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The Bankruptcy Galaxy

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FOREWORD

THE BANKRUPTCY GALAXY

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The excellent articles in this Symposium issue, which it is my pleasure to introduce, comprise a microcosm of the bankruptcy galaxy. The bankruptcy galaxy travels within the universe of American law and society, but for many years it has been perceived as a self-contained entity. Bankruptcy might have rubbed up against other systems in the legal universe, for example tax and commercial law, but the impact of these collisions was mild and there was no felt need to reconcile bankruptcy goals with competing social and legal imperatives. However, the isolation of bankruptcy has been shattered by Congress's drive to reform the system; the bankruptcy galaxy has confronted the American universe as never before. An astronomical metaphor may seem awkward, but it conveys both the internal structure of bankruptcy and the system's relations with law and society in general. After sketching the symposium articles through their relation to the bankruptcy galaxy, I will add a few words about the collision among worlds that inspired bankruptcy reform legislation.

These symposium articles display the diversity of issues subsumed by bankruptcy as well as the surprising uncertainty in the law and gaps in our knowledge of the now-twenty-year-old system spawned by the Bankruptcy Code. The center of the galaxy consists of "simple" matters of debt collection and debt relief, exemplified by Professor Mattingly's article.[1] When the Supreme Court rejected[2] the *Durrett* rule,[3] which held that some foreclosure sales were susceptible to attack in bankruptcy court as fraudulent transfers, many people assumed the coast was clear for regularly conducted foreclosure sales. Professor Mattingly disagrees, contending that artificially low creditor bid-ins at foreclosure may yet be challenged as preferential transfers. Thus, at the heart of the galaxy that represents traditional bankruptcy, the relationship of debtors and secured creditors, there is flux and uncertainty.

As we move within the traditional realm of bankruptcy to the Chapter 11 reorganization, we confront the vacuum of empirical knowledge about the system. Much of the bankruptcy galaxy remains mysterious, unexplored, and unexplained by means of economic and social scientific research. Mr. Ancel

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1. Basil H. Mattingly, *Reestablishment of Bankruptcy Review of Oppressive Foreclosure Sales: The Interaction of Avoidance Powers as Applied to Credit Bid-Ins*, 50 S.C. L. REV. 365 (1999).

2. BFP v. Resolution Trust Corp., 511 U.S. 531 (1994).

3. Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980).

and Professor Markell have begun filling the void with their report on the incidence and success of Chapter 11 reorganizations in two Midwestern districts during the early 1990s.[4] Painstaking, on-the-ground research of this sort is a key ingredient of bankruptcy policymaking.

The traditional bankruptcy galaxy affects worlds outside bankruptcy when it impinges on tax codes. Not only does bankruptcy cause an enormous loss of revenue to public authorities, but it also consumes vast administrative resources. The policies behind tax and bankruptcy law fundamentally conflict, as Professor Williams and Ms. Ogier's article demonstrates with respect to Chapter 13.[5] Exacerbating the policy conflict are technical and confusing rules for the payment or discharge of debtors' tax claims. A simple and consistent, friction-reducing theory, like that proposed by Professor Williams, would provide a model for other intersections of bankruptcy and the worlds outside.

Bankruptcy takes on a wholly new dimension when, in the guise of adjusting debtor-creditor relations, it attempts to absorb the sub-galaxy of tort law dealing with mass torts. Unlike the instances in which bankruptcy law faces off against a competing regime of law, such as tax or commercial law or government regulatory authority, the conflict of bankruptcy with mass torts is not a fair fight. That is because mass torts are a description of a legal problem for which no solution has been crafted, little law has been formulated, and hence, no legal or policy hierarchy has developed. Bankruptcy exists to protect the debtor, but no substantive-law scheme yet identifies how to quantify mass tort claims, what priority they should receive, or the assets—present or future—from which mass tort claimants may seek compensation. Mr. Rice and Ms. Davis's article explains how bankruptcy procedure and policy thus threaten to engulf relatively amorphous mass tort claims without satisfactorily resolving them.[6]

The metaphysical aspect of bankruptcy cosmology resides in the hoary adage that bankruptcy court is an equity court. Invoking equity, bankruptcy courts can do pretty much whatever they think best in individual cases—if the parties have enough money to litigate and raise the pertinent issues before the courts. But what will happen if the equity label is proved false? Judge Krieger's[7] meticulously researched article challenges the equity adage and, in so doing, may provoke a reexamination of contemporary bankruptcy's deepest premises. Reading and applying law and formulating general rules are different tasks than using legal principles to "do equity." Approaching bankruptcy from

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4. Steven H. Ancel and Bruce A. Markell, *Hope in the Heartland: Chapter 11 Dispositions in Indiana and Southern Illinois, 1990-96*, 50 S.C. L. REV. 345 (1999).

5. Jack F. Williams & Tamara Miles Ogier, *A Collision of Policy: Chapter 13 and Taxes*, 50 S.C. L. REV. 313 (1999).

6. Joseph F. Rice & Nancy Worth Davis, *The Future of Mass Tort Claims: Comparison of Settlement Class Action to Bankruptcy Treatment of Mass Tort Claims*, 50 S.C. L. REV. 407 (1999).

7. Marcia S. Krieger, *"The Bankruptcy Court Is a Court of Equity:" What Does That Mean?*, 50 S.C. L. REV. 275 (1999).

the standpoint of a law court instead of an equity court may, in my view, lead to a more even balance between debtors' and creditors' rights. In any event, rejecting the equity court adage will clarify bankruptcy courts' image and discourage attorneys from making stale, sterile appeals to equity at the expense of rigorous legal reasoning.

The subjects discussed in this Symposium all reside firmly within the bankruptcy galaxy. They illumine the system and will contribute to its improvement. But the galaxy itself is about to become a different place, no longer isolated or insulated. The apparent cause of the change will be bankruptcy reform legislation, which is a high priority in Congress. However, the actual cause is this decade's enormous increase in personal bankruptcy filings. The escalation in filings has revealed many little facts, the cumulative proof that in case after case, bankruptcy's powerful debt-relief tools are often misused. To complete the metaphorical explanation, the disturbance within the bankruptcy galaxy is thus precipitated by intragalactic evolution, which has forced a response from the outside universe. Or, to put it bluntly, bankruptcy has become a victim of its own success.

Bankruptcy's "success" appears graphically in the rising number of individual case filings. Since 1990, bankruptcy cases have nearly doubled, reaching 1.4 million case filings in 1998. Astonishingly, this escalation has occurred during a time of unprecedented national prosperity. Although the increase has not been definitively explained, it is not far off the mark to suggest that rising bankruptcy filings beget more filings. As more citizens file bankruptcy, there is a wider awareness of its generous debt relief provisions and increased social acceptance of the resort to bankruptcy. At one time, personal shame and social stigma would have bedeviled people filing bankruptcy, and their credit rating would have been ruined. That is no longer true. Hollywood stars, sports celebrities, and even political figures file bankruptcy petitions with aplomb, often crowing about their ability to shelter valuable assets. Lenders have carved out the euphemistically-named sub-prime market for borrowers with bad credit ratings, which often derive from past bankruptcy filings. Finally, the impact of advertising by lawyers and by bankruptcy mills should not be underestimated. The result is an entirely different cultural attitude toward bankruptcy than existed even a short time ago in our history. The change is vividly demonstrated by one comparison: more people sought bankruptcy relief in the first half of 1997 than during the entire decade of the Great Depression!

The argument is made that creditors, particularly credit-card issuers, are to blame for increasing bankruptcies because of allegedly misleading advertising or imprudent credit granting policies. In my view, this argument is a red herring. Professor Todd Zywicki and I have analyzed and refuted the creditors-

cause-bankruptcy theory in another article.[8] Suffice it to say in this compressed format that although creditors' practices may not fulfill our most exacting specifications, it is debtors who charge the purchases, who undertake excessive financial obligations, who decide when to seek bankruptcy protection, and who, increasingly, file bankruptcy before they have actually fallen behind in payments to creditors. Personal responsibility plays an important role.

The increase in filings has gone hand in hand with a new administrative model for bankruptcy. Most consumer bankruptcies are now filed by professionals who specialize in the area, handling dozens of new cases each month. Bankruptcy is traditionally a field in which compensation is relatively low and the risk of nonpayment relatively high. To make a go of it, bankruptcy lawyers have to operate a volume practice, and this requires heavy reliance on paralegals and interns. Ethical risks proliferate because the lawyers are unable to devote proper attention to each client. The consequences of poor lawyering are visited most severely upon clients, but also upon the creditors and courts.

Oversight of the integrity of the bankruptcy system has also been impaired by the large volume of cases. Not only debtors' lawyers, but Chapter 13 trustees, panel trustees, the U.S. Trustee, and the bankruptcy courts themselves are responsible for maintaining public confidence in the system. These participants also cleave to an outdated notion that they can accomplish individually equitable outcomes while processing dozens of cases at a time. To take but one or two examples, consider the panel trustee who regularly holds docket call for fifty cases per hour. To what extent can the trustee scrutinize the accuracy of the debtors' schedules and statements of affairs? Judges often hold reaffirmation hearings in which dozens of creditors are present, and courts conduct Chapter 13 confirmations at breakneck speed. Judges can hardly observe or investigate abuses when the dockets are moving so swiftly. Similarly, the U.S. Trustees' offices are overwhelmed with routine administrative burdens, and their ability to control the integrity of these systems is correspondingly diminished.

In a system that, much like the federal income tax system, depends upon the integrity of the individual participant, is it any wonder that debtors are advised or easily learn of ways to manipulate bankruptcy for additional advantage? Opportunities for fraud and abuse abound, beginning with the filing of the debtor's schedules and statement of affairs, which are supposed to recite all of the debtors' assets available to pay creditors. It is widely understood that these schedules are simply not to be trusted, even though they are filed under penalty of perjury. A few debtors file multiple bankruptcies in order to forestall foreclosure rather than to gain a fresh start. Others buy new automobiles prior to filing, counting on a "cramdown" to reduce their post-Chapter 13 payments. Others may simply go on a shopping spree, knowing that the bankruptcy court

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8. Edith H. Jones & Todd J. Zywicki, *It's Time for Means-Testing*, 1999 BYU L. REV. ___ (forthcoming 1999).

will relieve them of the responsibility to pay for the purchases.

The abuse of prerogatives afforded a debtor in bankruptcy is just as detrimental to the system as outright fraud. Abusive practices employ the letter of the law for an unworthy or improper purpose. For example, ex-husbands may resort to bankruptcy to avoid paying child support and alimony or to reduce the state-court-ordered payments. A business partner may file bankruptcy to circumvent a lawsuit with other partners or pressure them for a change of control. Tort-feasors, such as doctors who commit malpractice, may discharge in bankruptcy the judgments for injury they caused others. Ponzi scheme artists can file bankruptcy to "reorganize" their debts. Wealthy debtors can move to a jurisdiction in which liberal exemption laws allow them to shelter millions in homestead equity from creditors. And, of course, the test for obtaining bankruptcy relief is so standardless that well-off, income-earning people can and do file for the convenience of shedding debts.

Personal responsibility and institutional accountability have been severely eroded by the contemporary bankruptcy system. Only a reform of the underlying law can reinstill public confidence and realign bankruptcy policy to promote individual responsibility as well as humane debt relief. Legislation that would take important steps toward realizing these goals nearly passed Congress in 1998 and is being re-introduced in the current session. The principal goals of the reform package are to enhance the reliability of disclosures made by debtors, to curtail obviously fraudulent and abusive devices, and to institute a modest-means test that requires well-off, income-earning debtors to repay a portion of their unsecured debts.

Many bankruptcy professionals and judges have voiced strident objections to the reform legislation. Three principles lie behind the objections: an atavistic preference for the status quo, no matter what its effects on the larger economy; a preference for equity rather than specific legal rules; and visceral dislike of any means-testing formula. In another article, Professor Zywicki and I have explained the legislative means-testing formula and responded to its critics, so I will not repeat our arguments here. The other two objections are as vehement as they are wrong, and they are intertwined.

A defense of the status quo necessarily involves the preference for the "equitable" concept of the bankruptcy court. Granting the accuracy of Judge Krieger's criticism of bankruptcy court as an equity court, the bankruptcy law is nevertheless riddled with discretionary grants of authority. Practically no sanction is mandatory. Discharge is only rarely to be denied, and nondischargeability claims by creditors are to be construed narrowly in favor of the debtor. Hardly any deadlines are fixed, notwithstanding that from a creditor's standpoint, time is money.

Discretion may have been an acceptable characteristic of the old bankruptcy regime, when social factors discouraged filing and the courts' much lighter dockets permitted actual scrutiny of each case. Now that filings have skyrocketed to over one million cases per year—and no reforms proposed by Congress would dramatically lower that number—discretion is at best

superfluous and at worst mischievous. Courts that process bankruptcy cases en masse have few opportunities to exercise the discretion that exists. The flexibility of the rules and lack of standards enable debtors to exploit the bankruptcy process with little expectation of being sanctioned. Liberal exercise of judicial discretion also leads to widely varying and, therefore, to unfair results among districts and even among individual courts within the same district. If Congress chooses to enact firm rules that discourage manipulative practices and enhance uniformity, why is this objectionable? Congress represents the collective will of the American people, and it is entitled to replace judicial discretion with firm rules. Paradoxically, many of the defenders of the status quo acknowledge the existence of debtor abuses even as they carp about limiting the judges' discretion.

No advocate of bankruptcy reform wishes to uproot America's uniquely liberal debt system. However, reform is mandated for the sake of the greater good. As more people seek bankruptcy relief, bad-debt losses escalate. Creditors' losses are passed on to consumers in the form of higher prices for goods and services and credit. Unfortunately, lower-income Americans bear the brunt of bankruptcy-enhanced costs, as they are members of the class more likely to file for protection. Those who struggle to pay their bills each month in effect subsidize ever larger numbers of debtors who are either able to repay some debts or are unfairly manipulating the system. More ominously, given the high level of bankruptcy filings during a period of economic prosperity, one must be concerned that a precipitous increase will occur when the economy turns down. The bankruptcy system and the consumer credit system could suffer severely.

The need for bankruptcy reform is manifest. The first steps for accomplishing it are relatively easy, and they are embodied in the specific proposals passed by Congress in 1998. The administrative model that has served bankruptcy in the past must be replaced with clearer standards in recognition of the present inability of the system to do equity in each case. The bankruptcy system has served its humanitarian purpose well, and it will continue to do so even after it is reformed to enhance public confidence and personal responsibility.