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### Why Bankruptcy?

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## WHY BANKRUPTCY?

*Richard Levin\**

Thank you for this impressive award, impressive because of the Bankruptcy Hall of Fame luminaries who have previously received it, people who have had a lasting impact on bankruptcy law and practice: Harvey Miller, Professor Frank Kennedy, Judge William Norton, Professor Kenneth Klee, Senator Dennis DeConcini, and Professor, now Senator, Elizabeth Warren, among others. I'm honored to be in their presence, let alone in their company.

It's a little disconcerting, however, to receive a "Lifetime Achievement" award, for at least two reasons. Time has gone so quickly since my first introduction to bankruptcy law just about 40 years ago, that it does not seem like a lifetime. As the old saying goes, "Choose a job you love, and you will never have to work a day in your life." I hope that each of you will be able to find that as well. Also, I think of a Lifetime Achievement award as coming at the end of a career. I don't think I'm anywhere near done. There are still many years ahead. Or are the editors trying to tell me something? I'm somewhat encouraged by some of the prior award recipients. I understand, for example, that Professor Warren was able to find something useful to do after she received the award. In any event, it's very gratifying to receive the award. I will cherish it.

In accepting this award, the question I pose for you tonight is, "Why Bankruptcy?" Sure. From a lawyer's perspective, practicing bankruptcy law can be challenging, demanding, intellectually stimulating and rewarding. Practicing business bankruptcy law combines law and finance and operations; practicing consumer bankruptcy law combines law and social work. It is a specialty practice focusing on creditors' rights, insolvency law, and bankruptcy law and a general practice, addressing all of a client's legal problems, whether they are property, commercial, banking and secured transaction, tax, intellectual property, consumer protection, family law and constitutional law, just to name a few. It is Code-based, and it is common law-based. It is a deal practice that requires all of a lawyer's negotiation and documentation skills.

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And it is a litigation practice that requires legal research and writing, discovery, and presentation of evidence and argument in court. It allows—indeed requires—the practitioner to be the “complete lawyer.” And for the most part, the bankruptcy community is a wonderful community with deeply committed professionals who work together even while they’re working against each other in particular cases. Given the nature of the problems their clients face, they struggle on with a shared sense of purpose and a shared sense of irony and humor to get them through the difficulties.

But from a larger perspective, why bankruptcy? The Framers did not write bankruptcy into the Constitution just to give all of us interesting careers. In fact, in most peoples’ minds, bankruptcy is evil. It is vilified. Public opinion surveys suggest that bankruptcy is considered more shameful than divorce,<sup>1</sup> and the stigma associated with bankruptcy remains high.<sup>2</sup> Many believe that an individual who files bankruptcy has abused the financial system, if not the bankruptcy system, by taking on more obligations than he or she can meet and that it is morally, ethically and financially wrong for someone to walk away from their financial obligations. Many believe that businesses that reorganize through bankruptcy and survive treat their creditors unfairly,<sup>3</sup> not realizing that typically the shareholders are wiped out, even though the corporate entity and the business survive.

And every creditor and shareholder will tell you why they or their situation is special and why either bankruptcy should not affect them or their claims should receive priority. In consumer bankruptcy, special treatment is given to

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<sup>1</sup> Compare Worth Magazine/Roper Starch Poll # 1993-472-660: Survey of America’s Inner Financial Life (1993) (finding that 76% of individual bankruptcy debtors felt “just terrible” about filing), with Lydia Saad, *Cultural Tolerance for Divorce Grows to 70%*, GALLUP (2008), <http://www.gallup.com/poll/107380/cultural-tolerance-divorce-grows-70.aspx> (last visited April 8, 2013) (finding that only 22% of polled Americans believed divorce was morally wrong).

<sup>2</sup> See Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, *Less Stigma or More Financial Distress: An Empirical Analysis of the Extraordinary Increase in Bankruptcy Filings*, 59 STAN. L. REV. 213, 214-15 (2006); see also Sara Murray, *Bankruptcy Comes with Social Stigma*, THE WALL STREET JOURNAL: REAL TIME ECONOMICS, <http://blogs.wsj.com/economics/2010/11/25/bankruptcy-comes-with-social-stigma/> (last visited Nov. 25, 2012). Historically, it was worse. See Rafael Efrat, *The Evolution of Bankruptcy Stigma*, 7 THEORETICAL INQUIRIES L. 365, 369 (2006). Prof. Bruce Mann reports that the Colonial-era warden of the Philadelphia common jail expressed concern that a new debtors’ prison built adjacent to the jail “might corrupt the morals” of the common prisoners. BRUCE H. MANN, *REPUBLIC OF DEBTORS: BANKRUPTCY IN THE AGE OF AMERICAN INDEPENDENCE* 95 (2009).

<sup>3</sup> See, e.g., Barry E. Alder, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 446-54 (1992) (criticizing reorganization as a means by which junior creditors and equity may extract extra-contractual concessions from senior creditors).

first mortgage lenders,<sup>4</sup> car lenders,<sup>5</sup> student loan creditors,<sup>6</sup> taxing agencies,<sup>7</sup> former spouses and dependent children,<sup>8</sup> drunk driving victims,<sup>9</sup> and, not to be outdone, the FDIC.<sup>10</sup> In business bankruptcy, there are trade suppliers;<sup>11</sup> shopping center landlords;<sup>12</sup> farmers and fishermen;<sup>13</sup> union employees;<sup>14</sup> retirees;<sup>15</sup> buyers or sellers of commodities, from coal to grain to foreign currencies;<sup>16</sup> regulated utilities;<sup>17</sup> and transportation equipment lenders and lessors,<sup>18</sup> to name just the more prominent ones. And, of course, there is the very special treatment given to secured debt.<sup>19</sup>

The provisions are designed to protect their beneficiaries from bankruptcy losses. But losses happen independent of bankruptcy. Blaming bankruptcy for losses is like blaming hospital emergency rooms for auto accidents.

There are clearly good justifications for each of these special provisions. Tax agencies are involuntary creditors—they do not choose their debtors and so should not be held to the same risks as voluntary lenders. Tort creditors are involuntary creditors too, but the Code does not provide special treatment, except for drunk driving victims, so their claims are made nondischargeable to discourage or punish drunk driving. Shopping center leases deserve special

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<sup>4</sup> 11 U.S.C. §§ 1123(b)(5), 1322(b)(2) (2012).

<sup>5</sup> *Id.* § 1325(a).

<sup>6</sup> *Id.* § 523(a)(8) (educational loans nondischargeable absent undue hardship).

<sup>7</sup> *Id.* § 507(a)(8) (most taxes entitled to priority); *id.* § 523(a)(1) (most tax debts nondischargeable).

<sup>8</sup> *Id.* § 507(a)(1) (domestic support obligations and related debts entitled to first priority); *id.* § 523(a)(5), (15) (domestic support obligations and related debts nondischargeable).

<sup>9</sup> *Id.* § 507(a)(10) (granting priority for claims resulting from death or personal injury caused by the debtor while intoxicated); *id.* § 523(a)(9) (debts for death or personal injury caused by the debtor while intoxicated nondischargeable).

<sup>10</sup> *Id.* § 507(a)(9) (priority for certain claims of financial institution regulatory agencies); *id.* §§ 523(a)(11), (12) (certain debts to financial institution regulatory agencies nondischargeable).

<sup>11</sup> *Id.* § 503(b)(9) (administrative expense priority for goods received within 20 days before bankruptcy); *id.* § 546(a) (preservation of common law and U.C.C. reclamation right for suppliers of goods).

<sup>12</sup> *Id.* § 365(b)(3) (providing special adequate assurance requirements for assumption of shopping center lease assumptions); *id.* § 365(d) (special pre-assumption protections for shopping center lessors).

<sup>13</sup> *Id.* § 507(a)(6)–(7) (priority for certain claims of farmers and fishermen).

<sup>14</sup> *Id.* § 1113 (special protections for and special procedures for rejection of a collective bargaining agreement in a chapter 11 case).

<sup>15</sup> *Id.* § 1114 (special protections for and special procedures for modification of certain retiree benefits).

<sup>16</sup> *Id.* § 546(d)–(e) (limiting trustee's power to avoid margin or settlement payments to commodity brokers, payments to sellers of grain, and others); *id.* § 556 (preserving certain contractual rights of commodity brokers and others notwithstanding any provisions of the Code).

<sup>17</sup> *Id.* § 366 (special protections for utilities).

<sup>18</sup> *Id.* § 1110 (granting special protections for lessors of and lenders secured by aircraft and engines, railroad rolling stock and vessels).

<sup>19</sup> *See, e.g., id.* §§ 361, 362(d), 363(e), 364(d), 725, 1129(b)(2)(B).

treatment because they are part of an integrated real estate development and cannot be evaluated separately from the entire center. Educational lenders cannot foreclose on the “asset” that they financed. Financial contract counterparties and financial regulatory agencies need protection because of the need to prevent disruptions to the financial system. Exceptions for first mortgages and transportation equipment financing are necessary to lower the cost of and make capital available to those important markets. And so on.

These are all good reasons, as are the reasons supporting the other bankruptcy exceptions. But there’s a problem. When the Bankruptcy Code was enacted in 1978, there were seven exceptions to the automatic stay,<sup>20</sup> nine exceptions to discharge<sup>21</sup> and six categories of unsecured claim priorities.<sup>22</sup> Now there are 27, 19, and 10 respectively,<sup>23</sup> each to protect some group that has argued for special treatment. Every few years, a few more of these exceptions find their way into the bankruptcy law,<sup>24</sup> and there are often efforts to insert more.<sup>25</sup> If the trend continues, and all major creditor constituencies are protected from the effects of bankruptcy, the automatic stay and the discharge, then the only people or companies who will be able to get any benefit from using the bankruptcy laws are those who are already able to meet all their obligations. The bankruptcy laws will effectively have been repealed.

Our economy needs bankruptcy to function, just as a society dependent on the automobile needs emergency rooms. The astronaut Frank Borman, who later became a successful businessman, said, “Capitalism without bankruptcy is like Christianity without Hell.”<sup>26</sup> But I think that misses the point. In some sense, bankruptcy can have the effect of punishment for failing. But that is not its primary purpose, at least not today. Bankruptcy is perhaps more like

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<sup>20</sup> Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 95th Cong., 2570-71 (1978) (enacting § 362(b)).

<sup>21</sup> *Id.* at 2590–91 (enacting § 523(a)).

<sup>22</sup> *Id.* at 2583–84 (enacting § 507(a)).

<sup>23</sup> 11 U.S.C. §§ 362(b), 507(a), 523(a).

<sup>24</sup> *See, e.g.*, H.R. 4935, 97th Cong., § 3 (1982) (enacted) (exempting from the automatic stay and preference liability the liquidation and setoff of mutual debts and claims arising under securities contracts, commodity contracts and forward contracts); H.R. 5174, §§ 391-95, 98th Cong., (1984) (enacted) (extending the same exemptions to repurchase agreements). They do not always appear in the Bankruptcy Code. *See* 42 U.S.C. §§ 254o(d), 292f(g) (2012) (certain medical and public health education loans); *id.* § 656(b) (assigned child support obligations).

<sup>25</sup> *See, e.g.*, H.R. 5503, 111th Cong., § 7, (2010) (effectively granting a priority to oil spill victims); *Financial Situation of the Airlines: Hearing Before the S. Comm. on Commerce, Sci., and Transp.*, (2004) (statement of Bradley D. Belt, Exec. Dir., Pension Benefit Guar. Corp.), available at <http://www.pbgc.gov/news/testimony/page/tm100704.html> (proposing an exemption from the automatic stay for the PBGC to perfect a lien on assets of defaulting pension plan sponsor).

<sup>26</sup> THE YALE BOOK OF QUOTATIONS 96 (Fred R. Shapiro ed., 2006).

purgatory, a place to absolve financial sins and return to the marketplace cleansed of them.<sup>27</sup> It is also a way of clearing a clogged financial pipeline,<sup>28</sup> where over-indebted consumers cannot participate in the economy, over-indebted businesses cannot thrive or grow, and lenders with unrecognized losses on their balance sheets cannot effectively redeploy capital through further lending.

Our liberal corporate reorganization system allows businesses to continue operating despite over-indebtedness, rather than requiring immediate liquidation.<sup>29</sup> Establishing an operating business, all of its productive assets and all of the internal relationships within the firm that allow it to function, is an expensive and time consuming process, even when most of the principal assets all have two legs and can walk out the door at any time. By permitting going concern reorganizations, chapter 11 preserves jobs and investments and enhances creditor and, sometimes, shareholder recoveries every bit as much as railroad equity receiverships did at a time when the only alternative was tearing up the tracks and selling the steel, wood, and rolling stock for scrap. As the practice has developed, a sale of substantially all of a debtor's business under section 363<sup>30</sup> facilitates a transfer of a troubled operating business to a new owner without material interruption in operations. It has also effectively acted as a federal foreclosure procedure, substituting for separate proceedings in various state or federal courts where the debtor's assets are located, again, while allowing the business to continue operations. Thus, for many secured and unsecured creditors, bankruptcy is the solution, not the problem. It resolves financial distress that precedes bankruptcy, rather than causing financial distress.<sup>31</sup>

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<sup>27</sup> See Benjamin Iverson, *Get in Line: Chapter 11 Restructuring in Crowded Bankruptcy Courts*, Harvard U. Job Market Paper, Nov. 29, 2012, at 2 ("Bankruptcy, then, has an important impact on the allocation of capital in an economy, as it acts as a filter that separates distressed firms that are still economically viable from those whose assets should be redeployed via liquidation.").

<sup>28</sup> See Stuart Gilson, *Coming Through in a Crisis: How Chapter 11 and the Debt Restructuring Industry Are Helping to Revive the U.S. Economy*, 24 J. APPLIED CORP. FIN. 23, 23 (2012).

<sup>29</sup> See *id.* at 26 n.15 (comparing the U.S. bankruptcy regime, which favors reorganization and rehabilitation, to that of other jurisdictions, where liquidation is the essence of bankruptcy); Oscar Couwenberg & Stephen J. Lubben, *Solving Creditor Problems in the Twilight Zone: Superfluous Law and Inadequate Private Solutions*, INT'L REV. L. & ECON. 34, 2013, at 61, 61–76 (suggesting that a robust corporate reorganization regime may act as a helpful substitute for wrongful trading legislation, which may require liquidation upon insolvency).

<sup>30</sup> 11 U.S.C. § 363 (2012).

<sup>31</sup> Chapter 11 is not inexpensive, and reorganization expenses can indeed make a substantial dent in creditor recoveries. However, the alternative is likely far more costly, and research suggests that firms

On the consumer side, bankruptcy operates as a relief valve to allow failed consumers to re-enter the economy. With consumer spending contributing to upwards of 70% of economic activity in this country,<sup>32</sup> side-lining consumers who have incurred more debt than they can handle—in effect, fouling them out of the game of life—may do more harm to the economy than allowing them a way back in. A recent Wall Street Journal article, headlined “Lingering Bad Debts Stifle Europe Recovery,” reported that European consumers’ inability to be discharged from debts incurred during the economic and housing booms of the mid-2000’s is weighing heavily on European recovery and growth from the Great Recession.<sup>33</sup> I have spoken with consumers who move into the cash economy—they “go underground”—when they cannot get relief from debt, such as student loan debt. The result? They do not pay taxes; they do not work in jobs for which they are most qualified; the economy suffers. Numerous studies report how severe financial distress contributes to divorce, job loss and illness.<sup>34</sup>

Bankruptcy does not help just overburdened debtors. It provides substantial benefits to creditors as well, despite the complaints one hears so often from creditors about it. Though creditors complain of the losses they suffer in bankruptcy, the losses are more the result of the debtor’s financial failure before bankruptcy. It is neither the emergency room, nor, in the worst case, the mortuary, that causes the injuries in an auto accident. Bankruptcy provides creditors with an orderly collection process. Outside of bankruptcy, “the race is to the swift.”<sup>35</sup> Of course, that means that bankruptcy may require some creditors to slow down to permit an equal distribution. But without such a rule,

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experience significantly improved financial performance during the pendency of a chapter 11 case. See generally, Avner Kalay, et al., *Is Chapter 11 Costly?*, 84 J. FIN. ECON. 772, 773–75 (2007).

<sup>32</sup> Lisa S. Mataloni, *GDP and the Economy*, U.S. DEPT. OF COMMERCE, BUREAU OF ECON. ANALYSIS, 2 (March 2013), [http://www.bea.gov/scb/pdf/2013/03%20March/0313\\_gdpecon.pdf](http://www.bea.gov/scb/pdf/2013/03%20March/0313_gdpecon.pdf).

<sup>33</sup> Gabriele Steinhauser & Matthew Dalton, *Lingering Bad Debts Stifle Europe Recovery*, WALL ST. J., Jan. 31, 2013, at A1. *But see* Eamon Quinn, *Ireland Unveils New Debtor Regime to Ease Household Debt Crisis*, WALL ST. J. (Apr. 18, 2013), <http://online.wsj.com/article/BT-CO-20130418-710486.html>.

<sup>34</sup> See, generally, Amiram D. Vinokur, et al., *Hard Times and Hurtful Partners: How Financial Strain Affects Depression and Relationship Satisfaction of Unemployed Persons and Their Spouses*, 71 J. PERSONALITY & SOC. PSYCHOL. 166, 166–79 (1996) (linking financial difficulties and depressive symptoms in relationships); Bernard Poduska, *Money, Marriage, and Maslow’s Hierarchy of Needs*, 35 AM. BEHAV. SCIENTIST 756 (1992) (explaining the role of money in marriage); Rand D. Conger, et al., *Linking Economic Hardship to Marital Quality and Instability*, 52 J. MARRIAGE & FAM. 643, 653 (1990) (linking increased economic strain with increased hostility of husband towards their wives); *Debtors Wracked by Depression and Anxiety, Study Shows*, INDEPENDENT (Jan. 16, 2013) <http://gtdebtsolutions.ie/debtors-wracked-by-depression-and-anxiety-study-shows-irish-independent-16th-january-2013/> (In Ireland, about “[h]alf of all debtors experience mental health problems such as depression and anxiety.”).

<sup>35</sup> See *Clark v. Williard*, 294 U.S. 211, 212 (1935).

debtors' estates would be shredded. The automatic stay, after all, is as much to protect creditors as the debtor, as the courts have recognized.<sup>36</sup>

Bankruptcy helps creditors in another way. Creditors lend and investors invest based on their perception of, among other things, what the future holds, whether that be the borrower's success or otherwise. A clear, fair bankruptcy system promotes credit and investment, because it allows creditors and investors greater certainty about what happens if a borrower fails. That too helps the economy.<sup>37</sup>

Why am I telling you this? It is not just to make you feel good about your chosen field, though you should. The bankruptcy system and those who keep it running are helpful not only to the overall economy, but also to the individuals who have suffered financial reverses. Rather, I am telling you this because of the constant need to support, protect and improve the bankruptcy system.

As I said, bankruptcy is vastly unpopular. The bankruptcy law is subject at every turn to legislative and judicial attack to narrow its scope, to make it less available, to carve out exceptions to protect certain creditors groups, whether by exception to discharge or by special priorities.

Your responsibility, as those who will understand the operation and importance of the bankruptcy system and earn their living from the system, will be to give back to the system so that it can continue to provide relief to overburdened debtors and support for our credit-based economy.

What can you do? As you develop your careers, devote time, not just financial contributions, to some of the following activities:

- Join and become active in groups that promote and stand for sound bankruptcy laws, such as your local, state or national bar association and its bankruptcy committee or any of the several bankruptcy organizations, such as the American Bankruptcy Institute, Turnaround Management Association or National Association of Consumer

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<sup>36</sup> See *Hunt v. Bankers Trust Co.*, 799 F.2d 1060, 1069 (5th Cir. 1986); *Holtkamp v. Littlefield* (*In re Holtkamp*), 669 F.2d 505, 508 (7th Cir. 1982); *Fidelity Mortg. Investors v. Camelia Builders, Inc.* (*In re Fidelity Mortg. Investors*), 550 F.2d 47, 55 (2d Cir. 1977); *AP Indus., Inc. v. SN Phelps & Co.* (*In re AP Indus., Inc.*), 117 B.R. 789, 798 (Bankr. S.D.N.Y. 1990); see also H.R. REP. NO. 95-595, at 340 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6297 ("The automatic stay also provides creditor protection").

<sup>37</sup> See generally, *Edith H. Jones, Statement of Judge Edith H. Jones before the ABI Commission to Study the Reform of Chapter 11*, AM. BANKR. INST., Feb. 21, 2013 available at [http://commission.abi.org/sites/default/files/statements/21feb2013/REDRAFT\\_ABI\\_Commission\\_Study\\_Reform\\_Ch\\_11.pdf](http://commission.abi.org/sites/default/files/statements/21feb2013/REDRAFT_ABI_Commission_Study_Reform_Ch_11.pdf).

Bankruptcy Attorneys, just to name a few. The bankruptcy community, despite its growth, is still a close-knit community. Participating in these organizations allows you to interact in a non-adversarial setting with your every-day adversaries and to build the cooperation and trust needed for the system to function smoothly. It also enhances your profile in the community and allows you to join with others in promoting good bankruptcy policy.

- Participate in a pro bono program for consumer debtors. Nearly every judicial district has a program, and they are always looking for volunteers. The number of pro se debtors is increasing, so the need for legal help is growing. Many programs provide training, so even if you practice business bankruptcy law, you can help at a consumer bankruptcy clinic. A period of financial distress is a frightening time in a family's life. Providing professional guidance and a steady hand is important, even if you're a business lawyer, and it is appreciated more than you can imagine.
- Help educate the public, the press and legislators about the importance of the bankruptcy system and why we need an effective, not a punitive, one, and one that does not have insurmountable barriers to entry. Write articles about bankruptcy for the legal and non-legal press, such as industry trade publications and op-ed pieces for newspapers. Show how bankruptcy helped solve a problem for a client, which can highlight not only the system's value, but your value as well.

At least one of these activities should be more than just an occasional or incidental activity. They need to become a regular part of your professional career. I assure you that if you devote yourself to them, they will return more to you than you give, through recognition in the profession and the community, through new business development and, more importantly, through the satisfaction of having contributed something meaningful to the individuals whom you help and to the system that supports not only your career but also our credit-based economy.

On a personal note, I suspect that it is my continuing involvement in these activities, more than client engagements, that is being recognized tonight. If I'm right, it is more than gratifying to be recognized for doing the right thing and something that I have always enjoyed doing and that has value in its own right. So to those who selected me for this award, I extend my deepest gratitude.