed their responses to the Survey could affect the outcome of the legislation pending before Congress, that could have effected responses. For example, in areas of the country without a United States Trustee program, perhaps Respondents were minimizing abuse and the Estate Administrator Respondents were remarking on the well-being of the system to avoid a nationwide system. On the other hand, as previously noted, the United States Trustee Respondents may have been justifying their existence. Only time and further study will begin to unravel these issues.

344. *See* Pub. L. No. 99-554, § 302, 100 Stat. ___.

345. *Supra* note 72 and accompanying text.

Section 707(b)

The 1986 Amendments permit the United States Trustee to raise the issue of dismissal for substantial abuse, thereby increasing the opportunity for such an issue being raised. As indicated by the responses, Section 707(b) has not, to date, produced the results sought by the Consumer Credit Industry.[346] Courts are not conducting a great deal of review of cases and in many instances hearings are not even held on the issue.[347] Therefore, the amendment to Section 707(b) should allow the issue to come to the fore more frequently, a result that will be beneficial to the Consumer Credit Industry.

Several issues are raised by the change, however. First, to date, the United States Trustee Respondents have concentrated their efforts on Chapter 11 cases.[348] The United States Trustee Respondents spent less time on individual Chapter 7 cases (which are the ones in which a Section 707(b) issue can even be raised) than did the Judge Respondents. Therefore, the Judge Respondents spent more time on Chapter 7 cases involving individuals and yet did not have the time to consider Section 707(b) issues. Now, the expectation is that United States Trustees, who spent less time on Chapter 7 cases, will be able to raise the Section 707(b) issue with frequency. Time will be the only test of whether, in fact, the frequency of Section 707(b) hearings increases. It may require a reallocation of the time expenditure of the United States Trustees, although one has to question whether that allocation of time is merited.

When asked for suggestions for improving the Consumer Credit Amendments,[349] approximately fifty percent of those responding suggested allowing a party other than the Court to raise issues under Section 707(b). Of those who wanted to expand who had authority to raise the issue, approximately 43% of the Respondents wanted "any party in interest" to be able to bring a motion, while approximately 20% of the Respondents wanted the United States Trustee to be able to raise the issue. What this suggests, at a minimum, is that the changes wrought by the 1986 Amendments comport with those suggested by the Respondents. The responses also reinforce the observations garnered in the context of the closed-ended questions in respect of Section 707(b), namely that the Section was not operating satisfactorily.

One has to question, however, why it was even necessary to amend Section 707(b) in the first instance. Section 707(a) would permit the United States Trustee and a creditor to seek dismissal of a case -- without the constraints of Section 707(b). Second, the lack of utilization of Section 707(b) by the courts only reinforces the lack of judicial activity. The solution to that may not be the addition of other parties to raise Section 707(b) issues but rather motivation of the court. This is particularly true if one views the United States Trustees as representatives of the creditor body, a group who were not to be able to raise the Section 707(b) issue. Therefore, the 1986 Amendments achieve indirectly what, at least in the view of some, was expressly prohibited in the first instance.[350]

346. *Supra* note 245 and accompanying text.

347. *Supra* note 262.

348. *Supra* note 72 and accompanying text.

349. *See* Appendix A, Question C21.

350. *Supra* note 245.

In the Joint Explanatory Statement of the Committee of the Conference,[351] it is expressly stated that the amendment to Section 707(b) "clarifies" that United States Trustees are permitted to bring such actions, apparently because they are not parties in interest -- at least for purposes of Section 707(b). The Statement goes on to state that panel trustees can bring evidence of fraud or abuse to the attention of the United States Trustee who could, in turn, bring the matter to the attention of the court. At one level, all this suggests is that while a creditor cannot *directly* seek dismissal under Section 707(b), that creditor could bring the matter to the attention of the panel trustee who could bring it to the attention of the United States Trustee who could, finally, bring it to the attention of the court. Other ways of increasing the utilization of Section 707(b) should have been considered and perhaps studied, before the 1986 Amendment was made.

Section 1225(b)

Chapter 12, which was created by the 1986 Amendments, is patterned in large part on Chapter 13.[352] Therefore, the responses in the Survey to provisions which appear in Chapter 13 bear on how similar provisions will operate in Chapter 12. As observed, Section 1325(b) has not been perceived as an overwhelming success.[353] The Survey reveals that Chapter 13 plans are frequently confirmed without all of the debtor's disposable income being dedicated to the plan.[354] Further, 44% of the Respondents did not believe that the section increased distributions to creditors.[355] Many Respondents perceived "no change" as a consequence of the section.[356]

Therefore, Section 1225(b) may not operate as efficiently or effectively as some may contemplate. Creditors may not be receiving all of the debtor's disposable income. This suggests, once again, that the root of the problem may not be debtors and creditors, per se, but judicial non-compliance with statutory mandates. Wholesale adoption of Chapter 13 provisions for purposes of Chapter 12, without adequate study of how Chapter 13 is operating, compounds the problem. If Section 1325(b) is found not to be operating effectively, there is every reason to believe Section 1225(b) will not operate effectively. What is needed is study before change.

351. *Supra* note 319.

352. *Supra* note 264.

353. *Supra* note 264 and accompanying text.

354. *Supra* note 276 and accompanying text.

355. *Supra* note 266 and accompanying text.

356. *Supra* note 266.

Section X

CONCLUSIONS AND RECOMMENDATIONS

The Survey discloses a great deal about the effect and effectiveness of the 1984 Amendments. It provides insights into the practice of bankruptcy law and allows us to make certain projections about how the 1986 Amendments will operate. Above all else, the Survey has forced us to think and search for explanations -- it reminds us that there are no simple answers to any issues raised in the bankruptcy context.

The conclusions are divided into two categories: specific conclusions based on questions contained in the Survey Questionnaire, as more fully developed in the report, and general conclusions drawn from various themes established by the Survey responses. The recommendations address to both the specific and general conclusions.

Specific Conclusions

A. Demographics

1. Business Chapter 7 cases accounted for 16% of all work of the Respondents; individual Chapter 7 cases accounted for 27% of all work; Chapter 11 cases accounted for 43% of all work; and Chapter 13 cases accounted for 13% of all work.[357]

2. The Lawyer Respondents and United States Trustee Respondents spent more of their time on Chapter 11 cases than did the Judge Respondents and the Estate Administrator Respondents. The Judge Respondents and Estate Administrator Respondents spent more of their time on Chapter 13 cases than did the Lawyer Respondents and the United States Trustee Respondents. All categories of Respondents expended approximately the same amount of time on business Chapter 7 cases while the Lawyer Respondents and United States Trustee Respondents spent less time than the other categories of Respondents on individual Chapter 7 cases.[358]

3. The average level of bankruptcy experience among the Respondents was 12 years. The average experience level for the Judge Respondents was 17 years, for the Lawyer Respondents was 11 years, for the United States Trustee Respondents was 7 years and for the Estate Administrator Respondents was 6 years.[359]

4. Forty-nine percent (49%) and 51%, respectively, of the work in medium and large firms was secured creditor related while only 27% of the work in small firms was secured

357. *Supra* note 76.

358. *Supra* note 76 and accompanying text.

359. *Supra* note 72 and accompanying text.

creditor related. Forty percent (40%) of the work in small firms was debtor related while only 24% and 23%, respectively, of work in medium and large firms was debtor related. Small firms handled considerably more of the individual Chapter 7 and Chapter 13 work than did the medium and large firms. Chapter 11 work was principally handled by the large firms, with the medium firms following thereafter.[360]

5. Lawyer Respondents with fewer years of bankruptcy experience were less involved in trustee related work. There was no correlation between experience levels and representation of debtors and unsecured creditors. Less experienced Lawyer Respondents handled more of the secured creditor work.[361]

B. Overview Questions

6. Seventy-three percent (73%) of the Respondents ranked the current bankruptcy system "good" to "excellent", although 63% of the responses were in the category "good." Less than 1% of the Respondents ranked the system "very poor," leaving 26% of the Respondents who ranked the system "fair" to "poor".[362]

7. While not statistically significant at a .05 level, the United States Trustee Respondents ranked the current bankruptcy system "excellent" 29% of the time while the Lawyer Respondents only ranked the system "excellent" 8% of the time.[363]

8. Forty-two percent (42%) of the Respondents thought the 1984 Amendments had had no effect on the bankruptcy system while 21% of the Respondents thought they had made the system worse and 37% of the Respondents thought they had made it better.[364]

9. Since the passage of the 1984 Amendments, 20% of the Respondents did not believe practice had changed, 11% thought it had changed substantially and 69% of the Respondents thought it had changed somewhat.[365]

10. Twenty-one percent (21%) of the Respondents perceived that there was a "great deal" of abuse of the bankruptcy system and 77% of the Respondents thought there was a "little" abuse. Only 2% of the Respondents thought there was no abuse at all. Phrased differently, 98% of the Respondents thought there was at least a little abuse of the federal bankruptcy system.[366]

11. The United States Trustee Respondents thought there was a great deal of abuse more frequently than the other categories of Respondents. The Creditor Lawyer Respondents thought there was more abuse than the Debtor Lawyer Respondents. Less ex-

360. *Supra* note 77 and accompanying text.

361. *Supra* note 77 and accompanying text.

362. *Supra* note 79 and accompanying text.

363. *Supra* note 79.

364. *Supra* note 82 and accompanying text.

365. *Supra* note 91 and accompanying text.

366. *Supra* note 95 and accompanying text.

perienced Respondents thought there was abuse more frequently than more experienced Respondents.[367]

12. Among the Circuits, the greatest abuse was perceived in the Fifth, Ninth and Eleventh Circuits and the least amount of a "great deal" of abuse was felt in the Sixth and Tenth Circuits.[368]

C. The Automatic Stay

13. Fifty-two percent (52%) of the Respondents indicated that a preliminary or final hearing was commenced within 30 days "almost all of the time" while 11% of the Respondents indicated that such a hearing was "hardly ever" conducted within 30 days. Thirty-eight percent (38%) of the Respondents indicated that such hearings were commenced between "some of the time" and "most of the time".[369]

14. Compliance with the statutory mandate that hearings be commenced within 30 days varied among the circuits, with the greatest compliance perceived in the Fourth, Sixth and Eleventh Circuits and the least compliance perceived in the Second and Third Circuits.[370]

15. Fifty-nine percent (59%) of the Respondents indicated that Judges permitted the automatic stay to remain in effect notwithstanding a statutory provision that the stay was effectively terminated while 42% of the Respondents indicated that the stay was "hardly ever" allowed to remain in effect.[371]

16. Statutory compliance with the mandate that the stay be lifted was perceived to be greatest in the Fourth, Sixth, Tenth and Eleventh Circuits and least compliance was perceived in the First, Second and Third Circuits.[372]

17. Forty-seven percent (47%) of the Respondents indicated that final hearings were commenced within 30 days after conclusion of the preliminary hearing, as mandated by statute, "almost all the time", leaving 53% of the Respondents who perceived some degree of statutory non-compliance.[373]

18. While not statistically significant at a .05 level, statutory compliance with the requirement that a final hearing be commenced within 30 days after conclusion of the preliminary hearing was greatest in the First, Sixth, Tenth and Eleventh Circuits, while least com-

367. *Supra* note 97 and accompanying text.

368. *Supra* note 103 and accompanying text.

369. *Supra* note 125 and accompanying text.

370. *Supra* note 127 and accompanying text.

371. *Supra* note 133 and accompanying text.

372. *Supra* note 137 and accompanying text.

373. *Supra* note 140 and accompanying text.

pliance was noted in the Second and Third Circuits.[374]

19. Forty-eight percent (48%) of the Respondents perceived that decisions were rendered by the court within 30 days after conclusion of the final hearing, as required by the Bankruptcy Rules, "almost all the time", while the balance of the Respondents perceived some degree of statutory non-compliance.[375]

20. Opinions were issued more frequently within the 30 day period in the Fourth and Sixth Circuits and less frequently in the Second, Third and Seventh Circuits.[376]

21. Sixty-one percent (61%) of the Respondents thought there was no change in the frequency with which hearings were held as a consequence of the 1984 Amendments, although 36% of the Respondents did perceive an increase in the frequency of such hearings.[377]

D. Preference Provisions

22. Forty-three percent (43%) of the Respondents thought there was no change in the frequency with which trustees and debtors-in-possession pursued the recovery of preferences, whether in or out of court.[378]

23. Forty-two percent (42%) of the Respondents thought settlements of preference actions occurred more frequently while 7% of the Respondents thought settlements had decreased and 51% of the Respondents perceived no change.[379]

24. Forty-six percent (46%) of the Respondents perceived no change in creditor success in defending preference litigation as a consequence of the 1984 Amendments while 39% of the Respondents thought creditors were more successful.[380]

25. Fifty percent (50%) of the Respondents thought the focus in litigation on the term "ordinary course of business" had increased while 43% of the Respondents thought there was no change.[381]

26. Seventy-one percent (71%) of the Respondents thought that there was no change in credit policies as a consequence of the 1984 Amendments to the preference section and

374. *Id.*
375. *Supra* note 141 and accompanying text.
376. *Supra* note 142.
377. *Supra* note 147.
378. *Supra* note 172.
379. *Supra* note 180 and accompanying text.
380. *Supra* note 184.
381. *Supra* note 194 and accompanying text.

22% of the Respondents perceived that credit policies had become less liberal.[382]

E. Consumer Credit Amendments

27. Fifty-seven percent (57%) of the Respondents reported that distributions to creditors were unchanged as a consequence of the passage of the Consumer Credit Amendments while 37% of the Respondents thought distributions had increased.[383]

28. Twenty-one percent (21%) of the Respondents indicated that the Consumer Credit Amendments had no effect in dealing with individual debtor abuse and 22% of the Respondents indicated that the Amendments proved "good" to "excellent".[384]

29. Twenty-two percent (22%) of the Respondents thought Chapter 7 filings had increased as a consequence of the Consumer Credit Amendments while only 12% of the Respondents thought Chapter 7 filings had decreased.[385]

30. Three percent (3%) of the Respondents thought issues under Section 707(b) were raised "often" and 44% of the Respondents thought the issue was never raised.[386]

31. Sixty-seven percent (67%) of the Respondents indicated that courts were conducting negligible Section 707(b) review and 8% of the Respondents perceived significant review.[387]

32. Fifty-eight percent (58%) of the Respondents perceived no change in the number of Chapter 13 plan confirmations as a consequence of the Consumer Credit Amendments and 64% of the Respondents stated that there was no change in the number of Chapter 13 plans carried out in accordance with their original terms.[388]

33. Forty-four percent (44%) of the Respondents thought that Section 1325(b) had no effect on distributions to creditors while 52% of the Respondents thought distributions had increased.[389]

34. Forty-five percent (45%) of the Respondents thought that there was no change in the number of zero or minimal repayment plans as a consequence of Section 1325(b) while 41% of the Respondents thought such plans had decreased.[390]

35. Twenty-four percent (24%) of the Respondents indicated that courts were con-

382. *Supra* note 199 and accompanying text.

383. *Supra* note 216 and accompanying text.

384. *Supra* note 233 and accompanying text.

385. *Supra* note 235.

386. *Supra* note 245.

387. *Supra* note 249.

388. *Supra* note 264.

389. *Supra* note 266.

390. *Supra* note 269.

firming Chapter 13 plans without all of the debtor's disposable income dedicated to plan payments, in contravention of the provisions of the Code, almost all the time. Eight percent (8%) of the Respondents indicated that courts were never confirming Chapter 13 plans without all of the debtor's disposable income committed to plan payments.[391]

F. Jurisdiction and Procedure

36. Fifty-four percent (54%) of the Respondents indicated that more time was being spent, both in and out of court, determining which court had jurisdiction to hear a particular matter or case.[392]

37. Fifty-three percent (53%) of the Respondents indicated that the time period in which cases could be closed or confirmed had not changed as a consequence of the 1984 Amendments.[393]

38. Forty-eight percent (48%) of the Respondents indicated that more time was expended to reach the merits while 39% of the Respondents indicated that the same amount of time was expended.[394]

39. Forty-three percent (43%) of the Respondents indicated that they believed more problems existed under the pre-1978 jurisdictional system (with summary and plenary jurisdiction) than under the post-1984 system, and 24% of the Respondents thought there were more problems under the post-1984 system than under the pre-1978 system.[395]

40. Forty percent (40%) of the Respondents thought more time was spent under the pre-1978 system (with summary and plenary jurisdiction) than was spent under the post-1984 system while 30 % of the Respondents thought more time was expended post-1984.[396]

41. Thirty-eight percent (38%) of the Respondents thought more time was spent by higher courts reviewing final orders in core matters than recommendations in non-core matters.[397]

General Conclusions

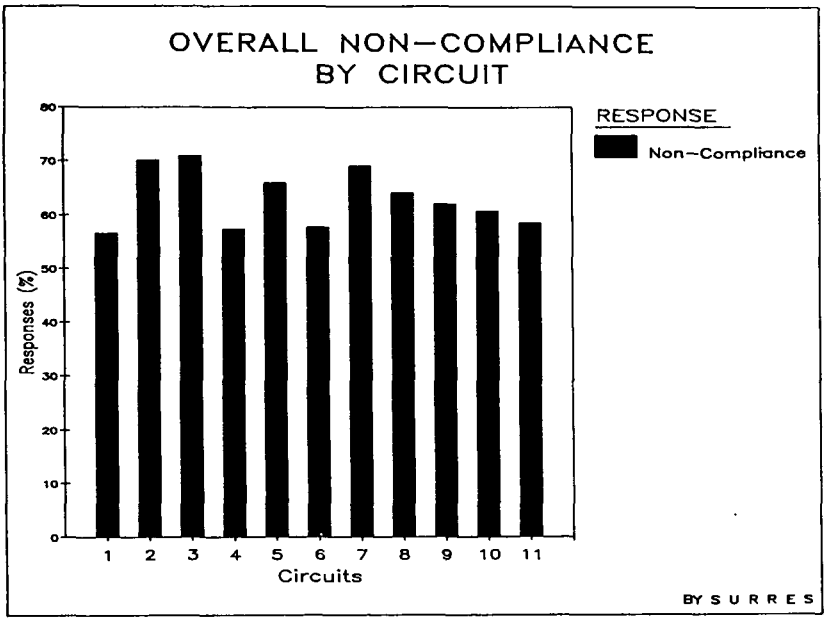
1. There is significant non-compliance by bankruptcy judges with statutory mandates. As revealed in the combined variable looking at statutory compliance throughout the Survey,[398] sixty-four percent (64%) of the Respondents perceived non-compliance with the

391. *Supra* note 276.
392. *Supra* note 288.
393. *Supra* note 289.
394. *Supra* note 297.
395. *Supra* note 304.
396. *Id.*
397. *Supra* note 310.
398. *Supra* note 63 and accompanying text.

statutory mandates specifically addressed in the Survey.[399] As the combined variable reveals, non-compliance was recognized by all categories of Respondents, with the United States Trustee Respondents perceiving the greatest degree of non-compliance followed by the Lawyer Respondents. The Judge Respondents did not generally perceive as much non-compliance as the Lawyer Respondents. However, the Judge Respondents and Lawyer Respondents in the Second Circuit agreed that there was non-compliance with the specific statutory mandates addressed approximately 70% of the time. The lack of a direct correlation between the amount of non-compliance perceived by these types of Respondents does not suggest that there is no compliance but rather that the actual amount of non-compliance is in dispute.

The degree of non-compliance varied from circuit to circuit. This is revealed in the following chart:

CHART 10[400]



399. *Supra* note 282.

400. P Values could not be calculated in connection with the combined variable mandate.

As the Chart depicts, there was considerable non-compliance in the Second, Third and Seventh Circuits and better compliance in the First, Fourth, Sixth and Eleventh Circuits. However, in no circuit was the degree of compliance greater than 44%. Moreover, there were additional questions in the Survey Questionnaire which touched on judicial activity, with the responses thereto suggesting a lack of judicial action.[401] The lack of judicial review of cases to determine substantial abuse and the absence of hearings under Section 707(b) are examples of this.

Some of the judicial non-compliance can be attributed to the large number of bankruptcy cases pending nationally, although the lack of compliance does not correlate to heavy new case filings on a per judge basis.[402] Too many circuits with large numbers of new cases per judge have "high" degrees of compliance. Some judicial non-compliance could be attributable to the Code containing unreasonably short time periods within which hearings must be commenced. When asked what should be done to improve Section 362 of the Code,[403] for example, approximately 37% of those responding indicated that the 30 day period should be expanded to take into account current case volume. Some of the non-compliance may be attributable to intentional judicial dissatisfaction with a particular Code provision, as may be the case with Section 707(b).[404] In some instances, judicial non-compliance is caused by the lack of efficient and creative case load management by the judges and their staff. Whatever explanations exist, it would not appear that they account for over fifty percent non-compliance.

This non-compliance persists, at least in part, because attorneys do not take steps to require judicial compliance. In fact, the Survey results show that there is acquiescence to the non-compliance. Lawyers do not challenge non-compliance by proceeding as if the stay were not in effect nor are they appealing non-compliance or seeking writs of mandamus or other declaratory judgments. Complaints are not apparently being lodged with any federal agency or bar association. Had attorneys taken these measures, the Survey would not have revealed such great non-compliance. In sum, non-compliance has become part of the system.

It is possible the lawyers are unwilling to rock the boat in that they appear repeatedly before the same bankruptcy judges and hence any action to prevent non-compliance could come back to haunt them in other cases. Perhaps the lawyers also are unwilling to have their clients "pay" for the privilege of having statutory compliance, assuming that there are other ways to achieve their desired goal, without cost and risk.

Apparently, the United States Trustees have not been able to curb the amount of non-compliance either, although the Survey results are not broken down on a district by district basis, thereby making the success of the pilot United States Trustee program difficult to assess. The inability of the United States Trustees may be attributable in part to the fact that only a pilot program was in force during the time of the Survey and resources were scarce and staffing too low. However, in the Sixth Circuit, which had *no* pilot program, compliance was the highest in the nation -- which does not bode well for the effectiveness of the nation-

401. *Supra* notes 245 and 282 and accompanying text.

402. *Supra* notes 154 and 282 and accompanying text.

403. *See* Appendix A, Question E8.

404. *Supra* note 252 and accompanying text.

wide United States Trustee program.

The varying degrees of non-compliance among the circuits suggest that bankruptcy law is practiced quite differently in various parts of the country. While the Bankruptcy Code may be uniform in substance, as required by the Constitution, its application is far from uniform. Moreover, the lack of uniformity is not based on different judges having different interpretations of terms susceptible to differing interpretations as, for example, in the case of the term "adequate protection", which has produced a series of inconsistent interpretations among the circuits. The non-compliance looked at by the Survey is related to clear, almost "rule-like", requirements that are not subject to varying interpretation. It is not a matter of having varying statutory interpretations of the requirement that a hearing be held within 30 days; there is nothing to interpret. This is quite different from a requirement that, for example, a hearing be commenced within a reasonable time. Therefore, freedom of judicial interpretation should not be affecting compliance in a significant way.

The lack of consensus among the circuits concerning the degree of conformity with statutory mandates suggests that creditors and debtors who can control where a case is filed may want to consider doing so.[405] For example, a creditor who perceives that the stay may need to be lifted should be inclined to seek venue in a jurisdiction where statutory compliance with Section 362(e) is the greatest (i.e. the Fourth and Sixth Circuits) and should avoid circuits with the least compliance (i.e. the Second and Third Circuits). Debtors will, of course, have the converse reaction and want to seek venue in a jurisdiction with the least amount of statutory compliance. This results in forum shopping.

In a recent decision addressing the issue of adequate protection, the Fifth Circuit observed that courts were establishing new doctrines to protect creditors although existing Code provisions for creditor protection existed.[406] The problem, observed the court, is that bankruptcy cases are not being administered effectively.[407] Therefore, there is a recognition that the Code should be complied with before new doctrines are added to correct a problem that stems not from the Code's denial of rights to a particular party but ineffective judicial administration of the existing Code.

The degree of statutory non-compliance revealed by the Survey raises the question about the amount of non-compliance in other areas of the law. It would be hard to believe that bankruptcy judges alone do not comply with clear statutory requirements. Therefore, what the Survey suggests is that judicial non-compliance is a significant national issue to be addressed. The time has passed to close our eyes to judicial non-conformity. The question that is unanswered is what should be done about it.

2. There is considerable perceived abuse of the bankruptcy process. Only 2% of the Respondents thought there was no abuse of the bankruptcy system,[408] with 21% of the

405. See 28 U.S.C. § 1408.

406. *Supra* note 162.

407. *Supra* note 165.

408. *Supra* note 95 and accompanying text.

Respondents indicating that there was a great deal of abuse. As Chart 4 in Section IV reveals,[409] there was more abuse of the system perceived in some circuits than others. A great deal of abuse was perceived more frequently in the Fifth, Ninth and Eleventh Circuits. Moreover, the Judge Respondents did not always perceive the same amount of significant abuse as the Lawyer Respondents.[410] The Judge Respondents in the Eleventh Circuit, for example, perceived substantially less significant abuse than the Lawyer Respondents while the Judge Respondents in the Ninth Circuit perceived that there was a great deal of abuse significantly more frequently than the Lawyer Respondents.

Additionally, the United States Trustee Respondents perceived more abuse than the other categories of Respondents, with the United States Trustee Respondents indicating that they perceived a great deal of abuse in 50% of their responses while 15%, 34% and 21% of the Judge Respondents, Estate Administrator Respondents and Lawyer Respondents, respectively, shared this perspective. Among the Lawyer Respondents, the Creditor Lawyer Respondents perceived that there was a great deal of abuse more frequently than did the Debtor Lawyer Respondents.

The Respondents also perceived significant abuse by *individual* debtors, with 19% of the Respondents responding that they perceived significant abuse. Again, significant degrees of abuse were perceived more frequently by the United States Trustee Respondents than the other categories of Respondents. The perception of the amount of significant abuse again varied among the Circuits, with the greatest amount of significant abuse appearing in the responses of Respondents in the First, Fifth and Ninth Circuits and the least amount of significant abuse being perceived in the Fourth, Sixth and Eighth Circuits. What is striking is that the First Circuit, which did not report high levels of perceived abuse of the system generally, demonstrated high levels of significant abuse by individual debtors.

The comparison of the results to both questions on abuse and the questions on statutory compliance reveals that the greatest levels of non-compliance do not appear in the circuits with the greatest perceptions of abuse. This suggests that abuse entails something more than non-compliance with statutory mandates. When those Respondents who perceived abuse were asked to describe that abuse,[411] a significant number indicated that abuse occurred through asset hiding, dissipation and under-valuation and the exemption scheme. While the 1984 Amendments did address the issue of exemptions, problems specifically related to asset valuation, dissipation and disappearance were not specifically addressed. Nor did the 1986 Amendments specifically address these issues. Another large group of responses indicated that Chapter 11 was being utilized for purposes of delay, with the debtor operating his or her business with no intent of reorganizing. This topic was also not addressed by the 1984 or 1986 Amendments, respectively.[412] Additional Respondents indicated that the Code was utilized to delay and that the filings themselves were abusive.

409. *Supra* note 103.

410. *Id.*

411. *See* Appendix A, Question F1.

412. This subject is the focus of an informal study undertaken by a special Task Force appointed by the Business Bankruptcy Committee of the American Bar Association. This task force, which is chaired by Timothy Curtin, Esq. of Varnum, Riddering, Schmidt & Howlett, and on which the Reporter of this Survey serves, plans to release its report in the autumn of 1987.

Other Respondents indicated that the discharge in Chapter 13 was too all-encompassing.

What these responses suggest is that the abuse of the bankruptcy system goes beyond individual debtors who seek relief from indebtedness that they are capable of repaying. This, then suggests, that our focus may have been misplaced. In our struggle to overcome "abuse", we failed to understand what the abuse was that existed. Therefore, the corrective measures that were undertaken by the 1984 Amendments did not get at the heart of the problem – at least in part because the problem was obscured.

Moreover, perhaps the focus of the attention of the new nationwide United States Trustee system will be misplaced and, based on the results of this Survey, the program should assess where it should best allocate its available resources and what problems it should be tackling.

3. The 1984 Amendments selected for study did not dramatically change the bankruptcy system. Forty-two percent (42%) of the Respondents did not perceive any change in the bankruptcy system as a result of the 1984 Amendments generally.[413] Thirty-seven percent (37%) of the Respondents thought the system was better, not exactly an overwhelming endorsement. What is striking is that while the substantive effect of the Amendments may not have been overwhelming, 69% of the Respondents thought that practice had changed "somewhat."[414] This suggests that while the 1984 Amendments may have caused changes, the changes did not have a material, substantive effect in many instances.

These observations are supported by the analysis of the specific Amendments studied in the Survey. When asked whether the changes to Section 362(e) affected the frequency with which hearings were commenced to vacate the automatic stay, 61% of the Respondents thought there was *no* change as a result of the Amendments.[415] When asked whether creditors were more successful in defending preference litigation after the changes to Section 547(c)(2), 46% of the Respondents perceived no change.[416] When asked whether the Consumer Credit Amendments had increased dollar distributions to creditors,[417] 57% of the Respondents reported no change. When asked whether the changes to the jurisdiction of the bankruptcy court had effected the dollar amount of distributions to creditors, 66% of the Respondents reported no change,[418] although over fifty percent of the Respondents who suggested improvements indicated that they still would like bankruptcy judges to have Article III status.[419]

If one considers that the purpose of new legislation is to effect change, then optimally, individuals would indicate that things had changed 100%. As revealed by the Survey, the 1984 Amendments did not produce the degree of change that many anticipated. While change most assuredly occurred, it frequently appeared in the guise of "procedural" chan-

413. *Supra* note 87.

414. *Supra* note 91.

415. *Supra* note 147.

416. *Supra* note 184.

417. *Supra* note 216.

418. *Supra* note 291.

419. *See* Appendix A, Question B13.

ges, with no net effect on the dollar distributions to creditors. The absence of marked change also suggests that the Amendments may not have produced dramatic results because the need for change was not as necessary as some perceived and hence the system responded by integrating the changes into the system without the system itself changing or needing to change. It is also possible that in integrating the changes, the participants in the bankruptcy process integrated the changes in the manner that produced the least ripple, thereby curtailing the effect of the Amendments.

4. Some of our "working" hypotheses about how bankruptcy law is practiced were confirmed while others were undermined. Although Creditor Lawyer Respondents perceived more abuse of the bankruptcy system than did the Debtor Lawyer Respondents, creditor lawyers do not always think differently from debtor lawyers. In the areas of jurisdiction and statutory compliance, these individuals had similar responses.

Similarly, while in some instances there appears to be a difference between the way lawyers in large firms and small firms think about issues, these responses were quite similar on issues involving statutory compliance and the Consumer Credit Amendments.[420] Although large firms may represent different clients from small firms, the firms' perceptions about the bankruptcy process are not dramatically different.

Experience level affected the responses, the less experienced Respondents perceiving greater problems in the bankruptcy system. This suggests that experience is an essential factor in operating under the system and bankruptcy may be best understood by those who have been involved with it for a longer period.

5. The responses to the Survey suggest that at least some of the 1986 Amendments may not prove as successful as might be hoped. The creation of additional judgeships, while necessary for reasons that have nothing to do with this Survey, will not necessarily reduce abuse or statutory non-compliance.[421] The establishment of a virtually nationwide United States Trustee Program will not necessarily eradicate abuse or increase statutory compliance.[422] The amendment to Section 707(b) may well increase the utilization of this section, although the price may be to undermine the goal of the Section in the first instance.[423] The creation of selected aspects of Chapter 12 which parallel provisions in Chapter 13 will suffer from the same problems as exist under the current sections.[424]

6. The bankruptcy system, despite its flaws, is operating remarkably well. Seventy-three percent (73%) of the Respondents ranked the system good to excellent and less than five percent of the Respondents thought the system was poor or very poor. Among the categories of Respondents, there was overall consensus of responses, although there was

420. *See* e.g. *supra* notes 131, 139 and 281.

421. *Supra* note 319.

422. *Supra* note 330.

423. *Supra* note 346.

424. *Supra* note 352.

some variation among the Circuits, with the Fifth Circuit feeling the least positive about the system and the Sixth Circuit feeling the most positive. What this suggests is that the bankruptcy system is inherently stable and that while changes may be made, the practice -- in form and substance -- continues to survive and function adequately for the participants in the bankruptcy process.

Relevant to the Survey are the comments made by Supreme Court Justice Antonin Scalia at a dinner in April 1987 at Rutgers Law School. In his remarks, Justice Scalia noted the problem of Americans honoring what is technically legal over what is morally right, and Justice Scalia cites as an example the federal bankruptcy laws wherein someone can remain rich at the expense of creditors.[425] While this seems to be a sentiment shared by at least some of the Respondents who objected to the delay created by the bankruptcy system, abuse of the bankruptcy system is perceived more frequently by those with less experience in bankruptcy. This is not to say that experienced individuals do not perceive abuse -- they most assuredly do but they also see that the system is working and not in dismal shape. Perhaps J. Weidman's observation about bankruptcy in his book Fourth Street East has relevance. "Bankruptcy," he wrote, "is one of those words, like "war", that you heard all your life and think you finally understood until you actually became involved in the process the word was intended to identify."[426]

Recommendations

The Survey would not be complete without some recommendations about where to proceed from here. Certainly each reader can suggest things that ought to be thought about and pursued. The following list is not all-inclusive; however, it isolates at least some of the areas that should be pursued further.

1. Additional studies are needed in certain areas based on the issues raised by the Survey. There needs to be further study of: (A) the nature and extent of abuse in the bankruptcy system; (B) the operation of the nationwide United States Trustee program; and (C) compliance by bankruptcy judges with other statutory mandates created by the Bankruptcy Code.

To the extent that the United States Trustee program is evaluated, the results under the program should be studied in light of the two states which *will not* have the program to determine whether the program is producing differing results. In addition, it seems apparent that the Sixth Circuit, the only non-pilot circuit in the country, should be studied carefully once the United States Trustee program is in place there. The Second Circuit, which stood at odds on many issues with other circuits, should be evaluated more closely.

Future studies should allow for *district by district*, as well as circuit by circuit, analysis of the data. While this is a more costly and difficult process, it will allow for more detailed results, comparisons of results under districts within each circuit and better comparisons

425. The New York Times, April 4, 1987, Sec. 2, p. 32, col. 1.

426. J. Weidman, *Fourth Street East* at 219 (1970).

with the data collected by the Administrative Office.

2. There should be follow-up studies based on the Survey Questionnaire to determine whether any changes have occurred through the passage of time. It would be possible to choose other respondents or to follow-up with the existing Respondents, to the extent they remain willing to participate in additional studies. Such a follow-up will, for the first time, allow for comparative perceptual data on bankruptcy matters. Such a project should be undertaken, given the speed with which the bankruptcy law is evolving, in 1988.

3. Before other and further changes to the Bankruptcy Code are made, a serious and conscious effort should be made to study the areas contemplated for change in an objective and non-partisan manner. As the Respondents' responses indicated, there were changes that did not achieve what at least proponents of the legislation would have wanted. Moreover, the Respondents, in answering the open-ended questions,[427] had distinct suggestions for how the system could be improved.[428] Some of these suggestions should have been, and apparently were not, carefully considered before the 1984 Amendments were added. For example, over 50% of those who responded to how Section 547 could be improved indicated that a definite time period should be reinstated in Section 547(c)(2) or an effort should have been made to define more clearly what constitutes "ordinary course of business". Of the Respondents who offered suggestions in the context of Section 362 of the Code,[429] approximately 37% of them thought the 30 day period should be extended to set a more realistic timetable. Additional Respondents indicated that the preliminary hearing should be eliminated as unnecessary and an additional cost. Even if these suggestions are ultimately rejected, they should, at a minimum, be addressed -- as they represent the views of those actually dealing with the bankruptcy process on a daily basis.

4. There needs to be a better and more efficient method of monitoring judicial compliance. Additionally, all participants in the bankruptcy process should serve to promote judicial compliance by taking an active role in seeking such compliance. As the Survey has revealed, there do not appear to be individuals willing at present to take the risk to make the system work. Perhaps the nationwide United States Trustee system will help. Something more seems to be needed -- vigilance and action by the lawyer participants in the process and perhaps peer pressure among the judges themselves.

5. The jurisdictional system should be re-evaluated once again to determine whether the creation of Article III bankruptcy courts is a feasible and sound solution. Over fifty percent of the Respondents indicated a desire to have Article III bankruptcy courts.[430]

427. *Supra* note 47 and accompanying text.

428. *See* Appendix A, Question D9.

429. *See* Appendix A, Question B13.

430. *Supra* note 48.

Moreover, the Survey has revealed that the current system may not be operating in a constitutionally sound manner.[431] The issue of statutory non-compliance certainly suggests that the current system is not working optimally and certainly raises very serious questions about whether the existing bankruptcy bench should attain Article III status, should such a system be implemented. It would be valuable to look at judicial compliance *outside* the bankruptcy context, at both the state and federal court level to determine if compliance issues are, indeed, a unique creature of bankruptcy and, if they are not, what can be done about the problem generally.

6. Other and further studies are needed on topics in bankruptcy which were *not* specifically addressed by the Survey. In response to an open-ended question at the close of the interview,[432] the Respondents to the Survey highlighted areas they thought needed study. These topics included (excluding those previously addressed in these Recommendations):

a. Chapter 11 -- its uses and abuses

b. The Effectiveness of Chapter 12

c. Chapter 13 -- its uses and abuses

e. Standards for attorney's fee allowances

f. Adequate Protection

g. Fraudulent Transfers

h. Exemptions

7. Further avenues have to be created for dialogue and interaction among the various participants in the bankruptcy process. This should not only increase awareness of what is happening in the bankruptcy system but also assist in the eradication of abuse and non-compliance with statutory mandates.

8. Additional sources of funding for studies and dialogues among the bankruptcy participants should be pursued, both in the private and public sectors.

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The Survey report is now concluded but the issues raised in this report are only just beginning to be discussed. The report alerts us to the importance of gathering the perceptions of those participating in the bankruptcy process. The reality of these and other participants' day to day life in the bankruptcy system may well be affected by these perceptions ... the time for understanding has just begun.

431. *Supra* note 313.

432. *See* Appendix A, Question F10.

Appendix A

```
>pid1<  [allow 6] [loc 0/1] [end]
>id1<   [allow 6] [loc 1/1] [end]
>cid1<  [store pid1 in id1] [end]
>crd1<  [allow 1] [end]
>cd1<   [store <1> in crd1] [end]
>std<   [allow 3] [end]
>stud<  [store <886> in std] [end]
>pid2<  [allow 6] [loc 2/1] [end]
>id2<   [store id1 in pid2] [end]
>crd2<  [allow 1] [end]
>cd2<   [store <2> in crd2] [goto type] [end]
>set<   [store <> in type] [store <> in intr] [end]
>type<  Record type of respondent.
        <1> Judge
        <2> U.S. Trustee
        <3> Estate Administrator
        <4> Lawyer
        ===> [loc 1/11]
>intr<  Hello, my name is _______. I would like to speak with _______ about
        the American Bankruptcy Institute study described in a letter you
        should have received from Judge George Paine dated _____. Is _____
        available?
        ** IF RESPONDENT NOT AVAILABLE, ARRANGE A TIME TO CALL BACK
        ** WHEN RESPONDENT ANSWERS:
        Hello, I'm _______ calling from the Survey Research Center at the
        University of Maryland. We are conducting a study for the American
        Bankruptcy Institute (ABI); you should have received a letter from
        Judge George Paine describing the project. As you are aware, your
        name was selected at random from a list of professionals working with
        bankruptcy related matters. Your responses will be completely
        confidential. A summary of the results of this study will be sent
        to all participants.
        The Interview should take approximately 30 minutes. If this is a
        convenient time, we can begin.
        ** IF NOT A GOOD TIME THEN ASK -- What would be a convenient time?
        ** TYPE <go> when ready to begin interview.
        ** type <no> if call back, refusal, wrong number, etc ... [goto set]
        ===> [loc 0/35]
>A1<    First, overall would you rate the current U.S. bankruptcy system
        as: (READ OPTIONS 1 THRU 5)
        <1> excellent
        <2> good
        <3> fair
        <4> poor
        <5> very poor
        <8> dk
        <9> ns-ref
        ===> [loc 1/12]
>A2<    Would you say as a result of the 1984 Amendments (BAFJA-Bankruptcy
        Amendments and Federal Judgeship Act), the bankruptcy system is:
        ** READ OPTIONS 1 THRU 3
        <1> better
        <2> worse
        <3> about the same
        <8> dk
```

<9> na-ref
===>

>A3< As a result of the 1984 Amendments, do you feel the practice of bankruptcy law has: (READ OPTIONS 1 THRU 3)
<1> changed substantially -- How has it changed? [specify]
<2> changed somewhat
<3> not changed at all
<8> dk
<9> na-ref
===>

>B1< Now, I would like to ask you some questions on Jurisdictional and Procedural changes in the 1984 Amendments. In answering these questions, you are asked to compare how the system operates now as opposed to under post-1978, but pre-Marathon Law.
In your opinion, is more time, less time or about the same amount of time being spent both in and out of court determining what court has jurisdiction to hear a particular case or matter?
<1> more time
<2> less time
<3> same amount of time
<8> dk
<9> na-ref
===>

>B2< In cases where more than one court can hear a bankruptcy matter, is more time, less time, or about the same amount of time being spent both in and out of court determining which state or federal court is the best forum?
<1> more time
<2> less time
<3> same amount of time
<8> dk
<9> na-ref
===>

>B3< Has the time period in which bankruptcy cases can be confirmed or closed: (READ OPTIONS 1 THRU 3)
<1> increased
<2> decreased
<3> remained the same
<8> dk
<9> na-ref
===>

>B4< In your opinion, as the consequence of the jurisdictional and procedural changes, has the time period both in and out of court in reaching the merits of issues within a bankruptcy case:
** READ OPTIONS 1 THRU 3
<1> increased
<2> decreased
<3> remained the same
<8> dk
<9> na-ref
===>

>B5< In your opinion, has the dollar amount of distribution to creditors:
** READ OPTIONS 1 THRU 3
<1> increased
<2> decreased

<3> remained the same
<8> dk
<9> na-ref
===>

>B6< In your opinion, under the current system is a lot of time, some time, little time or no time spent both in and out of court determining whether a particular court should abstain from hearing a bankruptcy matter?
<1> a lot of time
<2> some time
<3> little time
<4> no time
<8> dk
<9> na-ref
===>

>B7< Again under the current system, would you say a lot of time, some time, little time or no time is being spent both in and out of court determining what is an appealable order of the bankruptcy court?
<1> a lot of time
<2> some time
<3> little time
<4> no time
<8> dk
<9> na-ref
===>

>B8< In your opinion, would you say the definition of "core proceedings" contained in Section 157 of Title 28 is over-inclusive, under-inclusive or about right? (READ OPTIONS 1 THRU 3)
<1> over-inclusive -- Why is that? [specify]
<2> under-inclusive -- Why is that? [specify]
<3> about right
<6> over- and under-inclusive -- Why is that? [specify]
<7> over- and under-inclusive and about right
<8> dk
<9> na-ref
===>

>B9< Do district courts spend more time reviewing recommendations of bankruptcy judges in non-core matters, spend more time reviewing final appealable orders issued by bankruptcy judges in core proceedings or is the time spent on both about the same?
** READ OPTIONS 1 THRU 3
<1> more on reviewing recommendations
<2> more on reviewing appealable orders
<3> about the same
<8> dk
<9> na-ref
===>

>B10< In your opinion, were there more problems with the summary and plenary jurisdiction under the pre-1978 bankruptcy law or are there more problems now with the 1984 jurisdictional and procedural changes or are the problems about the same?
<1> more problems pre-1978
<2> more problems 1984
<3> both about the same
<8> dk

<9> na-ref
===>

>B11< Was more time spent in summary and plenary jurisdiction determinations under the pre-1978 bankruptcy law or is more time spent now on jurisdictional and procedural matters under the 1984 Amendments or is the time spent about the same?
<1> more time pre-1978
<2> more spent 1984
<3> both about the same
<8> dk
<9> na-ref
===>

>B12< Think back to the initial six-month period following the effective date of the 1984 Amendments, that was July 1984 to January 1985. Was more time spent initially on jurisdictional and procedural changes, or is more time spent now on jurisdictional and procedural changes or is the time spent about the same?
<1> more spent initially
<2> more spent now
<3> about the same
<8> dk
<9> na-ref
===>

>B13< Do you have any suggestions for improving the jurisdictional and procedural system created by the 1984 Amendments?
<0> no
<1> yes -- What is that?
** PROBE -- Anything else? [specify]
<8> dk
<9> na-ref
===>

>C1< Now we have some questions that have resulted from the Consumer Credit Amendments generally, and some of the specific amendments within the Consumer Amendments. The first specific section that will be referenced is Section 707(b) which, as you are aware, permits a court to dismiss a Chapter 7 case for substantial abuse. Secondly, we will reference Section 1325(b), which as you are aware, provides that if the Chapter 13 debtor is not paying creditors in full, the debtor's projected disposable income over the next three years must be applied to fund the Chapter 13 plan. (Disposable income is defined as that income not reasonably necessary for the maintenance or support of the debtor and dependents).
As a result of the Consumer Credit Amendments, do you believe that the dollar amount of distribution to creditors has:
** READ OPTIONS 1 THRU 3
<1> increased
<2> decreased
<3> remained the same
<8> no opinion
<9> na-ref
===>

>C2< Do you believe that the current amount of individual debtor abuse of the Code is: (READ OPTIONS 1 THRU 3)
<1> significant
<2> moderate

<3> negligible
<8> no opinion
<9> na-ref
===>

>C3< Do you believe that the current amount of individual debtor abuse of the Code as to which the court is unaware is: (READ OPTIONS 1 THRU 3)
<1> significant
<2> moderate
<3> negligible
<8> no opinion
<9> na-ref
===>

>C4< As a result of the passage of the Consumer Credit Amendments, do you feel that there has been an increase, a decrease or no change in the number of Chapter 7 cases filed by individual debtors?
<1> increased
<2> decreased
<3> no change
<8> dk
<9> na-ref
===>

>C5< Increase, decrease or no change in the number of Chapter 13 cases filed?
<1> increased
<2> decreased
<3> no change
<8> dk
<9> na-ref
===>

>C6< Increase, decrease or no change in the number of cases involving individual debtors which are converted from Chapter 7 to Chapter 13?
<1> increased
<2> decreased
<3> no change
<8> dk
<9> na-ref
===>

>a1< [if type eq <4> then goto C7] [store <9> in C7] [goto C8] [end]

>C7< Increase, decrease, or no change in the number of individual debtors electing not to seek relief under any chapter of the federal bankruptcy law?
<1> increased
<2> decreased
<3> no change
<8> dk
<9> na-ref
===>

>C8< Increase, decrease or no change in the number of Chapter 13 plans which are confirmed?
<1> increased
<2> decreased
<3> no change
<8> dk
<9> na-ref
===>

>C9< Increase, decrease or no change in the number of confirmed Chapter 13 plans which are successfully carried out to date by the debtor in accordance with its original terms?
<1> increased
<2> decreased
<3> no change
<8> dk
<9> na-ref
===>

>C10< Now in reference to Section 707(b):
Specifically, as a result of Section 707(b), have the instances in which the court has raised dismissal of a Chapter 7 case of an individual debtor been: (READ OPTIONS 1 THRU 3)
<1> often
<2> sometimes
<3> never
<8> dk
<9> na-ref
===>

>C11< In your opinion, do you believe courts are conducting significant, moderate or negligible Section 707(b) review of the Chapter 7 cases filed in their district?
<1> significant
<2> moderate
<3> negligible
<8> dk
<9> na-ref
===>

>C12< In 707(b) hearings, has the number of debtors who have been successful convincing the court that they have not substantially abused the Code been: (READ OPTIONS 1 THRU 4)
<1> significant
<2> moderate
<3> negligible
<4> there have been no 707(b) hearings
<8> dk
<9> na-ref
===>

>C13< Aside from courts bringing motions to dismiss Chapter 7 cases, would you say that the number of dismissal actions brought by creditors under any section of the code has: (READ OPTIONS 1 THRU 3)
<1> increased
<2> decreased
<3> remained the same
<8> dk
<9> na-ref
===>

>C14< Following passage of section 707(b), do you feel that the number of creditors who have successfully obtained the dismissals they have sought has: (READ OPTIONS 1 THRU 3)
<1> increased
<2> decreased
<3> remained the same
<8> dk
<9> na-ref

===>

>C15< Now in reference to Section 1325(b):
Specifically, as a result of Section 1325(b), have the proportion of creditors who have successfully improved their treatment in Chapter 13 plans by negotiating pre-confirmation plan modifications:
** READ OPTIONS 1 THRU 3
<1> increased
<2> decreased
<3> remained the same
<8> dk
<9> na-ref
===>

>C16< As a result of Section 1325(b), has the number of confirmed zero or minimal payment plans: (READ OPTIONS 1 THRU 3)
<1> increased
<2> decreased
<3> remained the same
<8> dk
<9> na-ref
===>

>C17a< Do you believe that Section 1325(b) has increased, decreased, or has had no effect on distribution to creditors?
<1> increased [goto C17b]
<2> decreased
<3> remained the same
<8> dk
<9> na-ref
===>

>a2< [store <9> in C17b] [goto C18] [end]

>C17b< Do you believe that Section 1325(b) is being raised as an issue to increase distribution to creditors: (READ OPTIONS 1 THRU 3)
<1> often
<2> sometimes
<3> never
<8> dk
<9> na-ref
===>

>C18< When creditors object, do courts confirm Chapter 13 plans without debtors' committing all of their disposable income:
** READ OPTIONS 1 THRU 5
<1> almost all of the time
<2> most of the time
<3> some of the time
<4> hardly ever
<5> never
<8> dk
<9> na-ref
===>

>C19< Would you say that the effectiveness of the Consumer Credit Amendments in dealing with the abuse of the Code by individual debtors is:
** READ OPTIONS 1 THRU 6
<1> excellent
<2> good
<3> fair
<4> poor

<5> very poor
<6> had no effect
<8> dk
<9> na-ref
===>

>C20< In your opinion, have the Consumer Credit Amendments made things better for creditors, better for debtors, made things equal for both, or has had no effect on either?
<1> better for creditors
<2> better for debtors
<3> equal for both
<4> has had no effect
<8> dk
<9> na-ref
===>

>C21< Do you have any suggestions for improving the Consumer Credit Amendments to the Code?
<0> no
<1> yes -- What is that?
** PROBE -- Anything else? [specify]
<8> dk
<9> na-ref
===>

>D1< As you know, the 1984 Amendments changed Section 547(c)(2) by deleting the 45 day ordinary course of business exception to preference actions. As a result of the changes to Section 547(c)(2) contained in the 1984 Amendments to the code has the number of times that trustees or debtors-in-possession are, both in and out of court, pursuing the recovery of preferences: (READ OPTIONS 1 THRU 3)
<1> increased
<2> decreased
<3> remained the same
<8> dk
<9> na-ref.
===>

>D2< In your opinion, has the amount of preference litigation actually pursued by trustees and debtors-in-possession:
** READ OPTIONS 1 THRU 3
<1> increased
<2> decreased
<3> remained the same
<8> dk
<9> na-ref
===>

>D3< Has the proportion of creditors who are successful in defending preference actions: (READ OPTIONS 1 THRU 3)
<1> increased
<2> decreased
<3> remained the same
<8> dk
<9> na-ref
===>

>D4< In your opinion, has the proportion of preference litigation focusing on the meaning of the term "ordinary course of business":
** READ OPTIONS 1 THRU 3

<1> increased
<2> decreased
<3> remained the same
<8> dk
<9> na-ref
===>

>D5< Has the proportion of litigated preference actions which are settled increased, decreased or remained the same?
<1> increased -- Why is that? [specify]
<2> decreased -- Why is that? [specify]
<3> remained the same
<8> dk
<9> na-ref
===>

>D6< As a result of the amendments to Section 547(c)(2), do you believe that the dollar amount of distribution to unsecured creditors has:
** READ OPTIONS 1 THRU 3
<1> increased
<2> decreased
<3> remained the same
<8> dk
<9> na-ref
===>

>D7a< Has the result of the amendments to Section 547(c)(2) made things better for unsecured trade creditors, made things worse for unsecured trade creditors or made no difference?
<1> better
<2> worse
<3> no difference
<8> dk
<9> na-ref
===>

>D7b< Made things better for secured creditors, made things worse for secured creditors or made no difference?
<1> better
<2> worse
<3> no difference
<8> dk
<9> na-ref
===>

>D7c< Made things better for commercial paper lenders, made things worse for commercial paper lenders or made no difference?
<1> better
<2> worse
<3> no difference
<8> dk
<9> na-ref
===>

>D8< As a result of the amendments to Section 547(c)(2), have creditors' credit policies toward financially troubled entities become:
** READ OPTIONS 1 THRU 3
<1> more liberal
<2> less liberal
<3> remained about the same
<8> dk

<9> na-ref
===>

>D9< Do you have any suggestions for improving Section 547 of the Code?
<0> no
<1> yes -- What is that?
** PROBE -- Anything else? [specify]
<8> dk
<9> na-ref
===>

>E1< Under the 1984 Amendments to Section 362, courts are required to commence final hearings for relief from the automatic stay within 30 days after conclusion of the preliminary hearing.
In proceedings seeking relief from the automatic stay, are preliminary or final hearings commenced within thirty (30) days:
** READ OPTIONS 1 THRU 4
<1> almost all of the time
<2> most of the time
<3> some of the time
<4> hardly ever
<8> dk
<9> na-ref
===>

>E2< There is a statutory mandate that the automatic stay expire at the end of 30 days if no hearing in respect of relief from the stay is commenced. In general, are judges permitting the automatic stay to remain in effect without the consent of the parties beyond the thirty day period as prescribed by the statute:
** READ OPTIONS 1 THRU 4
<1> almost all of the time
<2> most of the time
<3> some of the time
<4> hardly ever
<8> dk
<9> na-ref
===>

>E3< There is a statutory mandate that a final hearing in respect of relief from the automatic stay be commenced within 30 days after conclusion of a preliminary hearing. In general, are judges commencing final hearings within thirty days as prescribed by the statute:
** READ OPTIONS 1 THRU 4
<1> almost all of the time
<2> most of the time
<3> some of the time
<4> hardly ever
<8> dk
<9> na-ref
===>

>E4< Since the passage of the 1984 Amendments, has the frequency of commencing final hearings for relief from the automatic stay within thirty days after the conclusion of the preliminary hearing:
** READ OPTIONS 1 THRU 3
<1> increased
<2> decreased
<3> remained the same
<8> dk

<9> na-ref
===>

>E5< Since the passage of the 1984 Amendments, has the automatic stay been lifted during the time period between the preliminary hearing and the conclusion of the final hearing:
** READ OPTIONS 1 THRU 4
<1> almost all of the time
<2> most of the time
<3> some of the time
<4> hardly ever
<8> dk
<9> na-ref
===>

>E6< Following the conclusion of a final hearing seeking relief from the automatic stay, are courts deciding the issues presented at such final hearing within thirty days:
** READ OPTIONS 1 THRU 4
<1> almost all of the time
<2> most of the time
<3> some of the time
<4> hardly ever
<8> dk
<9> na-ref
===>

>E7a< Have the changes to Section 362 contained in the 1984 Amendments made things better for debtors, worse for debtors or made no difference?
<1> better
<2> worse
<3> made no difference
<8> dk
<9> na-ref
===>

>E7b< Have the changes to Section 362 contained in the 1984 Amendments made things better for creditors, worse for creditors or made no difference?
<1> better
<2> worse
<3> made no difference
<8> dk
<9> na-ref
===>

>E8< Do you have suggestions for improving Section 362 of the Code?
<0> no
<1> yes -- What is that?
** PROBE -- Anything else? [specify]
<8> dk
<9> na-ref
===>

>F1< Some people have suggested that there is abuse of the federal bankruptcy system while other people have said no abuse exists. In your opinion, do you believe that there is no abuse, little abuse or a great deal of abuse?
<0> no abuse
<1> little abuse
<2> a great deal of abuse -- What is the abuse? [specify]

```
        <8> dk
        <9> na-ref
        ===>
>F2<    Finally, I have just a few questions I would like to ask you to help
        us compare different groups of respondents interviewed.
        First, how many years have you spent working on bankruptcy matters?
        <00>    less than one year
        <01-60> record one to sixty years
        <61>    over 60 years
        <88> dk
        <99> na-ref
        ===>
>a3<    [if type ne <1> then goto F3] [store <99> in F4] [goto F5] [end]
>F3<    In what circuit or circuits are you involved with bankruptcy
        matters? [allow 1] [loc 0/20]
        ===> [specify]
>F4<    In how many districts do you practice or administer bankruptcy related
        matters?
        <00>    none
        <01-60> record one to sixty
        <61>    over sixty
        <88>    dk
        <99>    na-ref
        ===> [loc 1/73]
>F5<    What is the principal district in which you handle bankruptcy
        matters? [allow 1] [loc 0/21]
        ===> [specify]
>a4<    [if type eq <4> then goto set2] [store <999> in F6a]
        [store <999> in F6b] [store <999> in F6c] [store <999> in F6d]
        [store <999> in F6e] [goto F7a] [end]
>set2<  [store <> in F6a] [store <> in F6b] [store <> in F6c]
        [store <> in F6d] [store <> in F6e] [end]
>F6a<   With respect to the following categories: secured creditor, unsecured
        creditor, debtor, and trustee, approximately what percent of your
        bankruptcy practice falls within each category:
        First, what percent of your bankruptcy practice is secured-creditor
        related? [loc 2/8]
        <0>     none
        <01-99> record 1 to 99 percent
        <100>   100 percent [goto a5]
        <888>   dk
        <999>   na-ref
        ===> [goto a6]
>a5<    [store <000> in F6b] [store <000> in F6c] [store <000> in F6d]
        [store <000> in F6e] [goto F7a] [end]
>a6<    [allow 3] [loc 0/22] [end]
>a7<    [store <100> in a6] [end]
>a8<    [if F6a ge <888> then goto F6b] [subtract F6a from a6]
>F6b<   What percent of your bankruptcy practice is unsecured-creditor
        related? [loc 2/11]
        ** THIS PERCENT SHOULD NOT BE LARGER THAN [fill a6] PERCENT
        <0>     none [goto F6c]
        <01-99> record 1 to 99 percent
        <100>   100 percent
        <888>   dk [goto F6c]
```

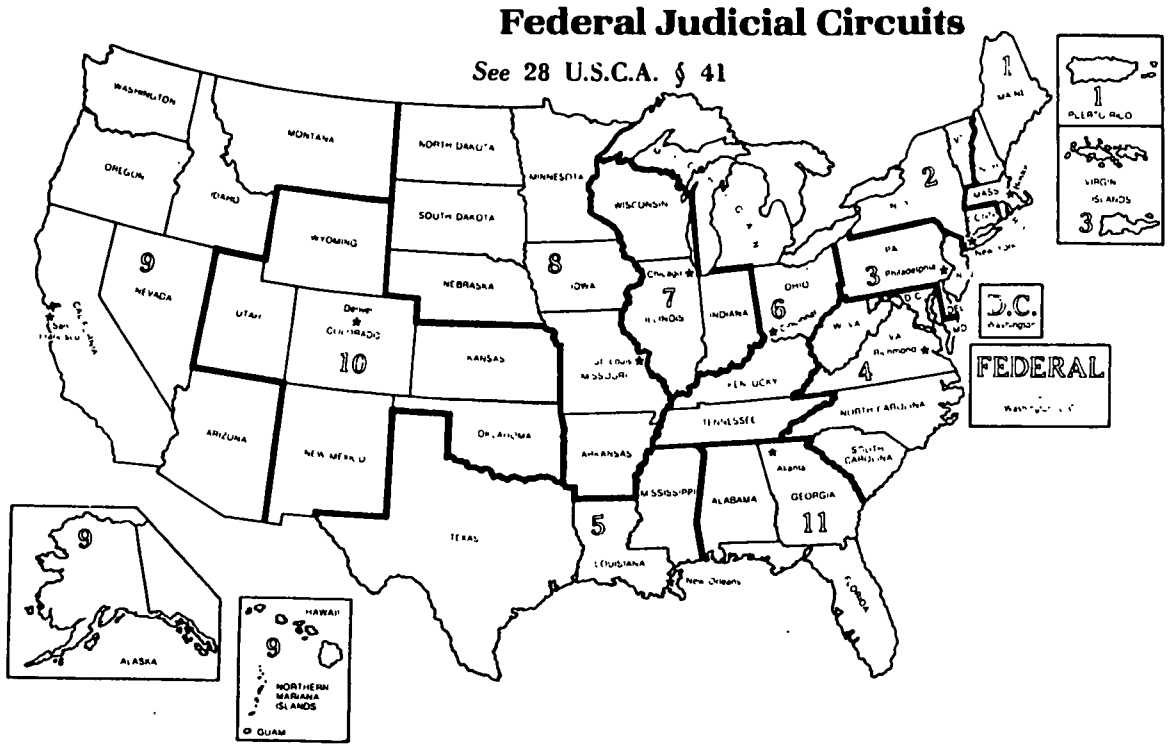
```
        <999>   na-ref [goto F6c]
        ===>
>a9<    [if F6b gt a6 then goto fix] [if F6b ne a6 then goto a10]
        [store <000> in F6c] [store <000> in F6d] [store <000> in F6e]
        [goto F7a] [end]
>a10<   [subtract F6b from a6] [end]
>F6c<   What percent of your bankruptcy practice is debtor-related?
        ** THIS PERCENT SHOULD NOT BE LARGER THAN [fill a6] PERCENT
        <0>     none [goto F6d]
        <01-99> record 1 to 99 percent
        <100>   100 percent
        <888>   dk [goto F6d]
        <999>   na-ref [goto F6d]
        ===>
>a11<   [if F6c gt a6 then goto fix] [if F6c ne a6 then goto a12]
        [store <000> in F6d] [store <000> in F6e] [goto F7a] [end]
>a12<   [subtract F6c from a6] [end]
>F6d<   What percent of your bankruptcy practice is trustee-related?
        ** THIS PERCENT SHOULD NOT BE LARGER THAN [fill a6] PERCENT
        <0>     none
        <01-99> record 1 to 99 percent
        <100>   100 percent
        <888>   dk [goto F6e]
        <999>   na-ref [goto F6e]
        ===>
>a13<   [if F6d gt a6 then goto fix] [if F6d ne a6 then goto a14]
        [store <000> in F6e] [goto F7a] [end]
>a14<   [subtract F6d from a6] [if F6a ge <888> then goto F6e]
        [if F6b ge <888> then goto F6e] [if F6c ge <888> then goto F6e]
        [store a6 in F6e] [goto F7a] [end]
>F6e<   What percent of your bankruptcy practice does not fall into any
        of the above categories?
        ** THIS PERCENT SHOULD NOT BE LARGER THAN [fill a6] PERCENT
        <0>     none [goto F7a]
        <01-99> record 1 to 99 percent
        <100>   100 percent
        <888>   dk [goto F7a]
        <999>   na-ref [goto F7a]
        ===>
>a15<   [if F6e gt a6 then goto fix] [goto F7a] [end]
>fix<   I have recorded more than 100 percent of bankruptcy activity.  Could
        we just check those numbers again? [loc 0/25]
        ** TYPE <go> WHEN READY
        ===> [goto set2]
>set3<  [store <> in F7a] [store <> in F7b] [store <> in F7c]
        [store <> in F7d] [store <> in F7e] [end]
>F7a<   With respect to the following categories: individual Chapter 7,
        business Chapter 7, Chapter 11, and Chapter 13, approximately what
        percent of your bankruptcy practice or administration falls within
        each category:
        First, what percent of your bankruptcy practice or administration
        involves individual Chapter 7 cases? [loc 2/23]
        <0>     none
        <01-99> record 1 to 99 percent
        <100>   100 percent [goto a16]
```

```
        <888>   dk
        <999>   na-ref
        ===> [goto a17]
>a16<   [store <000> in F7b] [store <000> in F7c] [store <000> in F7d]
        [store <000> in F7e] [goto a27] [end]
>a17<   [allow 3] [loc 0/27] [end]
>a18<   [store <100> in a17] [end]
>a19<   [if F7a ge <888> then goto F7b] [subtract F7a from a17]
>F7b<   What percent of your bankruptcy practice or administration involves
        business Chapter 7 cases? [loc 2/26]
        ** THIS PERCENT SHOULD NOT BE LARGER THAN [fill a17] PERCENT
        <0>     none [goto F7c]
        <01-99> record 1 to 99 percent
        <100>   100 percent
        <888>   dk [goto F7c]
        <999>   na-ref [goto F7c]
        ===>
>a20<   [if F7b gt a17 then goto fix2] [if F7b ne a17 then goto a21]
        [store <000> in F7c] [store <000> in F7d] [store <000> in F7e]
        [goto a27] [end]
>a21<   [subtract F7b from a17] [end]
>F7c<   What percent of your bankruptcy practice or administration is
        Chapter 11 related?
        ** THIS PERCENT SHOULD NOT BE LARGER THAN [fill a17] PERCENT
        <0>     none [goto F7d]
        <01-99> record 1 to 99 percent
        <100>   100 percent
        <888>   dk [goto F7d]
        <999>   na-ref [goto F7d]
        ===>
>a22<   [if F7c gt a17 then goto fix2] [if F7c ne a17 then goto a23]
        [store <000> in F7d] [store <000> in F7e] [goto a27] [end]
>a23<   [subtract F7c from a17] [end]
>F7d<   What percent of your bankruptcy practice or administration is
        Chapter 13 related?
        ** THIS PERCENT SHOULD NOT BE LARGER THAN [fill a17] PERCENT
        <0>     none
        <01-99> record 1 to 99 percent
        <100>   100 percent
        <888>   dk [goto F7e]
        <999>   na-ref [goto F7e]
        ===>
>a24<   [if F7d gt a17 then goto fix2] [if F7d ne a17 then goto a25]
        [store <000> in F7e] [goto a27] [end]
>a25<   [subtract F7d from a17] [if F7a ge <888> then goto F7e]
        [if F7b ge <888> then goto F7e] [if F7c ge <888> then goto F7e]
        [store a17 in F7e] [goto a27] [end]
>F7e<   What percent of your bankruptcy practice or administration does
        not fall into any of the above categories?
        ** THIS PERCENT SHOULD NOT BE LARGER THAN [fill a17] PERCENT
        <0>     none [goto a27]
        <01-99> record 1 to 99 percent
        <100>   100 percent
        <888>   dk [goto a27]
        <999>   na-ref [goto a27]
```

```
        ===>
>a26<   [if F7e gt a17 then goto fix2] [goto a27] [end]
>fix2<  I have recorded more than 100 percent of bankruptcy activity.  Could
        we just check those numbers again? [loc 0/30]
        ** TYPE <go> WHEN READY
        ===> [goto set3]
>a27<   [if type eq <4> then goto F8] [store <999> in F8] [goto F9] [end]
>F8<    Including partners and associates, what is the total number of
        lawyers in your firm?
        <001-800> record 1 to 800
        <801>     over 800
        <888>     dk
        <999>     na-ref
        ===> [loc 2/38]
>F9<    In what state is your office located?
        ** THE OFFICE IN WHICH RESPONDENT IS CURRENTLY AT.
        <01> ALABAMA            <18> KENTUCKY           <35> NORTH DAKOTA
        <02> ALASKA             <19> LOUISIANA          <36> OHIO
        <03> ARIZONA            <20> MAINE              <37> OKLAHOMA
        <04> ARKANSAS           <21> MARYLAND           <38> OREGON
        <05> CALIFORNIA         <22> MASSACHUSETTS      <39> PENNSYLVANIA
        <06> COLORADO           <23> MICHIGAN           <40> PUERTO RICO
        <07> CONNECTICUT        <24> MINNESOTA          <41> RHODE ISLAND
        <08> DELAWARE           <25> MISSISSIPPI        <42> SOUTH CAROLINA
        <09> D.C.               <26> MISSOURI           <43> SOUTH DAKOTA
        <10> FLORIDA            <27> MONTANA            <44> TENNESSEE
        <11> GEORGIA            <28> NEBRASKA           <45> TEXAS
        <12> HAWAII             <29> NEVADA             <46> UTAH
        <13> IDAHO              <30> NEW HAMPSHIRE      <47> VERMONT
        <14> ILLINOIS           <31> NEW JERSEY         <49> VIRGINIA
        <15> INDIANA            <32> NEW MEXICO         <50> WASHINGTON
        <16> IOWA               <33> NEW YORK           <51> WEST VIRGINIA
        <17> KANSAS             <34> NORTH CAROLINA     <52> WISCONSIN
        <99> OTHERS NOT LISTED                          <53> WYOMING
        ===>
>F10<   The American Bankruptcy Institute intends to conduct similar
        surveys in the future.  What bankruptcy topics would you like
        to see surveyed if any? [allow 1] [loc 0/32]
        ===> [specify]
>F11<   That is all the questions I have.  Thank You for your help.
        ** RECORD RESPONDENT'S SEX
        <1> male
        <2> female
        ===> [loc 2/43]
>iid<   RECORD YOUR INTERVIEWER ID NUMBER
        <00-99>
        ===>
>date<  [allow 6] [end]
>dat1<  [setdate date] [end]
>tele<  RECORD THE AREA CODE OFF OF THE CALL RECORD SHEET.
        <201-919> record the area code
        ===>
>set4<  [store <> in id1] [store <> in pid2] [end]
>code<  RECORD RESPONDENT'S ID CODE OFF OF CALL RECORD SHEET
        ** DON'T FORGET TO PUT THE CASE NUMBER ON THE CALL RECORD SHEET
```

```
        ** LAST CHANCE TO CORRECT OR ADD COMMENTS
        <010001-130000>
        ===> [loc 1/1]
>set5<  [store code in pid2] [end]
>end<   [complete] [end]
```

Appendix B



Taken from the West Reporter system.

Record Statement of

ALVIN O. WIESE, JR.

on behalf of the

AMERICAN BANKERS ASSOCIATION

AMERICAN FINANCIAL SERVICES ASSOCIATION

CONSUMER BANKERS ASSOCIATION

CREDIT UNION NATIONAL ASSOCIATION

NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

NATIONAL RETAIL MERCHANTS ASSOCIATION

The American Bankers Association (ABA) is the professional and trade association of the commercial banking industry. The combined assets of ABA members represent approximately 95 percent of the industry total.

The American Financial Services Association (AFSA) is the nation's largest trade association representing nonbank providers of consumer financial services. Organized in 1916, AFSA represents a diversified group of companies ranging from independently-owned consumer finance offices to the nation's largest financial services, retail and automobile companies.

The Consumer Bankers Association (CBA) was founded in 1919 to provide a progressive voice for the retail banking industry. CBA represents approximately 700 federally insured banks , savings and loans and credit unions that hold more than 80 percent of all consumer deposits, and more than 70 percent of all consumer credit held by federally insured depository institutions.

The Credit Union National Association (CUNA) represents over 15,000 cooperatively owned credit unions through 52 state credit union leagues.

The National Association of Federal Credit Unions (NAFCU) exclusively represents the interests of our nation's federally chartered credit unions.

The National Retail Merchants Association (NRMA) is the largest national trade association representing the general merchandise retail industry. NRMA's members operate more than 40,000 department, chain, specialty and independent stores across the country and an additional 1,000 stores in fifty nations abroad. NRMA's domestic members' annual sales exceed $175 billion and they employ more than three million workers.

Mr. Chairman and Members of the Subcommittee:

My name is Alvin O. Wiese, Jr., a practicing attorney from Indian Wells, California, where I specialize in the area of creditors' rights and bankruptcy. *

I am filing this statement for the record on behalf of the American Bankers Association (ABA), the American Financial Services Association (AFSA), the Consumer Bankers Association (CBA), the Credit Union National Association (CUNA), the National Association of Federal Credit Unions (NAFCU) and the National Retail Merchants Association (NRMA).

We appreciate this opportunity to comment on consumer bankruptcy issues and the findings of the American Bankruptcy Institute (ABI) Survey.

I would also like to present our view of the state of consumer bankruptcy today and review previous legislative efforts in this area.

Consumer Bankruptcy Today

Data supplied by the Administrative Office of the U.S. Courts indicate that both Chapter 7 and Chapter 13 filings have increased since the passage of the Consumer Credit

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*Mr. Wiese is the Vice Chairman of the Law Forum of the American Financial Services Association. For 33 years he was a partner in the North Hollywood California firm of Styskal, Wiese and Melchione where he practiced bankruptcy law. From 1980 to 1984 he served as a consultant to the Bankruptcy Discussion Group, an informal organization representing consumer creditors, which formed The National Coalition for Bankruptcy Reform. Mr. Wiese also testified on behalf of the Coalition before the Judicial Conference with respect to the Rules under the 1984 Act.

Amendments of 1984. From 1984 to 1985, Chapter 7 filings increased 5% from 232,778 to 244,647 filings. Chapter 13 filings increased from 91,480 to 98,452, during the same period, representing approximately an 8% increase.

The increases from 1985 to 1986 are more dramatic. Chapter 7 filings increased 36% from 244,647 to 332,675 filings. Chapter 13 filings increased from 98,452 to 120,726, an increase of approximately 23%.

Unfortunately, there are no figures available on rates of conversion from one chapter to another.

The increase in non-business filings continued in 1986-87. Chapter 7 petitions increased from 332,675 to 360,078, or by approximately 8%. Chapter 13 filings increased from 120,726 in 1986 to 130,009 in 1987, also almost an 8% rate of increase.

The 1984 and 1986 Consumer Amendments

In major pieces of bankruptcy legislation before two Congresses, the legislative history demonstrates a clear expression of Congressional intent to provide a mechanism to deal with unjustified filing of consumer bankruptcies.

The Bankruptcy Amendments and Federal Judgeship Act of 1984 added a new concept to the law governing consumer bankruptcies. It recognized for the first time in bankruptcy legislation that a case consisting of consumer debts should be dismissed if its filing constituted a "substantial abuse" of the provisions of chapter 7 of the Code.

This provision resulted from a compromise between creditor groups, including those for whom I am testifying, who advocated

a subjective "threshold test" before a debtor was eligible to file for bankruptcy, and Senate opposition to any pre-petition hurdle faced by a consumer debtor.

The original Senate version of the 1984 Amendments, S. 445 sponsored by Senator Robert Dole (R-KS), entitled the "Bankruptcy Improvements Act of 1983," included a chapter 7 "threshold test." The test provided that debtors would be eligible for chapter 7 relief only if they could not repay a reasonable portion of their debts out of anticipated future income.

A problem arose in attempts to define what was a reasonable portion of the consumer debts and when a debtor should be able to repay. Consumer groups felt that such a test would not have uniform application and any effort to administer an eligibility test that was subjective would burden the bankruptcy system with excessive costs.

As ultimately passed by the Senate, S. 445's provision that filing a consumer chapter 7 petition was not a matter of right remained intact. The Senate, recognizing that debtors who could afford to pay should not be permitted to discharge debt in a chapter 7 required the debtor as a condition to filing to receive counseling from the bankruptcy trustee who informed the debtor of his or her rights under both chapters 7 or 13 in order that the debtor could make an election of bankruptcy remedies.

In the House, in both the 97th and 98th Congresses, several bills were introduced containing variations of and entry or eligibility test for consumer bankruptcy relief. In the 97th

Congress, H.R. 4786, sponsored by Rep. Billy Lee Evans (D-GA), contained a future income test which restricted bankruptcy relief for debtors who had sufficient future income to pay their debts. In the 98th Congress, the same bill was reintroduced as H.R. 1168, sponsored by Rep. Marilyn Lloyd (D-TN). Neither bill was reported out of the House Judiciary Committee.

The bill ultimately passed by the House, Rep. Mike Synar's (D-OK) H.R. 1800, the "Consumer-Debtor Bankruptcy Amendments of 1983," was similar in intent to S. 445. It also replaced the entry test with a system of consumer counseling and granted a court authority, on its own motion, to dismiss or suspend a consumer bankruptcy case if the court decides the debtor does not need the relief sought.

A creditor had no right to challenge chapter 7 relief, and had no right to appeal the granting of such relief, and could not pressure a debtor not to pursue chapter 7 straight bankruptcy. Additionally, consumer debtor counseling was to be provided by the clerk of the court or a designee of the court. An individual debtor who files a chapter 7 petition was to have been counseled as to relief available under the various chapters of the Bankruptcy Code.

While the counseling provision did not survive, what did survive was Congressional recognition that consumer bankruptcy was not a matter of right and Congress gave the bankruptcy courts new found authority to dismiss abusive filings (section 707 (b)).

The legislation fell short of its objective in failing to define a substantial abuse and provide for uniform application of the statute. The ABI Survey confirms this.

Time has proven that the problem with the 1984 Consumer Bankruptcy Amendments was not that Congress failed to recognize that consumers who could afford to pay should not be entitled to discharge their debts. The problem is that in the twilight of the legislative year in which the consumer amendments passed it was not possible to achieve agreement on the "test" or "standard" and by which ineligibility for Chapter 7 relief should be measured.

The 1984 legislation states that the Supreme Court rules should define the practice and procedures under section 707(b) (Public Law No. 98-353, 1984, section 320). The rules have failed to respond in any meaningful way.

It was then assumed that the courts would respond through judicial interpretation. They have in part but the system needs and deserves legislative help. [See In Re Edwards, 50 B.R. 933 (1985), In Re Bell, 56 B.R. 637 (1986), In Re Hudson, 56 B.R. 415 (1985), In Re White, 49 B.R. 869 (1985).]

Most recently, the 9th Circuit Court of Appeals in In re Kelly, No. 87-1560 (March 2, 1988) has, in addition to finding section 707(b) constitutional, held that a debtor's ability to pay debts when due, as determined by the debtor's ability to fund a Chapter 13, plan is the paramount consideration in determining whether granting Chapter 7 relief would be a substantial abuse under section 707(b) of the Bankruptcy Code.

Notwithstanding these cases, the courts and the bar are troubled over the application of this statute and the definitions of substantial abuse. There is a reluctance on the part of bankruptcy judges to examine each file and a reluctance to raise this issue on their own motion.

The pattern of the reported cases acknowledges without question that it was Congressional intent that a debtor who can pay all or a substantial portion of his debts out of future income is not eligible for Chapter 7 relief. Each case confirms in its discussion of substantial abuse that the court was seeking guidance in applying section 707 (b) both in determining the level of ability to repay and in what evidence can be considered and from what sources.

Congress then enacted the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, which amended Section 707 (b) to allow the United States Trustee to file a motion to dismiss abusive cases as the trustee was found not to be a party in interest. As I will discuss later, the timing of ABI survey precluded reflections on the 1986 amendments operation.

Findings of the ABI Survey

One portion of the ABI Survey focused on the Consumer Credit Amendments in 1984. The study found that the Consumer Credit Amendments did not have a dramatic effect in curbing individual debtor filings. The Survey finds that some of the ineffectiveness of the 1984 amendments had nothing to do with the amendments themselves, but found that there was substantial statutory non-compliance with the amendments throughout the bankruptcy system.

The Survey also found significant variance in the perceived effectiveness of the amendments and abuse of the system depending upon the respondents interviewed.

While 14% of the judicial respondents and 19% of the lawyer respondents perceived a "significant" amount of individual debtor abuse, 27% of the estate administrator respondents and 43% of the United States Trustee respondents perceived that there was significant abuse of the system.

Perhaps the most startling result of the Survey was the discovery that 72% of the judicial respondents noted that there was little or no review of case filings for substantial abuse under section 707(b). The Survey opines that the statute does not require such judges to review each file for abuse and that judges may be precluded from doing so because of their heavy case loads.

In the area of the effectiveness of section 707(b), only 3% of the survey respondents indicated that the issue was raised often while 44% of the respondents noted that the issue was never raised or considered in the Chapter 7 process.

Conclusion

The conclusion from the foregoing is apparent. Congress must address the issue of completing the 1984 and 1986 amendments to guarantee the implementation and, unfortunately, to ensure their application.

Among the key issues to be addressed are:

- standards to define substantial abuse,

- the need to require service upon creditors of bankruptcy schedules, the statement of income and expense, and the statement of intention with respect to collateral,
- the elimination of reaffirmation hearings when the debtor is represented by counsel, and
- the assurance of compliance by providing that any stay of creditors rights required by section 362 will automatically dissolve without court hearing upon the debtor's failure to meet his or her obligations in the bankruptcy proceeding.

Over the course of this year, the various trade associations representing the consumer credit community will be working on these and vital proposed amendments to the Code. We hope to have the opportunity to present them to you later this year or early in the next Congress.

Thank you for the opportunity of placing our views on the record as you consider bankruptcy issues.

Senator HEFLIN. The next panel is on intellectual property bankruptcy protection. Mr. John Pickitt, Mr. Steven C. Mendell, Mr. John P. McLaughlin, Mr. George Hahn, Mr. Jeffrey Tarkenton, if you will come forward. Mr. Pickitt, we will hear from you, first.

[A copy of S. 1626 follows:]

19-685 O - 89 - 8

II

100TH CONGRESS
1ST SESSION

S. 1626

To keep secure the rights of intellectual property licensors and licensees which come under the protection of title 11 of the United States Code, the bankruptcy code.

IN THE SENATE OF THE UNITED STATES

AUGUST 7 (legislative day, AUGUST 5), 1987

Mr. DECONCINI (for himself and Mr. HEFLIN) introduced the following bill; which was read twice and referred to the Committee on the Judiciary

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A BILL

To keep secure the rights of intellectual property licensors and licensees which come under the protection of title 11 of the United States Code, the bankruptcy code.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Intellectual Property Bankruptcy Protection Act of 1987".

SEC. 2. Section 365 of title 11 of the United States Code is amended by inserting at the end the following new subsection:

"(n)(1) For the purpose of this title—

"(A) the term 'protected information' means trade secrets and other confidential technical information to the extent the confidentiality thereof is protected by applicable nonbankruptcy law; and

"(B) the term 'intellectual property' includes inventions, designs, works of authorship, mask works, protected information, trademarks, trade names, service marks, and other products of intellectual or creative effort now or hereafter protected by applicable nonbankruptcy law.

"(2) Until and unless a trustee assumes an executory contract or unexpired lease under which the debtor has granted rights in intellectual property, the trustee may not interfere with the grantee's rights (A) to deal with the intellectual property, as provided in the contract or lease, (B) to gain access to or possession of any information or property in existence as of the time of the filing which the contract or lease provided would be made available to the grantee if the debtor failed to perform its affirmative obligations, and (C) in the case of a trademark, trade name, service mark, or similar intellectual property, to permit existing grantees to continue in concert the quality assurance procedures of the licensor. If the trustee rejects such contract or lease, the trustee is relieved only from the specific performance of prospective obligations thereunder measured from the filing date and is pro-

hibited from taking any action which would interfere with the grantee's rights set forth in subparagraphs (A), (B), and (C) of this paragraph. Subject to subsection (g) of this section and to section 553 of this title, if the grantee elects to exercise its rights under the contract or lease as set forth in this subsection, the grantee must satisfy its obligations under such contract or lease.

"(3) If the debtor was the grantee under an executory contract or unexpired lease which granted rights in intellectual property, prior to assumption or rejection and notwithstanding rejection of such contract or lease, the trustee, the debtor, and the grantor must maintain the confidentiality of any protected information obtained pursuant to the executory contract or unexpired lease to the extent required by applicable nonbankruptcy law. Prior to assumption or rejection, the grantor is entitled to adequate assurance of the continued confidential treatment of such protected information. If the contract or lease is rejected, upon request by the grantor including an offer of reimbursement of expenses, all materials embodying protected information shall be returned to the grantor. The trustee, after he has received actual notice of the existence of the protected information in the bankruptcy estate, and the debtor, are not, by reason of the rejection, permitted to disclose protected information without the con-

sent of the person to whom the obligation of confidentiality is owed.".

○

S. 1626: INTELLECTUAL PROPERTY BANKRUPTCY PROTECTION

STATEMENT OF A PANEL CONSISTING OF JOHN L. PICKITT, PRESIDENT, COMPUTER AND BUSINESS EQUIPMENT MANUFACTURERS ASSOCIATION, WASHINGTON, DC, ACCOMPANIED BY MARILYN SHEA-STONUM, COUNSEL, BANKRUPT LICENSOR COALITION; STEVEN C. MENDELL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, XOMA CORP., BERKELEY, CA; JOHN P. McLAUGHLIN, VICE PRESIDENT FOR GOVERNMENT AFFAIRS, GENENTECH INC., WASHINGTON, DC; GEORGE HAHN, CHAIRMAN, EXECUTORY CONTRACTS COMMITTEE, NATIONAL BANKRUPTCY CONFERENCE, HAHN & HESSEN, NEW YORK, NY; AND JEFFREY TARKENTON, AMERICAN BANKRUPTCY INSTITUTE, HUNTON & WILLIAMS, WASHINGTON, DC

STATEMENT OF JOHN L. PICKITT

Mr. PICKITT. Good morning, Mr. Chairman.

I am John Pickitt, president of the Computer and Business Equipment Manufacturers Association. I am here this morning representing the Bankrupt Licensor Coalition, which represents the leading edge of American high-technology companies, computers, chemicals, business equipment, telecommunications, and pharmaceuticals.

Coalition members have had combined sales of more than $258 billion in 1987. They represent nearly 6 percent of the United States Gross National Product.

Accompanying me this morning is Marilyn Shea-Stonum from the law firm of Jones Day Reans & Pogue and she is counsel to the coalition.

The success of our industries is based on intellectual properties. The discoveries, creations protected by our Nation's copyrights and patents, are unique, as you know, by definition.

The authority to use, build on, and market someone else's intellectual property is critical to inventors, small companies, and large corporations alike. Licenses are a very important legal agreement that permits one to use, with consent, another person's unique intellectual property. They are a crucial vehicle by which we spread the benefits of new discoveries among many companies in this country.

Originating individuals and companies can often increase the benefits from their discoveries by licensing others to also use their intellectual property. Licensing companies can legally employ ideas developed outside their own staff and facilities. In the information technology industry, for example, a single product frequently uses dozens, sometimes hundreds of licensed ideas. If licenses are lost without warning, there is little ability to recover rapidly because replacement has to be thought through as another invention that does not infringe, in any way, on the copyright or patent which was lost.

It can take months or years to develop a similar product or process, if it can be done at all. In the meantime, you cannot make a product or sell it. This can be a severe financial blow to the compa-

ny, possibly a reduction in employees, possibly going bankrupt or out of business.

The *Lubrizol* decision threatens the use of license in business today. Prior to this decision, people in business knew when their license would expire and could plan accordingly. The decision allows the bankruptcy trustee to take a valid license, that is not in any way harming the bankrupt company and which may, in fact, be rewarding it, and decide to abrogate the license right. This trustee can set aside a license currently bringing benefits to both parties to shop around for a better deal which, when all factors are considered, may not in fact exist.

The situation is even more risky in the high-technology area, where license often comes from small new ventures highly subject to financial difficulty.

So in our view, something must be done. We believe that retaining the usefulness of license is key to the health and competitiveness of the U.S. industry. We need to promote fairly compensated ideas and build products and companies on those ideas.

New ideas are the key to ever expanding exports and ever declining prices. They are key to our national competitiveness in an international marketplace. If we destroy or erode the fundamental usefulness of a license, many are going to suffer. The individual inventors are going to have difficulty finding ways to market their ideas and intellectual property. The small companies are going to find it difficult to bring together the combination of ideas that will permit them to develop a competitive product.

Large companies are going to be reluctant to join with the small entrepreneurs and inventors and to lead them into large and increasing self-research and development. The consumer is going to lose on every hand by a slower realization of new products, by not seeing improvements and refinements of established products, and paying higher prices in every case.

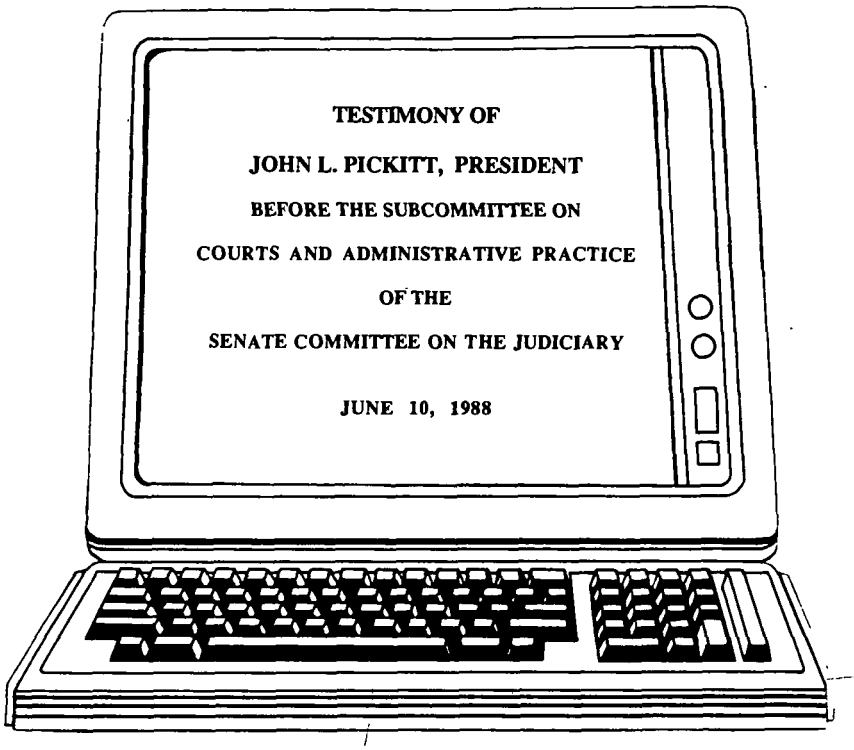
In addition, our foreign competitors who still rely on the concept of license under the rules of their countries will be able to use that advantage to leap ahead both technically——

Senator HEFLIN. Please summarize in 30 seconds.

Mr. PICKITT. We urge you to pass S. 1626 with the utmost speed. It is crucial to the health of the United States industry and its continued contributions to the international competitiveness of the United States.

Thank you, sir.

[The prepared statement of Mr. Pickitt follows:]



TESTIMONY OF

JOHN L. PICKITT, PRESIDENT

BEFORE THE SUBCOMMITTEE ON

COURTS AND ADMINISTRATIVE PRACTICE

OF THE

SENATE COMMITTEE ON THE JUDICIARY

JUNE 10, 1988

CBEMA

Computer and Business Equipment Manufacturers Association
311 First Street, N.W. • Washington, D.C. 20001 • 202-737-8888

1.

I am John Pickitt, President of the Computer and Business Equipment Manufacturers Association (CBEMA), also representing the Bankrupt Licensor Coalition (membership list attached). I am here today to offer my very strong support for S. 1626, the "Intellectual Property Bankruptcy Protection Act of 1987."

CBEMA represents the leading edge of American high technology companies in computers, business equipment and telecommunications. Its members had combined sales of more than $218 billion in 1987, representing 4.9% of the U.S. gross national product.

This description of our industry indicates the impressive position we have earned since our birth, in the middle of World War II just 45 years ago. In less than half a century, computers, copiers and other high technology inventions have revolutionized the way America lives, the way America does business. We have introduced the Information Age, an age in which individuals have, sitting on their desktops and on their kitchen tables, information management power our grandparents did not even dream of. At the click of a few keys on a keyboard, Americans today have the ability to find answers to questions, analyze information and create the new ideas that are sustaining our society providing the driving force of our economy.

The evolution of information technology is based on the solid foundation of the U.S. legal system. Our companies have developed their products by relying firmly on the protections our legal system has long offered to people and companies with creative ideas. We have relied on intellectual property protections--copyrights, patents, trade secrets, and most clearly

licenses--to protect the value of the revolutionary American hardware and software we created. As a result of intellectual property protection, our companies have been able to realize the monetary value of their creations and gain the resources needed to build a thriving industry that today employs well over a million people.

At issue today is one of those very important protections: the license. Licensing is a key element in the way our industry functions. One person or one company cannot possibly come up with all the best ideas on how to improve products or create new ones. In fact, even in competition with our best laboratories, we still find that sometimes individuals working alone at night in their garages or living rooms come up with some of the best and most creative ideas.

It is not every person who has the management capability or even desires to follow the path of Ken Olson, who founded Digital Equipment Corporation based on his creative ideas. Instead, it is often to the benefit of everyone--inventor, company and consumer--for the inventor to license the idea to a company that's already established. Then the company uses its management team to efficiently produce and distribute the product to society at low costs, and the inventor gains the resources justly deserved and needed for continued creative efforts.

Why license rather than buy the technology outright? There are several reasons:

o First, it is often difficult to establish the exact value of an idea

or an invention before it gets onto the marketplace. Our industry has many ideas thought to be "great" that didn't sell as well as some that did. Company planners, no matter how perceptive, do not always have the prescience to tell one from the other; the consumer tells us which ideas are really worthwhile when they buy them.

- Second is a related issue: sharing the risk. Through licenses, we can incorporate ideas into a product and share the financial risk with the ideas' creators. If the ideas work, everyone benefits. If they do not, the company absorbs the direct loss in manufacturing costs but doesn't have to pay a high price for an innovation that went nowhere. It is similar to risk-sharing in other industries, such as publishing: the professor whose textbook doesn't sell doesn't get royalties; the author of a bestseller reaps handsome rewards.

- Third, today's creators understand market potential. They understand the value of their ideas. They don't want to sell them outright; they want to share in the total financial rewards of their ideas. Licensing allows the creator to share financial rewards while authorizing established companies to develop and deliver exciting new products to customers in minimum time at low cost.

Last week, in hearings on similar legislation on the House side, Jim Burger from Apple Computer gave a good example of the value of licensing when he described the situation with their important new product Hypercard.

Hypercard is a revolutionary product that allows enormous flexibility in

arranging and accessing data. It delivers information in forms that go beyond traditional list and database report methods. For instance, through Hypercard, today's students studying geography can actually point to a spinning globe on their computer screen, designate Washington and see an aerial view of the city. Then, the student can zoom in on the Lincoln Memorial and watch a film clip of Ramond Massey reading the Gettysburg Address. With Hypercard, educators are revolutionizing the education experience--only one example of the many diverse uses of the product.

Hypercard is a licensed product. It was authored by Bill Atkinson, who persuaded Apple of its value in 1985. Apple recognized it as a great idea. But would it sell? Could the company persuade people to use it?

If Apple had had to buy the Hypercard technology, it would have done so. But because of the risk, the company would not have paid a very high price. Licensing, however, allowed Apple to share the risk with Atkinson. As a result, the inventor has been very handsomely rewarded and customers are using this new information management capability in an increasing variety of ways.

This scenario has been repeated hundreds of thousands of times in our industry. Consumer happiness with our industry's products and, consequently, our continued development of new and better products is dependent on our access to such licensed ideas.

Our entire industry was shaken by the Supreme Court's decision not to intervene in the case of Lubrizol vs. Richmond Metal Finishers. The Court

alloved to stand a lover court decision that seriously undermines the utility of the license as a business relationship. In essence, that decision declared that the licenses of a bankrupt company or person can be abrogated, that they can be declared void with very little notice, no matter what the damage is to the licensing company, no matter what the effect is on the customer.

Let me tell you what the effects would be if this decision were alloved to stand and our industry continued to license products:

- Inevitably, licensors would go bankrupt.

- The affected company would find itself without a key part of a product. For instance, it might lose the right to use a key chip in a personal computer.

- The production line for the personal computer would immediately shut down.

- It is possible that, if the company anticipated a long delay, it would be forced to divert workers to other lines or other plants. For some companies, that could translate into people out of work.

- Then there is the financial impact on the company. If the company is small, or even medium size, it could be faced with a massive financial problem.

- Then comes the ripple effect. If the company can not solve the problem rapidly, some dealers could well go bankrupt also.

- And then there are customers. Expansion plans are wiped out. Even worse, if something goes wrong with their installed computer, they may not be able to get it fixed because they can not get a spare part. For business customers, that could mean a slow-down in their productivity.

- In the meantime, the company is scrambling around trying to find a substitute for the key chip. Over time, they may be able to do it. But at what cost? And at how much delay?

If this sounds like the old children's verse about "for want of a nail, the shoe was lost" and so on until the war is lost, you are right. The unexpected loss of a license for a key product--an eventuality that, under today's law, no company can protect against--can hit healthy companies with a lethal blow from which recovery could be difficult or even impossible. No company in our industry, no company that uses licensed technology in any way, is safe from this problem until the law is changed.

Obviously, our industry could not continue to do business under these circumstances. We would have to discontinue our use of the license and to enter into negotiations to buy out all those rights on which we now depend. Everyone loses. Company costs would go up because we have to search for substitutes for products that inventors refuse to sell outright. And inventors would lose their chance to completely reap the rewards of their

best ideas.

The Lubrizol decision also has a negative effect on U.S. international competitiveness. By chilling the climate, that fosters the free flow of technology and ideas within the U.S., we place our companies at a serious disadvantage when they compete with companies based in countries in which the licensing process is secure despite bankruptcy.

Clearly, no one wants this outcome. For years, our society has believed that, during bankruptcy proceedings, technology licenses were to be treated the same as real estate leases--that is, they were to be in effect until the expiration date in the license, and then subject to renegotiation.

I commend Senator DeConcini and Senator Heflin for recognizing the need for Congress to close this loophole. It is an outcome clearly unintended by the drafters of current law. Hundreds of thousands of companies, millions of workers depend today on licenses for their economic future. We need to ensure that they are not subject to sudden economic disaster because of bankruptcies that might take place among their licensors before they can find substitutes for the licensed products.

Even more important is our ability to continue to use the license as an instrument of commerce. The benefits are clear: it gets the best ideas to the customer at the most reasonable cost. It allows the customer to determine which ideas to pay for and which to reject. The technology license is a key building block that has enabled the U.S. high technology industry to compete internationally.

I urge you to ensure that the license is once again free from the enormous threat that hangs over it today. I urge you to pass S. 1626 and thus to restore the license to a secure place as a legal girder to U.S. high technology. We have the chance to solve a problem before it becomes a crisis. Your leadership in this issue is greatly appreciated. The membership of CBEMA and the Bankrupt Licensor Coalition stand ready to help.

BANKRUPT LICENSOR COALITION

3M
ADAPSO
AT&T
Apple Computer, Inc.
Computer and Business Equipment Manufacturers Association
Control Data Corporation
Digital Equipment Corporation
Hewlett-Packard Company
IBM Corporation
Information Industry Association
Intellectual Property Owners, Inc.
Lubrizol Corporation
Pfizer, Inc.
Texas Instruments, Inc.
Wells Fargo Bank

STATEMENT OF STEVEN C. MENDELL

Mr. MENDELL. Thank you, Mr. Chairman.

I am chairman and chief executive officer of XOMA Corp. and we believe that S. 1626 is important legislation for the future of the American biotechnology industry, as well as other high-technology industries. The legislation would have a major beneficial impact on XOMA Corp., as well as other young companies engaged in creating and developing new health care technologies and products.

XOMA is typical of many young companies working in research intensive fields. XOMA is engaged in the development of monoclonal antibody-based pharmaceutical products. These include products to treat cancer, autoimmune diseases such as rheumatoid arthritis, and septic shock, a disease that kills over 80,000 Americans each year.

XOMA was formed in 1981 and has over 150 employees; 80 percent of these employees are involved in scientific development. Since its inception, the company has spent over $50 million on research and development and, as its products are not yet commercialized, has been operating at a loss.

In the 7 years since its formation, XOMA's R&D efforts have resulted in numerous products, patents, and patent applications, as well as a substantial body of medical and scientific know-how on monoclonal antibodies.

One of the most efficient ways to develop and commercialize XOMA's products is through licensing. Careful licensing allows companies such as XOMA to develop its technology and maximize its commercial potential.

Licensing is also a useful tool to raise R&D funds to complete new product development. XOMA has done precisely this with a large pharmaceutical company which is funding XOMA's septic shock program in exchange for a license to market the product.

Over the next 5 years, XOMA will consider for each of its products and technologies whether to engage partners for development and marketing. Almost every such corporate relationship will require XOMA to grant the other company some type of license for its product and intellectual property. At the present time, there is a serious cloud over the licensing mechanism.

The present cloud on licensing stems from certain judicial decisions under the bankruptcy law which have been reviewed today. For biotechnology companies such XOMA, the current situation raises particular issues that could have an impact on our industry's development.

Most biotechnology companies are relatively small companies with limited operating histories. While XOMA is in a healthy financial condition, it is a new company operating in an R&D phase, and potential licensing partners could be concerned about the financial staying power of the company. These perspective licensees may not easily enter into a license arrangement with a small new company, spend millions to fund the development of a product, and then face the potential loss of all rights to the product. While licensees, at present, can attempt to take certain protective measures, these are by no means satisfactory to either party.

To fund and fully develop aspects of XOMA's technology, it may be difficult to avoid licenses and companies must be able to grant secure licenses to intellectual property. To the extent that licenses cannot be consumated, development activities could be curtailed and ultimately the future health of numerous innovative companies could be in jeopardy.

The enactment of S. 1626 will remove a major problem for all companies which rely on licensing of intellectual property. Enactment would once again make licensing an attractive mechanism to develop and commercial new products.

XOMA and other companies engaged in developing new technologies and products, often on the cutting edge of science and health care, represent to a large extent, the future of American industry. The future growth and well-being of these companies will determine whether this Nation's leadership in biotechnology, communications, lasers, computers and other high technology fields will be sustained.

Thank you.

[The prepared statement of Mr. Mendell follows:]

STATEMENT

OF

STEVEN C. MENDELL,
CHAIRMAN OF THE BOARD and CEO
XOMA CORPORATION

BEFORE

SUBCOMMITTEE ON COURTS AND ADMINISTRATIVE PRACTICE
OF
SENATE JUDICIARY COMMITTEE

ON S.1626

JUNE 10, 1988

S.1626 is important legislation for the future health and viability of the American biotechnology industry as well as other high technology industries. The legislation would have a major beneficial impact on Xoma Corporation as well as other young companies engaged in creating and developing new technologies and technology-based products.

Xoma is typical of many young biotechnology companies as well as other companies working in other research-intensive fields. Xoma is engaged in the development of monoclonal antibody-based pharmaceutical products. These include products to treat septic shock, a frequently fatal infectious disease, cancer, and immune related disorders including organ transplant rejection and auto-immune diseases such as rheumatoid arthritis. Xoma, formed in 1981, presently has about 150 employees of which approximately 60 are engaged in research and development activities. The

Company has spent since its inception about $50 million on R&D and, since its products are not yet commercialized, has been operating at a loss.

In the seven years since its formation, Xoma's R&D efforts have resulted in numerous patents and patent applications as well as a substantial body of scientific and technical information and know-how on monoclonal antibodies. Thus, at this time one of Xoma's most important assets is its "intellectual property".

The licensing of intellectual property plays a crucial role in the development and commercialization of new technologies and related products. Unfortunately, recent developments under the Bankruptcy law will hinder or impede this licensing. To the extent that research-intensive companies have difficulty entering into licensing transactions, there may well be detrimental effects on their overall R&D activities and on the speed with which products become publicly available.

For a company such as Xoma, one of the most efficient ways to develop and commercialize its products is through licensing. In a licensing transaction, the R&D company grants rights under its intellectual property to another company or companies which would generally pay royalties based on the production, use or sale of the licensed technology or products. Licensing permits, for example, a patent owner to grant rights under its patent to one company for one use and to

other companies for the same or different uses. Licenses can also be granted on a geographical basis with different licensees in different countries. Thus, careful licensing allows the owner of intellectual property to develop its technology in an efficient manner and to maximize commercial potential. Licensing is also a useful tool to enable a company to raise R&D funds to complete the development of its new products. Xoma has done precisely this with a large pharmaceutical company which is funding Xoma's septic shock program, including clinical trials necessary to obtain FDA approval, in exchange for a license to the product.

Over the next one to five years Xoma will have to consider for each of its products and technologies whether to develop and market alone or to engage "partners", in particular for commercialization outside the United States. Almost every corporate relationship will require Xoma to grant to the other company some type of license to Xoma's intellectual property, and at present there is a serious cloud over the licensing mechanism.

The present cloud on licensing stems from certain judicial decisions under the Bankruptcy law. In the event of the insolvency of the licensor, the trustee in bankruptcy for the licensor can "reject" the license agreement. This rejection would have the effect of terminating the license arrangement and extinguishing the rights granted to the licensee. Herein

lies the problem for Xoma as well as for many other high-technology companies.

Many companies engaged in innovative research are small companies with limited operating histories. The biotechnology field is a good example of an industry with many highly innovative small companies. However, because of the very nature of the innovative process, there are substantial risks and the potential for failure is ever present. While Xoma is in a healthy financial condition, it is a new company operating in an R&D loss phase, and potential licensing partners could be concerned about the future of the Company. These prospective licensees may not easily enter into a license arrangement with a small new company, spend millions to complete the development of a product, and then face the insolvency risk and the potential loss of all rights to the product. While licensees at present can attempt to take certain protective measures, these are by no means satisfactory to either the company granting the license or the licensee.

Unfortunately, to form relationships to fund and fully develop aspects of Xoma's technology, it may be difficult to avoid licenses. Companies such as Xoma must be able to grant secure licenses to their intellectual property. To the extent that licenses cannot be consummated, development activities could be curtailed and, ultimately, the future health of numerous innovative companies could be in jeopardy.

The enactment of S.1626 will remove a major problem for all companies which rely on the licensing of intellectual property. Enactment would once again make licensing an attractive mechanism to develop and commercialize new products both in the United States and abroad. Xoma and other companies similarly engaged in developing new and innovative technologies and products, often on the "cutting edge" of science, represent, to a large extent, the future of American industry. The future growth and well being of these companies will determine whether this nation's leadership in biotechnology, communications, lasers, computers and other high-technology fields will be sustained.

STATEMENT OF JOHN P. McLAUGHLIN

Mr. McLAUGHLIN. Good morning, Mr. Chairman, members of the committee. I am John McLaughlin, a vice president with Genentech. I appreciate the opportunity to testify this morning on S. 1626.

Genentech is a biotechnology company which was founded in 1976 and which uses recombinant DNA technology to produce human pharmaceuticals. With over $140 million in sales and the discovery, in 1987 alone, of 29 new proteins or new uses for proteins, we are a leader in the fledgling biotechnology industry.

To appreciate the importance of licensing arrangements involving intellectual property, particularly the revenues from those arrangements, I have to tell you a little bit about the cost of high-tech startups. Our field, human pharmaceuticals, is very research intensive. According to a study commissioned by the Pharmaceuticals Manufacturers Association, the average cost of bringing a new drug to market is over $100 million a year.

In addition, high-tech startups also face the cost of constructing manufacturing facility. Again, using Genentech as an example, we wanted to produce drugs using a novel, breakthrough technology. We had to construct a new facility which could take advantage of that, costing tens of millions of dollars.

Most high-tech companies finance these expenses through a combination of equity capital and revenues from licensing arrangements. Our case is probably typical. We generally use equity capital for the construction of plants and we use licensing revenues to pay for the day to day R&D activities.

There are two important public policies served by the current system of licensing of intellectual property. The first, to which I have already alluded, is it provides a stream of revenue for R&D startups. In the early days, Genentech licensed a number of products to a number of companies. It provided us with a steady stream of revenues to fund R&D operations.

By retaining ownership of the technology, and simultaneously generating a steady stream of revenues, we were able to enhance the value of the company, so that when we had to go back into the equity markets to get additional financing so that we could expand, so that we could market our own products, we were able to do it.

There is another, equally important purpose served by the current system of licensing. That is, it allows society to fully utilize products. In 1983 Genentech was still a relatively small company. We were developing human growth hormones for the treatment with a growth deficiency disease. We did not have the ability to adequately serve patients in foreign markets. By licensing the product to Kabi-Vitrum, a Swedish manufacturer, we were able to make sure that the product did get to those patients overseas.

Unfortunately, a number of recent decisions, including *Lubrizol,* undercut these public policies by threatening the integrity of the licensing arrangements involving intellectual property. The *Lubrizol* court acknowledged that it might have an adverse effect on companies in financial difficulty. They overlooked, however, the effect on startup companies.

These are small companies. They have no financial track record, to speak of. At some point in their history, unfortunately, there comes a time where their resources are stretched very thin to meet their obligations. Potential licensees are very much aware of that phenomena. As a result of the *Lubrizol* decision, potential licensees are saying we would rather own the property, thanks very much. We do not want to take our chances if you wind up in bankruptcy court. Sometimes they are proposing very unattractive licensing arrangements, which really do not do very much to help R&D companies.

The effect of this has been a diminution of that steady stream of revenues that Genentech of a couple of years ago and today's companies need to fund their operations. It has also had a more detrimental effect, and while it is difficult to quantify, you can extrapolate from the experience of Genentech in the early 1980's. If we could not license our products overseas, those patient populations would not have been able to get our therapies. That is detrimental to them, but it is also detrimental to the national goal of making American companies competitive in international markets.

We support S. 1626 because it is a reasonable and responsible solution to the problems caused by *Lubrizol,* and we commend Senators DeConcini and Heflin for their leadership on this issue and we urge its enactment.

Thank you.

[The prepared statement of Mr. McLaughlin follows:]

Genentech, Inc.

SUMMARY OF STATEMENT OF JOHN P. McLAUGHLIN, GENENTECH, INC.

Founded in 1976 to develop pharmaceutical products utilizing recombinant DNA technology, Genentech has become the leader in the fledgling biotechnology industry.

The costs incurred by new, high tech companies (such as Genentech was in the early eighties) are enormous. Genentech's particular field, human pharmaceuticals, is among the most research intensive in the industry. According to a recent study, the cost of bringing a new drug to market is over $100 million. In addition, most, new concerns in a high technology field have the expense of constructing a manufacturing facility. Start ups including Genentech generally finance their operations through a combination of licensing revenues and equity capital.

A number of public policies are served by the current system of licensing of intellectual property. The first is a means of funding for small, high technology companies. It also permits the full and expeditious utilization of an innovative product to the benefit of all society. Perhaps the most important public policy served by the licensing of intellectual property rights is the retention of ownership of intellectual properties by small, innovative companies. Through the use of nonexclusive licenses for different geographical markets, small, start up companies can generate revenues and still maintain ownership of their intellectual property. The resulting enhancement of the value of a start up company is critical if it is to attract the additional capital from the equity markets needed for continued growth.

Unfortunately, Lubrizol and similar court decisions interpreting the application of Title 11 of the Bankruptcy Code to technology licenses threaten the integrity of technology licensing arrangements. As a result of the Lubrizol decision, many companies are reluctant to enter into intellectual property licensing agreements with small, start ups. Instead those companies are insisting on ownership of the intellectual property. Thus, one effect of the Lubrizol decision has been to diminish that stream of revenues for research activities which are important to small, innovative companies.

While more difficult to quantify, the Lubrizol decision has also had a detrimental effect upon the utilization of innovative products. In particular, foreign markets are not being served. This undercuts our national interest in making American companies more competitive in international markets. Equally disturbing is the sale of intellectual property by small, high tech companies to a foreign competitor which may transfer technology overseas resulting in a loss of this country's technological leadership.

Genentech supports S. 1626 as a reasonable and responsible solution to the difficulties caused by the Lubrizol decision.

Genentech, Inc.

1747 Pennsylvania Avenue NW
Suite 1223
Washington, DC 20006
(202) 296-7272
FAX (202) 296-7290

STATEMENT OF

JOHN P. McLAUGHLIN

VICE PRESIDENT, GOVERNMENT AFFAIRS

GENENTECH, INC.

BEFORE THE
SUBCOMMITTEE ON COURTS AND ADMINISTRATIVE PRACTICE
COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

ON
S. 1626
INTELLECTUAL PROPERTY BANKRUPTCY PROTECTION ACT OF 1987

June 10, 1988

1

INTRODUCTION

Good morning, Mr. Chairman and Members of the Subcommittee. I am John McLaughlin, Vice President of Government Affairs for Genentech, Inc. I appreciate this opportunity to appear before you to testify on S. 1626, a bill to keep secure the rights of intellectual property licensors and licensees which come under the protection of Title 11 of the Bankruptcy Code.

GENENTECH, INC.

Genentech was founded in 1976 to develop pharmaceutical products utilizing recombinant DNA technology. Today, with $140 million in sales, over 1700 employees, and the discovery in 1987 of 29 new proteins or new uses for proteins, the company has become the leader in the fledgling biotechnology industry. It is responsible for four of the five biotech drugs which have been approved for sale including: human insulin for the treatment of diabetes; human growth hormone for the treatment of growth deficient children; interferon for the treatment of hairy cell leukemia; and tissue plasminogen activator for the treatment of the estimated 1.5 million persons who suffer heart attacks each year.

LICENSING AS A SOURCE OF REVENUE

To understand the importance of revenues from technology licenses to small, beginning companies, I must explain briefly about the costs associated with high technology companies. Our

particular field, human pharmaceuticals, is among the most research intensive in industry. According to a recent study conducted for the Pharmaceutical Manufacturers Association, the cost of bringing a new drug to market is over $100 million. This investment begins when testing is initiated and continues until final approval for marketing is obtained from the Food and Drug Administration - a period of five or more years.

In addition to the significant cost of research and development activities, most new concerns in a high technology field have the expense of constructing a manufacturing facility. In Genentech's case, the company sought to produce pharmaceuticals based on genetic engineering techniques which it had pioneered. To utilize this breakthrough technology, the company had to spend tens of millions of dollars to construct an entire new production facility.

Most new, high tech companies finance their operations through a combination of equity capital and licensing revenues. At Genentech, equity capital was generally used to finance the acquisition of assets such as laboratory equipment, computers, and manufacturing facilities. Revenues derived from the licensing of intellectual property such as proteins and expression processes were generally used to fund research and development activities.

While the magnitude of revenues which Genentech required as a start up may be unique to a biotechnology company entering into the pharmaceutical industry, all new, high tech companies share

the same need for funding for capital construction and research activities.

PUBLIC POLICIES IN SUPPORT OF LICENSING

A number of public policies are served by the current system of licensing of intellectual property. The first, to which I have previously alluded, is a means of funding for small, high technology companies. For example, the grant of a license to Eli Lilly for world-wide rights to recombinant human insulin and to other companies for other products afforded Genentech a steady stream of revenue to fund research and testing of other important therapies which Genentech subsequently marketed on its own behalf.

Yet the current licensing system serves another, equally important public purpose. It permits the full and expeditious utilization of an innovative product to the benefit of all society. When Genentech was developing recombinant human growth hormone in the early eighties, it did not have the capability to meet fully the needs of patient populations outside the United States. By licensing the drug to Kabi-Vitrum, a Swedish pharmaceutical company, for sales outside this country, the product was made available to patients in all markets.

Perhaps the most important public policy served by the licensing of intellectual property rights is the retention of ownership of intellectual properties by small, innovative companies. Through the use of nonexclusive licenses for different

geographical markets, small, start up companies can generate revenues and still maintain ownership of their intellectual property. The resulting enhancement of the value of a start up company is critical if it is to attract the additional capital from the equity markets needed for continued growth.

LUBRIZOL DECISION

Unfortunately, a number of recent court decisions interpreting the application of Title 11 of the Bankruptcy Code to technology licenses threatens the integrity of technology licensing arrangements. For example, in Lubrizol Enterprises Inc. v. Richmond Metal Finishers, 756 F.2d 1043 (4th Cir. 1985), Lubrizol had a nonexclusive license from Richmond Metal to utilize a metal coating technology. Approximately a year later, Richmond Metal filed for protection under Title 11 and sought to reject the licensing agreement with Lubrizol on the basis that it was an executory contract and that Richmond Metal could get more money by selling the rights to the technology. Lubrizol sued to maintain its license but lost on appeal when the court held that the technology licensing arrangement was an executory contract and that the bankruptcy laws permitted Richmond Metals to reject an executory contract. As a consequence of that decision, Lubrizol was barred from using the metal coating technology and had to drop out of that business.

EFFECT OF THE LUBRIZOL DECISION

As the court acknowledged in Lubrizol, its decision "could have a chilling effect upon the willingness of such parties to contract at all with businesses in possible financial difficulty." The Fourth Circuit overlooked, however, the effect of its decision upon new, small, high technology companies.

While such companies may not be in financial difficulty, most start up companies in a high technology field face a period in their history when their resources are barely able to meet their obligations. Potential licensors are all too keenly aware of this phenomenon.

After the Lubrizol decision, many companies are reluctant to enter into intellectual property licensing agreements with small, start ups. Instead those companies are insisting on ownership of the intellectual property or are willing to accept a license only on terms which are much less favorable to the start up. Thus, one effect of the Lubrizol decision has been to diminish that stream of revenues for research activities which are important to the Genentechs of today - the small, innovative companies just beginning.

While more difficult to quantify, the Lubrizol decision has also had a detrimental effect upon the utilization of innovative products. Some markets are not being served because small companies cannot license their technology and are unwilling to sell ownership of it. This is particularly true of foreign

markets.

Start ups generally do not have the ability to serve foreign markets. For example, in the early eighties, Genentech licensed a number of its products to European and Japanese partners to serve marketplaces outside this country. The Genentechs of today may be foreclosed from foreign markets because of the uncertainty caused by Lubrizol and similar decisions. This undercuts our national interest in making American companies more competitive in international markets.

An equally disturbing aspect of the insistence of potential licensees on the sale of intellectual property rather than a license is the potential transfer of technology overseas. When such sales of technology are made to foreign competitors, they may result in a loss of this country's technological leadership.

S. 1626, INTELLECTUAL PROPERTY BANKRUPTCY PROTECTION ACT

Genentech supports S. 1626 as a reasonable and responsible solution to the difficulties caused by Lubrizol and similar decisions. This legislation would restore the integrity of licensing agreements by preventing a bankrupt licensor from rejecting an executory contract or unexpired lease granting rights in intellectual property. There is ample precedent for affording this kind of protection to intellectual property licensing arrangements. The Bankruptcy Code currently affords similar protection to real estate leases and union members under collective bargaining contracts.

CONCLUSION

For new, high tech companies, the ability to license intellectual property is critical. Such licensing schemes assure that the innovations of start ups become readily available while at the same time providing revenues so that the new companies can continue their research. The Lubrizol decision adversely effects the ability of small, high tech companies to license their intellectual property. Genentech commends Senators DeConcini and Heflin for their leadership in proposing legislation to address the problem caused by Lubrizol and urges enactment of S. 1626.

Thank you.

STATEMENT OF GEORGE A. HAHN

Mr. HAHN. Good morning, Mr. Chairman. I am a New York City attorney and I am appearing here this morning on behalf of the National Bankruptcy Conference.

The Conference supports the necessity for legislation to undo some of the unfortunate effects of the *Lubrizol* decision. But the Conference is not in favor of enactment of S. 1626 as it is presently structured. Rather, the Conference favors the enactment of a model draft bill which was worked out in recent months by the Conference in conjunction with the Industry Committee and with the help and assistance, as well, of the Business Bankruptcy Committee of the American Bar Association. Copies of that draft bill have been supplied to your staff, and copies are attached to our report to the committee this morning.

The *Lubrizol* decision distorted and exaggerated the effects that rejection of an executory contract should cause in a bankruptcy case. The purpose of a rejection is to relieve the debtor of the burden of performing the executory portion of the contract. It is not intended to unravel that portion of the contract that has already been executed prior to bankruptcy.

The *Lubrizol* Fourth Circuit Court failed to observe that distinction and allowed the licensee in that case to be stripped of the technology it was using, that it had acquired from the licensor long before the licensor's bankruptcy. It is no wonder that that effect has had a severe reaction in the industry. The licensee can never be sure, under the *Lubrizol* decision, that the technology that is so unique, that he is relying on, and that he is paying dearly for, can be retained by him. At any moment, a bankruptcy of the licensor can oust him of his ability to continue to use and rely upon that technology.

While that decision of the fourth circuit is not necessarily the law of various other circuits of the United States, the perception and the influence of that case has had a very apparent chilling

effect on people entering into these arrangements. There is nothing in the short term that the courts can do to undo that damaging effect, and therefore, some legislation is clearly indicated and the Conference is favorable to some legislation to deal with this immediate problem.

Unfortunately, S. 1626, although well intended, creates other problems and fails to achieve a reasonable balance between the needs of the debtor in reorganization and the needs of the licensee. For that reason, the Conference cannot support that bill as now structured.

During the last few months, the coalition of industry people came to the Conference and asked for our help in developing a revised bill. We were happy to have helped them. We worked unstintingly with them. Out of that emerged the revised model draft bill to which I made reference before. We believe that draft bill, which has the support both of the Conference, the ABA, and the coalition of the industry people, is the correct way to go.

Basically, without going into all the details of that bill, its essential feature is that it enables the licensee, after rejection, to retain the technology that has been conveyed to him prior to bankruptcy. But he must pay for its use by continuing to make the royalty payments pursuant to the terms of the licensing agreement for the duration of the contract, without any right of deduction or setoff.

Thus, both sides gain what they need in order to reorganize and to go forward. The licensor is relieved of the burden of performing the contract in any material way following rejection. At the same time, he retains the cash flow from the royalty payments that will be made by the licensee. This enables him to have the cash he needs in order to reorganize the company in the chapter 11 proceeding.

The licensee, from his point of view, retains and can count on retaining the technology and to use that technology, so long as he pays for it. He has a damage claim, as he has today under the code, for any damages that result from the rejection and the breach of that contract.

This achieves a satisfactory balance and we would urge the subcommittee to consider that bill. We think it is a good piece of legislation, that it clearly meets the problem in a way that is consistent with bankruptcy principles and that should be acceptable to all parties in interest because it carefully balances the needs of the debtor, its creditors, and the needs of the licensee.

Thank you.

[The prepared statement of Mr. Hahn follows:]

Testimony of George A. Hahn, Esq.
on Behalf of the
National Bankruptcy Conference
On S.1626, Intellectual Property
Bankruptcy Protection Act of 1987
June 10, 1988

Summary of Statement

. The decision of the Fourth Circuit of Appeals in Lubrizol Enterprises v. Richmond Metal Finishers distorted the proper effects flowing from the rejection of an executory contract in bankruptcy when it stripped the licensee of rights to intellectual property which the licensor had provided to the licensee prior to the licensor's bankruptcy.

. The Lubrizol ruling creates great uncertainty about the ability of licensees to retain their existing rights to use licensed intellectual property in the event of a licensor bankruptcy. This has the potential of discouraging prospective licensees from entering such agreements with new, young companies working at the frontiers of technology.

. Legislation is needed to protect the right of licensees to retain the use of intellectual property conveyed prior to the licensor's bankruptcy.

. While the National Bankruptcy Conference is sympathetic to the objectives of S.1626, the provisions of that bill contain serious infirmities. The Conference therefore is unable to support the bill in its present form.

. After the introduction of S.1626, the National Bankruptcy Conference worked with the coalition of industry representatives to fashion a revised bill. The revised Draft Bill which is submitted as part of this statement, has the support both of the National Bankruptcy Conference and the coalition of industry representatives.

NATIONAL BANKRUPTCY CONFERENCE

(A voluntary organization composed of persons interested in the improvement of the Bankruptcy Code and its administration.)

STATEMENT OF GEORGE A. HAHN

OF THE LAW FIRM OF HAHN & HESSEN

ON BEHALF OF

THE NATIONAL BANKRUPTCY CONFERENCE

ON S. 1626,

INTELLECTUAL PROPERTY BANKRUPTCY PROTECTION ACT OF 1987

BEFORE THE

SUBCOMMITTEE ON COURTS AND ADMINISTRATIVE PRACTICE

OF THE

COMMITTEE ON THE JUDICIARY

UNITED STATES SENATE

June 10, 1988
10:00 A.M.

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Mr. Chairman and members of the Subcommittee:

I appreciate this opportunity to comment on the proposed legislation to protect rights to intellectual property in bankruptcy.

I am appearing here on behalf of the National Bankruptcy Conference (the "Conference"). I am chairman of the Committee on Stays and Executory Contracts of the Conference. I am a senior partner of the New York City law firm of Hahn & Hessen.

Lubrizol Ruling

The decision of the Fourth Circuit Court of Appeals in Lubrizol Enterprises v. Richmond Metal Finishers, 756 F.2d 1043 (1985), cert denied 475 U.S. 1057 (1986) determined that the particular technology license agreement in that case was an executory contract within contemplation of 11 U.S.C. § 365(a) and therefore could be rejected by the debtor licensor in the exercise of its sound business judgment. The licensed technology had been disclosed by the debtor to Lubrizol, the licensee, prior to the bankruptcy filing. Nevertheless, the Fourth Circuit determined that rejection had the effect of depriving Lubrizol of its right to use the technology already in its possession, leaving Lubrizol solely with a damages remedy. The court acknowledged that its ruling was likely to have a general chilling effect upon the willingness of corporations to contract at all with businesses that might be in financial difficulty.

The Lubrizol decision misconstrued the effects of rejection of an executory contract, thereby creating an impediment

to the licensing of intellectual property that could have been avoided.

Rejection under 11 U.S.C. § 365 should not set aside or retrieve rights which the non-debtor party has already obtained under the contract. It should not deprive the non-debtor party who is not in default, of the benefits of the debtor's contractual performance already made prior to his bankruptcy. Section 365 addresses only future specific performance obligations of the parties. In re Executive Technology Data Systems 79 Bankr. 276 (Bankr. E.D. Mich. 1976). Rejection denies the right of the contract creditor to require the debtor to perform the executory portions of the contract, relegates the creditor to a claim for damages for breach of contract, and prohibits the rejecting debtor from compelling the contract creditor to perform its executory obligations. Rudaw /Empirical Software Products Ltd. v. Elgar Electronics Corporation, 83 Bankr. 241, 246 (Bankr. S.D.N.Y. 1988). Rejection does not have any impact upon the executed portions of a contract. Rejection is not the equivalent of rescission. Murphy v. C&W Limited Corp. (In re Murphy) 694 F.2d 172, 174 (8th Cir. 1982).

The Lubrizol Court correctly prophesied the adverse consequences of its decision. Businesses are unlikely to risk major investment in new technology if the party offering the licenses is apt to be in financial difficulty. Many start-up software and biotechnology companies are in relatively weak financial condition, but own valuable intellectual property which they seek to license rather than sell. Such licensing furthers the

public interest and advances the development of U.S. technology in world markets.

Need for Legislation

The Lubrizol decision is not necessarily the law of other circuits that have yet to pass upon these issues. Nevertheless, the Lubrizol decision cannot be ignored by any counsel representing companies seeking to license intellectual property. Without further legislation, there is no way to repair the damaging effects of the Lubrizol decision, at least in the near term.

Some have suggested this problem may gradually cure itself as courts learn to better balance the equities between the debtor licensor and the licensee, pointing to the willingness of a few courts to curtail the trustee's power to reject where the evidence shows rejection would cause injury to the non-debtor party disproportionate to any benefit to the estate of the debtor.[1] While a better balancing of the equities is welcome, the view of a majority of courts remains that hardship to the non-debtor party from rejection is not a factor to be considered in determining the debtor's application for rejection. See Borman's Inc. v. Allied Supermarkets, Inc., 706 F.2d 187 (6th Cir.), cert. denied, 464 U.S. 908 (1983); Lubrizol, supra.

Even if a majority of courts became willing to weigh the rights of the non-debtor party in determining whether to permit

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[1] See e.g., In re Chi-Feng Huang, 23 Bankr. 798 (9th Cir. 1982); Infosystems Technology, Inc. v. Logical Software, No. 87-0042, slip op. (D. Mass. June 27, 1987), In re Petur U.S.A. Instrument Co., Inc., 35 Bankr. 561 (Bankr. W.D. Wash. 1983).

rejection this alone would not change the outcome in most cases. Frequently, rejection is necessary in order to relieve the debtor of the burden of future performance, but this should not strip the licensee of rights acquired by him before bankruptcy. The primary problem lies not with rejection itself, but with the exaggerated consequences of rejection under the Lubrizol decision.

S. 1626

Responding to the genuine need for legislation, Senator DeConcini introduced S.1626 to protect the licensee's rights to intellectual property conveyed prior to bankruptcy. While sympathetic to these objectives, the National Bankruptcy Conference found too many infirmities and ambiguities in S.1626 to be able to support it without substantial revision. Some of the Conference's objections to S. 1626 are:

a) The definition of intellectual property ("Intellectual Property") in the bill, in its references to protected information and products of creative effort, is imprecise. Also, by including trademarks, tradenames and service marks in the definition, the bill appears to bring every retail franchise involving a trademark within the purview of the legislation, thus extending the reach of the bill far beyond what appears necessary.

b) The inclusion of trademarks also raises the thorny issue of continuing quality assurance for trademarks in the midst of a bankruptcy, and the bill does not deal with this problem in an adequate way.

c) Provisions contained in the bill to assure continued confidentiality with respect to intellectual property are unnecessary, inasmuch as 11 U.S.C. §107(b) already empowers the bankruptcy court to enter orders to protect the right to confidentiality of intellectual property.

d) Where the debtor is the licensee, the bill requires the debtor to maintain confidentiality to the extent required by applicable non-bankruptcy law. This could be interpreted as prohibiting the debtor from revealing information to his trustee in bankruptcy, thereby interfering with the trustee's ability to operate the debtor's business;

e) While preserving the licensee's rights to intellectual property, the bill does not assure continuation of the debtor's reciprocal obligation to make any royalty payments to the debtor that are provided for in the licensing agreement. Without such royalty payments the debtor may be unable to reorganize its business.

The Revised Draft Bill

In the fall of 1987 a coalition of representatives from American Industry and trade associations calling themselves the "Bankruptcy Licensor Coalition", approached the Conference for its assistance in regard to this legislation. The Conference responded favorably to this request. During the winter of 1987 representatives of the Conference and representatives of the Business Bankruptcy Committee of the American Bar Association ("ABA") participated in a series of meetings with Coalition representatives. From these discussions and the work of a drafting

group formed by them a new, draft bill ("Draft Bill") emerged[2] (copy attached hereto as Exhibit A).

At its mid-year meeting the Conference adopted a resolution in support of the Draft Bill. Similarly, the Business Bankruptcy Committee of the ABA adopted a resolution in support of the Draft Bill. In both instances approval was given subject to "fine tuning" and subject to the further proviso that the legislative history should include a statement that the bill is not intended to affect executory contracts other than licenses of intellectual property. This precaution is for the purpose of avoiding an inference that Congress, by failing to include executory contracts not involving intellectual property in any amendment, intended a particular result in other cases. New legislation should be neutral in its effect upon other forms of executory contracts. Hopefully, this will avoid a repetition of the kind of negative statutory construction engaged in by the Lubrizol Court.[3]

The central feature of the Draft Bill is that it permits the licensee under an executory contract of intellectual property rights to retain such rights obtained by him prior to the licensor's bankruptcy for the duration of the contract if the trustee rejects the contract. The Draft Bill, to an extent,

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[2] The recently introduced House Bill 4567 is based upon the draft bill.

[3] See Lubrizol Enterprises Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 at 1048 ("...no comparable special treatment is provided for technology licensees"...)

parallels the existing provisions of 11 U.S.C. § 365(h) relating to rejection of an unexpired lease of real property, perhaps in order to suggest that the draft bill treats licensees of intellectual property rights no more specially than holders of other unique rights have been treated, such as real property lessees. Under present subsection (h) the lessee may treat the lease as terminated by the rejection, or in the alternative, may elect to remain in possession of the leasehold for the balance of the lease term and for any renewal or extension thereof. Similarly, under the Draft Bill, the licensee of intellectual property may treat the contract as terminated by such rejection or in the alternative, may elect to retain its rights to such intellectual property for the duration of the contract and any period for which such contract may be extended. But the remaining provisions of present subsection (h) and the Draft Bill are dissimilar. Under subsection (h)(2) the lessee of real property who remains in possession may offset against the rent, damages caused by the debtor's nonperformance of any obligations under the lease, but otherwise has no damage claim. In contrast, the licensee under the Draft Bill waives any right of setoff and must make all payments due under the contract for the duration of the contract and any period for which the licensee extends it. However, the licensee will retain a general claim for damages from rejection, as a breach of contract under § 365(g).

The Draft Bill seeks to balance the competing interests of the parties. The essential purpose of rejection of executory contracts is to relieve the debtor of the burden of future specific performance. The Draft Bill accomplishes this, relieving the

licensor of providing maintenance services or updating technology or any other material performance obligation. The rejection power, however, is not an avoidance power for the unraveling of executed transactions. The Draft Bill therefore, overrules the Lubrizol decision and permits the licensee to retain his rights to intellectual property conveyed prior to the commencement of the case, despite rejection. This restores the rejection power to reasonable limits in keeping with its essential purpose, while preserving the system of licensing of intellectual property, with all of its flexibility and multiple uses.

In exchange for his ability to retain rights to intellectual property, the licensee is required to make all payments due under the contract without right of setoff. This assures the debtor-licensor of the cash flow of royalty payments under the contract, which may be essential to the debtor's reorganization. Thus, through rejection the debtor is relieved of future specific performance and its burdens and still retains enjoyment of the cash flow from the contract, free from setoff. What he can no longer count on is a windfall from recapture and resale of rights previously conveyed (if the licensee elects to retain them and make the required contract payments).

If the licensee elects to retain his rights to the intellectual property, it is intended that such rights shall be of the same extent and quality as provided in the contract. If the contract grants the licensee an exclusive use, such exclusivity would be preserved to the licensee. The licensee therefore can invest in research and marketing of intellectual property in

reliance upon his ability to retain an exclusive right to such use, if he so contracted.[4]

The Draft Bill calls for the trustee on written request of the licensee to provide to the licensee any intellectual property held by the trustee and to not interfere with the licensee's right to obtain intellectual property from a third party. The reference to a third party is intended to address problems connected with arrangements such as software escrow agreements.

In its definition of intellectual property, the Draft Bill makes reference to "embodiments" which is intended to encompass tangible products in which the intellectual property is embodied such as a disc, phono record, etc. The definition of intellectual property in the draft bill excludes trademarks for the reasons mentioned earlier.

The Conference is aware that licensing agreements may provide, not only for royalty payments from the licensee, but for various forms of non-monetary consideration, such as an exchange of intellectual property or some other performance by the licensee. The bill does not expressly address what happens to these other non-monetary obligations of the licensee in the event the agreement is rejected by the debtor licensor and the licensee elects to retain rights to intellectual property. It is believed most of these other obligations of the licensee will survive and the

[4]This has the effect of overruling the decision of Felix Cattle Company v. Silver (In re Select-A-Seat Corporation), 625 F.2d 290 (9th Cir. 1980), decided under the former Bankruptcy Act, which held that upon rejection, the debtor-licensor was relieved of any obligations of exclusive dealing.

licensee, if he elects to retain rights to the intellectual property, will be required to perform them in addition to making the royalty payments. There may be some obligations, however, that the licensee may be relieved of (not royalty payments which will be mandated by the statute) by a court on the ground they are so closely tied to reciprocal duties which the licensor was relieved of by rejection that it would be inequitable to make the licensee perform them. In any event, it is impossible for legislation to fix in advance which obligations (other than royalty payments) should survive in an infinite variety of situations. This issue must be left to the equitable discretion of the bankruptcy court in the light of the circumstances of each case.

The Draft Bill represents the product of close collaboration between industry members, their counsel and bankruptcy counsel, who together have worked to reconcile the needs of technology licensees with those of debtor-licensors undergoing reorganization. The Conference believes the proposed Draft Bill will bring about an acceptable balancing of the interests of the debtor, its creditors and licensees consistent with correct bankruptcy principles.

Exhibit A

Draft Bill

"(h)(1) If the trustee rejects an unexpired lease of real property of the debtor under which the debtor is the lessor, a timeshare interest under a timeshare plan under which the debtor is the timeshare interest seller, or an executory contract under which the debtor is the licensor of rights in [or to] intellectual property, the lessee, timeshare interest purchaser, or licensee under such lease, timeshare plan, or executory contract may treat such lease, timeshare plan, or executory contract as terminated by such rejection, where such rejection by the trustee amounts to such a breach as would entitle the lessee, timeshare purchaser, or licensee to treat such lease, timeshare plan, or executory contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or other agreement that the lessee, purchaser, or licensee has made with other parties. In the alternative, the lessee or purchaser may remain in possession of the leasehold or timeshare interest under any lease or timeshare plan the term of which has commenced for the balance of such term and for any renewal or extension of such term that is enforceable by such lessee or purchaser under applicable nonbankruptcy law; or the licensee may retain its rights to the intellectual property, as it existed at the filing of the petition, under such executory contract for the balance of the term and any renewal or extension of such term that is enforceable by such licensee under applicable nonbankruptcy law, except, other than as provided in this subsection, for any right to compel specific performance by the trustee.

(2) [As enacted]

(3) If such licensee of intellectual property retains its rights as provided in paragraph (1) of this subsection --

(A) the extent, nature, and quality of such rights shall be the same as provided in such executory contract; and

(B) such licensee shall continue to make all payments due under such executory contract for the balance of the term and for any renewal or extension thereof and shall be deemed to have waived --

(i) any rights of offset it may have; and

(ii) any claims it may have under Section 503(b) of this title with respect to such executory contract other than claims against the estate for the trustee's failure to comply with the requirements of this subsection.

(4) Unless and until the trustee rejects an executory contract under which the debtor is the licensor of intellectual property, the trustee shall on written request to the trustee from the licensee, --

(A) to the extent provided in such executory contract, either (i) perform or, in the alternative, (ii) disclose or turn over to the licensee any intellectual property held by the estate; and

(B) not interfere with the rights of the licensee as provided in such executory contract or associated agreement (i) to use the intellectual property, or (ii) to obtain the intellectual property from a third party.

(5) Upon rejection of an executory contract under which the debtor is the licensor of intellectual property and a retention of rights by the licensee as provided in paragraph (1) of this subsection, on written request to the trustee from the licensee, the trustee shall --

(A) to the extent provided in such executory contract, disclose or turn over to the licensee any intellectual property held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such executory contract or associated agreement (i) to use the intellectual property, or (ii) to obtain the intellectual property from a third party.

(6) In this section, "intellectual property" means, to any extent protected by applicable nonbankruptcy law, --

(A) trade secrets;

(B) confidential research, development, or commercial information;

(C) patents;

(D) copyrights;

(E) mask works;

(F) plant variety protection certificates; or

(G) embodiments of any of the above.

STATEMENT OF JEFFREY TARKENTON

Mr. TARKENTON. Mr. Chairman and members of the subcommittee, I appreciate this opportunity to speak today regarding S. 1626. I practice law with the firm of Hunton & Williams here in Washington, DC, and appear today as a representative of the American Bankruptcy Institute. During the last year, I have chaired the ABI's subcommittee which has been monitoring this piece of legislation.

While I appear today as a representative of the ABI, the views I express are necessarily my own and do not represent the official view of the ABI. I will direct my comments to the amended version of the bill which Mr. Hahn referred to in his statement.

The Bankruptcy Code is a carefully crafted tool which balances the interests of debtors, creditors, and other parties in interest in bankruptcy proceedings. Because of the fourth circuit's decision in *Lubrizol Enterprises* v. *Richmond Metal Finishers,* that balance is now out of sync.

Under section 365 of the Bankruptcy Code, debtors may with court approval reject their executory contracts. For instance, in *Lubrizol,* the court permitted the debtor to reject its nonexclusive technology licensing agreement with *Lubrizol.*

But in *Lubrizol,* the court went one step further. The court not only permitted the debtor to reject its continuing future obligations of performance, but it also permitted the debtor to completely rescind the completed portion of the transfer of technology.

Section 365 was enacted both to enable debtors to abandon burdensome obligations and to take advantage of better business opportunities. But it was not enacted to permit debtors to rescind completed transfers. Section 365, as a result of the *Lubrizol* decision, is now an incentive for some companies to file bankruptcy simply to take advantage of this loophole and reject completed transfers.

This decision has infused a large degree of risk into the licensing of intellectual property. Because licensees cannot be certain they will be able to retain the intellectual property rights which they have a license to use, their incentives to develop projects using the intellectual property is chilled.

The amended version is a principled solution to this problem. This legislation parallels existing legislation in the bankruptcy code regarding treatment of other unique rights, such as real property leases.

In sum, the legislation would permit the licensee of intellectual property rights to retain the rights it received before the filing of the bankruptcy petition. The debtor can reject the license agreement, but the licensee can retain whatever rights it has received under the license. If the licensee retains its rights, then it must pay the debtor for their use.

Clearly, legislation is needed to protect the intellectual property licensing problem which has been testified about today. The proposed legislation is a fair and balanced cure for this problem. If enacted, this legislation will re-establish the balance between the interests of debtors, creditors, and other parties in interest, which

Congress initially crafted when it enacted the Bankruptcy Reform Act of 1978.

Thank you for this opportunity to share my thoughts with you regarding this legislation.

[The prepared statement of Mr. Tarkenton follows:]

HUNTON & WILLIAMS

TESTIMONY OF JEFFREY L. TARKENTON
HUNTON & WILLIAMS

ON BEHALF OF THE AMERICAN BANKRUPTCY INSTITUTE

ON S.1626

June 10, 1988

SUMMARY OF STATEMENT

- Section 365 of the Bankruptcy Code was enacted in part to relieve debtors of burdensome obligations to perform executory contracts.

- Section 365, as interpreted by the Fourth Circuit Court of Appeals decision in Lubrizol Enterprises v. Richmond Metal Finishers enables debtor licensors to use this shield against burdensome obligations as a sword to unravel completed transfers of intellectual property.

- A debtor licensor whose intellectual property has increased in value may reject an executory contract involving the license of the intellectual property, license the use of the intellectual property to another party, and reap substantially higher royalty payments than it reaps under the existing license.

- Because a debtor licensor can reject an executory contract involving the license of intellectual property and thereby deny the licensee the right to use the intellectual property in the future, licensees face great risk when deciding whether to invest to develop products based upon the license. As a result, the licensees' incentives to use the licensed intellectual property to develop products is chilled and licensors are encouraged to file bankruptcy petitions in order to reject licenses and rescind transfers which cannot be rescinded outside of a bankruptcy proceeding.

- S.1626 is a principaled solution to the problem created by the Lubrizol decision. This legislation treats intellectual property rights in a manner which is similar to the manner in which the Bankruptcy Code treats other unique rights such as real property leases. Where the debtor licensor rejects the license, the licensee of the intellectual property rights can retain the rights which the licensor conveyed to it prior to bankruptcy.

Testimony of

Jeffrey L. Tarkenton
Hunton & Williams

On Behalf Of

American Bankruptcy Institute

Concerning S.1626

Before the Subcommittee on Courts and Administrative Practices

of the

Senate Judiciary Committee

June 10, 1988

TESTIMONY OF JEFFREY L. TARKENTON
HUNTON & WILLIAMS
ON BEHALF OF
AMERICAN BANKRUPTCY INSTITUTE

On behalf of the American Bankruptcy Institute, I extend my sincere appreciation to the Chairman and the Members of the Subcommittee for the opportunity to appear before you to discuss S.1626. The ABI is a nonpartisan membership organization of more than 2,200 lawyers, judges, accountants, bankers, business leaders, professors and others who are actively involved with the operation of the nation's bankruptcy laws. While I appear before you as a representative of the ABI, the views I express are necessarily my own and do not represent the official view of the ABI. My comments regarding S.1626 will be directed to the proposed amended version of that bill and not to the version which has been introduced.

Because the drafters exercised a great deal of care and skill in drafting S.1626, I have no comments regarding the technical provisions of the proposed legislation. Instead, I will turn my attention to the effect the legislation will have on the Bankruptcy Code.

The two fundamental policies underlying the Bankruptcy Code are that creditors should be treated equally and that debtors should have an opportunity for a fresh start. Congress carefully crafted the Bankruptcy Code in order to balance these two competing policies. When the Bankruptcy Code is amended,

there is always a risk that this balance will be lost. Where the Bankruptcy Code is altered to benefit particular groups, the change may be made at the expense to other parties in interest thereby rendering the Bankruptcy Code less effective in balancing competing interests.

The provisions of Chapter 11 illustrate this balance. These provisions give each player in the reorganization process certain bargaining power. By distributing bargaining power, Congress ensured that in most cases a confirmed Chapter 11 plan would be the result of negotiation and compromise.

The proposed legislation will not upset the balance which Congress crafted. Instead, it will effectively balance the competing interests of creditors, trustees and debtors in possession in a section of the Bankruptcy Code which, because of the decision by the Fourth Circuit Court of Appeals in Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (1985), cert. denied 475 U.S. 1057 (1986), there is a glaring lack of balance.

The Bankruptcy Code containes few restrictions that limit a debtor's right to reject an executory contract. Under executory contracts, the debtor can, subject to court approval and subject to certain exceptions, assume or reject an executory contract provided that in the debtor's business

judgment the assumption or rejection is in the estate's best interest. Generally, a debtor enjoys material benefits and has material obligations under an executory contract. In the context of intellectual property licenses, when the debtor rejects an executory contract, it avoids its obligation to perform its contractual duties and it loses the benefits it would receive if the other contracting party performed its duties under the license agreement. Because of the development of the system of granting rights for the use of intellectual property, often the licensor's sole responsibilities under the executory contract are to pay royalties and to maintain the confidentiality of the intellectual property. Meanwhile, the licensor enjoys the royalties which the licensee pays for the use of the intellectual property.

The system of licensing the use of intellectual property, rather than transfering ownership, evolved as a method of ensuring that intellectual property would have wide opportunities for development. The Lubrizol decision imperils this system. In Lubrizol, the court permitted Richmond Metal Finishers, the licensor and debtor in possession, to reject its nonexclusive technology-licensing agreement with Lubrizol. The court not only permitted the debtor to reject its future performance obligations, but also permitted the debtor to completely rescind the completed transfer of technology. Under

the Lubrizol decision, the debtor can strip the other contracting party of intellectual property which was transferred long before the debtor filed its bankruptcy petition.

Since § 365 of the Bankruptcy Code was enacted in part to relieve debtors of burdensome obligations of future performance, the Lubrizol decision enables debtor licensors to use this shield against burdensome obligations as a sword to unravel completed transfers of intellectual property. For example, a licensor whose intellectual property has increased in value can in bankruptcy reject an executory contract involving the license of the intellectual property, license use of the intellectual property to another party, and reap substantially higher royalty payments than it reaps under the existing license. The licensor may file bankruptcy to take advantage of this right to rescind which does not exist outside of a bankruptcy proceeding. By rejecting the license, the debtor licensor can deprive the licensee of irreplaceable intellectual property which it has invested in and developed.

Because a debtor licensor can reject an executory contract involving the license of intellectual property and thereby deny the licensee the right to use the intellectual property in the future, licensees face great risk when deciding whether to invest through research and marketing in order to

develop products based upon the license. Because licensees can not be assured that they will be able to retain the intellectual property rights which they have a license to use, their incentives to use the licensed intellectual property to develop products is chilled. Furthermore, as noted above, the Lubrizol decision encourages licensors to file bankruptcy petitions and reject licenses where the intellectual property has substantially increased in value. The proposed amendment is a principaled solution to this problem.

The proposed amendment treats intellectual property rights in a manner which is similar to the manner in which the Bankruptcy Code treats other unique rights such as real property leases. The new bill has been drafted to parallel the existing provisions of 11 U.S.C. § 365(h)(1). Section 365(h)(1) provides that where a debtor lessor rejects an unexpired lease of real property, the lessee may treat the lease as terminated or, alternatively, may remain in possession of the real property for the balance of the lease term and for any renewal or extension of the term that is enforceable under nonbankruptcy law.

In a similar manner, the bill would permit the licensee of intellectual property rights to retain the rights which were conveyed to him prior to the licensor's filing of a bankruptcy petition. If the debtor licensor rejects the license, the

licensee either may treat the executory contract under which the debtor is the licensor of rights in intellectual property as terminated or may retain its rights for the balance of the licensee's term and any renewal or extension thereof. If the licensee elects to retain its rights in the intellectual property, then the licensee must make all payments due under the executory contract for the balance of the term and for any renewal or extension thereof. However, if the licensee elects to retain the rights, it is deemed to waive any offset rights for claims arising out of the rejection of the contract. As a result, the licensee may not offset claims it has arising out of the debtor's nonperformance of its obligations under the executory contract against the licensor's rights to receive royalty payments which might be crucial to its reorganization.

The proposed legislation does an excellent job in establishing a balance between the interests of licensees and debtor licensors. If this bill is enacted, debtor licensors will not be able to unravel transfers of intellectual property which were completed long before the bankruptcy filing. Although the bill eliminates the incentive some debtor licensors face to reject existing licenses in order to execute new, more lucrative licenses, the bill does not hinder the debtor licensor's opportunities to effectively reorganize.

Senator HEFLIN. I would like someone, Mr. Pickitt, Mr. McLaughlin, or your attorney with you, to reply to what Mr. Hahn has said pertaining to this, and what perhaps Mr. Tarkenton said, if there are differences there. What is your position, in regards to Mr. Hahn's bill that the conference has prepared.

Ms. SHEA-STONUM. We appreciate the opportunity to address that question. The introduction of S. 1626 focused attention on the need for legislation. We recognize that the Bankruptcy Code addresses many interests.

What S. 1626 did was to bring interests other than the licensors into focus. We have had a very good working relationship with the National Bankruptcy Conference, with the American Bankruptcy Institute, with the Business Bankruptcy Section of the ABA, with the Patent Section of the ABA, and with the Science and Technology Section of the ABA, which was essentially initiated or kicked off, if you will, by the introduction of S. 1626.

You gentleman did a great service by making people realize there is a problem and that the Senate was interested in paying attention to it. We do, at this point, believe that the revised bill, which is an attachment to Mr. Hahn's testimony, is perhaps a better balancing of all of the interests that are affected by the bankruptcy system. We have worked with staff and I think staff wanted to have a full hearing with respect to this.

We believe, for instance, that the retention of royalties by the debtor in possession is a significant improvement. What we had done, when we had approached this problem initially, was to take the treatment of real estate leases and use that as a paradigm. There are reasons for departing from that paradigm.

It was pointed out to us by both the National Bankruptcy Conference and the Business Bankruptcy Section ABA representatives that if you allow setoff against the royalty stream, you may very well imperil the reorganization process. That was a point that was well made and we accept that.

On the other hand, we have worked with them and pointed out the need to maintain exclusivity. If a license, pre-petition, was an exclusive license the bill, as attached to Mr. Hahn's written statement, would maintain that exclusivity. We think, to effectuate the goals that have been very well stated today by both Mr. Mendell and Mr. McLaughlin, it is very necessary to have licensors and licensees coming to the bargaining table with confidence that the deals they strike will not be undone in bankruptcy.

In short, while we believe that S. 1626, as is presently drafted, would be an improvement over the present situation, we think that the cooperative process which the introduction of S. 1626 kicked off has resulted in an even better solution.

Senator HEFLIN. What about the completed transfer aspect?

Ms. SHEA-STONUM. I am sorry, sir?

Senator HEFLIN. What about the completed transfer aspect, raised by Mr. Tarkenton?

Ms. SHEA-STONUM. Senator, I was counsel of record in the *Lubrizol* case and on the narrow facts, I still believe that that case was wrong. However, what it did was to point out a much broader problem. The *Lubrizol* case dealt with trade secrets, and we believe that

once a trade secret has been disclosed, that disclosure cannot be rescinded.

What the court focused on in *Lubrizol* was the fact that, for instance, in patent licenses and copyright licenses, while the business community perceives of such licenses as completed transfers, when one parses them legally, there is no transfer of property.

What the patent license and the copyright license are are essentially continuing promises not to sue for infringement. The alternative to the license is the assignment, which is a completed transfer. The problem is that the assignment is like surgery with a butcher knife instead of a scalpel. What you have is an all or nothing proposition.

The licensing system has grown up and it allows tremendous flexibility in the development of intellectual property. I think that I should defer to the gentleman from XOMA and from Genentech to talk about the range of possibilities in field-of-use licensing. But field-of-use licensing, in short, allows the most diverse and simultaneous development of the U.S. technological base.

It is the cloud that has been cast over that system by the *Lubrizol* case that we are here to correct. It is not simply the *Lubrizol* case. While we think, on the narrow facts, the *Lubrizol* case is incorrect, we think that other courts, dealing with patent licenses and copyright licenses, have and will continue to reach this same result, unless Congress provides the clarification suggested by the fourth circuit in *Lubrizol*.

We believe that it is a situation where it is an overly literal interpretation of the Bankruptcy Code. We do not believe that Congress, in 1978, intended in any way to disturb the intellectual property licensing system. But the courts look and they see exclusions for real estate leases. They see exclusions for time share arrangements.

The fourth circuit explicitly said, we see all these exclusions. We do not see an exclusion for intellectual property licenses. Go see Congress. The coalition thus is here.

Senator HEFLIN. We will submit questions in writing and we would appreciate your prompt return of those.

I understand there is some testimony from witnesses who were not able to be here, who oppose this legislation. They desire their statements to be made part of the record. Those statements will be made a part of the record.

[The prepared statement of Mr. Hemnes follows:]

TESTIMONY OF
THOMAS M.S. HEMNES
BEFORE
THE SUBCOMMITTEE ON COURTS AND ADMINISTRATIVE PRACTICE
OF THE
SENATE COMMITTEE ON THE JUDICIARY
REGARDING
S.1626

Intellectual Property Bankruptcy Protection Act of 1987

JUNE 10, 1988

SUMMARY OF TESTIMONY

There is no question that the Lubrizol case has created a problem for some intellectual property licensors and licensees. The question is not whether something needs to be done in response, but what, and by whom.

S.1626 (both as originally proposed and in its current working draft) is not the answer. It would create substantial inequities by abrogating the fundamental contract principle of mutuality of obligation. It would interfere with the reorganization of debtors by making it practically impossible for a trustee to reject a wide variety of executory contracts that Lubrizol has not affected. It would, finally, jeopardize trade secret protection presently available for intellectual property.

There are many alternatives to S.1626 that would cause far less harm to fundamental bankruptcy policies. The most equitable solution would be to require bankruptcy courts to consider the impact of rejection on intellectual property licensees before approving rejection, and to structure relief following rejection to minimize the impact on such licensees. This approach could be modeled on Section 1113 of the Bankruptcy Code, which Congress recently enacted to ensure that union members' interests are considered before collective bargaining agreements are rejected.

A second legislative alternative is to permit a licensee to retain rights ("Protected Rights") in intellectual property only where the rights are nonexclusive and are tied solely to the licensee's obligation to pay and to protect the intellectual property. This would leave contracting parties the freedom to decide whether to incorporate such "Protected Rights" into their licenses. When they have done so, the licensee could elect to continue with the Protected Rights following rejection of the over-all license by a trustee for the licensor.

This latter alternative is the closest to S.1626. It would allow parties to provide the certainty against rejection that some licensees demand, but at the same time retain the principle of mutuality of obligation and thereby avoid the inequities and overbreadth of the current bill.

Mr. Chairman:

Please allow me to begin by expressing my appreciation at this opportunity to testify before your Subcommittee regarding S.1626. This is an important bill which would, in my judgment, substantially alter the balance of equities between a debtor in bankruptcy, the debtor's creditors and the debtor's licensees. I hope by means of this testimony to provide information which will assist your Subcommittee in its consideration of this proposed legislation.

By way of introduction, I am an attorney practicing in Boston, Massachusetts, where I am a member of the law firm Foley, Hoag & Eliot. I also teach intellectual property law as a Lecturer at Northeastern University School of Law. I have published numerous articles on a variety of legal subjects. The most pertinent is an article I published last year with one of my colleagues entitled The Bankruptcy Code, The Copyright Act, and Transactions in Computer Software, 7 Computer/Law Journal 327.

I am appearing solely on my own behalf, and not as a representative of any interested group or client.

I. Bankruptcy Policy

S.1626 and the Proposed Bill[1] are a response to a celebrated case decided by the Fourth Circuit Court of Appeals in 1985 entitled Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.[2] In Lubrizol, the debtor (Richmond Metal Finishers ("RMF")) had granted Lubrizol a nonexclusive license to use a proprietary metal coating process. After filing for reorganization under Chapter 11 of the Bankruptcy Code,[3] RMF decided that an exclusive license would fetch a better price for its technology. It therefore petitioned the bankruptcy court under Section 365 of the Bankruptcy Code for leave to "reject" its license to Lubrizol.

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[1] At the suggestion of your staff, my comments will be directed primarily to the most current working draft of S.1626 available to me, a copy of which is attached hereto as Appendix A. I will refer to the bill as introduced as "S.1626" and to the working draft as the "Proposed Bill".

[2] 756 F.2d 1043 (4th Cir. 1985), cert. denied, 106 S.Ct. 1285 (1986), rev'g In re Richmond Metal Finishers, 38 Bankr. 341 (Bankr. E.D. Va. 1984).

[3] 11 U.S.C. §365 (1986) (citations to Title 11 of the United States Code may be referred to hereinafter as the "Bankruptcy Code" or the "Code").

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A contract can be rejected under Section 365 if it is "executory", which generally means that there are material, unperformed obligations on both sides. In the Lubrizol case, RMF was obligated to defend any patent infringement suit regarding the licensed technology, to indemnify Lubrizol for losses caused by any misrepresentation or breach of warranty by RMF, and to give Lubrizol the benefit of a "most favored licensee" clause. Lubrizol was required to pay royalties to RMF based on quarterly written reports. Finding these obligations sufficient to make the license executory, the Fourth Circuit held that the debtor could reject the license and thereafter prevent Lubrizol from using the licensed technology.

There is no doubt the Lubrizol case has created significant hurdles for some vendors and licensees of intellectual property. The possibility that a licensor could file bankruptcy and thereafter cut off a licensee's access to vital technology is very chilling to certain types of business transactions.

It is important, however, that any legislative response to Lubrizol be tailored to the more acute problems created by that case, and not extend its reach to situations in which Section 365 is vital to the reorganization of bankrupt vendors. My basic point is that the Proposed Bill casts its net wider than is necessary to solve the Lubrizol problem.

To make this point it will be necessary to provide a very brief description of the purposes and policies of bankruptcy proceedings. It is a popular misconception to say that bankruptcy proceedings are a debtor's remedy. It is true that some features of bankruptcy proceedings -- notably the "automatic stay" of Section 362 of the Bankruptcy Code -- provide the debtor relief from the immediate demands of its creditors. However, the goal of this relief is not to prevent the creditors from collecting on their claims. Instead, it is to prevent any one of them from collecting disproportionately from the debtor's estate, and to prevent the premature liquidation of particular claims from interfering with the successful reorganization of the debtor.

Thus, bankruptcy actually functions as a clearing house for creditors' claims. Beginning with the proposition that all of the unsecured creditors cannot be paid in full, bankruptcy provides a means to ensure that they are paid ratably and in the largest percentage possible under the circumstances.[4]

The bankruptcy trustee has the responsibility to maximize the value of the debtor's estate and then distribute that value equitably among the creditors. In some cases, the best way to maximize the value of the debtor's estate is to preserve the debtor as a on-going business under Chapter 11 of the Bankruptcy Code; in other cases, liquidation under Chapter 7 is in order. In

[4] See Jackson, Bankruptcy, Non-bankruptcy Entitlements and the Creditor's Bargain, 91 Yale L.J. 857 (1982).

either case, the Trustee has the power and duty to get rid of ("abandon") any property that costs more to maintain than it is worth, since such property represents a net drain on the creditors' recovery. 11 U.S.C. §554.[5]

The debtor's estate includes not only tangible assets such as real estate and personal property, but also all of the debtor's contract rights. Just as an old auto can be far more costly to maintain than it is worth, the cost of compliance with an improvident contract can easily exceed its benefits. It is therefore in the interest of the creditors to "abandon" such a contract by rejection under Section 365. Rejection cuts off the contractual obligee's right to obtain specific performance and thus converts the debtor's obligation to perform into a general unsecured claim which may be treated on a par with other unsecured claims. 11 U.S.C. §502(g). If the trustee did not have the power to reject a burdensome executory contract, then an unsecured obligee under an executory contract would in effect be given a right to drain the debtor's assets to the detriment of other unsecured creditors.

The facts of the Lubrizol case itself provide a good example of how Section 365 of the Bankruptcy Code directly pursues these underlying policies. It will be recalled that the license in that case imposed very limited executory obligations on the debtor RMF, but that they included an obligation to defend patent infringement suits. It is not at all uncommon for the defense of a patent infringement suit to cost between $250,000 and $1.5 million in fees for attorneys, expert witnesses and court costs. If RMF could not have rejected its license to Lubrizol, and if a patent infringement suit were filed regarding the licensed technology, Lubrizol could have compelled RMF to defend the suit. The administrative expense of such a suit could easily wipe out a debtor's entire estate, leaving nothing for its other creditors, while providing a windfall for a licensee such as Lubrizol.

Rejection under Section 365 does not extinguish RMF's obligation to defend our hypothetical patent infringement suit. Instead, it puts the cost of such a defense on a par with RMF's other unsecured obligations. The Bankruptcy Code accomplishes this by preventing Lubrizol from obtaining "specific performance" -- i.e., an order forcing RMF to actually defend the infringement claim -- and substituting instead a general, unsecured claim for the cost of such a defense. See 11 U.S.C. §502(g).

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[5] After the filing of bankruptcy proceedings, the debtor's estate is administered by either a debtor in possession, an independent person (trustee) appointed by the bankruptcy court or, in some jurisdictions, by the United States Trustee. See 11 U.S.C. §§1101(a), 1104, 1501, 15108(a). All three have the same powers for purposes of the matters discussed in this testimony, and all three will be referred to as the "trustee."

The trustee's power to reject a burdensome executory contract under Section 365 is thus central to the administration of a debtor's estate. It is part of the trustee's more general authority (and, indeed, responsibility) to get rid of "property" that is burdensome to the debtor's estate. It is also necessary to the realization of the basic tenet of bankruptcy justice, which is that all creditors of the same class should be treated equally. Trimming the trustee's power makes it harder to administer the estate equitably and reduces the recovery of unsecured creditors.

II. Objections to the Proposed Bill

A. The Proposed Bill Would Create Substantial Inequities

My most fundamental disagreement with the Proposed Bill is that it abrogates one of the basic principles of equity: mutuality of obligation.[6] Under this principle, a debtor that decides to assume an executory contract must first make good any outstanding defaults under the contract and must provide adequate assurance that will perform its future obligations under the contract. 11 U.S.C. §365(b). By contrast, a licensee that elects to "retain" rights under the Proposed Bill is excused from any obligation other than the obligation to make payments, and even this obligation may be subject to the defense that the debtor is materially in default of its obligations.

The Value Added Resale and Distribution Agreement attached as Appendix B provides a vivid example of the inequities that the Proposed Bill would create. This is an actual agreement currently in use.[7] Under it, Vendor appoints Distributor as Vendor's distributor within designated areas for Vendor's computer-aided software engineering ("CASE") program called "Vendor/Work" (Section 3). Vendor also grants Distributor an option to acquire a perpetual, royalty-free license to use and market Vendor/Work if Distributor's royalty payments exceed $XX million (Section 13). Distributor, for its part, agrees to pay Vendor certain up-front fees, plus a sublicense fee for each copy of Vendor/Work that Distributor sells (Section 7). The agreement includes a variety of other mutual obligations, including a complicated interplay of software development, sales and support services (Sections 4 and 5).

Like many distribution and development agreements, this one includes cross-licenses of the parties' intellectual property rights in computer programs and other materials (see Section 2 of the agreement). The Vendor licenses the Distributor to use and to sublicense others to use Vendor's computer programs (Sections 2.3,

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[6] See 2 Collier on Bankruptcy §365.01 at 365-12 (L. King 15th ed. 1987).

[7] For the sake of confidentiality, I have deleted from Appendix B names, schedules and other identifying materials.

2.4, 2.5, and 2.7), and Distributor licenses Vendor to use Distributor's computer programs for Vendor's internal purposes and for research and development purposes (sections 2.1 and 2.2). Because it contains intellectual property licenses, the distribution agreement would clearly fall within the Proposed Bill's definition of an "executory contract under which the debtor is the licensor of rights to intellectual property," regardless of which party went bankrupt.

Bad distribution agreements are, in my experience, a frequent cause of financial difficulty for high technology companies. If Vendor went bankrupt, it is quite possible that Vendor's trustee would wish to reject this agreement. Under the Proposed Bill, Distributor could elect to "retain its rights in the intellectual property" following rejection by Vendor's trustee. This would permit Distributor to continue to exercise its rights to market and sublicense the Vendor's product under Section 2.7 of the agreement for the balance of its term. It is arguable that it would also permit Distributor to exercise its option to acquire a perpetual, royalty-free license under Section 13.

Once the Vendor's trustee had rejected the contract, the trustee would have no continuing obligation under the Proposed Bill to perform executory obligations such as training, enhancements, technical support, and software maintenance services. On the other hand, such services are required by Section 5 of the agreement, and Vendor's failure to perform such obligations would therefore constitute a breach of the agreement by Vendor.[8] Under section 9.2.2 of the agreement, Distributor could use this breach to terminate the license granted by Sections 2.1 and 2.2 of the agreement to use Distributor's technology for development and other purposes. Distributor could also use the breach to terminate its own obligations to meet sales targets under Section 4.4 of the agreement, to service Vendor's customers under section 4.5 of the agreement, and even to pay royalties owing under Section 7.

Vendor's right of access to Distributor's technology, Distributor's obligation to sell Vendor's product and Distributor's obligation to service Vendor's customers were undoubtedly important considerations in setting the amount of royalties payable under the license. For this reason, Distributor's obligation under the Proposed Bill's Subsection 365(h)(3)(B) (hereinafter "Proposed Section 365, etc.") to continue to make payments under the license would give Vendor far less than the benefit of its bargain.

The existence of a distributor having such a sweetheart deal would be unfair to the debtor and its other distributors and other

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[8] S.1626 seems to imply that the licensee cannot treat the rejection of an executory intellectual property license as a breach under Section 365(g) of the Bankruptcy Code if the licensee has elected to retain rights under Proposed Section 365(h)(1).

creditors. It is the last thing that a bankrupt intellectual property licensee needs, and yet it is exactly what the Proposed Bill would create.

Inequities of this type would be common if the Proposed Bill were enacted into law. They would arise whenever part of the consideration for an intellectual property license is a cross-license, an obligation to market a product, an obligation to perform development services, or any other nonmonetary benefit to the licensor. In my experience, such features are the rule and not the exception in intellectual property licensing.[9]

To give another example of the inequities the Proposed Bill would cause, I have attached as Appendix C a second license agreement entitled "Agreement for ABC Software Systems." This is another real agreement, currently in use, from which identifying materials have been deleted. Under the agreement, ABC, the licensor, permits the licensee to use certain computer programs created by ABC. The agreement also grants the licensee a sublicense covering an underlying program, which I have called, for the sake of confidentiality, the Model XXX.

The failure of the Proposed Bill to address the licensee's continuing obligations (other than for payment) would cause substantial inequities in connection with Sections 7 ("Warranties; Limitations"), 8 ("Patent and Copyright Indemnification") and 9 ("Term; Termination") of this agreement. All of these are absolutely standard terms in intellectual property licenses.

As to Sections 7 and 8, the basic question is whether these provisions survive the process of rejection followed by a retention of rights. It seems clear that the licensee could not get specific performance of the debtor's obligations to "correct or replace" software under its warranty obligations in Section 7, and to defend certain claims under Section 8. The more difficult question, though, is whether the debtor's failure to meet these obligations could be asserted as an affirmative defense by the licensee in an action by the debtor for payments due under Proposed Section 365(h)(3)(B). If the debtor's default under such clauses provides a defense, then as a practical matter Proposed Section 365(h)(3)(B) is likely to become a dead letter and licensees will usually exercise their rights under the Proposed Bill for free. If the default does not provide a defense, then the requirement of payment under Proposed Section 365(h)(3)(B) will in many cases require licensees to make payments even under circumstances where the licensed intellectual property proves to

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[9] By contrast, payments "in kind" are, I believe, rare in real estate leasing and time share interest transactions. For this reason, the provisions of Section 365(h) of the Code regarding real estate leases and time share interests (on which the Proposed Bill appears to be modeled) cause far fewer inequities than the Proposed Bill would cause.

be worthless because of warranty defects or infringement liability to third parties.

Section 9 is also highly problematic under the Proposed Bill. The question is whether the debtor retains its right to terminate the contract under Section 9.2 on the ground of the licensee's default, and whether, in the event of such termination, the debtor can compel the licensee to cease using the intellectual property under Section 9.3. Suppose, for example, that the licensee makes all payments due under the contract in compliance with Proposed Section 365(h)(3)(B), but improperly decomplies object code (i.e., takes the program apart to see how it works) in violation of Section 6.5 of the contract. Can the debtor terminate the licensee's retention of rights under Proposed Section 365(h)(1)?

This question raises the more general issue left entirely undecided by the Proposed Bill: whether a licensee who has elected to retain rights is bound by the rejected license agreement, or whether the licensee instead enjoys a statutory right to use certain property subject to a sort of compulsory license fee. If there is an enforceable agreement, then what the Proposed Bill really means is that contracts that include intellectual property licenses cannot be rejected without the consent of the nonbankrupt contracting party. On the other hand, if there is not a contract, then the Proposed Bill leaves the trustee for the licensor completely without any remedy for breaches by a licensee who has elected to retain rights, with the sole exception of breaches caused by failure of the licensee to pay.

B. The Proposed Bill Is Overbroad

As applied to a simple license of the type involved in Lubrizol, the Proposed Bill is not a bad piece of legislation. It would have allowed RMF's trustee to "reject" the license, thus converting Lubrizol's potential claims for infringement defense and indemnification into general, unsecured claims that can be paid out of the debtor's estate proportionately with other such claims. At the same time, it would have permitted Lubrizol to elect to continue to use the licensed technology on a nonexclusive basis, as long as Lubrizol paid the royalties it had agreed to pay.[10] Altogether a very fair-seeming result.

Unfortunately, simple licenses of the type involved in Lubrizol are the exception rather than the rule. Intellectual property rights permeate modern commercial transactions. There is scarcely an asset purchase agreement, a research and development contract, a distributorship agreement, or even a contract for the sale of goods that does not include a license of intellectual property. H.R. 4675 would make many of these agreements difficult

[10] As discussed above, Lubrizol might have escaped its obligation to pay by forcing RMF to sue and then asserting the affirmative defense that RMF was in breach of its obligations under the contract.

for a trustee to reject. In the vast majority of such transactions, outright termination of the non-bankrupt party's right to use licensed technology is unlikely to be fatal to the licensee. At the same time, interference with the debtor's inability to reject such contracts can be potentially catastrophic to the successful reorganization of the debtor.

The distributorship agreement attached as Appendix B is an example of a contract to which the Proposed Bill should not, but does, apply. It has already been observed that the Distributor could elect to retain its right to sublicense Vendor's product following rejection of the contract by Vendor's trustee. In exchange, Distributor would be required to continue to make payments owing under the contract, but it would probably be excused from its obligations to meet sales targets and to provide adequate service to Vendor's customers.

In effect, the Proposed Bill would give the distributor a statutory sinecure within the geographic area covered by the distributorship agreement. As a practical matter, the existence of an entrenched distributor able to sell Vendor's program at a low royalty rate without any marketing or service obligations would make it virtually impossible for the trustee to negotiate a better distributorship arrangement with anyone else within Distributor's territory. Depending on the size of the distributor's territory, the trustee's hands could be tied so completely that it would spell the death knell for the Vendor's reorganization. The only alternative would be for the trustee to affirm the distributorship agreement -- which could well be one of the business mistakes that forced Vendor into bankruptcy proceedings in the first place.

A research and development joint venture is another example of a transaction to which the Proposed Bill would inappropriately apply. In such an arrangement, each of the contracting parties might license the others to use of its intellectual property for research and development purposes. The essence of the transaction is an agreement to pool technology and then share in the intellectual property rights to any new developments. If one of the parties to such an arrangement went bankrupt and attempted to avoid its executory obligations by rejection, the other parties could elect to retain their licenses of the bankrupt party's intellectual property. At the same time, they could refuse to share the results of their research and development activities on the ground that the bankrupt had failed to meet its executory obligations for research and development.

In short, in the context of a research and development joint venture of the type described above, the Proposed Bill would present the trustee with a choice between allowing the other parties to raid the debtor's storehouse of intellectual property without obligating them to grant any rights in return, or affirming the contract and incurring research and development expenses as an administrative expense of the debtor's estate.

Either alternative could be damaging to the debtor's chances at reorganization and highly unfair to the debtor's other creditors.

C. The Proposed Bill would Jeopardize Rights in Intellectual Property and Chill Sublicensing

One of the most important executory obligations imposed by typical intellectual property licenses is the obligation to protect the licensed technology as confidential information (i.e., as a trade secret). An example of a clause imposing this obligation is Section 6 of the agreement I have attached as Appendix C.

The Proposed Bill gives no assurance that the licensee would be required to abide by confidentiality obligations such as those found in Section 6. Instead, protection of the trade secret status of the licensed programs would require a petition for relief under Section 107(b) of the Bankruptcy Code.

While it might be argued that it would not be particularly unfair or burdensome to require the debtor to take the affirmative step of filing such a petition, it seems highly unreasonable to impose this burden -- as well as the risk that the court might deny the petition -- on the "prime" licensor DEF Corporation, which is neither bankrupt nor a party to the bankruptcy proceedings.

In the case of the actual business transaction to which Appendix C relates, the sublicensed program called Model XXX is a highly confidential and valuable database management system, individual licenses for which cost in excess of $100,000. It is unthinkable that DEF Corporation would permit ABC Systems to sublicense this program if there would be the slightest chance that the sublicensee could continue to use it without being bound by Section 6 of this Agreement.

Sublicensing of the type found in this agreement is very common. By jeopardizing the ability of the ultimate licensor to protect its technology in the hands of sublicensees, the Proposed Bill would tend to discourage sublicensing and thus interfere with transactions of the very type it is intended to facilitate.[11]

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[11] The distribution agreement attached as Appendix B raises a related problem under the Proposed Bill: how to deal with a contract that covers both "intellectual property" as defined in Proposed Section 365(h)(6) and trademark rights. The Proposed Bill does not include trademarks within its definition of intellectual property. Thus, Distributor could not elect to retain its license of Vendor's trademarks under Section 2.8 of the agreement. However, Section 2.7.2 of the agreement requires Distributor to use Vendor's trademarks in marketing the licensed

(footnote continued)

III. Alternatives to the Proposed Bill

For the reasons described above, I am persuaded that the Proposed Bill would create many more problems than it would solve. There are several alternatives to the Proposed Bill that would, in my judgment, address the problems created by Lubrizol with far less collateral damage to other important bankruptcy concerns.

The first alternative is to do nothing. This is not as bad as it sounds. It would give the courts and attorneys for licensees and licensors more time in which to devise accepted means of accommodating the needs of intellectual property licensees within the existing framework of bankruptcy proceedings.

We have already begun to see this process working itself out. Some courts have shown themselves willing to curtail the trustee's power of rejection in situations where rejection would cause more harm to the licensee than it would cause benefit to the estate of the debtor.[12] At the same time, the escrow agreement -- under which the licensor's intellectual property, or embodiments of it, is placed in the hands of an escrow agent for distribution to licensees in the event of the licensor's default -- is undergoing a process of refinement that promises to make it a more effective barrier against bankruptcy trustees.[13] Notable refinements include coupling the escrow with a security interest, or styling it a trust agreement, under which the trustee holds a security interest in the licensor's intellectual property and acts very much like the traditional indenture trustee.

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product. Does this mean that Distributor can elect to continue to use the trademarks even though the Distributor has no continuing obligation to comply with Vendor's quality standards, including those in Section 4 of the agreement? This could result in the granting of a "naked" license that would void vendor's trademark rights. Or does it mean that Distributor cannot elect to continue to sublicense Vendor's programs, notwithstanding an election to retain such rights? Or does it mean that Distributor may begin applying some other trademark to Vendor's products? Any one of these alternatives seems equally undesirable.

12 See, e.g., In re Chi-Feng Huang, 23 Bankr. 798 (9th Cir. 1982); In re Select-a-Seat Corp., 256 F.2d 290 (9th Cir. 1980)(rejection allowed, but licensee's right to use technology unaffected), Infosystems Technology, Inc. v. Logical Software, No. 87-0042, slip op. (D. Mass. June 27, 1987), In re Meehan, 59 Bankr. 380 (E.D.N.Y. 1986); In re Midwest Polychem, Ltd, 61 Bankr. 559 (Bankr. N.D. Ill. 1986); In re Chipwich, Inc. 54 Bankr. 427 (S.D.N.Y. 1985); In re Turbowind, Inc. 42 Bankr. 579 (Bankr. S.D. Cal. 1984); In re Petur U.S.A. Instrument Co., Inc., 35 Bankr. 561 (Bankr. W.D. Wash. 1983).

13 See Matter of Newcomb, 744 F.2d 621 (8th Cir. 1984), for an example of a case finding an escrow agreement enforceable against a trustee in bankruptcy.

The objection to this most conservative alternative is not that it will not work: I am confident that it will work, eventually. The objection, rather, is that it will take time. There is a strong -- and probably well-founded -- sense within the intellectual property bar that some more immediate relief is required.

To the extent that quicker relief is needed, a more balanced legislative reaction could be modeled on the protection for collective bargaining agreements found in Section 1113 of the Bankruptcy Code. Thus, Congress could require bankruptcy courts to consider the impact of rejection of an intellectual property license on the licensee before approving rejection, and allow the licensee to continue to use the licensed property for limited periods or under limited conditions if necessary to mitigate the damage caused by rejection.

The foregoing alternative has the advantage of giving the bankruptcy court the greatest possible latitude in which to find a solution that is fair to all. On the other hand, it has the disadvantage of unpredictability. Some licensees may feel that they cannot tolerate even a remote possibility that a court might hold against their right to continue to use licensed technology. The mere chance of an unfavorable result would, it is argued, chill licensing in a wide range of transactions.

I believe that arguments of this type reflect a desire by licensees for Congress to provide more certainty than is realistically attainable in the context of bankruptcy proceedings. However, it is possible to structure a legislative response that would provide a larger measure of certainty than one modeled on Section 1113 of the Bankruptcy Code.

The basic error committed by the Proposed Bill is that it assumes that one can extract a simple, essentially nonexecutory license (a right to use, coupled with an obligation to pay) from every license agreement. As the examples I have given demonstrate, this simply is not the case. By imposing such a license on parties who have not agreed to it, the Proposed Bill violates the principle of mutuality of obligation. This results in the bill's proclivity for inequitable results.

A better approach would be to give the licensee an option to retain its rights under a simple, nonexecutory license only where the parties have already incorporated such a license into their business relationship. This could be accomplished by permitting a licensee to retain its licensed rights only if they meet certain criteria.

I would suggest the following criteria for a licensed right of the type that a licensee could elect to retain following

rejection (hereinafter, a "Protected Right"): a nonexclusive[14] right to use or to license others to use intellectual property owned by the licensor under which the licensor's only substantial executory obligation is to permit the licensee to exercise such right and the only grounds on which such right may be terminated are the licensee's failure to make payments or failure to protect the property against loss or misappropriation (e.g., by failing to place appropriate copyright notices on copies of the property or by failing to comply with nondisclosure or noncompetition obligations).

Given this definition, Section 365 could provide that wherever a contract that includes such a Protected Right has been rejected by a trustee for the licensor, the licensee may elect to retain the Protected Right. Upon such election, the provisions of the rejected contract creating such a right and the associated obligations to pay and to protect the licensed intellectual property would be severed from the balance (if any) of the agreement and remain in full force and effect, notwithstanding the rejection of the agreement.

Such a provision would have the certainty that is provided by the Proposed Bill. It would also have many advantages over the Proposed Bill. It would, in the first place, avoid the inequities the Proposed Bill would create by preserving the principle of mutuality of obligation. It would also avoid the overbreadth of the Proposed Bill because licensors would be unlikely to agree to the creation of a "Protected Right" in highly interdependent contexts such as distributorships and research and development projects where a substantial portion of the consideration for the license grant is nonmonetary. It would, finally, protect "prime" licensors' rights in their intellectual property by requiring sublicensees who wish to be protected from rejection to obtain a

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[14] The nonexclusive right could be a part of a larger exclusive license. I would not, however, protect the right of exclusivity against rejection for several reasons. First, outstanding exclusive rights are likely to constrain a trustee's efforts at reorganization much more than outstanding nonexclusive rights. Second, the principal fear of licensees under Lubrizol is loss of access to license technology; preserving a nonexclusive right would be sufficient to address this concern. Third, there are a variety of means by which exclusive licensees can protect themselves under existing law. An exclusive license of a copyrighted work can probably be protected against a bankruptcy trustee by recording under Section 205 of the Copyright Act. An exclusive patent or trade secret license can be recorded as a transfer, with the licensor/transferor retaining a reversionary interest, secured by a security interest. Fourth, where an exclusive licensee fails to avail itself of these means of protection, it should not be protected against rejection any more than a secured party that fails to perfect its security interest should be protected against being treated as an unsecured creditor.

separate license from the prime licensor (just as a real estate lessee obtains a separate "ground lease" from its ultimate lessor).

In sum, the proposed creation of a category of "Protected Rights" would invite businesses to decide for themselves and in advance of bankruptcy whether it is commercially reasonable (and therefore equitable) to create the kind of right the Proposed Bill would impose on them by legislative fiat. It is respectfully submitted that this would be manifestly more equitable and workable than it would be for Congress to decide for the parties what is best for them, which is exactly what the Proposed Bill purports to do.

IV. Conclusion

To paraphrase Samuel Johnson, the possibility of bankruptcy concentrates a licensee's mind wonderfully. Lubrizol is a sobering reminder that it is dangerous for any business to become entirely dependent on a single vendor, or on a single item of licensed technology.

Considered in the long run, I am not sure that this is a bad thing. Neither S.1626, the Proposed Bill, nor any of the alternatives that I have described above, could protect an intellectual property licensee against the loss of support, consultation, maintenance, updates, enhancements, improvements, and a host of other routine services that a bankrupt licensor can no longer afford to provide. Preservation of a licensee's right to use licensed technology under any of these alternatives will in many cases provide no more than a breathing space within which the licensee must find alternative sources of technological support.

The Proposed Bill would purchase some relief for licensees, but at too high a cost. I respectfully submit that either of the two alternatives described above would strike a better balance between the interests of intellectual property licensees, a bankrupt licensor, and the bankrupt's creditors.

Thank you again for giving me this opportunity to share my views with your Subcommittee.

Appendix A

"(h)(1) If the trustee rejects an unexpired lease of real property of the debtor under which the debtor is the lessor, a timeshare interest under a timeshare plan under which the debtor is the timeshare interest seller, or an executory contract under which the debtor is the licensor of rights to intellectual property, the lessee, timeshare interest purchaser, or licensee under such lease, timeshare plan, or executory contract may treat such lease, timeshare plan, or executory contract as terminated by such rejection, where such rejection by the trustee amounts to such a breach as would entitle the lessee, timeshare purchaser, or licensee to treat such lease, timeshare plan, or executory contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or other agreement that the lessee, purchaser, or licensee has made with other parties. In the alternative, the lessee or purchaser may remain in possession of the leasehold or timeshare interest under any lease or timeshare plan the term of which has commenced for the balance of such term and for any renewal or extension of such term that is enforceable by such lessee or purchaser under applicable nonbankruptcy law; or, the licensee may retain its rights to the intellectual property, as it existed at the filing of the petition, under such executory contract for the balance of the term and any renewal or extension of such term that is enforceable by such licensee under applicable nonbankruptcy law, except, other than as provided in this subsection, for any right to compel specific performance by the trustee.

(2) [As enacted]

(3) If such licensee of intellectual property retains its rights as provided in paragraph (1) of this subsection --

(A) the extent, nature, and quality of such rights shall be the same as provided in such executory contract; and

(B) such licensee shall continue to make all payments due under such executory contract for the balance of the term and for any renewal or extension thereof and shall be deemed to have waived --

(i) any rights of offset it may have with respect to such executory contract; and

(ii) any claims it may have under § 503(b) of this title with respect to such executory contract other than claims against the estate for the trustee's failure to comply with the requirements of this subsection.

(4) Unless and until the trustee rejects an executory contract under which the debtor is the licensor of intellectual property, on written request to the trustee from the licensee, the trustee shall --

(A) To the extent provided in such executory contract, either (i) perform or, in the alternative, (ii) disclose or turn over to the licensee any intellectual property held by the ~~estate~~ trustee; and

ipso such provisions

(B) Not interfere with the rights of the licensee as provided in such executory contract or associated agreement (i) to use the intellectual property, or (ii) to obtain the intellectual property from a third party.

(5) Upon rejection of an executory contract under which the debtor is the licensor of intellectual property and a retention of rights by the licensee as provided in paragraph (1) of this subsection, on written request to the trustee from the licensee, the trustee shall --

(A) To the extent provided in such executory contract, disclose or turn over to the licensee any intellectual property held by the ~~trustee~~ trustee; and

(B) Not interfere with the rights of the licensee as provided in such executory contract or associated agreement (i) to use the intellectual property, or (ii) to obtain the intellectual property from a third party.

(6) In this section, "intellectual property" means, to any extent protected by applicable nonbankruptcy law, --

(A) trade secrets;

(B) confidential research, development, or commercial information;

(C) patents;

(D) copyrights;

(E) mask works;

(F) plant variety protection certificates; or

(G) embodiments of any of the above.

Appendix B

VALUE ADDED RESALE AND DISTRIBUTION AGREEMENT

This Agreement made this _____ day of _____, 198_, by and between Vendor Technologies Inc. (hereinafter "Vendor"), a corporation incorporated under the laws of the State of Delaware, United States of America, having its principal place of business at _____, and Distributor, Inc. (hereinafter "Distributor"), a corporation organized and existing under the laws of _____, having its principal place of business at _____.

W I T N E S S E T H:

WHEREAS, Vendor is engaged in the design and manufacture of "Vendor/WORK" (as hereinafter defined) and has the right to grant licenses and appoint distributors therefor;

WHEREAS, Distributor is engaged in the design, manufacture and marketing of "Product" (as hereinafter defined);

WHEREAS, Distributor desires to act as non-exclusive distributor of Vendor/WORK in connection with Product in "Region A" and "Region B" (as hereinafter defined); and

WHEREAS, Vendor and Distributor desire to develop modifications and enhancements to Vendor/WORK and Product that will result in the increased value of Vendor/WORK and Product;

NOW, THEREFORE, for and in consideration of the mutual promises and covenants herein contained and other good and valuable consideration, the parties hereto agree as follows:

1. Definitions

1.1. "Vendor Development Materials" shall mean the materials listed in Schedule A, Part 2.

1.2. "Customers" shall mean end users of Vendor/WORK in Region A or Region B.

1.3. "Connecting Software" shall mean software developed by Distributor, which shall accomplish the following:

1.3.1. Generate Product schemas from Vendor/WORK/IM models;

1.3.2. Integrate new data dictionary forms into Vendor/WORK in order to collect Product-specific information and add to Product design database; and

1.3.3. Port Product used with Vendor/WORK to the hardware platforms identified in Schedule A, Part 1.

1.4. "Internal Copies" shall mean a copy or copies of Vendor/WORK provided to Distributor or a copy or copies of Product or Connecting Software provided to Vendor, where such copies are provided solely for internal operation pursuant to the licenses granted in Sections 2.2 and 2.4.

1.5. "Product" shall mean the products of Distributor listed in Schedule B, Part 1.

1.6. "Region A" shall mean the countries identified in Schedule D, Part 1.

1.7. "Region B" shall mean the countries identified in Schedule D, Part 2.

1.8. "Distributor Development Materials" shall mean the materials listed in Schedule B, Part 2.

1.9. "Software License Agreement" shall mean an agreement substantially in the form attached hereto as Schedule C, as such form may be amended by Vendor from time to time, or such other form satisfactory to Vendor.

1.10. "Vendor/WORK" shall mean the products of Vendor listed in Schedule A, Part 1 in object code.

1.11. "Vendor/WORK Source Code" shall mean Vendor/WORK written in higher-level programming languages, which are intelligible to trained programmers and may be translated into object code for operation on computer equipment through the process of compiling. Vendor/WORK Source Code shall not include code that Vendor licenses from other persons, but does not own all rights to, regardless of whether Vendor incorporates such code into Vendor/WORK.

1.12. "Trademarks" shall mean the trademarks Vendor/WORK, Vendor/WORK/SA, Vendor/WORK/RT, Vendor/WORK/SD, Vendor/WORK/ACCESS and Vendor/WORK/IM.

2. Licenses

2.1. Distributor hereby grants to Vendor and Vendor hereby accepts a non-exclusive license to operate Distributor Development Materials, Connecting Software and Product for the purpose of developing integration and porting facilities for Vendor/WORK and Product.

2.2. Distributor hereby grants to Vendor and Vendor hereby accepts a non-exclusive, perpetual license to operate Product and Connecting Software Internal Copies solely for purposes of Vendor's internal use and Vendor/WORK development, provided that:

2.2.1. Vendor shall not copy, modify, market, sell, license, sublicense, publish, timeshare or disclose any Product Internal Copies;

2.2.2. Vendor shall pay Distributor an annual maintenance fee at the rate set forth in Schedule H for each copy of Product Internal Copies; and

2.2.3. Vendor shall perform obligations substantially the same as the obligations of the Licensee under the Software License Agreement in the form attached hereto as Schedule C as to each copy of Internal Copies. Vendor hereby agrees that so long as it possesses or controls Internal Copies it shall be bound by the Software License Agreement attached hereto as to each such copy as if it had executed such agreement separately for each copy of Internal Copies and its obligations under such agreement shall survive expiration or termination of this Agreement for any reason.

2.3. Vendor hereby grants to Distributor and Distributor hereby accepts a non-exclusive license to operate Vendor Development Materials for the following sole purposes:

2.3.1. developing Connecting Software and Connecting Software and Product modifications and enhancements;

2.3.2. providing Vendor with the following support services related to Connecting Software and Product: debugging, telephone assistance with software operation, maintenance and updating; and

2.3.3. developing or using integration or porting facilities for Connecting Software and Product.

2.4. Vendor hereby grants to Distributor and Distributor hereby accepts a non-exclusive, perpetual license to operate Vendor/WORK Internal Copies solely for purposes of Distributor's internal use and Connecting Software and Product development, provided that:

2.4.1. Distributor does not copy, modify, market, sell, license, sublicense, publish, timeshare or disclose any Internal Copies;

2.4.2. Distributor pays Vendor an annual maintenance fee at the rate set forth in Schedule G, Part 3 for each copy of Internal Copies; and

2.4.3. Distributor performs obligations substantially the same as the obligations of the Licensee under the Software License Agreement attached hereto as Schedule C as to each copy of Internal Copies. Distributor hereby agrees that so long as it possesses or controls Internal Copies it shall be bound by the Software License Agreement attached hereto as to each such copy

as if it had executed such agreement separately for each copy of Internal Copies and its obligations under such agreement shall survive expiration or termination of this Agreement for any reason.

2.5. Vendor hereby grants to Distributor and Distributor hereby accepts a non-exclusive license to operate Vendor/WORK Source Code for the following sole purposes:

2.5.1. providing Vendor with back-up support services;

2.5.2. facilitating integration of Vendor/WORK with Product or porting Product to the Vendor/WORK hardware platforms identified in Schedule A, Part 1; and

2.5.3. developing Product modifications and enhancements;

and provided that:

2.5.4. Distributor does not allow access to Vendor/WORK Source Code to anyone other than its employees and Distributor only allows access to its employees who have signed express written agreements not to disclose Vendor/WORK Source Code, which agreements shall be in a form acceptable to Vendor;

2.5.5. Distributor does not copy, modify, market, sell, license, sublicense, timeshare, publish or disclose any Vendor/WORK Source Code;

2.5.6. Distributor does not acquire rights in or to software similar to or competing with Vendor/WORK;

2.5.7. Distributor is not acquired by or merged with a company in competition with Vendor or which produces, markets or distributes software similar to or in competition with Vendor/WORK;

2.5.8. Distributor uses its best efforts to prevent access to or disclosure of Vendor/WORK Source Code to Vendor's competitors, including taking all appropriate actions and precautions; and

2.5.9. During the term of this Agreement and for three years immediately following the expiration or termination of this Agreement for any reason, Distributor does not develop, market or distribute any software similar to or in competition with Vendor/WORK.

2.6. Distributor has no right to use Vendor/WORK Source Code, other than as specifically provided in Section 2.5.

2.7. Vendor hereby grants to Distributor and Distributor hereby accepts a non-exclusive license to demonstrate, market and sublicense Vendor/WORK in Region A and Region B in accordance with Schedule D, Part 3, provided that:

2.7.1. Distributor only sublicenses Vendor/WORK in accordance with the terms and conditions of the Software License Agreement;

2.7.2. Distributor only markets Vendor/WORK in connection with Trademarks; and

2.7.3. Distributor only markets Vendor/WORK in connection with Product or Connecting Software.

2.8. The license granted in Section 2.7 shall also include the right to use Trademarks in connection with marketing of Vendor/WORK provided that:

2.8.1. Distributor shall only use Trademarks in connection with Vendor/WORK provided by Vendor and in accordance with Section 8;

2.8.2. such use of Trademarks shall inure to the benefit of Vendor; and

2.8.3. Trademarks shall remain the exclusive property of Vendor.

2.9. Either party may grant to the other party a license to operate, market or distribute other products as existing or may be developed, provided that the parties first agree to price and other terms and conditions.

3. Appointment and Acceptance

3.1. Vendor hereby appoints Distributor as its distributor for Vendor/WORK subject to the terms and conditions of this Agreement.

3.2. Distributor accepts this appointment and agrees to use its best efforts to promote vigorously the marketing and distribution of Vendor/WORK within Region A and Region B.

4. Distributor Obligations

4.1. Distributor represents that it has and shall maintain for the term of this Agreement the facilities, personnel, knowledge, experience and skill necessary: to develop Connecting Software; to market Vendor/WORK, Connecting Software and Product; to provide services to Customers; and to otherwise carry out its obligations under this Agreement.

4.2. Distributor shall provide Vendor with a reasonable number of Product and Connecting Software Internal Copies, at no license fee to Vendor.

4.3. Distributor shall provide Vendor with adequate Distributor Development Materials and Product and Connecting Software copies and information, including modifications, enhancements and updates.

4.4. Distributor shall at its sole expense provide marketing and sales services in Region A and Region B in accordance with the sales plan attached hereto as Schedule E, including the sales targets and milestones set forth therein, and Schedules D and G.

4.5. Distributor shall at its sole expense provide software maintenance services to Vendor/WORK Customers generally consistent with the training and maintenance offered by Vendor to its domestic customers and at least of the scope of the services described in Schedule F.

4.6. Distributor shall maintain adequately configured computer systems to demonstrate Vendor/WORK.

4.7. Distributor shall develop Connecting Software.

5. Vendor Obligations

5.1. Vendor shall provide training in _____ as follows: (a) Vendor shall conduct at no charge two courses for a maximum per course of ten core sales and technical specialists appointed by Distributor and (b) Vendor will provide additional courses at Vendor's current price for such courses. Distributor will be responsible for all specialists' salary, travel and living expenses related to training.

5.2. Vendor shall provide Distributor with a reasonable number of Vendor/WORK Internal Copies, at no license fee to Distributor.

5.3. Vendor shall provide Distributor with adequate Vendor Development Materials and Vendor/WORK copies and information for the uses provided in Section 2.3, including providing modifications, enhancements and updates.

5.4. Vendor shall provide to Distributor back up Customer technical support from Vendor's main office in _____, including providing hot line technical support to Distributor's designated technical support personnel during regular business hours. Vendor shall provide sales support to Distributor's designated sales and technical personnel as set forth in Schedule E.

5.5. At Distributor's request and subject to Customer agreeing to Vendor's standard maintenance agreement, Vendor shall provide software maintenance services for a maximum of one year to Customers that sublicense Vendor/WORK from Distributor, provided that such Customers shall pay appropriate maintenance fees to Vendor and Distributor shall not share in such fees. Maintenance services provided to Customers by Vendor shall be at least of the scope of the services described in Schedule F.

5.6. In order to minimize sales channel conflicts in Region A, Vendor shall pay to Vendor sales personnel commissions, at a rate in accordance with current Vendor practices, for orders in Region A taken by Distributor's sales personnel. Distributor agrees to provide Vendor with the necessary customer information to accurately calculate such commissions to Vendor's sales force and Vendor agrees that such Distributor customer information will be considered confidential.

5.7. Until March 30, 1990, in order to minimize sales channel conflicts in Region B, Vendor shall pay distributors in Region B an amount equal to 15% of a Customer's sublicense fee for each order in Region B taken by Distributor's sales personnel. Distributor agrees to pay Vendor an amount equal to 15% of a Customer's sublicense fee for each such order taken by Distributor in Region B, which amount shall be in addition to payments made under Section 7.

6. Order Procedure and Terms

6.1. Orders for Vendor/WORK on appropriate Vendor order forms shall be placed by Distributor with Vendor. After buy down of prepaid sublicense fees that are prepaid pursuant to Section 7.3, Distributor will make payment to Vendor within 30 days after the date of invoice for Vendor/WORK shipped to Distributor by Vendor. Distributor will provide financial statements and references for the establishment of its initial credit line. Vendor may revoke such open account terms should Distributor fail to make payments according to the terms set out above or fail to provide satisfactory financial statements or references, in which event Vendor may require Distributor to accompany its orders with irrevocable letters of credit or impose such other terms as Vendor may deem advisable.

6.2. All shipments of Vendor/WORK shall be F.O.B. Vendor's facility. Distributor will assume all risks of loss or damage upon delivery to the carrier at the point of shipment. Unless Distributor provides specific shipping instructions at the time of order, Vendor will select the carrier and ship on behalf of Distributor to the address set forth in this Agreement. All arrangements for transportation and insurance will be made by Vendor for Distributor's account.

6.3. Vendor reserves the right to cancel any orders placed by Distributor and accepted by Vendor as set forth above, or to refuse or delay any shipment thereof, if Distributor (a) fails to make any payment as provided in this Agreement or in the terms of payment set forth in any invoice or otherwise agreed to by Vendor and Distributor, (b) fails to meet reasonable credit or financial requirements established by Vendor, including any limitations on allowable credit, or (c) otherwise fails to comply with the terms and conditions of this Agreement. The parties agree that Vendor will not provide outdated versions of Vendor/WORK or other Vendor products. If an order is cancelled by Vendor because the requested product is outdated, such cancellation will not be considered a termination (unless Vendor so advises Distributor) or breach of this Agreement by Vendor.

7. Prices, Payment and Prepayment

7.1. Vendor shall invoice Distributor at time of shipment, F.O.B. Vendor's facility in Rhode Island, for all Vendor/WORK shipped. Vendor/WORK sublicense prices and maintenance fees shall be as set forth in Schedule G payable net 30 days, which prices may be revised by Vendor from time to time and which include packaging, but do not include prepaid insurance or transportation charges. In the event that Vendor pays insurance or freight charges, such charges will be invoiced with the software, payable net 30 days.

7.2. Vendor shall have no liability for any sales, property, use or other taxes, customs charges, import fees or other costs assessed or charged by any governmental authority with respect to any sale or licensing of Vendor/WORK hereunder, and Distributor shall indemnify and hold Vendor harmless from and against any liability or obligation therefor.

7.3. Distributor shall prepay Vendor/WORK sublicenses as follows: $X00,000 due and payable upon execution of this Agreement and $X00,000 due and payable upon first shipment of Vendor/WORK, but not later than December 31, 1988.

7.4. Distributor shall annually provide to Vendor audited verification of maintenance fees collected by Distributor.

8. Proprietary Rights

8.1. Distributor acknowledges that all title and interest, including all copyrights, in Trademarks, Vendor/WORK, Vendor/WORK Source Code and Vendor Development Materials are the exclusive property of Vendor. Distributor also acknowledges that Vendor/WORK, Vendor/WORK Source Code, Vendor Development Materials and any other materials received by Distributor and identified by Vendor as proprietary or confidential are proprietary and trade secrets of Vendor (hereafter "Vendor Proprietary Material").

8.2. Distributor agrees not to disclose Vendor Proprietary Material and neither to do nor to permit any act which may in any way jeopardize or be detrimental to the validity of Vendor's patents, copyrights, trade secrets or other rights in Vendor/WORK, Vendor/WORK Source Code, Trademarks, Vendor Development Materials or Vendor Proprietary Material.

8.3. Distributor shall take reasonable precautions to maintain the confidentiality of Vendor Proprietary Material and to protect Vendor's copyrights, patents and trademark, including taking such steps as Distributor takes to protects its own confidential information, copyrights, patents and trademarks.

8.4. No Vendor/WORK shall be transferred to a Customer unless Distributor shall prior to transfer have obtained from the Customer a signed copy of the Software License Agreement, copies of all of which shall be furnished to Vendor.

8.5. Vendor acknowledges that all title and interest, including all copyrights, in Product, Connecting Software and Distributor Development Materials are the exclusive property of Distributor. Vendor further acknowledges that Product, Distributor Development Materials and any other materials received by Vendor and identified by Distributor as proprietary or confidential are proprietary and trade secrets of Distributor (hereafter "Distributor Proprietary Material").

8.6. Vendor agrees not to disclose Distributor Proprietary Material and to neither do nor permit any act which may in any way jeopardize or be detrimental to the validity of Distributor's patents, copyrights, trade secrets or other rights in Product, Connecting Software, Distributor Development Materials or Distributor Proprietary Material.

8.7. Vendor shall take reasonable precautions to maintain the confidentiality of Distributor Proprietary Material, including taking such steps as Vendor takes to protect its own confidential information.

9. Duration and Termination

9.1. This Agreement shall commence on the date first above written and shall remain in full force and effect for three years. This Agreement may be extended for one-year terms, provided, however, that (a) Distributor meets the targets and milestones for purchases set forth in Schedule E and maintenance objectives set forth in Schedule F and (b) the parties agree in writing to price, target and other terms for each additional one year period.

9.2. This Agreement may also be terminated as follows:

9.2.1. By either party by written notice to the other party if (i) a receiver shall have been appointed over the whole or any substantial part of the assets of the other party, (ii) a

petition is filed by the other party initiating any bankruptcy or reorganization proceedings, (iii) such a petition is filed against the other party and such proceeding shall not have been dismissed or stayed with 60 days after such filing or (iv) action is taken to dissolve the other party; and

9.2.2. By either party upon written notice if the other party has breached the terms of this Agreement in any material respect and fails to cure such breach within 30 days after such other party's receipt of written notice of such default.

9.2.3. By Vendor by written notice effective upon receipt if (i) Distributor intends to or is acquired by or merged with a company in competition with Vendor or which produces, markets or distributes software similar to or in competition with Vendor/WORK, or (ii) Distributor acquires rights in or to software similar to or competing with Vendor/WORK.

9.3. Except as provided in the next sentence, the rights granted to Distributor pursuant to Section 2 of this Agreement shall terminate upon any termination of this Agreement. In the event of termination, excluding termination under Sections 9.2.1 and 9.2.2, Vendor agrees Distributor may sell Vendor/WORK during the 60-day period following termination of this Agreement with respect to quotations issued by Distributor to prospective Customers before the termination date.

9.4. Upon termination or expiration of this Agreement for any reason:

9.4.1. Distributor shall deliver to Vendor Vendor/WORK Source Code, Vendor Development Materials and all other Vendor Proprietary Material in Distributor's possession, custody or control, excluding Internal Copies and copies of Vendor/WORK purchased by Distributor prior to termination or expiration. Distributor shall verify to Vendor that Distributor has returned or destroyed all copies of Vendor/WORK Source Code.

9.4.2. Vendor, at its option, may repurchase any or all Vendor/WORK purchased by Distributor prior to termination or expiration and in Distributor's possession at per copy fees not greater than the per copy fees paid by Distributor for such Vendor/WORK. Upon receipt of any Vendor/WORK so repurchased from Distributor, Vendor shall issue an appropriate credit to Distributor's account;

9.4.3. Vendor shall deliver to Distributor Distributor Development Materials and all other Distributor Proprietary Material in Vendor's possession, custody or control, excluding Internal Copies and copies of Product purchased by Vendor prior to termination or expiration;

9.4.4. Distributor shall select one of the following:

9.4.4.1. Distributor may request that Vendor commence to provide some or all of Distributor's Vendor/WORK customers with maintenance services, commencing on the expiration or renewal date of each maintenance contract between Distributor and a customer. Vendor will provide contract documents to such customers and will bill such customers directly at Vendor's current published maintenance prices. Vendor will provide maintenance services for only the Vendor/WORK portion of products maintained by Distributor; or

9.4.4.2. Distributor may continue to provide maintenance services to Distributor's Vendor/WORK customers. If Distributor makes this selection, Distributor will pay to Vendor for the period of 24 months immediately following termination, a fee equal to 12% per year of cumulative purchase prices as of the date of termination of this Agreement. For subsequent periods, Distributor shall pay Vendor for each 12 month period a fee equal to the annual maintenance charges quoted by Vendor at the outset of such 12 month period. All payments under this Section 9.4.4.2. will be due quarterly on the first of each quarter in an amount equal to one quarter of the annual fee.

9.4.4.3. Distributor may only select to transfer maintenance responsibility under Section 9.4.4.1 at the time of termination or annually on the same date thereafter. Vendor must receive notice of intent to transfer this responsibility 90 days prior to each anniversary date. Unless transfer is made within two years of the termination date, Vendor may refuse to accept such transfer;

9.4.5. For a period for six months after the date of termination, Distributor shall make available to Vendor for inspection and copying all books and records of Distributor that pertain to Distributor's performance of and compliance with its obligations, warranties and representations under this Agreement;

9.4.6. Distributor will forthwith cease all use of Trademarks, and will not thereafter use any mark, tradename or slogan which is confusingly similar to any Trademarks;

9.4.7. Each party shall return to the other party all marketing literature and materials provided by such party;

9.4.8. Vendor SHALL NOT BE LIABLE TO Distributor FOR DAMAGES OF ANY KIND, INCLUDING INCIDENTAL OR CONSEQUENTIAL DAMAGES, ON ACCOUNT OF THE TERMINATION OF THIS AGREEMENT FOR ANY REASON; and

9.4.9. Distributor's obligations to pay all amounts due hereunder, as well as Distributor's and Vendor's rights and obligations under Sections 2.2, 2.4 and 8, shall survive termination of this Agreement.

9.5. Upon termination pursuant to Section 9.2.2 for Distributor's breach, the due date of all outstanding invoices to Distributor for Vendor/WORK shall automatically be accelerated so they become due and payable by immediate wire transfer on the effective date of termination, even if longer terms have been provided previously. All orders or portions thereof remaining unshipped as of the effective date of termination shall automatically be canceled.

10. Vendor's Disclaimer of Warranties; Limited Liability

10.1. Vendor warrants that, for a period of 90 days from installation, Vendor/WORK will perform substantially in the manner described in the applicable user manual provided by Vendor.

10.2. OTHER THAN THE LIMITED WARRANTY IN SECTION 10.1, Vendor MAKES NO WARRANTIES OR REPRESENTATIONS AS TO PERFORMANCE OF Vendor/WORK OR AS TO SERVICE TO Distributor OR TO ANY OTHER PERSON. Vendor RESERVES THE RIGHT TO CHANGE THE WARRANTY SET FORTH IN SUCH LIMITED WARRANTY AT ANY TIME, WITHOUT FURTHER NOTICE AND WITHOUT LIABILITY TO Distributor OR ANY OTHER PERSON.

10.3. TO THE EXTENT PERMITTED BY APPLICABLE LAW, ALL IMPLIED WARRANTIES, INCLUDING BUT NOT LIMITED TO IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PADistributorCULAR PURPOSE AND NON-INFRINGEMENT, ARE HEREBY EXCLUDED.

10.4. THE LIABILITY OF Vendor, IF ANY, FOR DAMAGES RELATING TO ANY Vendor/WORK COPIES SHALL BE LIMITED TO THE ACTUAL AMOUNTS PAID BY Distributor FOR SUCH COPIES AND SHALL IN NO EVENT INCLUDE INCIDENTAL OR CONSEQUENTIAL DAMAGES OF ANY KIND.

11. [Reserved]

12. Compliance with Governmental Regulations

The obligation of Vendor to supply Vendor/WORK shall at all times be subject to applicable U.S. export control laws and regulations and to applicable foreign import control laws. The parties will comply with such laws and regulations, including without limitation complying with record keeping and inspection requirements. Distributor understands that Vendor is subject to U.S. government regulations under which export or diversion of Vendor/WORK or other products and software to certain countries is prohibited. Distributor agrees that it will not re-export, outside the U.S., directly or indirectly, any of Vendor's products or technical data relating to such products, without the consent of Vendor and clearance under applicable regulations.

13. Option to Purchase Vendor/WORK

If Distributor first pays Vendor XXX million dollars in aggregate sublicense fees under this Agreement, Distributor shall have an option to purchase a non-transferable, non-exclusive,

perpetual license to operate, modify, market, distribute and sublicense Vendor/WORK and Vendor/WORK Source Code, provided that such license shall be limited as follows:

13.1. Distributor shall not use Trademarks or any trademark, trade name or slogan which is confusingly similar to Trademarks in connection with use, marketing, distribution or sublicensing of Vendor/WORK or Vendor/WORK Source Code;

13.2. Distributor shall market, distribute and sublicense Vendor/WORK and Vendor/WORK Source Code only as a part of a package including Connecting Software and Product;

13.3. For three years immediately following purchase of Vendor/WORK Source Code, Distributor shall not market, distribute, disclose or sublicense Vendor/WORK Source Code;

13.4. Software licensed to Vendor from vendors other than Distributor and incorporated in Vendor/WORK shall not be included in purchase of Vendor/WORK Source Code;

13.5. Distributor shall not acquire rights in or to software similar to or competing with Vendor/WORK;

13.6. Distributor shall not be acquired by or merged with a company in competition with Vendor or which produces, markets or distributes software similar to or in competition with Vendor/WORK;

13.7. Distributor shall use its best efforts to prevent access to or disclosure of Vendor/WORK Source Code to Vendor's competitors, including without limitation not selling or licensing to Vendor's competitors at such time when Distributor is entitled to sell or license Vendor/WORK Source Code and taking all appropriate actions and precautions; and

13.8. Distributor shall select one of the following:

13.8.1. Upon exercising this option Distributor shall pay to Vendor a lump sum payment in cash in an amount equal to four times the total sublicense fees and maintenance fees due and payable to Vendor during the 12-month period immediately preceding the date this option is exercised; or

13.8.2. Distributor shall pay to Vendor the following: (i) upon exercising this option Distributor shall pay in cash an amount equal to two times the total sublicense fees and maintenance fees due and payable to Vendor during the 12-month period immediately preceding the date this option is exercised; and (ii) for two years following exercise of this option, Distributor shall pay an amount equal to 5% of revenue from Vendor/WORK due and payable to Distributor, excluding maintenance fees payable to Distributor. For two years following exercise of

this option, Distributor shall adhere to the Vendor/WORK sublicense fee guidelines for the period preceding exercise of this option.

14. General

14.1. Distributor and Vendor not Agents

Vendor and Distributor are independent contractors and are not, and shall not represent themselves as, principal and agent, partners or joint venturers. Distributor shall act as a principal on its own behalf and is not authorized to act for or obligate Vendor in any manner. Vendor shall act as a principal on its own behalf and is not authorized to act for or obligate Distributor in any manner.

14.2. Assignability

Neither this Agreement nor any of the licenses or other rights granted under it shall be assignable by Distributor unless the written consent of Vendor shall have first been obtained.

14.3. Non-Competition

14.3.1. The parties agree that maintaining the secrecy of Vendor/WORK and Vendor Proprietary Material is necessary to develop marketable products. In consideration of the licenses granted in Section 2, Distributor agrees that it will not do or enter an agreement similar to this Agreement with any competitor of Vendor listed in Schedule I, Part 1.

14.3.2. The parties agree that exclusive packaging of Vendor/WORK and Product is necessary to develop marketable products. In consideration of the exclusive packaging provided in this Agreement and for so long as Distributor meets the targets and milestones set forth in Schedules E and G, Vendor agrees that it will not enter an agreement similar to this Agreement with any competitor of Distributor listed in Schedule I, Part 2.

14.4. Governing Law

This Agreement shall be governed by and construed in accordance with the laws of the State of Rhode Island.

14.5. Arbitration

All disputes between the parties which may arise in connection with this Agreement shall be finally settled by arbitration conducted in Massachusetts in accordance with the then current rules of the American Arbitration Association. Each party hereto shall be bound by the results of such proceedings.

The provisions of this section shall not preclude the application to any court for injunctive or other equitable relief to prevent the misuse or unauthorized disclosure of proprietary information, or the issuance of any court of such relief.

14.6. Complete Agreement

This Agreement contains the entire agreement of the parties, supersedes any prior oral or written representations or understanding concerning its subject matter, and may not be modified except by a writing executed by both parties.

14.7. Force Majeure

In the event of any delay in performance of this Agreement by reason of any cause arising from or attributable to acts, events, failure of events or other accidents or incidents beyond the reasonable control of the party required to perform, then the party so delayed shall be under no liability for losses or injury suffered by the other party thereby, and this Agreement shall be suspended during such delay. Upon cessation of the cause of the delay, this Agreement shall again become operative, provided that if as a result of such delay a modification of the terms of this Agreement or a cancellation hereof is requested by one party and it is reasonable that such modification or cancellation should be made, this Agreement shall be so modified or cancelled. The provisions of this section shall not in any case be construed to eliminate any obligation of one party for payments to the other party hereunder with respect to any period of delay occasioned by a cause covered by this section, which obligations shall be discharged promptly after such period of delay if not dischargeable during such period, nor shall this section excuse failure of Distributor to meet the purchase targets or milestones set forth in Schedule G or any such future obligations.

14.8. Trials

In the event that a Customer or potential Customer elects to accept Vendor/WORK for trial, Distributor shall obtain prior to delivery of Vendor/WORK, and shall forward to Vendor an executed Trial Letter in the form attached hereto as Schedule J. Upon expiration of the time of the trial, as specified in such Trial Letter, Distributor shall either obtain the return of Vendor/WORK covered thereby or obtain from the Customer a purchase order for Vendor/WORK and an executed Software License Agreement.

14.9. Notice

14.9.1. Vendor shall notify Distributor thirty days prior to Vendor assigning or transferring all its rights in and to Vendor/WORK or selling the company.

14.9.2. Any notices required or permitted to be made by either party to this Agreement shall be made in writing by registered mail, or communicated by cablegram, to the other party at the following addresses:

Vendor Technologies, Inc. Distributor, Inc.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement under seal by their duly authorized officer or representative as of the date first above written.

Distributor, INC.	Vendor TECHNOLOGIES INC.
By_____	By_____
_____	_____
Name (type or print)	Name (type or print)
_____	_____
Title	Title
_____	_____
Date	Date

Appendix C

ABC SYSTEMS,INC.
Address
City, State Zip Code

AGREEMENT FOR ABC SOFTWARE SYSTEMS

Licensee Name: _____
Billing Address: _____
_____
_____

ABC Systems, Inc. ("ABC") and Licensee agree that the following terms and conditions will govern each order submitted by Licensee and accepted by ABC for a ABC Software System.

Any order for a ABC Software System requires the submission by Licensee of an executed System Schedule in the form attached hereto.

TERMS AND CONDITIONS

1. Definitions

1.1 "Software System" shall mean a computer software system listed in a System Schedule, comprised of computer programs and routines, related Documentation, and any error corrections, modifications or updates ("Updates") furnished by ABC to Licensee with respect thereto.

1.2 "Documentation" shall mean the printed user manuals and other user documentation furnished to Licensee by ABC for use with ABC Software Systems.

1.3 "Designated Equipment" shall mean the central processing unit(s) designated in a System Schedule.

2. Orders

2.1 Licensee may place an order for Software Systems by submitting an executed System Schedule to ABC. Such order will be effective when accepted by ABC.

3. Grant of License

3.1 Upon ABC's acceptance of Licensee's order for a Software System, ABC will grant to Licensee a nonexclusive, nontransferable license to use such Software System upon the terms and conditions of this Agreement.

3.2 Each license granted under this Agreement authorizes Licensee to use a Software System only on the Designated

Equipment specified in the applicable System Schedule. A separate license is required to permit use of the Software System on any other central processing unit ("CPU") except that, in the event of a malfunction causing the Designated Equipment to become inoperable, Licensee may use the Software System on a back-up CPU on a temporary basis during such malfunction. Licensee may redesignate the CPU for a Software System, or the location of the Designated Equipment (but only to another location within the United States), by providing written notice thereof to ABC.

3.3 Each Software System contains, as an integral component thereof, a database management system known as "Model XXX". ABC's provision of Model XXX to Licensee is subject to a license granted to ABC by DEF Corporation, Address, City, State and Zip Code. This Agreement authorizes Licensee to use and access Model XXX only in conjunction with and by means of the application programs furnished to Licensee by ABC as part of a Software System. Any other access to and use of Model XXX by Licensee requires a separate license from DEF Corporation.

3.4 Licensee may use Software Systems only in connection with the operation and management of Licensee's own business. Licensee is not authorized to grant sublicenses for use of Software Systems or to permit other persons to use Software Systems on a rental, time-sharing, networking or other basis.

4. Charges

4.1 Licensee shall pay ABC the license fees and all other amounts specified in a System Schedule. One-half the amount due ABC shall be due and payable thirty (30) days after receipt of ABC's invoice following delivery of the Software System. The balance remaining due shall be due and payable thirty (30) days after ABC demonstrates, using its standard test data, the successful operation of the Software System.

4.2 Prices are exclusive of all federal, state, municipal and other governmental excise, sales, use, customs, value added, occupational, or other taxes, fees or duties now in force or enacted in the future, including all taxes that are based upon the use, transfer, sale, rental or licensing of computer software. In the event ABC is required at any time to pay any such tax, fee, duty or charge, Licensee will promptly reimburse ABC therefor. In lieu of such payment, Licensee may provide ABC with an exemption certificate or other document acceptable to the taxing authority prior to the assessment of such tax, fee or duty.

5. Delivery, Installation and Training

5.1 ABC shall deliver one copy of each Software System ordered by Licensee to Licensee at the Designated Equipment location specified in the System Schedule. ABC will use reasonable efforts to deliver Software Systems to Licensee on or before any

estimated delivery date furnished to Licensee. Estimated delivery dates, however, are approximate only and are not of the essence. ABC shall not be liable for any loss, expense or damages (incidental, consequential or otherwise) if ABC fails to meet an estimated delivery date.

5.2 To the extent specified in a System Schedule, ABC will assist Licensee in the installation of Software Systems on the Designated Equipment; Licensee shall pay all reasonable travel and living expenses incurred by ABC in providing installation assistance to Licensee.

5.3 ABC shall provide licensee with the initial set of Documentation specified in the System Schedule for use with a Software System. Licensee may order additional sets of Documentation at ABC's then current price.

5.4 ABC will conduct such training with respect to the use of Software Systems as is specified in the System Schedule. Licensee shall pay all reasonable travel and living expenses incurred by ABC in providing training to Licensee. Any additional training provided by ABC at Licensee's request will be provided at ABC's then current standard rates.

5.5 Licensee shall be exclusively responsible for the supervision, management and control of its use of a Software System, including, without limitation, selection of the Software System to achieve Licensee's intended results, determining the appropriate use and limitations of the Software System in Licensee's business, and assuring operation of the Software System by qualified, trained personnel.

6. Protection of Proprietary Material

6.1 "Proprietary Material" shall mean (1) Software Systems and any Updates and any portions thereof in any embodiment, and (2) any other information or data, in written, graphic or machine readable form, received by Licensee from ABC and identified by ABC in writing as proprietary or confidential, provided, however, that "Proprietary Material" does not include information which is or becomes available in the public domain (other than through unauthorized disclosure by Licensee).

6.2 Licensee acknowledges that the Proprietary Material is confidential and constitutes a valuable asset of ABC. Licensee shall not use any Proprietary Material for any purpose not specifically authorized in this Agreement.

6.3 Licensee will limit access to Proprietary Material to those employees or consultants whose use of or access thereto is necessary to Licensee's use of Software Systems. Licensee will enter into appropriate agreements with its employees and consultants to prevent the unauthorized use, disclosure or copying of Proprietary Material and shall take all reasonable

precautions to protect and maintain the confidentiality of Proprietary Material, including at a minimum, those precautions Licensee employs to protect its own confidential information. Licensee shall not disclose, publish, display or otherwise make available to any person any of the Proprietary Material or copies thereof without ABC's prior written consent. Licensee shall not duplicate, copy or reproduce any of the Proprietary Material, except with the prior written consent of ABC.

6.4 Licensee may make copies of Software Systems only (1) for use on the Designated Equipment and (2) for back-up or archival purposes. Licensee will keep records of the number and location of such copies and make such records available to ABC. Licensee shall not remove any copyright or proprietary rights notice included in any Proprietary Material and shall reproduce all such notices on any copies of any Proprietary Material which Licensee may make.

6.5 Licensee shall not be entitled to obtain source code for Software Systems furnished under this Agreement, except that ABC shall provide Licensee with the source code for the application component (i.e., not including Model XXX) of the Software System. Licensee shall not disassemble or decompile any object code version of a Software System or otherwise attempt to generate, use or modify any Software System source code.

6.6 ABC and its licensors shall retain all title, copyright and other proprietary rights in and to all Proprietary Material furnished by ABC to Licensee and all copies thereof made by Licensee.

6.7 Licensee's obligations under this Section 6 shall survive any termination or expiration of this Agreement.

7. Warranties; Limitations

7.1 ABC warrants that, during the one (1) year period following delivery of a Software System, the Software System will conform in all material respects to the specifications contained in the Documentation initially furnished to Licensee for use with the Software System. ABC's sole responsibility under this warranty shall be to correct or replace that portion of the Software System which fails to conform to said warranty. ABC will have no liability under the foregoing warranty if (1) Licensee modifies the Software System without ABC's prior written consent, (2) Licensee fails to give ABC written notice of the claimed breach of warranty within said one (1) year warranty period or (3) the failure to conform is caused in whole or in part by persons other than ABC or by products, equipment or computer programs not furnished by ABC.

7.2 THE EXPRESS WARRANTIES SET FORTH IN THIS SECTION 7 ARE THE ONLY WARRANTIES GIVEN BY ABC WITH RESPECT TO SOFTWARE SYSTEMS FURNISHED TO LICENSEE; ABC MAKES NO OTHER WARRANTIES, EXPRESS,

IMPLIED OR ARISING BY CUSTOM OR TRADE USAGE, AND SPECIFICALLY MAKES NO WARRANTY OF MERCHANTABILITY OR OF FITNESS FOR ANY PARTICULAR PURPOSE. ABC'S EXPRESS WARRANTIES SHALL NOT BE ENLARGED, DIMINISHED OR AFFECTED BY, AND NO OBLIGATION OR LIABILITY SHALL ARISE OUT OF, ABC'S RENDERING OF TECHNICAL OR OTHER ADVICE OR SERVICE IN CONNECTION WITH SOFTWARE SYSTEMS.

7.3 Except as is set forth in Section 8 of this Agreement, ABC's liability in contract, tort or otherwise arising out of or in connection with a Software System or this Agreement shall not exceed the license fee paid to ABC by Licensee with respect to said Software System. IN NO EVENT SHALL ABC BE LIABLE FOR SPECIAL, INCIDENTAL, CONSEQUENTIAL OR TORT DAMAGES, INCLUDING ANY DAMAGES RESULTING FROM LOSS OF USE, LOSS OF DATA, LOSS OF PROFITS, OR LOSS OF BUSINESS ARISING OUT OF OR IN CONNECTION WITH THE PERFORMANCE OF SOFTWARE SYSTEMS OR ABC'S PERFORMANCE OF SERVICES OR OF ANY OTHER OBLIGATIONS RELATING TO SOFTWARE SYSTEMS, EVEN IF ABC HAS BEEN ADVISED OF THE POSSIBILITY OF SUCH DAMAGES. Except with respect to damages caused by ABC's negligence, Licensee shall indemnify ABC and hold it harmless from any loss, claim or damage to any person arising out of Licensee's use of Software Systems.

8. Patent and Copyright Indemnification

8.1 ABC shall defend Licensee or, at ABC's option, settle, any claim that a Software System infringes any United States patent or copyright or any trade secret, and shall indemnify Licensee against all costs, damages and expenses finally awarded against Licensee which result from any such claim, provided that Licensee notifies ABC promptly in writing of any such claim, gives ABC full and complete authority, information and assistance to defend such claim and gives ABC sole control of the defense of any such claim and all negotiations for its compromise or settlement. Should a Software System or any part thereof become, or in ABC's opinion be likely to become, the subject of a claim of infringement, ABC shall have the right, at ABC's option and expense, either to procure for Licensee the right to continue using it, or to replace or modify it so that it becomes noninfringing (provided that such modification or replacement does not materially degrade its quality or performance) or, after reasonable attempts have been made with respect to the foregoing alternatives, to refund the license fee paid to ABC by Licensee, less a reasonable allowance for use.

8.2 ABC shall have no liability or obligation with respect to any infringement claim based upon the combination of Software Systems with other products not furnished by ABC or any addition to or modification of Software Systems made by any person other than ABC. ABC will have no obligation for any costs incurred by Licensee without ABC's prior written authorization. This Section states ABC's entire obligation and liability for infringement by Software Systems or the use thereof.

9. Term; Termination

9.1 This Agreement shall become effective on the date on which it is accepted by ABC at ABC's principal place of business in Boston, Massachusetts and shall remain in effect unless terminated as provided herein. The grant of license for a Software System shall take effect on the date on which the applicable System Schedule is accepted by ABC in Boston, Massachusetts and shall remain in effect unless terminated as provided herein or for the term, if any, set forth in the System Schedule.

9.2 If Licensee shall fail to perform or shall be in breach of any of its obligations hereunder and shall have failed or been unable to remedy said failure or breach within thirty (30) days after receipt of written notice from ABC with respect thereto, ABC may terminate this Agreement, or any license granted hereunder, by giving written notice of termination to Licensee.

9.3 Within one month after any termination or expiration of any license granted hereunder, Licensee (a) shall deliver to ABC all Proprietary Material received from ABC or made in connection with such license, including copies thereof, and (b) shall destroy or render unusable all other such Proprietary Material and copies thereof, including information and data relating to the Software System stored in any storage facility, which for any reason cannot be delivered to ABC. In addition, an authorized employee of Licensee shall certify in writing to ABC that all such Proprietary Material has been delivered to ABC, destroyed or rendered unusable and that use of the terminated Software System and any portion thereof has been discontinued.

10. General Provisions

10.1 This Agreement sets forth the entire agreement of the parties with respect to the subject matter hereof, and supersedes all prior oral and written agreements and understandings relating thereto. No representation, condition, understanding, statement of intention or agreement of any kind, oral or written, shall be binding upon the parties unless set forth or specifically incorporated herein. No waiver, alteration, modification, or cancellation of any of the provisions of this Agreement shall be binding unless made in writing and signed by the parties. The failure of either party at any time or times to require performance of any provision hereof shall in no manner affect the right at a later time to enforce such provision. No remedy referred to in this Agreement is intended to be exclusive, but each shall be cumulative and in addition to any other remedy referred to herein or otherwise available at law or in equity. Any provision of Licensee's order which is in any way inconsistent with or in addition to the terms and conditions of this Agreement shall not be binding upon ABC unless ABC specifically accepts any such provision in writing.

10.2 Neither ABC nor Licensee shall be liable for any delays in the performance of any of its obligations hereunder due to causes beyond its reasonable control, including, but not limited to, fire, strike, war, riots, acts of any civil or military authority, acts of God, judicial action, unavailability or shortages of materials or equipment, failures or delays in delivery of vendors and suppliers or delays in transportation.

10.3 All written notices to be given in connection with this Agreement shall be sufficient if sent by certified or registered mail, postage prepaid, addressed to the party entitled or required to receive such notice at the addresses specified on the first page hereof.

10.4 In the event that one or more of the provisions contained in this Agreement shall for any reason be held invalid, illegal or unenforceable in any respect, such invalidity, illegality or unenforceability shall not affect any other provisions contained in this Agreement.

10.5 This Agreement shall be subject to and interpreted in accordance with the substantive law of The Commonwealth of Massachusetts.

10.6 This Agreement shall be binding upon and inure to benefit of the parties and their respective successors, assigns and legal representatives, provided, however, that the rights, duties and privileges of Licensee hereunder may not be assigned, sublicensed or otherwise transferred by it, in whole or in part, without the prior written consent of ABC.

ABC AND LICENSEE ACKNOWLEDGE THAT THEY HAVE EACH READ THIS AGREEMENT AND AGREE TO ALL TERMS AND CONDITIONS STATED HEREIN.

Licensee

By:_____
(authorized signature)

Name:_____
(please type or print)

Title:_____

Date:_____

Accepted by
ABC Systems, Inc.

By:_____

Title:_____

Date:_____

Senator HEFLIN. Do I understand that you are all now in agreement with the bill by the National Bankruptcy Conference? Is that your position, too, Mr. Tarkenton?

Mr. TARKENTON. Yes, Your Honor.

Senator HEFLIN. Thank you. We appreciate your testimony. I will yield to Senator DeConcini. He is a sponsor of this.

Senator DECONCINI. Mr. Chairman, let me just ask Mr. Hahn or Mr. Tarkenton to respond to the argument by Thomas Hemnes, who testified before the House last week, and who submitted the testimony that I think the chairman is referring to here.

He argues that licensees would get a sweetheart deal because, after rejection, they would not have to fulfill their obligation that were considered when the royalty price was set. In other words, licensees would get the benefit of the technology for a low royalty price, without having to fulfill their part of the bargain.

Do you think that the legislation, even as modified here, would potentially have this effect?

Mr. HAHN. No, Senator, I do not think that is the case at all. The bill would specifically mandate that if the licensee was to retain the use of the technology, he would have to continue to make the royalty payments without deduction, without defense, without setoff.

What Mr. Hemnes is asking is what happens to these other nonmonetary obligations that the licensee might be called upon to perform under that agreement? The bill is silent on that point. But it seems to us that if the licensee makes the election to continue to use and retain the technology, a bankruptcy court will probably require the licensee to perform most of those nonmonetary obligations, possibly with the sole exception being that some duties may be so closely tied to the reciprocal duties of the licensor that he has been relieved of by the rejection, that a bankruptcy court might say as to those particular responsibilities, it would be inequitable to make the licensee perform them.

But subject to that one qualification, we believe that most of those other obligations would have to be performed by the licensee.

But what is the alternative? Are we to put into this bill a list of every conceivable obligation that might arise in a licensing agreement and then address each and every one of them? We could not possibly fix a solution to each and every obligation that might arise in a myriad of unforeseeable situations.

Therefore, that issue has to be left to the equitable discretion of a bankruptcy judge in dealing with a particular contract under the peculiar circumstances of a single case.

Senator DECONCINI. Do you agree with that, Mr. Tarkenton?

Mr. TARKENTON. Yes, Senator. Clearly, the licensee would have the obligation to make royalty payments if he elects to keep the license in place. Any nonmonetary obligations, I believe, should be left to the bankruptcy court to determine how they should fall out.

Senator DECONCINI. Thank you. Thank you, Mr. Chairman.

Senator HEFLIN. Senator Grassley, do you have an opening statement that you would like to make, or any questions?

Senator GRASSLEY. I have no statement, but I do have some questions.

As a general matter, I'd like to have your opinion as to how this legislation is consistent with the concept of debtor's "fresh start" if the debtor is forced to live with the terms of these agreements?

Mr. HAHN. The debtor will be relieved of the performances that are burdensome going forward. That is the purpose of having that ability to reject the contract in the first place. The debtor does not have a constitutional right anywhere to sell the same property twice, which is the argument that the opponents are making, concerning this bill.

I think that this strikes a fair balance between the rights of the licensee that he has obtained prior to bankruptcy and that he should be entitled to continue to retain and the needs of the licensor who will be receiving the cash flow if the licensee continues to use the technology. That cash flow will enable him to reorganize his company.

To go too much in the other direction will not only undermine the whole mechanism of licensing, but young startup companies that are undercapitalized will be more frequently in the bankruptcy courts. So in saving one or two reorganizations, you may be promoting many more reorganizations on the part of young startup companies.

I think some kind of a reasonable balance has to be struck. I think this bill does that.

Senator GRASSLEY. In an effort to get a fix on the scope of the problem, can any of you give me any examples where companies filed for chapter 11 with the avowed purpose of invoking the executory contracts provisions in the code, or to break an unprofitable license arrangement?

Mr. HAHN. I think the *Lubrizol* case was just that case. They went in there and seemingly the major purpose was to rid itself of a nonexclusive licensing arrangement with *Lubrizol*, which the company in that case maintained had to be done so that they could go out and sell that technology somewhere else in order to reorganize the company.

The bankruptcy court accepted that argument, considered that it was a reasonable exercise of a sound business judgment, and permitted it to happen.

Within a relatively short time thereafter, the debtor did not succeed and ended up being liquidated in a chapter 7 proceeding.

Ms. SHEA-STONUM. Mr. Grassley, if I may, the timing in the *Lubrizol* case, the petition to reject the license was filed within a week after the bankruptcy filing. While we cannot state categorically that that was the reason for the filing, I think it does support Mr. Hahn's observations.

Senator GRASSLEY. Were they challenged as bad-faith filings?

Ms. SHEA-STONUM. The argument was alluded to in the bankruptcy court, it is my understanding. I was not counsel of record in the bankruptcy court, but apparently the judge brushed aside any suggestion that that was a bad faith filing.

Senator GRASSLEY. Mr. Chairman, I will submit the rest of my questions for a response in writing.

Senator HEFLIN. Thank you. We appreciate your testimony.

[Members of the panel submitted the following material:]

CBEMA

July 13, 1988

The Honorable Howell Heflin
Chairman, Subcommittee on Courts
and Administrative Practice
Senate Judiciary Committee
223 Hart Office Building
Washington, DC 20510

Dear Senator Heflin:

Enclosed is our response to your questionnaire regarding S. 1626, the Intellectual Property Bankruptcy Protection bill.

I hope this information will be helpful to you in your consideration of S. 1626, and please do not hesitate to contact us if you have additional questions.

We look forward to working with you and your staff as this legislation moves toward markup.

Sincerely,

John L. Pickitt
President

Enclosure

Computer and Business Equipment Manufacturers Association 311 First Street, N.W., Suite 500, Washington, D.C. 20001 (202) 737-8888

QUESTIONS FROM SENATOR HOWELL HEFLIN (D-AL)

1. **Why should licensees of intellectual property rights be treated differently from other creditors who take the same risk of rejection of an executory contract?**

The system of licensing which has developed in the United States and in international trade has never, until the Lubrizol decision, been viewed by business people as creating a debtor-creditor relationship. Rather, licensing is a flexible method of dividing and "transferring" rights in intellectual property frequently insisted upon by developers of such property to permit the fullest and swiftest development of their creations. Through the adoption of S. 1626, licensees -- whose role in the development of new ideas and products is often critical -- will regain confidence that in bankruptcy they would be treated in a manner similar to transfers of other property. U.S. licensors must be freed of the burgeoning concern over Lubrizol. Only legislation can assure that the licensor's bankruptcy will not lead to the deprivation of rights established long before the bankruptcy on which licensees act in great reliance.

Intellectual property is by definition unique, and, therefore, the non-debtor party's ability to "cover" by obtaining performance from another source upon the bankrupt licensor's rejection is either nonexistent or extremely limited. Licensees are different from other contracting parties. After all, intellectual property rights are derived in large part, from the U.S. Constitution. (Federalist #6 quote here) The status of the licensor as a sole source is moreover the result of the operation of applicable non-bankruptcy laws meant to encourage the developers of intellectual property. Licensing is a primary tool implementing the reward system to inventors, authors and other creative people in our society. The unintended application of the existing Section 365 of the Bankruptcy Code to the present licensing system threatens to undo that system at great cost to the economy in general with little or no benefit to the few bankruptcy estates which may try to avail themselves of the interpretation of Section 365 in the Lubrizol decision.

2. **Is it necessary to amend the Bankruptcy Code to protect these kinds of business transactions? Could the licensee not simply purchase the technology outright?**

The alternative method of transferring intellectual property is an assignment of the property. Such an assignment severs the developer's rights in the intellectual property. If inventors cannot raise capital through licensing, but are left with only the alternative of selling their inventions, it will be a major disincentive for many inventors and will disrupt well-established, international techniques of financing research and development. The possibility that some very small, prospectively unidentifiable percentage of licensors may resort to bankruptcy should not lead to the unraveling of the licensing system which promotes faster and fuller development of the ideas of creative segment of the U.S. economy. Licensing is now a fully understood tool in international trade. Moreover, it is not desirable to create a legal environment where non-U.S. parties seeking a technology transfer insist upon an assignment of U.S. technology, rather accepting a license. This could lead to expatriation on a significant scale of U.S. technology and ideas.

3. **Do bankruptcy courts have the authority under current law to balance the equities in making the determination to approve an assumption or rejection of a contract involving intellectual property rights? Can the court take into consideration the effect of rejection on the non-debtor party to the contract?**

The answer varies from jurisdiction to jurisdiction. In the Fourth Circuit, for instance, the answer is no. In Lubrizol, the court explicitly stated that only the effects on the debtor are properly considered by the bankruptcy court. Numerous courts outside of the Fourth Circuit have adopted this same view. See, e.g., In re Wheeling-Pittshburgh Steel Corp., 72 Bankr. 845 (Bankr. W.D. Pa. 1987) ("Once the debtor established that rejection will benefit the estate, our inquiry ends.") Given the existing threat to the ability of United States technology developers to rely upon licenses, the problem is too acute to await years of bankruptcy courts' groping toward an equitable standard.

4. **The District Court in the Lubrizol case treated the transaction as a completed sale of property. The Fourth Circuit disagreed with this characterization and stated: "Licensing arrangements are more similar to leases than to sales of property because of the limited nature of the interest conveyed." (756 F.2d at 1046 F.N.)**

Leases are subject to rejection under Section 365 of the Code.

Would you comment on this distinction?

Leases and licenses are similar. Both grant possessary rights to less than the fee owner's right, title and interest. Under the proposed legislation, executory licenses will remain subject to rejection under Section 365, just as do unexpired leases. The proposed legislation seeks to deal with the exaggerated consequences of rejection and thereby place the licensee under a license rejected in bankruptcy in a position similar to that of a lessee under a lease in bankruptcy. The District Court in Lubrizol, however, was correct in its basic observation that business people think of licenses as a means of completing a transfer of intellectual property rights. (In addition, on the narrow facts of Lubrizol, which dealt with trade secrets, arguably there was a fully completed transfer which the Bankruptcy Court and the Fourth Circuit, in essence, rescinded.)

5. **Under the reasoning of Lubrizol, if a debtor is alloved to reject the contract, does that deprive the licensee of all rights to the technology?**

Yes. The intellectual property license is, in the analysis of the Fourth Circuit, simply a continuing promise to allov the licensee to use the property. Once the bankrupt licensor is not legally required to keep that promise, the licensee has no right to use intellectual property to which applicable non-bankruptcy law grants the bankrupt licensor a time-limited monopoly. Thus, the Fourth Circuit upheld the order of the bankruptcy court in Lubrizol which had been disclosed to the licensee more than a year prior to the bankruptcy filing.

6. **If the contract arrangement between the licensor and licensee grants exclusive rights to use the technology -- would that right of exclusivity be preserved to the licensee by this legislation?**

Yes. The Bankrupt Licensor Coalition has suggested language for the markup of S. 1626 that would require a bankrupt licensor which rejects its affirmative obligations under a license to honor its negative covenant not to license others in the event that the exclusive licensee elects not to have the rejection treated as the termination of the contract. The National Bankruptcy Conference supports this provision.

7. **Should the legislation provide for those situations where retention of exclusive rights by the licensee will prevent the debtor from reorganizing?**

No. Exclusive licenses have a central function in funding the development from ideas to saleable product of many ideas and inventions. Frequently, the party funding the many years of startup requires certain exclusive rights, such as an exclusive license for a given geographical territory or field of use. Exclusive licenses have been used successfully by many growing, innovative companies as part of their development strategies. If the prospect that those exclusive rights can be erased or diluted in the licensor's bankruptcy persists, a traditional and generally highly effective means of funding U.S. product development will be severely eroded. In many cases, capital will not be advanced unless the inventor gets exclusive rights. Thus, much technology will not be commercialized, because a licensee can only justify large investments in plant, inventory and marketing unless it has guaranteed exclusive rights for a period of time.

Exclusive licenses are, for all practical purposes, completed transfers. The Bankrupt Licensor Coalition submits that the economy of the United States is far better served by maintaining the integrity of exclusive intellectual property licensee than in intentionally condoning the act of the bankrupt licensor selling again property rights previously transferred. Many debtors might be able to reorganize if they could rescind otherwise nonavoidable repetition transfers and sell their former property a second time, for a better price. The suggested end not only does not justify the suggested means, rather it argues for the clarifying legislation sought by the Bankrupt Licensor Coalition.

8. **How does the bill affect obligations other than the payment of royalties under licensing arrangement?**

The Bankruptcy Code in Section 107(b), 11 U.S.C. § 107(b), already treats the important issue of maintaining the confidentiality obligations associated with the intellectual property. At the request of the National Bankruptcy Conference, the Coalition has withdrawn its previous suggestion that confidentiality be further addressed in the proposed legislation and accepts NBC's observation that Section 107(b) provides a flexible tool available for the protection of both the licensor and the licensee.

As to other obligations that the rejected license provided be performed by the licensee, the Bankrupt Licensor Coalition submits that the proposed legislation recognizes the right of the bankrupt licensor to be free of

affirmative ongoing performance obligations and believes that the licensee is generally relieved of performance obligations other than payment and very limited obligations, the non-performance of which would jeopardize the continued existence of the intellectual property which the licensee elects to continue to use.

9. One of the criticisms of this legislation is that it will apply to situations much more complicated than the licensing arrangement in the Lubrizol case. Would you respond to this?

The Lubrizol result also applies to situations which are much more complex than the facts of that case. It is in the complicated, high risk, high stakes, high benefit license deals where the protection is most critical. High impact startup companies are doing sophisticated deals, and that is where licensing provides the greatest leverage for economic and technological development.

10. Instead of amending the Bankruptcy Code to take care of a specific industry, should Congress look at Section 365 dealing with executory contracts in a more comprehensive fashion?

As representatives of both the National Bankruptcy Conference and the American Bankruptcy Institute testified, a re-examination of Section 365 may be appropriate but will take a minimum of several years. The immediate and imminent threat to the U.S. licensing system which Lubrizol has brought into sharp focus must be abated as soon as possible. The problem is not the few reported cases, but the many ideas that will be either undeveloped or underdeveloped until the Lubrizol cloud is removed. For instance, until this problem is solved, field of use licensing -- a mainstay in the biotechnology field -- will be inhibited. The United States cannot and should not allow such a legalistic cancer fester and inhibit the growth of our technological base.

11. If the licensee is allowed to retain rights to intellectual property under S. 1626 or the proposed bill, does the licensee have an obligation to keep confidential any and all information concerning the property?

Yes. See response 8.

12. Does the response in S. 1626 or the proposed bill provide a broader legislative response than is necessary to respond to the concerns raised by Lubrizol?

No. The proposed bill, in fact, represents a carefully crafted balancing of the rights of the bankrupt licensor (assuring, first, that the bankrupt licensor can be relieved from ongoing obligations if it chooses to reject an executory license and, second, the continued cash flow provided by the license because of the sacrifice of the licensee's rights of offset in the proposed legislation) and of the licensee (simply assuring that it will not be deprived of irreplacable intellectual property to which it was entitled as of the time of the filing). The proposed bill is highly sensitive to the needs of reorganizing debtors while eliminating much of the uncertainly surfaced by the Lubrizol decision.

Questions From Senator DeConcini

1. This bill is not intended to affect executory contracts other licenses of intellectual property. Why should intellectual property agreements be treated differently than other licenses?

The system of licensing which has developed in the United States and in international trade has never, until the Lubrisol decision, been viewed by business people as creating a debtor-creditor relationship. Rather licensing is a flexible method of dividing and "transferring" property rights frequently insisted upon by intellectual property developers to permit the fullest and swiftest development of their creations. Through the proposed bill, licensees would have confidence that in bankruptcy they would be treated in a manner similar to transferees of other property and not be concerned that the licensor's bankruptcy could lead to the deprivation of rights established long before the bankruptcy on which they may have acted in great reliance.

Intellectual property is by definition unique and therefore the non-debtor party's ability to "cover" by obtaining performance from another source upon the bankrupt licensor's rejection is either nonexistent or extremely limited. Licensees are different from other contracting parties. After all, intellectual property rights are derived in large part, from the U. S. Constitution. (Federalist #6 quote here) The status of the licensor as a sole source is moreover the result of the operation of applicable nonbankruptcy laws meant to encourage the developers of intellectual property. Licensing is a primary tool in implementing the reward system to inventors, authors and other creative people in our society. The unintended application of the existing Section 365 of the Bankruptcy Code to the present licensing system threatens to undo that system at great cost to the economy in general with little or no benefit to the few bankruptcy estates which may try to avail themselves of the present law.

2. Why are you taking the route of amending the bankruptcy law rather than the federal and state intellectual property laws?

The Senator in posing the question has provided a substantial portion of the answer. There are numerous sources of substantive intellectual property law, specifically, statutory and common law at both the federal and state law. To attempt to address this problem through statutory enactments referencing each source would be a difficult or, in the instances where the source of the substantive law is decisional rather than statutory or where the source of the substantive law would arguably be preempted by the operation of the federal bankruptcy laws, impossible task. Moreover, after careful consideration, the Coalition recognized that this problem is not solved by creating "nonexecutory" licenses, but in tempering the result of rejection under the bankruptcy laws. Simply stated, the Coalition recognizes that there will be times when a bankruptcy trustee will need to be relieved of affirmative performance obligations. S.1626, both as originally introduced and with the changes suggested as a result of discussions with representatives of the American Bankruptcy Institute, the Business Bankruptcy Section of the American Bar Association and the National Bankruptcy Conference, allows for such relief. This limited need should not, however, place in question the general viability of the system of licensing intellectual property which has evolved over many years and in gaining added importance in maintaining the preeminence of the United States in technological development.

3. Would you please respond to some of the arguments presented by Thomas Hemnes, who testified before the House and who submitted testimony to this Committee.

A. Mr. Hemnes argues that licensees would get a sweetheart deal because after rejection, they wouldn't have to fulfill their obligations that were considered when the royalty price was set. Do you think that the legislation could potentially have this effect?

This is highly unlikely to happen. Mr. Hemnes' argument ignores that the bankrupt licensor or its trustee has the option of assuming the contract if that is the action which would create a greater benefit to the estate.

Rejection under section 365 is only appropriate when the bankruptcy estate is being relieved of its executory contract. Mr. Hemnes' argument approaches sophistry: with a straight face he argues that the party who will no longer receive the benefit of future performance under the license is getting a sweetheart deal. If the deal is beneficial to the estate, the trustee can choose to assume (perhaps coupling the assumption with assignment if 11 U.S.C. §365(c) is inapplicable to the particular transaction), Mr. Hemnes appears to be asking Congress to redraft S.1626 in a manner which would give the best of all worlds to the bankrupt licensor, i.e., relieving the licensor of its affirmative performance obligations while requiring ongoing nonmonetary performance of the licensee. This would be an inequitable result in any set of circumstances and contrary to the general principles which have guided Congress in crafting the bankruptcy laws. It is particularly unsound to adopt such an approach when it threatens the vitally important system of intellectual property licensing. Imbedded in Mr. Hemnes' submission is the notion that, in enacting 11 U.S.C. §365 in 1978, Congress explicitly intended the result reached by the Fourth Circuit in Lubrizol. The Coalition operates from the opposite starting point, believing Congress did not condone the idea that functional partial transfers of intellectual property pursuant to licensing should not be automatically at risk in the bankruptcy of the licensor. S.1626 is a very balanced solution to the serious problem posed by Lubrizol, i.e., the "sweetheart deal" that a bankrupt licensor may otherwise claim for itself--the right to sell a second time that which was in every practical and business sense, transferred in good faith prior to its bankruptcy filing.

B. Mr. Hemnes also states that this legislation could force a trustee to "be one of the business mistakes that forced the debtor-licensor into bankruptcy proceedings in the first place." Is this essentially an argument that licensees should bear the burden of a licensor's bad business mistakes?

Yes, that is precisely the starting point which Mr. Hemnes assumes. And one of the many problems with that assumption is that it will, at a minimum, generally diminish the consideration that licensors will receive and is highly likely to sever for extraneous reasons the inventors' ownership of his invention or work of authorship. Indeed, the risk that the Lubrizol interpretation of section 365 thrusts upon the licensee is even greater: the licensee is called upon to invest large sums of development capital knowing it may lose its right to the development if, some years later, the bankrupt licensor decides not that it made a bad deal with the original licensee, but that, after the product is fully developed, it can make a better deal with a second licensee who does not bear the developmental risk.

This result is both unfair and unsound for the general economy. The Bankrupt Licensor Coalition believes that it was never intended by Congress and that the contrary interpretation by the Fourth Circuit and other courts should be promptly corrected.

C. Mr. Hemnes suggests that this legislation could chill sublicensing. A licensor may not allow sublicensing by a licensee if he is afraid that, after bankruptcy, the sublicensee will not abide by the confidentiality obligations. Under this legislation, would the sublicensee have a duty to the licensor?

The Bankrupt Licensor Coalition shares the concern of the Senator and Mr. Hemnes that obligations of confidentiality imposed by rejected licenses survive the rejection. S.1626, as originally proposed, addresses the issue of confidentiality in the body of section 365. After discussions with representatives of American Bankruptcy Institute, the Business Bankruptcy Section of the American Bar Association and the National Bankruptcy Conference, the Coalition members were persuaded that confidentiality issues are already adequately addressed in 11 U.S.C. §107(b). We do not share Mr. Hemnes view that licensors will decline to grant licensees the right to sublicense because of the belief of licensors that, at some future time in their own bankruptcies, they may reject the licenses and thereby create risks to the confidential treatment of licensed matters. In the real world, parties to a negotiation do not view themselves as the entity presenting the risk of future bankruptcy.

Questions From Senator Thurmond

S. 1626 would permit a licensee to continue to use, and have access to, intellectual property when the trustee for a licensor's estate rejects the parties' contract. Does this legislation provide any means of compensating the licensor for the continued use of the intellectual property?

Yes, under S.1626 as originally introduced and under the proposed revision of S.1626, if the licensee avails itself of the option to continue using the licensed intellectual property, it has an obligation to make payments due under the rejected license with respect to the retained rights to the bankruptcy estate of the licensor. S.1626, in the form introduced in August 1987, paralleled the present provisions of 11 U.S.C. §365(h) by providing that such payment obligations could be offset by any damages which the licensee suffered as a result of the licensor's nonperformance of obligations from which the licensor is relieved by the rejection. As a result of comments received from representatives of the Business Bankruptcy Section of the American Bar Association and the National Bankruptcy Conference, that provision was changed to assure that the bankruptcy estate would not be deprived of income due under the license in respect of the retained rights, pending determination of whether and to what extent such setoff rights existed. Thus, any royalty payments due under the license agreement (but not payments for the performance of ancillary services which the licensor is no longer providing because of the rejection) will be available cash flow to fund any reorganization attempts by the trustee or to pay creditors in accordance with standard bankruptcy principles. The result of this accomodation of the needs of the reorganizing licensor is that the licensee under the rejected license will generally have only a prepetition damage claim under 11 U.S.C. §365(g) and not a right of setoff.

NATIONAL BANKRUPTCY CONFERENCE
(A voluntary organization composed of persons interested in the improvement of the Bankruptcy Code and its administration.)

July 14, 1988

The Subcommittee on Courts and
Administrative Practice
Senate Judiciary Committee
223 Hart Senate Office Building
Washington, D.C. 20510

Re: Intellectual Property Bankruptcy
Protection Bill, S.1626

Dear Mr. Chairman:

This is in response to your letter of June 23, 1988 enclosing additional questions regarding my testimony on behalf of the National Bankruptcy Conference ("Conference") in connection with S.1626. I regret that court engagements prevented me from responding sooner. Set forth below are my answers to the consecutive numbered questions addressed to the panel, followed by my answers to the separate questions of Senator Thurmond and Senator DeConcini.

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QUESTIONS FOR PANEL ON LUBRIZOL

1. WHY SHOULD LICENSEES OF INTELLECUTUAL PROPERTY RIGHTS BE TREATED DIFFERENTLY THAN OTHER CREDITORS WHO TAKE THE SAME RISK OF REJECTION OF AN EXECUTORY CONTRACT?

2. IS IT NECESSARY TO AMEND THE BANKRUPTCY CODE TO PROTECT THESE KINDS OF BUSINESS TRANSACTIONS? COULD THE LICENSEE NOT SIMPLY PURCHASE THE TECHNOLOGY OUTRIGHT?

3. DO BANKRUPTCY COURTS HAVE THE AUTHORITY UNDER CURRENT LAW TO BALANCE THE EQUITIES IN MAKING THE DETERMINATION TO APPROVE AN ASSUMPTION OR REJECTION OF A CONTRACT INVOLVING INTELLECTUAL PROPERTY RIGHTS? CAN THE COURT TAKE INTO CONSIDERATION THE THE EFFECT OF REJECTION ON THE NON-DEBTOR PARTY TO THE CONTRACT?

4. THE DISTRICT COURT IN THE LUBRIZOL CASE TREATED THE TRANSACTION AS A COMPLETED SALE OF PROPERTY. THE FOURTH CIRCUIT DISAGREED WITH THIS CHARACTERIZATION AND STATED: "LICENSENING ARRANGEMENTS ARE MORE SIMILAR TO LEASES THAN TO SALES OF PROPERTY BECAUSE OF THE LIMITED NATURE OF THE INTEREST CONVEYED." (756 F.2D AT 1046 F.N.)

LEASES ARE SUBJECT TO REJECTION UNDER SECTION 365 OF THE CODE.
WOULD YOU COMMENT ON THIS DISTINCTION.

5. UNDER THE REASONING OF LUBRIZOL, IF A DEBTOR IS ALLOWED TO REJECT THE CONTRACT, DOES THAT DEPRIVE THE LICENSEE OF ALL RIGHTS TO THE TECHNOLOGY?

6. IF THE CONTRACT ARRANGEMENT BETWEEN THE LICENSOR AND LICENSEE GRANTS EXCLUSIVE RIGHTS TO USE THE TECHNOLOGY--WOULD

THAT RIGHT OF EXCLUSIVITIY BE PRESERVED TO THE LICENSEE BY THIS LEGISLATION?

7. SHOULD THE LEGISLATION PROVIDE FOR THOSE SITUATIONS WHERE RETENTION OF EXCLUSIVE RIGHTS BY THE LICENSEE WILL PREVENT THE DEBTOR FROM REORGANIZING?

8. HOW DOES THE BILL AFFECT OBLIGATIONS OTHER THAN THE PAYMENT OF ROYALITIES UNDER THE LICENSING ARRANGEMENT?

9. ONE OF THE CRITICISMS OF THIS LEGISLATION IS THAT IT WILL APPLY TO SITUATIONS MUCH MORE COMPLICATED THAN THE LICENSING ARRANGEMENT IN THE LUBRIZOL CASE. WOULD YOU RESPOND TO THIS.

10. INSTEAD OF AMENDING THE BANKRUPTCY CODE TO TAKE CARE OF A SPECIFIC INDUSTRY, SHOULD CONGRESS LOOK AT SECTION 365 DEALING WITH EXECUTORY CONTRACTS IN A MORE COMPREHENSIVE FASHION?

11. IF THE LICENSEE IS ALLOWED TO RETAIN RIGHTS TO INTELLECTUAL PROPERTY UNDER S. 1626 OR THE PROPOSED BILL, DOES THE LICENSEE HAVE AN OBLIGATION TO KEEP CONFIDENTIAL ANY AND ALL INFORMATION CONCERNING THE PROPERTY?

12. DOES THE RESPONSE IN S. 1626 OR THE PROPOSED BILL PROVIDE A BROADER LEGISLATIVE RESPONSE THAN IS NECESSARY TO RESPOND TO THE CONCERNS RAISED BY LUBRIZOL?

QUESTIONS FROM SENATOR DECONCINI

MR. HAHN:

DOES THE COMPROMISE BILL YOU PROPOSE AS A SUBSTITUTE TO S.1626 GIVE A LICENSEE ANY GREATER RIGHTS TO PROPERTY OF THE LICENSOR THAN IT WOULD HAVE IN THE ABSENCE OF BANKRUPTCY?

HOW ARE OTHER CIRCUITS TREATING THE ISSUE THAT WAS DEALT WITH IN LUBRIZOL?

Answers To Questions Addressed To The Panel
(numbers correspond to the question numbers)

1. Licensing agreements, both domestic and international, promote the free flow of intellectual property. Entire businesses may be built upon the licensing of intellectual property, which by definition, is unique and irreplaceable. There is today an ongoing technological revolution in which young American companies in computers and software, chemicals, pharmaceuticals and electronics depend upon licensing to finance their discoveries and innovations, the development of such and their practical applications. The free flow of intellectual property is important for American industrial competitiveness in international markets. The decision in Lubrizol Enterprises v. Richmond Metal Finishers, 756 F.2d 1043 (1985), cert. denied 475 U.S. 1057 (1986), threatens to put a serious damper on the national economic benefits fostered by this system to the detriment of the society. Because of the importance of industrial labor relations Congress accorded union members special treatment. 11 U.S.C. § 1113. In 1984 Congress accorded special treatment, wrongly in our judgment, to shopping center lessors (11 U.S.C. § 365d(3) and (4)), which the Conference opposed as special interest legislation. If the present bill was intended to promote one more parochial interest like shopping centers, the Conference would have declined

any support for the bill. This is not such an instance in the Conference's judgment.

2. Outright purchase of the technology by the licensee would avoid the problems of rejection in bankruptcy. However, new enterprises frequently are unwilling to sell their intellectual property outright, because it may be the enterprise's most important asset. It is often difficult to place a realistic monetary value on the intellectual property for sale when it involves discoveries or technology which have not been tested extensively or marketed and whose practical applications are yet to be fully explored. The prospective licensee may wish to exploit the intellectual property in only a single field of use and therefore be unwilling to pay a price higher than is warranted for that single field of use. In biotechnology, for example, one major discovery may have numerous potential applications and may be licensed to various parties, each of whom is granted an exclusive license in a separate, distinct field of use related to a particular illness or infirmity. The intellectual property is not static but often a continuous flow of cumulative developments and refinements to which the licensee is given access. Breaking up these accumulations into segments for outright sale may pose special problems. For all of these reasons the parties frequently disfavor outright sale, because it lacks all of the flexibilty,

variety and multi-purpose effects achievable through the medium of licensing agreements.

Lawyers representing licensees are being forced to try to devise new means of guarding the licensed intellectual property in the event of a licensor bankruptcy. These new strategies increase the transaction costs for the parties without achieving any certain measure of greater protection; or they involve encumbering the intellectual property with security interests which may inhibit the licensor's ability to obtain credit from financial institutions.

3. A trustee may assume or reject executory contracts and unexpired leases, subject to the court's approval. 11 U.S.C. § 365(a). The Bankruptcy Code provides no express standards under which the courts should approve or disapprove a proposed rejection (except collective bargaining contracts under § 1113). Courts now employ the business judgment test: will the rejection benefit the estate? Borman's Inc. v. Allied Supermarkets, Inc., 706 F.2d 187, 189 (6th Cir.) cert. denied, 464 U.S. 908 (1983); Lubrizol, supra; In re Minges, 602 F.2d 38, 42 (2d Cir. 1979); In re Tilco, Inc., 558 F.2d 1369, 1372 (10th Cir. 1977): In re NLRB v. Bildisco, 465 U.S. 513, 523 (1984), the Supreme Court noted that the business judgment test is the "traditional" test. The Court in In re Wheeling-Pittsburgh Steel Corp., 72 Bankr. 845 (Bankr. W.D. Pa. 1987) stated "once the debtor establishes that rejection will benefit the estate, our inquiry ends" and refused to consider the

impact of rejection upon the public utility and its customers; accord In re Sharon Steel Corp., No. 87 - 00207E, slip op. (Bankr. W.D. Pa. Nov. 23, 1987). The court in In re Richmond Metal Finishers, Inc., 34 Bankr. 521, 526 (Bankr. E.D. Va. 1983), rev'd on other grounds, 38 Bankr. 341 (E.D. Va. 1984), rev'd sub nom. Lubrizol Enter., Inc. v. Richmond Metal Finishers Inc., 751 F.2d 1043 (4th Cir. 1985), cert. denied sub nom, 475 U.S. 1057 (1986), rejected "fairness" as a test stating "whether one party is injured or rejection is "unfair" to a party is an inappropriate analysis." See also, In re Chi-Feng Huang, 23 Bankr. 798, 801 (Bankr. 9th Cir. 1982).

In contrast to this prevailing view, a minority of courts will disallow rejection if it finds that the non-debtor party would be damaged disproportionately to any benefit to be derived by general creditors. See Infosystems Technology Inc. v. Logical Software, Inc., No. 87-0042, slip. op. (D. Mass June 25, 1987); In re Petur U.S.A. Instrument Co., 35 Bankr. 561 (Bankr. W.D. Wash. 1983); see also, In re Southern California Sound Systems, Inc., 69 Bankr. 893 (Bankr. S.D. Cal. 1987) (case dismissed because debtor filed in bad faith only to reject agreement).

4. Arguably most agreements which license intellectual property more nearly resemble a lease than an outright sale because at their core they are simply continuing promises by the licensor

to allow the licensee the use of property which the licensor owns and controls.

5. Yes.

6. Yes, if referring to the proposed substitute bill; but no, if referring to S.1626 in its present form.

7. I question whether retention of exclusive rights by the licensee ever "will prevent the Debtor from reorganizing". Under the legislation proposed by the industry coalition and supported by the Conference (unlike S.1626), if the licensee elects to retain rights to intellectual property following rejection, the licensee is required to continue to make royalty payments in accordance with the licensing agreement for its duration, without offset. This is expressly mandated by the proposed statutory language.

8. My written testimony dated June 10, 1988 before the Subcommittee on Courts and Administrative Practice addressed the issue regarding obligations of the licensee other than the payment of royalties, (quoted below) in reference to the proposed substitute bill, and I do not believe there is anything further I can add:

> The Conference is aware that licensing agreements may provide, not only for royalty payments from the licensee, but for various forms of non-monetary consideration, such as an exchange of intellectual property or some other performance by the licensee. The bill does not expressly address what happens to

> these other non-monetary obligations of the licensee in the event the agreement is rejected by the debtor licensor and the licensee elects to retain rights to intellectual property. It is believed most of these other obligations of the licensee will survive and the licensee, if he elects to retain rights to the intellectual property, will be required to perform them in addition to making the royalty payments. There may be some obligations, however, that the licensee may be relieved of (not royalty payments which will be mandated by the statute) by a court on the ground they are so closely tied to reciprocal duties which the licensor was relieved of by rejection that it would be inequitable to make the licensee perform them. In any event, it is impossible for legislation to fix in advance which obligations (other than royalty payments) should survive in an infinite variety of situations. This issue must be left to the equitable discretion of the bankruptcy court in the light of the circumstances of each case.

9. This criticism of the legislation apparently proceeds from the erroneous premise that after rejection the licensee who nonetheless elects to retain rights to the intellectual property, will be relieved of all duties imposed by the licensing agreement, on the ground that rejection constitutes a breach. Although rejection constitutes a breach for which the licensee may be entitled to assert a general damage claim, the licensee will not be able to use the breach as a defense excusing his performance of the licensing agreement <u>if</u> he elects to continue to exercise rights to the intellectual property. By such an election, the licensee expressly takes upon himself the obligation to continue to make royalty payments without offset and may also be

required by the court to perform many, if not most of the other obligations imposed by the licensing agreement. The proposed legislation balances the interests of the debtor-licensor and the licensee, encouraging negotiations of such issues in the complex case. Should the parties find themselves unable to reach agreement, the legislation leaves the court with ample discretion to impose upon the licensee whatever contractual duties (in addition to royalties payments) may be necessary or appropriate in the given circumstances. Legislation cannot and should not attempt to anticipate infinite possibilities, but leave these to the court's equitable discretion.

10. It would be appropriate for Congress both to enact the proposed substitute bill and subsequently review § 365 in a comprehensive fashion. The Conference has already decided to undertake a comprehensive review of the entire field of executory contracts. It is hoped the Conference can reach definitive conclusions and recommendations in a year perhaps. Such a review, because it will be intellectually demanding and time consuming, is unlikely to lead to clear results any sooner. If legislation is then necessary, more time may have to elapse. It was the view of the Conference that the proposed bill answers an immediate concern of importance to the national economy, which in fairness should not be held hostage to the completion of a comprehensive study.

11. The licensee has an obligation to keep the intellectual property confidential, which is enforceable pursuant to 11 U.S.C. § 107(b)(1).

12. No. Those who have argued that the legislation is unnecessary usually suggest that the problem will be cured through a better balancing of equities between the debtor-licensor and licensee, pointing to a minority of courts which have expressed willingness to weigh hardship caused to the non-debtor party in determining whether to permit rejection. This is unpersuasive. Only a minority of courts have been willing to consider the impact on the non-debtor party. The prevailing view is to the contrary. Even if courts were willing to weigh the rights of the non-debtor party, that alone will not change the outcome in most cases. Rejection often is necessary in order to relieve the Debtor of its burden of future performance. The primary problem lies not with rejection, but with the exaggerated effects of rejection under the Lubrizol decision, which would strip the licensee of rights he acquired prior to the licensor's bankruptcy.

Response To Question Of Senator Thurmond

Senator Thurmond inquires what problems the Conference has with S.1626 and how the substitute bill would remedy these perceived problems. I will answer by highlighting the differences between the two proposed bills, indicating along the way the

reasons the Conference does not support S.1626, but does support the substitute:

(a) The new legislation should define "intellectual property" by specific reference to patents, copyrights, plant variety certificates, trade secrets and mask works. These terms are generally found in statutes referring to intellectual property. Instead of using these well understood terms, S.1626 relies upon general descriptive language which is imprecise. The proposed alternative bill more accurately defines intellectual property based upon these well known categories.

(b) S.1626 covers trademarks and service marks whereas the substitute bill excludes them. The Conference supports this legislation on a semi-emergency basis in order to further the activities of American research and development companies in the world race for technological leadership. The Conference sees no such emergency for and has no particular interest in, extending such protection to trademarks connected with traditional distributorships and retail businesses at this time.

(c) Moreover, trademark licensors have a responsibility for controlling the quality of the products or services sold to the public by the licensee under the trademark. The licensor's trustee in bankruptcy may be unable to give such quality assurance. This is a special problem which the Conference is not immediately prepared to address. S.1626 does not adequately deal with the

problem other than to suggest that licensees may "continue in concert the quality assurance procedures of the licensor" (n)(1)(B)(2) of S.1626. This would apparently transfer responsibility for quality control to the licensee and defuse that responsibility in a way which may not be feasible. S.1626 does not solve this particular problem or address it in any adequate way. For these reasons, we believe trademarks should be excluded from the legislation and left for further study and separate treatment hereafter, if necessary.

(d) Rejection of a contract does not entitle the debtor or the trustee to ignore the contractual rights of confidentiality enjoyed by the non-debtor party without liability. In any event, 11 U.S.C. § 1107(b)(1) directs the bankruptcy court to enter protective orders to protect rights of confidentiality to intellectual property, on request of a party in interest. S.1626 contains provisions to insure confidentiality which are unnecessary in the light of existing § 107(b)(1). The statute should not be cluttered with redundant provisions. The proposed bill relies on § 107(b)(1).

(e) S.1626 at sub-section (n)(3), states that where the debtor is the licensee, the debtor must maintain confidentiality "to the extent required by applicable non-bankruptcy law". This could be construed as prohibiting the debtor from revealing information to his own trustee in bankruptcy, thereby interfering

with the trustee's ability to liquidate, sell or operate the debtor's business. The proposed bill has no comparable provision.

(f) Both S.1626 and the proposed bill would permit the licensee to retain rights to the existing intellectual property after rejection by the debtor-licensor. Under S.1626 the licensee of exclusive rights would retain non-exclusive rights to the intellectual property. Under the proposed bill, if the licensee had received an exclusive license prior to the bankruptcy, then following rejection he may still retain his right of exclusivity. Licensees are unlikely to commit themselves to substantial royalties and costly exploitation of technology under an exclusive license unless they know that such exclusivity can be preserved to them in a bankruptcy of the licensor. The proposed bill recognizes this, whereas S.1626 did not address it.

(g) S.1626 provides: "subject to subsection (q)... and to Section 553..., if the grantee elects to exercise its rights under the contract... the grantee must satisfy its obligations under such contract..." § (n)(2) of S.1626. This is unsatisfactory. It would allow the licensee a damage claim arising from the rejection-breach as a setoff pursuant to § 553 against the debtor's claim to future royalty payments generated from the licensee's continued use of the intellectual property. Without the undiminished royalty payment stream, the debtor may be financially

unable to reorganize, to the detriment of his business and his creditors. S.1626 does not strike a reasonable balance between the fresh start policy of bankruptcy law and the entitlements of the licensee to retain the use of the existing intellectual property. The proposed bill, in contrast, deals with this problem more effectively. Under the proposed bill the licensee may elect to use existing intellectual property and retain his rights to file a damage claim from the breach, but such claim may not be offset against the royalty stream. The proposed bill contains a provision clearly requiring the licensee who continues to use the intellectual property to pay the royalties without deduction or offset, for the duration of the contract. This furthers reorganization while still protecting the legitimate rights of the licensee.

S.1626 usefully focused attention upon the Lubrizol decision. Although sympathetic to its objectives, the Conference found too many infirmities in S.1626 to be able to support it without substantial revision. The proposed bill, the product of the labors of the industry coalition, the Conference and representatives of the Business Bankruptcy Committee of the American Bar Association, represents a much more satisfactory approach.

Questions From Senator DeConcini

Senator DeConcini inquires whether the bill we propose as a substitute to S.1626 gives a licensee any greater rights to property of the licensor than it would have in the absence of bankruptcy. The proposed bill does not give the licensee greater rights than the licensee would have in the absence of bankruptcy, but gives him fewer rights. Outside of bankruptcy, because intellectual property is inherently unique and irreplaceable, the licensee would be entitled to specific performance of the agreement. The proposed bill makes no provision for future specific performance. Rejection relieves the debtor licensor of that burden. The licensee, under the bill, is allowed to retain only the rights he previously acquired from the already executed portions of the agreement, which rejection was never intended to retrieve (rejection not the equivalent of rescission. Murphy v. C&W Limited Corp., 694 F.2d 172, 174 (8th Cir. 1928)). This is far less than the specific performance state law would afford him. The rights to intellectual property the licensee retains following rejection, moreover, are fixed by the terms and provisions of the licensing agreement. Nothing in the bill entitles him to expand those rights or to disregard limitations provided for by the licensing agreement itself.

The Senator's final question asks how other circuits are treating the issue dealt with in Lubrizol.

Lubrizol has three significant holdings. First, Lubrizol follows Fenix Cattle Co. v. Silver (In re Select-A-Seat Corp.), 625 F.2d 290 (9th Cir. 1980), and holds that a licensor's continuing notice and indemnification obligations to licensee make the license executory. Lubrizol, 756 F.2d at 1045-46.

Second, Lubrizol holds that a debtor's motion to reject an executory contract (in Lubrizol, the debtor is a licensor and the executory contract a license) under 11 U.S. C. § 365 is determined under the business-judgment standard; the debtor's business judgment is deferred to unless it is manifestly unreasonable. Lubrizol, 756 F.2d 1046-47. Lubrizol's second holding has been followed in Wheeling-Pittsburgh Steel Corp. v. West Penn Power Co. (In re Wheeling-Pittsburgh Steel Corp.), 72 Bankr. 845, 849 (Bankr. E.D. Pa. 1987); In re California Sound Systems, Inc., 69 Bankr. 893, 899 (Bankr. S.D. Cal. 1987); Johnson v. Fairco Corp., 61 Bankr. 317, 320 (Bankr. N.D. Ill.. 1986); but See Infosystems Technology Inc. v. Logical Software Inc., No. 870042, slip op. (Dis. Mass. June 27, 1987) ("...in this uncertain area of law the Bankruptcy Court adopted an erroneous legal standard when it applied the Lubrizol test to the question whether Logical should be allowed to reject its agreement with ITI.")

In its third holding, the Fourth Circuit in Lubrizol stated it is well established bankruptcy law that specific performance is not a remedy for rejection of an executory contract

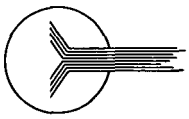
under 11 U.S.C. § 365(g) which provides only a damages remedy to the non-bankrupt party. This is nothing new. (See In re Sun Belt Electrical Constructors, Inc., 56 Bankr. 686, 689 (Bankr. N.D. Ga. 1986); and In re Aslan, 65 Bankr. 826, 829-31 (Bankr. C.D. Cal. 1986). However, the Fourth Circuit went further. It determined that rejection had the effect of depriving the licensee of all rights to use technology transferred to the licensee prior to the licensor's bankruptcy. This rescission of the executed portions of the licensing agreement is contrary to the Ninth Circuit holding in Fenix Cattle, supra (decided under the former Bankruptcy Act). Subsequent to the enactment of the Bankruptcy Code, no other court has had to address this issue of rescission in the context of a licensing agreement of intellectual property. But, this issue has arisen in other types of contracts. See for example, Rudaw/Emperical Software Products Limited v. Elgar Electronics Corp., 83 Bankr. 241, 246 (Bankr. S.D.N.Y. 1988). There the court refused to permit the debtor's rejection of an executory contract to also rescind an executed sale of software arising under the contract. The court observed that rejection is not the equivalent of rescission and that executed transactions are "not subject to the debtor's rejection power." Id. 246.

I very much appreciate having been given the opportunity to testify before your Subcommittee. If there is anything further you may require, please do not hesitate to so advise.

Sincerely,

George A. Hahn

GAH/pk



CERNER
CORPORATION

2800 Rockcreek Parkway—Suite 601
Kansas City, Missouri 64117
(816) 221-1024

June 23, 1988

Senator Howell Heflin
Chairman
Subcommittee on Courts & Administrative Practice
223 Hart Senate Office Building
Washington, DC 20510

Dear Senator Heflin:

Thank you very much for your letter of June 9, 1988, soliciting my comments on the above referenced bill. Cerner Corporation has followed with interest the legislative activity surrounding the Federal Bankruptcy Act and licensed technology.

As a company involved in the licensing of softvare, Cerner has been deeply affected by the Lubrizol v. Richmond Metal Finishers case. Accordingly, I would appreciate it if you would please be so kind as to include in your record the attached statement from Cerner Corporation concerning the importance of amending the Federal Bankruptcy Act to protect the interests of softvare technology licensees.

Thank you very much for your kind attention to this matter.

Very truly yours,

CERNER CORPORATION

By

Richard J. Wall, Jr.
Vice President
General Counsel & Secretary

RJW/dep

Attachment

Hearing
before
The U.S. Senate Subcommittee on Courts and Administrative Practice
June 10, 1988

Statement
of
Richard J. Wall, Jr.
Vice President, General Counsel & Secretary
on behalf of
Cerner Corporation
on
Senate Bill S.1626

Mr. Chairman, Cerner Corporation is a Kansas City-based software development company which manufactures, sells, installs and maintains computerized information management systems for medical laboratories and hospitals' clinical care departments. Cerner has developed its own proprietary software to perform these functions, and it integrates the software with hardware and operating system software supplied by other manufacturers

Cerner's proprietary software is a sophisticated product which improves the quality of healthcare, helps hospitals avoid errors, and keeps the price of healthcare down by alloving hospitals to track and manage costs associated with the delivery of healthcare services. The software is furnished to Cerner clients by way of a license.

The decision by the U. S. Court of Appeals for the Fourth Circuit in Lubrizol v. Richmond Metal Finishers has thrown our industry into turmoil, making it difficult to do business in the most efficient manner. Because of Lubrizol, many of our clients fear that a bankruptcy on the part of Cerner would jeopardize their continued access to Cerner software (software which is crucial to operation of the laboratory and clinical care information management systems purchased from Cerner).

As a result, companies in the software industry, as well as their clients, have wasted considerable time and money to create devices, such as trusts holding copies of their software, that they hope will reduce the possibility of a license agreement's rejection as executory. Such devices are not risk-free, however. And their failure could force licensees either to surrender their licensed software or perhaps to pay a second time for what they already purchased during the original license transaction.

Cerner believes that time and money spent on lawyers and consultants to jerry-build imperfect solutions to legal problems are better expended on

software development (which keeps American businesses ahead of competition from imports) and on patient care for the poor, the young and the elderly.

The best solution to legal uncertainty created by Lubrizol is Congressional action. Of the two bills presently before the Congress, S.1626 and H.R.4657, Cerner would, from the standpoint of the law on intellectual property, prefer the Senate version because of its slightly broader coverage, although we are aware of opposition to that bill by members of the Bankruptcy bar and others. Cerner finds H.R. 4657 acceptable, however, and respectfully urges the Congress to take immediate action to protect the rights of licensees to the intellectual property for which they have contracted.

Failure to safeguard the interests of such licensees will not only increase the cost of healthcare and reduce the efficiency of an important and highly successful segment of the American software industry, but it could also jeopardize the health and lives of thousands of desperately sick people who demand and deserve healthcare services of the highest quality.

On behalf of Cerner Corporation, I thank the Chairman and members of this Subcommittee for the opportunity to submit testimony to the Senate concerning this topic, which is of vital importance to developers and licensees of software used in the healthcare field.

Law Offices
MOSS & BARNETT
A Professional Association
1200 Pillsbury Center
200 South Sixth Street
Minneapolis, Minnesota 55402
Telephone (612) 347-0300
Telecopier (612) 339-6686

May 6, 1988

Writer's Direct Dial Number
347-0250

The Honorable Dennis DeConcini
United States Senator
Committee on the Judiciary
Washington, DC 20510-6275

Dear Senator DeConcini:

Pursuant to your letter of April 22, 1988, I enclose a written statement for the record in connection with the hearing to be held on May 10, 1988, regarding The Intellectual Property Bankruptcy Protection Act (S. 1626).

Thank you for your prompt response to my letter, and thank you for inviting my comments.

Yours truly,

Paul Van Valkenburg

Paul Van Valkenburg

PVV/crt
Enclosures

LAW OFFICES
MOSS & BARNETT
A PROFESSIONAL ASSOCIATION
1200 PILLSBURY CENTER
200 SOUTH SIXTH STREET
MINNEAPOLIS, MINNESOTA 55402
TELEPHONE (612) 347-0300
TELECOPIER (612) 339-6686

May 6, 1988

WRITER'S DIRECT DIAL NUMBER

347-0250

The Honorable Dennis DeConcini
United States Senator
Committee on the Judiciary
Washington, DC 20510-6275

Dear Senator DeConcini:

I have practiced computer law extensively for the last eight to ten years. I am a founding member of the Computer Law Committee of the Hennepin County Bar Association, and a charter member of the Computer Law Section of the Minnesota State Bar Association. I have served as Chairman of the Hennepin County Committee, and currently serve as Secretary of the State Bar Section. From time to time, I represent software vendors and/or software distributors. However, I primarily represent users of computer systems. The opinions expressed below are based upon my years of experience in that context, but are my opinions only, and do not represent the position of the Hennepin County Bar Association, the Minnesota State Bar Association, or Moss & Barnett.

Because of the Lubrizol decision, there is a great deal of uncertainty among computer users whether they will be permitted to continue to use the software in the event of the bankruptcy of the software vendor. As lawyers, we have tried in a number of different ways to protect the users without imposing impossible burdens upon the vendors. I have read extensively about this problem, and have conducted two seminars discussing possible solutions (see outlines attached).

At the current time, neither I nor anyone else to my knowledge has come up with a good solution to this problem. The best hope of eliminating the uncertainty caused by Lubrizol is the passage of The Intellectual Property Bankruptcy Protection Act (S. 1626).

Yours truly,

Paul Van Valkenburg

Paul Van Valkenburg

PVV/crt
Enclosures

Minnesota State Bar Association
Computer Law Section

DISTRIBUTION, LICENSING AND MAINTENANCE OF SOFTWARE

March 23, 1988

Maintenance Agreements

By Paul Van Valkenburg
Moss & Barnett

I. Introduction.

- A. What is maintenance?
- B. Why maintenance?
- C. When maintenance?
- D. Who maintenance?
- E. How maintenance?

II. Terms of the Agreement.

- A. Services provided.
  1. Installation.
  2. Testing.
  3. Training.
  4. Trouble shooting/problem solving/debugging.
  5. Documentation.
  6. Upgrades/enhancements.
- B. Fees; payment.
- C. Taxes.
- D. Term; effective date.
- E. Location.
- F. Liaison.
- G. Warranty; indemnification.
- H. Breach; effect.
- I. Remedies.
- J. Intellectual property/confidentiality.
- K. "Boilerplate"

III. Access to Source Code.

- A. Breach by Vendor.
- B. Alternatives for User.
- C. If User is to continue to use software, then User needs access to the source code.
  1. Deliver source code at the start.
  2. Deliver source code upon breach.
  3. Have third party hold source code.

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D. Problems of bankruptcy.
   1. Ipso facto clauses.
   2. Automatic stay.
   3. Right to property of debtor.
   4. In Chapter 11, right to reject "executory" contracts.
E. Problem of First Sale Doctrine.
F. Solutions.
   1. "New and improved" escrow.
   2. Irrevocable trust.
   3. Security interest.
   4. Use of escrow agent beyond the jurisdiction of U.S. Bankruptcy Courts.
   5. Sale of copy of source code.
      a. Sale of media.
      b. Sale of intangible.

Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., (4th Cir. 1985), 756 F2d 1043.

Richmond licensed certain technology to Lubrizol. Thereafter, Richmond filed bankruptcy under Chapter 11, claimed the license to Lubrizol was executory, and rejected it. The Bankruptcy Court approved this rejection. The District Court reversed the Bankruptcy Court, and held that 1) the license was not executory; and 2) the purported rejection of it was not beneficial to Richmond.

The Fourth Circuit Court of Appeals reversed the District Court and ordered judgment entered as ordered by the Bankruptcy Court:

1. A contract is "executory" when both parties have significant future obligations (Countryman definition).

2. An obligation by one party to pay the other party future royalties does not make an agreement "executory".

3. Richmond owed Lubrizol the following duties:

   A. If it licenses the same techonology to others, to notify Lubrizol;

   B. If it does so, and if the other licensee(s) is/are to pay a lower royalty rate, to reduce the royalty rate paid by Lubrizol; and

   C. If Richmond is sued for infringement, to notify Lubrizol and defend and indemnify it.

4. Lubrizol owed Richmond the following duties:

   A. To account for its sales based on the licensed technology;

   B. To provide quarterly sales reports to Richmond.

   C. To pay royalties to Richmond; and

   D. To keep the technology confidential.

Held:

Both parties had significant future duties and obligations, and therefore the contract was executory. Accordingly, it was proper for Richmond to terminate the license, and Lubrizol could no longer use the technology.

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HENNEPIN COUNTY BAR ASSOCIATION
COMPUTER LAW COMMITTEE

MINNESOTA STATE BAR ASSOCIATION
COMPUTER LAW SECTION CONTRACTS COMMITTEE

SOURCE CODE ESCROWS

I. Introduction.
   A. Overview of today's program.
   B. Today's speakers.
   C. Definitions.
      1. License/Licensor/Licensee.
      2. Software.
      3. Object Code/Source Code.
   D. Typical License Situation.

II. Needs of the Parties.
   A. Licensor.
      1. Retain ownership of software.
      2. Protect ownership of software.
      3. Allow Licensee only expressly limited rights to the software.
   B. Licensee.
      1. Software that works.
         a. Installation and debugging.
         b. Ongoing support.
      2. Archival copy(ies).
         a. On-site.
         b. Off-site.

III. Problems Faced By Licensee.
   A. Non-performance by Licensor.
      1. Justified by Licensee's breach.
      2. Caused by Licensor's bankruptcy filing.
         a. Chapter 7.
         b. Chapter 11.
      3. Licensor goes out of business.
      4. Other.
   B. Without access to the source code, Licensee's software may be (or may soon become) inoperable, and cannot be "fixed" either by Licensee or by a third party.

IV. Licensee's Possible "Solutions".
   A. Third-party escrow.

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1. The source code is placed in the custody of a neutral third party, such as a bank or storage company.

2. Upon the happening of an "event of default" by Licensor, the escrow agent delivers the source code to Licensee.

B. Problems.

1. Practical.

2. Bankruptcy Code.

a. "Ipso Facto" clauses.

b. Right to reject "executory" contracts in Chapter 11 proceedings.

c. Power to compel the return of the debtor's property.

d. Automatic stay.

C. "New and improved" escrow.

1. Actual transfer of title to one copy of the source code to the escrow agent.

2. Two separate agreements, with the agreement between Licensor and the escrow agent being similar to a letter of credit.

3. Avoid use of Ipso Facto clauses.

D. Irrevocable Trust.

1. Transfer title to one copy of the source code to the trustee.

2. No ongoing duties by Licensor.

E. Outright "sale" to the Licensee of one copy of the source code.

F. Use of escrow agent located beyond the jurisdiction of U.S. Bankruptcy Courts.

G. Other?

V. The Vault.

A. Services offered.

1. Secure storage.

2. Escrow.

3. Trust?

B. Forms of agreement.

1. Guidelines.

2. Escrow.

3. "Bare bones" trust (2 pages).

4. More detailed trust (6 pages).

Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., (Fourth Cir. 1985), 756 F.2d 1043.

Richmond licensed certain technology to Lubrizol. Thereafter, Richmond filed bankruptcy under Chapter 11, claimed the license to Lubrizol was executory, and rejected it. The Bankruptcy Court approved this rejection. The District Court reversed the Bankruptcy Court, and held that 1) the license was not executory; and 2) the purported rejection of it was not beneficial to Richmond.

The Fourth Circuit Court of Appeals reversed the District Court and ordered judgment entered as ordered by the Bankruptcy Court:

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2. Richmond owed Lubrizol the following duties:

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   C. If Richmond is sued for infringement, to notify Lubrizol and defend and indemnify it.

3. Lubrizol owed Richmond the following duties:

   A. To account for its sales based on the licensed technology;

   B. To provide quarterly sales reports to Richmond;

   C. To pay royalties to Richmond; and

   D. To keep the technology confidential.

Held:

Both parties had significant future duties and obligations, and therefore the contract was executory. Accordingly, it was proper for Richmond to terminate the license, and Lubrizol could no longer use the technology.

Senator HEFLIN. The next panel is on S. 1358, transfer provisions. Mr. Robert Zinman, Metropolitan Life Insurance Co. of New York; Mr. Herbert P. Minkel from New York; Mr. Philip Shuchman from Rutgers Law School. Mr. Zinman, we will hear from you first.

[A copy of S. 1358 follows:]

II

100TH CONGRESS
1ST SESSION

S. 1358

To amend title 11, United States Code, the Bankruptcy Code, to clarify the transfer provisions.

IN THE SENATE OF THE UNITED STATES

JUNE 11, 1987

Mr. DECONCINI introduced the following bill; which was read twice and referred to the Committee on the Judiciary

---

A BILL

To amend title 11, United States Code, the Bankruptcy Code, to clarify the transfer provisions.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 548 of title 11, United States Code, is amended by adding at the end thereof the following:

"(e) For the purposes of subsection (a)(2) of this section, a person gives a reasonably equivalent value if the person acquires an interest of the debtor in an asset pursuant to a regularly conducted, noncollusive foreclosure sale or execution of a power of sale for the acquisition or disposition

of the interest of the debtor upon default under a mortgage, deed of trust, land sale contract or security agreement.

"(f) The termination of a lease or contract pursuant to the terms of the lease or contract and permitted by applicable nonbankruptcy law is not voidable under subsection (a)(2) of this section.".

SEC. 2. Section 547 of title 11, United States Code, is amended by adding at the end thereof the following:

"(h) For purposes of this section, the acquisition of an interest of the debtor in an asset pursuant to a regularly conducted foreclosure sale, exercise of a power of sale, or other procedure permitted by law for the acquisition or disposition of the interest of the debtor upon default under a deed of trust, land sale contract, or security agreement, is deemed to be taken for new value and not in consideration of an antecedent debt.".

O

S. 1358: TRANSFER PROVISIONS

STATEMENT OF A PANEL CONSISTING OF PROF. ROBERT M. ZINMAN, ST. JOHN'S UNIVERSITY SCHOOL OF LAW, NEW YORK, NY; HERBERT P. MINKEL, JR., FRIED, FRANK, HARRIS, SHRIVER & JACOBSON, NEW YORK, NY; AND PROF. PHILIP SHUCHMAN, RUTGERS LAW SCHOOL, NEWARK, NJ

STATEMENT OF PROF. ROBERT M. ZINMAN

Mr. ZINMAN. Mr. Chairman, Senator Grassley, my name is Robert Zinman. I am a visiting professor of law, St. John's University School of Law, and former vice president and investment counsel at Metropolitan Life.

I appreciate this opportunity to speak today in favor of S. 1358 on behalf of the American Council of Life Insurance, the American College of Real Estate Lawyers, the American Land Title Association, the Mortgage Bankers Association of America, and the U.S. League of Savings Institutions. The American Bar Association also supports our position and has submitted an independent statement. The National Commercial Finance Association has asked me to express their feeling of support for our position, and that it will submit a statement of their own shortly.

S. 1358, as you know, would overcome the rule in *Durrett* v. *Washington National Insurance Company* which held, for the first time in 400 years, after the first fraudulent conveyance law, the Statute of 13 Elizabeth, that a noncollusive, regularly conducted foreclosure sale was a fraudulent transfer where the price paid at the foreclosure sale was less than what the court determined to be a reasonably equivalent value for the property.

The fraudulent transfer statutes were never intended to include noncollusive foreclosure sales and they were never applied to noncollusive foreclosure sales until *Durrett*.

I call your attention to the materials we have submitted, both the formal statement and the background materials, which contain numerous illustrations of the severe, unjust, and irresponsible risks placed on mortgage financing as a result of the incorrect interpretation of section 548 of the Bankruptcy Code by *Durrett*.

Referring to the hypothetical in our formal statement, assume a mortgage for $3 million, which goes into default. The mortgagee is the successful bidder at the foreclosure sale, bidding the mortgage balance of $3 million. The mortgagee then turns around and sells the property to a good-faith third party for the same price.

The former borrower then files in bankruptcy and claims that the property was worth $7 million. The judge says, I agree the value is $7 million. It is a fraudulent transfer and since you do not have the property, Mr. Mortgagee, you will now pay $4 million to the debtor's estate. (That is, the $7 million value less the $3 million bid.)

If that sounds almost impossible, it is essentially the holdings of the *Coleman* and *Littleton* cases, which are cited in the materials.

Durrett has also been extended to leases that have been terminated because of default of the tenant, where they claim it is not a termination of a lease but a reconveyance of the leasehold estate

back to the landlord. *Durrett* has been applied to tax foreclosure sales as well. It has been applied to UCC security interests.

The problem is that real estate appraisal is not an exact science, especially in the area of commercial transactions where the valuation is based on a capitalization of a projected stream of income generally about 10 years into the future. Under *Durrett*, a mortgagee is unable to determine what bid would satisfy a bankruptcy judge in the future who is permitted, under *Durrett*, to make a retrospective evaluation of the property with the benefit of 20/20 hindsight and perhaps a special agenda to get as much as possible for the bankrupt estate.

If *Durrett* is not overturned, it can only result in reduced competitive bidding at foreclosure sales, higher interest rates, tighter credit for people most in need of it, and disruption of the land records. This is true notwithstanding Professor Shuchman's study which he cites in his statement and which I believe is seriously flawed, with respect to the measuring years, with respect to the States that are determined to be pro or anti-*Durrett*, and because it is limited solely to residential mortgage figures. It is in the commercial area where the primary valuation problem exists.

I have some copies of my article analyzing that particular survey, and I will make them available to the committee, for insertion in the record.

I strongly urge passage of S. 1358 to correct a very serious problem in the real estate industry and is spreading into other areas. I appreciate Senator DeConcini's leadership in introducing this legislation into Congress.

Thank you.

[The prepared statement of Mr. Zinman, with supporting document, follows:]

STATEMENT OF THE

AMERICAN COUNCIL OF LIFE INSURANCE

Before the

SUBCOMMITTEE

on

COURTS AND ADMINISTRATIVE PRACTICE

UNITED STATES SENATE

on

S.1358 (To amend title 11, United States Code, the Bankruptcy Code, to clarify the transfer provisions)

June 10, 1988

Statement Made By:

Professor Robert M. Zinman
St. John's University School of Law

Mr. Chairman, I am a Professor of Law at St. John's University School of Law and formerly Vice President and Investment Counsel at Metropolitan Life Insurance Company. I appreciate this opportunity to speak today in support of S.1358 introduced by Senator DeConcini on June 11, 1987. I am testifying today on behalf of the American Council of Life Insurance, the American College of Real Estate Lawyers, the American Land Title Association, the Mortgage Bankers Association of America and the U.S. League of Savings Institutions. Also distributed is a separate statement of the American Bar Association, submitted by the Chairman of its Section of Real Property Probate and Trust Law, supporting our position in favor of S.1358. In addition, the National Commercial Finance Association will submit a separate statement in support of our position.

Let me begin with a hypothetical.

> A bank holds a mortgage loan with a balance of $3 million. The loan is in default and foreclosure is commenced. The bank's appraisers determine the value of the property is $2.8 million and the bank bids $3 million at the foreclosure sale and is the successful bidder. Six months later the bank sells the property to a good faith third party for the bid price of $3 million.
>
> The former borrower then files in bankruptcy and claims the property was worth $7 million at the time of foreclosure and that the sale to the bank was therefore not for a reasonably equivalent value and a fraudulent transfer. The bankruptcy judge, ignoring the second sale as an indication of value, agrees with the borrower and determines that the foreclosure sale was a fraudulent transfer.
>
> Under Section 550 of the Bankruptcy Code, no recourse can be had against a good faith purchaser from the purchaser at the "fraudulent" foreclosure sale. The

bankruptcy judge thus cannot order a re-transfer of the property, but orders the former mortgagee bank to pay $4 million ($7 million value less $3 million foreclosure sale bid) to the bankruptcy debtor's estate.

Impossible? No. The hypothetical above is similar to the court's conclusion in Coleman v. Home Sav. Ass'n. (In re Coleman), 21 Bankr. 832 (Bankr. S.D. Ga., 1988) and In re Littleton, 82 Bankr. 640 (Bankr. S.D. Ga., 1988). It illustrates just one of the severe, unjust and irresponsible risks placed on mortgage lenders as a result of the incorrect interpretation of Section 548 of the Bankruptcy Code by the court in Durrett v. Washington National Insurance Company, 621 F.2d 201 (5th Cir. 1980).

Durrett held that a regularly conducted, non-collusive (non-fraudulent) foreclosure sale could be held to be a fraudulent transfer where the price paid at the foreclosure sale was less than what the bankruptcy court at a later time considers to be a reasonably equivalent value for the property.

Because of the vagaries of real estate appraisal techniques, especially of commercial real estate, it becomes almost impossible for the mortgagee to protect itself from a Durrett holding. Since people buy interests in commercial real estate based on the income the property is expected to produce, the present value of such real estate is determined by estimating what people will pay to rent space over a future period of approximately ten years, and what that stream of income will then be worth, based on estimated interest rates during this future

period, as well as risk factors associated with the mortgaged property.

Mechanically, this value is determined by capitalizing a projected stream of income. An example of this and a discussion of real estate appraisal problems are contained in the attached materials under "Mortgagee Unable to Determine How Much To Bid." Small differences in either the projected income stream or the capitalization rate can cause dramatic differences in value. For example, in Perdido Bay Country Club Estates, Inc. v. Equitable Trust Co. (In re Perdido Bay Country Club Estates, Inc.) 20 Bankr. 36 (Bankr. S.D. Fla. 1982) the appraisals before the court ran between $7.8 million and $13.4 million, the lower appraisal equal to 58% of the higher, and the higher equal to 171% of the lower. Under Durrett, a bankruptcy judge, whose objective may be to obtain as much as possible for the estate, is given the power, with the 20-20 vision of hindsight, to second guess honest appraisals made at the time of foreclosure by retrospective valuations of the property.

No property has to go to foreclosure if there is substantial equity. The value of property is what people will pay for it and if there is substantial equity, the borrower can sell the property long before foreclosure or by exercising the borrower's equity of redemption, sell the property after acceleration of the debt. In either case, the borrower can pocket the "equity."

The unfortunate fact is, however, that there is seldom any equity in property being foreclosed upon, especially in the

commercial area where the borrowers are clearly sophisticated enough to know the value of the property and to sell the property and obtain its value prior to foreclosure. Even in residential situations, borrowers are usually very much aware of what houses in the neighborhood are selling for, and brokers are all too anxious to sell the property for them. Indeed, recent empirical studies have shown that mortgagees normally lose money on foreclosures, whether commercial or residential. (See 70 Cornell L.Q. 850, 780 (1975); Newsweek, October 6, 1986 at 36, cols. 2-3; and discussion of "The Myth of Commercial Real Estate Foreclosure Windfalls" in 9 Cardozo L. Rev. 581, 598 (1987)).

The Durrett rule, then, serves only as a technique to gain more money for the debtor's unsecured creditors in bankruptcy at the expense of good faith mortgage lenders, without any corresponding benefit for the borrowers or society. As the Durrett rule increases lending risks and costs, it can only result in increased interest rates and stricter credit requirements for mortgage loans, making it more difficult for the small homeowner in need of mortgage financing to obtain such financing and less likely that there will be competitive bidding at foreclosure sales.

Under S.1358, a collusive or intentionally fraudulent foreclosure sale will of course remain subject to being set aside as a fraudulent transfer, but a safe harbor is created for regularly conducted non-collusive foreclosure sale, which would no longer be held to be constructively fraudulent under

Section 548 of the Bankruptcy Code. With the wholehearted support of the organizations mentioned above, I urge the prompt enactment of S.1358.

WHY CORRECTIVE LEGISLATION IS NECESSARY TO SOLVE THE "DURRETT" PROBLEM

WHAT IS THE 'DURRETT RULE'?

Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980), held that a non-collusive, regularly conducted foreclosure sale is a fraudulent transfer in bankruptcy where the foreclosure sale price is less than what the court determines is a reasonably equivalent value ("fair consideration" under the bankruptcy law then in effect) for the property. In dictum, the Court indicated that any sale price under 70% of court determined value would probably be less than reasonably equivalent.

This was the first time in over 400 years since the Statute of 13 Elizabeth originally codified the law of fraudulent conveyances that a court has applied such law to non-collusive foreclosure sales. Since the Court agreed that the sale did not involve any intent to commit fraud (the purchaser was an innocent third party who saw the sale advertized in the newspapers and bid an amount equal to the balance of the mortgage) the intentional fraud provision of the bankruptcy law was inapplicable. The Court could find fraud only by finding constructive fraud.

The court thus applied what is now Section 548 (a) (2) of the Bankrutpcy Code, which makes a transfer fraudulent without the necessity of proving fraudulent intent, if the transfer takes place while the transferor is insolvent, within a year of the transferor's bankruptcy and is made for less than a reasonably equivalent value. While the constructive fraud provisions do not require proof of fraud, their development over the years - - from badges of fraud to presumptions of fraud and finally to constructive fraud - - clearly indicates that they were intended to help ferret out transfers designed to put property outside of the reach of creditors, not to attack non-collusive foreclosure sales conducted in accordance with applicable law. See Zinman, Houle and Weiss, Fraudulent Transfers According to Alden, Gross and Borowitz: A Tale of Two Circuits, 39 Bus. Law. 977, 986-95 (1984); Zinman, Noncollusive, Regularly Conducted Foreclosure Sales: Involuntary Nonfraudulent Transfers, 9 Cardozo L. Rev. 581 (1987); but see Kennedy, Involuntary Fraulent Transfers, Id. at 531.

JURISDICTIONS ADOPTING THE DURRETT RULE

The Durrett Rule has been adopted in the Fifth Circuit (where Durrett was decided) and the Eighth Circuit (In re Hulm,

738 F. 2d 323 (8th Cir. 1984) cert. denied, 469 U.S. 990 (1984)). It has been rejected in the Ninth Circuit (Madrid v. Lawyers Title Ins. Corp. (In re Madrid), 725 F. 2d 1197 (9th Cir. 1984) cert. denied, 469 U.S. 833 (1984)), the Sixth Circuit (In re Winshall Settlor's Trust, 758 F.2d 1136 (6th Cir. 1985)) and the Third Circuit in Calairo v. Pittsburgh Nat'l Bank (In re Ewing) 36 Bankr. 476 (W.D. Pa.) affd. mem., 746 F.2d 1465, (3rd Cir. 1984) cert. denied, 469 U.S. 1214 (1985).

INTOLERABLE UNCERTAINTY

Under the Durrett rule, the bankruptcy trustee (and creditors generally under state fraudulent transfer statutues) may move to strike down foreclosures as fraudulent transfers from one to twenty years after the foreclosure sale, and, in certain cases, there may be no limitation on the reach-back period. This places an intolerable burden on the reliability of land records and the freedom of people to enter into lawful contractual relationships.

Under Section 548 of the Bankruptcy Code, the transfer must occur within a year before the commencement of the bankruptcy. However, the bankruptcy trustee or debtor in possession may choose, instead, to act under Setion 544 of the Bankruptcy Code, which permits use of state fraudulent conveyance law to attack the transfer. Except in those jurisdictions (currently 16) that have adopted the new Uniform Fraudulent Transfer Act (which abrogates the Durrett rule in language similar to S.1358), fraudulent conveyance statutes contain the same constructive fraud language as Section 548 of the Bankruptcy Code except that they do not have a one year prior to bankruptcy limitation because bankruptcy is not a condition to their applicability. The only time limitation is the state statute of limitations. In New York the limit is 6 years. In many states it is far longer. Wisconsin apparently has a twenty year limitation period (see Schafer v. Wegner, 78 Wis. 2d 127, 254 N.W. 2d 193 (1977)) and in states like Connecticut the authorities suggest there may not be any statute of limitations for avoiding a fraudulent conveyance (see Carey v. Forlivio 32 Conn. Supp. 7, 336 A. 2d 587 (Conn. Super. 1974)).

Under Setion 544(b), the trustees can take advantage of state law by stepping into the shoes of a creditor who can attack the transfer under state law. If such a creditor is the Federal government, according to United States v. Gleneagles Investment Co., Inc., 565 F. Supp. 556 (M.D. Pa. 1983), there is no time limit because the federal government is not subject to state statutues of limitations.

MORTGAGEE UNABLE TO DETERMINE HOW MUCH TO BID

Because of appraisal uncertainty and the rapid fluctuations of real estate values, it is virtually impossible for the mortgagee to determine what bid will pass muster under the Durrett rule.

Real estate valuation is not an exact science. This is especially true in connection with commercial real estate where the "income capitalization method" is most often employed. Under this approach, an appraiser reaches today's value by determining what a person would pay today for the stream of income the property is expected to produce in the future. This is accomplished by first estimating the expected stream of income the property will produce over a future period of approximately ten years. This involves determining when leases will expire and what tenants will pay in rent at that time. The stream of income is then divided by a percentage known as the "capitalization rate" (determined by taking the so called riskless rate of return (i.e., government securities) and adjusting it upward by risk factors associated with the type of investment (office building, hotel etc.), the particular property (neighborhood, leases, expected future development of the area, etc.) and anticipated inflationary pressures. Small changes in capitalization rate or income stream can result in dramatic differences in value. The mortgagee is concerned that the bankruptcy judge, who may feel obligated to obtain the most for the estate, may, however inappropriately, select those variables that will produce a value well in excess of what the property was really worth on foreclosure.

EXAMPLE A - - APPRAISAL: Prior to foreclosure, the mortgagee hires an appraiser who projects a stream of income of $1 million (100,000 rentable s.f. x net rent of $10 per rentable s.f.), and applies a capitalization rate of 10%. Dividing the $1 million projected income by the 10% capitalization rate, the appraiser arrives at a value of $10 million. The mortgage balance is $11,000,000 and the mortgagee bids this amount at the foreclosure sale. In the ensuing bankruptcy of the borrower, the judge projects the stream of income at $1,760,000 (110,000 rentable s.f. x net rent of $16 per s.f.) and applies a capitalization rate of 8% bringing a value of $22,000,000. The mortgagee's appraiser's valuation is only 45% of the judge's appraisal (the judge's appraisal is 220% of the mortgagee's appraisal) and the mortgagee's successful bid of $11,000,000 ($1,000,000 over its appraiser's valuation) is only 50% of the judge's valuation.

Differences in value such as those shown in Example A are not uncommon. In the Perdido Bay case (23 Bankr. 36 (Bankr. S.D. Fla. 1982)), the appraisals before the court ran from $7.8 million to $13.4 million. In the KRO case (4 B.C.D. 462 (Bankr. S.D.N.Y. 1978)) under Chapter XII of the old Bankruptcy Act where the court found a low value (enabling the bankruptcy partnership to keep the property free of liens by paying the mortgagees a small portion of the mortgage balance) the court used a 20% capitalization rate to reach a value of $895,000 notwithstanding the fact that there were mortgages on the property totaling $16 million.

Another concern of the mortgagee is that real estate values tend to fluctuate, with economic conditions. In making its retrospective valuation at the time of bankruptcy, changed economic conditions beyond the expectation of the appraisers at the time of foreclosure will affect, through hindsight, what the judge concludes the value was at the time of foreclosure.

EXAMPLE B - - HINDSIGHT: Mortgagee has two appraisals made at the time of the foreclosure. One appraiser finds a value of $10 million. Another appraiser finds a value of $9 million. The mortgagee bids the $11 million balance of the mortgage and is the successful bidder. After foreclosure, the mortgagee rehabilitates the office building and completes items of maintenance previously deferred by the borrower. Depressed market conditions begin to ease. Five years later the stream of income is $1,760,000 and an appropriate capitalization rate is 8% bringing a value of $22 million. The borrower was insolvent at the time of foreclosure, recovered solvency for a few years after the foreclosure, but now has again suffered reverses and has filed in bankruptcy. The bankruptcy court using state law under Section 544 of the Bankruptcy Code, finds that the foreclosure five years before had been a fraudulent transfer. Looking at the current value of at least $22,000,000, the court concludes that the value at the time of foreclosure must have been at least $16,000,000 and that the sales price was only 68% of value.

NO PROTECTION FOR THE MORTGAGEE

The mortgagee affected by the Durrett rule, is not given reasonable protection under the Bankruptcy Code. Under Section 548 (c) and 550 (d) of the Bankruptcy Code, a purchaser that the court finds to have acted in "good faith" has a lien on the property recovered by the trustee equal to the sale price plus the increase in value (not exceeding cost) resulting from

improvements made after transfer. Notwithstanding the fact that the Durrett rule involves constructive fraud applied to non-collusive foreclosure sales, it is possible for a court to find, however incorrectly, that a mortgagee with knowledge of the property who bids less than an amount the court considers reasonably equivalent to the value of the property is not acting in "good faith." Indeed, in the recent case of In re Littleton 82 Bankr. 640 (Bankr. D. Ga., 1988), the court so held. Even if the court should find the mortgagee to be in good faith, the lien may not cover foreclosure costs and legal expenses, as well as costs of repairs, alterations and improvements that do not, in the court's judgment, increase the value of the property.

> EXAMPLE C - - IMPROVEMENTS: After acquisition of the mortgaged property at foreclosure and until the sale is set aside as a fraudulent transfer under the Durrett rule in the borrower's bankruptcy, the mortgagee expended $2 million for the following: (i) a new boiler; (ii) redecoration and alterations to the lobby; (iii) rent collection fees; and (iv) operating losses. The bankruptcy court finds that the mortgagee acted in "good faith" when bidding the mortgage balance at the foreclosure sale but rejects inclusion of any of these costs in the mortgagee's lien on the ground that (a) a new boiler was unnecessary and all that will be included is what the cost of repairs to the old boiler would have been; (b) the redecoration and alterations to the lobby were garish and actually drecreased the value of the property; and (c) rent collection fees and operating costs are not "improvements" under Section 550 (d) (2).

Perhaps more troubling to the mortgagee is that under Section 550 (a) the court can recover in lieu of the property, the value of the property transferred, from even a good faith purchaser at the foreclosure sale and may even recover the property or the value from subsequent transferrees from the purchaser at the foreclosure sale if the court finds such transferees were not acting in good faith. If the court finds that such remote purchasers were acting in good faith, it may still require the original purchaser at the foreclosure sale to pay the debtor's estate the difference in value, as illustrated in the following example.

> EXAMPLE D - - RECOVERY OF VALUE: After foreclosure of the property described in Example A, the mortgagee

resells the property to a third party for $11 million, the same amount the mortgagee had bid at the foreclosure sale. The court finds that the foreclosure sale is fraudulent under the Durrett rule and determines that the third party acted in good faith. Thus there can be no recovery of the property or the value of the property from the third party. However the court orders the mortgagee to pay $11 million ($22 million value less the $11 million bid at the foreclosure sale) to the estate. The mortgagee thus is out of pocket $11 million and has no mortgage and no lien on the property. The facts in this example and the results are similar to those in In re Coleman, 21 Bankr. 832 (Bankr. S.D. Tex 1982), and In re Littleton, (82 Bankr. 640 (Bankr. D. GA., 1988).

UNREASONABLE EXTENSIONS OF THE DURRETT RULE

While the Durrett case involved a non-judicial foreclosure sale under the old Bankruptcy Act, the Durrett rule has been applied to judicial foreclosure sales under the Bankruptcy Code; terminations of contracts for deed; foreclosures of security interests under Article 9 of the Uniform Commerical Code; and termination of leases on default by the tenant.

With leases, the argument is that the termination of the lease represents a reconveyance of the leasehold estate from the tenant to the landlord which can be a fraudulent transfer where the value of the leasehold estate is greater than the present value of the rental payments (which is almost always the case for fixed rent leases in a rising rental market).

EXAMPLE E - - LEASES: A leases space to B at $20 a square foot for a term of 10 years. After five years B is in default in payment of rent and the lease is terminated. Because the rental market has become tight, A is able to lease the premises to C at $30 a square foot. B goes into bankruptcy and the bankruptcy court finds that the termination of the lease was fraudulent because it constituted a reconveyance of the leasehold estate from the tenant to the landlord for less than a reasonably equivalent value. Capitalizating the rental payments, the court concludes that the value of the loss to the landlord of the rents under the lease was worth on 66% of the value of the leasehold estate reconveyed, and that the Durrett rule applies.

Building on the Durrett decision, at least two cases have struck down foreclosures as unlawful preferences under Section 547 of the Bankruptcy Code. The theory is that if foreclosure

is a transfer, it is done in consideration of an antecedent debt and if the sale is within the reachback period of three months (or one year if the transferee is an "insider"), the transfer might be set aside as an unlawful preference. Here, of course, reasonably equivalent value is not an issue and the court can attack foreclosure sales at full value if in payment of an antecedent debt. This theory would appear to be wrong since a foreclosure sale that extinguishes the mortgage should be considered to be made for contemporaneous consideration. However, statutory correction is necessary to prevent continued misapplication of Section 547.

> EXAMPLE F - - PREFERENCES: The mortgage balance on foreclosure is $11 million. The borrower files for bankruptcy the day after the foreclosure sale. The bankruptcy court concludes that the sale is not a fraudulent transfer because the value of the property is $11 million. The court nevertheless orders the sale set aside because it concludes that the sale was in consideration of an antecedent debt and within three months of bankruptcy.

WHO WILL BE HURT BY THE DURRETT RULE?

With fine impartiality, borrowers and lenders, landlords and tenants, parties to contracts and in the end the national economy will be severely hurt if the Durrett rule is not overcome. This was recognized by the American Bar Association when on August 3, 1983, its House of Delegates, without opposition, urged by resolution the enactment of Federal and state Legislation to overrule Durrett. It was again recognized by the National Conference of Commissioners on Uniform State Laws, which on August 2, 1984, approved language for state adoption in the new Uniform Fraudulent Transfer Act that would overrule Durrett. A finding of a fraudulent transfer under the Durrett rule will not help the borrower. Any advantage obtained by setting aside the sale or obtaining the value of the property will go to the estate to pay unsecured creditors. The following are some of the adverse consequences that could occur if the Durrett rule should become generally accepted.

1. Discourages Bidding. Since a purchaser at a foreclosure sale is subject to an unreasonable period of exposure to liability under the Durrett rule (see "Intolerable Uncertainity" above) third parties will be discouraged from bidding at foreclosure sales, thus reducing competitive bidding and resulting in lower, not higher, foreclosure sale prices.

2. Restricts Extension of Credit and Increases in Costs of Borrowing. Lenders will be encourgaged to restrict

financing to those with high credit ratings since lenders may not be able to rely on the security. Mortgages are designed to allow financing for families who need mortgage loans to buy their homes. It will be those people who will be primarily hurt by the restrictions on credit resulting from the Durrett rule. In addition, the increased costs involved in mortgage lending covered by Durrett will eventually be reflected in higher interest rates and increased overall costs of borrowing.

3. Restricts Small Business Financing Under Article 9 of the UCC. Institituions will more cautiously engage in inventory, receivables and equipment financing. Prior to the adoption of Article 9 of the Uniform Commercial Code those small businesses that wished to obtain credit based on their inventories and receivables, were relegated to exorbitant interest rate loans from non-institutional lenders because institutions were uncertain whether they could realize on their security under then existing chattel security laws. While the U.C.C. has been successful in bringing institutions into this field of financing, the Durrett rule, if it were to become generally accepted, may destroy years of effort and dry up institutional financing for such small businesses. It would also have similar negative impact on the growing equipment financing industry.

4. Reduced Capital Availability for Housing and Commercial Real Estate Development. Non-recourse mortgage financing, important for the real estate limited partnership, will be restricted as lenders will feel that they need the personal liability of the borrower to compensate for the risks posed by the Durrett rule.

5. Adverse Impact on Sale-Leasebacks. Sale-leaseback financing will become imposible since the rent paid often relates to the purchase price, not necessarily the value of the real estate, and thus were the purchase price and with it the rent is low, the leasehold estate will have a relatively high value, makingit a prime target for Durrett Rule treatment.

6. Land Records. The Durrett rule will have severe consequences for the certainty of land records since title companies will be unable to determine from the record the true interests in the property, they be forced to take exceptions for possible bankrupty of the borrower in both mortgage and fee policies. This is one reason the American Land Title Association and the American College of Real Estate Lawyers have so strongly favored legislation to overrule Durrett.

7. Disrupted National Economy. A stable society requires that its members know within a reasonable period that the consequences of a particular legitimate course of action are

fixed and final. This is precisely why our judicial system works under the principles of res judicata and finality of judgment.

By subjecting non-collusive properly conducted foreclosure sales to a second review often much later and under changed circumstances, this certainty and finality is vitiated, with consequent adverse effect on the viability of mortgage financing, so essential to the national economy.

STATEMENT OF HERBERT P. MINKEL, JR.

Mr. MINKEL. I am Herbert Minkel, member of the New York Bar. I am also a member of the Legislation Committee of the National Bankruptcy Conference and Chairman of the Avoiding Powers Subcommittee of the ABA Business Bankruptcy Committee. I am appearing here today on behalf of the National Bankruptcy Conference.

The NBC opposes S. 1358. The basis of the opposition is that it is our view that *Durrett* was properly reasoned and that the solution to some of the problems which are presented by *Durrett,* namely, the insulation of all foreclosures from attack under the fraudulent conveyance laws is overkill under the circumstances.

There are some legitimate problems, which are referred to in the numerous scholarly articles that have been written on this subject. In my statement, I have cited 16 different articles and notes that take different positions for and against the *Durrett* result. There are numerous articles on this subject which are not cited in the statement.

The bottom line, Senator, is that you can take a hypothetical case and you can apply the *Durrett* decision. You can say it creates an unfortunate result.

By the same token, it is a well-known fact that in many states the foreclosure laws do not provide for adequate notice. They do not provide for real bidding. They do not produce results which approximate fair value for properties. If this S. 1358 is enacted, it relieves any burden on a lender to ascertain what the value is and see to it that he bids enough of his mortgage indebtedness to insulate himself from a *Durrett* attack.

I can illustrate that by a situation where the lender believes the property is worth $700,000 if it was properly marketed. The lender has a $1 million mortgage. He comes in and bids only $100,000, thereby generating a $900,000 deficiency claim in the case.

S. 1358 would insulate that transfer from attack and thereby would permit that mortgage lender to have that $900,000 claim competing with retirees in a liquidating case, product liability claimants, all sorts of involuntary creditors who have no ability to participate in the foreclosure sale, will not get notice of it, and just do not have an ability to protect their interest.

With *Durrett* in place, the lender has to take a look at the situation and say I better bid at least $700,000, thereby reducing my deficiency claim to $300,000, or I run the risk of a problem if this debtor goes into bankruptcy.

So *Durrett,* in certain situations, produces a disciplined and therefore a fairer result. It in effect gives a redemption right to creditors. Because of bankruptcy, it allows people to get the property back if an unfair price has been obtained in the foreclosure sale.

I agree with Bob Zinman that there are problems in valuing real estate which sometimes pop up, but I think the better course of action would be to limit the time period under which a trustee could attack a sale. Section 548 of the Bankruptcy Code applies only to transfers within 1 year of bankruptcy. There is, in certain situations, an almost unlimited time period post-bankruptcy in which a transfer can be attacked.

It would probably be a better way of approaching this to limit the time period within which a debtor or a trustee could attack a foreclosure sale, and thereby, after a certain period of time, title would not be subject to attack and the concerns of title companies and the rest would be addressed in that fashion.

Thank you.

[The prepared statement of Mr. Minkel, Jr., with an attached memorandum, follows:]

STATEMENT OF HERBERT P. MINKEL, JR.
BEFORE THE SUBCOMMITTEE ON COURTS AND
ADMINISTRATIVE PRACTICE OF THE
SENATE COMMITTEE ON THE JUDICIARY
JUNE 10, 1988

I am a member of the firm of Fried, Frank, Harris, Shriver & Jacobson and am a member of the Legislation Committee of the National Bankruptcy Conference. I am also Chairman of the Avoiding Powers Subcommittee of ABA Business Bankruptcy Committee.

I have been invited to testify today on behalf of the National Bankruptcy Conference concerning S.1358, which proposes to amend 11 U.S.C. § 548 by adding subsections 548(e) and (f) and by amending 11 U.S.C. § 547 by adding subsection (h).

The National Bankruptcy Conference is a nonprofit unincorporated organization composed of representatives of different groups who are interested in the administration of bankruptcy law, including bankruptcy judges, full-time professors of law and practicing attorneys who specialize in this area. There are 65 full members and two associate members and all areas of the country are repressented in the membershhip. Since about 1932 the Conference has devoted itself to the improvement of the bankruptcy law and its administration.

The amendments proposed in S.1358 are intended to reverse the decision of the Fifth Circuit in Durrett v. Washington National Insurance Co., 621 F.2d 501 (5th Cir. 1980). In that case, the court held that a debtor-in-possession could avoid a transfer of real property pursuant to a nonjudicial foreclosure of a deed of trust on the ground that the debtor had received less than fair value in consideration of the transfer of the property.[1] The court noted that no transfer of real property which was the subject of an avoidance action under Section 67(d) of the Bankruptcy Act had been approved when the transfer was for less than 70 percent of the market value of the property. The court held that sale proceeds of 57.7 percent of the property's fair market value did not consitute a "fair equivalent" for the

1. On April 7, 1969 Durrett executed a note secured by a deed of trust in favor of Southern Trust and Mortgage Company in the amount of $180,000. Southern assigned the note on the same date to Washington National Insurance Company. Following Durrett's default, and pursuant to the terms of the deed of trust, the trustee on the deed of trust held a foreclosure sale on December 13, 1976 at which the property was purchased by the sole bidder for a price of $115,400, the exact amount due on the deed of trust. Nine days later Durrett filed a petition for an arrangement under Chapter XI of the Bankruptcy Act, and subsequently, as a debtor-in-possession sought to void the foreclosure sale as a fraudulent conveyance. The district court held that the foreclosure sale constituted a transfer under Section 67(d) of the Bankruptcy Act, but further held that the amount paid by the purchaser was fair consideration. The Fifth Circuit reversed the district court.

transfer of the property within the meaning of Section 67(d) of the Bankruptcy Act. Durrett has been followed by courts in numerous real property cases.[2] The theory has been approved for nonjudicial foreclosures,[3] judicial foreclosures,[4] execution sales,[5] and strict foreclosures.[6] It has been used by trustees in chapter 7 cases,[7] by debtors in chapter 11 cases,[8] and by debtors in chapter 13 cases.[9]

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2. Henning, An Analysis of Durrett and Its Impact on Real and Personal Property Foreclosures: Some Proposed Modifications, 63 N.C.L. Rev. 257 (1985).

3. See Federal Nat'l Mortgage Ass'n v. Wheeler (In re Wheeler), 34 Bankr. 818, 820 (N.D. Ala. 1983); (Cooper v. Smith (In re Smith), 24 Bankr. 19, 23 (Bankr. W.D.N.C. 1982). See also Calairov v. Pittsburg Nat'l Bank (In re Ewing), 33 Bankr. 288 (Bankr. W.D. Pa. 1983), rev'd, 36 Bankr. 476 (W.D. Pa. 1984), reversal based on application of theory from Alsop. (Bankruptcy court used Durrett to void an involuntary transfer of personal property; district court reversed used Alsop.)

4. See First Fed. Sav. & Loan Ass'n of Bismark, Inc. v. Hulm (In re Hulm), 738 F.2d 323 (8th Cir. 1984); Home Life Ins. Co. v. Jones (In re Jones), 20 Bankr. 988 (Bankr. E.D. Pa. 1982).

5. See Frank v. Berlin (In re Frank), 39 Bankr. 166 (Bankr. E.D.N.Y. 1984); Richard v. Tempest (In re Richard), 26 Bankr. 560 (Bankr. D.R.I. 1983).

6. See Carr v. Demusis (In re Carr), 34 Bankr. 653 (Bankr. D. Conn 1983); Berge v. Sweet (In re Berge) 33 Bankr. 642 (Bankr. W.D. Wis. 1983).

7. See In re Richard, 26 Bankr. at 560; In re Smith, 26 Bankr. at 19.

8. See In re Frank, 39 Bankr. at 166; In re Berge, 33 Bankr. at 642.

Courts addressing this issue subsequent to Durrett have adopted three different approaches. Several cases, including Abramson v. Lakewood Bank and Trust Co., 647 F.2d 547 (5th Cir. 1981), cert. denied, 454 U.S. 1164 (1982) and In re Richardson, 23 Bankr. 434 (Bankr. D. Utah 1982), have followed Durrett. In Alsop v. Alaska (In re Alsop), 14 Bankr. 982 (Bankr. D. Alaska 1981), aff'd 22 Bankr. 1017 (D. Alaska 1982), the court rejected Durrett's interpretation of when a "transfer" occurs, and instead held that a transfer is effected, for the purposes of section 548, at the time that a security interest attaches. In Alsop, such date was the date of execution of the mortgage deed, which was well in advance of the one year reach of section 548.

Two years after the Durrett decision, the Ninth Circuit Bankruptcy Appellate Panel, in Lawyers Title Insurance Corp. v. Madrid, 21 Bankr. 424 (Bankr. 9th Cir. 1983), held that a foreclosure sale conducted in a regular, noncollusive manner presumptively establishes "reasonably equivalent value" for purposes of section 548 of the Bankruptcy Code. The Ninth Circuit affirmed on different grounds. See Madrid v. Lawyers Title Insurance Corp., 725 F.2d 1197 (9th Cir.), cert. denied, 105 S. Ct. 125 (1984).

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9. See United Penn Bank v. Dudley (In re Dudley), 38 Bankr. 666 (Bankr. M.D. Pa. 1984); In re Wheeler, 34 Bankr. at 818; In re Carr, 34 Bankr. at 653.

Attached as Exhibit A is a memorandum dated August 14, 1985 from H. P. Minkel, Jr. to Joel Zweibel which analyzed the case law as of that date and the provisions of the Uniform Fraudulent Transfer Act as proposed by the National Conference of Commissioners on Uniform State laws.

The National Conference of Commissioners on Uniform State Laws, at its July 1984 conference, codified the holding of the bankruptcy appellate panel in Madrid in the Uniform Fraudulent Transfer Act (UFTA). Section 3(b) of the UFTA says that reasonably equivalent value is given by a person who purchases property at a regularly conducted noncollusive foreclosure sale. Section 8(e) anticipates problems resulting from Durrett that may arise in the context of execution sales pursuant to Article 9 of the Uniform Commercial Code, and provides that a transfer is not voidable if it results from enforcement of a security interest in compliance with Article 9 of the U.C.C. The effect of the amendment of state law is to limit the application of Durrett to actions commenced under 11 U.S.C. § 548, which is limited in scopy to transfers that occur within one year of the filing date of the petition for relief.

As members of the Subcommittee are undoubtedly aware, Congress considered in 1984 a package of amendments which were intended to reverse Durrett. See Amendment in the Nature of a Substitute for H.R. 5174 (98th Cong. 2d Sess. 1984). In

connection with the enactment of the Bankruptcy Amendments and Federal Judgeship Act of 1984,FN+Pub. L. No. 98-353 (1984).+ the definition of "transfer" contained in 11 U.S.C. § 101(50) was amended to include "foreclosure of the debtor's equity of redemption". This amendment had the perhaps unintended effect of reversing Alsop, supra. In addition, 11 U.S.C. § 548(a) was amended to add language to the effect that a debtor's involuntary transfer of an interest in property could be voided under Section 548. A third amendment substantially in the form of a proposed new subsection 548(e) was deleted. These amendments and deletions caused certain commentators to conclude that Congress was codifying Durrett.[10] The confusion produced by these provisions caused Senators DeConcini and Dole to engage in a colliqué three months after the effective date of the amendments in an attempt to establish that Congress did not intend to codify Durrett. 130 Cong. Rec. S13771 (daily ed. Oct. 5, 1984) (Statement of Sen. DeConcini).

S.1358 would effectively exempt the transfer of property pursuant to a regularly conducted noncollusive foreclosure sale or execution of a power of sale for the

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10. See 1985 Collier Pamphlet Editions of the Bankruptcy Code. (Section 548 subsection (a) was amended probably with the thought to codify the holder of the Durrett case and overturn the Madrid case.)

acquisition or disposition of the debtor's interest upon default under a mortgage, deed of trust, land sale contract or security agreement, from attack under 11 U.S.C. § 548(a)(2) by providing that a person gives "a reasonably equivalent value" if the person acquires an interest of the debtor in property in connection with such a sale. The National Bankruptcy Conference does not believe that all foreclosure sales should be exempted by statute from attack under 11 U.S.C. § 548. If Section 548 is amended in the manner proposed in S.1358, there will be no incentive for secured creditors to ascertain the fair market value of the property and to bid in a sufficient portion of their debt to insulate the foreclosure sale from attack. If a secured creditor is permitted to obtain the property by bidding in an amount of secured indebtedness well below the collateral's fair market value, unsecured creditors will be prejudiced to the extent that the debtor has unencumbered property available to satisfy the claims of prepetition unsecured creditors and the secured creditor is permitted to assert a deficiency claim. In addition, S.1358 would prejudice unsecured creditors in those states where foreclosure can be effected without adequate notice so as to stimulate competitive bidding and hence produce sale prices closer to fair market value.

Much has been written with respect to Durrett and its progeny. In fact, very few cases of recent memory have

produced as much scholarly analysis. A number of commentators have taken a strong position against Durrett. See Baird & Jackson, Fraudulent Conveyance Law and its Proper Domain, 38 Vand. L. Rev. 829, 843 (1985); Castanares, Foreclosures in Bankruptcy: Are They Fraudulent Conveyances?, 21 Idaho L. Rev. 517 (1985). The other commentators have defended the court's reasoning in Durrett and have taken the position that voiding foreclosure sales are justified in certain circumstances. See Henning, An Analysis of Durrett and Its Impact on Real and Personal Property Foreclosures: Some Proposed Modifications, 63 N.C. L. Rev. 257 (1985); Alden, Gross & Borowitz, Real Property Foreclosure as a Fraudulent Conveyance: Proposal for Solving a Durrett Problem, 38 Bus. Law. 1605 (1983). But see Zinman, Houle & Weiss, Fraudulent Transfers According to Alden, Gross & Borowitz: A Tale of Two Circuits, 39 Bus. Law. 977 (1984); See also Ehrlich, Avoidance of Foreclosure Sales as Fraudulent Conveyances: Accommodating State and Federal Objectives, 71 Va. L. Rev. 933 (1985); Roberts & Moriarty, Mortgage Foreclosure Sales as Fraudulent Conveyances: The Durrett Issue, 10 Okla. City U.L. Rev. 579 (1985); Kirby, McGuinness & Kandel, Fraudulent Conveyance Concern in Leverage Buyout Lending, 43 Bus. Law. 27, 33 n.25 (1987); Coppel & Kann, Defanging Durrett: The Established Law of "Transfer", 100 Banking L.J. 676 (1983); Comment, Mortgage Foreclosure as Fradulent Conveyance: Is Judicial Foreclosure

an Answer to the Durrett Problem?, 1984 Wis. L. Rev. 195 (1984); Comment, Nonjudicial Foreclosure Under Deed of Trust May Be a Fraudulent Transfer of Bankrupt's Property, 47 Mo. L. Rev. 342 (1982); Note, Applying Hulm In Iowa: Avoiding Involuntary Transfers As Fraudulent Conveyances Under Section 548(a) of the Bankruptcy Code, 71 Iowa L. Rev. 1437 (1986); Comment, Mortgage Foreclosure Sales as Fraudulent Conveyance: Living Under Durrett, 13 Ohio Northern U.L. Rev. 631 (1986); Note, Big Chill: Applicability of Section 548(a)(2) of the Bankruptcy Code To Noncollusive Foreclosure Sales, 53 Fordham L. Rev. 813 (1985); Note, Regularly Conducted Non-collusive Mortgage Foreclosure Sales: Inapplicability of Section 548(a)(d) of the Bankruptcy Code, 52 Fordham L. Rev. 261 (1983); Note, Can Mortgage Foreclosure Sales Really Be Fraudulent Conveyances Under § 548(a)(2) Bankruptcy Code?, 22 Houston L. Rev. 1221 (1985).

Although we are of the view that criticism of Durrett is overstated, there are several aspects of Durrett and its progeny which could be the subject of congressional action. Critics of Durrett have suggested that the doctrine creates uncertainty with respect to title for an indefinite period of time and that such uncertainties have a significant negative effect on the price which will be paid by a bidder at a foreclosure sale. We would suggest that this problem is less significant than portrayed by certain commentators since the

Uniform Fraudulent Conveyance Act is not applicable to involuntary transfers.[11] Since the trustee will not have recourse to state laws pursuant to the "strong-arm powers" contained in 11 U.S.C. § 544, a trustee will be able to void a transfer made in connection with a foreclosure solely on the basis of 11 U.S.C. § 548. Thus, a foreclosure would have to be made within one year of the filing date. Congress could further restrict recourse to this section by limiting the time period within which an action to void a transfer made in connection with a foreclosure sale must be commenced, to one year from the date of entry of the order for relief.

Durrett creates a de facto Federal right of redemption. The advantage of this redemption right is it extends protection to unsecured creditors who are presently not protected by existing state statutory redemption provisions. Approximately twenty-five states permit post-sale redemption
and, in those states, one can fairly question whether Durrett significantly effects the willingness of potential purchasers to participate in foreclosure sales.

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11. The Uniform Fraudulent Transfer Act, which has been codified in fifteen states, specifically exempts noncollusive foreclosures.

Durrett also represents the judicial recognition of the fact that certain states provide virtually no protection for a debtor's equity. Notice of sale may be minimal and since the property is not sold through a qualified broker and since a purchaser must pay the purchase price in cash at the time of the sale, the bidding pool is significantly limited. Legislative attempts to reform this system has not been successful. One attempt in the form of the Uniform Land Transactions Act would provide that:

> "Sale may be at a public sale or by private negotiations, by one or more contracts, as a unit or in parcels, at any time and place, and on any terms including sale on credit, but every aspect of the sale, including the method, advertising, time, place, and terms, must be reasonable."[12]

The range of positions taken by commentators suggests that the Durrett problem should be given further analysis by this Subcommittee and should not be addressed in the manner suggested by S.1358.

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12. Unif. Land Transactions Act, § 3-508(a) (1977).

A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

MEMORANDUM

TO: Joel Zweibel August 14, 1985

FROM: H. P. Minkel, Jr.

1. Introduction

The National Conference of Commissioners on Uniform State Laws has adopted the Uniform Fraudulent Transfer Act ("UFTA"). The UFTA, if adopted by state legislatures, would replace the Uniform Fraudulent Conveyance Act ("UFCA"), which has been adopted in 26 U.S. jurisdictions. This memorandum will address various issues related to the UFTA, including the treatment of issues generated by Durett v. Washington Nat. Ins. Co., 621 F.2d 201 (5th Cir. 1980) ("Durrett"), the "insider" fraudulent conveyance issue, and other possible amendments to section 548 and related sections.

2. Durrett

In order to intelligently address the issue of whether section 548 should be amended to overrule Durrett, I believe it is useful to review the current state of the law, at the risk of restating matters of which the members of our committee are entirely familiar.

The Durrett court held that a debtor in possession could avoid a transfer of real property pursuant to a non-judicial foreclosure of a deed of trust on the ground

that the debtor had received less than fair value in consideration of the "transfer" of the property. The court noted the comprehensive definition of "transfer" contained in the Bankruptcy Act and held that it was broad enough to include the surrender of possession effected through a mortgage foreclosure. The court noted that no transfer of real property which was the subject of an avoidance action under Section 67(d) of the Bankrupty Act had been approved when the transfer was for less than 70 percent of the market value of the property and held that sale proceeds of 57.7 percent of the property's fair market value did not constitute a "fair equivalent" for the transfer of the property within the meaning of Section 67(d) of the Act. The Durrett decision has been widely but incorrectly interpreted as adopting an objective 70 percent benchmark for determination of "reasonably equivalent value" in the context of foreclosure sales. See, Gillman v. Preston Family Investment Company (In Re Richardson), 23 Bankr. 434, 448 (Bankr. D. Utah 1982).

In Alsop v. Alaska (In re Alsop), 14 Bankr. 982 (Bankr. D. Alaska 1981), aff'd, 22 Bankr. 1017 (D. Alaska), the court held that a transfer is effected for the purposes of section 548 at the time that a security interest attaches. The court conceded that a foreclosure sale standing alone might satisfy the definition of transfer under section 101(40) of the Code, but under section 548(d)(1) the

court determined that the transfer was deemed to have been made at the time the original deed of trust was recorded. Since the date of the deed of trust was outside the one year period for avoidance under section 548(a), the foreclosure sale could not be avoided. On appeal, the district court affirmed. Underlying the Alsop court's rejection of Durrett is a concern that a contrary ruling would have an untoward negative effect on the lending community. In this connection, the court referred to minimal participation at foreclosure sales and inadequate sale prices which would result from a lack of active bidders. Alsop, 14 Bankr. at 987. The court noted that Alaska does not grant a statutory right of redemption from a non-judicial foreclosure sale for the purpose of enhancing the reliability of the title acquired at the sale, ostensibly encouraging participation at the bidding. To follow Durrett, the court reasoned, would undermine state law. The court noted that under Alaskan law, a foreclosure sale under a deed of trust may only be set aside if the price received was inadequate and the sale was tainted with either fraud or unfairness. In the court's opinion, it would be contrary to established state law to allow a properly conducted foreclosure sale to be avoided because the proceeds represented less than "reasonably equivalent value." Alsop, 14 Bankr. at 989.

The Ninth Circuit Bankruptcy Appellate Panel in Lawyers Title Insurance Group v. Madrid, 21 Bankr. 424

(Bankr. 9th Cir. 1982), rejected an approach based on the determination of the time of transfer and held that a foreclosure sale conducted in a regular, non-collusive manner presumptively establishes "reasonably equivalent value" for purposes of section 548 of the Code. The Ninth Circuit affirmed on different grounds, see Madrid v. Lawyers Title Insurance Corp. (In re Madrid), 725 F.2d 1197 (9th Cir.), cert. denied, ___ U.S. ___, 105 S. Ct. 125 (1984), and endorsed the Alsop court's characterization of "transfer" under the Code while rejecting Durrett. The Ninth Circuit not only agreed with the Alsop court's interpretation of section 548(d)(1) as narrowing the definition of transfer set out in section 101(41) of the Code, but as an alternative holding stated that a transfer under section 548(a) of the Code did not occur since a mortgage foreclosure is an involuntary conveyance triggered by the debtor's failure to fulfill an obligation secured by a mortgage or deed of trust (rather than a voluntary conveyance). In re Madrid, 725 F.2d at 1202. The alternative holding espoused by the Ninth Circuit has its origins in state fraudulent conveyance law. See infra, discussion under "Uniform Fraudulent Conveyance Act."

Alsop and Madrid have attracted few adherants. Note, Bankruptcy and Non-Judicial Foreclosures as Fraudulent Transfers Under § 548 of the Bankruptcy Code-Madrid v. Lawyers Title Insurance Corp., 10 U. Dayton L. Rev. 399, at

405-407 (1985); but see, Strauser v. Veterans Admininstration, et al., 40 Bankr. 868 (Bankr. N.D. Ohio 1984). Courts considering Alsop and Madrid have been unpersuaded by the Alsop court's attempt to limit the broad definition of transfer contained in section 101(41) of the Code through application of section 548(d)(1). In Lakeview Investment Group v. A.B. Pemberton, et al., 40 Bankr. 449, 452 (Bankr. E.D.N.C. 1984), the court reasoned:

> The Court (sic) in the Madrid case relies heavily on the language of 11 U.S.C. § 548(d)(1) in concluding that the "transfer" occurred at the time of perfection of the deed of trust rather than at the foreclosure sale. There is no doubt that a transfer occurs at the time the deed of trust is perfected; however, the debtor has multiple interests in real property. It may be accurate to state that no junior mortgagee of the debtor can acquire rights in the property superior to the rights of the senior mortgagee; however, the rights of an owner of the property are superior rights to those of a mortgagee. Frequently, the property has value in excess of the perfected liens. Although this right is subject to the perfected security interest, it is nonetheless an interest which is superior to the security interest.

Courts and commentators alike have turned from the strained interpretation espoused by Alsop and Madrid and have generally followed Durrett.

(a) Durrett Transfer Endorsed; 70 Percent Benchmark Rejected

Subsequent to Durrett, the Fifth Circuit reaffirmed its holding that a non-judicial foreclosure sale constitutes a transfer under the Act in Abramson v. Lakewood Bank and Trust Co., 647 F.2d 547 (5th Cir. 1981), cert. denied, 454 U.S. 1164 (1982). The Fifth Circuit has not had occasion to

adopt or reject the 70 percent benchmark for determinination of "reasonably equivalent value" attributed to it by numerous courts and commentators. Most have endorsed the Fifth Circuit's reading of transfer as embracing a non-judicial foreclosure sale, see, Note, Bankruptcy and Non-judicial Foreclosures, supra at 405 n.56, but have rejected the 70 percent benchmark attributed to the Durrett court. See id. at 405 n.58.

(b) Foreclosure Sale As Transfer

Courts have noted that section 101(41) of the Code defines "transfer" broadly, encompasses any interest of the debtor in property, expressly includes involuntary transfers, and does not require that the transfer be made by the debtor. See, First Fed. Sav. & Loan Ass'n of Bismarck, Inc. v. Hulm (In re Hulm), 738 F.2d, 323, 326 (8th Cir. 1984). As stated by the court in Lakeview, 40 Bankr. at 452:

> The debtor's equity of redemption is an interest in property. The foreclosure sale disposes of the debtor's interest in the property. It might be argued that an interest in property is not transferred in that the foreclosure sale simply "extinguishes" the debtor's right of redemption. However, regardless of the semantics, a property right of the debtor is "disposed" of by the sale and this is clearly within the definition of a transfer. 11 U.S.C. § 101(41).(Citation omitted).

While the foregoing construction clearly threatens to undermine state foreclosure law -- "such facts cannot be dispositive for [courts] must follow the plain language of the federal law and apply that which Congress has established

to promote the equal distribution of the debtor's assets to all creditors. Although certain provisions of the Code . . . may require [a court] to apply state law, section 548(a)(2)(A) is not one." Frank v. Berlin (In re Frank), 39 Bankr. 166, 176 (Bankr. E.D.N.Y. 1984); see also In re Hulm, infra, 738 F.2d at 327.

The Eighth Circuit recently held that a judicial foreclosure sale and issuance of a sheriff's deed constituted a transfer under section 101(41) of the Code. First Fed. Sav. & Loan Ass'n of Bismarck, Inc. v. Hulm, 738 F.2d 323 (8th Cir. 1984). While the Eighth Circuit did not cite Durrett in support, the court adopted the same reading of transfer and held that a judicial mortgage foreclosure sale was subject to avoidance under section 548 of the Code if the transfer was for less than "reasonably equivalent value." The court remanded for an evidentiary hearing on the question of "reasonably equivalent value."

On the issue of when a transfer occurs, Madrid appears to represent the minority view and the trend of decisions seems to support Durrett.[1]

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1. Nonjudicial foreclosures: see, Federal Nat'l Mortgage Ass'n. v. Wheeler, 34 Bankr. 818, 820 (Bankr. N.D. Ala. 1983); Cooper v. Smith, 24 Bankr. 19, 23 (Bankr. W.D.N.C. 1982); Gilman v. Preston Family Inv. Co. (In re Richardson), 23 Bankr. 434, 448 (Bankr. D. Utah 1982); Wickham v. United Am. Bank in Knoxville (In re Thompson), 18 Bankr. 67, 70 (Bankr. E.D. Tenn. 1982) (relief denied because reasonably equivalent value given); Marshall v.

Footnote Continued

(c) 70 Percent Benchmark Rejected

Courts outside the Fifth Circuit adopting Durrett's holding that a foreclosure sale is a transfer for purposes of section 548(a) of the Code, have almost uniformly rejected a 70 percent objective test for the determination of "reasonably equivalent value." Rather than applying an objective approach, courts have adopted a case-by-case method for determining reasonably equivalent value. As noted by the court in Cooper v. Smith, 24 Bankr. 19, 23 (Bankr. W.D.N.C. 1982):

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1. Footnote Continued From Previous Page

Spindale Sav. & Loan Ass'n, 15 Bankr. 738 (Bankr. W.D.N.C. 1981). Judicial foreclosures: see, First Fed. Sav. & Loan Ass'n of Bismarck, Inc. v. Hulm, (In re Hulm), 738 F.2d 323 (8th Cir. 1984); United Penn Bank v. Dudley, 38 Bankr. 666 (Bankr. M.D. Pa. 1984) (relief denied because reasonably equivalent value given); Home Life Ins. Co. v. Jones, 20 Bankr. 88 (Bankr. E.D. Pa. 1982). Strict foreclosures: see Frank v. Berlin, 39 Bankr. 166 (Bankr. E.D. N.Y. 1984), Richard v. Tempest, 26 Bankr. 560 (Bankr. D.R.I. 1983); Smith v. American Consumer Fin. Corp., 21 Bankr. 345 (Bankr. N.D. Fla. 1982). Execution sales: see, Car v. Demusis, 34 Bankr. 653 (Bankr. D. Conn. 1983); Berge v. Sweet, 33 Bankr. 642 (Bankr. W.D. Wis. 1983); Perdido Bay Country Club Estates, Inc. v. Equitable Trust Co., 23 Bankr. 36 (Bankr. S.D. Fla. 1982) (applying Vermont law). Trustees in Chapter VII proceedings: see, Richard v. Tempest, 26 Bankrupt 560 (Bankrupt 1983); Cooper v. Smith, 24 Bankr. 19 (Bankr. W.D.N.C. 1982) In re Richardson, 23 Bankr. 434 (Bankr. D. Utah 1982); In re Thompson, 18 Bankr. 67 (Bankr. E.D. Tenn. 1982). Debtors in Possession: see Frank v. Berlin, (In re Frank, 39 Bankr. 166 (Bankr. E.D.N.Y. 1984); Burge, 33 Bankr. 642; Perdido Bay, 23 Bankr. 36. See generally Henning, An Analysis of Durrett and Its Impact on Real and Personal Property Foreclosures: Some Proposed Modifications, 63 N.C.L. Rev. 257, 266 nn. 54, 55, 56, 57, 58, 59, 60, and 61 (1985); Frank v. Berlin, 39 Bankr. 166, 169-70 (Bankr. B.D.N.Y. 1984).

> [T]his Court feels that the percentage the amount paid for the transfer is of the fair market value of the property is but one factor to be used in determining 'reasonably equivalent value' under 11 U.S.C. § 548(a)(2)(A). ... All the facts and circumstances of each case must be considered together before 'reasonably equivalent value' can be determined. Factors to be considered include the good faith of the transferee, the relative difference in the amount paid compared to the fair market value, and the percentage the amount paid is of the fair market value.

One court has noted that the term "reasonable equivalence" contained in section 548(a)(2) was designed to facilitate a factual inquiry, and that reasonable equivalence will depend on the facts of each case. In re Richardson, supra, 23 Bankr. at 446-448. Another court has suggested that while reasonable equivalence under section 548 must be determined on a case-by-case basis, the Durrett 70 percent benchmark should be considered a rebuttable presumption of equivalence. Berge v. Sweet, 33 Bankr. 642, 649-650 (Bankr. W.D. Wis. 1983). A few courts have stated that reliance on a 70 percent benchmark test could result in injustice if courts were bound to follow such a rigid rule rather than a totality of the circumstances test in determining reasonably equivalent value. (See, e.g., In re Smith, 24 Bankr. at 23; the court disapproved of the 70 percent rule and noted that a building with a fair market value of $1 million could be sold at a foreclosure sale for $700,000 and while meeting a benchmark test, under a totality of the circumstances test, may be held to have been transferred for less than reasonably equivalent value; therefore, only a case-by-case

determination can assure a just application of the reasonably equivalent value standard.)

A clearly articulated analytical structure for determining reasonably equivalent value under section 548(a)(2)(A) of the Code, in the context of avoidance of mortgage foreclosure sales, appears in In re Richardson, supra, 23 Bankr. at 441-43 n.11.[2] On remand from the Eighth Circuit, the bankruptcy court in First Federal Savings & Loan Association of Bismarck v. Hulm, 45 Bankr. 523, 528 (Bankr. D.N.D. 1984), applied Richardson's analysis to determine that 64.44 percent of market value was not a

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2. The court in In re Richardson, supra, 23 Bankr. at 441-442 n.11, set forth a method for determining "reasonably equivalent value" calculated by subtracting post sale liens from the fair market value of the property, then comparing the bid price with the equity remaining after the foregoing determination. If a substantial amount of equity relative to the bid price remains, the foreclosure sale should be avoided.

   Policies underlying the fraudulent conveyance sections of the Code justify avoiding some transactions regardless of the debtor's lack of equity in the property. If the property is subject to multiple recourse mortgages, and a senior mortgagee acquires the property through foreclosure for an amount less than fair market value and free of subsequent liens, and a junior mortgagee asserts a deficiency judgment against the bankrupt's estate, avoidance may be proper. If the sale is avoided and the trustee can sell the property for an amount above the bid price, the deficiency claim against the bankrupt estate will be reduced concommitantly to the benefit of unsecured creditors generally. Therefore, while the debtor has no equity in the property, it may still be possible in the context of recourse mortgages to enlarge the estate by reducing deficiency claims.

"reasonably equivalent value" for the property sold at foreclosure under the facts as presented. See infra n.4.

(d) Judicial and Non-Judicial Foreclosures

Courts have applied Durrett to both judicial and non-judicial foreclosure sales. While some courts are reluctant to void state-court supervised foreclosure sales, there appears to be no reason to distinguish between judicial and non-judicial foreclosure sales where state procedures for judicial foreclosures are bereft of procedures which insure that market forces will be brought into play which will produce fair market value.

(e) Congressional Response to Durrett

In connection with the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 1984 U.S. Code Cong. & Ad. News (98 stat.) 333, Congress considered Durrett. While it may not have been the intent of Congress to support or reverse Durrett,[3] amendments were adopted which, nonetheless, potentially affect existing cases. For example, the definitiions of "transfer" has been amended to provide that:

> "Transfer" means every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption.

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3. See colloquy between Senators DeConcini and Dole concerning Congressional intent regarding the Durrett issue, ____ Cong. Rec. S13,771-772 (daily ed. Oct. 5, 1984).

11 U.S.C. § 101(48) (emphasis added to indicate amendment). Foreclosure of a debtor's equity of redemption is now explicitly contained in the definition of "transfer" in the Code, although previously most courts and commentators considered the definition of transfer broad enough to include the disposition of the debtor's equity of redemption at a foreclosure sale. Note, Bankruptcy: Non-Judicial Foreclosures, supra at 407.

Section 548(a) was also amended and now provides in pertinent part as follows:

> (a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily -
>
> (1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or
>
> (2) (A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
>
> (B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
>
> (ii) was engaged in business or a transaction, or is about to engage in business or a transaction, for which any property remained with the debtor was an unreasonably small capital;
>
> . . . .

11 U.S.C. § 548 (emphasis added to indicate amendment).

The amendment contained in section 548(a) clearly indicates that for purposes of the fraudulent conveyance section of the Code, voluntary action is not required by the debtor to give rise to the avoidance powers of the trustee. This differs from traditional state fraudulent conveyance law and the current Uniform Fraudulent Conveyance Act. The amendment has the effect, even if unintentional, of reversing the alternative holding contained in Madrid that a debtor must make a voluntary act for a transfer to have occurred for purposes of section 548(a) of the Code.

The Madrid court relied on section 548(d)(1) of the Code as the primary basis for its holding that a mortgage foreclosure sale does not constitute a transfer for purposes of section 548. Section 548(d)(1) has not been amended by Congress and technically Madrid is still good law in the Ninth Circuit.

(f) Uniform Fraudulent Conveyance Act

The concern that a trustee under section 544(b) may avoid a mortgage foreclosure sale under the avoidance provisions of the UFCA has been expressed by at least one commentator. See, Zinman, Houle, & Weiss, Fraudulent Transfers According to Alden, Gross and Borowitz: A Tale of Two Circuits, 39 Bus. Law. 977, 983 (1984). The UFCA, however, may not be used as a vehicle for upsetting a mortgage foreclosure sale untainted by fraud or collusion between the mortgagor and mortgagee. "Conveyance" under the

UFCA is not defined as broadly as "transfer" under the Code. The UFCA pertains only to voluntary conveyances, and this does not include a mortgage foreclosure sale or an execution sale of personal property. Only when tainted with actual fraud, or when a foreclosure is part of a scheme to avoid payment to creditors, will a state court utilize the provisions of the UFCA to upset a foreclosure sale. See, Alden, Gross, and Borowitz, Real Property Foreclosure as a Fraudulent Conveyance: Proposals for Solving the Durrett Problem, 38 Bus. Law. 1605, 1606 n.3 (1983).

Section 1 of the UFCA includes among its definitions: "[c]onveyance includes every payment of money, assignment, release, transfer, lease, mortgage or pledge of tangible or intangible property, and also the creation of any lien or encumbrance." Section 4 of the UFCA is the provision relating to constructive fraud: "[e]very conveyance made . . . by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a fair consideration." (Emphasis added.)

In Hearn 45 St. Corporation v. Jano et al., 283 N.Y. 139, 27 N.E. 2d 814, 816 (1940), the court noted that to state a claim under the UFCA it was not necessary to show actual fraud, but "a complete cause of action may be stated by a showing of the bare facts of a voluntary conveyance resulting in insolvency." (Emphasis added.) In Meriam v.

Wimphheimer, et al., 25 F. Supp. 405, 406 (S.D.N.Y. 1938), Judge Woolsey stated, in construing New York's version of the foregoing sections of the UFCA, "[i]t seems to me that there was not a conveyance by the bankrupt . . .under [the New York version of Section 4 of the UFCA]. The laws of New York seem to require a voluntary act by the transferor to constitute a conveyance." (Emphasis added.) The case involved a foreclosure on a pledge of stock. Judge Woolsey based his interpretation on a number of cases involving collusion between the debtor and a creditor or crony where the debtor was, in effect, an actor in the foreclosure. Active participation by the debtor rendered otherwise involuntary transfers effected by foreclosure voluntary conveyances for the purposes of the UFCA. For an example of such a case, see C.H. Swain v. Kirkpatrick Lumber Company and Calcasieu National Bank, et al., 78 So. 140 (La. 1918), where the court upheld the overturning of a sheriff's sale noting that either actual fraud or a scheme between mortgagor and mortgagee to deter active bidding at the sale can justify upsetting a foreclosure sale.

When the original mortgage or grant of a security interest is part of a scheme between the debtor and the creditor/mortgagee in an effort to defraud creditors, the mortgage and foreclosure will be merged and the conveyance considered voidable pursuant to the UFCA. Justice Cardozo in Shapiro v. Wilgus et al., 287 U.S. 348, 353-54, stated:

> The conveyance and the receivership are fraudulent in law as against non-assenting creditors. They have the unity of a common plan, each stage of the transaction drawing color and significance from the quality of the other; but, for convenience, they will be considered in order of time as if they stood apart. The sole purpose of the conveyance was to divest the debtor of his title and put it in such a form and place that levies would be avoided. . . . The conveyance to the corporation being voidable because fraudulent in law, the receivership must share its fate. It was part and parcel of the scheme whereby the form of a judicial remedy was to supply protective cover for a fraudulent design."

Clothing a fraudulent design in a legally sanctioned form will not insulate the transaction from avoidance under the UFCA. If the court finds such a plan or design, the foreclosure or execution sale will be considered elements of a voluntary conveyance by the debtor and will be subject to avoidance under the UFCA. In Harris v. Wagshal, 343 A.2d 283, 293 (D.C. Cir. 1975), the court noted "[w]hile the most common claim of a fraudulent conveyance attacks the tranfer of property by a debtor to a creditor or other party, the coverage of the statute is sufficiently comprehensive to include the induced foreclosure under a mortgage or other security interest if accomplished fraudulently. Generally, any conveyance of property may be vitiated by fraud, and the form of the transfer is not controlling."

State law cases avoiding mortgage foreclosure sales under the UFCA invariably involve a transaction tainted with actual fraud or involve a conspiracy between the mortgagor and mortgagee which renders the foreclosure a voluntary conveyance. See Alden, supra at 1606 n.3. The following

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long-standing common law rule relating to mortgage foreclosure sales is left undisturbed by the UFCA: "mere inadequacy of price alone does not justify the setting aside of [an] execution sale, and ordinarily even a grossly inadequate price does not justify such action unless combined with other circumstances indicative of fraud, unfairness, or mistake . . . ." Annot., 5 ALR 4th 794, 798.

In In re Richardson, 23 Bankr. 440-41, the court examined the possibility of upsetting a foreclosure sale pursuant to the UFCA. The court noted that the matter was one of first impression in Utah and avoided deciding the issue. In dicta, the court noted that a state court disposed to allowing avoidance of foreclosure sales under the UFCA may conclude that a voluntary conveyance was made by the debtor because it was made with the authorization given in the deed of trust, that the grant of authority to sell and the sale itself are separate transfers, that the transfer by way of the sale was without fair consideration, that it rendered the debtors insolvent, that it deprived the debtor's other creditors of a significant asset, and that the policies of creditor protection reflected in the UFCA mandate avoidance of the transfer. The foregoing line of reasoning could justify a finding that the foreclosure sale, combined with the deed of trust, was a "voluntary conveyance" by the mortgagor, permitting avoidance of the mortgage foreclosure sale under the UFCA. The Richardson court noted, however,

that a state court may be reluctant to adopt such a creative reading of the UFCA for it would undermine the legislatively enacted mortgage foreclosure laws. Because of this latter consideration, it is unlikely that a state court would follow the hypothetical line of reasoning advanced by Richardson. The court acknowledged that one of the primary justifications of Durrett is that federal bankruptcy law is plenary and controls notwithstanding conflicting state mortgage foreclosure laws, and such is not the case when accommodating two state laws each with separate policy justifications. Id. at 448.

(g) Uniform Fraudulent Transfer Act

The proposed UFTA expands the scope of state fraudulent conveyance law by subjecting involuntary as well as voluntary dispositions of a debtor's property to possible avoidance. The definition of transfer in the UFTA is broad enough to embrace noncollusive mortgage foreclosure sales. However, the UFTA definition of "reasonably equivalent value" addresses the Durrett problem in an attempt to insure that title derived through a foreclosure sale cannot be attacked.

The comments to the UFTA state that the definition of "transfer" was derived principally from section 101(48) of the Code. Section 1(12) of the UFTA provides as follows:

> "Transfer" means every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an asset or an interest in an asset, and includes payment of money, release, lease, and creation of a lien or other encumbrance. (Emphasis added.)

Comments to Section 1 acknowledge that the UFCA does not explicitly apply to involuntary transfers, but asserts that decisions under the UFCA were generally consistent with such an interpretation. The comments suggest that the broad definition of transfer contained in the UFTA does not alter the existing concept of "conveyance" in the UFCA. The comment refers to authorities which involved foreclosure and execution sales tainted with actual fraud or conspiratorial schemes between the mortgagor and mortgagee to deter bidding at the sale for their mutual benefit. The cases do not support bringing non-collusive foreclosure sales within the ambit of the UFCA.

Sections 4(a)(2) and 5 set forth the constructive fraud provisions of the UFTA and provide that a transfer of property by a debtor for less than "reasonably equivalent value" which imperils the debtor's ability to conduct business, or which is made while the debtor is insolvent or renders the debtor insolvent, is subject to avoidance. Section 3(b) of the UFTA directly addresses Durrett and provides as follows:

> For the purposes of Sections 4(a)(2) and 5, a person gives a reasonably equivalent value if the person acquires an interest of the debtor in an asset pursuant to a regularly conducted, noncollusive foreclosure sale or execution of a power of sale for the acquisition or disposition of the interest of the debtor upon default under a mortgage, deed of trust, or security agreement.

Section 8(e) anticipates problems resulting from Durrett that may arise in the context of execution sales pursuant to Article 9 of the U.C.C. and provides as follows:

A transfer is not voidable under Section 4(a)(2) or Section 5 if the transfer results from:

(1) termination of a lease upon default by the debtor when the termination is pursuant to the lease and applicable law; or

(2) enforcement of a security interest in compliance with Article 9 of the Uniform Commercial Code.

Sections 3(b) and 8(e) prevent the Durrett problem from infiltrating the UFTA. While the broad definition of "transfer" in the UFTA would seem to open the door to Durrett, the definition of reasonably equivalent value closes the door in the absence of evidence of collusive bidding or failure to follow state procedure.

(h) Article 9 Implications

In light of Durrett and subsequent amendments by Congress, there is not reason to think that the foreclosure of a security interest in personal property is immune from attack under section 548(a). See, Henning, An Analysis of Durrett and Its Impact on Real and Personal Property Foreclosures: Some Proposed Modifications, 63 N.C. L. Rev. 257, 277-78 (1985). While the Uniform Commercial Code is generally more protective of the debtor's equity in collateral than are real property foreclosure laws, UCC Section 9.507(2) reflects the common law rule relating to foreclosure sales that mere inadequacy of price will not be sufficient to support a finding that a sale is commercially unreasonable (giving rise to a cause of action against the secured party).

The Durrett doctrine has been applied to Article 9 foreclosures in Calairo v. Pittsburgh Nat'l Bank, 33 Bankr. 288 (Bankr. W.D. Pa. 1983), in which the court denied a secured party's motion to dismiss a trustee's attack on a foreclosure sale on pledged stock. The district court reversed, endorsing the Alsop rationale. Calairo v. Pittsburgh National Bank, 36 Bankr. 475 (W. D. Pa 1984). Given the disrepute into which Alsop has fallen, the reversal is suspect and future cases involving personality may follow Durrett.

Recommendation

It is no secret that the deliberations of the drafting committee concerning the UFTA and Durrett were at times acrimonious. It would appear that reasonable persons can, and do, differ on whether blanket immunity for transfers in connection with non-collusive foreclosure sales is appropriate. The case law is confusing and, in certain instances, intellectually dishonest. The results of the 98th Congress' attempt to address Durrett has resulted in the addition of statutory language which has further confused matters.

My personal opinion is that a transfer of property of the estate pursuant to a foreclosure sale should be voidable if less than reasonable equivalent value has been given and the estate has been diminished or secured claims have been inflated by reason of such fact. This means that

the dollar amount paid at a sale would be irrelevant in a case where the sale effected the discharge of non-recourse debt in excess of the court determined value of the property since the estate was not deprived of an asset (i.e. equity) nor were any additional claims created by reason of a low bid.

I recognize that since any long-term exposure to an avoidance action could adversely affect the market for property which is the subject of a foreclosure sale, the statute of limitations applicable to avoidance actions involving the transfer of title pursuant to a non-collusive foreclosure sale should be relatively short and the remedy should be recovery of the property and not entry of a money judgment if the property is in the hands of the purchaser at the foreclosure sale. Whether the statute of limitations applicable to avoidance actions relating to transfers in connection with foreclosures should be reduced, is an appropriate subject for discussion by the Avoidance Powers Committee.

3. Other UFTA Issues

(a) Definition of Transfer

Section 548(d)(1) of the Code provides that a transfer is made for purposes of section 548 when the transfer is so far perfected that a bona fide purchaser from the debtor cannot acquire an interest superior to the interest of the transferee. Section 6 of the UFTA

incorporates the "lien creditor" test to personal property and fixtures and a "bona fide purchaser" test to real property. The UFTA approach would protect a holder of a security interest in chattel paper perfected by filing under the UCC. Since a bona fide purchaser who obtains possession of chattel paper has priority over the holder of a security interest perfected by filing, under section 548(d) the transfer would be deemed to occur immediately prior to the filing date even though the sale occurred outside of the one year limitation period contained in section 548.

Recommendation

Consideration should be given to amending section 548(d)(1) to conform with Section 6 of the UFTA.

(b) Guarantee Obligations

Section 6(5) of the UFTA contains a new section which deals with the effective date of the incurrence of an obligation. This section provides that:

> An obligation is incurred (i) if oral, when it becomes effective between the parties; or (ii) if evidenced by a writing, when the writing accepted by the obligee is delivered to or for the benefit of the obligor.

This section was added to the UFTA for the purpose of overriding that portion of Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979 (2d Cir. 1981), which held that a debtor incurs an obligation whenever funds are drawn under an existing line of credit and, thus, the time for determining the avoidability of preexisting guarantees would be the date

of each advance under the line of credit. The effect of the incurrence test is to make the date of execution and delivery of the guarantee the operative date for determining whether such obligation can be voided.

Recommendation

Consideration should be given to amending section 548 to add a provision similar to Section 6(5) of the UFTA.

(c) Definition of Value and Insider Rule

The definition of "value" in Section 3 of the UFTA replaces the description of "fair consideration" in Section 3 of the UFCA. Section 3 conforms with section 548 by deleting the subjective element of "good faith" which was included in the UFCA definition of "fair consideration." The UFTA, however, has added Section 5(b) which permits recovery of transfers to an insider (i) for other than the present reasonable equivalent value, (ii) at a time when the debtor was insolvent, and (iii) if the insider has reasonable cause to believe the debtor was insolvent. This provision tracks the insider preference provisions of section 547.

Recommendation

There is no need for any consideration of an amendment to section 548.

STATEMENT OF PROF. PHILIP SHUCHMAN

Mr. SHUCHMAN. Gentleman, my name is Philip Shuchman. I am a professor of law at Rutgers Law School. I was deputy director of the Commission on Bankruptcy Laws of the United States, and I am not a member of the American Bankruptcy Conference.

I have provided a full statement to the clerk and counsel and I hope that can be made part of the record.

Mr. Zinman has, if you will refer to my statement, made clear what the claims of the creditor groups are. That is on pages 4 and 5 of my statement. Short of the republic falling, it appears that the mortgage market will dry up, that debtors will be hurt, that mortgage loans will not be made, that foreclosure sales will be a disaster.

And they said this all over, not merely Mr. Zinman, then employed by Metropolitan Life Insurance Co., but the same group of lawyers. They appeared in all of the fora that were available to them.

If you look on page 6 of my statement, these are just the major places they appeared, making these claims. After *Durrett*, they began to get very busy. They filed amicus briefs. They were before the Congress in 1983. They are the same people who were responsible for the ABA section report, all of these now favoring some means of overruling *Durrett.* These were the same people who were the advisors; the same groups who were the advisors to the Uniform Commissioners.

They have lobbied in the States for enactment of the Uniform Fraudulent Transfer Act in an effort to exempt foreclosure sales here.

I take it that a law is what it does and I have therefore looked to see what happened as a result. What happened as a result is the annotation of these graphs, which are the last page in my statement. Basically what the graphs show is that nothing happened. I am surprised, of course, that the American Council of Life Insurance and the other groups do not present these data. They know all of this. They know it much better than I did.

The data which are available from public corporations and agencies of the Federal Government show that there was virtually no impact of any kind from the major decisions beginning with *Durrett* in 1980, and that is now some 8 years ago, and going to Madrid which went the other way 2½ years ago. The figures in Texas and California, two large populous States, show virtually no changes one way or the other, as a result of these two decisions.

It appears, in fact, from the data provided by public agencies that in all of the States—with little blips here and there—everything follows the national averages. Therefore, these terrible effects have not come to pass and there is no need to pass S. 1358, which would change a law which now may help some consumers. It may even help some small businesses. And it does not, evidently, hurt the mortgage lenders.

Thank you, Mr. Chairman.

[The prepared statement of Professor Shuchman follows:]

UNITED STATES SENATE, COMMITTEE ON THE JUDICIARY
SUBCOMMITTEE ON COURTS AND ADMINISTRATIVE PRACTICE
Hearings on S. 1358
Statement of Philip Shuchman, Professor of Law
Rutgers University Law School - Newark
June 10, 1988

Durrett v. Washington National Insurance Co.[1] held that a foreclosure sale is a transfer of a debtor's interest in property. Given a bankruptcy filing within one year, such a repetition, non-judicial foreclosure sale could be avoided as a fraudulent transfer of the debtor's equity if the foreclosure price was, as put in that case, less than about 70 percent of the property's fair market value at the time of the sale. Durrett was the first decision to hold that, under the Bankruptcy Code, a non-judicial foreclosure sale made within a year prior to bankruptcy is a transfer of a debtor's equity in property which may be avoided as a fraudulent transfer if less than a reasonably equivalent value was paid for the property.

The narrow issue is whether a regularly conducted, non-collusive, prepetition foreclosure sale of a debtor's property should be avoidable as a fraudulent transfer if the property was sold for less than a reasonably equivalent value within one year before a bankruptcy petition.

Most of the courts in which the issue has been raised have

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[1] 621 F.2d 201 (5th Cir. 1980).

tended to follow the Durrett rule that the foreclosure is a transfer within the meaning of Bankruptcy Code § 548; some of the later cases also apply the newly revised Code § 101(5), which provides that a transfer includes foreclosure of the debtor's equity of redemption thus extending the one-year period of Code § 548. Although there has been vehement criticism of the Durrett holding, the courts that have ruled are mostly in agreement that a transfer sufficient to invoke Bankruptcy Code § 548 occurs at foreclosure.

The Durrett doctrine is termed a federal redemption statute. Mortgage lenders claim that is very bad. They say that "rights of redemption have been universally condemned as harmful to debtors because they chill bidding, decrease the prices received at foreclosure sales and increase deficiencies and deficiency judgments". There is no evidence in the sources cited for these assertions about the harmful effects of statutory redemption under state laws. The supporting citations in the creditor groups' amicus brief and in their journal articles do not provide any factual basis for the repeated assertions of the adverse effects of statutory redemption on debtors. These critics cite almost no empirical evidence on the effects of statutory

redemption under state law, and what little there is largely dates from the depression of the 1930's .

The most recent survey of the literature on statutory redemption concludes that, "the available empirical evidence suggests that the problem of price inadequacy is real and that statutory redemption may play an appreciable role in reducing its effects by deterring its occurrence or by enabling some of its consequences to be corrected. Overall, the available empirical evidence has not shown that judicial foreclosure and statutory redemption produce no benefits and affirmatively establishes that statutory redemption actually has produced some benefits."[2]

State redemption statutes may be little-used by mortgagors who have defaulted and whose homes have been foreclosed. But that does not prove at all that bid prices are lower because of state redemption laws. One would have to compare, over time, the bid prices as a function of market values in states with and without statutory redemption rights. The California Law Revision

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[2] Bauer, Judicial Foreclosure and Statutory Redemption: The Soundness of Iowa's Traditional Preference for Protection Over Credit, 71 Iowa L. Rev. 1 (1985).

Commission implicitly suggested just that: "It is difficult to assess the actual effect of statutory redemption. The states are almost evenly divided between those that permit redemption... and those that do not; however there do not appear to be any studies comparing the results in redemption states as opposed to nonredemption states."

Durrett was decided in July, 1980. Thereafter the various creditor groups involved in real estate mortgage lending asserted the terrible effects of the Durrett doctrine:

> (1) The Durrett doctrine will undoubtedly reduce the amount that a purchaser, including the mortgagee, would be willing to bid at a foreclosure sale.
>
> (2) Secured creditors, especially mortgagees, will not extend credit to marginal debtors, even when more than adequate collateral secures a loan.
>
> (3) Even for the non-marginal debtors who do get secured credit, the loan value of their collateral will be discounted. If the Durrett doctrine is upheld, other things being equal, this will result in smaller loans due to a lower loan-to-price ratio.
>
> (4) Interest rates would be increased to reflect the additional risk involved in expanding credit on the basis of collateral that may not be marketable after foreclosure.

(5) Even a transferee from the original purchaser at a foreclosure sale could be sued under § 548 unless that buyer could prove that he purchased the property in good faith for value, and without knowledge of the voidability of the transfer. Such potential liability would undoubtedly cause many would be buyers and their lenders to be reluctant to buy or finance the purchase of foreclosed property.

(6) Since, according to the creditor groups, most title insurance companies in states subject to the Durrett rule will only insure foreclosure sale titles with exceptions for § 548 actions, it would be difficult for a buyer from the successful bidder to claim he was without knowledge.

Then, in February, 1984, there was holding contrary to Durrett. The case was Madrid,[3] decided by the Ninth Circuit Court of Appeals, which held that the transfer for purposes of the federal bankruptcy code took place not at the date of foreclosure but when the real estate mortgage was recorded.

In August, 1984 the Uniform Fraudulent Transfer Act (UFTA) in its final form was released for enactment in the states by the Commissioners on Uniform Laws. Section 3(b) provides that an ordinary foreclosure sale results in reasonably equivalent value

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[3] Lawyers Title Ins. Co. v. Madrid (In re Madrid), 21 Bankr. 424, 426-27 (Bankr. 9th Cir. 1982) (B.A.P.), aff'd on other grounds, 725 F.2d 1197 (9th Cir.), cert. denied, 469 U.S. 833 (1984).

whatever the final bid price. Section 3(b) is explicitly designed, and has as its sole purpose, to overrule the Durrett doctrine.

The A.B.A. Section of Real Property Law urged that the UTFA include a provision such as section 3(b) in an effort to remedy the Durrett problem. The Section Report is dated August 1983.

Thus, some of the relevant dates which may be helpful for the Subcommittee, follow:

Durrett decision	July, 1980
Amicus Briefs in Madrid	November, 1982
Hearings on S. 445	April, 1983
A.B.A. Section Report	August, 1983
Madrid decision	February, 1984
UFTA Proposed	August, 1984

The importance of these dates is that data on the cost of mortgage loans the amount of mortgage debt created, and the loan-to-price ratios were known for the years and in some instances for the months or quarters before after each of these dates. Yet no such data were presented at any time by the well-organized groups opposed to the Durrett rule. (Durrett was decided eight years ago and Madrid more than four years ago.) In their amicus

briefs and journal articles they state that the cost of mortgage credit (interest) and the availability of mortgage loans, as measured by the totals of mortgage debt created, are the accepted indicators of the effects of these important decisions on this particular market. These claimed results should be evident in Texas and California, the large populous states directly affected.

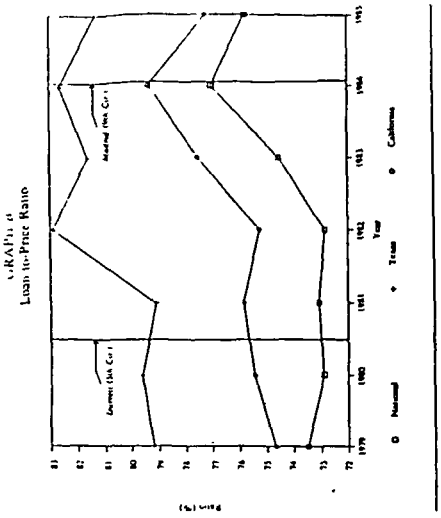
I gathered information on the key variables which would affect the mortgage loan market: interest rates and loan-to-price ratios. These data were obtained from various sources but mainly from the Federal Home Loan Banks and the Federal Home Loan Mortgage Corporation ("Freddie Mac"). The data are for residential mortgage loans (one to four family dwellings) during the years from 1979 (before the Durrett decision) through 1985 (well after the Madrid decision and about a year and a half after the UFTA). My findings are that the available aggregated statistical data on interest rates and loan-to-price ratios, for mortgage loans created before and after these decisions, show that Durrett and Madrid made little, if any, apparent difference either way in those variables. The graphs presented below very strongly suggest that the interest rates and the loan-to-price

ratios -- with both variables measured by state and by year--have followed the national averages regardless of whether the state had adopted or rejected Durrett. Thus, while Durrett created fears and increased risk among mortgage lenders, and Madrid may have allayed their anxieties, neither decision appears to have had measurable market place effects. The terrible consequences claimed by the mortgage lenders had not come to pass by the end of 1985.

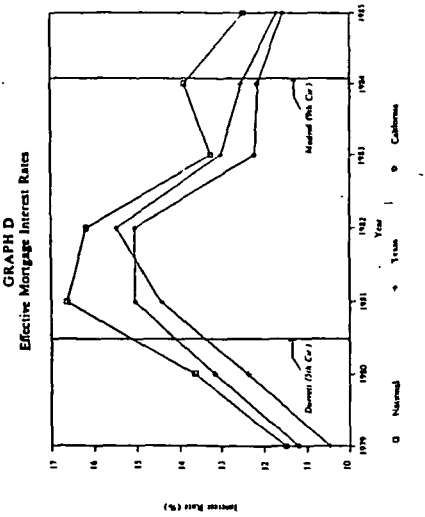
These lenders should not now, by S.1358, get rights they could not get from the Congress before[4] or from most of the federal courts. They have not evidently been hurt by application of the Durrett doctrine; nor, despite their claims, does it appear that the residential mortgage lending markets have been adversely affected by Durrett or helped by Madrid. But some individual debtor-homeowners may very well be helped by application of the Durrett doctrine. It is also possible that some unsecured creditors and junior lienors are helped by the present law applying the Durrett doctrine.

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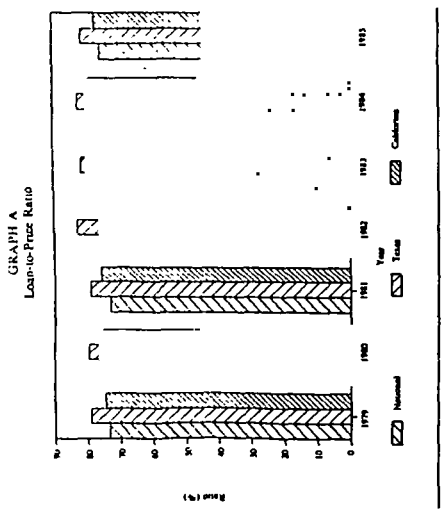
[4] Senate Bill 445 (1983) contained a proposed section 548(d)(2)(C) which was another effort by the same groups to repeal the rule of Durrett-type cases. The Congress declined to enact that section.



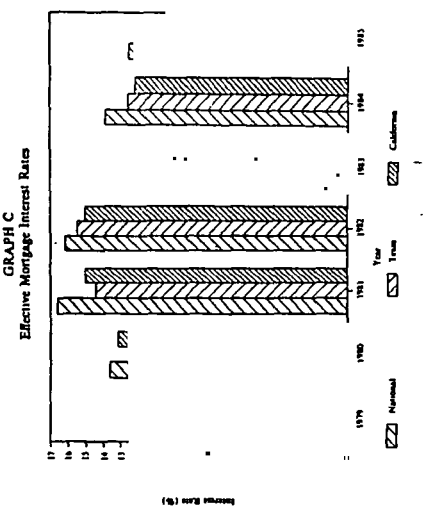
GRAPH B
Loan-to-Price Ratio



GRAPH D
Effective Mortgage Interest Rates



GRAPH A
Loan-to-Price Ratio



GRAPH C
Effective Mortgage Interest Rates

Senator HEFLIN. We will submit some questions in writing to you and we appreciate your prompt reply. Senator Grassley, do you have any questions?

Senator GRASSLEY. Yes. I do not want to let this opportunity to go by without asking Mr. Zinman how he looks at chapter 12 today, 2 years later, because he was among those doomsayers pronouncing a parade of horribles before we enacted it; that credit would dry up, banks would lose money, and farmers would be hurt. And of course, a year and a half later, the results could not be more different.

Here's a June 3 Des Moines Register headline I will give you: "Average farm income soars, $13,300," the largest 1-year increase in history. Here's another: "Iowa banks roll up record profits," May 15, 1988.

Senator HEFLIN. What has that got to do with this?

Senator GRASSLEY. I want him to be thinking about this as I view his opinions on this bill. [Laughter.]

Here's another headline, from April 15: "USDA reports rise in Iowa farmland values." So we have got farm earnings up and banks are making record profits. Implement dealers are doing better. All after you said the farm economy would be crippled by chapter 12.

I even had an opportunity to read an article in February that said that Metropolitan Life—your company—which once announced that it was going to stop lending because of chapter 12, was planning a major new investment program in farmland.

Beyond the newspaper headlines, I have had a chance to talk to judges, lawyers, farmers, all over the country about chapter 12, and the comments we have received have been almost universally positive. They all say that chapter 12 is a very positive tool to encourage parties to work out restructuring of farm debts. It is a perfect compliment to the State mediation laws.

Hundreds of farmers have successfully used it to rewrite debts and keep their land and their way of life. And by the way, filings are down, just as we said they would when the farm economy rebounded.

Given the experiences over the past year and a half, I am wondering if you would admit maybe you misjudged the impact and purposes of chapter 12, and are a little sorry you worked so hard against it?

Mr. ZINMAN. I think my main objections to chapter 12 were two. One was constitutionality, which I still think is a problem. The other one was the damage that it was doing to the absolute priority rules of the Bankruptcy Code on cram down in bankruptcy.

Senator GRASSLEY. Would you admit, though, that the horrible things that you said in your testimony would happen, have not happened?

Mr. ZINMAN. I am sorry, I did not testify on that bill, but I did think it was and still think it is a serious problem. Under chapter 12, the mortgage may be reduced to the value of the collateral.

Now, with the value of farmland having gone down so low, it would be very difficult to envisage a situation where under a mortgage made today at 60 percent of value (and the value is like 50

percent of what it was some years ago) could reduce so significantly as to really jeopardize the mortgagee.

So I can see where today chapter 12 would not have a terribly serious effect on mortgage lending, but it might very well have such an effect when property values increase, as they seem to be doing.

But I think I would agree with you, sir, that these low values have certainly made chapter 12 less troublesome than could be anticipated at the time of its passage.

Senator GRASSLEY. For the chairman's benefit and for the record, when I was chairman of the subcommittee, some of the same people that are for this bill are the ones that were lobbying against chapter 12.

I have no more questions.

Senator HEFLIN. I interpret that to mean that they can never testify again on any bill?

Senator GRASSLEY. I just thought that is a fact that Your Honor ought to be acquainted with.

Senator HEFLIN. All right, sir.

Mr. ZINMAN. I think that the *Durrett* situation is a very serious one for the whole concept of a proper bankruptcy administration and I believe that the S. 1358 is essential to preserve the continued viability of the mortgage financing.

Senator HEFLIN. Mr. Minkel, I believe you have some thoughts on S. 2279, the interest swap legislation; would you care to share those with us?

Mr. MINKEL. Yes, Senator, I think that arguably the interest swap structure is covered by present definitions, but there is some ambiguity. Certainly S. 2279 accords with the policies which were adopted by Congress, in passing the Bankruptcy Reform Act of 1978, and I point in particular to section 553 on setoff, which exempted setoffs of commodity accounts, so as to prevent a bankruptcy from interfering with the orderly process of settlements in the commodity area.

S. 2279 is also consistent with the bankruptcy amendments in 1982 and 1984 which deal with swap transactions. These amendments recognized huge volumes of repo's and swaps and the potential for severe disruption in financial markets and evidence Congress' concern that these type of transactions should not be stayed by reason of a bankruptcy filing.

The statement which has been filed by the International Swap Deals Association, which I reviewed, I think adequately sets forth what the situation is. Two years ago, there were in excess of $200 billion of swap transactions. I think that the amendments are justified.

I take that position, however, not on behalf of the National Bankruptcy Conference which has not had an opportunity to review this bill. I do think it is consistent with the position the NBC has taken previously on other similar types of legislation.

Thank you.

Senator HEFLIN. Thank you. We appreciate your testimony and written questions will be submitted and we would appreciate your prompt response to them.

[Members of the panel submitted the following material:]

ANSWERS TO QUESTIONS OF SENATORS HEFLIN, DECONCINI AND THURMOND TO ROBERT M. ZINMAN AS A RESULT OF HIS TESTIMONY BEFORE THE SUBCOMMITTEE ON COURTS AND ADMINISTRATIVE PRACTICE OF THE SENATE COMMITTEE ON THE JUDICIARY JUNE 10, 1988

I appreciate this opportunity to answer the questions of the distinguished Senators concerning S.1358. In connection with some of my answers I have included suggestions for possible amendments to the legisation to overcome perceived problems raised at the hearing. While I must emphasize that I do not believe such problems will arise under S.1358, there is really no problem raised at the hearing that cannot be resolved through drafting modifications without destroying the legitimate purposes of the proposed legislation.

Because of the short time frame for replies to the questions, the organizations on behalf of which I testified have not been able to function on possible changes in the language of S.1358. Thus the views expressed with respect to modifications of S.1358 are my own and not necessarily the views of those organizations. I would be happy to assist in suggested drafting changes and make myself available to discuss the effect of any proposed modifications of the bill at the convenience of the Subcommittee.

QUESTIONS FROM SENATOR HEFLIN

Question 1

YOU STATE IN YOUR TESTIMONY THAT THE DURRETT RULE WILL INCREASE LENDING RISKS AND COSTS AND CAN ONLY RESULT IN INCREASED INTEREST RATES AND STRICTER CREDIT REQUIREMENTS FOR MORTGAGE LOANS. THE DURRETT DECISION WAS RENDERED IN 1980. HAVE THESE PREDICTIONS COME TRUE AND COULD YOU PROVIDE SUPPORTING EVIDENCE?

1. Durrett Increases Lending Costs. No one can or has denied that a generally accepted Durrett rule would increase lending costs. It would provide a vehicle for bankruptcy lawyers to attack as fraudulent transfers, virtually every noncollusive foreclosure sale held in accordance with law and without fraudulent intent, as long as the sale occurred within the perscribed time periods of federal and state law. The cost of defending these suits, win or lose; the cost of unjustified settlements lenders, who cannot predict what a court's appraisal will be may be forced into; the possible unlimited liability (see Coleman discussed in my testimony, where the court indicated it could require a mortgagee who sold the property for the amount bid at the foreclosure sale, to pay the debtor's estate seven times the mortgage balance)--all will become part of the cost of lending.

No one loves a lender, so the focus of the opposition is on the mortgagee. But it is not just the mortgagee who will be hurt. Bankruptcy lawyers can and are raising the Durrett

argument to strike down default termination of leases; attack foreclosures of UCC security interests; make unlawful preferences subject to Durrett; attack installment land contracts; and even strike down tax sales to the consternation of financially pressed local governments. Durrett is a treasure trove of potential litigation and potential lending cost increases.

2. Increased Lending Costs Result in Increased Borrowing Costs and Increased Lending Risks Result in Tighter Credit. It is sheer fiction for Durrett supporters to maintain that increased lending costs will not be reflected in increased borrowing costs and that increased risks will not make lenders more cautious.

Savings and loan associations and other thrift institutions, already in serious trouble, must earn enough to cover expenses and pay interest to their depositors. Their costs have to be reflected in what they charge for credit.

Insurance companies and other large lenders have choices of types of investments to make--corporate indentures, corporate debentures, stock, real estate equities, etc. Their funds will flow inexorably to the investments producing the higher net return.

If the mortgagee's ability to realize on its collateral is jeopardized in bankruptcy, mortgage loans will be made to those less likely to file in bankruptcy, that is, the more affluent.

These are the facts of investment life.

3. "Supporting Evidence." Supporters of Durrett obfuscate the obvious by demanding facts proving that lending costs and risks are reflected in borrowing costs and lending policy. They know that there has been thus far only approximately 100 Durrett cases, (as of June 24, 1988, Westlaw reports that there have been only a total of 98 federal court cases citing Durrett), hardly enough to cause panic. They also know that there are a wide variety of factors that influence the cost of borrowing. They are either obtuse or disingenuous when they imply that lenders are not really concerned about Durrett and will absorb the costs if the rule should become generally accepted.

The fact that so many organizations--the American Council of Life Insurance, the American Land Title Associaiton, the National Commercial Finance Association; and the Mortgage Bankers Association of America, to name a few--want Durrett overturned (many had hoped to testify but were not permitted to do so because of time constraints) shows how broad and pervasive is the lender's concern about the proliferation of the Durrett rule.

If, notwithstanding the foregoing, one wishes to check statistics, it would be appropriate to start with Professor Shuchman's own figures in Texas for the year following denial of certiorari in the 1982 Fifth Circuit Abrahamson case (a parallel

Durrett decision); figures that show lower increases in the average loan amount and, substantially lower increases in mortgage lending in Texas as compared with the rest of the nation. (Professor Shuchman chooses not to point up these figures but cites figures for the year following the Durrett decision, before appeal of the issue in the Fifth Circuit had been terminated with denial of certiorari, when most lenders were either unaware of the decision or its significance, or convinced it would be overturned.) Notwithstanding the foregoing statistics favorable to S.1358, it would seem that at this stage in the development of the Durrett rule there have been too few cases in the context of too many variables to rely upon statistics on either side.

The fact is that Durrett today is like a cancer on the lending industry. As it metastasizes, it will increase the cost and risks of lending. In turn these increases will increase the cost of borrowing, affect lending policies, and result in tighter credit. No sleight of hand use of statistics can change that fact of investment life.

Question 2

ONE CONCERN RAISED BY THOSE WHO OPPOSE AMENDING SECTION 548 IN THE MANNER PROPOSED IN S.1358 IS THAT THERE WOULD BE NO INCENTIVE FOR SECURED CREDITORS TO ASCERTAIN THE FAIR MARKET VALUE OF THE PROPERTY AND TO BID IN A SUFFICIENT PORTION OF THEIR DEBT TO INSULATE THE FORECLOSURE SALE FROM ATTACK. WOULD YOU COMMENT ON THIS CRITICISM.

It should be emphasized that virtually every organization of professional real estate people support S.1358. The opposition is from a small but vocal group of bankruptcy lawyers and some bankruptcy academics-without substantial real estate background. Indeed the concerns they raise indicates a lack of a full understanding of the realities of mortgage investment.

1. "Incentive" to Bid Full Debt; Possible Change in S.1358. The opponents speak of the mortgagees needing an "incentive" to bid "a sufficient portion of their debt to insulate the foreclosure sale from attack." (See National Bankruptcy Conference Testimony, page 7). In reality, mortgagees normally bid the full indebtedness. With commercial debt non-recourse, and deficiency judgments hedged by statute and extremely rare, mortgagees make a nominal bid only where such a bid means avoiding excessive transfer taxes on the sale.

The problem for the mortgagee is that even in bidding the FULL indebtedness they are still not insulated from attack. (Durrett, Madrid, Caliaro, Windhall--all involved bids of the full indebtedness.)

If bidding less than the indebtedness concerns its opponents, S.1358 can be amended to provide that it is applicable only where the mortgagee has bid the full indebtedness or waived any deficiency judgment.

2. **"Incentive" for Ascertaining Property Value.** The opponents suggest that "incentive" is needed for the mortgagee to "ascertain the fair market value of the property." (See National Bankruptcy Conference Testimony, page 7). Lenders routinely appraise properties in foreclosure. The problem for lenders is that under Durrett, the value they ascertain can be second guessed by a hindsight bankruptcy judge whose interest may be in the size of the debtor's estate.

Commercial real estate appraisal represents a best estimate projection of the project over a period of approximately 10 years in the future. The appraiser estimates what income stream the property will produce over that time, and divides that figure by a capitalization rate, that is, a percentage based on an estimate of the cost of funds over the future 10 years as adjusted by risk factors related to the property. Thus what one appraiser determines the value to be may not be what the judge will agree it had been worth. The mortgagee needs no incentive to determine what it believes the value of the property to be. What the mortgagee needs is some degree of certainly that a foreclosure conducted without collusion and in accordance with state statute will not be overturned.

3. Mortgagees Lose on Foreclosures. If the opponents are implying that mortgagees make windfall profits on foreclosure, they are wrong. Indeed empirical studies have shown that mortgagees lose money on foreclosure. See 70 Cornell L.Q.850, 870 (1975; Newsweek, October 6, 1986 at 36, cols, 2-3; and this witness' discussion of "The Myth of Commercial Real Estate Foreclosure Windfalls," at 9 Cardozo L. Rev. 581, 598 (1987).

4. Possible Modification of S.1358. Virtually all commercial properties and most residential properties in foreclosure are not worth the mortgage balance. If there were substantial equity over mortgages, there would be no foreclosure because the borrower would simply sell the property to pay off the mortgage, and keep the equity. With respect to residential property, however, it is possible that because of personal stress (divorce, sickness, etc.) some homeowners may not be in a position to direct their attention to the sale of their property before foreclosure. If it is these homeowners that concern the National Bankruptcy Conference, it is certainly possible to bifurcate the legislation and create an exception as to type and amount of mortgage (e.g., non-collusive regularly conducted foreclosure sale prices will be deemed to be for a reasonably equivalent value except where the collateral is a one-family house and the mortgage balance is less than $200,000.). Since mortgagees can more easily prove the value of residential properties, which are appraised not on an income capitalization basis, but on the basis of comparison sales; a change such as this can meet the objective raised at the hearing while protecting the commercial mortgage market from unfair Durrett attack, etc.

Question 3

IF THE CONCERN IS THE INSTABILITY OF LAND RECORDS AND THE UNCERTAINLY OF FORECLOSURE SALES, COULD THE BANKRUPTCY CODE BE AMENDED TO ALLOW AVOIDANCE OF A TRANSFER FOR LESS THAN FAIR VALUE, WITHIN A CERTAIN TIME FRAME, SAY ONE YEAR, AS OPPOSED TO AMENDING THE TRANSFER PROVISIONS?

This well-meaning proposal suggested by the National Bankruptcy Conference would seem to require that the bankruptcy court make a determination of fraudulent transfer within a year after the transfer takes place, in lieu of the present requirement that the bankruptcy be instituted within a year after the transfer.

While we are in sympathy with such a change, such a change which would help in limiting the destructive effect on land records, it will not solve the other major problems for the mortgagee created by Durrett. For example, the mortgagee still would be unable to dispose of the property for one year out of fear that the court will order the mortgagee to pay cash equal to the difference between the court's value and the foreclosure bid, regardless of what price the mortgagee received on the disposition ofe property, and if the property has not been sold and a reconveyance is ordered, the mortgagee may not even receive its lien back on the property (see In re Littleton, 82 Bankr. 640 (Bankr. S.D. Ga, 1988). Much more is needed to reselve the inherent inequity for the mortgagee created by Durrett.

Question 4

HAVE BIDDERS AT FORECLOSURE SALES BECOME MORE SENSITIVE TO LOW BIDDING AS A RESULT OF THE DURRETT DECISION? WHY SHOULD A FORECLOSING LENDER BE HELD TO A LESSER STANDARD OF "REASONABLY EQUIVALENT VALUE" THAN ALL OTHER TRANSFERREES OF THE DEBTOR'S PROPERTY?

1. Bidding at Foreclosure Sales. Since the mortgagee normally believes that the property being foreclosed upon is worth substantally less than the mortgage balance, there is no way the mortgagee can guess what a judge in a subsequent bankruptcy will determine the property to have been worth. Thus a mortgagee really has no recourse but to continue its practice of bidding the mortgage balance and preparing to defend itself as best as possible in a subsequent bankruptcy. Any third parties in Durrett jurisdictions who continue to bid at foreclosure sales are probably still unaware of the dangers of Durrett.

2. Standards. We are not suggesting that the mortgagee be held to a different standard than other transferees. We are suggesting that a non collusive regularly conducted foreclosure sale is not and never was a fraudulent transfer. The history of fraudulent transfer law is a history of attempting to find better methods of ferreting out those transfers that were intended to hinder, delay or defraud creditors. The

constructive fraud provisions of section 548 applied in the Durrett case were enacted for that purpose.

Non-collusive foreclosure sales are by definition, non-fraudulent. Thus, until Durrett, over the 400 years that followed codification of fraudulent transfer law in the Statute of 13 Elizabeth, in the 380 years after Twyne's case first developed the so-called badges and presumptions of fraud, or in the 60 or so years after constructive fraud replaced the badges and presumptions, no court ever applied constructive fraudulent transfer provisions to non-collusive foreclosure sales conducted in accordance with state law, because such transfers were never part of the mischief for which the statute was written. Durrett, then extends fraudulent transfers to the mortgagee contrary to the obvious intention of statutory draftsmen through the centuries, and of Congress in enacting section 548 of the Bankruptcy Code.

Question 5

IT IS MY UNDERSTNDING THAT IN SOME JURISDICTIONS NOTICE OF FORECLOSURE SALES ARE VERY INADEQUATE, SOMETIMES LIMITED TO POSTINGS ON THE COURTHOUSE DOOR. THIS WOULD SEEM TO INDICATE THAT COMPETITIVE BIDDING IS NON-EXISTENT IN SOME AREAS OF THE COUNTRY. IS IT FAIR TO SIMPLY PROVIDE THAT VALUE GIVEN IN A NONCLUSIVE FORECLOSURE SALE IS REASONABLY EQUIVALENT VALUE? IS THIS NOT IN FACT DETRIMENTAL TO THE RIGHTS OF OTHER CREDITORS?

1. Competitive Bidding at Foreclosure Sales. If there is a limited amount of competitive bidding, it is primarily because the competitive bidder will have to bid in excess of the mortgage balance to outbid the mortgagee, and the property is seldom worth the mortgage balance on foreclosure. If there were many properties in foreclosure with substantial equity, my experience indicates that real estate brokers and developers would read the notices, even if only posted on the court house door, and be there at the sale to bid.

2. Suggestion for Revision of S.1358. For every state that has short notice periods or posting on the court house door, there is a state where it often takes over two years to foreclose in a judicial proceeding presided over by court. If the real objection to S.1358 is based on a dislike of foreclosure laws in jurisdictions where notice requirements are perceived to be inadequate, is it fair to saddle all mortgagees with the burdens of Durrett in order to attack collaterally through the Bankruptcy Code the laws of a few jurisdictions? If it is state foreclosure notice provisions that are the basis of opposition to S.1358, the statute could be amended to provide that it is applicable only to those states meeting specified reasonable notice requirements. Thus this objection, too, can be overcome through drafting change without destroying the thrust of the bill.

3. Effect of S.1358 on Other Creditors. A creditor has the choice of making a loan on an unsecured basis or taking collateral for the obligation. By taking collateral the

creditor is entitled to look to that asset ahead of all junior interests including unsecured creditors. A creditor electing to make an unsecured loan is normally compensated for the more riskly position with a higher interest rate or more favorably loan terms and knows that there is no particular property to which recourse can be had to satisfy the obligation.

It is certainly true that if there is equity in the property over the liens on the property, that equity goes to the debtor or the debtor's other creditors. The real issue is how best to determine whether such surplus value exists--by hindsight second guessing of noncollusive regularly conducted foreclosure sales, or by accepting the results of a commercially reasonable procedure designed by law to determine that value. I urge the latter course and point out, as suggested in paragraph 2 above, that the statute can be limited to states providing fore foreclosure procedures containing specified commercially reasonably standards.

Question 6

HOW DO EXECUTION SALES DIFFER FROM FORECLOSURE SALES AND DOES S.1358 APPLY TO EXECUTION SALES.

S.1358 does not apply to execution sales. There are public policy reasons for recovering assets transferred on an execution sale that may involve the attempt by a judgement creditor to seize as much of the unencumbered assets of the debtor as possible before other creditors can get them. The debt for which execution is made is usually unrelated to the value of the property, and thus execution sale prices may vary more readily from the value of the property being acquired at the execution sale.

Foreclosure sales, on the other hand, represent the realization upon collateral pursuant to a preexisting lien on the specific property being foreclosed upon, validly created pursuant to the provisions of law. Unless there is some collusion, public policy would seem to support protecting the validity of these mortgage liens, the rights of mortgagees to realize on their collateral under state law, and the sanctity and certainly of land records. These public policy reasons were the basis for the adoption of the anti Durrett provisions similar to S.1358 in the new Uniform Fraudulent Transfer Act.

QUESTIONS FROM SENATOR DECONCINI

Question 1

SHOULDN'T THERE BE A CONCLUSIVE PRESUMPTION OF VALUE AT SOME POINT IN THE PROCESS? ISN'T THE CREDITOR FORECLOSURE POINT AS GOOD A POINT AS ANY?

Secured credit is essential to the smooth functioning of our economic system. Only the affluent have sufficient assets and credit standing to obtain financing without providing

security. Those who do not qualify for unsecured credit use their property as security for their obligations.

However, if the secured party cannot be certain that the property can be realized upon when default occurs, or if the secured party can be subjected to unlimited liabilities notwithstanding honest and noncollusive compliance with the provisions of state law, then the whole structure of secured financing is in peril. The foreclosure point is not simply "as good a point as any," it is the most appropriate point at which the rights of the parties should be determined.

Question 2

WHY SHOULD NONCOLLUSIVE, REGULARLY CONDUCTED FORECLOSURE SALE BE SUBJECT TO ATTACK.

It should not. The history of mortgage law represents a series of trade-offs as the courts and the legislatures wrestled with the problem of balancing the rights of the borrower and the lender. The equity of redemption was fashioned by the early courts to protect the borrower against the unfair harshness of the failure to pay on time. The foreclosure of the equity of redemption was fashioned by those same courts to protect the lender against indeterminate risk of attacks on its title. The foreclosure sale was instituted by statute to protect the borrower against the hazards of strick foreclosure. Over the years various protections for the borrower have been built into state foreclosure law by statute and judicial decision, including notice requirements, restrictions on deficiency judgments, the setting of upset prices, the confirmation of sales by a court and rights of redemptions. For a discussion of the development of these borrower protections, see, 39 Bus. Law. 977, 1003 (1984).

At the same time that mortgage law was being developed to balance the rights of lender and borrower, fraudulent transfer law was developing with the object of setting aside transfers intended to hinder, delay and defraud creditors. Since persons intent on fraudulent transfer do not ordinarily advertise this fact, it was necessary to look to circumstances surrounding the transfer to determine if the requisite intent existed. Thus were developed badges of fraud, presumptions of fraud and finally constructive fraud of the type applied in Durrett.

Both these laws developed along their own track. Fraudulent transfer law was never applicalbe to foreclosure sales unless they were collusive, that is, conducted for the purpose of hindering creditors. Noncollusive foreclosure sales, being non fraudulent by definition, were not subject to attack by fraudulent transfer law until Durrett.

Question 3

CALIFORNIA REQUIRES A FORECLOSURE CREDITOR TO WAIVE A DEFICIENCY CLAIM. SHOULD THE CREDITOR HAVE TO BID THE ENTIRE DEBT OR WAIVE A DEFICIENCY?

Deficiency judgments are strictly regulated by statute and are seldom obtained. As mentioned in answer to Senator Heflin's question 2, even the remote possibility of a bid at lower than market with a deficiency claim for the difference can be eliminated by restricting S.1358 to those situations where the mortgagee has bid the full mortgage indebtedness or waived the deficiency.

QUESTION FROM SENATOR THURMOND

IN YOUR PREPARED STATEMENT YOU ARGUE THAT AS THE REACH OF THE DURRETT RULE CONTINUES TO GROW, IT WILL RESULT IN INCREASED INTEREST RATES AND STRICTER CREDIT REQUIREMENTS FOR MORTGAGE LOANS. PLEASE EXPLAIN WHY YOU BELIEVE THE DURRETT RULE WILL HAVE AN ADVERSE IMPACT UPON FUTURE LENDERS AND BORROWERS.

As explained in answer to Senator Heflin's first question, a generally accepted Durrett rule will increase lending costs and risks. This will result inexorably in a changed lending equation--increased interest rates to cover increased costs, the shifting of lending funds away from mortgage investments, and secured financing limited to those with the ability to obtain unsecured credit. Those who argue that these results will not occur are blinding themselves to the facts of secured investing, to the detriment of lender and borrower alike.

CARDOZO
LAW REVIEW

DURRETT DATA: SHUCKING THE HUSKS FROM THE GRAIN

Robert M. Zinman

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COMMENTARY

DURRETT DATA: SHUCKING THE HUSKS FROM THE GRAIN

*Robert M. Zinman**

After I had prepared my Article[1] on fraudulent transfers as interpreted in *Durrett v. Washington National Insurance Co.*[2] for the Fraudulent Conveyance Symposium in the Cardozo Law Review,[3] I was shown a copy of Professor Shuchman's study, "Data on the *Durrett* Controversy,"[4] also published as part of the Symposium. Professor Shuchman's study did not deal with the substance of the *Durrett*[5] controversy, but concentrated on the purported response of the lending community to *Durrett* cases. I was concerned that the publication of the study might lead to the unwarranted conclusion that the substantive problems created by *Durrett* were not really very troublesome to lenders. At that time, however, it was not possible to publish a separate response to Professor Shuchman in the Symposium issue, but the editors offered me space for a brief comment here.

My concerns about Professor Shuchman's study generally fall into four categories: (1) its reliance on residential mortgage statistics to the exclusion of commercial mortgages; (2) its inconclusive and, I believe, misleading results; (3) its assumption that mortgage lending officers and their real estate lawyers will react quickly to bankruptcy decisions; and (4) its implicit assumption that the costs and risks of

* Member of the New York Bar. Adjunct Professor of Law, Fordham and New York University Schools of Law; Advisor to the Drafting Committee of the National Conference of Commissioners on Uniform State Laws for the Uniform Fraudulent Transfer Act (representing the American College of Real Estate Lawyers); Vice President and Investment Counsel at Metropolitan Insurance Company. I wish to express my appreciation for the research assistance provided by Howard I. Keisman, Esq., a member of the New York Bar.

[1] Zinman, Noncollusive, Regularly Conducted Foreclosure Sales: Involuntary, Nonfraudulent Transfers, 9 Cardozo L. Rev. 581 (1987).

[2] 621 F.2d 201 (5th Cir. 1980).

[3] See 9 Cardozo L. Rev. 531-905 (1987).

[4] Shuchman, Data on the *Durrett* Controversy, 9 Cardozo L. Rev. 605 (1987).

[5] *Durrett* held that a noncollusive, regularly conducted foreclosure sale could be held to be a fraudulent transfer where the borrower was insolvent and the price paid at the foreclosure sale was less than a reasonably equivalent value for the property. 621 F.2d at 202. The substance of the *Durrett* controversy was covered in the Symposium by Professor Frank R. Kennedy, Involuntary Fraudulent Transfers, 9 Cardozo L. Rev. 531 (1987). My Article was in response to Professor Kennedy's conclusions.

lending do not affect the cost of borrowing and the availability of financing.

I. Unjustified Reliance on Residential Loan Statistics

Professor Shuchman's study is based on residential loan statistics.[6] From these figures, conclusions are drawn as to the effect of *Durrett* on the entire mortgage lending industry. However, it is the commercial lenders that face the greater problems and risks created by the *Durrett* decision[7] and thus would be more likely to react sooner than thrift institutions, which are involved primarily in making home mortgage loans.

For example, commercial properties are appraised using the capitalization-of-income approach involving many variables in projecting a stream of income and determining a capitalization rate. Small changes in these variables produce dramatic differences in value.[8] Commercial lenders cannot be certain, or even reasonably comfortable, that a bankruptcy judge, with the benefit of hindsight and perhaps a special agenda,[9] will accept a valuation previously made when the foreclosure sale was held. On the other hand, one-family houses are normally appraised on the basis of comparison sales figures, often available in abundance. Residential lenders are thus in a position to produce objective evidence of the value of the mortgaged property on foreclosure at a later bankruptcy proceeding, and so are better able to live with *Durrett*.

Furthermore, commercial lenders such as insurance companies may make many kinds of investments in addition to mortgage loans,[10] and therefore are in a position to allocate available funds relatively quickly to investments producing the best "bottom line." Many residential mortgage lenders lack this flexibility, with the consequence that the effect of cases such as *Durrett* may not be reflected immediately in the number of residential loans made, but rather must show up eventually in the cost of loans to borrowers and the underwriting standards employed. Thus, even if the results of Professor Shuchman's figures were conclusive with respect to residential loans, they would not justify drawing conclusions as to the entire lending industry's reaction to *Durrett*.

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[6] Shuchman, supra note 4, at 624.

[7] Zinman, supra note 1, at 594-601.

[8] Appraisal techniques are discussed in Zinman, supra note 1, at 594-97.

[9] Id. at 596.

[10] These investments include unsecured corporate loans, secured corporate loans, corporate equity and stock investments, and real estate equity investments (acquisitions and joint ventures).

II. INCONCLUSIVE AND MISLEADING RESULTS

Even with respect to the residential loans studied, the results of the Shuchman survey, as an indication of the lack of impact of *Durrett*,[11] appear at best less than conclusive, and at worst misleading. Professor Shuchman acknowledges that there are other possible conclusions to be drawn when he discusses some of the alternative reasons for the data.[12] From my point of view, the two most significant indications that the results are less than meaningful are (1) the classification of jurisdictions as pro- or anti-*Durrett*, and (2) the measuring years chosen to determine lenders' reaction to *Durrett*.

A. *Classification*

The study presumes that if the *Durrett* consequences are as bad as its opponents claim, lenders would be expected to react decisively in jurisdictions adopting the doctrine. It is, therefore, especially unfortunate that Professor Shuchman's classification of certain states as supporting or opposing *Durrett* is questionable.

For example, New York, Pennsylvania, and North Carolina are cited as pro-*Durrett* jurisdictions[13] based on only one or two bankruptcy court decisions applying the *Durrett* rule in each state.[14] However, a bankruptcy court decision is a long way from a decision by the Second, Third, or Fourth Circuit on the issue. Lenders cannot be expected to react decisively to such individual lower court holdings.

Indeed, after the cited bankruptcy court case supporting *Durrett* was decided in the Eastern District of Pennsylvania,[15] the Third Circuit rejected *Durrett* on the relation-back theory.[16] In New York, the pro-*Durrett* bankruptcy court is balanced by at least one bankruptcy court rejecting *Durrett* [17] a year after the decision in the case on which the survey relied.[18]

On the other hand, California is studied as anti-*Durrett* because of the Ninth Circuit decision in *Madrid v. Lawyers Title Insurance*

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[11] Shuchman, supra note 4, at 624-25.

[12] Id. at 637-40.

[13] Id. at 630-32.

[14] Id. New York, Frank v. Berlin, (*In re* Frank), 39 Bankr. 166 (Bankr. E.D.N.Y 1984); Pennsylvania, Home Life Ins. Co. v. Jones (*In re* Jones), 20 Bankr. 988 (Bankr. E.D. Pa. 1982); North Carolina, Cooper v. Smith (*In re* Smith), 24 Bankr. 19 (W.D.N.C. 1982); Marshall v. Spindale Sav. & Loan Ass'n (*In re* Marshall), 15 Bankr. 738 (Bankr. W.D.N.C. 1981).

[15] *In re Jones*, 20 Bankr. 988.

[16] Calairo v. Pittsburgh Nat'l Bank (*In re* Ewing), 36 Bankr. 476, 479 n.8 (Bankr. W.D. Pa.), aff'd, 746 F.2d 1465 (3d Cir. 1984), cert. denied, 469 U.S. 1214 (1985). For a discussion of the effect of relation back, see text accompanying infra notes 21-22.

[17] *In re* Upham, 48 Bankr. 695 (Bankr. W.D.N.Y. 1985).

[18] *In re Frank*, 39 Bankr. 166.

Corp. (In re Madrid).[19] Professor Shuchman assumes that if *Durrett* were bad for the lending community, a rejection of *Durrett* should result in an increase in lending and a reduction in interest rates.[20] However, the rejection of *Durrett* does not *improve* the lender's position unless the prior law had supported *Durrett*. Since the Ninth Circuit had not previously ruled on this issue, its "rejection" merely left the lenders in an unchanged position.

Actually, the Ninth Circuit "rejected" *Durrett* on the very limited grounds of the relation-back theory,[21] which does not affect foreclosures of mortgages recorded within the year before bankruptcy or within a longer period under state law.[22] Thus, the Ninth Circuit decision actually moved the law toward *Durrett* and away from the clear rejection of *Durrett* by the Bankruptcy Appellate Panel in *Madrid*.[23] Lending institutions had hoped the Ninth Circuit would affirm the Panel in declaring that a noncollusive, regularly conducted foreclosure sale is deemed to be for a reasonably equivalent value. The limited holding was, in fact, a disappointment to the lenders, and thus would not result in the reductions in interest rates and increases in mortgage lending that Professor Shuchman expected would result from an anti-*Durrett* decision. If anything, the opposite could be expected.

B. *Measuring Years*

Putting aside the classification of jurisdictions, the figures themselves seem less than conclusive to me, perhaps because of my disagreement with Professor Shuchman's choice of measuring years. For example, *Durrett* was decided in 1980,[24] but the appeal of the *Durrett* issue in the Fifth Circuit continued until certiorari was denied in *Abramson v. Lakewood Bank & Trust Co.* in 1982.[25] I believe that it was the finality of certiorari denial that would most likely have begun to convince lenders in the Fifth Circuit that *Durrett* was a problem. In-

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19 725 F.2d 1197 (9th Cir.), cert. denied, 469 U.S. 833 (1984).

20 Shuchman, supra note 4, at 607.

21 725 F.2d at 1198. See also Zinman, supra note 1, at 589-90.

22 Under section 548 of the Bankruptcy Code, 11 U.S.C. § 548 (1982 & Supp. IV 1986), a transfer is subject to attack only if it occurs within a year prior to the filing of the bankruptcy petition. However, under section 544 of the Bankruptcy Code, 11 U.S.C. § 544 (1982 & Supp. IV 1986), the trustee or debtor in possession may step into the shoes of a creditor under state fraudulent conveyance law. The reach-back of state law is limited only by the state statute of limitations for fraud. See Zinman, supra note 1, at 590.

23 Lawyers Title Ins. Corp. v. Madrid (*In re* Madrid), 21 Bankr. 424, 426-27 (Bankr. 9th Cir. 1982), aff'd on other grounds, 725 F.2d 1197 (9th Cir.), cert. denied, 469 U.S. 833 (1984).

24 Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980).

25 647 F.2d 547 (5th Cir. 1981), cert. denied, 454 U.S. 1164 (1982).

deed, in 1983, the year following certiorari denial, Professor Shuchman's own figures show that while residential mortgage lending increased in Texas by 50.8%, this increase was *less than half* of the national increase of 111.6%.[26] In 1984, mortgage lending actually *decreased* in Texas by 11.9% while *increasing* by 0.76% nationally.[27] Professor Shuchman's figures also reveal that average loan amounts increased in Texas in 1983 by 6.9% as against 8.9% in the nation,[28] and in 1984 by 1.8% as compared to 7.7% in the nation.[29] While factors other than *Durrett* may have influenced the smaller residential lending volume and loan size increases in Texas during 1983 and 1984, the figures are hardly arguments for the lack of lender reaction to *Durrett*.

III. LACK OF BANKRUPTCY SOPHISTICATION OF MORTGAGE LENDING OFFICERS

Sometimes we become so involved in the subjects that interest us that we fail to understand the slow reaction of the rest of the population to developments in these areas. So it is with the hypothesis behind Professor Shuchman's survey, which assumes a greater bankruptcy sophistication among lending officers than is justified.

Professor Shuchman compares what he apparently considers to be lenders' mild response to the *Durrett* decision to the significant increase in claims for lost opportunity costs by mortgage lenders[30] after the Ninth Circuit, in *Crocker National Bank v. American Mariner Industries (In re American Mariner Industries)*,[31] decided that adequate protection entitled undersecured lenders to lost opportunity costs.[32] It was natural that *bankruptcy* lawyers representing lenders would react quickly to *American Mariner* and immediately begin to ask the courts for lost opportunity costs in subsequent bankruptcy cases—cases that would be conducted regardless of the *American Mariner* decision. It is quite another thing, in a nonbankruptcy setting, to expect lending officers, most of whom are not lawyers, and most of whose lawyers are not bankruptcy specialists, to make a sudden major *economic* decision to change their lending policies on the

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26 Shuchman, supra note 4, at 628.

27 Id.

28 Id.

29 Id.

30 Id. at 605.

31 734 F.2d 426 (9th Cir. 1984).

32 Id. at 435. On January 19, 1988, the Supreme Court rejected the *American Mariner* result. See United Sav. Ass'n v. Timbers of Inwood Forest Assocs. (*In re* Timbers of Inwood Forest Assocs.), No. 86-1602, slip op. (1988), aff'g 808 F.2d 363 (5th Cir. 1987).

basis of a holding in a bankruptcy case that did not affect them directly.[33] Today, with relatively few *Durrett* cases having been decided in the entire country,[34] and with the circuits that have spoken hopelessly split,[35] the judicial situation is hardly acute enough to start a panic. However, should the *Durrett* thesis become the rule rather than the exception, lenders will face greater financial costs in the future than they do at present—costs that will have to be reflected in lending policy.[36]

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[33] Professor Shuchman seems to imply that lenders would normally hedge bankruptcy risks prospectively, by a reduction in lending or an increase in interest rates, based on isolated adverse bankruptcy decisions involving other parties. Shuchman, supra note 4, at 607. Perhaps lenders should. The fact is lenders are human and generally do not act until their own bottom line is affected, especially if they believe the case makes no sense and will be corrected eventually.

[34] According to Westlaw, as of January 6, 1988 there were only a total of 98 federal court cases citing *Durrett*.

[35] The circuits that have spoken are divided as follows:

Anti-*Durrett*: Third Circuit, Calairo v. Pittsburgh Nat'l Bank (*In re* Ewing), 746 F.2d 1465 (3rd Cir. 1984), affg 36 Bankr. 476 (W.D. Pa.), cert. denied, 469 U.S. 1214 (1985); Sixth Circuit, *In re* Winshall Settlor's Trust, 758 F.2d 1136 (6th Cir. 1985); Ninth Circuit, Madrid v. Lawyers Title Ins. Corp. (*In re* Madrid), 725 F.2d 1197 (9th Cir.), cert. denied, 469 U.S. 833 (1984). The Third and Ninth Circuit cases were decided under the relation-back theory. The Sixth Circuit case was decided on the reasonable equivalent theory.

Pro-*Durrett*: Fifth Circuit, Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980); Eighth Circuit, First Fed. Sav. & Loan Ass'n v. Hulm (*In re* Hulm), 738 F.2d 323 (8th Cir.), cert. denied, 469 U.S. 990 (1984); Eleventh Circuit, the first decision of the Eleventh Circuit, after it was carved out of the Fifth Circuit, held that until the Eleventh Circuit speaks on an issue, its lower courts are bound by decisions of the Fifth Circuit. Bonner v. City of Prichard, 661 F.2d 1206, 1206 (11th Cir. 1981).

[36] Professor Shuchman also analogizes the alleged lack of reaction to *Durrett* to the alleged lack of reaction to Constance v. Harvey, 215 F.2d 571 (2d Cir. 1954), cert. denied, 348 U.S. 913 (1955) (overruled by Lewis v. Manufacturers Nat'l Bank, 364 U.S. 603 (1961)), which "so far as I could determine, made no difference in the cost or availability of secured credit." Shuchman, supra note 4, at 606. The relevance of the analogy aside for the moment, Professor Shuchman cites no figures in support of his contention that the case made no difference (other than a citation to a previous book, id. at 607 n.12, that refers to his inquiries and "archival investigation" that produced "limited information . . . from the reports that national banks filed with the Comptroller of the Currency and from the Federal Reserve System." P. Shuchman, Problems of Knowledge in Legal Scholarship A-5 to A-6 (1979)). Despite that contention, he quotes Professor James Angell MacLachlan as stating that the decision " 'has, of course, made secured credit costlier and harder to get in the Second Circuit, and it has cast its shadow elsewhere.' " Shuchman, supra note 4, at 606 n.8 (quoting MacLachlan, Two Wrongs Make a Right, 37 Tex. L. Rev. 676, 679 (1959). Professor MacLachlan is the author of section 70c of the former Bankruptcy Act, see Creedon & Zinman, Landlord's Bankruptcy: Laissez Les Lessees, 26 Bus. Law. 1391, 1441-42 (1971), the section in contention in *Constance*.

More importantly, the relevance of the analogy is questionable because the effects of the cases are different. Unlike *Durrett*, where the mortgagee's valuation is always subject to second guessing by a bankruptcy court at a later date, the risk of *Constance* could easily be overcome by the mortgagee's filing in a timely manner, though often at considerable expense. As the time limit for filing is shortened, expenses increase. The burdens are greatest where immediate filing is required. See, e.g., 1951 Mich. Pub. Acts 244 (amended by 1959 Mich. Pub. Acts 110

IV. THE RED SEA SYNDROME

If the survey is correct that lenders have not responded to *Durrett*, the reason might be either that lenders do not receive windfalls on foreclosure[37] and thus have not been subject to fraudulent transfer attack, or that there simply have not been enough *Durrett* cases to affect the bottom line and cause lenders to act to protect their investment return. If the *Durrett* rule were to become generally accepted and there were sufficient cases to make an impact, these reasons would indicate either that *Durrett* is unnecessary to protect unsecured creditors, or that the costs of *Durrett* would either be passed on to borrowers or affect lender underwriting.

The one thing that cannot be concluded is that the sea will part and allow borrowers to walk in safety while the courts do what they want to lenders. Certainly many factors go into the decision to make a mortgage loan in a particular amount to a particular borrower at a particular interest rate, and *Durrett* is just one of those factors. However, if a savings and loan association is paying its depositors x%, it must recover x+% from its borrowers or call in the FSLIC; and if an insurance company can produce better dividends for its policyholders, stockholders, or pension customers by making equity debenture investments rather than mortgage loans, it will. It is thus unrealistic to believe that, by some miracle, the expenses and risks created by a widely accepted *Durrett* rule would not be passed on to borrowers or otherwise figure into the lending equation.

(amendment to provide for a 10 day filing period)) (repealed by adoption of the Uniform Commercial Code). As a law student, I remember Peter Coogan describing to our Corporate Reorganizations seminar how important closings were held after midnight with planes standing by to fly associates to the recording offices to insure recording the moment the office opened in the morning. Since the borrower normally pays the lender's legal fees and expenses, it seems unreasonable to think that such costs did not affect the cost of obtaining credit.

[37] A recent empirical study confirms that lenders normally lose on foreclosures. See Zinman, supra note 1, at 598 nn.66-67.

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DATA ON THE *DURRETT* CONTROVERSY

*Philip Shuchman**

Sometimes abrupt changes in applicable law make a measurable difference; sometimes they result in no difference or no revealed difference; and sometimes they have unforeseen effects. Mostly, we lack information on the impacts of changes in the law. Occasionally, the impact of a changed law is immediate and apparent, although one cannot always predict how long the effect will last. One recent example is the landmark decision in *Crocker National Bank v. American Mariner Industries* (*In re American Mariner Industries*),[1] which held that adequate protection for a secured creditor under Bankruptcy Code section 361 could include postpetition interest payments on the value of the collateral.

Two years later, when the Fifth Circuit Court of Appeals in *In re Timbers of Inwood Forest Associates*[2] had to decide that same issue, it obtained some simple statistics from the clerk of the District Court for the Southern District of Texas. These showed that the frequency of section 362(d) motions for adequate protection had been about ninety-two motions per 100 cases. But, after the *American Mariner* decision in 1984, that frequency increased to 135 such motions per 100 cases; and in 1985 the frequency "increased further, to 151 motions per 100 new cases. . . . In the first three months of 1986, the rate grew to 163 motions for relief from the stay per 100 new cases. . . ."[3] The court concluded that "many more [section] 362 motions are filed today than in years past, and these statistics make it clear that the increase is not due simply to an increase in new bankruptcy filings."[4]

In this suggestive example, the incentive for secured creditors is obvious and the rewards for a successful section 362(d) motion are immediate. The issues in this litigation are relatively simple: The court need only evaluate the collateral and determine whether the debtor has any equity and whether the collateral is necessary for a successful reorganization. Of course, the evaluation of commercial real estate can sometimes be an exceedingly complicated

* Professor of Law, Knowlton Scholar in Law, Rutgers University School of Law (Newark).

1 734 F.2d 426 (9th Cir. 1984).

2 United Sav. Ass'n v. Timbers of Inwood Forest Assocs. (*In re* Timbers of Inwood Forest Assocs.), 793 F.2d 1380 (5th Cir. 1986), cert. granted, 107 S. Ct. 2459 (1987).

3 Id. at 1408-09 n.49.

4 Id.

undertaking.[5]

Another illustrative example may be the apparent lack of an expected impact from a sudden change in law; in these cases, involving both the change and its later reversal. The claimed pernicious career of the ideal hypothetical lien creditor doctrine in *Constance v. Harvey* (1955),[6] was, like the *Durrett*[7] rule, taken for granted by the almost entirely critical commentators in the law journals.[8] I suppose its ill effects were also argued by those who wrote the briefs in *Lewis v. Manufacturer's National Bank* (1961)[9] which, some six years later, overruled *Constance v. Harvey*.

It seemed self-evident to the commentators that since *Constance v. Harvey* increased the risk for some secured creditors in the event of a later bankruptcy filing by the debtor, secured credit would increase in cost and become more difficult to obtain.[10] The language of the critics then is much like what is heard of the *Durrett* doctrine.[11]

But in the nearly six years of its life, the *Constance v. Harvey* doctrine, so far as I could determine, made no difference in the cost or availability of secured credit; nor did *Constance* or *Lewis*, the decision which overruled it, appear to have any effect on secured credit, as

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[5] See Zinman, Noncollusive, Regularly Conducted Foreclosure Sales: Involuntary, Nonfraudulent Transfers, 9 Cardozo L. Rev. 581 (1987).

[6] 215 F 2d 571 (2d Cir. 1954), cert. denied, 348 U.S. 913 (1955). Here, a creditor delayed filing a chattel mortgage for ten months after the transaction. Under New York law, any other person who extended credit after the last day on which the chattel mortgage should have been recorded until the date of the bankruptcy filing could defeat the rights of the chattel mortgagee, the secured creditor. No one else did extend credit during that ten-month period until the chattel mortgage was finally recorded. When the debtor-mortgagor later became bankrupt, however, the Court of Appeals for the Second Circuit held that the trustee in bankruptcy had the rights of an "ideal" hypothetical lien creditor and could, therefore, invalidate the chattel mortgage even though there existed no actual creditor who could have done so.

[7] Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980).

[8] See, e.g., MacLachlan, Two Wrongs Make a Right, 37 Texas L. Rev. 676 (1959). Professor MacLachlan asserted that the *Constance* decision "has, of course, made secured credit costlier and harder to get in the Second Circuit, and it has cast its shadow elsewhere." Id. at 679. I assume the last phrase means that secured credit was, though perhaps to a lesser extent, also costlier and more difficult to obtain in other states with similar recordation statutes.

[9] 364 U.S. 603 (1961).

[10] A student casenote on Lewis v. Manufacturer's Nat'l Bank relates that the *Lewis* decision "removes a serious threat to security transaction," and cites and follows Professor MacLachlan's assertion that after the *Constance* decision, credit became costlier and more difficult to get in New York. The student also adds a gloss of his own: "It is apparent that the rule [of Constance v. Harvey] would result in a greater impairment of credit in a jurisdiction" with a recordation law like that of New York. Recent Cases, Bankruptcy—Assets—Trustee's Rights Under 70(c) Ascertained at Date of Bankruptcy Rather Than Anterior Point of Time, 14 Vand. L. Rev. 1009, 1012 (1961). The teacher's manual of a popular 1975 casebook refers to the decision as "a disaster in jurisdictions having statutes like California . . . and New York."

[11] See infra Part II.

measured from before and after the dates of the two decisions.[12]

Likewise, the Fifth Circuit's decision in *Durrett v. Washington National Insurance Co.*,[13] in conjunction with *In re Hulm*,[14] four years later, was expected to wreak havoc on the mortgage credit markets in states bound by that doctrine. But reference to the relevant financial data measured from the year before *Durrett* through 1985, strongly suggests that the anticipated harms did not materialize; or, if to some extent, they did, the effects were short-lived.

The graphs that follow show the lack of change in two crucial variables—effective interest rates and loan-to-price ratios—over seven years in the Nation, Texas, and California. (The Tables in Part IV provide more precise figures.) Our thesis is that the bad consequences claimed for that period of time are not at all apparent, and that there is little or no evidence that these decisions had any effect other than the creation of arguments about correct doctrine.

Part I of this Article reviews the *Durrett* doctrine and sketches a chronology of the events which serve as time markers for an inquiry into the statistical data of the mortgage market before and after that decision and some of its successor cases. Part II discusses the harmful consequences anticipated and claimed by the critics of *Durrett* (who were the proponents of *Madrid*, the contrary ruling). Part III outlines the conventional economic model upon which the critics base their assertions. Part IV displays gross statistical data in an effort to show what impact the *Durrett* decision had on the cost and availability of residential mortgage loans in selected states. We conclude that the impact appeared to be negligible or indeterminate. Finally, Part V presents other plausible explanations for the before-and-after data compiled in our tables.

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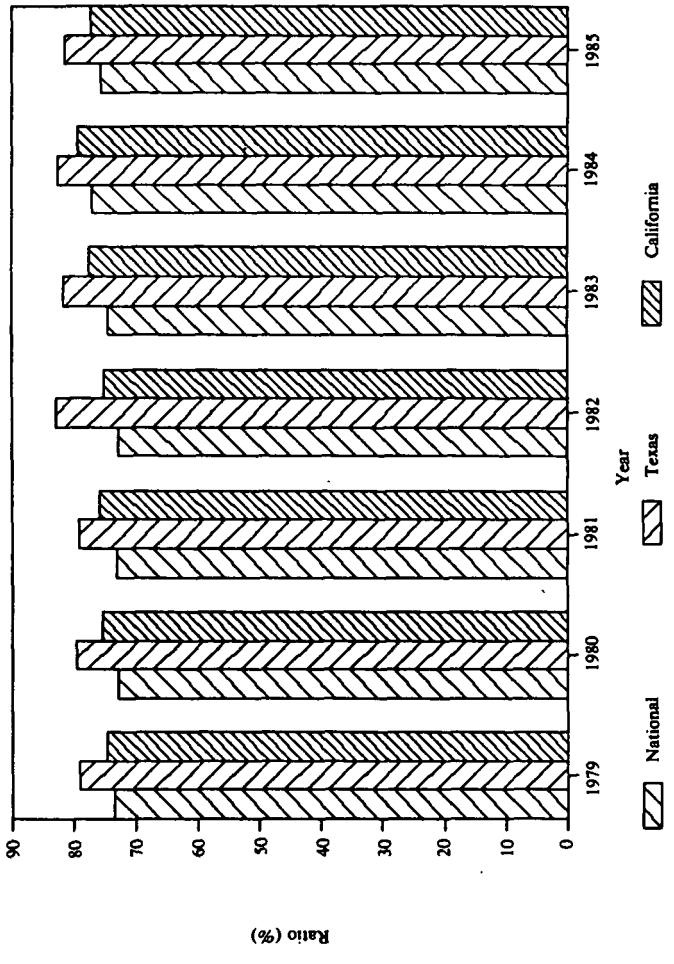
[12] P. Shuchman, Problems of Knowledge in Legal Scholarship A-4 to A-7 (1979).

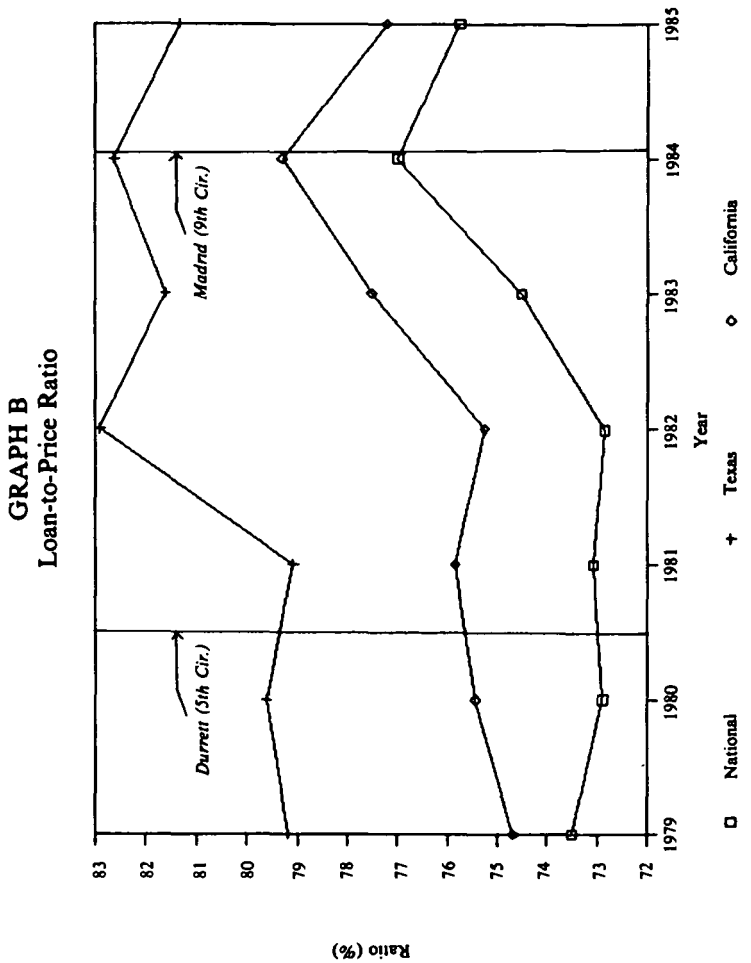
One difference between the examples probably is the decisionmaker. Regarding the § 362 motions, lawyers who have strong incentives to move in that direction are most apt to decide. The question whether or not large institutions continue to create mortgage loans is not only different in kind but involves no personal behavioral assumptions such as the lawyers' actions. There is, however, a nonpositivistic sense, commonly used, in which institutions are, as it were, constructed from individual propensities to behave generally in certain ways.

[13] 621 F.2d 201 (5th Cir. 1980).

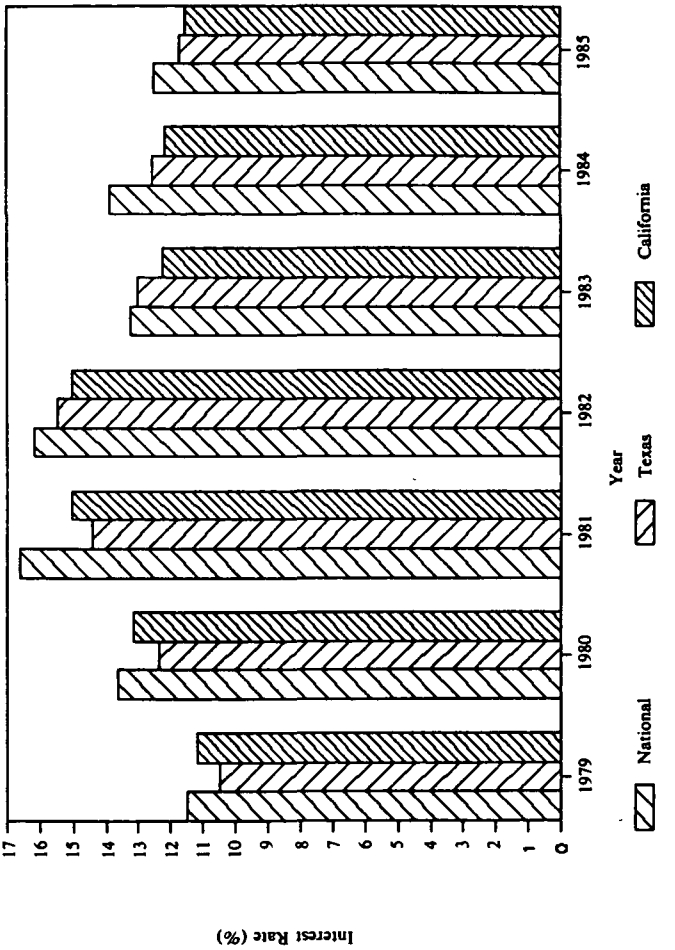
[14] First Fed. Sav. & Loan Ass'n v. Hulm (*In re* Hulm), 738 F.2d 323 (8th Cir.), cert. denied, 469 U.S. 990 (1984). In *In re Hulm*, the mortgagee sought a determination that foreclosed property was not within the protective sphere of the postpetition debtor's estate. Although the Eighth Circuit held that the foreclosure was a "transfer" within the meaning of § 548, the court refused to set aside the foreclosure; instead, it remanded for a finding of whether or not the foreclosure price constituted a reasonably equivalent value in exchange. Id. at 325.

GRAPH A
Loan-to-Price Ratio

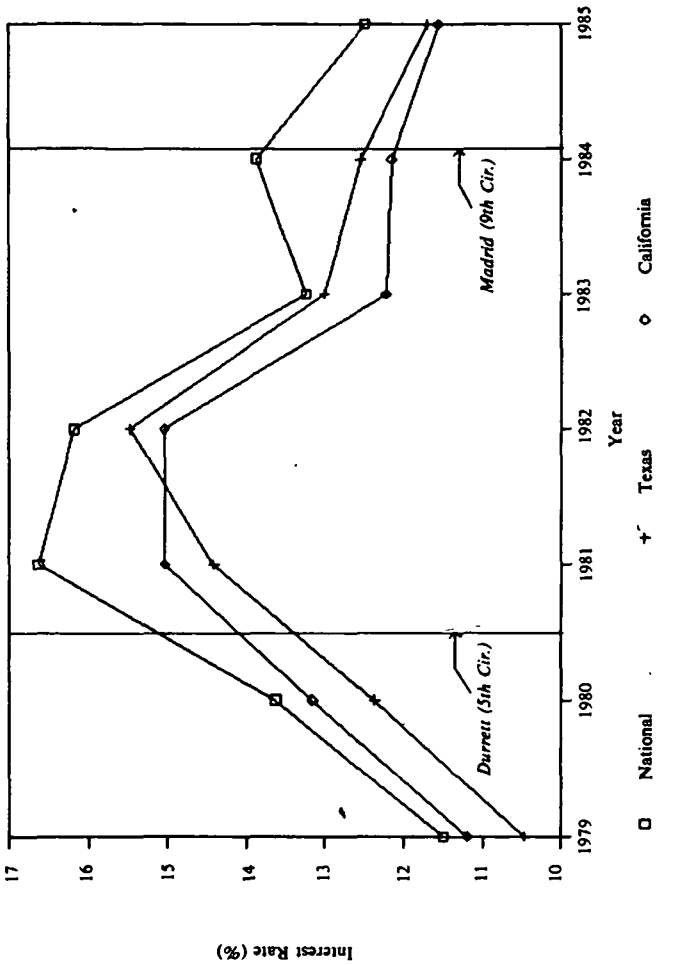



GRAPH B
Loan-to-Price Ratio
Durrett (5th Cir.)
Madrid (9th Cir.)
Ratio (%)
83
82
81
80
79
78
77
76
75
74
73
72
1979
1980
1981
1982
1983
1984
1985
Year
National
Texas
California

GRAPH C
Effective Mortgage Interest Rates



GRAPH D
Effective Mortgage Interest Rates



I. THE *DURRETT* DECISION

Durrett v. Washington National Insurance Co.[15] held that a foreclosure sale is a transfer of a debtor's interest in property and that a prepetition, nonjudicial foreclosure sale could be avoided as a fraudulent transfer of the debtor's equity, if the foreclosure price was, as suggested in that case, less than about 70% of the property's fair market value at the time of the sale. *Durrett* was the first decision to hold that, under the Bankruptcy Code, a nonjudicial foreclosure sale made within a year prior to bankruptcy is a transfer of a debtor's equity in property which may be avoided as a fraudulent transfer if less than a reasonably equivalent value was paid for the property. The narrow issue is whether a regularly conducted, noncollusive, prepetition foreclosure sale of a debtor's property should be avoidable as a fraudulent transfer if the property was sold for less than a reasonably equivalent value within one year before a bankruptcy petition.

The *Durrett* rule has been followed and rejected in several real property cases; it has been approved for nonjudicial foreclosures,[16] judicial foreclosures,[17] execution sales,[18] and strict foreclosures.[19] It has been used by trustees in Chapter 7 liquidations,[20] by debtors in Chapter 13 proceedings,[21] and by debtors in possession in Chapter 11 proceedings.[22] *Durrett* has also been applied to dispositions of personal property collateral under article 9 of the Uniform Commercial Code.[23]

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[15] 621 F.2d 201 (5th Cir. 1980). Beyond this brief introductory excursion into the competing legal doctrines, readers have available a cornucopia of journal literature very well analyzed and summarized in this Symposium by Professor Kennedy and Mr. Zinman. See Kennedy, Involuntary Fraudulent Transfers, 9 Cardozo L. Rev. 531 (1987); Zinman, supra note 5.

[16] See Ruebeck v. Attleboro Sav. Bank (*In re* Ruebeck), 55 Bankr. 163 (Bankr. D. Mass. 1985); Willis v. Borg-Warner Acceptance Corp. (*In re* Willis), 48 Bankr. 295 (Bankr. S.D. Tex. 1985); Lakeview Inv. Group, Inc. v. Pemberton (*In re* Lakeview Inv. Group), 40 Bankr. 449 (Bankr. E.D.N.C. 1984).

[17] See *In re* Hulm, 738 F.2d 323; Home Life Ins. Co. v. Jones (*In re* Jones), 20 Bankr. 988 (Bankr. E.D. Pa. 1982).

[18] See, e.g., Frank v. Berlin (*In re* Frank), 39 Bankr. 166 (Bankr. E.D.N.Y. 1984).

[19] See, e.g., Carr. v. Demusis (*In re* Carr), 34 Bankr. 653 (Bankr. D. Conn. 1983), aff'd, 40 Bankr. 1007 (D. Conn. 1984).

[20] See, e.g., Consove v. Cohen (*In re* Roco Corp.), 701 F.2d 978 (1st Cir. 1983).

[21] Marshall v. Spindale Sav. & Loan Ass'n (*In re* Marshall), 15 Bankr. 738 (Bankr. W.D.N.C. 1981).

[22] See, e.g., Abramson v. Lakewood Bank and Trust Co., 647 F.2d 547 (5th Cir. June 1981), cert. denied, 454 U.S. 1164 (1982); William v. Travelers Ins. Co. (*In re* William), 39 Bankr. 989 (D. Minn. 1984); Berge v. Sweet (*In re* Berge), 33 Bankr. 642 (Bankr. W.D. Wis. 1983).

[23] See Corporate Jet Aviation, Inc. v. Vantress (*In re* Corporate Jet Aviation, Inc.), 57 Bankr. 195 (Bankr. N.D. Ga. 1986); Join-In Int'l (U.S.A.) v. New York Wholesale Distribs., Corp. (*In re* Join-In Int'l (U.S.A.)), 56 Bankr. 555 (Bankr. S.D.N.Y. 1986). See also Koger & Acconcia, The Hulm Decision: A Milestone for Creditors, 91 Com. L.J. 301, 318-20 (1986)

Different doctrinal bases have been applied to this general situation:

(1) That the one-year transfer period of Code section 548 is to be measured from the date of perfection of the security interest or recording of the mortgage or deed of trust.[24]

(2) That the one-year transfer period runs from the date of the foreclosure sale or other disposition.[25]

(3) That "a reasonably equivalent value" means not less than a given percentage—about 70% is the *Durrett* figure—of the fair market value of the property.

(4) Some courts eschew a given percentage and would rely on the facts of the particular case, including the situations of the parties and the marketability of the property.[26] Ordinarily this would involve an evidentiary hearing more complicated than what would be needed to comply with *Durrett*.

(5) That a regularly conducted nonjudicial foreclosure sale results in a price which is defined as fair market value, or at least satisfies the "reasonably equivalent value" requirement of Code section 548(a)(2).[27]

Durrett did seem to change prior law by effectively creating a possible federal right of redemption if a bankruptcy petition was filed within a year after the foreclosure.[28] Moreover, the period of uncertainty was longer than the usual state laws permitting statutory post-sale redemption.

Most of the courts in which the issue has been raised have tended to follow the *Durrett* rule that the foreclosure is a transfer within the meaning of Code section 548. Some of the later cases also apply the newly revised Code section 101(50), which provides that a transfer includes foreclosure of the debtor's equity of redemption, thus extending the one-year period of Code section 548. Although there has

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(discussing the application of article 9 and § 548 in foreclosure sales involving personal property).

[24] Madrid v. Lawyers Title Ins. Corp. (*In re* Madrid), 725 F.2d 1197 (9th Cir.), cert. denied, 469 U.S. 833 (1984).

[25] Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980).

[26] First Fed Sav. & Loan Ass'n v. Hulm (*In re* Hulm), 738 F.2d 323 (8th Cir.), cert. denied, 469 U.S. 990 (1984).

[27] Lawyers Title Ins. Co. v. Madrid (*In re* Madrid), 21 Bankr. 424, 426-27 (Bankr. 9th Cir. 1982) (B.A.P.), aff'd on other grounds, 725 F.2d 1197 (9th Cir.), cert. denied, 469 U.S. 833 (1984). *In re* Ristich, 57 Bankr. 568 (Bankr. N.D. Ill. 1986), adds a gloss: if "the purchaser at the foreclosure sale is an unrelated third party, there is an irrebuttable presumption that the sale was for a reasonable equivalence." Id. at 577.

[28] See infra notes 39-54 and accompanying text.

been vehement criticism of the *Durrett* rule,[29] the courts that have ruled are mostly in agreement that a transfer sufficient to invoke Code section 548 occurs at foreclosure.

Durrett, decided in July 1980, and the cases that followed it, caused great alarm in the creditor community. But neither in the April 1983 Senate Hearings on S.445[30]—which would have changed section 548 of the Bankruptcy Code to undo the *Durrett* doctrine—nor elsewhere since then could we find any empirical evidence of the claimed bad consequences. If any groups had such evidence it should have been those involved, for example, two-and-a-half years later, (November 1982) as *amici* in *Madrid* (decided in February 1984): American Land Title Association; Mortgage Brokers Institute; American Council of Life Insurance; California Bankers Association; California Clearing House Association.[31]

Senate Bill 445 (1983) contained a proposed section 548(d)(2)(C) which was an unsuccessful effort to repeal the rule of *Durrett*-type cases. Professor Kennedy's strong statement to the Congress in opposition was apparently persuasive and the proposed section 548(d)(2)(C) was deleted and does not appear in the final legislation.[32]

The recently promulgated Uniform Fraudulent Transfer Act[33] (UFTA) defines reasonably equivalent value as the result of a regularly conducted, noncollusive, foreclosure sale. Section 3(b) of the UFTA as proposed by the Commissioners on Uniform Laws would apply to security interests in personal and real property. The final version released for enactment by the states is dated August 1984.[34]

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[29] See the list compiled in Kennedy, Involuntary Fraudulent Transfers, 9 Cardozo L. Rev. 531, 532-34 n.6 (1987).

[30] Bankruptcy Improvements Act: Hearings on S.445 Before the Comm. on the Judiciary, 98th Cong., 1st Sess. 574 (1983) [hereinafter Hearings on S.445].

[31] The most important amicus brief for secured creditors was that filed on behalf of the California Bankers Association and the California Clearing House Association. Brief of Amici Curiae in Support of Position of Lawyers Title Insurance Corp., Madrid v. Lawyers Title Ins. Corp. (*In re* Madrid), 725 F.2d 1197 (9th Cir.), cert. denied, 469 U.S. 833 (1984). That brief was widely circulated among other large mortgage lending firms. It has since been widely cited, and is herein referred to as the Association Brief.

[32] Hearings on S.445, supra note 30, at 330-33 (Statement by Professor Frank R. Kennedy).

[33] 7A U.L.A. 639 (1985 & Supp. 1987).

[34] Sixteen states have adopted the UFTA: Arkansas, Bill No. 967 (76th Gen. Assembly Reg. Sess. 1987) (copy on file at the Cardozo Law Review); California, Cal. Civ. Code §§ 3439 to 3439.12 (West Supp. 1987); Florida, House Bill No. 236, ch. 79 (1987) (copy on file at the Cardozo Law Review); Hawaii, Haw. Rev. Stat. §§ 651c-1 to -10 (1987); Idaho, Idaho Code §§ 55-910 to -922 (Supp. 1987); Maine, Me. Rev. Stat. Ann. tit. 14, §§ 3571-3582 (Supp. 1986); Minnesota, Minn. Stat. Ann. §§ 513:20 to :32 (1987) (copy on file at the Cardozo Law Review); Nevada, Assembly Bill #60 (1987) (copy on file at the Cardozo Law Review); New Hampshire, N.H. Rev. Stat. Ann. §§ 545A:1 to :12 (1987) (copy on file at the Cardozo Law

The A.B.A. Section of Real Property Law urged that the UFTA include a provision such as section 3(b) in an effort to remedy the *Durrett* problem.[35] The Section Report is dated August 1983.

Thus, some of the relevant dates for our purposes—and which may be helpful for the reader—follow:

Durrett decision	July, 1980
Amicus Briefs in *Madrid*	November, 1982
Hearings on S.445	April, 1983
A.B.A. Section Report	August, 1983
Madrid decision[36]	February, 1984
UFTA Proposed	August, 1984

The importance of these dates is that data on the cost of mortgage loans and the amount of mortgage debt created was known for the years and in some instances for the months or quarters before and after each of these dates. Yet no such data were presented at any time by the well-organized groups opposed to the *Durrett* rule. The Association Brief contends that the cost of mortgage credit (interest) and the availability of mortgage loans, as measured by the totals of mortgage debt created, are the accepted indicators of the effects of these important decisions on this particular market.[37] These results should be evident in Texas and California, the large populous states directly affected. The thrust of this Article is that the available aggregated statistical data on interest rates, loan-to-price ratios, and total loans created before and after these decisions show that *Durrett* and *Madrid*

Review); North Dakota, N.D. Cent. Code §§ 13-02.1-01 to -10 (Supp. 1987); Oklahoma, Okla. Stat. Ann. tit. 24, §§ 112-123 (West 1987); Oregon, Or. Rev. Stat. Ann. §§ 95.200 to .310 (Supp. 1987); Rhode Island, R.I. Gen. Laws §§ 6-16-1 to -12 (Supp. 1987); South Dakota, S.D. Codified Laws Ann. §§ 54-8A-1 to -12 (Supp. 1987); Texas, House Bill No. 2193 (70th Reg. Sess. 1987); West Virginia, W. Va. Code §§ 40-1A-1 to -12 (Supp. 1987).

[35] 1983 A.B.A. Sec. of Real Prop., Prob. & Tr. L. Rep. 106B, at 1.

[36] While *Madrid* was making its way from the bankruptcy court decision (May 1, 1981) to its conclusion with the denial of petition for writ of certiorari (October 1, 1984), it was, for its first fourteen months (May 1, 1981 to June 22, 1982, the date of the Bankruptcy Appellate Panel's reversal) a holding more or less consistent with *Durrett*, and undoubtedly, according to the mortgage lenders' lawyers, was considered a threat which increased risk.

Thereafter, the two increasingly authoritative judicial decisions would compel a result contrary to *Durrett*. However, Bates v. Two Rivers Construction (*In re* Bates), 32 Bankr. 40 (Bankr. E.D. Cal. July 28, 1983) (holding that a foreclosure sale for $2200 of a property found to be worth about $45,000 could be set aside under Code § 548) suggests that there was no clear consensus on this issue in California.

As Tables J, K, & L show, from 1980 through 1985 the changes in the four relevant variables in California fairly well tracked the national averages. These claimed dramatic developments in the law of fraudulent conveyances in bankruptcy appeared to make little difference in the mortgage money market.

[37] Association Brief, supra note 31, at 32-33.

made little, if any, apparent difference either way in those variables.[38] The tables presented below[39] very strongly suggest that the interest rates and the total mortgage loans created—with both variables measured by state and by year—have all followed the national averages regardless of whether a state (of those states for which we present data) had adopted or rejected *Durrett*. Thus, while *Durrett* created fears of increased risk among mortgage lenders, and *Madrid* may have allayed their anxieties, neither decision appears to have had marketplace effects as measured by these aggregated statistical data.

II. STATUTORY REDEMPTION AND THE ANTICIPATED HARMFUL CONSEQUENCES OF *DURRETT*

The *Durrett-Hulm* doctrine is likened to a federal redemption statute. That is claimed to be very bad because "rights of redemption have been universally condemned as harmful to debtors because they chill bidding, decrease the prices received at foreclosure sales and increase deficiencies and deficiency judgments."[40] There is very little

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[38] For most of the six years 1980 through 1985 there has been an increasing use of Adjustable Rate Mortgages (ARM's). The interest rates vary by time—from six months to two years or more. The most common benchmark used in conventional mortgage loans is the National Mortgage Contract Rate (NMCR), which is the average interest rate of all mortgages created (closed) during the preceding period. There are various indexes used to calculate the ARM's. These include, separately and sometimes in combination, six-month treasury bills and treasury bills and notes for one year and for three and five years.

The fluctuations of these reflections of the money marketplace are translated into the variations, up and down, of the interest paid on adjustable mortgage loans. Hence the NMCR tracks money-market rates and is directly related to the mortgage loan market. ARM Index Comparison Table (May 1987) (compiled and available from HSH Associates, 10 Mead Ave., Riverdale, N.J., 07457). The NMCR calculation of national average mortgage loan rates was available to us, and I suppose to the mortgage loan industry firms and their lawyers, for the latter part of calendar year 1983, all of years 1984 and 1985, and to the middle of 1986.

The very widespread use of the NMCR seems to overwhelm any state-wide or circuit-wide factors. Variables such as the *Durrett* or *Madrid* (or *Hulm*) rules do not appear to make any difference in the aggregate. Of course the different legal settings may affect individual cases. Or, as we indicate, these opposed and different legal models may have had effects which are not revealed in the overall gross figures There are alternative and rival explanations which, separately or in several combinations, could plausibly account for the apparent no-change or conceal the existence of changes; or the changes could have been much greater or smaller because of the differential legal impacts.

[39] See infra Part IV

[40] Association Brief, supra note 31, at 27.

The *Durrett* doctrine

> creates a redemption period for all foreclosure sales in which there arises the specter of a voiding of the foreclosure sale itself as a fraudulent transaction under § 548(a)(2). Lenders such as insurance companies will therefore hesitate to lend substantial sums of money in reliance on security upon which they may not be able to realize when a default occurs.

Brief for Amicus Curiae American Council of Life Insur. at 6, Madrid v. Lawyers Title Ins. Corp. (*In re* Madrid), 725 F.2d 1197 (9th Cir.), cert. denied, 469 U.S. 833 (1984)

evidence in the sources cited for these assertions about the harmful effects of statutory redemption under state laws. A 1958 article in the Business Lawyer[41] (the American Bar Association section journal) states that "the facts . . . demonstrated by actual experience, show the following:

(1) Only 0.927%, or less than 1%, of properties foreclosed is ever redeemed; . . .

(3) In 99.3% of "public" sales, the mortgagee is the buyer . . . ."[42]

None of the other citations in the Association's amicus brief provide any claimed supporting data at all. Much of the writing about redemption cites this (Prather) article without more.[43]

The citation[44] to a 1953 student note[45] refers to the "great number of foreclosures" in 1937 but provides no empirical information on redemptions under state law. The note refers to a New York Report of the Joint Legislative Committee on Mortgage Moratorium and Deficiency Judgments,[46] which reported that "of 40,853 foreclosures reported, the mortgagee bid in the property in 40,570 cases."[47] The California Law Revision Tentative Recommendation cited also relies on the report of "a 1938 study showing that, out of 22,000 properties foreclosed, only 204 were redeemed."[48]

An article by Shattuck entitled, "Security Transactions"[49] is also cited in the California Law Revision Commission Tentative Recommendation.[50] Shattuck refers to "[a] recent study conducted by the Washington Mortgage Correspondents Association and covering the period Jan. 1, 1956 - Jan. 1, 1960, [which] disclosed that in a representative group of 276 foreclosures there was but one redemption by a mortgagor and but two redemptions by persons other than

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41 Prather, A Realistic Approach to Foreclosure, 14 Bus. Law. 132 (1958). No sources are given nor does the writer state any basis for his data by place, time, or number of cases. The article has been widely cited.

42 Id. at 135.

43 See, e.g., Lifton, Real Estate in Trouble: Lender's Remedies Need an Overhaul, 31 Bus. Law. 1927, 1937 n.38 (1976).

44 Association Brief, supra note 31, at 27.

45 Note, Statutory Redemption: The Enemy of Home Financing, 28 Wash. L. Rev. 39, 45 (1953). This too is widely cited.

46 Id. at 40 n.13 (citing State of New York, Report of the Joint Legislative Committee on Mortgage Moratorium and Deficiency Judgments, Doc. No. 58 (1938)).

47 Id.

48 California L. Revision Comm'n, Tentative Recommendation Proposing The Enforcement of Judgments Law, at 2115 n. 404 (1980).

49 36 Wash. L. Rev. 239, 303 (1961).

50 Calif. L. Revision Comm'n, supra note 48, at 2116 n.4.

mortgagors."[51]

And so it is with the rest of the supporting citations in the Association's amicus brief and in the journal literature and the judicial opinions: none provide any factual basis for the repeated assertions of the adverse effects of statutory redemption on debtors. These critics cite almost no empirical evidence on the effect of statutory redemption under state law, and what little there is largely dates from the Great Depression of the 1930's.

The most recent survey of the literature[52] concludes that:

> [T]he writer and others have empirically examined the incidence of price inadequacy and the extent to which it has been rectified or deterred by statutory redemption. While these examinations are subject to various limitations of scope and measurement, the available empirical evidence suggests that the problem of price inadequacy is real and that statutory redemption may play an appreciable role in reducing its effects by deterring its occurrence or by enabling some of its consequences to be corrected.
>
> Overall, the available empirical evidence has not shown that judicial foreclosure and statutory redemption produce no benefits and affirmatively establishes that statutory redemption actually has produced some benefits.[53]

It may be that, even now, state redemption statutes are little-used by mortgagors who have defaulted and whose homes have been foreclosed.[54] But that does not prove at all that bid prices are lower because of state redemption laws. Again, it is the model—not the known sets of empirical facts—that leads to this conclusion. One would have to compare, over time, the bid prices as a function of market values in states with and without statutory redemption rights. This could be a complicated undertaking because redemption laws vary from state to state. But such an investigation could be done.[55]

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[51] See Shattuck, *supra note* 49, *at* 311 *n.*3.

[52] Bauer, Judicial Foreclosure and Statutory Redemption: The Soundness of Iowa's Traditional Preference for Protection Over Credit, 71 Iowa L. Rev. 1 (1985).

[53] Id. at 74-75 (footnotes omitted).

[54] Nevertheless, a simple economic model should hold that state statutory redemption rights would create a secondary market of buyers of the redemption rights who think the foreclosure sale price is profitably lower than the actual market value at some time during the redemption period.

[55] The California Law Revision Commission's incisive comment (not mentioned in the *Madrid* amici briefs) implicitly suggests just that: "It is difficult to assess the actual effect of statutory redemption. The states are almost evenly divided between those that permit redemption . . . and those that do not; however there do not appear to be any studies comparing the results in redemption states as opposed to nonredemption states." California L. Revision Comm'n, *supra note* 48, *at* 2115.

III. THE CONVENTIONAL ECONOMIC MODEL OF THE CRITICS OF *DURRETT*

The authors of the amicus briefs in *Madrid*,[56] and the writers of the opinion and the journal literature critical of *Durrett*, accept a conventional economic model which holds that the perception of increased risk flowing from what will or what might happen in the legal process, will have dramatic effects on the mortgage market. Though the various creditor groups and their lawyers say nothing of the actual impact of *Durrett* in later journal literature and in the *Madrid* amicus briefs, they nevertheless forecast the following effects:

(1) The *Durrett-Hulm* doctrine will undoubtedly reduce the amount that a purchaser, including the mortgagee, would be willing to bid at a foreclosure sale.[57] On this matter we have only anecdotal evidence of unknown value.[58]

(2) Secured creditors, including mortgagees and secured parties under the UCC, will not extend credit to marginal debtors, even when more than adequate collateral secures a loan.[59] We do not know

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[56] These writers' claims to knowledge are inherently credible. They are speaking of the behavior of the firms with which they are associated or by which they are employed to make decisions about risks under different laws.

[57] Simpson, Real Property Foreclosures: The Fallacy of *Durrett*, 19 Real Prop., Prob. & Tr. J. 73 (1984). "An inevitable consequence of the uncertainty generated [by the *Durrett* rule] will be to dampen the bidding at foreclosure sales and thereby to reduce the amounts that can be expected to be realized at such sales." Id. at 76.

Academics seem to hedge:

> One effect of a rule that subjects all foreclosure sales to the possibility of being set aside at some later time may be to depress the price realized at these sales still further. Potential buyers at foreclosure sales will be afraid that a low-priced sale will cause a court to find a fraudulent conveyance. Anyone who buys at foreclosure sales in a world in which such sales are fraudulent conveyances when a court after the fact finds the price too low will pay even less for the property.

Baird & Jackson, Fraudulent Conveyance Law and Its Proper Domain, 38 Vand. L. Rev. 829, 846 (1985).

[58] It is said that in Texas after *Durrett* most of the foreclosing creditors got appraisals and most bid at least 70% of the appraised fair market value. (The incidental impact of *Durrett* and *Hulm* may be that real estate appraisers are the beneficiaries of that legal doctrine as it was the sellers of video equipment who benefitted from the *Miranda* ruling.).

[59] Association Brief, supra note 31, at 32-33. On the question whether the real estate which is the security for the mortgage loan is diminished in loan value because of the uncertainty generated by the *Durrett-Hulm* rule, and whether the loan value remained constant given the more secure legal position of the *Madrid* rule, the nearest proxy we have is the loan-to-price ratio. This is expressed as a percentage and is available for residences (one-to-four family homes) during the years 1979-1985 from the Federal Home Loan Bank Board reports. Through these seven years the national average loan-to-price ratio shows an annual range from 72.86% to 77.00%. From its minimum in 1982 to its maximum in 1984 is a 5.68% increase which is more than the usual historical range of the ratio.

The Texas loan-to-price ratio should reflect the impact of *Durrett* from after *Durrett* until about the middle of 1980. Yet this ratio hardly changed from year to year.

whether the amounts or types of credit secured by personal property changed in the states of the Fifth Circuit after *Durrett*.[60]

(3) Even for the nonmarginal debtors who do get secured credit, the loan value of their collateral will be discounted. If the *Durrett* doctrine is upheld, other things being equal, this will result in smaller loans.[61]

(4) "[I]nterest rates would be increased to reflect the additional risk involved in extending the credit on the basis of collateral that may not be marketable after foreclosure."[62]

1979 = 79.19%
1980 = 79.61%
1981 = 79.09%

The national loan-to-price ratio shows a slightly greater fluctuation.

1979 = 73.50%
1980 = 72.90%
1981 = 73.09%

While the ratio for all the states decreased from 1979 through 1981 by eight-tenths of one percent, the Texas loan-to-price ratio *increased* by five-tenths of one percent.

In Texas during the year of *Durrett* the loan-to-price ratio ranged from a January 1980 high for the year of 81.76% to 81.70% in December 1980. The ratio was virtually unchanged and was always within a narrow range during the 12 months of 1980. There is no indication that *Durrett* raised the cost or reduced the availability of residential mortgage loans in Texas, except perhaps for a few months. See infra note 80.

Madrid, similarly, does not seem to have had any positive impact on the mortgage loan market in California. The average loan size increased from 1983 through 1985; and, after *Madrid* in February, 1984, the loan-to-price ratio percentage *decreased* for most of the rest of 1984.

[60] Some of the gross distortions in the foreclosure process and its results by disposition of personal property collateral (automobiles) under the Uniform Commercial Code and the state retail installment sales laws are documented in the three cited empirical studies. See Wechsler, Through the Looking Glass: Foreclosure by Sale as *De Facto* Strict Foreclosure—An Empirical Study of Mortgage Foreclosure and Subsequent Resale, 70 Cornell L. Rev 850, 870-71 (1985); Shuchman, Profit on Default: An Archival Study of Automobile Repossession and Resale, 22 Stan. L. Rev. 20 (1969); Comment, Business as Usual: An Empirical Study of Automobile Deficiency Judgment Suits in the District of Columbia, 3 Conn. L. Rev. 511 (1971); Note, I Can Get It For You Wholesale: The Lingering Problem of Automobile Deficiency Judgments, 27 Stan. L. Rev. 1081 (1975).

[61] Association Brief, supra note 31, at 32-33.

[62] Id. at 33. We have some information on interest rates for commercial mortgage loans for 1983 through 1986. These are monthly figures and, except for 1984—the year of *Madrid*—we have calculated the annual averages by averaging the monthly figures.*

Commercial Mortgage Interest Rates—National**

1983	(11 months)	12.773%
1984		
	January	12.938%
	February	12.688%
	March	12.813%
	April	13.563%
	May	13.750%

(5) Even a transferee from the original purchaser at a foreclosure sale could be sued under Code section 548 unless that buyer could prove that he purchased the property in good faith, for value, and without knowledge of the voidability of the transfer. Such potential liability would undoubtedly cause many would-be buyers and their lenders to be reluctant to buy or finance the purchase of foreclosed property.[63]

(6) Since, according to the creditor groups, most title insurance companies in states subject to the *Durrett* rule will only insure foreclosure sale titles with exceptions for section 548 actions,[64] it would be difficult for a buyer from the successful bidder to claim he was without knowledge.

The amicus brief submitted by the California Bankers Association and the California Clearing House Association ("the Association" in the brief) states that "[a]s a result of the uncertainty caused by the *Durrett* rule, most title insurance companies will not insure purchasers or lenders on foreclosed property against any loss caused by a Section 548 attack."[65]

	June	14.625%
	July	14.625%
	August	14.125%
	September	13.750%
	October	13.563%
	November	12.875%
	December	12.500%
1985	(full year)	11.954%

These rates are set against the benchmark of the ten year U.S. treasury securities which appear to be about 2.5% below the prevailing mortgage loan rates. There is little change in these commercial mortgage interest rates during the months of 1984; and the variations are consistent with the changes in the benchmark of ten-year U.S. securities which are not affected by decisions such as *Durrett* and *Madrid*. Nor did these rates decrease or increase less after the *Madrid* decision in February, 1984. They more or less tracked the benchmark through the entire year.

* Calculating a yearly average by averaging the 12 months is not the preferred method. But given the form of the data, we have no other way to state these yearly average interest rates (except by range) and we think this should not distort the figures presented. To the extent there is distortion, it should exist in all the states and be a kind of washout.

** Baron's/Levy Survey Rates (Sovran Mortgage Corp.).

63 Association Brief, supra note 31, at 30-31.

64 See Zinman, Houle, & Weiss, Fraudulent Transfers According to Alden, Gross and Borowitz: A Tale of Two Circuits, 39 Bus. Law. 977, 1016 (1984); Coppel & Kann, Defanging *Durrett*: The Established Law of "Transfer", 100 Banking L.J. 676, 677 (1983). See also Castañares, Foreclosures in Bankruptcy: Are They Fraudulent Conveyances?, 21 Idaho L. Rev. 517, 523-24 (1985) ("The *Durrett* rule destroys the quality of the title which can be conveyed at a foreclosure sale by rendering the purchaser's title vulnerable to attack for some indefinite period of time.").

65 Association Brief, supra note 31, at 31.

The Association's brief points out that title insurance "will only be written if the insured can demonstrate that the price paid at the foreclosure sale was at least equal to 70% of the fair market value of the real property."[66] Title insurance companies will issue title insurance only if satisfied that the 70% *Durrett* threshold has been met.

All these effects will be revealed by the usual proxy for increased risk which is in fact the title of Part 4 of the major amicus brief in *Madrid*: "Application of Section 548 . . . will Decrease the Availability and Increase the Cost of Credit."[67]

One would have supposed that in the twenty-eight months from the July 1980 *Durrett* decision to the November 1982 filing of the amicus briefs in *Madrid*, these creditor groups would have provided evidence beyond the conjecture of inferences drawn from their model of the marketplace. There was empirical evidence in the form of data on the interest rates, loan-to-price ratios, and total amounts of mortgage debt created for Texas and other states which followed the *Durrett* rule,[68] as well as for states which had not yet ruled on the section 548 issue. National data on mortgage interest rates and total dollar amounts was available as well. Also, both for the nation and for the states, there were important figures on average size of mortgage loans and the loan-size-to-price ratios.

One expects from lawyers as advocates arguments that, even if cast in a broad utilitarian form, support the position of their clients: in this setting, that the effect upon the common weal will be disastrous and, for example, those persons most in need of secured credit will be unable to get it.[69] The A.B.A. Section of Real Property, Probate and

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66 Id.

67 Id. at 32; Brief of Amicus Curiae American College of Real Estate Lawyers, Madrid v. Lawyers Title Ins. Co (*In re* Madrid), 725 F.2d 1197 (9th Cir.), cert. denied, 469 U.S 833 (1984). "[T]he mortgage market would be severely jeopardized by the uncertainty created by *Durrett*. . . [B]orrowers will find mortgage money harder to obtain. . . " Id. at 13. This, they conclude, would result in more hardship to the national economy.

68 See Tables B, F, G, & H, infra Part IV.

69 Were the *Durrett* rule "to become the generally accepted law, [it] would cause untold harm to the national economy and . . . hurt most of those people . . . it was designed to protect." Zinman, Houle, & Weiss, supra note 64, at 978; see also Castañares, supra note 64, at 524 (*Durrett* rule will inhibit lending contrary to policy underlying fraudulent conveyance law); Coppel & Kann, supra note 64, at 681-82 (*Durrett* rule " 'will naturally inhibit a purchaser other than the mortgagee from buying at foreclosure.' ") (quoting Abramson v. Lakewood Bank & Trust Co., 647 F.2d 547, 549 (5th Cir. 1981) (Clark, J. dissenting)).

The Association's Brief also predicts that if *Durrett* is not followed in the Ninth Circuit, such a decision—as was later rendered in *Madrid*—"would restore the stability of title to foreclosed real property and permit buyers, sellers, lenders and title insurance companies to safely and predictably engage in transactions involving such property " Association Brief, supra note 31, at 31

Trust Law, in its August 1983 report[70] to the House of Delegates, contended that the *Durrett* decision is a disaster and will have these effects:

> a. *Foreclosure Sales*
> The immediate effect is to make it unlikely that purchasers other than mortgagees will buy at a foreclosure sale; to inhibit competitive bidding at such a sale; to increase the likelihood of deficiency judgments; and to decrease the likelihood of bids in excess of the mortgage balance—amounts that otherwise would have gone to the owner-debtor.
> b. *Creditors*
> Creditors will hesitate to make any mortgage loans under conditions where they may not be able to realize upon their security in the event of default, and those that make such loans will make them only to people with the highest credit rating or with higher interest rates to cover the increased risk.
> c. *Borrowers*
> Borrowers most in need of secured credit will not be able to get it. On initial default, lenders will be discouraged from working with borrowers and will be forced to foreclose as soon as possible to lower the risk that the debtor will file for bankruptcy during the following years.
> . . . .
> e. *The Economy*
> The entire result will have a severe adverse effect on the economy and stifle mortgage and other secured investments at a time when they should be encouraged.[71]

The Report was approved by the House of Delegates on August 3, 1983.

Judges also act as social scientists and use this simple economic model. The opinion in *Alsop v. Alaska* (*In re Alsop*),[72] and other cases,[73] accepts the particular economic model advocated by the secured creditors and predicts the effects of the *Durrett* rule (or the "reasonably equivalent value" test of *Hulm* applied on a case-by-case approach). The judge thinks the rule "would significantly chill participation at foreclosure sales, thus depressing bid prices, to the detriment of debtors in general."[74] So also, and with elaborations, say

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[70] 1983 A.B.A. Sec. Real Prop., Prob. & Tr. L. 106B.

[71] Id. at 5.

[72] 14 Bankr. 982, 987 (Bankr. D. Alaska 1981), aff'd, 22 Bankr. 1017 (D. Alaska 1982).

[73] See, e.g., Abramson v. Lakewood Bank & Trust Co., 647 F.2d 547, 550 (5th Cir. 1981), cert. denied, 454 U.S. 1164 (1982); Moore v. Gilmore (*In re* Gilmore), 31 Bankr. 615 (Bankr. E.D. Wash. 1983).

[74] 14 Bankr. at 987.

the lawyers for the mortgage lenders.[75]

IV. ANALYSIS OF THE IMPACT OF *DURRETT*

What follows are annotations of a few simple tables showing the cost and availability of residential mortgage loans in some states. The states are located in federal circuits where a court had ruled on the issue raised in *Durrett*:[76] whether a regularly conducted, noncollusive, prepetition foreclosure sale of a debtor's property is voidable as a fraudulent conveyance under Code section 548[77] if the property was sold for less than a reasonably equivalent value within one year before the debtor's bankruptcy filing.

The states were selected by reason of data available for the years before *Durrett* to after *Madrid*. We divided the states into two categories—pro-*Durrett* and pro-*Madrid*—which represent the opposed doctrinal positions. *First Federal Savings & Loan Association v. Hulm* (*In re Hulm*)[78] is more a variant of only one aspect of *Durrett*, that the bright line in *Durrett* of less than 70% of the fair market value being a fraudulent conveyance is rejected, because that figure, in later cases, had become the test for less than a reasonably equivalent value.

The dates and locations of the several judicial decisions are set out in the tables, as well as, to the extent possible, data on mortgage loan cost, loan-to-price ratios, and total amounts from before and after those decisions.

We used data collected nationally and by state from several different sources: the Federal Home Loan Bank Board (Primary Mortgage Interest Rate Surveys), the Federal Home Loan Mortgage Corporation ("Freddie Mac"), the Federal Home Loan Bank of San Francisco, the Federal Home Loan Bank of Cincinnati, the Department of Housing and Urban Development (H.U.D.), the Sovran Mortgage Corporation (Richmond, Virginia), and HSH Associates

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[75] "The immediate effect of the acceptance of the *Durrett* rule would be to chill bidding at foreclosure sales. Third parties will be unlikely to bid for properties knowing that the application of fraudulent conveyance laws could set aside the sale at a later date. The absence of competitive bidding will in all likelihood reduce prices at foreclosure sales and increase the likelihood of deficiency judgments in those states where they are permitted." Zinman, Houle, & Weiss, supra note 64, at 1013. See also Castañares, supra note 64, at 523 ("*Durrett* places . . downward pressure on foreclosure sale prices."); Coppel & Kann, supra note 64, at 682 ("[T]he probable result is that the potential bidder either will not bid at all or will merely speculate with a bid substantially lower than he would otherwise offer.").

[76] Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980).

[77] *Durrett* was decided under Bankruptcy Act § 67d(6), the predecessor to Code § 548. Id.

[78] 738 F.2d 323 (8th Cir.), cert. denied, 469 U.S. 990 (1984). *Hulm* follows the wording of Code § 548(a)(2)(A). A transfer in exchange for less than a "reasonably equivalent value" can be set aside as a fraudulent conveyance; but without defining the crucial three-word phrase

(Riverdale, N.J.). While problems can arise from non-uniform methods of data collection, in the gross terms we employed for our purposes, the possible errors due to this artifact should not distort matters. The numbers of mortgages and the total dollar amounts are so great that the variations should be relatively small.

Presentation of these data in this form provides a basis for comparing the same jurisdictions before and after the change in the law (long enough, we hope, to allow for anticipated changes while a case was pending and for adjustment after a decision); and also to compare the jurisdictions with a *Durrett-Hulm* rule to those bound by or adopting *Madrid*, as well as to some jurisdictions that had not ruled on this issue.

1125 Fifteenth Street, N.W.
Washington, D.C. 20005

Mortgage Bankers Association of America

Burton C. Wood
Senior Staff Vice President and Legislative Counsel
202-861-6507

June 24, 1988

The Honorable Howell Heflin
Chairman
Subcommittee on Courts and Administrative Practice
Committee on the Judiciary
United States Senate
Washington, DC 20515

Dear Mr. Chairman:

The Mortgage Bankers Association of America (MBA) respectfully submits this statement for the record for the hearing held on June 10 before the Judiciary Subcommittee on Courts and Administrative Practice on S 1358, introduced by Senator Dennis DeConcini, which amends the Bankruptcy Code to overturn the Durrett Rule.

MBA strongly supports S 1358. Favorable action on this bill would eliminate the possibility of a foreclosure sale being set aside as a fraudulent transfer if the sale price is less than 70 percent of a court-determined value.

Sincerely,

Burton C. Wood

1125 Fifteenth Street, N.W
Washington, D C 20005
202-861-6500

Mortgage Bankers Association of America

STATEMENT OF THE

MORTGAGE BANKERS ASSOCIATION OF AMERICA

before the

SUBCOMMITTEE ON COURTS AND ADMINISTRATIVE PRACTICE

COMMITTEE ON THE JUDICIARY

UNITED STATES SENATE

For the Hearing on

Bankruptcy Issues
S 1358: Transfer Provisions

June 10, 1988

The Mortgage Bankers Association of America (MBA)* submits this statement for the record for the hearing held on June 10, 1988, on S 1358, which concerns the transfer provisions of the Bankruptcy Code and which would overturn the Durrett rule.

The 1980 U.S. Fifth Circuit Court decision in Durrett v. Washington National Insurance Co., 621 F.2d 201, established, for the first time, the possibility, in bankruptcy cases, of a foreclosure sale being set aside as a fraudulent transfer if the sale price is less than a court-determined reasonably equivalent value (at least 70 percent of the property's value). This applies to a non-collusive, regularly conducted foreclosure sale if the transfer occurs before the bankruptcy filing. The court found constructive fraud and agreed there was no intent to commit fraud. The reachback period depends on whether the Federal or state statute of limitations is used. The Durrett rule has been both adopted and rejected by other Circuit courts. Because the U.S. Supreme Court has denied certiorari, legislation is needed to resolve this conflict.

S 1358, introduced on June 11, 1987, by Senator Dennis DeConcini, amends the Bankruptcy Code to state specifically that "reasonably equivalent value" is given for foreclosure sale property if a "person acquires an interest of the debtor pursuant to a regularly conducted,

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*The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of housing and other real estate finance. MBA's membership comprises mortgage originators and servicers, as well as investors, and a wide variety of mortgage industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, selling, and servicing real estate investment portfolios. Members of MBA include:

- o Mortgage Banking Companies
- o Commercial Banks
- o Mutual Savings Banks
- o Savings and Loan Associations
- o Mortgage Insurance Companies
- o Life Insurance Companies
- o Mortgage Brokers
- o Title Companies
- o State Housing Agencies
- o Investment Bankers
- o Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005; telephone: (202) 861-6500.

non-collusive foreclosure sale." This would eliminate the possibility, established in Durrett, of the sale being set aside as a fraudulent transfer if the sale price is less than 70 percent of a court-determined value.

MBA strongly supports S 1358, and urges that Congress enact it into law.

Historically, bankruptcy laws provided a creditor with a remedy to collect a debt where the debtor defaulted on an obligation. Bankruptcy was basically an asset-based proceeding, in which the creditor could look to the asset owned by the debtor securing the debt for payment. The debtor surrendered such asset and was discharged from further liability on the debt.

The 1970s witnessed a major change in the way credit was extended--unsecured consumer credit became a huge industry. Because consumer lending was not based on assets, but on the borrower's ability to pay the debt out of future income, concern grew for protecting consumers who found themselves overburdened by debt. The National Commission on Bankruptcy Laws, commissioned by Congress to review existing law and make recommendations for reforms, focused on the "fresh start" as the protection consumers needed. However, in extending this special protection to consumers in the Bankruptcy Reform Act of 1978, Congress lost sight of the difference between secured and unsecured credit and treated both the same.

One example of non-asset based bankruptcy law is the "automatic stay," a new concept in the law which stops the lender's ability to foreclose on a mortgage on the date the bankruptcy petition is filed. MBA believes that not enough attention has been focused on the plight of the secured creditor.

Durrett creates a high level of uncertainty regarding foreclosure sales and offers lenders no assurance that foreclosure sales will not be set aside in a subsequent year, even though foreclosure procedures have been complied with in good faith. Under Durrett, the fair market value of the property at the time of the sale is subject to revision by a future bankruptcy trustee. Real estate market values, which can be particularly susceptible to variation over a period of time, are significantly affected by Durrett.

Secured lenders have always relied on their compliance with state and Federal foreclosure laws to collect the debts owed to them and to protect themselves from future attack by bankruptcy trustees. Durrett has robbed secured creditors of their ability to rely on such compliance.

Lenders are discouraged from making loans in circumstances where they might not be able to enforce their lien in case of default. The increased risk associated with Durrett results in loans with higher interest rates where the lender is faced with the possibility of an avoidance of a foreclosure sale. Furthermore, a third-party purchaser of a foreclosed property is uncertain about whether the sale may be voided and has a clouded title, factors bearing on the price the purchaser is willing to pay.

Mortgage credit markets would operate more efficiently, and at lower cost to borrowers, if the Durrett rule, as well as other unreasonable obstacles to enforcement of liens by secured lenders, were removed.

MBA appreciates this opportunity to present its views on various other bankruptcy issues affecting lenders.

Lack of Notice. Under existing law, borrowers are not required to notify lenders and other creditors of the filing of bankruptcy petitions. Debtors should be required to notify all secured creditors at the address specified in the loan documents simultaneously with the filing of their bankruptcy petitions and provide proof of such notices to the court with their petitions. Enforcement provisions should include, but not be limited to, exempting a foreclosure sale from an attendant automatic stay if creditors are not so notified.

Lost Opportunity Costs. Existing bankruptcy law encourages rather than discourages the tendency of debtors to use the Bankruptcy Courts to cause delays. During a period of delay, lenders often do not even receive current payments, much less payment of arrearages, even when the property is producing income. Whenever a borrower files a petition in bankruptcy, an automatic stay is imposed on all proceedings against the borrower, including the right to foreclosure. A motion by a creditor for relief from the stay can take up to six months to be granted. Relief from the stay is granted for cause, including cases where there is a lack of "adequate protection" afforded the lender. The Court can provide for adequate protection in several ways, including granting relief that will result in the "indubitable equivalent" of a lender's interest in a property. The Bankruptcy Code should be expanded to include lenders' rights to periodic payments, including post-petition interest owed, and the loss of the use of funds (additional interest on pre-petition arrearages) representing payments missed or delayed over an extended time.

The need for legislation to provide "adequate protection" to secured creditors may be even more critical because of a U.S. Supreme Court decision handed down in late January 1988. In Timbers of Inwood Forest Associates Ltd., the U.S. Supreme Court resolved conflicting Circuit court decisions by ruling that secured creditors whose collateral during a Chapter 11 reorganization is less than the loan amount are not entitled to compensation

for the period in which their funds and property interest are tied up in bankruptcy court. The case involved a mortgage loan made in 1982 by United Savings Association of Texas to the owners of a Houston apartment project. The loan at time of default was $4,370,000, while the property was valued at $4,250,000 when the debtors filed for bankruptcy. An April 1985 bankruptcy court decision that United was entitled to compensation of 12 percent per year was overruled by the U.S. Circuit court in New Orleans in January 1987. On appeal by United, the U.S. Supreme Court sided with the Circuit court and also rejected the Justice Department's position urging that United was entitled to compensation.

Legislation should be approved to require that, during a debtor's rehabilitative efforts in Chapter 13 and Chapter 11 proceedings, additional interest on the arrearages be mandatory, perhaps at the contract rate. The lost opportunity costs of waiting for the affected loan to be brought current would not be equivalent to a "penalty" or "interest on interest"; it should be characterized simply as a cost associated with the right to restrictive repayment.

Modification of Mortgage Terms ("cram downs"). Legislation should prohibit any court from decreasing the interest rates charged on loans or otherwise changing obligations to the detriment of lenders in Chapter 11 cases. The judge has the authority, based on a valuation of the property, to reduce the secured creditor's interest in the property to said amount, leaving, in some cases, the balance of the debt unsecured. The judge also has wide discretion to modify the terms of the loan (interest rate, maturity date, prepayment penalty, etc.) if he finds it in the best interest of the debtor and all creditors. There should also be a prohibition against super priority liens.

Timing Issues. The Bankruptcy Code gives judges the discretion to extend many of the time limits for various actions that need to be taken. Consequently, there are numerous delays which add to costs and lender losses that generally are passed on to future borrowers.

In addition, there are a number of other procedural deficiencies that cause delays and cost money. Under a Chapter 11 reorganization, the debtor has the exclusive right, for 120 days following the filing of the bankruptcy petition, to file a reorganization plan, and extensions for up to 180 to 270 days are often granted. The debtor should have the exclusive right to file a plan for only 30 to 60 days. After that time (whether or not the debtor has filed its own plan), any creditor or group of creditors should be entitled to file a plan. A much stronger alternative would be to require the Court to dismiss or convert a case to a Chapter 7 liquidation if the debtor fails to file a proposed plan within 30 to 60 days. In Chapter 11 cases, the subject loans are typically the larger "jumbo" obligations where the debtor continues to operate as a "debtor-in-possession." As such, the debtor is under no pressure to immediately implement a plan to repay its creditors. Absent the clout of a dismissal or conversion, the debtor can simply do nothing. The debtor should be required to either formulate and implement a reasonable plan or face liquidation.

Another practice that should be eliminated is the trend by many Chapter 13 Trustees to require all post-petition regular mortgage payments as well as pre-petition arrearages to be paid through the Trustee/Plan—as opposed to paying directly to the lender by the debtor. The result is that payments due lenders may be held for several months by the Trustee before disbursement. The Trustee floats on the delays of the payments that the debtor has made in good faith. Direct payments to secured creditors of all post-petition payments should be a uniform requirement.

Bad Faith and Fraud. Borrowers engaged in fraud or bad faith should not be afforded the protection of the bankruptcy courts. For example, where an insolvent borrower agrees to a workout plan in which the property is sold to what is represented as a third party, and that third party turns out to be related to the original borrower, the third party should not be afforded the protection of the bankruptcy courts, at least for the loan in which the borrower misled the Lender.

There has been an alarming increase in the frequency of debtor abuse and bad faith utilization of the bankruptcy system. The new forms of abuse include (i) proliferation of multiple bankruptcy filings by the same or related debtors and (ii) multiple transfers of title (in whole or part) to persons on the eve of foreclosure who then file bankruptcy. Legislation should be adopted which mandates sanctions or penalties associated with such bad faith actions.

With respect to multiple bankruptcy filings, before a debtor can take advantage of an automatic stay, perhaps the Court should require a hearing to determine whether a re-filing should be legitimized. By placing the burden on a debtor to show "just cause" why a new bankruptcy should be allowed, a significant area of abuse could be minimized.

Currently, when there is bad faith or fraud, such as multiple filings, the judge can impose fines. However, sanctions for abusing the process need to be strengthened. There is a precedent for making some actions criminal offenses. The Federal Housing Administration provides for turning equity skimming investors over to the Federal Bureau of Investigation.

MBA appreciates this opportunity to present its views and would be happy to provide any additional information at your request.

United States Bankruptcy Court
District of Massachusetts
1101 Boston Federal Office Building
10 Causeway Street
Boston, Massachusetts 02222-1074

Harold Lavien
Judge

617-565-8097

June 16, 1988

The Honorable Dennis DeConcini
Senate Judiciary Committee
United States Senate
328 Senate Hart Office Building
Constitution Ave. & Delaware Avenue, N.E.
Washington, D. C. 20510

Re: S. 1358

Dear Senator DeConcini:

I am taking the liberty of sending this article which will shortly appear in the Massachusetts Law Quarterly.

The article suggests that you are correct in recognizing that Durrett v. Washington National Insurance Co., 621 F.2d 201 (5th Cir. 1980) brought to the forefront a serious problem in mortgage foreclosure. However, I respectfully suggest S. 1358 perpetuates rather than corrects the problem. This article offers a possible alternative.

Thank you for giving this material your consideration. If I can answer any questions you may have, please feel free to contact me.

Sincerely yours,

Harold Lavien

HL/af
Enc: Article

INSURING FAIRNESS IN FORECLOSURE--BANKRUPTCY'S ROLE

Honorable Harold Lavien*
Bankruptcy Judge
District of Massachusetts

Courts across the country and in Massachusetts have applied the Bankruptcy Code fraudulent conveyance section, 11 U.S.C. § 548, to invalidate foreclosure sales where the purchase price is not reasonably close to the fair value of the property. Durrett v. Washington National Ins. Co., 621 F.2d 201 (5th Cir. 1980); Ruebeck v. Attleboro Savings Bank, 55 B.R. 163, 13 B.C.D. 1106 (Bankr. D. Mass. 1985); In re General Industries, 79 B.R. 124, 16 B.C.D. 775 (Bankr. D. Mass. 1987). Academics have criticized this action as an undesirable extension of bankruptcy law.[1] Lenders and conveyancers, in a never ending quest for certainty in the foreclosure process, are pressuring Congress and state legislators to undo the effects of those cases and their progeny by simply removing foreclosures from the ambit of the bankruptcy fraudulent conveyance section. That is like covering a skin cancer with a band-aid and trying to ignore the infection.

* I would be remiss in not acknowledging the editorial and research assistance of my law cler, Herbert Weinberg.

1 Baird & Jackson, Fraudulent Conveyance Law and its Proper Domain, 38 Vand. L. Rev. 829 (1985).

Ignoring the need for meaningful notice of a foreclosure sale is tantamount to denial of due process. The underlying issue may be highlighted by the answer to this question: Are the collective creditors of the insolvent debtor, whose real estate is usually the only substantial asset, denied due process when notice of sale is not reasonably calculated to maximize interest and stimulate the subsequent bid process?

> An elementary and fundamental requirement of due process in any proceeding which is to be accorded finality is 'notice reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action' and afford them an opportunity to present their objections.

Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306, 314 (1950) (citations omitted). See also, Greene v. Lindsay, 456 U.S. 444 (1982).

One unwarranted but continually asserted basic assumption is that foreclosure sales should have absolute certainty. Why should this be so? NOTHING IN LAW OR LIFE IS ABSOLUTE EXCEPT DEATH. Law generally governs our activities within loosely fixed parameters which require liability to be determined on a case by case basis and yet society functions without any clamor for rules of absolute certainty.

People must exercise a "reasonable" level of care in their everyday business and professional relationships to avoid tort liability. B & B Insulation, Inc. v. Occupational Safety & Health Review Commission, 583 F.2d 1364 (5th Cir. 1978). A determination of the reasonableness of actions or inactions requires an examination of all the circumstances surrounding the

injury. Gay Ocean Transport & Trading Ltd., 546 F.2d 1233 (5th Cir.), reh'g denied, 549 F.2d 203 (5th Cir. 1977). This calls for courts to explore the reasonableness of actions in cases involving almost every conceivable profession and industry. Briggs v. Spaulding, 141 U.S. 132 (1891) (corporate directors); Campbell v. Otis Elevator Co., 808 F.2d 429 (5th Cir.) reh'g denied, 814 F.2d 658 (5th Cir. 1987) (maintenance contractor); Caldwell v. Bechtel, Inc., 631 F.2d 989 (D.C. Cir. 1980) (engineering firm); Kuehn v. Garcia, 608 F.2d 1143 (8th Cir. 1979), cert. denied, 445 U.S. 443 (1985) (attorneys); Mayor & City Council of Columbus v. Clark Dietz & Associates-Engineers, Inc., 550 F. Supp. 610 (M.D. Miss. 1982), appeal denied sub nom. Clark Dietz & Associates-Engineers, Inc. v. Basic Construction Co., 702 F.2d 67 (5th Cir. 1983) (architectural engineer); Gross v. Diversified Mortgage Investors, 431 F. Supp. 1080 (S.D.N.Y. 1977), aff'd sub nom. Durban v. Diversified Mortgage Investors, 636 F.2d 1201 (2d Cir. 1980) (accountants); Clark v. Garfield, 40 Mass. 427 (1864) (guardians and conservators).

For 30 years the Uniform Commercial Code ("U.C.C.") used the "commercially reasonable" standard (see § 9-502(2)) without producing empirical evidence of depressed prices in secured party sales of hundreds of millions, if not billions, of dollars of personal property. This standard has remained unchanged throughout years of review and changes by the National Conference of Commissioners on Uniform State Laws. There is no uproar from secured lenders for a more certain standard in the U.C.C.

On the other hand, the evidence found in case law of abuse in foreclosure sales is flagrant enough under the conveyancer's championed certainty standard to warrant changes. Under the present procedure, all too often a mortgagee buys real estate at a foreclosure sale at an amount that is substantially less than it was determined to be worth when the loan was made. The result is that the debtor has not only lost the property, which is frequently the family residence and the only sizeable asset, but will also be saddled with a deficiency. The debtor's other creditors will be deprived of any potential payment they would have received if the property had been sold at fair market value. Creditors who are not paid from the proceeds of the foreclosure sale are most often unlikely to be paid at all. Instead, the first mortgagee realizes a windfall at the expense of other creditors and the debtor when the property is resold at the market price. The goal of foreclosure procedures should be not only to protect the legitimate interests of the mortgagee, but also to be fair to the mortgagor, junior lienholders and other creditors. A procedure is needed which is more apt to produce fair value and which may inure to the benefit of first mortgagees who, for a small added inconvenience, may suffer fewer deficiencies.

Any finality and certainty to a foreclosure should be earned by a noticing process calculated to impart confidence that the procedure has been designed to produce the best price under the circumstances at the time. If secured parties were to employ the same procedures that prudent owners would employ in liquidating their own property, the debtors and their creditors should not

have complaints. For too long, however, states have allowed foreclosure procedures calculated to minimize the expense and inconvenience to the secured lender without regard to the likely diminution in the sales price. It has become apparent in cases such as Durrett and Ruebeck and their progeny that state foreclosure procedures afford only the barest of safeguards for debtors and other creditors. Only in bankruptcy, with its concern for collective representation of unsecured creditors, is there a forum presently concerned with attempting to restore the balance.

The Durrett case came about because of the total inadequacy of the notice requirements under Texas foreclosure law. Under the law then in effect, public notice consisted essentially of posting a notice at the courthouse door. A Texas court ruled there was no requirement that the notice should even provide the hour when the sale would commence. Mabray v. Abbott, 471 S.W.2d 442 (Tex. Civ. App. 1971). Presumably that requirement would be met if a notice was posted at 9:00 A.M. and the famous Texas wind blew it off at 9:05 A.M. The law was amended, effective only in 1988, to require that an approximate time be provided.[2] Even now, no advertising is required.

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2 Vernon's Ann. St. § 51.002.

Note that despite amendments in 1984 and 1987, the statute still does not require any advertising, notice to junior lienors or any specific title information. In addition, the time of sale in the notice may be as much as three hours different from when the sale is actually scheduled to take place.

It is pure chutzpah to suggest this procedure would produce fair market value for the property without recognizing the most likely result is that the secured creditor can scoop it up at a low price as the sole buyer.[3] Massachusetts notice

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3 Chutzpah classically is defined as the action of the lad who murders his parents and then seeks mercy as an orphan. The Seventh Circuit has recently provided us with a new definition: A prison inmate sought to offset a restitution claim by the government for the autopsy and burial expense of a fellow prisoner he had killed by applying the funds he saved the government for housing and feeding his victim. United States v. House, 808 F.2d 508 (7th Cir. 1986).

provisions[4] are substantially better but still are not calculated to produce a commercially reasonable approach. While the courts in Massachusetts do not characterize objections based on the low amounts received at foreclosure sales as fraudulent conveyances, they have stated that a foreclosing party must act as a reasonably prudent person would in selling his own property. Karolsky v. Kaufman, 273 Mass. 418, 422, 173 N.E. 499, 501, (1930); Clark v. Simmons, 150 Mass. 357, 360, 23 N.E. 108, 109 (1890). The gloss later decisions placed on the mortgagee's duty greatly reduced the actual result. A sale will be invalidated only where deficiencies in the statutorily required procedures caused an

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[4] Mass. General Laws ch. 244 § 14 provides, in relevant part, as follows:

> The mortgagee . . . may, upon breach of condition and without action, do all the acts authorized or required by the power; but no sale under such power shall be effectual to foreclose a mortgage, unless, previous to such sale, notice thereof has been published once in each of three successive weeks, the first publication to be not less than twenty-one days before the day of sale, in a newspaper, if any, published in the town where the land lies or in a newspaper with general circulation in the town where the land lies and notice thereof has been sent by registered mail to the owner or owners of record of the equity of redemption as of thirty days prior to the date of sale, said notice to be mailed fourteen days prior to the date of sale to said owner or owners . . . and unless a copy of said notice of sale has been sent by registered mail to all persons of record as of thirty days prior to the date of sale holding an interest in the property junior to the mortgage being foreclosed, said notice to be mailed fourteen days prior to the date of sale to each such person . . . .

A form of notice is provided which requires the time, place, and a description including status of title as listed in the original mortgage. There is, however, no statutory requirement for noticing any adjournment of the sale.

inadequate price to be received at the sale. Chartrand v. Newton Trust Co., 296 Mass. 317, 321, 5 N.E.2d 421, 423 (1936).

The Massachusetts Supreme Judicial Court court noted:

> It has become settled by repeated and unvarying decisions that a mortgagee in executing a power of sale contained in a mortgage is bound to exercise good faith and put forth reasonable diligence. Failure in these particulars will invalidate the sale even though there be literal compliance with the terms of the power. . . .
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> The mortgagee is a trustee for the benefit of all persons interested.

Sandler v. Silk, 292 Mass. 493, 496-97, 198 N.E. 749, 751 (1935) (citations omitted).

Despite the strong language, foreclosure sales which simply comply with Mass. Gen. Laws ch. 244, § 14, have not been subject to effective challenge regardless of an alleged inadequate price; a mere discrepancy in price does not invalidate a sale if the letter of the law is followed. See, e.g., Commonwealth v. Vaden, 373 Mass. 397, 367 N.E.2d 621 (1977); Seppala & Aho Construction Co. v. Peterson, 373 Mass. 316, 367 N.E.2d 613 (1977); Sandler v. Silk, 292 Mass. at 497, 198 N.E. at 751. See also Sher v. South Shore National Bank, 360 Mass. 400, 274 N.E.2d 792 (1971).

Foreclosure notices are frequently published in local papers specializing in tombstone ads--papers of very limited local distribution with a minimum of material other than legal notices and advertisements. This type of notice certainly lacks any element of fairness. In this regard, the Supreme Court had this to say about effective noticing:

> In assessing the propriety of actual notice in this context consideration should be given to the practicalities of the situation and the effect that requiring actual notice may have on important state interests. Mennonite, supra, at 798-799; Mullane, 339 U. S., at 313-314. As the Court noted in Mullane, "[c]hance alone brings to the attention of even a local resident an advertisement in small type inserted in the back pages of a newspaper." Id., at 315.

Tulsa Professional Collection Services, Inc. v. Pope, No. 86-1961, slip op. at 11 (S.Ct. April 19, 1988). In addition, there is no statutory provision governing notice for an adjourned sale. The accepted practice is to simply announce the continuance at the adjourned sale. But see Way v. Dyer, 176 Mass. 448, 57 N.E. 448 (1900); Clark v. Simmons, 150 Mass. 357, 23 N.E. 108 (1890).

Conveyancing attorneys have their favorite stories of property being sold for a low price at foreclosure and almost immediate high resales. The Ruebeck case is but one illustration of the effect of inadequate noticing. Several potential bidders and the bank attended the initial sale despite the limited notice. After several continuances with no additional notice, only one persistent buyer and the bank attended the sale, and the buyer obtained the property for a few hundred dollars over the mortgage. At the hearing on the complaint for voiding the sale as a fraudulent conveyance, the buyer recounted the difficulties in obtaining information from the bank as to the continuation dates. The property was purchased at foreclosure for $40,400, the Bankruptcy Court overturned the sale, and the property was sold by the trustee for $114,000.

In a recent case, In re Hagemann, 804 F.2d 1252 (9th Cir. 1986) cert. denied sub nom. Hagemann v. American Savings Loan Association, -- U.S. --, 107 S.Ct. 1574 (1987), simply indicating an unpublished opinion in support, the court continued to follow In re Madrid, 725 F.2d 1197 (9th Cir. 1984), and refused to recognize the foreclosure as a fraudulent conveyance, even though the property was valued at $600,000 more than realized at the sale.

In light of state law failing to protect creditors collectively who in the end must bear the shortfall of the foreclosure sale, should bankruptcy courts intervene to protect creditors and debtors? There are academics who postulate that bankruptcy should not intrude into state law matters such as foreclosure sales.[5] The scholarly view not only lacks an understanding of the world in which creditors and debtors struggle but lacks a historical or constitutional basis. Bankruptcy is not a static concept nor is its constitutional underpinnings intended to limit the ability to cope with a vibrant credit economy.

Bankruptcy's early history in the United States was creditor oriented. A primary concern has been how to best achieve the maximum payment for the creditors as a group.

> WHEN THE FRAMERS of our Constitution in 1787 drafted the provision authorizing Congress to legislate 'on the subject of

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5 See, for example, the debate between Professor Elizabeth Warren, Bankruptcy Policy, 54 U. Chi. L. Rev. 775 (1987), and the reply of Professor Douglas G. Baird representing both his and Professor Thomas H. Jackson's position, Baird, Loss Distribution, Forum Shopping and Bankruptcy: A Reply to Warren, 54 U. Chi. L. Rev. 814 (1987).

> bankruptcies,' they spent little time debating the content of the 'subject of bankruptcies.' Neither did the ratifying conventions in the states. Presumably they had in mind, as a general concept, the system of bankruptcy as it had developed in England.
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> The English system, as it then was, had its origins in Roman Law where scholars have traced to 118 B.C. a crude form of bankruptcy liquidation, under which the estate of a defaulting debtor was sold in one lump sale to one buyer who would pay the creditors a percentage of the debts, but under which the debtor got no discharge of unpaid balances.
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> If this remedy was crude, so were the debtor's alternatives. He was liable for his debts with his life and body; if he did not pay, he was either killed, made a slave, imprisoned, or exiled.

Countryman, A History of American Bankruptcy Law, 81 Comm. L. J. 226 (June/July 1976).

The favoring of one creditor over another through payments considered preferential or by fraudulent conveyances has been an anathema for hundreds of years.

> As early as 1571, Parliament acted to outlaw transfers of property of a debtor with the intent and effect of hindering, delaying, or defrauding creditors. The Statute of 13 Elizabeth made such a transfer a crime and punished the parties to it, except for transferees for 'good consideration and bona fide.' Punishment consisted of imprisonment and forfeiture of one year's value of real property and 'the whole value' of personalty involved in the transfer, with one half of the recovery going to the 'party or parties grieved.' But King's Bench promptly concluded that, under this statute, a judgment creditor could treat a fraudulent conveyance as void and levy execution on the property as if the conveyance had not been made.
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> Many states either reenacted this ancient English statute or treated it as a part of their inherited common law. In half of the states, the matter is now covered by the Uniform Fraudulent Conveyance Act (UFCA).

> The UFCA does not limit the ability to avoid fraudulent conveyances to creditors with judgment. Courts in many states not adopting the UFCA have reached the same result, because of the merger of law and equity or through the aid of a rule similar to the Federal Rule of Civil Procedure 18(b).

Countryman, The Concept of a Voidable Preference in Bankruptcy, 38 Vand. L. Rev. 713, 715 (1985).

The history of bankruptcy in the United States also demonstrates that the traditional goal is to maximize the return to all creditors. The four Bankruptcy Acts prior to the 1898 Act were each short lived because even their limited debtor concessions were considered too liberal by the creditor community. Countryman, supra and King, An Ode to the Bankruptcy Lawr, 81 Comm. L. J. 234 (June/July 1976).

The concern has and continues to be to obtain the greatest pro rata return for all creditors and the abhorrence of any favoritism to a particular creditor. Of course, in the real world of compromise and political pressure groups, there are occasional recognized deviations from the general goal of pro rata distribution, for example, priority classes which give certain creditors special treatment in the distribution of estate assets.

There is no constitutional basis for favoring secured interests over unsecured interests in the disposition of the equity of the debtor in bankruptcy.[6] Congress, through the

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[6] See Rogers, The Impairment of Secured Creditors' Rights in Reorganization; A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause, 96 Harv. L. Rev. 973 (1982); In re Cartridge Television, Inc., 535 F.2d 1388 (2d Cir. 1976); In re Bruch, 7 F.Supp. 184, 185 (N.D. Ill. 1933).

Bankruptcy Clause, has the constitutional and legal authority to resolve problems affecting the rights of creditors when and to the extent it deems a uniform national law to be in the country's best interest.

> The Constitution expressly confers on the Congress the power to establish uniform laws on bankruptcy throughout the nation. Generally, this authority includes the power to discharge the debtor from his contracts and legal liabilities as well as to distribute his property. Hanover National Bank v. Moyses, 186 U.S. 181, 188, 22 S.Ct. 857, 860, 46 L.Ed. 1113 (1902). Thus, bankruptcy legislation has traditionally operated to affect creditors' interests which vested prior to the effective date of the legislation. See Wright v. Union Central Life Ins. Co., 304 U.S. 502, 516, 58 S.Ct. 1025, 1033, 82 L.Ed. 1490 (1938). Unlike the states, Congress is not prohibited from passing laws that impair contractual obligations. Continental Bank v. Rock Island Ry., 294 U.S. 648, 680, 55 S.Ct. 595, 608, 79 L.Ed. 1110 (1935). See also, Kuehner v. Irving Trust Co., 299 U.S. 445, 452, 57 S.Ct. 298, 301, 81 L.Ed. 340 (1937). In fact, the very essence of the bankruptcy laws is the modification or impairment of contractual obligations.
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> There is, however, as respects the exertion of the bankruptcy power, a significant difference between a property interest and a contract, since the Constitution does not forbid impairment of the obligation of the latter. Kuehner, 299 U.S. at 451-52, 57 S.Ct. at 301. But the 'bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment.' Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 589, 55 S.Ct. 854, 863, 79 L.Ed. 1593 (1935).

In re Webber, 674 F.2d 796, 802 (9th Cir. 1982).

In matters such as foreclosure, state legislators ideally could and should provide procedures that would comport with a fair and balanced recognition of the collective interests of all of the creditors, and that should be true whether bankruptcy is involved or not. As previously illustrated, however, this has not happened in the real world and now, particularly in a consumer bankruptcy where real estate is usually the only substantial asset, the problem must be faced. How should bankruptcy cope with the collective rights of all of the creditors? What is needed is not a change in state ordered priorities but a procedure which will insure that, in fact, priorities are followed. That means that one creditor, usually the first mortgagee, cannot be the bankruptcy court's sole concern when it is possible, without derogating from the first mortgagee's rights, to protect the vital interests of all creditors when this can be accomplished by simply insisting on the noticing that is basic to due process.

Bankruptcy has historically stepped in where it is necessary to protect the collective interests of creditors when existing state laws were inadequate to the task. In fact, the sine qua non of bankruptcy is its ability to do what the states cannot do, namely, to alter contractual rights where necessary to protect the collective creditors' interests from a single creditor's preferred position. The bankruptcy courts' historic willingness to do whatever is necessary has long been recognized and has been labeled by one author as the "Dooms Day Principle." Festerson, Equitable Powers in Bankruptcy Rehabilitation: Protection of the Debtor and the Dooms Day Principle, 46 Am. Bankr. L.J. 311 (1972). The

author points out the willingness of bankruptcy courts to invoke their equitable powers when the purposes underlying the joint goals of maximizing the return to all creditors and providing debtors' a fresh start would otherwise be doomed under a conventional approach.

The concept of voiding preferential transfers[7] is a long-standing classic example of altering even secured creditors' rights validly perfected under the state law of substantially all states in the absence of bankruptcy. When payment of the preferred creditor's perfectly legitimate obligation prevents the collective creditors from receiving their pro rata shares, however, the secured obligation is voided. In as early as 1931, Justice Holmes concluded in Moore v. Bay, 284 U.S. 4, that when a trustee uses a creditor's claim to set aside a fraudulent conveyance, the entire transaction is rescinded and is not limited to the size of the initial creditor's claim. Of equal, if not more importance, is that the entire recovery goes to the estate to be divided pro rata among the creditors with no special edge to the creditor whose claim initiated the action.

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7 Generally, transfers considered preferential are those interests perfected or payments made by an insolvent debtor within 90 days of the bankruptcy filing, or within one year in the case of an insider, not in the ordinary course of business, on account of an antecedent debt. 11 U.S.C. 547. See generally Countryman, The Concept of a Voidable Preference in Bankruptcy, supra.