

# Fresh Start, False Start, or Head Start?

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## INTRODUCTION

Bankruptcy is a judicial proceeding authorized by federal statute.<sup>1</sup> Its primary objectives are an equitable distribution of a debtor's assets and, in appropriate instances, the discharge of obligation. In well over ninety percent of all filings, the debtor is an individual who seeks bankruptcy in order to obtain debt relief.<sup>2</sup> In this Article, I examine the bankruptcy protection currently available to individuals—protection often referred to as the debtor's "fresh start." This fresh start has three primary components:<sup>3</sup> a discharge of obligation,<sup>4</sup> the protection of exempt assets,<sup>5</sup> and a prohibition of discrimination against those who resort to bankruptcy.<sup>6</sup> Before turning to the rules governing discharge of obligation, I look briefly at the history of bankruptcy legislation in the United States.

## I. HISTORY OF BANKRUPTCY OF INDIVIDUAL DEBTORS

For more than one hundred years, this country functioned without a permanent bankruptcy statute. During most of the nineteenth century, bankruptcy legislation was transitory. Each of three statutes, one in 1800, one in 1841, and another in 1867, followed a financial panic. Each soon expired by its own terms or was repealed with the return of less troubled times.<sup>7</sup> Then, in 1898,<sup>8</sup> Congress adopted legislation which continued in force with relatively few amendments until 1979; when it was replaced by the current statute. When the term "Bankruptcy Code" is used in this Article, it refers to the statute which was enacted in 1978 and became effective on October 1, 1979.<sup>9</sup>

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1. 11 U.S.C. §§ 101-1330 (1988 & Supp. V 1993).

2. DATA USER SERVS. DIV., U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1993 (113th ed.).

3. Other components that provide additional protection for the debtor exist. For example, the Bankruptcy Code includes the right to cure defaults and modify security agreements during bankruptcy, 11 U.S.C. § 1322(b)(2), (5) (1988), and provides for the regulation of utility service. *Id.* § 366 (1988).

4. *Id.* § 727(a) (1988).

5. *Id.* § 522 (1988 & Supp. V 1993).

6. *Id.* § 525 (1988).

7. CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 9, 19, 85, 122 (1935).

8. Bankruptcy (Nelson) Act of July 1, 1898, ch. 514, 30 Stat. 544, *repealed by* Bankruptcy Law Reform of 1978, Pub. L. No. 95-598, 92 Stat. 2349 (1979) (codified as amended at 11 U.S.C. §§ 101-1330).

9. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2349 (1979) (codified as amended at 11 U.S.C. §§ 101-1330).

The Bankruptcy Act of 1898 was the product of a prolonged legislative struggle between agrarian interests which wanted only voluntary (debtor-initiated) proceedings and banking interests which fought for a creditor-controlled involuntary system.<sup>10</sup> The eventual compromise included both voluntary and involuntary proceedings, a special rule for farmers,<sup>11</sup> and discharge provisions that, even as they exist today, are more generous to debtors than those of any other major industrialized nation. The pro-debtor aspects of the current statute are the product, to a great degree, of the political views of another era. Today, creditor interests are ascendant. If a bankruptcy statute were to be considered as an original proposition by the current Congress, the resulting legislation would likely be much less favorable to individual debtors.<sup>12</sup>

At first, American law authorized only liquidation bankruptcy. The assets (present in only a small number of cases) were sold by a trustee and the proceeds were distributed to creditors. Worthy debtors received a discharge; discharge protection was not purchased. In the original 1898 legislation, no significant connection existed between payments to creditors and eligibility for discharge. Deserving debtors received discharges, notwithstanding that there were no dividends for creditors.<sup>13</sup>

Eventually, another model of bankruptcy developed, one which featured non-liquidation alternatives, the reorganization of business entities, and the rehabilitation of natural persons.<sup>14</sup> For many years, rehabilitation was not a meaningful option for individuals;<sup>15</sup> today it is, but the price can be high. Rehabilitation requires payments to creditors over a period of time, with a bankruptcy discharge granted only at the end of the rehabilitation period.<sup>16</sup> In this type of bankruptcy, there is an important link between distributions to creditors and eligibility for discharge. After explaining how individuals obtain relief in liquidation bankruptcy, I will return to a discussion of proceedings that emphasize rehabilitation.

10. WARREN, *supra* note 7, at 134-43.

11. This concession is still in effect. Even today, farmers cannot be forced into bankruptcy through an involuntary petition. 11 U.S.C. § 303(a) (1988). For a critique of this rule see JAMES A. MACLACHLAN, *HANDBOOK OF THE LAW OF BANKRUPTCY* 28 (1956).

12. Since this lecture was presented, President Clinton signed House Bill 5116, The Bankruptcy Reform Act of 1994, which contains a number of provisions applicable to individual debtors. According to a memorandum prepared by the National Association of Consumer Bankruptcy Attorneys, eight of the changes are considered beneficial to individual debtors and eight are viewed as harmful to individual debtors. *Legislative Report re H.R. 5116* (National Ass'n of Consumer Bankruptcy Attorneys, MacLean, Va.), Oct. 14, 1994, at 1-2.

13. Douglass G. Boshkoff, *Limited, Conditional, and Suspended Discharges in Anglo-American Bankruptcy Proceedings*, 131 U. PA. L. REV. 69, 108-09 (1982).

14. A 1938 amendment authorized rehabilitation proceedings (arrangements) for individuals. 1 COLLIER ON BANKRUPTCY ¶ 0.07 (James W. Moore et al. eds., 14th ed. 1976).

15. For a variety of reasons, few debtors took advantage of these provisions. See REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, 93d Cong., 1st Sess., pt. 1, at 157-58 (1973) [hereinafter BANKRUPTCY COMMISSION REPORT]; MACLACHLAN, *supra* note 11, at 374-75.

16. 11 U.S.C. § 1328(a) (1988 & Supp. V 1993).

## II. LIQUIDATION BANKRUPTCY FOR INDIVIDUAL DEBTORS

Prior to and outside of bankruptcy, the debtor-creditor relationship is defined, for the most part, by state law. Debtors are protected against overly repressive collection tactics by exemption statutes which allow them to shelter specific assets—such as the family homestead—from the claims of creditors. Exemption statutes usually include value limitations to prevent abuse; however, these limitations are often low. For example, in Indiana only the first \$7500 of a debtor's equity in the family homestead is protected.<sup>17</sup> Thus, unless there is a very large mortgage on the property, creditors will eventually be able to force a sale of the family residence. Furthermore, once the equity in the property reaches \$7500, any subsequent increases in the value of this important asset benefits the creditors, not the debtor. Such increases occur, for example, when a part of the debtor's regular mortgage payment is applied to reduce the outstanding loan balance.

Liquidation bankruptcy usually provides better long-term protection against creditor collection activity than any state exemption statute. The discharge bars existing creditors from reaching all future assets—most importantly the debtor's post-bankruptcy earnings and the product of such earnings.<sup>18</sup> Exemption laws protect only designated assets.<sup>19</sup> Except in unusual circumstances, harassed debtors eventually decide to seek bankruptcy protection.

Debtors who opt for liquidation usually obtain immediate and permanent relief. The filing of a bankruptcy petition triggers an automatic stay—a statutory injunction prohibiting almost every type of collection activity.<sup>20</sup> Within a few months, the bankruptcy judge authorizes a discharge which permanently continues many of the restraints imposed by the automatic stay.<sup>21</sup>

Bankruptcy, however, does not provide lasting relief for every debtor and protection against all creditors. First, not every debtor receives a discharge. The statute directs the court to deny a discharge to an individual debtor in a variety of situations.<sup>22</sup> Debtor misconduct—typically some improper activity which is prejudicial to creditors holding present claims against the debtor—is an element of almost every case in which the discharge is withheld.<sup>23</sup> Note, however, that in liquidation bankruptcy, there is no link between eligibility for discharge and the amount which will be paid to creditors out of present assets or future earnings. While the existing system limits the situations in which a discharge can be granted, it in no way conditions the right to discharge on a certain level of payments to creditors.<sup>24</sup>

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17. IND. CODE § 34-2-28-1(a)(1) (1993).

18. 11 U.S.C. § 541(a)(6) (1988).

19. *See, e.g., id.* § 522(d)(1) (1988) (dealing with residence and burial plots).

20. *Id.* § 362(a) (1988).

21. *Id.* § 524(a)(2) (1988).

22. *Id.* § 727(a) (1988).

23. *Id.* § 727(a)(2)-(7).

24. *Id.* § 727(a); *see also* Boshkoff, *supra* note 13, at 104 (discussing the United States' rejection of discharge conditioned on payments to creditors).

One should also be aware that the bankruptcy discharge does not always provide complete relief from collection activity. Certain claims continue to be enforceable, notwithstanding the existence of a discharge, because they are especially meritorious<sup>25</sup> or are the result of debtor misconduct.<sup>26</sup> With one exception, which I will discuss shortly, none of these exclusions from discharge require consideration of what creditors have received or what a diligent debtor might be able to pay creditors in the future. Thus, while the current statute occasionally limits the effect of the discharge, it does not ordinarily condition the possibility of discharge on payments to creditors.

The treatment of educational obligations is the one exception to the framework presented above. Many educational debts do not become fully dischargeable until seven years after the date when the first repayment obligation accrues, unless repayment "will impose an undue hardship on the debtor and the debtor's dependents."<sup>27</sup> A debtor who is capable of paying creditors something out of future income has not demonstrated the existence of "undue hardship."<sup>28</sup>

The genesis of this exception to discharge is quite interesting. The most significant educational assistance program for students at institutions of higher education originated during Lyndon Johnson's final term as President.<sup>29</sup> The funds advanced were never loans as that term is conventionally understood. It is difficult to imagine any responsible lender advancing funds to a borrower who has no assets to serve as collateral and no steady income to support repayment. Calling these grants of public assistance "loans" was simply a way to make this program politically palatable. The term suggested no long-term claim on the fisc. Not surprisingly, default was soon common as some students did what many of us might do: following graduation, they filed for bankruptcy to protect future earning power.<sup>30</sup> As the default rate shot up in the early 1970's, legislators anxious for political cover and looking for a scapegoat found it in the shiftless scholars who too quickly sought bankruptcy protection.<sup>31</sup> The congressional reaction to this outrageous demonstration of moral laxity was the exception to discharge for educational debt.

According to a report issued by a bankruptcy study commission,

25. For example, the Bankruptcy Code recognizes the validity of claims based on the collection of taxes, 11 U.S.C. § 523(a)(1) (1988), marital obligations, *id.* § 523(a)(5) (1988), and educational loans, *id.* § 523(a)(8) (1988 & Supp. V 1993).

26. Such misconduct can include debt obtained through fraud, false representations, embezzlement, or larceny, *id.* § 523(a)(2), (4) (1988), debt incurred from a court-ordered judgment or consent decree in connection with the operation of a motor vehicle while legally intoxicated, *id.* § 523(a)(7) (1988), and debt arising from a fine paid to a governmental unit, *id.* § 523(a)(9) (Supp. V 1993).

27. *Id.* § 523(a)(8).

28. *See id.* § 1325(b) (1988).

29. Higher Education Act of 1965, Pub. L. No. 89-329, § 401, 79 Stat. 1230, 1245 (codified as amended at 20 U.S.C. §§ 1001-1146 (1988 & Supp. V 1993)).

30. S. REP. NO. 673, 89th Cong., 1st Sess. 35 (1965); H.R. REP. NO. 1178, 89th Cong., 1st Sess. 15 (1965); H.R. REP. NO. 621, 89th Cong., 1st Sess. 20 (1965). For a history of the student loan legislation and its problems see 3 COLLIER ON BANKRUPTCY ¶ 523.18 (Lawrence P. King et al. eds., 15th ed. 1994).

31. Educational loans were first excepted from discharge in 1976. 3 COLLIER, *supra* note 30, at 523-148 to 523-149.

[A] loan or other credit extended to finance higher education that enables a person to earn substantially greater income over his working life should not as a matter of policy be dischargeable before he has demonstrated that for any reason he is unable to earn sufficient income to maintain himself and his dependents and to repay the educational debt.<sup>32</sup>

The rationale for the unique status of educational obligations is unconvincing. If the benefit received, including an ability to flourish in the future, is a justification for nondischargeability, then other credit extensions, most notably for food and health care, merit similar treatment. But among voluntary creditors, only the educational lender (backed by the Federal Government) receives special treatment. Is it overly cynical to suggest that, as the Federal Government becomes more involved in providing medical services, the country may witness a similar development with regard to health care obligations?

In any event, the concept of "undue hardship" has been part of the educational loan dischargeability formula since 1976. The core ingredient of undue hardship is the lack of ability to repay all or part of the educational obligation out of future income. Thus, with regard to such debt, for the first time in this century, Congress has created a significant linkage between ability to pay and discharge. A wholesale shift to conditional discharge policy, a shift which may be in progress today, would create an entirely different bankruptcy process for individual debtors in the twenty-first century.

### III. REHABILITATION BANKRUPTCY FOR INDIVIDUAL DEBTORS

#### *A. The Development of the Modern Conditional Discharge Policy*

I now turn to an examination of rehabilitation bankruptcy for individual debtors. This type of bankruptcy first appeared in the 1930's but, prior to 1979, it was never very popular.<sup>33</sup> The reason for its lack of use is clear. In this type of bankruptcy, the debtor gained nothing, except personal satisfaction, from completing a court-approved repayment plan.<sup>34</sup> Conscientious debtors could achieve the same amount of satisfaction by commencing a liquidation proceeding and then making post-bankruptcy voluntary payments to creditors whose claims had already been discharged.

While considering new legislation in the late 1970's, Congress wanted to encourage greater use of rehabilitation plans, believing that this would increase dividends paid to creditors during bankruptcy.<sup>35</sup> Since a vast majority of liquidation bankruptcies are "no asset cases,"<sup>36</sup> any increase

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32. BANKRUPTCY COMMISSION REPORT, *supra* note 15, pt. 2, at 140.

33. MACLACHLAN, *supra* note 11, at 374-75.

34. *Id.*

35. H.R. REP. NO. 595, 95th Cong., 1st Sess. 118 (1977).

36. A "no asset" case is one in which no significant assets remain after the debtor's claim of exemptions. Many liquidation proceedings fall into this category. TERESA A. SULLIVAN ET AL., AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 230-34 (1989). For this

would be a significant improvement. Compulsory use of Chapter 13 was rejected as being impractical and, possibly, unconstitutional.<sup>37</sup> Accordingly, Congress decided to try a carrot rather than a stick approach and created incentives for use of rehabilitation bankruptcy. Prominent among the incentives that Congress chose to use to encourage debtors to resort to Chapter 13 proceedings were a far better discharge than the one available in Chapter 7 proceedings and, even more significantly, no restrictions on eligibility for this much improved discharge. Even the most devious miscreant could become eligible for the highly desirable Chapter 13 discharge. Debtors with all types of dischargeability problems were invited to try a Chapter 13 proceeding.<sup>38</sup>

What was the price for this generous treatment? Originally, Congress demanded relatively little. There was no minimum term for the Chapter 13 plan.<sup>39</sup> As for payment levels, the statute required only that the court-approved plan propose to pay unsecured creditors at least as much as they would have received if the debtor had resorted to Chapter 7.<sup>40</sup> This was not a demanding standard since most liquidations yielded nothing for general creditors. Soon there was a flood of debtors who proposed plans of short duration which paid nothing ("zero payment plans") on unsecured claims. Some courts, reading the statute literally, approved such plans.<sup>41</sup> Other courts, relying on a statutory requirement that the rehabilitation plan also be proposed in good faith, refused to approve those which did not provide meaningful payments to creditors.<sup>42</sup> Congress soon acted to resolve this split in authority, when, in 1984, it adopted legislation that required either a 100% payout to objecting unsecured claim holders (a highly unlikely occurrence) or a minimum plan term of three years during which all of the debtor's

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reason, one rule authorizes that a notice be given to creditors stipulating that there are no assets from which dividends can be paid. 11 U.S.C. app. BANKR. R. 2002(e) (Supp. V 1993). This provision has been recognized as a "welcome and practically beneficial change[]" in the rules. DANIEL R. COWANS, *BANKRUPTCY LAW AND PRACTICE* § 12.5(c), at 20 (6th ed. 1994).

37. The bankruptcy statute is subdivided into eight chapters. Three contain provisions of general applicability. The remainder authorize various types of bankruptcy proceedings. Chapter references provide an easy way to identify the type of proceeding. A Chapter 7 proceeding is a liquidation bankruptcy. A Chapter 13 bankruptcy is a rehabilitation proceeding for individual debtors.

38. The use of incentives is discussed in SULLIVAN ET AL., *supra* note 36, at 230-34.

39. There still is no explicit minimum term. In practice, however, the Bankruptcy Code establishes a three-year minimum term. If an unsecured claim holder objects (which it is almost certain to if less than full payment is proposed), the debtor must commit all of her "disposable income" to the plan for a minimum of three years. 11 U.S.C. § 1325(b).

40. *Id.* § 1325(a)(4) (1988).

41. *In re Chaffin*, 816 F.2d 1070 (5th Cir. 1987); *In re Porter*, 102 B.R. 773 (Bankr. 9th Cir. 1989); *In re Little*, 116 B.R. 615 (Bankr. S.D. Ohio 1990). For reference to more illustrative cases, see 2 KEITH M. LUNDIN, *CHAPTER 13 BANKRUPTCY* § 5.22, at 5-65 & n.229 (2d ed. 1994).

42. *In re Gier*, 986 F.2d 1326 (10th Cir. 1993); *In re Noreen*, 974 F.2d 75 (8th Cir. 1992); *In re Caldwell*, 895 F.2d 1123 (6th Cir. 1990). For reference to other cases see 2 LUNDIN, *supra* note 41, at 5-66 & n.230. For a discussion of the pre-1984 situation see 2 DAVID G. EPSTEIN ET AL., *BANKRUPTCY* § 9-14 (1992).

disposable income would be devoted to payments.<sup>43</sup> Disposable income was defined as income less reasonably necessary expenses.<sup>44</sup>

Although the statutory language is different, the hardship discharge rule for educational loans and the disposable income requirement for Chapter 13 plans have one thing in common: entitlement to bankruptcy relief is in some way related to financial condition. Income flow and expenditure patterns are evaluated.

As a result of these changes in discharge policy, bankruptcy judges now monitor and occasionally dictate lifestyles. With regard to educational loans, courts have carefully scrutinized career choices.<sup>45</sup> The courts presume that work is available and that a glutted employment market is only a temporary condition.<sup>46</sup> Further, courts expect students to maximize income by taking the highest paying job available, even if the debtor would prefer another, less lucrative, line of work.<sup>47</sup> Courts policing the disposable income requirement for Chapter 13 plans appear to be less interested in monitoring income<sup>48</sup> and more concerned with excessive expenditures.<sup>49</sup> Every budget item, no matter how personal, is subject to court scrutiny and possible disapproval.<sup>50</sup>

In the fairly short period between the initial student loan legislation and the imposition of the disposable income requirement, conditionality (a linkage between payment and debt relief) has become a significant aspect of a bankruptcy discharge system which had previously relied exclusively on rules of limitation. Naturally, pro-creditor interests are quite happy with this development. An active bankruptcy judge can be a very effective debt collector if she is so inclined. Throughout this century, creditors have been pressing for a more rigorous discharge policy and now, to some extent, they have succeeded. Popular support for debt relief has declined in recent years

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43. 11 U.S.C. § 1325(b)(1).

44. *Id.* § 1325(b)(2).

45. For example, in describing the undue hardship standard, one court stated:

The experience of life teaches us that, other than the privileged few, all encounter intervals in which they cannot do precisely what they desire because it simply does not pay enough money.

A resolute determination to work in one's field of dreams, no matter how little it pays, cannot be the fundamental standard from which "undue hardship" . . . is measured.

*In re Healey*, 161 B.R. 389, 395 (Bankr. E.D. Mich. 1993) (finding that a student with an education degree could earn nearly twice as much by working as a secretary).

46. A leading decision requires a showing that the debtor's financial misfortune is likely to continue for a significant time period. *Brunner v. New York State Higher Educ. Servs. Corp.*, 831 F.2d 395 (2d Cir. 1987); see also *In re Mathews v. Higher Educ. Assistance Found.*, 166 B.R. 940, 946 (Bankr. D. Kan. 1994) (finding that the debtor did not demonstrate "that she cannot and will not earn more income in the future").

47. *Healey*, 161 B.R. at 395-96.

48. The Code requires that the debtor's "projected disposable income" be dedicated to plan payments. 11 U.S.C. § 1325(b)(1)(B). For a discussion of the difficulty of looking into the future, see 2 LUNDIN, *supra* note 41, § 5.35.

49. It is easier for a judge to demand income maximization when determining dischargeability than when computing disposable income. The consequences of a wrong determination (on the high side) in a student loan situation are not immediately apparent. They become obvious only when collection activity occurs. The consequences are only temporary and the education loan eventually becomes dischargeable. Overestimating income in Chapter 13 cases, on the other hand, has obvious and immediate consequences: The plan fails.

50. See 2 LUNDIN, *supra* note 41, § 5.36.

and creditor complaints about the laxness of the debtor relief laws now receive more attention than they did fifteen years ago.

I have mixed feelings about these changes. The treatment of educational assistance grants seems misguided. These are not, in any sense of the word, "loans." Students are taking the heat for politicians who created a very costly entitlement program. Furthermore, as recent newspaper accounts show, the student loan program is poorly administered.<sup>51</sup> The fiscal burden of this maladministered program, especially as implemented by the policy of nondischargeable debt, is not fairly distributed. Many student borrowers come from low income families, enroll in marginal institutions, receive no education of value, and graduate under a staggering burden of educational debt.<sup>52</sup> The inability of student borrowers to obtain immediate bankruptcy relief makes it even more difficult for them to escape from poverty.

On the other hand, I see merit in the argument that some special effort should be expected from those debtors who wish to take advantage of the special features of Chapter 13, at least as long as resort to Chapter 13 is entirely voluntary. Regrettably, however, resort to this type of bankruptcy is now sometimes coerced. Included in the 1984 legislative package that introduced the disposable income requirement was another provision that authorized the bankruptcy court to dismiss a liquidation proceeding "filed by an individual debtor . . . whose debts are primarily consumer debts if it finds that the granting of relief would be a substantial abuse" of the bankruptcy statute.<sup>53</sup> The objective of this provision was to force some debtors into Chapter 13 by denying them access to Chapter 7; to encourage, if you will, a human receivership. To some extent, this creditor effort has been successful. American discharge policy provides a less generous fresh start to individual debtors than it did fifteen years ago.

It is not yet clear whether the shift to a conditional discharge policy will continue or become more pronounced in the years ahead. If the concepts of "undue hardship" and "disposable income" are precursors of discharge policy in the twenty-first century, tomorrow's individual debtors will need to work harder for bankruptcy relief within the confines of a much less hospitable insolvency system.

Those who applaud these developments should realize that a debt relief system which mandates consideration of present or future ability to repay creditors is highly interventionist and difficult to control. Judges with an inclination toward micromanagement of the debtor's affairs are invited, and, in some instances, required, to scrutinize every item in the debtor's budget. Since there is no national consensus on an appropriate standard of living, trial

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51. For a good account of the problems with this governmental assistance program, see Michael Winerip, *Billions for Education Lost in Fraud, Waste and Abuse*, N.Y. TIMES, Feb. 2, 1994, at A1; Michael Winerip, *In Managing Federal Money, Education Officials Fall Short*, N.Y. TIMES, Feb. 3, 1994, at A1; Michael Winerip, *Overhauling School Grants: Much Debate but Little Gain*, N.Y. TIMES, Feb. 4, 1994, at A1.

52. Michael Winerip, *Laws Mean Well, but Don't Sit Well*, N.Y. TIMES, Feb. 4, 1994, at A16.

53. 11 U.S.C. § 707(b) (1988).



court lifestyle decisions are ad hoc, and meaningful appellate review is often impossible.

Consider, for example, the status of tithing by Chapter 13 debtors, a matter of some current controversy.<sup>54</sup> Any proposal to tithe raises at least two questions. First, does the First Amendment either sanction unrestricted tithing (the Free Exercise Clause) or prohibit any tithing during bankruptcy (via the Establishment Clause)?<sup>55</sup> Second, is the proposed tithe reasonable in light of the statutory requirement that the debtor fund the plan with "disposable income" for a three-year period? A trial court ruling on the constitutional issue can easily be reviewed. A bankruptcy judge's decision that a certain level of tithing is appropriate or inappropriate (given the debtor's income and other obligations) is so fact sensitive, however, that deference to the action of the trial court is the only likely outcome of an appeal. For better or worse, a bankruptcy discharge system which utilizes rules of condition rather than rules of limitation relies almost exclusively on the trial judge's sense of fairness in implementing discharge policy. This is not necessarily bad or uncivilized—the English have been operating in this fashion for many years.<sup>56</sup> But it certainly is different from the bankruptcy discharge process that soon celebrates its one-hundredth birthday.

There is a second, and more disturbing, aspect of the current conditional discharge system. This type of bankruptcy process could, with one simple statutory change, be converted into an even more effective collection device. Congress has already restricted access to liquidation proceedings. Creditors need only to persuade Congress that access to this type of bankruptcy should be eliminated altogether. The individual debtor would then always face a Hobson's choice: submit to the indignities of traditional creditor collection activity or commence Chapter 13 proceedings and adopt whatever lifestyle is mandated by the bankruptcy judge.

It is, of course, by no means clear that further restrictions on access to liquidation bankruptcy will be imposed. Creditors, however, seem to have the upper hand in current debates over bankruptcy policy and such a change is not beyond all possibility. Insofar as discharge of debt is concerned, bankruptcy's fresh start policy has become somewhat stale in recent years.

There is one other aspect of discharge policy which I should mention. Discharged obligations have always been too easily revived. Suppose that, after bankruptcy, a debtor promises to pay a discharged obligation. Contract law does not require new consideration for a debtor's promise to pay a debt discharged in bankruptcy.<sup>57</sup> The act of making the promise is sufficient in

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54. See generally Leonard J. Long, *Religious Exercise As Credit Risk*, 10 BANKR. DEV. J. 119 (1993) (discussing the arguments for and against considering religious contributions as a necessary expense during Chapter 13 proceedings).

55. These constitutional issues can also arise in litigation involving 11 U.S.C. § 707(b) and § 523(a)(8). See *In re Lynn*, 168 B.R. 693 (Bankr. D. Ariz. 1994) (dealing with undue hardship); *In re Faulkner*, 165 B.R. 644 (Bankr. W.D. Mo. 1994) (dealing with substantial abuse).

56. Boshkoff, *supra* note 13, at 118-19.

57. RESTATEMENT (SECOND) OF CONTRACTS § 83 (1979).

itself. Reaffirmation promises are often hasty and ill conceived. The promisor, burdened with the guilt accompanying financial failure and intoxicated at the promise of a future free of debt, fails to understand the consequences of reaffirmation. Therefore, these reckless commitments rarely produce reasonably equivalent benefits for the promisor.<sup>58</sup> Indeed, one would have thought that state laws authorizing particularly easy enforcement of reaffirmation agreements would be in impermissible conflict with bankruptcy discharge policy.<sup>59</sup> A challenge to the common law of contracts rooted in the Supremacy Clause never materialized, however. Fortunately, Congress eventually recognized how seriously reaffirmations undercut the fresh start policy. When the Bankruptcy Code became effective, reaffirmation agreements were subjected to rigorous controls. Prominent among the statutory restrictions was a requirement that a bankruptcy judge approve most agreements, and the approval was granted only upon a finding that the agreement did not impose "an undue hardship on the debtor or a dependent of the debtor . . . and . . . [was] in the best interest of the debtor."<sup>60</sup> Bankruptcy judges rarely gave their approval.<sup>61</sup> Creditors targeted this requirement for change.<sup>62</sup>

The protective controls over reaffirmations were quickly emasculated. By 1984, creditors had convinced Congress that an affidavit from the debtor's attorney should be substituted for judicial scrutiny. Accordingly, the statute now requires that the debtor's counsel certify that the reaffirmation "(A) represents a fully informed and voluntary agreement by the debtor; and (B) does not impose an undue hardship on the debtor or a dependent of the debtor."<sup>63</sup> Secured creditors routinely demand a reaffirmation if the debtor wishes to retain collateral subject to a lien, and debtors, in turn, request affidavits from their attorneys.<sup>64</sup>

This amendment forces conscientious attorneys to oppose their clients' reaffirmation plans. As Grant Shipley, a Fort Wayne, Indiana, bankruptcy specialist, has observed:

The role of debtor's counsel as guardian of the discharge creates a certain tension in the attorney-client relationship. The consumer debtor in bankruptcy clings all the more fiercely to the material objects which convey the appearance of wealth—the home they can't afford, the fancy car whose monthly payments strain their budget, the \$700.00 vacuum cleaner, the multi-media home electronic audio-visual entertainment center with Virtual Reality laser-guided imaging system and 7.9 Richter Scale quadrophonic sound system.

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58. Reaffirmations of secured loans, however, can be advantageous to the debtor.

59. Douglass G. Boshkoff, *The Bankrupt's Moral Obligation to Pay His Discharged Debts: A Conflict Between Contract Theory and Bankruptcy Policy*, 47 IND. L.J. 36 (1971).

60. 11 U.S.C. § 524(c)(4)(A) (1984) (amended by 11 U.S.C. § 524(c)(6)(A) (1988)).

61. Jeffrey W. Morris & Joseph E. Ulrich, *Reaffirmation Under the Consumer Bankruptcy Amendments of 1984: A Loser for All Concerned*, 43 WASH. & LEE L. REV. 111, 114-15 (1986).

62. *Id.*

63. 11 U.S.C. § 524(c)(3) (1988). The original rule still applies to pro se debtors. See *id.* § 524(c)(6) (1988).

64. *Id.* § 1325(a)(5)(B)(i) (1988).

The debtor *wants* this stuff. Surrender of such collateral is bitter medicine, indeed. But the relationship between attorney and client is not the same as a relationship between physician and patient. The physician selects the remedy for the patient, but the attorney must let the client select a "remedy"—surrender of collateral . . . or reaffirmation, based on the attorney's analysis of the facts and the law. The attorney must, in effect, bargain with his own client, attempting to dissuade the client from foolishly reaffirming on debts.<sup>65</sup>

Not all attorneys are as diligent as Mr. Shipley. The 1984 amendments have seriously weakened debtor protection against unwise reaffirmation agreements.

I mention the new reaffirmation rule for two reasons. First, I think that the rule's creditor sponsors were extraordinarily clever. Instead of trying to eliminate the approval requirement, a difficult task, they opted for a change in the person whose approval was needed. They replaced the independent bankruptcy judge with an attorney decision-maker who often will find it difficult to oppose his client's wishes. As far as I can tell, the difference between the position of these two decision-makers was not widely understood when this legislation passed through Congress. What finesse!

Secondly, the creditors' ability to obtain this legislative change shows how much the balance of power had swung away from debtor interests by 1984, a mere six years after enactment of the Bankruptcy Code. The present reaffirmation procedure is just one of several recent pro-creditor changes in the law governing discharge.<sup>66</sup> In retrospect, October 1, 1979 (the date when the Bankruptcy Code became effective), was the zenith for debtor protection sentiments. The nadir is not yet in sight.

### *B. Protection of Exempt Property*

I now turn to the second component of the fresh start policy: the protection of exempt property. Here the news for debtors is a bit more encouraging.

Exemption laws exist independently of bankruptcy and protect specific assets from creditor collection activity.<sup>67</sup> The laws provide a different type of protection than the protection offered by discharge. If the bankruptcy

65. Grant F. Shipley, Reaffirmation Agreements, Paper presented to the Bankruptcy & Creditors' Rights Section, Indiana State Bar Ass'n 15-16 (Apr. 29, 1993) (emphasis in original) (copy on file with the *Indiana Law Journal*). Shipley further noted that it took him two months to talk his debtor clients out of a proposed reaffirmation on the above mentioned vacuum cleaner. *Id.* at 15 n.1.

66. Congress amended 11 U.S.C. § 523(a)(2) by adding subdivision (c) in 1984. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, sec. 307, § 523(a)(2), 98 Stat. 333, 353. The same legislation added § 523(a)(9) and narrowed the availability of relief under § 523(d). *Id.* at 353-54. Congress broadened the definition of nondischargeable obligations in § 523(a)(8) and extended the nondischargeable period from five to seven years. There were also changes in the Chapter 13 discharge rules. For example, 11 U.S.C. § 1328(a)(2) was amended to include debts nondischargeable under § 523(a)(9). See Crime Control Act of 1990, Pub. L. No. 101-647, sec. 3102, § 523(a)(9), 104 Stat. 4789, 4916. The same legislation added § 1328(a)(3). *Id.* sec. 3103, § 1328(a).

67. Assets that can be exempted under Indiana law fall under the following categories: fraternal and society benefits, homestead or residential property, insurance, partnership property, pension and retirement benefits, personal and nonresidential real property, tenancies by the entirety, unemployment compensation, and worker's compensation. See, e.g., 7 COLLIER ON BANKRUPTCY, *supra* note 30, at 207-08.

discharge were always available and if the discharge barred the enforcement of all existing obligations, a good argument could be made against recognition of any exemptions in bankruptcy. Such is not the case, however. As the discharge of debt is not always available, the bankruptcy statute honors non-bankruptcy exemptions.<sup>68</sup>

Even though entitlement to exemption is generally less important to debtors than discharge of obligation, a disagreement concerning exemption policy provoked one of the most heated debates preceding the adoption of the current statute. The Bankruptcy Act of 1898 had provided that the state law of the debtor's domicile would determine her entitlement to exemptions.<sup>69</sup> Many critics faulted this rule since it sanctioned a non-uniform exemption policy.<sup>70</sup> Debtors in more generous western and southwestern jurisdictions could retain more assets in a liquidation proceeding than those domiciled elsewhere.<sup>71</sup> As a corrective, these critics argued that federal law should provide an exclusive list of exemptions which would be available for all bankrupt debtors, thereby insuring nationwide conformity.<sup>72</sup> This proposal evoked two responses: (1) some felt that an exclusive federal list would be less generous than the exemptions available in the most debtor-oriented jurisdictions, and (2) some critics saw it as a federal intrusion into an area of law traditionally reserved to the states.<sup>73</sup>

Unable to reconcile these conflicting views, Congress eventually adopted a compromise: debtors were allowed to choose either traditional nonbankruptcy exemptions or those exemptions provided in the Bankruptcy Code.<sup>74</sup> This calmed the objections from jurisdictions with more generous exemption statutes. States' rights advocates were placated by another provision that allowed individual jurisdictions, via legislation, to veto the use of the federal bankruptcy exemptions.<sup>75</sup> Thirty-six jurisdictions have now exercised this right to opt out of the federal exemption list,<sup>76</sup> and as a result, the Bankruptcy Code has almost completely reverted to the former pattern of non-uniform exemptions.

The legislative ballet described above was not a complete waste of time. Exemptions with value limitations become outmoded due to the effects of inflation over a period of time. As the states exercised their right of veto,

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68. 11 U.S.C. § 522(b).

69. Bankruptcy (Nelson) Act of July 1, 1898, ch. 514, § 6, 30 Stat. 544, *repealed by* Bankruptcy Law Reform of 1978, Pub. L. No. 95-598, 92 Stat. 2349 (codified as amended at 11 U.S.C. §§ 101-1330).

70. BANKRUPTCY COMMISSION REPORT, *supra* note 15, pt. 1, at 170-71.

71. *Id.*

72. *Id.* The original statute recommended by the Bankruptcy Commission provided that exemptions would be authorized exclusively by federal law. *See id.* pt. 2, at 125-30.

73. *The Bankruptcy Reform Act: Hearings Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 94th Cong., 1st Sess. 28-41 (1975) (statement of Charles Seligson).

74. 11 U.S.C. § 522(b)(2)(A) (1988).

75. *Id.* § 522(b)(1) (1988).

76. HENRY J. SOMMER & GARY KLEIN, *CONSUMER BANKRUPTCY LAW AND PRACTICE* § 10.2.1 n.15 (4th ed. 1992).

some also reexamined their existing exemptions, raised value limitations, and created new exemptions.<sup>77</sup> The passage of new federal bankruptcy legislation thus encouraged states to modernize their exemption laws, all to the benefit of debtors who may never be the subject of bankruptcy proceedings.

The Bankruptcy Code made a second change in exemption policy, one which promises to have a more lasting nationwide effect. Under the 1898 Bankruptcy Act, each state enjoyed the right to mold its exemption law as it chose. Exemptions were not required to be 100% effective. A state, for example, might establish a set of exemptions and then allow the debtor to execute a contractual waiver of exemption in favor of a specific creditor. This waiver would be enforced in bankruptcy proceedings and the debtor would lose the protection of the exemption statute.<sup>78</sup> Despite some criticism,<sup>79</sup> this rule continued until 1979. The new statute invalidates waivers<sup>80</sup> and permits avoidance of other devices which impair a debtor's right to exempt property.<sup>81</sup> States remain free to establish exemption levels, but once an exemption is created, the bankruptcy statute sharply restricts the state's ability to selectively withdraw exemption protection.<sup>82</sup>

Until recently, the debtor-creditor relationship was almost entirely a construct of state law. Now, however, federal law plays a central role in the debtor-creditor relationship. For example, the Due Process Clause limits the ex parte issuance of creditors' writs,<sup>83</sup> and collection activity must conform to requirements found in the Fair Debt Collection Practices Act.<sup>84</sup> Other aspects of debt-related activity are also controlled by federal law.<sup>85</sup> The Bankruptcy Code's aggressive concern with exemption policy is, therefore, quite consistent with the federalization of the debtor-creditor relationship occurring outside the context of bankruptcy. Indeed, it is somewhat surprising that a comprehensive federal solution has not yet been adopted for the most intractable problem of exemption law—the legitimacy of exempt asset acquisition on the eve of bankruptcy.

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77. Indiana's code is illustrative of changes in exemption statutes. Indiana opted out of the federal bankruptcy exemption statute, yet still decided to increase its own exemption value limitations. In 1976, the Indiana real estate exemption statute covered "real estate, constituting the personal or family residence of the debtor, or estates or rights therein or thereto of the value of not more than five thousand dollars (\$5,000)." Act of Apr. 12, 1977, Pub. L. No. 329, 1977 Ind. Acts 1503-04. The real estate exemption statute was amended in 1980, after Indiana opted out, to read, "real estate or personal property constituting the personal or family residence of the debtor or of a dependent of the debtor, or estates or rights therein or thereto of the value of not more than seven thousand five hundred dollars (\$7,500)." Act of Mar. 3, 1980, Pub. L. No. 196, 1980 Ind. Acts 1625-26 (codified at IND. CODE § 34-2-28-1(a)(1)).

78. *Lockwood v. Exchange Bank*, 190 U.S. 294 (1903).

79. MACLACHLAN, *supra* note 11, at 164-66.

80. 11 U.S.C. § 522(e) (1988).

81. *Id.* § 522(f) (1988).

82. *See id.* § 522(e)-(f).

83. *Sniadach v. Family Fin. Corp.*, 395 U.S. 337 (1969).

84. 15 U.S.C. §§ 1692-1692o (1988).

85. For example, Chapter 41 of Title 15 governs Consumer Credit Protection. *Id.* §§ 1601-1667e (Consumer Credit Cost Disclosure); §§ 1671-1677 (Restrictions on Garnishments); §§ 1681-1681f (Credit Reporting Agencies); § 1691-1691f (Equal Credit Opportunity).

Every state, by statute or judicial decision, prohibits asset transfers which interfere with creditor collection rights (known as fraudulent conveyances). Whenever a debtor takes advantage of an exemption statute, she exchanges an asset subject to creditor process (quite often money) for an asset not subject to creditor process. The usual term for such activity when it occurs shortly before bankruptcy is "exemption planning," a benign label for a most controversial practice.<sup>86</sup> The exchange of nonexempt assets for exempt property clearly interferes with creditor collection rights. There is a direct conflict between laws prohibiting fraudulent transfers and statutes authorizing exemptions. Unfortunately, state legislators have not harmonized these two conflicting bodies of law. The result is a chaotic body of judicial decisions, a corpus of case law which emphasizes the subjective good faith of the debtor as a prerequisite for exemption acquisition on the eve of bankruptcy.<sup>87</sup> And like beauty, "good faith" is often in the eye of the beholder.

In one notorious pair of cases, decided on the same day by the same panel of judges, the Eighth Circuit affirmed two lower court decisions, one approving<sup>88</sup> and one condemning<sup>89</sup> the purchase of exempt assets on the eve of bankruptcy. Judge Richard Arnold, in concurrence, thought that the facts of these two cases were indistinguishable:

The Court attempts to reconcile the results in the two cases by characterizing the question presented as one of fact—whether the conversion was undertaken with fraudulent intent, or with an intent to delay or hinder creditors. In *Tveten*, the Bankruptcy Court found fraudulent intent, whereas in *Hanson* it did not. Neither finding is clearly erroneous, the Court says, so both judgments are affirmed. This analysis collapses upon examination. For in *Tveten* the major indicium of fraudulent intent relied on by the Bankruptcy Court was Dr. Tveten's avowed purpose to place the assets in question out of the reach of his creditors, a purpose that, as a matter of law, cannot amount to fraudulent intent, as the Court's opinion in *Hanson* explicitly states. The result, in practice, appears to be this: a debtor will be allowed to convert property into exempt form, or not, depending on findings of fact made in the court of first instance, the Bankruptcy Court, and these findings will turn on whether the Bankruptcy Court regards the amount of money involved as too much. With all deference, that is not a rule of law. It is simply a license to make distinctions among debtors based on subjective considerations that will vary more widely than the length of the chancellor's foot.<sup>90</sup>

The consequences of improper exempt asset acquisition are significant and include the following: loss of exemption, likely loss of discharge because of fraudulent conduct, and possible criminal liability.<sup>91</sup>

86. See, e.g., SOMMER & KLEIN, *supra* note 76, § 10.4.1.

87. As one commentator has observed, "the doctrine is soft and the issue in every case is very fact-intensive." 2 EPSTEIN ET AL., *supra* note 42, § 8-32, at 574.

88. *Hanson v. First Nat'l Bank*, 848 F.2d 866 (8th Cir. 1988).

89. *Norwest Bank Neb., N.A. v. Tveten*, 848 F.2d 871 (8th Cir. 1988).

90. *Hanson*, 848 F.2d at 870-71 (Arnold, J., concurring) (citations omitted).

91. Section 312 of the Bankruptcy Reform Act of 1994 creates a new crime entitled "Bankruptcy Fraud." This crime appears to include the filing of a bankruptcy petition after improper exemption planning.

The bankruptcy statute could easily be revised to provide a rule which would eliminate the uncertainty in this area. There are two possibilities. First, the statute could allow the debtor to claim only a federal exemption. That exemption would be a fixed dollar amount, perhaps \$50,000, which could be claimed in any asset or combination of assets. There would then no longer be any need for the debtor to manipulate asset ownership on the eve of bankruptcy.

This solution is simple, effective, and politically unrealistic. Remember that Congress refused to go along with a proposal for exclusive federal exemptions when the current bankruptcy statute was adopted.<sup>92</sup> I doubt that sentiments have changed a great deal in the last fifteen years, at least with regard to this matter.

A second possibility would be to establish a pre-bankruptcy period of vulnerability for exempt asset acquisition. Transactions occurring before a certain date, perhaps ninety days before the petition, could never be challenged as fraudulent. Assets acquired within ninety days of bankruptcy could never be exempted.

The alternative solution holds more promise. It builds upon a concept which is firmly established in the bankruptcy law: certain transfers (such as preferential payments to creditors on the eve of bankruptcy) can be set aside because they interfere with the administration of the bankruptcy estate.<sup>93</sup> The same could be said of exemption claims in assets acquired immediately before bankruptcy. Legislation along these lines is not likely, however, until more members of the bankruptcy community become convinced that the problem of exemption planning needs a more predictable solution. Now that unsuccessful exemption planning constitutes a crime, interest in a bright-line rule, a pre-bankruptcy period of vulnerability, should become much more intense.

### *C. Bankruptcy-Based Discrimination*

The third, and for me the most interesting, component of the fresh start policy is the rule prohibiting bankruptcy-based discrimination.<sup>94</sup> While there are some gaps in this protection, bankruptcy law currently prohibits a number of acts which, if permitted, could seriously undercut the debtor's fresh start. For example, employees may not be fired solely because they commence bankruptcy proceedings.<sup>95</sup> Likewise, the occurrence of bankruptcy cannot be used by a state to withhold or revoke an occupational license or a motor vehicle registration.<sup>96</sup> While suppliers of goods and services need not extend credit to bankrupt debtors, some courts have held that they may not refuse to

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92. See *supra* notes 69-74 and accompanying text.

93. 11 U.S.C. § 547(b) (1988).

94. See Douglass G. Boshkoff, *Bankruptcy-Based Discrimination*, 66 AM. BANKR. L.J. 387 (1992).

95. 11 U.S.C. § 525(b); Boshkoff, *supra* note 94, at 393-99.

96. 11 U.S.C. § 525(a); Boshkoff, *supra* note 94, at 409-13.

deal with bankrupt debtors on a c.o.d. basis.<sup>97</sup> As far as I can discover, no other nation offers similar protection against the collateral consequences of financial failure.

The foundation for this protective doctrine was established by the U.S. Supreme Court in 1934. In *Local Loan Co. v. Hunt*,<sup>98</sup> the debtor had executed an assignment of present and future wages for a loan of \$300. Under Illinois law, a wage assignment created a lien on future wages, notwithstanding the fact that the debt secured was discharged in bankruptcy. The Supreme Court prohibited post-bankruptcy enforcement of the assignment. Speaking for a unanimous Court, Justice Sutherland offered these observations on the paramount importance of rehabilitation through discharge:

When a person assigns future wages, he, in effect, pledges his future earning power. The power of the individual to earn a living for himself and those dependent upon him is in the nature of a personal liberty quite as much as, if not more than, it is a property right. To preserve its free exercise is of the utmost importance, not only because it is a fundamental private necessity, but because it is a matter of great public concern. From the viewpoint of the wage earner there is little difference between not earning at all and earning wholly for a creditor. Pauperism may be the necessary result of either. The amount of the indebtedness, or the proportion of wages assigned, may here be small, but the principle, once established, will equally apply where both are very great. The new opportunity in life and the clear field for future effort, which it is the purpose of the bankruptcy act to afford the emancipated debtor, would be of little value to the wage earner if he were obliged to face the necessity of devoting the whole or a considerable portion of his earnings for an indefinite time in the future to the payment of indebtedness incurred prior to his bankruptcy. Confining our determination to the case in hand, and leaving prospective liens upon other forms of acquisitions to be dealt with as they may arise, we reject the Illinois decisions as to the effect of an assignment of wages earned after bankruptcy as being destructive of the purpose and spirit of the bankruptcy act.<sup>99</sup>

*Local Loan* was a bold, progressive decision. The Supreme Court was, however, slow to follow and expand upon Justice Sutherland's reasoning. For example, seven years later in *Reitz v. Mealey*,<sup>100</sup> the Court upheld the validity of a New York statute which authorized the suspension of a driver's license for failure to pay a claim for injuries caused by the negligent operation of a motor vehicle, even though the liability had been discharged in bankruptcy.<sup>101</sup> According to Justice Roberts,

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97. See, e.g., *Elsinore Shore Assocs. v. New Jersey Div. of Alcohol Control*, 66 B.R. 708 (Bankr. D.N.J. 1986) (invoking *Perez v. Campbell*, 402 U.S. 637 (1971), and § 525 to invalidate a state regulation denying liquor wholesalers the option of extending credit to financially strapped retailers); *In re Jacobsmeier*, 13 B.R. 298 (Bankr. W.D. Mo. 1981) (invalidating a state regulation that prohibited any sales—cash or credit—to a retailer who had failed to pay for earlier purchases and ordering the resumption of deliveries to the debtor on a c.o.d. basis); see also Boshkoff, *supra* note 94, at 402.

98. 292 U.S. 234 (1934).

99. *Id.* at 245.

100. 314 U.S. 33 (1941), *overruled by Perez*, 402 U.S. 637.

101. *Id.* at 35.



The penalty which § 94-b imposes for injury due to careless driving is not for the protection of the creditor merely, but to enforce a public policy that irresponsible drivers shall not, with impunity, be allowed to injure their fellows. The scheme of the legislation would be frustrated if the reckless driver were permitted to escape its provisions by the simple expedient of voluntary bankruptcy, and, accordingly, the legislature declared that a discharge in bankruptcy should not interfere with the operation of the statute. Such legislation is not in derogation of the Bankruptcy Act. Rather it is an enforcement of permissible state policy touching highway safety.<sup>102</sup>

The majority opinion did not discuss, or even cite, any Supreme Court authority. Justice Douglas, in dissent, argued vigorously that the New York law violated the principle established in *Local Loan*:

Under the New York scheme a creditor whose claim has been discharged still holds a club over his debtor's head. The state has given him a remedy which survives bankruptcy. If the bankrupt refuses to pay his discharged debt, the creditor will see to it that his driver's license is suspended. If, however, the bankrupt will pay up, the creditor will refrain.

....

In practical effect the bankrupt may be in as bad, or even worse, a position than if the state had made it possible for a creditor to attach his future wages. Such a device would clearly contravene the Bankruptcy Act. The present one likewise runs afoul of the Act.<sup>103</sup>

I began teaching a bankruptcy course at Indiana University in 1962. That same year, in *Kesler v. Department of Public Safety*,<sup>104</sup> the Supreme Court upheld the validity of a Utah statute which permitted the creditor additional control over the debtor's right to drive.<sup>105</sup> The creditor, for example, might consent to the restoration of the right to drive if the debtor promised to pay the discharged debt in installments. The suspension could be reinstated if the debtor later defaulted. Once again, an attempt to protect the value of the discharge was rejected. As the Court stated:

The Safety Responsibility Act is not an Act for the Relief of Mulcted Creditors. It is not directed to bankrupts as such. Though in a particular case a discharged bankrupt who wants to have his rightfully suspended license and registration restored may have to pay the amount of a discharged debt, or part of it, the bearing of the statute on the purposes served by bankruptcy legislation is essentially tangential.<sup>106</sup>

Even a novice teacher could tell that these two cases were incorrectly decided and that *Local Loan* was being ignored. I once criticized both decisions in class, but I never expected that they would be overturned. You can imagine my surprise when, nine years later in *Perez v. Campbell*,<sup>107</sup> the Supreme Court did an abrupt about-face, acknowledged the wisdom of its

102. *Id.* at 37.

103. *Id.* at 41 (citing *Local Loan*, 292 U.S. 234).

104. 369 U.S. 153 (1962), *overruled by Perez*, 402 U.S. 637.

105. *Id.* at 154-55.

106. *Id.* at 174.

107. 402 U.S. 637 (1971).

opinion in *Local Loan*, overruled its two prior decisions, and invalidated the Arizona Financial Responsibility Act. Justice White, writing for the majority, announced a broad rule which protects debtors from harmful activity by the state even though debt collection is not the object of the challenged act.

We can no longer adhere to the aberrational doctrine of *Kesler* and *Reitz* that state law may frustrate the operation of federal law as long as the state legislature in passing its law had some purpose in mind other than one of frustration. Apart from the fact that it is at odds with the approach taken in nearly all our Supremacy Clause cases, such a doctrine would enable state legislatures to nullify nearly all unwanted federal legislation by simply publishing a legislative committee report articulating some state interest or policy—other than frustration of the federal objective—that would be tangentially furthered by the proposed state law. . . . Thus, we conclude that *Kesler* and *Reitz* can have no authoritative effect to the extent they are inconsistent with the controlling principle that any state legislation which frustrates the full effectiveness of federal law is rendered invalid by the Supremacy Clause.<sup>108</sup>

Remember that *Local Loan* involved a creditor who attempted to enforce a wage assignment. The conflict in that case between state law and discharge policy was direct and obvious. *Perez* went much further than *Local Loan* because it condemned activity which undercut the rehabilitative effect of bankruptcy even though the challenged act was not an attempt by a creditor to collect a debt. Within a few years, courts began to extend *Perez* to employment relationships. Municipal units, for example, were prevented from enforcing rules that called for termination of employment if the employee filed for bankruptcy.<sup>109</sup>

Congress was considering bankruptcy law reform when *Perez* was decided. Justice White's strong statement of principle provided the inspiration for § 525 of the Bankruptcy Code.<sup>110</sup> This section prohibits a variety of discriminatory acts by public and private entities. Employers, licensing agencies, buyers and sellers of goods and services, and others are prohibited from taking action which is inconsistent with the rehabilitative goal of bankruptcy. The development of rules prohibiting bankruptcy-based discrimination has not proceeded without incident, however. A recurring question is whether the prohibitions contained in § 525 are exclusive. For example, § 525(b) prohibits employment discrimination by private entities.<sup>111</sup> What are we to say about an entity which, because of bankruptcy, terminates its relationship with an independent contractor? The cases are split.<sup>112</sup> The

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108. *Id.* at 651-52.

109. *Rutledge v. City of Shreveport*, 387 F. Supp. 1277 (W.D. La. 1975); *In re Loftin*, 327 So. 2d 543 (La. Ct. App. 1976).

110. 11 U.S.C. § 525(a) was originally enacted as § 525 in 1978. Section 525(b) was added in 1984. See 11 U.S.C. § 525(a)-(b).

111. *Id.* § 525(b).

112. See *McNeely v. Hutchinson Fin. Corp. (In re McNeely)*, 82 B.R. 628 (Bankr. S.D. Ga. 1987) (stating that § 525(b) would apply to independent contractors); *Madison Madison Int'l (In re Madison Madison Int'l)*, 77 B.R. 678 (Bankr. E.D. Wis. 1987) (refusing to apply § 525(b) to an independent contractor).

better view is that the termination is illegal and that the explicit statutory prohibitions do not fix the outer limits of protection.<sup>113</sup> I hope that this view ultimately will prevail.

Even with its current gaps in coverage, the United States' prohibition of bankruptcy-based discrimination is unique. Many nations discharge debt and reorganize corporations. No other country, however, has had the wisdom to prohibit activity by entities other than creditors when such activity stands as a barrier to the fullest possible implementation of bankruptcy policy.<sup>114</sup>

### CONCLUSION

What will the future bring? Justice Harlan coined the term "head start" in describing a result which he thought was too favorable to individual debtors.<sup>115</sup> I expect we will hear more talk about bankruptcy's "head start" in the years ahead, particularly during congressional debates.

Bankruptcy's tripartite protection for individual debtors developed slowly over most of this century. In retrospect, we can see that 1979 marked the end of a period in which pro-debtor sentiments often influenced legislation. The Bankruptcy Code made many changes in the law applicable to individuals, including, as I have discussed, the change in discharge rules to create a debtor preference for Chapter 13 rehabilitation. Some of the changes were controversial, and the move to modify or repeal them, led by the consumer credit industry, began almost immediately.

Debtors, at first, had strong allies in this legislative struggle including influential members of Congress and, most importantly, labor unions.<sup>116</sup> The latter were particularly effective in blocking unfavorable proposals. The result was a legislative deadlock lasting for several years. Then, on February 22, 1984, the U. S. Supreme Court announced its decision in *NLRB v. Bildisco & Bildisco*.<sup>117</sup> The Court decided that debtors involved in Chapter 11 proceedings could unilaterally abrogate their collective bargaining agreements without committing an unfair labor practice.<sup>118</sup> This decision provoked a firestorm

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113. See generally Boshkoff, *supra* note 94, at 393-97 (discussing employment discrimination in both the independent contractor and employee contexts).

114. I happen to have a personal interest in the *Perez* decision. One of the students in my third bankruptcy class at Indiana University, Professor Winton Woods, Class of 1965, who now teaches at the University of Arizona Law School, served as co-counsel for the debtor, Adolfo Perez, during the trial and subsequent appeals. Remembering my criticism in class of both *Reitz* and *Kesler*, he called for advice immediately after the adverse ruling by the trial court. I remember advising him, in no uncertain terms, to drop the case. I was sure that an appeal was a waste of time. I never imagined that the Supreme Court would even agree to hear the case. Of course, I was wrong, very wrong as it turned out. And I have always been pleased that Professor Woods had the good sense not to pay the slightest bit of attention to my advice.

115. *Lines v. Frederick*, 400 U.S. 18, 21 (1970).

116. See Ronald Brownstein, *Going Bankrupt—Is It Just a Way To Get Out of Labor Contracts?*, NAT. L.J., Nov. 12, 1983, at 2353; Lawrence P. King, *The Plague of Special Interest Groups*, N.Y. TIMES, Mar. 4, 1984, § 3, at 2.

117. 465 U.S. 513 (1984).

118. *Id.* at 553-54.

of criticism.<sup>119</sup> Legislation overruling *Bildisco* was introduced in Congress,<sup>120</sup> and soon political alliances began to change. Union sponsors of this legislation discovered that they would be unable to pass it without the support of the consumer credit lobby. The consumer credit lobby and labor unions joined forces<sup>121</sup> and individual debtors paid a price for this collaboration. The resulting legislation both overruled *Bildisco* and made a number of significant pro-creditor changes in the law governing individual bankruptcies, including the elimination of the requirement for bankruptcy judge approval of reaffirmation agreements, imposition of a disposable income requirement for Chapter 13 plans, and addition of the "substantial abuse" ground for dismissal of liquidation proceedings.

Today, there are other groups sympathetic to debtor concerns such as the National Consumer Law Center in Boston, the recently organized National Association of Consumer Bankruptcy Attorneys, and the National Bankruptcy Conference.<sup>122</sup> None of these groups, however, appears to have enough legislative strength to resist pro-creditor pressures. Therefore, more retrenchment in debtor protection can be expected in the next few years. Like it or not, the debtor's fresh start will surely be somewhat less generous when, in 1998, the United States celebrates the one hundredth birthday of its first permanent bankruptcy statute.

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119. See, e.g., Donald H.J. Hermann & David M. Neff, *Rush to Judgment: Congressional Response to Judicial Rejection of Collective Bargaining Agreements Under Chapter 11 of the Bankruptcy Code*, 27 ARIZ. L. REV. 617, 623 (1985).

120. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, sec. 307, § 523(a)(2), 98 Stat. 333, 353.

121. *Bankruptcy is not a Weapon*, N.Y. TIMES, May 22, 1984, at A26.

122. See *United States Trustee Program in Bankruptcy: Hearing Before the Subcomm. on Economic and Commercial Law of the Comm. on the Judiciary*, 102d Cong., 2d Sess. 158-59 (1992) (explaining the activities of the National Bankruptcy Conference); SOMMER & KLEIN, *supra* note 76, at 2 (discussing the activities of the National Law Center); *National Association of Consumer Bankruptcy Attorneys*, NACBA PROTECTING THE LEGAL RIGHTS OF DEBTORS (n.d.).