

Testimony  
*United States Senate Committee on the Judiciary*  
**The Looming Foreclosure Crisis: How To Help Families Save Their Homes**  
December 5, 2007

**Hon. Thomas B. Bennett**

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Testimony of  
Hon. Thomas B. Bennett  
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before the  
Senate Committee on the Judiciary  
“The Looming Foreclosure Crisis: How To Help Families Save Their Homes”  
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Chairman Leahy, Presiding Member Durbin, Ranking Member Specter, and Members of the Committee, I want to thank you for the opportunity accorded me today. It is with pleasure and humility that I speak. The pleasure arises not just from having one of my home state Senators, Senator Sessions, on this Committee. It also comes from the fact that Ranking Member Specter lives in the city where I attended elementary through high school at Girard College while he served as an active District Attorney for Philadelphia and Assistant Attorney General for Pennsylvania. In similar fashion, I have great affinity for Committee Member Whitehouse’s Rhode Island and the welcome given to my daughter and me by the university she attends in Providence. The same is true for Member Kyl and the fact that he represents a state where I have maintained a residence for a number of years while another of my daughters strives to join the Senator as a Wildcat alumnus. There is also the status I share with Member Cornyn as an almost three decade member of the State Bar of Texas which I joined shortly after serving as a law clerk for a former chief judge of the old United States Court of Appeals for the Fifth Circuit, the late John R. Brown. There is additionally the fact that I hold undergraduate and graduate degree from West Virginia University in a discipline, economics, in common with Committee Members Cardin, Durbin, and Brownback. It is also an area that I have taught on the university level in what some refer to as a prior life and which I have continued to explore by studying its intersections with the law with the help of, among others, an economist, non lawyer, professor emeritis at the University of Virginia Law School which holds among its graduates Senators Kennedy, Cornyn, and Whitehouse. Then there is the law for which I hold another degree from West Virginia University. In this area of endeavor, one of my former professors for whom I have the greatest respect and who has had great impact on my life as a lawyer by the insights given me during his first years as a law school teacher some thirty years ago was later enticed to join the faculty of the John F. Kennedy School of Government as the Frank Stanton Professor of The First Amendment which is part of the alma mater of Senators Schumer, Kennedy, Feingold, and Kohl.

Perhaps the greatest portion of the pleasure and reason for humbleness is that I am able to convey a few of my thoughts to a Committee composed of individuals who have dedicated a

significant portion of their professional lives to the people of the United States. It is also due to the difficult challenge the issues being discussed today presents to each of this Committee's Members and the Members' bipartisan willingness to attempt to assist those in great need which is evidenced by the proposal sponsored by Senator Durbin and another put forth by Senator Specter. These are reasons why I thank each you for your service and urge others to thank all of you.

A few caveats to my remarks are warranted. I want to make clear that I am expressing my views. They are not those suggested to me by others. Similarly, I appear in my individual capacity and not as the representative, member, or officer of a group or an organization.

As you are aware, there has been an increasing number of foreclosures of residential real properties which are the homes of Americans. The current projections are that this upward trend may continue into at least the early portions of 2008. One of the perceived and real reasons for this is the number of mortgage obligations with adjustable interest rates which have and will adjust upward. Another is the fact that loans to purchase residences were made to some to whom they should not have been made. Coupled with these are the contentions—which are undoubtedly correct in some instances and wrong in others—that less than pristine lending practices were involved in some of these extensions of credit. It is in this context that this Committee is exploring ways to help some of those with the greatest financial distress, those who file bankruptcy. However, this is only a segment of the group facing foreclosures in the near future.

#### Reach And Effects Broader Than Possibly Desired When Viewed By The Part

Let me start my more substantive comments with an overview. I am here to urge caution and restraint in doing anything which attacks what is only a portion of a greater problem. Today, we are at or near the cusp in the slope and magnitude of the direction of what will happen in our economy. The increase in the number of mortgage foreclosures is both a symptom of a deeper rooted problem and a portion of the cause of it. What makes your task all the more difficult is the lack of complete and accurate information regarding various factors both relevant and material to the steps, if any, which should be taken to address one symptom, increasing mortgage foreclosures, without exasperating what is the perceived greater problem of a seizing in the credit market. I say perceived because it remains to be known whether this is the real problem or just another symptom. This imperfect knowledge is some of what creates difficulty in attempting to solve part of the mortgage foreclosure rise through the bankruptcy laws and has an inherent risk of aggravating a cause of the rise in a fashion that may do further harm to those you desire to assist and to many more not contemplated to be affected by the proposed legislation.

Yet another facet of your dilemma arises from the fact that conceptualization of the symptom, the cause or causes, and the solution or solutions is founded on the primary analytical tool of lawyers, judges, and legislators: words. As our counterparts in other professions have learned, verbal analysis has limits which we who deal in laws frequently do not take fully into account. This is especially true of those in my profession, lawyers and judges. What we do is the perverse of those who develop rules and laws using more quantitative and scientific means. We take one perceived set of fact which is a mere subset of a global set and develop a rule or law to be applied to all factual variations within the global set with no way of knowing whether it will or

will not work for the majority of matters which are within the global set. When the rule or law does not work for a variant on the subset of fact, we attempt to either exclude the application of the law by distinguishing the given fact set so it is outside the global set or piecemeal alter the rule or law to make it work for more of the factual variations within the global set, but still not necessarily all of them. Rules or laws developed using quantitative methods such as econometric modeling are not by any means perfect. However, the methodologies do allow one to take into account to a greater degree more of the variations within a global set while simultaneously seeing how different treatments may affect the whole.

This highlights one of the issues confronting you today in your consideration of the proposed legislation. Each bill is believed to be designed to operate only within the context of bankruptcy. Unfortunately, this is not the case. Even if the application of these bills could be contained to be within the bankruptcy context, the focus of both bills is verbally on the relationship between bankrupt borrowers and those who own the residential mortgage secured obligations. This is only some of those impacted by the legislation. Indeed, the application of both bills is not limited to the category of mortgage debts which is a significant reason for your greater focus on foreclosures: adjustable rate mortgages mostly originated in what is called the sub-prime market. This is because both S. 2133 and S. 2136 apply to all categories of mortgages due to the fact that the determination of which mortgages may be altered in principal, interest, and/or certain fees and charges is premised on a debtor's income, not the type of mortgage. For S. 2133, it is whether one is below the applicable category of median family income. In S. 2136, the calculus is current monthly income and disposable income as determined via sections 1325(b)(3) and 707(b)(2)(A) & (B) of the Bankruptcy Code. S. 2133 limits its application to principal residence mortgage obligations for those below certain targeted amounts of median family income. This operates to exclude those who are relatively more well off than those with less income. By contrast, S. 2136 has no such limit. In fact, one with a relatively high income coupled with large non-mortgage secured debt payments would be able to utilize S. 2136's principal residence mortgage modification provisions.

Some of why both bills go beyond their targeted purpose arises from what has happened in the residential lending and borrowing market over the last thirty or so years. As the residential mortgage loan market expanded from a more local to a national and then international market aided, in part, by federal banking and interest rate/usury law alterations, the mortgage loan products were designed over time to become more and more like a commodity and then into multiple commodities by splitting the ownership of what was once one loan with a principal and interest payment into multiple ownerships of portions of the aggregate amount repayable over the life of the loan. The result for purposes of this part of the discussion is that the ownership of a residential mortgage debt claim against a bankrupt is frequently not one person or entity. Rather, it is many. The limit on how the various portions of a mortgage debt may be subdivided is limited only by the creativity of the person designing how it is to be divided and the market for such debt. There is the potential for multiple portions of the principal of any given debt to be held by more than one creditor and for various portions of the interest stream to likewise be owned by more than one person. At least prior to the alteration of the principal balance, S. 2133 requires agreement of the debtor and the holder of the claim being adjusted. However, it does not similarly require such an agreement on interest rate adjustments or waiver of repayment or prepayment penalties. S. 2136 has no such agreement requirement for any of the modifications

allowed for principal residence mortgage debt. Thus, both will potentially affect multiple owners of such debt obligations in varying and different ways.

For instance, one owning only a portion of the interest stream will be potentially significantly, adversely impacted by any adjustment in the interest rate downward. If the downward adjustment is great enough and the portion of the interest stream is sufficiently far from the date of modification—and far need not be more than a few years, not the twenty or thirty some may think—the value of what the owner purchased could be reduced to a small fraction of what was paid for this portion of the mortgage debt even though all portions of the debt are fully secured! Given the right mix of interest rate adjustment, time attenuation from the date of the adjustment, and the portion of the interest stream purchased, it is possible that a creditor's property, its claim against a debtor, could be almost totally eliminated which would mean that the investment/purchase price paid would suffer the same fate. The import is that the implicit assumption that what is proposed will be contained within a one debtor, one creditor relationship is wrong for innumerable of the principal residence mortgage debts within the purview of each of these bills. A similar, though for some, not so dramatic impairment potential arises for those owning portions of the principal balance payment stream. What I describe as changing mortgage secured debts into multiple commodities and selling them to others is the factor which causes differing impairment of property interests of owners of portions of these types of debts and which for owners of some of these payment streams is different from and greater in degree than if the entire unpaid stream of payments were owned by one creditor. It is a matter not contemplated to the extent it should be in the makeup of each of the bills, but more so with respect to S. 2136. It is of extreme importance because the treatment of these commodities representing mortgage debt repayment streams under S. 2136 could for some be a forced diminution in value of Constitutional proportions.

More on why the S. 2136 structure of adjustable rate mortgage debt modification will have greater repercussion on creditors' property interests is that its design is to cause a permanent modification to the mortgage debt repayment stream which results in a decrease in the aggregate current value of all streams of repayment—both principal and interest. It is of necessity greater in amount than the delay and prohibition of an increase in interest contemplated by S. 2133. An example of this result is presented later in these remarks.

Although some may argue that this type of impairment already occurs in bankruptcy, this analogy is misplaced in the context of the extent to which the underlying value of what one purchased is impaired. This misplaced analogy compares alteration of what are shorter term vehicle and similar personal property secured loans with terms generally of no more than five to seven years to residential property secured loans with maturities of as much as thirty years and sometimes longer. The diminution in today's value of a part of it by a downward interest rate adjustment on the longer maturity portion of the residential secured debt is dramatically greater than that which occurs with the shorter term portions of the vehicle and other types of nonresidential secured debts.

To give a full view of the degree of any impairment in value which would occur, the Committee should also know that for owners of packages or pools of relatively similar streams of payment constituting portions of the ownership of mortgage secured debts, the loss which

would occur from the proposals may or may not be somewhat mitigated by a given pool's makeup. Determination of whether the pool of such mortgage secured obligations lessens the degree in the lowering of property value of a creditor depends on the number of the obligations in the pool which are ultimately modified by the proposed legislation. It does not change the fact that the value will be affected.

This is an example of the external to bankruptcy effects of each bill on valuation. Another is who owns the debt and who stands to lose from modifications to such debts. All owners of the various portions of these obligations are not easy to identify. Even if one could, the fact that one is the owner is not synonymous with the person or entity who/which will ultimately bear any losses from a modification in a mortgage secured obligation through the bankruptcy process. In some cases, it will be the original lender. In others, it will be a subsequent purchaser of some or all of the debt. Still in others, it will be a person or entity which lent money to the owner of the mortgage debt. The persons and entities occupying these categories include financial institutions, retirement and pension plan trusts, individual's IRA and 401(k) accounts, money market funds, and innumerable other persons and entities, public and private. In some instances, it will undoubtedly embrace some of the bankrupts each bill is designed to attempt to help because an IRA or 401(k) or similar exempt property held, maybe unknown to the bankrupt, either directly or indirectly, an interest in such residential mortgage debts. The scope and extent this may occur is not the primary thrust of this point, nor is the impairment discussion in the prior paragraph. It is that these are factors on which we do not have sufficiently accurate or reliable information. A multitude of others exist. The next important aspect is the potential created by the imperfect nature of information we possess and what its impact may be on the relevant market.

In our economic system, the degree of information and its accuracy are factors which bear on the equilibrium between the supply and the demand for a product including mortgage secured loans. Changes in the amount and accuracy of information can have both positive and negative impact on supply and demand for a product. To the extent that the proposed legislation makes less certain and less accurate knowledge available to the market regarding various aspects of the granting of credit, each would cause a shift in the supply of credit if all other factors remain unchanged. In more technical terms, the shift in the supply curve would be to the left and upward which means that the supply of credit at any given interest rate will be less. Another way of looking at it is that the uncertainty is viewed as increased risk which some suppliers of credit will not take and others will not incur at, in terms of these bills, at the rate of interest or price which was the equilibrium point for supply and demand which existed before enactment of one of these bills.

Why this is important is that the implementation of the policy behind each of S. 2133 and S. 2136 is left to thousands of very bright attorneys and hundreds of equally competent judges. That there will be lack of consistency in application of these provisions is evidence by what was and remains the lack of uniformity in how confirmed Chapter 13 plans differ on what the appropriate interest rate adjustment should be for vehicle and other nonresidential secured debts. This mixed application of interest rates for vehicles and other personalty secured loans exists even after years of variation and following a ruling by the Supreme Court of the United States on the issue of what is an appropriate interest rate. At a minimum, this most likely means that there

will be an extended period of uncertainty in the market regarding what will happen to principal residence mortgage loans when the bankruptcy of the borrower ensues. In other words, it creates greater inaccuracy in information and greater potential risk for the lender. Should the other factors affecting supply and demand for such credit remain unchanged, one can expect that the supply of credit will decrease and its cost increase. However and because the informational and risk factors created by enactment of either of these bills in their current formulations will have to be assessed by lenders making loans to those not in bankruptcy, but all potential candidates, the market for the assessment of those supplying credit and at what price is the broader market for credit. It is not limited to one, if such a sub-market exists, involving only bankrupts. What this represents is a potential for the decline in credit available to everyone and the prospect of an increase in the cost of obtaining credit from what it would otherwise have been. This is the risk inherent in all imposed regulation of markets for goods and services.

In times when credit markets are less skittish, the result of such bankruptcy legislation might not be as significant as it could be in the current state of the credit market. Essentially, the likelihood and cost of making a mistake may be far greater than in more stable market conditions. The question is whether such a chance should be taken by adjustment of bankruptcy laws without reference to the whole market for credit which includes non-bankrupts. This also entails the question of whether even very bright and capable lawyers and equally competent judges should be the implementors of bankruptcy laws which may involve their application to a large percentage of the current and future mortgage loan defaults using laws which give great discretion as to how each version, if enacted, would be applied. I respectfully suggest that a change, if any, focused on only a portion of a bigger market for credit should not be so undertaken and that any policy regarding how to deal with adjustments of interest rates on mortgages should in the first instance be assigned to those equally bright and capable professionals with the knowledge and training appropriate for the mission. I believe these professionals should not be lawyers and the courts. It is an unfortunate, but true, fact that the overwhelming majority, if not almost all, lawyers and judges have not had the training and education in both degree and quantity to become and remain sufficiently knowledgeable in virtually all technical and scientific matters, including economic ones, which is why our formalized legal system encompassing our courts is being avoided to an ever increasing degree.

As indicated an objective of this piece of my comments has been to point out that there is implicit in how S. 2133 and S. 2136 treat all mortgage debts that they are owned as a complete unit as was the case some decades ago. To a substantial degree, this is not the case today. The overarching reality is that the expansion of the market for credit has occurred in part by an alteration of how mortgage secured obligations are funded and owned. It is the failure to take this reality into account which creates many of the legal and economic problems inherent in how each of these bills may be implemented. This reality is also why in my initial comments I expressed how difficult the task is that this Committee's Members face. It is also a ground for my opinion that one should not use the insular arena of bankruptcy to propose a believed correction for the increase in foreclosures by amendments to the Bankruptcy Code, 11 U.S.C. § 101 et seq., when the result will have implications of potentially great moment beyond the context of what is trying to be achieved. Rather, and if anything in the nature of what is proposed should be done, it more appropriately needs to be from a view that is not limited by the confines of what is in and added to our bankruptcy statutes. This also highlights my point regarding verbal

analysis. It is far too easy when discussing an issue in what is part of the framework to the exclusion of the whole to miss sometimes subtle, yet important details. Because of time constraints, I have limited my comments in this section to what is an overarching problem. Other equally subtle, yet consequential issues exist.

#### Technical Comparisons: Mortgages In A More Limited Way Compared to Mortgages And More

There are other difficulties which are revealed by examination of the details of each bill. Unlike S. 2133, S. 2136 mandates that all mortgage debt be modified by the language of the enacted section 1322(a) that a plan “shall” do certain things joined with the proposed wording which would be a new section 1322(b)(11) set forth in Title I, section 101(a)(3) of the bill, calling for modifying an “...allowed secured claim secured by the debtor’s principal residence...” This modification potentially includes the interest rate for and the term of the loan. Because as drafted it is a required provision of a plan where the bankrupt debtor is below the current monthly income as calculated under S. 2136 via sections 1325(b)(3) and 707(b)(2)(A) & (B), this provision may have the effect of requiring an increase in the interest rate of an adjustable rate mortgage secured loan where the loan rate is lower than that specified under the adjustment in S. 2136. Furthermore and by converting the interest rate to a fixed one, the bill prevents a future potential decrease in what was an adjustable rate. In a declining interest rate market environment such as the one we are currently in for at least the short run, this means that for some the legislation would increase the interest rate instead of what would have been a decrease. Furthermore, this interest rate increase would become the rate for the residual term of the loan. This change to a fixed, increased rate of interest under S. 2136 in one Chapter 13 would not be subject to a future modification in a subsequent Chapter 13 because once the interest rate is altered to be a fixed one it is outside the scope of S. 2136's adjustment mechanism. This happens for some mortgage secured debts due to the fact that the adjustment as proposed in S. 2136 applies to all types of adjustable rate mortgage debts, not just those with initial teaser rates set below the prevailing market rate.

This scenario is all too likely for some because it has already happened in a similar context under existing Bankruptcy Code provisions. By way of example, the Bankruptcy Code provision which allow adjustment of the interest rate on vehicle loans, among others, to be at prime plus a so-called risk increase of some magnitude above prime has been successfully utilized by holders of motor vehicle secured debt to increase interest rates on loans that were made at zero and other rates lower than the market rate of interest. Thus, the possibility of this occurring under S. 2136 is not mere speculation. Since S. 2133 does not change an adjustable rate of interest to a fixed one and does not direct that the rate be calculated based on an indexed rate plus an upward risk adjustment, its application will not mandatorily increase the rate of interest on a mortgage debt. It allows for the stopping of a change or the delaying of a change which avoids the potential for an increase like the one which may happen under S. 2136.

Unfortunately S. 2133's design, as that of S. 2136, does not contemplate that rates may decline under the adjustable regime and, as a result of the “shall” language in section 1322(a) would require as currently drafted the delaying or prohibiting of an adjustment which would benefit a borrower. In its favor, S. 2133 does not impose a permanent fixing of the rate of interest for what could be almost thirty years. This would be of great importance should the interest rate

atmosphere for credit be on a long term downward trend after the fixing of interest on a mortgage loan under the proposed legislation. One does not need to go back to the depression era of the 1930s to find examples of sustained low interest rates. More recent examples are Japan until relatively recently and the United States in the 1950s. The argument that should this occur the borrower could refinance his or her mortgage does not hold the answer. In such an atmosphere, the ability of a bankrupt debtor to quickly and at lower cost obtain refinancing is not assured. If there is a bright side to any long term downward trend in interest rates for credit, it is that the reduction in the owner's value of any portion of residential mortgage debts caused by S. 2136, and to a lesser degree by S. 2133, could be reduced and in certain instances eliminated.

These sorts of issues also demonstrate that there are almost always unintended consequences to the amendment of any statute, especially one which has become overly complex and technical by numerous amendments since its original enactment in 1978. Further changes of the sort contained in the proposed bills which make the Bankruptcy Code more complex and technical causes more uncertainty in outcomes which means greater risks to creditors and the concomitant potential for a restriction in the supply of credit to all borrowers along with increased costs to borrowers and lenders of all ilk, not just those involved in bankruptcy cases.

Although the discussion so far has been fixed on broader concerns entailed by enactment of the bills' adjustment of principal and income portions of residential mortgage debt obligations, a look at the technical aspects of each reveals important differences between the two. It also highlights problems within each, though more so with S. 2136 than in S. 2133.

The most obvious difference between S. 2133 and S. 2136 is that S. 2133 is more constrained in its approach. It is purely limited to the adjustable interest rate mortgage debt issues and has a temporal limitation of seven years as a statutory provision and longer on the time it allows alteration of both mortgage debt principal and interest repayment. At least with respect to the adjustment of the unpaid principal balance of a mortgage secured debt, it allows it to occur only with the written agreement of the debtor and the claim holder.

S. 2136 on the other hand encompasses a far wider undertaking. It not only deals with the mortgage debt adjustments previously mentioned, it also does not have the sunset provision of S. 2133 and allows its adjustments to be spread over up to almost three decades. The mathematics of the costs to creditors and of their losses by such an extension coupled with any decrease in the contractual rate of interest is potentially far greater than that which might be wrought by application of S. 2133. Unlike S. 2133, the modifications required under the language of S. 2136 do not require the agreement of any owner of any portion of the principal or income streams of mortgage secured debt.

Both S. 2133 and S. 2136 have language designed to eliminate what are called prepayment penalties and also an early repayment penalty is within S. 2133. Although my remarks on this issue may not be a well received comment, they should be made. The dislike for these sorts of provisions in mortgage secured debt is that they can be of such a dollar magnitude that refinancing or other form of early repayment or prepayment either is prohibitive or makes no current economic sense. That these sorts of agreements have this effect is indisputable. There is another side to this type of commitment by a debtor in obtaining credit. It is that absent this

agreement, she, he, or they would not in some and may not in other instances have been able to have obtained credit or credit at the price which was paid. Now recall the overarching reality that a lot of mortgage secured debt is no longer held by one owner and that it is frequently owned not just in streams of principal repayments and interest payments, each of which can be subdivided. This ownership format is an aspect of how the credit market has been able to expand and represents a reason for these types of requirements: it allows one to better assess the risk of gain and loss from ownership of a portion of a stream of payment of a debt. In other words, it is part of the calculation of what one will pay for ownership of one or more of the streams of principal and interest which in the aggregate constitute the complete mortgage secured obligation. Without this charge on early payment, the cost of what was obtained by the borrower would most likely have been greater or the borrower would not have obtained the loan in the first place. This is another of those subtle issues of importance which make your task more difficult because any unilateral ability to eliminate these provisions will make the obtaining of credit both more difficult and more costly for many beyond those who are bankrupt.

Both bills have language which may limit collection of fees, costs, and other similar charges. However, how each treats what is limited and the range of what is limited is different. S. 2133 applies to a substantial failure to disclose material terms regarding interest, late fees, or other fees related to a claim secured by a security interest in a debtor's residence. If such a significant failure to disclose has occurred, S. 2133 treats monies received for interest, late fees, or other fees related to the claim as a constructively fraudulent transfer under section 548(a)(1)(B) of the Bankruptcy Code. If such a significant failure to disclose has not occurred, this subsection of S. 2133 has no application to interest, late fees or other fees related to such a claim. It is broader than S. 2136 to the extent that it includes interest payments. It is narrower because it is constrained to the pre-bankruptcy period by its inclusion in section 548 governing fraudulent transfers which by the makeup of the Bankruptcy Code occur only before one files bankruptcy. By way of contrast, S. 2136 concerns only such fees, costs, or other charges for the after bankruptcy period and disallows them for all principal residence secured debt when the value of this security is less than what is owed. S. 2136 also would permit disallowance of such fees and charges for an over secured creditor if the required notice to the court is not timely given or the court makes a determination that they are not one or more of lawful, reasonable, and provided for in the underlying contract. The allowance of these sorts of items is only following an affirmative determination of the court under S. 2136 whereas S. 2133's limitation is not mandatory as is evidenced by its "may treat" language.

There is curious interpretation of the language of S. 2136 regarding the disallowance of fees, costs, and charges which might be incurred after one files bankruptcy. It is that the wording of what is to be added to section 1322(c) of the Bankruptcy Code allows the addition of these to a debtor's Chapter 13 plan's treatment of the secured debt if the proper notice to the court is given joined with the finding that they are lawful, reasonable, and provided for in the contract, but literally disallows collection of these fees, costs, and charges after the end of the bankruptcy case only for failure to give the required notice to the court during the bankruptcy case. If the required notice was given, the collection of these is not necessarily precluded.

The balance of what is Title II of S. 2136 is where other, greater deviations from the application of what S. 2133 is limited to happens. They are in the "Providing Other Debtor Protections." The

one in section 202 of S. 2136 amends section 554 of the Bankruptcy Code by adding a new subsection (e). It has the effect of materially undoing section 554(d) dealing with administration of property of a bankruptcy estate which has as its correlates the legal principle of standing and the developing case law on judicial estoppel for failure of a debtor to schedule an asset.

The current status of one component of the law is that property of the estate defined under section 541 of the Bankruptcy Code which a debtor does not disclose and which is not otherwise dealt with during the pendency of his, her, or its bankruptcy case—the technical term under the Bankruptcy Code is administered—remains property of the estate after the debtor's bankruptcy case is over and closed. This causes the property which is not administered during the pendency of a bankruptcy case to be, for want of a better description, locked in a bankruptcy case and deprives one not the representative of the bankruptcy estate of standing to assert such a claim and certain types of defenses. When this happens with a claim or certain defenses which an individual debtor wishes to assert against another person or entity, the debtor lacks standing to assert the claim or defense unless and until the representative of the estate, generally the trustee, either decides to prosecute the claim or defense on behalf of the estate or to not do so. If the trustee decides not to prosecute known claim or defense, it is effectively administered and will revert back to the debtor. Following this, the debtor will have standing to assert the matter. This reversion may require an abandonment under or may by the provisions of section 554 be deemed to revert to a debtor. In a closed bankruptcy case, this may occur with unadministered property of the estate only after a reopening of the bankruptcy case. This formulation of what property interests a debtor may prosecute is not new to the Bankruptcy Code. Its origins and case law decisions on this issue go back at least to the Bankruptcy Act of 1898. The defense of lack of standing because a claim and certain types of defenses have not been scheduled in a bankruptcy case is frequently asserted by parties to litigation. This defensive maneuver does not without more forever bar one, maybe not the debtor, from asserting the claim against another.

The other element of the law which section 202 of S. 2136 is designed to address is a body of case law which has prevented debtors who fail to schedule a claim and certain types of defenses from ever asserting them in a court proceeding. It is the case based doctrine of judicial estoppel. For brevity and somewhat simplistically, this judicial doctrine developed to prevent a party to a court proceeding from playing fast and loose with the judicial process by taking inconsistent legal positions in different legal proceedings. Part of the recent evolution of the application of this doctrine to those who have been bankrupts occurred in the Alabama's courts and shortly thereafter in the United States Court of Appeals for the Eleventh Circuit. Since the Eleventh Circuit's holdings in recent years, other United States Courts of Appeals and lower federal courts have also used judicial estoppel to prevent a debtor who did not schedule a cause of action or similar matter on his or her bankruptcy schedules from asserting it in a subsequent lawsuit. The unfortunate aspect of some of these decisions is that the issue of judicial estoppel should never have been reached because the causes of action were barred for want of standing by the former bankrupt, now claimant who failed to have the undisclosed property interest of the estate disclosed and administered. Just why judicial estoppel was pushed by the defending litigants in lieu of the lack of standing is that the judicial estoppel bar is a permanent one against the former bankrupt while the lack of standing is generally only a temporary bar or stalling in the prosecution of the litigation. Judicial estoppel of this sort has been gaining wider application by the courts in recent years and has become a staple of the defenses asserted by opposing litigants.

Because of the greater use of certain types of lawsuits by plaintiffs, both judicial estoppel and the standing defense arising from a cause of action not having been administered in a bankruptcy case have made prosecution of many lawsuits by a debtor more difficult and often impossible.

What section 202 of S. 2136 tries to do is alter the dynamics of what the current state of case and statutory law is for individual debtors who fail to disclose property interests which are those belonging to a bankruptcy estate. It imposes on the trustee of a bankruptcy estate a requirement to take action within what is called a reasonable time to join a pending lawsuit. If the trustee does not join the suit by joinder or substitution, the debtor who failed to disclose the property interest is given standing to assert the action and the doctrine of judicial estoppel is made inapplicable. Although it may be an oversight, the language of this section of S. 2136 does not encompass such causes of action which are not the subject of a pending lawsuit. It will thus leave the existing case law and statutory law unchanged until a lawsuit is filed. Although not delineated in section 202, the literal language deprives the representative of the bankruptcy estate of the ability to prosecute available property interest even if the trustee does not know of its existence. This is the result of not fixing the "reasonable time" to join or substitute from when the trustee learns of the existence of the claim. Additionally and when dealing with an already closed bankruptcy case, there is no trustee to join or be substituted into a lawsuit. This presents the question of whether this section applies to closed cases. If it does, there is no trustee to join or substitute until after the case is reopened and a trustee is appointed. Lastly and due to the placement of this section in section 554 of the Bankruptcy Code which is captioned "Abandonment of Property of the Estate," is the intention of this legislative language to the effect that once a trustee does not join or substitute within a reasonable time in the pending litigation that the property interest of the bankruptcy estate is abandoned to the debtor or is something else contemplated?

Section 203 of S. 2136 undoes the federal statutory enforcement of arbitration of claims and causes of action and its enforcement by courts, including bankruptcy courts, for what are defined as core proceedings in a bankruptcy case of an individual debtor with primarily consumer debts. The range of application of this section of the bill is subject to debate and will engender litigation. This is in no small part due to the fact that the jurisdictional grant to bankruptcy courts as distinguished from Article III courts has been subject to much litigation. Any provision of this nature will most likely only increase the number of cases involving jurisdiction issues.

There are two more sub-parts of S. 2136 which complete Title II's "Providing Other Debtor Protections." One is the creation of a new federal exemption for a principal residence of a debtor or dependent of a debtor. It is available to a debtor who is 55 or older who files bankruptcy and is limited to an aggregate amount of \$75,000.00. It creates a new, stand alone exemption for those who are entitled to use non-section 522(d) federal exemptions along with state law exemptions. Similarly, it adds to section 522(d)(1) an identical exemption under the federal exemptions for those persons in jurisdictions which did not opt out of the federal exemptions of section 522(d). This represents a meaningful attempt, though partial in application, to bring back exemptions to where they once were. I applaud this attempt because I hold a different view for why bankruptcy case filings increased in the years prior to the 2005 enactment of the Bankruptcy Abuse and Consumer Protection Act. Part of the increase, maybe a large one, comes from the degradation of state exempt property amounts by the passage of time

and the influence of inflation without sufficient—and in some cases, no—increases in the exemption amounts. In some jurisdictions, exemption sums have not been increased for over a century. In others, what did shield most, if not all, of a debtors property sufficient to ensure the ability to have at least a minimal standard of living free from interference of creditors no longer does this, let alone give one the fresh start that is one of the long standing goals of our bankruptcy system. This has left many debtors with only one workable avenue to attempt to rehabilitate her or his financial affairs: filing a bankruptcy case. To my knowledge, no one has done a quantitatively meaningful study of how the degradation of exemptions has influenced bankruptcy filings.

I do not have a similar opinion regarding the last of the consumer protections in Title II of S. 2136. It is section 205 “Disallowing Claims from Violations of Consumer Protection Laws.” It purports to allow one in bankruptcy to contest the allowance of some or all of a creditor’s claim which is part of a mortgage transaction regardless of what another court may have already adjudicated. For one subset of consumer protection law founded claims and defenses, it strives to undo a basic principle of our jurisprudence, the finality of judgments of courts of competent jurisdiction, when it comes to the allowance or disallowance of any claim. Its grasp is also not just mortgage debts secured by principal residences of debtors. The reason is that although not as universally used today, a mortgage has been and may still be used as a security vehicle for nonresidential personality as well as both real and personal property interests used as one’s principle residence. The undoing of the principle of finality of a judgment which includes within its swath claims known to have existed which were not raised in jurisdictions which use judicial foreclosure. These are collectively referred to under the terminology of preclusion. Adding to the problematic nature of this section is the fact that arguably there is no time limit placed on its application. When a foreclosure judgment has been rendered that there is no time limit is clear. More elusive is that fact that the language effectively makes Truth in Lending Act and all other applicable state and federal consumer protection claims in force when the offending act happened a basis for the disallowance of the creditor’s claim in bankruptcy regardless of whether it could be so used outside a bankruptcy case.

The refinement in this language is that it allows offensive claims and certain defenses to a creditor’s claim which are barred by a statute of limitations or similar limitation. It would at the same time do the same for purely defensive contests to claims of creditors arising from the same transaction or the same occurrence which is called recoupment. It is, however, unnecessary for preservation of recoupment as a defense to a claim. As a general rule, recoupment is not barred by a statute of limitations. So, this provision of S. 2136 is not directed at putting into play recoupment as a defense to the allowance of a creditor’s claim. It already is and will remain one without enactment of this legislation. What it is designed to do is to do away with time limits placed on the offensive types of claims and defenses which a debtor may have but cannot use because of the passage of a statute of limitations or similar time bar. This also includes use of the defense of setoff/offset which technically is the setting off of claims which arise from different transactions/contracts or occurrences. It means that a time barred claim of a debtor against a creditor for, say one occurring in the making or collecting of an automobile loan, may be resurrected as a contest to an unrelated consumer mortgage or personality indebtedness which if successful reduces this otherwise fully enforceable creditor’s claim. In fairness to the drafters and in recognition of the difficulty of drafting amendments to what is a highly technical and

complex statute, I suspect that the intent of section 205 of S. 2136 is to preserve offensive and defensive means to reduce or eliminate the allowance of a claim of only a creditor which is secured by and arose from a transaction involving a consumer debtor's principal residence. As drafted, though, it does more than this.

Regardless of what one may think of the propriety of what S. 2136 describes in Title II as "Providing Other Debtor Protection," these sections constitute a major difference between the ambit of S. 2133 and that of S. 2136. Not only do they make more complex and technical the provisions of the Bankruptcy Code, 11 U.S.C. §101 et seq., some of which have been discussed, they do the same to other federal and state laws ranging from the Truth in Lending Act and its related Regulation Z to a whole strata of other federal and state consumer protection laws and regulations. What time does not permit is discussion of the whether and how these proposals may transmute these other laws and regulations. This, too, should be investigated in advance of enactment of any version of S. 2136. To do otherwise, may create other and as complicated problems in the consumer protection laws and their resulting economic impact as those I have mentioned today from the vantage point of amending the bankruptcy laws.

Having said all that I have set forth, a final comparative comment regarding S. 2133 and S. 2136 is warranted. It is that despite my belief that neither of these bills should be enacted in their present formulations, S. 2133's reach is far less intrusive and creates far less risk of unintended, untoward consequences.

Given the extremely limited time within which I have had to prepare this written testimony, I have not been able to detail all of the problems, difficulties, and nuances presented by each of S. 2133 and S. 2136. Rather, I have attempted to spotlight two general categories for your consideration. One is what is the bigger picture viewpoint of how each piece of proposed legislation will have more far reaching ramifications than those possibly intended. The other is from a narrower perspective of the difference in the details of what each bill tries to accomplish and why each may or may not do so. Also within the narrower category is why what is being suggested does something beyond what was envisioned. I have not made these remarks to foster the adoption of one bill in favor of the other. My purpose is to highlight the very difficult and technical task you are undertaking, to suggest a different approach than contemplated by either bill, and to urge extreme caution and equally diligent restraint on what, if anything, is done. To further these ends, I am willing to further assist by review, comment, or otherwise any and all of the Members of this Committee and its staff in the task of determining how to best help those facing the financial crisis which has precipitated what is the subject matter of this hearing.

Once more, Mr. Chairman, I thank you and the other Members for allowing me to present these views. More importantly and despite any differences in views we may have, I thank each of you for your dedicated service to our Country.