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Special Topic Bankruptcy

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*Robert K. Rassmusen**

INTRODUCTION

This issue of the VANDERBILT LAW REVIEW contains two outstanding student pieces on bankruptcy law. Few would be surprised by this observation. As to the quality of the works, they fall in with a long tradition of outstanding student scholarship published by the REVIEW. The choice of topic—bankruptcy law—also does not raise eyebrows. After all, Congress has recently enacted the most sweeping changes to the Bankruptcy Code since its original enactment in 1978. This legislation was the culmination of a more than decade-long effort to revise our nation's bankruptcy law. Any major reform effort of this scope surely generates puzzles for students to solve. One would expect that the coming years will see a steady flow of student work grappling with the changes wrought by the new legislation. Constitutional issues and interpretative problems have already hit the courts, and ambitious students looking for challenging legal issues on which to hone their analytical skills will find much in the new law to keep them busy.

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The surprising feature of the two Notes in this issue, however, is that they have nothing whatsoever to do with the recent legislation. To be sure, it is not because they are unimportant matters. The application of principles of judicial estoppel in bankruptcy proceedings has caused much consternation in the courts, as Rob Dugas ably catalogs. The appropriate rate of interest on a "cram down" in Chapter 13, the topic of Matthew O'Brien's contribution, is an issue that confronts bankruptcy courts every day.

Despite the fact that neither Note wrestles with the new legislation, each casts light on the legislative process in its own way. When Congress revisits an area of law, what is left undisturbed is as much a way of evaluating Congress's performance as is looking at what was changed. Ideally, when a legislature steps into an area it limits its reach only to those areas where Congress has an institutional advantage. For example, much has ink has been spilled on whether debtors should have to buy their discharge of past debts with income earned after they file for bankruptcy. The debate here is fierce, and Congress, as opposed to the courts, is the institution that should strike the balance. Similarly, the use of various financial products has become widespread since the original enactment of the Code, and the new legislation allowed Congress to put in place rules that set forth how these products are to be treated in bankruptcy.[1] At the same time, if there is no desire to shift course or provide guidance if the courts are not in disarray, Congress should stay its hand. Legislation is a scarce good. There is an optimal division between issues that should be left for judicial consideration and issues that should be resolved at the legislative level.

The record presented by these two Notes is decidedly mixed. Consider first in this regard Rob Dugas's Note exploring the application of judicial estoppel in bankruptcy proceedings. Judicial estoppel is a doctrine that originated outside of bankruptcy law. It prohibits a party who makes an assertion in one proceeding from making a contrary assertion in another. Courts, however, have struggled to translate this doctrine into the bankruptcy forum. The judicial estoppel issue arises when a debtor files for bankruptcy and fails to disclose as an asset a lawsuit in which it is the plaintiff. After the case is closed, the debtor seeks to prosecute that lawsuit. The defendant then attempts to invoke judicial estoppel so as to dismiss

1. That Congress enacted special rules here does not necessarily mean that it made the correct policy choice. *See generally* Edward R. Morrison & Franklin R. Edwards, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 Yale J. Reg. 91 (2005) (questioning the economic wisdom behind provisions designed to protect the derivatives markets).

the suit. The defendant points out that not listing the lawsuit as an asset in the bankruptcy proceeding is in effect an assertion that the lawsuit has no value, and the defendant wants to estop the plaintiff from now asserting otherwise. Courts have struggled in solving this problem. Dugas articulates the concerns that created the judicial estoppel doctrine and carefully applies this doctrine to the bankruptcy setting in a way that ensures that the omissions of the debtor are not used so as to deprive creditors of the recovery to which they are entitled.

Dugas's analysis is careful in that it attends to the differences between individual and corporate debtors as well as the Chapter under which the debtor has filed. To be sure, one could quickly craft legislation that captures Dugas's solution. Yet few would fault Congress for not doing so. The doctrine of judicial estoppel is a creature of the court. It is designed to protect the integrity of the courts. While the judicial development to date has been uneven, courts are institutionally capable of defining its appropriate scope. Moreover, the facts that give rise to judicial estoppel occur relatively infrequently. Hence, there is little to suggest that, even if Congress could craft an improvement on the current state of affairs, this would be time well spent.

Of course, few would contend that the congressional decision not to intervene was the product of considered neglect. A public choice view of the matter would begin with the observation that it is difficult to conceive of any interest group that would expend resources to clarify the law in this area. When a debtor is able to conceal assets from the bankruptcy court, the loss falls on the unsecured creditors who would have otherwise enjoyed the value of that asset. To the extent that debtors routinely omitted lawsuits from their schedules, a coordinated group of creditors, such as credit card companies, could push for legislation to curb this practice. However, the game is probably not worth the candle. While judicial estoppel occurs with some frequency, it probably does not do so often enough to make it worth any interest group's time and effort to pursue legislation. Regardless of why Congress did not intervene here, that it left the matter to the courts seems to be appropriate.

While one may thus not be surprised to find that Congress did not wade into the morass of judicial estoppel, its failure to address the topic of the second Note in this issue creates something of a puzzle. Chapter 13 of the Bankruptcy Code allows a debtor to keep an asset in which it has granted a creditor a security interest over the objection of that creditor, but only if the debtor promises the creditor "the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim."[2] Put simply, the debtor can "cram down" a Chapter 13 plan on a dissenting secured creditor so long as the payments promised to that creditor have a value, measured on the date of the plan, that is equal to the amount of the creditor's collateral. Because mortgages are handled by targeted provisions in Chapter 13, the property for which this is most often an issue is the debtor's car. The method by which a court is to ascertain the "value" of the payments to the automotive lender divides the lower courts. In short, courts split on how to account for the risk that the debtor will default on the promised payments. The Supreme Court entertained this issue in *Till v. SCS Credit Corporation*,[3] but did not provide an answer to the question.

In his Note, O'Brien attempts to provide guidance to lower courts struggling to deal with the confusion wrought by *Till*. He suggests that rather than use either the "formula" approach endorsed by four justices or the "contract" approach backed by a different four, courts can use available data to gain some insight as to the interest rate that would make a secured creditor indifferent to getting the value of its collateral now or the stream of payments offered by the debtor. O'Brien examines data available from securitizations of car loans and the limited evidence on Chapter 13 success rates to attempt to move beyond the approaches offered to date.

Yet one has to wonder why this miasma was allowed to linger. It does not take much work to realize that, in the aggregate, a substantial sum of money turns on the approach chosen to calculate the default risk. We may not be able to tally the precise amount at stake, but even a cursory analysis suggests that the stakes here are far from trivial. In *Till* itself, the lender and the debtors agreed that the present value of the car was $4000. The Chapter 13 plan called for the Tills to pay this off over three years. The Tills put forward a rate of prime plus 1.5%, or 9.5%. The secured creditor suggested staying with the rate of interest called for by the contract, which was 21%. In other words, there was roughly an $800 variance between the payments suggested by the Tills and those by the lender.[4] To be sure, we have no information on how many debtors attempt to keep cars in Chapter 13 or on the extent to which the value of the Tills' car fairly

2. 11 U.S.C. § 1325(a)(5)(B)(ii) (2006).

3. 541 U.S. 465 (2004). For an argument that the Court's failure in this regard represents a "calamity," see Robert K. Rasmussen, Till v SCS Credit Corporation: *The Only Wrong Decision is Not Making* One, 67 Ohio St. L.J. (forthcoming 2006).

4. The Tills rate yields a monthly payment of $128.13 a month; that pressed by the lender yields a payment of $150.70 a month. Over the three-year plan period, the difference is $812.52.

reflects the average value of cars in Chapter 11.[5] Still, with over 400,000 Chapter 13 cases a year, the overall impact of which rate is chosen seems substantial.

The Supreme Court proved unable to provide meaningful guidance on the interest rate issue, yet Congress stayed its hand. This failure to act is all the more troublesome if we assume that Congress adheres to its decision to give secured lenders in Chapter 13 a stream of payment equal to the value of their collateral. There is a deep market for car loans and there have been millions of Chapter 13 cases. As O'Brien points out, these two sets of information make it possible to ascertain what rate of interest, as a general matter, will make the secured lender indifferent to getting the value of its collateral or the promised payment. While O'Brien has garnered what he could, he acknowledges his information is by no means perfect. Congress, not the courts, seems to be the institution better suited for supplying the missing facts.

The puzzle is heightened by comparing this issue of how to calculate the cram down rate with an issue that Congress did address in the new legislation. One recurring issue in Chapter 13 cases over the years has been how to value automobiles. On this question, the Supreme Court provided much guidance in its *Rash* decision where it held that the Code required the car to be valued with reference to its replacement value.[6] The Court, however, left open some wiggle room. It opined that "[a] creditor should not receive portions of the retail price, if any, that reflect the value of items the debtor does not receive when he retains his vehicle, items such as warranties, inventory storage, and reconditioning." Thus, while the Court decided that as between the value a car would generate at foreclosure and the value for which the car could be sold at retail, it did leave some ambiguity as to how the replacement value standard was to be implemented in each case. Congress eliminated this residual ambiguity in the new legislation when it mandated that in individual cases under Chapter 7 or 13, the secured creditor's "claim shall be determined based on the replacement value of such property as of the date of the filing of the petition without deduction for costs of sale or marketing."[7]

The contrast between the cram down rate issue and the valuation rate issue creates a puzzle. If anything, one would think that Congress should have resolved the interest rate issue first. The

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5. By way of comparison, the vehicle at issue in *Rash* was a truck which all parties agreed had a value in excess of $30,000. Associates Commercial Corp. v. Rash, 520 U.S. 953, 957–58 (1997).

6. *See Rash*, 520 U.S. at 955–56.

7. 11. U.S.C. 506(a)(2) (2006).

degree of doctrinal confusion is much greater here than it is in the valuation area. Moreover, the amount of money affected by the interest rate issue seems larger than the amount affected by the valuation issue, at least post-*Rash*. One could imagine Congress weighing in on both issues, neither issue, or perhaps only the interest rate issue. Yet from the perspective of sound institutional policy, tweaking the valuation standard while leaving the cram down rate untouched seems irresponsible.

To the extent that one harbors a vision of Congress as maintaining a steady hand on the progress of its legislation, the failure to address the interest rate issue gives one pause. Yet a public choice explanation of the legislature's inaction is only somewhat satisfactory. As has been well-discussed in the popular press, the driving force behind much of the recent legislation was the credit card companies. Credit card companies by and large appear as unsecured creditors in bankruptcy cases. As such, there is tension between their interests and those of secured creditors. Debtors, after all, can only offer a set stream of income. The size of the pie is fixed; what is at issue is the allocation of the slices. If the Chapter 13 plan allocates more of the debtor's post-bankruptcy income to the secured creditor, less can be directed to the unsecured creditors.

Credit card companies thus benefit from a low cram down rate. Such a rate frees up cash for payments on unsecured debt. The credit card lobby would therefore seem to be a powerful force for enacting the formula standard, which is generally lower than the contract standard. However, there is at least one other interest group for which such a rate would be anathema. Lenders who make automobile loans would fare less well under the formula approach. They would support legislation mandating a higher rate, such as the contract rate discussed in *Till* or a rate constructed along the lines suggested by O'Brien. There is no reason to think that the credit card industry can steamroll the automotive lending industry, and there is no reason to think that the automobile lenders can best the credit card lobby. Thus, one could attribute the congressional inaction here to a stalemate between powerful interest groups.[8]

If these opposing interests explain why Congress side-stepped the interest rate issue, what explains the legislative desire to tilt settled law in favor of the auto lenders on the valuation front? If there

8. Of course there is some overlap between these two groups (i.e., some banks issue credit cards and make automobile loans). Yet it is clearly the case that specialization in the lending industry is common enough that the development of two very powerful interest groups with conflicting agendas is hardly a stretch of the imagination.

is no room for compromise on interest rates, why is there a victory for the auto lenders on valuing the collateral? One could always posit an argument that smacks of a "just so" story. The argument would be that this legislative change was a transfer from the credit card industry to the auto finance industry in order to have the auto industry support the legislation.

Such an ad hoc explanation illustrates an aspect of public choice that some find unsettling. When Congress takes no action, one can posit either that no group was interested in spending resources to push for legislation, or that two influential interest groups wanted inconsistent policies. When Congress does act, however, one can argue that an interest group was either unopposed or that it was getting a side payment from another interest group. To be sure, there are successful predictions as to the outcome of legislative process, but on the whole, interest-group theory here offers better explanations than it does predictions.

Regardless of what dynamic was actually at work in the areas of judicial estoppel and cram down rates, these two Notes demonstrate the continued value of student work. Both make substantial progress on problems that escape the attention of Congress and require us to think hard about the interaction between the courts and the legislature. Enjoy!

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