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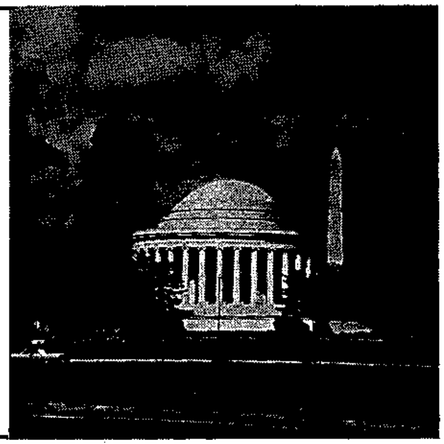

Congress and the Bankruptcy Act of 1976

By Kenneth N. Klee

AS CONGRESS returned last month from its August recess, lawyers, judges, businessmen, and consumers asked about the status of the proposed new Bankruptcy Act. To appreciate where the legislation stands now and what is likely to happen, one needs to review history a bit.

Congress has invoked its constitutional power to enact uniform laws on bankruptcy four times since the nation's founding—the bankruptcy acts of 1800, 1841, 1867, and 1898. The current law—the Bankruptcy Act of 1898—has been amended several times, with major amendments occurring in 1938 (the Chandler Act), 1966, and 1970.

In 1970, because of numerous complaints about the indequacy of the present statute, Congress established the Commission on the Bankruptcy Laws of the United States, the purpose of the commission being to evaluate the act and to propose a concrete statutory alternative. Members of the commission were Harold Marsh, Jr., a Los Angeles lawyer, who was chairman; the late Charles Seligson, who was professor emeritus at the New York University School of Law; J. Wilson Newman; Quentin N. Burdick and Marlow W. Cook, members of the Senate; Don Edwards and Charles E. Wiggins, members of the House of Representatives; and United States district judges Edward Weinfeld and Hubert Will.

The commission submitted its findings and recommendations to Congress in a two-part report with appendixes in July of 1973 (H.R. Doc. No. 93–137). Part II of the report was a statutory proposal optimistically entitled the Bankruptcy Act of 1973.

The commission's proposed new act was introduced by Representative Edwards for himself and Representative Wiggins as H.R. 10792 in October of 1973 in the Ninety-third Congress. An identical proposal went in as S. 2565 with the sponsorship of Senators Burdick and Cook. Both were referred to the judiciary committees, and then in the House to the Subcommittee on Civil Rights and Constitutional Rights and in the Senate to the Subcommittee on Improvements in Judicial Machinery. In the Ninety-third Congress there were no hearings in the Senate and only one day in the House.

Late in the second session of that Congress the National Conference of Bankruptcy Judges formulated a statutory alternative to the commission's proposal. This was introduced in September of 1974—in the House as H.R. 16643 by Representatives Edwards and Wiggins, and in the Senate as S. 4046 by Senators Burdick and Cook. No hearings were held on these bills during the Ninety-third Congress.

Once the judges' bill was assigned to a subcommittee, the staff in both houses began to compare the two versions. Throughout the nation many groups held seminars and conferences at which the two bills were analyzed. Lobbyists then started to show interest and began to formulate their tactics for the Ninety-fourth Congress.

That Congress, which organized in January of this year, reflected the Democratic landslide in 1974. Representative Edwards, a Democrat from California, remained chairman of the renamed Subcommittee on Civil and Constitutional Rights of the House Judiciary Committee, and Senator Burdick, a Democrat from North Dakota, retained his subcommittee chairmanship in the Senate. Senator Cook, a Republican from Kentucky who was a member of the commission, failed to win re-election. Representative Wiggins, a Republican from California, was re-elected but chose to become the ranking minority member of House Judiciary's Subcommittee on Criminal Justice, a subcommittee that would not deal with the proposals.

Bills representing the two proposals were reintroduced in the Ninety-fourth Congress in January of 1975—in the House, H.R. 31, the commission's bill, and H.R. 32, the judges' bill; in the Senate, S. 236, the commission bill, and S. 235, the judges' bill. Indicative of a bilateral commitment to move forward, additional staff members were employed by the subcommittees in both the Senate and the House.

The Senate subcommittee initiated hearings on S. 235 and S. 236 on February 19, 1975, and nine days of hearings on consumer bankruptcies ended on April 30. Additional hearings are planned on business bankruptcies. Witnesses included prior members of the commission, bankruptcy judges, consumer representatives, and members of various banking and credit organizations. Mr. Burdick has been the only senator to attend the hearings. The Senate is expected to complete the process of subcommittee and full committee markup and approval by the end of January, 1976. Shortly after that the Senate can be expected to pass its version of the Bankruptcy Act of 1976.

It is impossible to predict with any certainty the contents of the Senate bill as it will be reported out of subcommittee, much less as it will be passed by the Senate. Senator Burdick, however, has indicated his position on nondischargeability of debts obtained by a false financial statement. He favors the approach used in the 1970 amendments to Sections 14c (3) and Section 17a(2) (11 U.S.C. §§ 32(c)(3) and 35(a)(2)) of the Bankruptcy Act. The discharge is denied under Section 14(c)(3) if the bankrupt obtained credit for his business based on a written false financial statement. Under Section 17a(2) provable debts that are liabilities for credit obtained in reliance on a false financial statement that the bankrupt made with intent to deceive are nondischargeable. The commission's proposal departs from current law by allowing consumer debts obtained by means of a false financial statement to be discharged. In addition, the commission's bill eliminates the use of a false financial statement in a business transaction as a ground for denying a discharge. While the judges' bill similarly departs from Section 14c(3), it is consistent with Section 17a(2).

Senator Burdick has not indicated publicly his views on any other issues in the bills, but witnesses before the Senate subcommittee have testified on many provisions of the two proposals. Certain issues seem to be more controversial than others. Treatment of the false financial statement as a ground for denying a discharge or rendering a debt nondischargeable has been a subject of interest.

Another issue that has evoked heated debate in the area of nondischargeability is the educational loan exception in each bill. Although not drafted identically, the general thrust of both bills is to render nondischargeable any "educational debt" if the first payment was due after or on a date less than five years prior to the filing of the petition. Even an educational debt in that category will be discharged if nondischargeability will cause an undue hardship on the debtor.

"Educational debt" is a term defined in each bill to include debts for postsecondary education owed to a school or in the form of government-made or government-guaranteed loans. Private loans are not included within the definition.

Defenders of the government educational loan programs favor the provision. Private sources of education loans want the definition of educational debt to be expanded to cover private loans. Many creditors who do not make educational loans oppose the provision on the ground that it creates an unjustifiable priority.

Members of Congress will have to evaluate available data to determine whether the rate of discharge of educational loans under current law warrants a special provision excepting them from being discharged. If a special provision is thought necessary, then Congress will have to decide if the distinction between public and private sources of loans is desirable. If different conclusions are reached in the House and Senate, then the issue will probably be resolved in conference prior to final passage.

Other controversial issues that have surfaced during testimony center around the effectiveness of a discharge. Under the present act, nothing prevents a debtor from reaffirming a debt discharged in bankruptcy, and this agreement is enforceable under nonbankruptcy law. Creditors can extract a reaffirmation of a previously discharged debt as a condition precedent for new credit. The present law does not prohibit creditors from basing the decision to extend new credit on a person's past financial history. A bankrupt can be classified as a bad credit risk, and reaffirmation of a discharged debt may be viewed as a compensating factor. Reaffirmation of a discharged debt also may be encouraged by a lienholder who potentially can enforce a lien against exempt household goods of the bankrupt unless the bankrupt assents to reaffirm other debts to the lienholder discharged in bankruptcy.

To ensure that the bankrupt will be given a fresh start, both bills include three provisions designed to bolster the effectiveness of a discharge. One section gives the debtor a right to redeem property from a lien securing a dischargeable consumer debt, provided the property is exempt or has been abandoned by the trustee, by paying the lienholder the lesser of the amount of the claim or the fair market value of the property. Another forbids reaffirmation of a discharged debt and renders void any judgment that the debtor is liable to pay a discharged debt. The third prohibits discriminatory treatment against a debtor or against any other person who has failed to pay a discharged debt.

"Fresh Start" Controversy

These three "fresh start" provisions are controversial because they alter significantly the debtor-creditor relationship. Members of Congress will determine whether these sections are desirable in theory to give the debtor a fresh start. If the provisions are philosophically attractive, then the congressmen will consider the practical effect of these sections on the extension of credit. Underlying this inquiry are fundamental questions concerning allocation of the cost of credit and whether there should be a right to the extension of credit.

The Senate testimony has indicated differences of opinion concerning the administrative structure of the bankruptcy system. In response to legends of bankruptcy rings and the involvement of bankruptcy judges with administrative activities, the commission formulated a structure to separate administrative from judicial functions. This structure establishes a separate bankruptcy court with judges confined in their functions to resolving disputes. An administrative agency in the executive branch of government is created to execute all administrative functions. One of the functions of the administrator is to counsel the debtor as to forms of relief available under the act. The counseling function is itself a volatile issue.

The structure adopted in the judges' bill differs sharply from that in the commission's bill. Although each bill sets up a separate bankruptcy court, bankruptcy judges perform many functions in the judges' bill that are left to the administrator in the commission bill. Under the judges' proposal, the residual functions not given to the court are assigned to a director who operates the Branch of Bankruptcy Administration of the Administrative Office of the United States Courts in the judicial branch. The counseling function of the director is limited to assisting the debtor in the mechanics of filling out forms. Reference to a list of lawyers is provided if the debtor wishes to receive legal advice. If the debtor cannot afford legal advice, the director may provide it.

House and Senate subcommittees will need to resolve the issue of structure early in the legislative process. The manner in which the administrative and legislative functions are separated can be expected to affect both procedural and substantive aspects of bankruptcy law. The distribution of administrative and judicial functions should occur only after a determination is made at a theoretical level that indicates a rational basis of classification. An activity such as legal counseling may be determined to be neither a judicial nor an administrative function. Even if Congress includes counseling within the bankruptcy structure, it will have to decide whether both debt counseling and legal counseling should be provided.

The controversial issues that have surfaced in testimony on the Senate side reflect the fact that consumer bankruptcy has been the subject focused on in the nine Senate hearings held from February 19 through April 30. These same issues probably will dominate the House hearings on consumer bankruptcy as well.

Rep. Don Edwards has scheduled

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forty-two hearings on H.R. 31 and H.R. 32 during the Ninety-fourth Congress. Two background hearings held prior to the August recess provided a framework indicating the present volume of cases and the amount of assets administered by the bankruptcy courts. The Subcommittee on Civil and Constitutional Rights is scheduled to meet every Monday and Friday Congress is in session through March, 1976. Issues on philosophy will be covered in four hearings, then two hearings on structural issues will be held. Because of the financial plight of New York City, two hearings on municipal reorganizations will be held in October. The final twelve hearings during the remainder of 1975 will focus on structure and consumer bankruptcy, wage earner plans, and several areas in which bankruptcy impinges upon other law, *e.g.*, tax law, securities law, administrative law, international law. Twenty hearings during the first three months of 1976 will examine business bankruptcies, reorganizations and arrangements, and transition provisions.

Exemptions should receive considerable examination during the House hearings. Most exemptions are determined by state law under Section 6 of the Bankruptcy Act (11 U.S.C. § 24). Each bill departs from current law by federalizing exemptions. The judges' bill provides federal exemptions as an alternative to state exemptions, thereby creating a "federal floor." The commission's bill completely pre-empts the area by establishing exclusive uniform federal exemptions. Fewer controversial issues are likely to arise in the areas of business bankruptcies and corporate reorganizations than in consumer bankruptcies. A number of factors may account for this phenomenon, including the political nature of the issues and the *expertise* of the commission in drafting business provisions.

A fundamental structural consideration will be whether business and consumer bankruptcies should be included under the same system of administration. Although the bills treat business or corporations differently from consumers in some instances, the general administrative procedure of each bill is applicable to both consumer and business debtors in cases of liquidation. Since the proposed administrative structure appears to have been drafted to accommodate the consumer debtor, witnessess representing business interests will have the burden of arguing for separate treatment. Congress will determine whether administrative differences with respect to business and consumer debtors warrant separate provisions, either within the existing administrative framework or in a separate administrative structure.

Various aspects of the provision on preferences may evoke discussion because each bill markedly departs from Section 60 of the Bankruptcy Act (11 U.S.C. § 96). A major change lies in the definition of antecedent debt. Under current law, a debt is antecedent to a transfer if the debt is incurred prior to the transfer paying or securing the debt. *National City Bank* v. *Hotchkiss*, 231 U.S. 50 (1913), held that repayment of money borrowed at 10:00 A.M. before 3:00 P.M. the same day was a preference.

The commission's bill protects short-term credit extensions by defining antecedent debt to be a debt incurred more than five days before a transfer paying or securing the debt. The judges' bill extends the five-day period to thirty days. Long-term credit interests can be expected to argue that departure from current law will result in an unfair priority being given to short-term creditors. Congress must decide if either proposal adequately protects short-term credit extensions without significantly undermining the fundamental principle of equity between creditors.

Special Treatment of Transfers

Another departure from present law involves special treatment of transfers to "inside" creditors. The commission's bill invalidates as preferential all transfers to pay antecedent debts within one year prior to bankruptcy if the creditor was a member of the immediate family, a partner, an affiliate, a director, an officer, or a managing agent of or for the debtor and if the debtor was insolvent and the creditor has reasonable cause to believe the debtor was insolvent at the date the transfer occurred. Within three months prior to the filing of the petition, inside creditors are treated identically with other creditors.

The judges' bill provides a separate preference test, similar to the commission's test, for inside creditors with respect to all transfers made within one year prior to the filing of the petition. This bill also shifts the burden of proving solvency to the inside creditors.

Congress will decide whether to depart from current law by providing more stringent preference rules for insiders. Opposition to these provisions can be expected from witnesses who argue that inside financing is the last source of credit to save a failing business and that the effect of making repayment of these debts a preference will deter advances, especially if a provision of the commission's bill that subordinates any inside debt not repaid, is adopted.

In the area of corporate reorganizations and arrangements, two topics are likely to receive the bulk of congressional attention.

First, the issue of whether to consolidate Chapters X, XI, and XII into one chapter, as was done in the case of the commission's Chapter VII, or into two chapters, as in Chapters VII and VIII of the judges' bill, will need to be resolved. While few witnesses can be expected to argue for the retention of three separate chapters, many probably will suggest that a streamlined procedure with a distinct standard of fairness is needed for arrangements as distinguished from corporate reorganizations. Supporters of the commission's position will contend that arrangements not affecting publicly held securities are given streamlined treatment within the framework of Chapter VII.

To that end, if all classes of creditors accept the plan of arrangement, the court need not apply any standard of fairness to confirm the plan.

Second, agreement will need to be reached concerning the choice of a standard of fairness. The commission's bill modifies the absolute priority test currently used in Chapter X to allow delayed participation rights, compensation for future value to be given to the business, and less strict methods of valuation. The judges' bill concurs in these modifications but retains the best-interests-of-creditors tests with respect to arrangements made under Chapter VIII.

Congressional decisions on consolidation and fairness probably will be made at the same point during the legislative process because of the logical dependence of the issues.

The decision-making and drafting process in the Subcommittee on Civil and Constitutional Rights initially will occur during study sessions conducted after hearings have concluded on a particular subject rather than at the conclusion of hearings on the entire bill. Although these decisions will be tentative, the subcommittee will be able to channel the direction of the hearings based on the early resolution of threshold issues. At the conclusion of hearings next March, the subcommittee will re-examine the entire panoply of topics in business meetings resulting in the drafting of a bill to be reported to the full Committee on the Judiciary. This process of "mark-up" probably will last two months.

If all goes well, the full committee will report out a bill to the House of Representatives and the House will pass its version of the new Bankruptcy Act by June, 1976. Since the House bill undoubtedly will not be identical to that passed by the Senate, it is likely that a conference will be created to resolve the differences. Once the compromise reached in conference is ratified by the House and the Senate, the bill will be sent to the president to be signed into law.

At the present it is difficult to predict when the legislative process will run its course, but if all goes well the nation will have a new Bankruptcy Act by the end of 1976. ▲