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BAPCPA Turns 20

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BAPCPA TURNS TWENTY

In 2005, Congress enacted sweeping changes in the Bankruptcy Code in a law commonly known as BAPCPA (bap-SEE-puh). Most insolvency professionals will recognize BAPCPA's changes to consumer bankruptcy: the means test, changes to the discharge exceptions, and new limits on homestead exemptions. But BAPCPA affected business bankruptcy too, making chapter 12 permanent and creating the notion of a "small business case" in chapter 11. As BAPCPA turns twenty, join ABI's panel of experts to reflect on the past two decades of BAPCPA: what worked, what didn't, and what might come next.

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Lessons from Bankruptcy Reform in the Private Student Loan Market

*Alexei Alexandrov and Dalié Jiménez**

INTRODUCTION

It is often said that "consumer protection comes at a price."[1] Providing a consumer-friendly service or increasing consumers' ability to obtain recourse for harm or an inadequate product involves costs.[2] These costs are often passed on to consumers as higher prices, lower quality, or lower product availability.[3] Laws and regulations can change the market equilibrium by either enhancing consumer protection (and raising costs and often prices) or by stripping some of the existing consumer protections (and lowering costs and often prices).

Economic theory predicts that laws that reduce consumer protection typically have three effects on consumers: (1) the direct effect of consumers losing some of their existing protections, (2) the indirect effect of consumers receiving lower prices (to the extent that the cost decrease is passed to the consumers), and (3) the demand-expansion effect of lower prices leading new consumers to enter the market.[4] The reverse is true for laws that enhance consumer protections rather than reducing them.[5]

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[1] Omri Ben-Shahar & Oren Bar-Gill, *Regulatory Techniques in Consumer Protection: A Critique of European Consumer Contract Law*, 50 COMMON MKT. L. REV. 109, 113 (2013); Hans-Bernd Schäfer & Katrin Lantermann, *Jurisdiction and the Choice of Law in Economic Perspective*, 1 GERMAN WORKING PAPERS L. & ECON. 1, 16 (2005); *Europe's Proposed Chemicals Regulations Are Less Nasty Than Feared*, ECONOMIST (Oct. 30, 2003).

[2] *See generally* Ben-Shahar & Bar-Gill, *supra* note 1.

[3] *See, e.g.*, Richard Craswell, *Passing On the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 STAN. L. REV. 361 (1991) (explaining the exact mechanisms behind consumer price increases after firms have to adhere to new legal rules). These costs may be partially offset by increased sales if consumers value this service or ability to obtain recourse.

[4] Note that if consumers are perfectly informed, value the future option of discharging the debt in exactly the same way, and the market prices the option exactly at that value, effect (3) would be absent (there should be neither market expansion nor contraction). However, we doubt that either of these conditions is satisfied, let alone all of them.

[5] Among the more recent laws and regulations in the consumer finance space that enhance consumer protection are the Consumer Financial Protection Bureau's rule establishing a requirement for the creditor to document and consider the consumer's ability-to-repay prior to originating a mortgage, the Credit CARD Act passed by Congress that severely limited penalty fees, repricing, and marketing to students in the credit card market, the proposed rule that

This article is about a law that reduced consumer protection: the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA).[6] It explores the effects of BAPCPA in the private student loan market.[7] Overall, our findings (with all the caveats below) suggest that bankruptcy reform failed miserably at helping students. We make two proposals for reform in light of our findings.

The level of student debt in the United States is staggering. At over $1.3 trillion—a number that has doubled since 2007—student loans make up the second largest category of outstanding household debt.[8] Only mortgage debt is higher.[9] Student debt is also pervasive: almost a quarter of consumers in the United States have some type of student loan debt.[10] Over sixteen percent of consumers with student loans are at least thirty days past due on those loans.[11]

While the majority of student loan debt was issued or is insured by the federal government, a sizable fraction (about ten percent of outstanding debt) is in the form of private student loans—that is, loans issued by financial firms without any government backing.[12] Pricing on these loans is similar to credit cards (i.e., the interest rate is variable and depends on the borrower's creditworthiness). For undergraduate students especially, these loans today typically require a co-borrower who will be legally bound to

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would weaken mandatory arbitration clauses to allow consumers to join a class action dispute without the fear of that class litigation being blocked.

[6] This article is limited to the changes bankruptcy reform wrought on the private student loan market, but with regard to consumer bankruptcy, BAPCPA was designed writ large to strip many consumer protections. *See, e.g.*, A. Mechele Dickerson, *Regulating Bankruptcy: Public Choice, Ideology, & Beyond*, 84 Wash. U.L. Rev. 1861 (2006); Robert M. Lawless et al., *Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors*, 82 Am. Bankr. L.J. 349 (2008); Robert M. Lawless & Elizabeth Warren, *Shrinking the Safety Net: The 2005 Changes in U.S. Bankruptcy Law* (Ill. Law and Econ. Working Paper No. LE06-031, 2006), http://papers.ssrn.com/pape.tar?abstract_id=949629 [https://perma.cc/AM4Z-WDZ4]; Michelle J. White, *Abuse or Protection? Economics of Bankruptcy Reform Under BAPCPA*, 2007 U. Ill. L. Rev. 275. For a discussion about a setting in which it might be socially optimal to enact laws that decrease consumer protections, see generally Christine Jolls, *Fairness, Minimum Wages, and Employee Benefits*, 77 N.Y.U. L. Rev. 47 (2002).

[7] By "private student loans" we mean student loans issued by private institutions that are not backed by the federal government. Prior to 2010, private institutions offered Stafford, PLUS, and consolidation student loans that were backed by the federal government. *See Programs: Federal Family Education Loan (FFEL) Program*, U.S. Dep't of Educ., http://www2.ed.gov/programs/ffel/index.html [https://perma.cc/P35T-63N8] (last modified Apr. 9, 2014); *see also* Section II.A *infra*.

[8] *Student Loan Debt by Age Group*, Fed. Reserve Bank of N.Y. (Mar. 29, 2013), https://www.newyorkfed.org/studentloandebt [https://perma.cc/5AJU-N2RL].

[9] *Id.*

[10] *FRBNY Consumer Credit Panel/Equifax*, Fed. Reserve Bank of Phila. (Sept. 17, 2016), https://www.philadelphiafed.org/eqfx/webstat/index.html [https://perma.cc/8GMG-XMMC].

[11] "Severe delinquency is defined as having at least one account 90+ days past due (DPD), in collections, or classified as severely derogatory. For student loans, this includes loans that are 30+ DPD, although many lenders do not begin to report past-due student loans until payments are 90+ DPD." *Id.*

[12] Calculation by the authors. Consumer Fin. Prot. Bureau, Private Student Loan Report 1, 3 (2012) [hereinafter CFPB PSL Report] (estimating $150 billion in outstanding PSLs).

repay if the student borrower does not.[13] These loans also have few or no protections for borrowers (or co-borrowers) who are in financial distress, leading some to argue these loans "are one of the riskiest, most expensive ways to pay for college."[14]

The concept of a "fresh start" for a bankrupt is a significant one. If a debtor is eligible to seek bankruptcy protection, she will ordinarily have all of her debts extinguished (discharged) when she finishes the process. There are a handful of debts that are nondischargeable, however. In general, "nondischargeability is an extraordinary rule, often held out for extraordinary debts (such as, for example, an intentional tort-feasor's debt for a damages or restitution award to her victim)."[15] As examples: credit card debts, medical debts, tort liabilities, mortgage and auto deficiencies, and old tax debts are all automatically dischargeable in bankruptcy.

Since 1976, federal student loans have enjoyed presumptive nondischargeability in bankruptcy.[16] That is, they are nondischargeable unless the debtor files a federal lawsuit and convinces the bankruptcy court that it should discharge her loans.[17] According to all the available research, very few students are able to clear this high hurdle, making student loans effec-

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[13] "All told, more than 90% of private loans had co-signers last year, according to the Consumer Financial Protection Bureau, up from 67% in 2008." Kelly Greene, *New Peril for Parents: Their Kids' Student Loans*, WALL ST. J. (Oct. 26, 2012), http://www.wsj.com/articles/SB10000872396390444024204578044622648516106 [https://perma.cc/8JBF-9MES]. This was not always the case. In 2005, just over sixty percent of loans had a co-borrower, and that number dipped below sixty percent in 2006 and 2007. But by 2008, the percentage of loans with co-borrowers was increasing dramatically. CFPB PSL REPORT, *supra* note 12, at 27 (Figure 13).

[14] Letter from Bankr. Coal. to the Honorable Stephen Cohen in Support of the Private Student Loan Bankr. Fairness Act of 2013 (Feb. 6, 2016), http://ticas.org/sites/default/files/pub_files/Bankruptcy_coalition_letter_to_Rep_Cohen_Jan_2013.pdf [https://perma.cc/MJ5A-PKZZ]. In some circumstances, paying with cash could turn out to be even more expensive since it does not create a debt that could potentially be discharged in bankruptcy. However, few students are able to pay today's tuition costs in cash. *See, e.g.*, U.S. CENSUS BUREAU, TABLE H-6 REGIONS BY MEDIAN AND MEAN INCOME, http://www.census.gov/data/tables/time-series/demo/income-poverty/historical-income-households.html [https://perma.cc/Y26C-DQ2B] (reporting a median household income across the US in 2015 of $56,516); COLL. BD., TUITION AND FEES AND ROOM AND BOARD OVER TIME, https://trends.collegeboard.org/college-pricing/figures-tables/tuition-fees-room-and-board-over-time [https://perma.cc/R7DX-4HHB] (reporting average tuition, fees, and room and board for an in-state student at a public four-year university at $19,548 and $43,921 for a private four-year university).

[15] John A. E. Pottow, *The Nondischargeability of Student Loans in Personal Bankruptcy Proceedings: The Search for a Theory*, 44 CANADIAN BUS. L.J. 245, 250 (2006).

[16] *See generally* Rafael I. Pardo & Michelle R. Lacey, *Undue Hardship in the Bankruptcy Courts: An Empirical Assessment of the Discharge of Educational Debt*, 74 U. CIN. L. REV. 405 (2005).

[17] It is a common misconception that student loans are impossible to discharge. Unlike other categorical exceptions to discharge—such as the one prohibiting the discharge of child support debt—student loans are dischargeable in bankruptcy after the debtor proves in a lawsuit that it would be an "undue hardship" to continue to repay their loans. Xiaoling Ang & Dalié Jiménez, *Private Student Loans and Bankruptcy: Did Four-Year Undergraduates Benefit from the Increased Collectability of Student Loans?*, *in* STUDENT LOANS AND THE DYNAMICS OF DEBT 175, 180 (Kevin Hollenbeck & Brad Hershbein eds., 2015).

tively nondischargeable.[18] In 2005, Congress lumped private and federal loans together and decided that borrowers of both should have almost no chance of discharging their educational loans, no matter who made them. Before BAPCPA, student loans issued by a private financial institution with no guarantee or backing from any government were automatically dischargeable in bankruptcy. After BAPCPA became effective, in October 2005, all private loans (no matter when issued) became presumptively and effectively nondischargeable in bankruptcy.[19]

The rationale for BAPCPA's special treatment of private student loans (PSLs) consisted of effects two and three mentioned above. That is, scholars expected that the law would lower the cost of private loans and that more students would choose to attend college due to the lower costs.[20] As one example, Judge Posner theorized that "by increasing the rights of creditors in bankruptcy . . . [bankruptcy reform] should reduce interest rates and thus make borrowers better off."[21]

Using a novel loan-level administrative dataset from the Consumer Financial Protection Bureau (CFPB) and econometric techniques, we quantify effects two (lower prices) and three (increased demand). First, we show that BAPCPA did not have a significant effect on the price of loans for the lowest credit score individuals relative to individuals with higher credit scores. In other words, students became effectively unable to discharge their loans in bankruptcy (effect one), but did not experience a compensating decrease in price (effect two). Second, we do see an increase in loan volumes, but since we do not observe a change in prices and we find that the price elasticity of demand for student loans is not significantly different from zero, we do not attribute this change in originations to a price effect (effect three). It is thus easy to argue that BAPCPA was not very helpful to students: they lost the ability to discharge their private student loans, but received no discount in return.

To quantify the change in prices after BAPCPA, we assume that the loans given to students who were unlikely to end up in bankruptcy (as measured by their credit score) were not affected by the law.[22] PSL issuers can and do price discriminate among students based on various factors, including

[18] *See* Jason Iuliano, *An Empirical Assessment of Student Loan Discharges and the Undue Hardship Standard*, 86 Am. Bankr. L.J. 495, 495–96 (2012); Daniel A. Austin, *Student Loan Debt in Bankruptcy: An Empirical Assessment* 1–11 (Ne. Univ. Sch. of Law Research Paper No. 188-2014, 2014), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2442312 [https://perma.cc/3G5E-9RPN].

[19] Ang & Jiménez, *supra* note 17, at 177.

[20] Pottow, *supra* note 15, at 262 ("[N]ondischargeability could be justified as an attempt to make private loans 'cheaper' for students.").

[21] Ang & Jiménez, *supra* note 17, at 183 (quoting Richard Posner, *The Bankruptcy Reform Act—Posner*, Becker-Posner Blog (Mar. 27, 2005), http://www.becker-posner-blog.com/2005/03/the-bankruptcy-reform-act—posner.html [https://perma.cc/XQ2G-5NS7]). However, note that this is not necessarily true for all borrowers *ex ante*; borrowers with prime credit scores who did not think they would be likely to file bankruptcy might prefer lower prices to the availability of a bankruptcy discharge.

[22] Here we use the credit score cutoff of 645.

credit score and school, and they have no reason to cross-subsidize *a priori* risky students (those with low credit scores) by charging *a priori* safer students (those high credit scores) higher rates.[23] For the *a priori* safer students with extremely low probabilities of ending up in bankruptcy before paying off their student loans, BAPCPA should not have had any effect: the loan issuers should have predicted that these borrowers posed almost no bankruptcy risk even before BAPCPA came into effect. Thus, we measure the effects of BAPCA by comparing the spread in rates given to risky and safe students before BAPCPA to the spread in rates after the statute was passed. We find that risky students (who economic theory would predict would have been those most likely to receive a discount after the law change) saw little to no savings from the reduction in bankruptcy protections that BAPCPA created.[24]

Although students did not experience significant changes as a result of BAPCPA, we explore the theoretical question of what would have happened if prices had decreased. To measure whether more students would choose to attend college if prices decreased, we first show that the cutoff FICO credit score of 645 (using the higher of the student's and the co-borrower's scores if there was a co-borrower)[25] was used by PSL issuers to split students into safe and risky categories, with a sizable difference in interest rates between the two groups.[26] Based on the data, we assume that students with scores just

[23] We find that the safe category in 2005 (the year that BAPCPA became effective) consisted of students with a credit score of over 645 or a co-borrower with such a credit score. Alternatively, we looked at a super-safe category: seniors at several dozen of institutions defined as Tier 1 or Tier 2 institutions as defined by Barron rankings in 2005—students that were virtually assured of completing the degree and getting a good job. The best schools were in Tier 1, there were four tiers of ranked schools, but the vast majority of the schools in the U.S. were unranked (effectively a giant Tier 5). As a reference point, the University of California, Berkeley was in Tier 2. The results are virtually unchanged when we use these students as a control group instead.

[24] As we discuss below, we found an effect of 0.07%. Our econometric technique and data available do not allow us to rule out an effect as large as one percent at the standard ninety-five percent confidence level. However, as also noted below, even this large of an effect would not have led to more borrowing.

[25] We term this the "maximum FICO."

[26] As we outline in the Appendix, this threshold is evident from the data. While it is not *a priori* obvious why issuers would use a threshold, as opposed to a continuous function, this type of FICO threshold is prevalent both in the mortgage and in the credit card industry. However, the FICO thresholds differ between industries: in credit cards, a FICO of 660 is usually the boundary between prime and subprime, and for mortgages it might be closer to 700, with Fannie Mae and Freddie Mac using a variety of thresholds (all with FICO scores divisible by 10). Martha Poon, *From New Deal Institutions to Capital Markets: Commercial Consumer Risk Scores and the Making of Subprime Mortgage Finance*, 34 ACCT. ORGS. & SOC'Y 654, 663 (2009) (noting that in 1995, Freddie Mac announced that "a FICO® score of 660 was the eyeball threshold for their definition of loans eligible for the prime investment. Within a month Fanny Mae swiftly followed suit adopting the identical convention in October to demarcate their prime loans."). The existence of such thresholds is likely an artifact of the past when computerized models were not ubiquitous, but in either case the analysis of the optimality of such thresholds is outside of the scope of this article. *See, e.g.*, *id.* at 668 (noting that "[t]he [Federal Reserve Board's] Commercial Bank Examination Manual and the Bank Holding Company Supervision Manual both observe that a FICO of 660 is the reported industry benchmark for the subprime lending (consumer credit and mortgages) although they are

above 645 (say, 646) and just below 645 (say, 644) are virtually the same along any unobserved dimensions.[27] Nevertheless, these two otherwise virtually identical students face markedly different interest rates. We analyze the difference in student loan take-up between these two groups (just below and just above the FICO threshold), and find that despite the markedly different interest rates, safe and risky students behave virtually identically. In other words, students are insensitive to price. Students whose maximum FICO is near the 645 threshold do not seem to react to changes in interest rate of roughly three percentage points,[28] a considerable price difference. Put another way, students behave as if they are completely inelastic to interest rate changes which means that even if BAPCPA had lowered prices, it is unlikely that more students would have chosen to take out student loans, and thus to attend college, if interest rates decreased. We discuss potential reasons for this finding below.[29]

The effects of being able to discharge a debt on future outcomes of the borrower are hard to measure empirically. The effects of *not* being able to discharge a particular kind of debt are also hard to measure.[30] However, in the broader context of filing Chapter 13 bankruptcy, two recent studies show that being able to discharge debt in bankruptcy has enormous positive effects.

One study uses Social Security Administration records matched to bankruptcy filers and shows that the ability to discharge debts leads to an increase in annual earnings of $5,600, a decrease in five-year foreclosure rates of nineteen percentage points, and a one percentage point decrease in five-year mortality rates.[31]

Using a different dataset that links over 175,000 bankruptcy filings to credit bureau records, another study estimates that a Chapter 13 bankruptcy discharge "decreases an index measuring adverse financial events such as

careful to indicate that the government guidance does not endorse any 'single definitive cutoff point for subprime lending.' ") (citation omitted).

[27] We present evidence of this in the Appendix *infra*.

[28] We refer to interest rates in percentages in this article, for ease to the general reader.

[29] This finding is consistent with finding of significant price dispersion (and thus, likely highly inelastic demand) in other consumer financial markets such as mortgages and credit cards. *See, e.g.*, Victor Stango & Jonathan Zinman, *Borrowing High Versus Borrowing Higher: Price Dispersion and Shopping Behavior in the U.S. Credit Card Market*, 29 Rev. of Fin. Stud. 979 (2016); Alexei Alexandrov & Sergei Koulayev, No Shopping in the U.S. Mortgage Market: Direct and Strategic Effects of Providing Information (Oct. 31, 2015), http://www.ftc.gov/system/files/documents/public_events/945353/Koulayev_no_shopping_in_the_US_mortgage_market_file_2016_0.pdf.

[30] However, we can perhaps learn something from research that links student loan debt to other types of spending, like buying a home. Analogizing to this context also leads us to suspect a high cost to students. *See, e.g.*, Alvaro Mezza et al., *On the Effect of Student Loans on Access to Homeownership* 32 (FEDS Working Paper No. 2016-10, 2016), http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2732030 [https://perma.cc/XLH2-3KJC]. The data is not encouraging. *See id.* (finding "that a 10 percent increase in student loan debt causes a 1 to 2 percentage point drop in the homeownership rate for student loan borrowers . . . . ").

[31] *See* Will Dobbie & Jae Song, *Debt Relief and Debtor Outcomes: Measuring the Effects of Consumer Bankruptcy Protection* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 20520, 2015).

civil judgment and repossession by 0.323 standard deviations for the marginal recipient, and significantly decreases seven of the eight individual measures of financial strain that compose the index."[32] It also estimates that bankruptcy protection increases "the marginal recipient's credit score by 17.0 points over the first five post-filing years, a 3.0 percent increase from the dismissed filer mean."[33] This research suggests that the inability to discharge private student loans could be a significant cost for students and their co-borrowers.[34]

Troublingly, this cost is one that affects a growing number of students and a large proportion of already-vulnerable individuals. A recent study estimated that nineteen percent of students at a four-year college or university who graduated with debt had some PSLs.[35] The average private loan debt load as of 2012 was $13,600 per student.[36] In the meantime, default rates "have spiked significantly since the financial crisis of 2008."[37] As of 2011, "[c]umulative defaults on private student loans exceed $8 billion, and represent over 850,000 distinct loans."[38]

Also alarming: poor and minority students are disproportionately affected by our system of student loans. Minority students are more likely to enroll in for-profit schools, borrow more than their white counterparts for the same degrees,[39] more likely to fail to graduate,[40] and more likely to default on student loans in general.[41] Research also suggests that while white

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[32] Will Dobbie, Paul Goldsmith-Pinkham & Crystal Yang, *Consumer Bankruptcy and Financial Health* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 2103, 2015), http://scholar.princeton.edu/sites/default/files/wdobbie/files/dgy_bankruptcy.pdf [https://perma.cc/46V3-V7TX].

[33] *Id.*

[34] *See generally* Katrina M. Walsemann et al., *Sick of Our Loans: Student Borrowing and the Mental Health of Young Adults in the United States*, 124 Soc. Sci. & Med. 85 (2015).

[35] Inst. for Coll. Access & Success, Student Debt and the Class of 2015: 11th Annual Report 16 (Oct. 2016), https://consumermediallc.files.wordpress.com/2016/10/classof2015.pdf [https://perma.cc/U8V4-QAQV].

[36] *Id.* at 8.

[37] CFPB PSL Report, *supra* note 12, at 8.

[38] *Id.*

[39] Sara Goldrick-Rab, Robert Kelchen & Jason Houle, *The Color of Student Debt: Implications of Federal Loan Program Reforms for Black Students and Historically Black Colleges and Universities* (Wisconsin Hope Lab, Discussion Paper, 2014).

[40] Lucia Graves, *The Gap in Graduation Rates*, U.S. News & World Rep. (May 2, 2008), http://www.usnews.com/education/articles/2008/05/02/the-gap-in-graduation-rates [https://perma.cc/QRN6-HGCD].

[41] Minority and poor students are also more likely to enroll in for-profit schools. *See* Alexia Elejalde-Ruiz, *Why Lower-Income Students Are Drawn to For-Profit Schools*, Chi. Trib. (Oct. 6, 2016), http://www.chicagotribune.com/business/ct-black-youth-for-profit-trade-schools-1009-biz-20161007-story.html [https://perma.cc/N65S-76ZP] ("[T]he number of students enrolling in for-profit schools has risen dramatically over the past 15 years. And low-income minority students are 3-1/2 times more likely to enroll in for-profit institutions than higher-income students, according to a 2015 study from the Pell Institute . . . ."). "Student loan default rates are also two to three times higher for borrowers who attend for-profit schools than those who attend private nonprofit and public four-year schools, according to a 2015 study by the nonprofit College Board." *Id.*

A number of large for-profit schools have recently shut down after regulators sued them for violations of law, including charges that they steered students into predatory loans. *See, e.g.*, college graduates seem to enjoy an "economic cushion" from their college education, African American college graduates do not.[42] Unlike their white counterparts, "African American college graduates are equally likely to file for bankruptcy as African Americans without a college diploma."[43] Most recently, researchers at the Brookings Institution found that "[f]our years after graduation, black graduates have nearly $25,000 more student loan debt than white graduates: $52,726 on average, compared to $28,006 for the typical white graduate."[44]

Given these findings, we offer some recommendations to reform how student loans are treated in bankruptcy and to regulate private student loans. First, we join with many others in calling for an amendment to the Bankruptcy Code to treat PSLs in the same way as credit cards or other types of unsecured debt are treated. That is: PSLs should be automatically dischargeable in bankruptcy unless the bankruptcy judge finds that the bankruptcy petition has been filed in bad faith. This is, we think, the simplest and best solution to the problems we identify.

Nonetheless, we recognize that rolling back the protection PSL lenders obtained in 2005 may be a hard sell politically. A number of bills have been proposed attempting to do just that and none have gained much traction. Consequently, we propose an alternative. Given students' inelastic demand and the fact that PSL lenders are in a better position to know the true likelihood of loan repayment, the CFPB should implement an ability-to-repay rule similar to the one they have implemented in the mortgage markets. In other words, private student loan lenders would incur liability to borrowers if they originated loans without verifying a borrower's ability to repay that loan. Because this verification is a complex endeavor, we outline some of the features of PSLs that could be packaged as a "qualified PSL," a safe harbor to the ability-to-repay rule.

Part I provides some background on PSLs and rebuts some of the economic justifications for their special treatment in bankruptcy. Part II describes the data and Part III our empirical strategy. Part IV lays out our results: we find that BAPCPA failed to lower prices and also that even if it had, it is unlikely that more students would have chosen to attend college.

Danielle Douglas-Gabriel, *Government Watchdog Wins $530 Million Lawsuit Against For-Profit Corinthian Colleges. Too Bad It Will Never See a Dime*, WASH. POST (Oct. 8, 2015), https://www.washingtonpost.com/news/grade-point/wp/2015/10/28/government-watchdog-wins-530-million-lawsuit-against-for-profit-corinthian-colleges-too-bad-it-will-never-see-a-dime [https://perma.cc/P22U-8YVA]; Press Release, Consumer Fin. Prot. Bureau, CFPB Sues For-Profit College Chain ITT for Predatory Lending (Feb. 26, 2014), http://www.consumerfinance.gov/about-us/newsroom/cfpb-sues-for-profit-college-chain-itt-for-predatory-lending [https://perma.cc/FP34-T5JN].

[42] Abbye Atkinson, *Race, Educational Loans, & Bankruptcy*, 16 MICH. J. RACE & L. 1, 2 (2010).

[43] White college graduates are less likely to file for bankruptcy "relative to their proportion in the general population." *Id.*

[44] Judith Scott-Clayton & Jing Li, *Black-White Disparity in Student Loan Debt More Than Triples After Graduation*, 2 EVIDENCE SPEAKS REP. 1, 2 (2016), https://www.brookings.edu/research/black-white-disparity-in-student-loan-debt-more-than-triples-after-graduation [https://perma.cc/H6BU-7WSP].

Part V discusses our results and proposes two major recommendations: PSLs should be automatically dischargeable in bankruptcy, but in the alternative, we adapt a tool from the mortgage markets and recommend that the CFPB enact ability-to-repay requirements for PSL issuers. Part VI concludes. Throughout this article, we have attempted to balance the need to give enough technical information about our analysis for those interested in evaluating it with the need to make it readable to the lay reader.[45]

I. Background

A. *Private Student Loans (PSLs): A Primer*

We begin with a definition: as the name implies, these loans are issued by private institutions for educational purposes.[46] PSLs are distinct from other types of educational loans issued by private institutions. Table 1 illustrates the main differences.[47]

Table 1: Comparison of student loan types, by issuer for loans issued between 2000–July 1, 2006

	Direct Loan Program	**Federal Family Education Loan Program (FFELP)**	**Private Student Loans (PSL)**
Lender	Department of Education	Private entities	Private entities
Guarantor	Federal government	Federal government	Private entities (sometimes nonprofit)
Risk-pricing	No risk-pricing; same interest rate across products	No risk-pricing; same interest rate across products	Lender risk-prices loan and charges premium (margin) at origination
Co-borrowers[48]	None allowed	None allowed	Between 80–90% of loans require co-borrower

[45] The Appendix, for example, is intended for an audience familiar with statistics or econometrics. Although some parts of the main article contain technical language, we have strived to translate the technical aspects for the lay reader. We thank our editors in helping us do this. Any failures are entirely ours.

[46] Issuers of PSLs are private institutions, which includes both for-profit and not-for-profit lenders.

[47] Because loan programs have changed slightly throughout the years, we limit our discussion to those issued between 2000–06. One example of the changes that are not relevant to our analysis is that beginning on July 1, 2006, FFELP and Direct Loans had fixed interest rates that were set every year. *Interest Rate and Fees*, U.S. Dep't of Educ., https://studentaid.ed.gov/sa/types/loans/interest-rates [https://perma.cc/CA5D-9NMJ].

[48] While FFELP and Direct Loans are made to one person alone, it is not always the student. FFELP and Direct PLUS loans could be taken out by a student's parents to assist in

Interest Rates	Set by Congress; varied by loan status (in school, deferred, in repayment)	Set by Congress; varied by loan status (in school, deferred, in repayment)	Set by lender for each loan; variable rate fixed to an index
Bankruptcy Treatment[49]	Presumptively nondischargeable since 1998	Presumptively nondischargeable since 1998	Presumptively nondischargeable since 2005
Programs for Borrowers in Trouble	Set by Congress; various forbearance programs	Set by Congress; various forbearance programs	Set by lender on ad-hoc basis (few or none contractually required)
Forgiveness Programs	Set by Congress: includes death forgiveness, public interest forgiveness, other programs	Set by Congress: includes death forgiveness, public interest forgiveness, other programs	Set by lender on ad-hoc basis (few or none contractually required)

From 1965 until 2010, private institutions could originate federally-guaranteed student loans under the Federal Family Education Loan Program (FFELP).[50] These loans were primarily issued with private capital, but the federal government served as a full guarantor.[51] In 1992, Congress authorized the Department of Education to issue and administer the Direct Loan Program.[52] At that time, and until the program ended in 2010, FFELP loans were practically identical to the loans made directly by the Department of Education under the Direct Loan program. In particular:

(1) the loans were not risk-priced (the interest rates were the same across all borrowers for a particular type of loan);
(2) almost all the loans had fixed interest rates (meaning the lender and ultimately the government took the risk of interest rate volatility);
(3) the loans were made to only one borrower (no co-borrowers); and
(4) there were (and are) a number of loan forbearance and forgiveness programs available to borrowers.[53]

In contrast, PSLs are almost exclusively variable rate loans tied to an index such as the London Interbank Offered Rate (LIBOR)[54] or the 3-month

financing their education. *PLUS Loans*, U.S. DEP'T OF EDUC., https://studentaid.ed.gov/sa/types/loans/plus [https://perma.cc/26N6-YZMC].

[49] For a history of how and when various kinds of student loans became presumptively nondischargeable, see generally Pardo & Lacey, *supra* note 16.

[50] Congress ended FFELP on July 10, 2010. Health Care and Education Reconciliation Act of 2010, Pub. L. 111–152, 124 Stat. 1029 and note.

[51] David M. Herszenhorn & Tamar Lewin, *Student Loan Overhaul Approved by Congress*, N.Y. TIMES (Mar. 25, 2010), http://www.nytimes.com/2010/03/26/us/politics/26loans.html [https://perma.cc/5PWN-GTA3] (reporting on the end of the guaranteed loan program).

[52] *Id.*

[53] FFELP borrowers can consolidate their loans into the Direct Loan Program to obtain public service loan forgiveness. *See Public Service Loan Forgiveness*, U.S. DEP'T OF EDUC., https://studentaid.ed.gov/sa/repay-loans/forgiveness-cancellation/public-service [https://perma.cc/9V4V-JXDK].

[54] "LIBOR (or ICE LIBOR) is the world's most widely-used benchmark for short-term interest rates. It serves as the primary indicator for the average rate at which banks that con-

Treasury Bill Index.[55] PSL interest rates can also be considerably higher than FFELP or Direct Loan interest rates. As an example, Stafford loan interest rates were 4.17% in the 2004–2005 academic year and 6.10% in the 2005–2006 academic year, whereas PSLs offered in that time period had initial rates of as much as 19% for the riskiest borrowers.[56]

PSL interest rates vary because they are risk-priced at origination.[57] This is in direct divergence from federal loans that have a statutorily set interest rate that is offered to all students who take the loan.[58] PSL lenders price the loan primarily using the borrower and co-borrower FICO credit scores.[59] Students with lower credit scores (sometimes called "subprime" borrowers) are almost always required to borrow with a co-borrower. The co-borrower is liable for the loan in the same way as the student. When students borrow with a co-borrower, lenders typically price the loan according to the highest credit score between the borrower and co-borrower (what we call the "maximum FICO").[60] Upwards of ninety percent of PSLs made to undergraduates in 2011 were made with a co-borrower.[61]

The final major difference is the treatment of the loans in bankruptcy. Whereas federal student loans have been presumptively nondischargeable in bankruptcy (in some fashion) since 1976,[62] PSLs received that treatment relatively recently. Before 2005, PSLs were treated similarly to credit cards, car loan deficiencies, and medical bills: they were automatically dischargeable in bankruptcy. It was only in 2005, with the sweeping bankruptcy reform

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tribute to the determination of LIBOR may obtain short-term loans in the London interbank market." *What is "LIBOR,"* INVESTOPEDIA, http://www.investopedia.com/terms/l/libor.asp [https://perma.cc/TE72-YNQS].

[55] "An index based on the auctions of U.S. Treasury bills . . . commonly used in determining mortgage rates for mortgages with an unfixed component and as a performance benchmark for investors in the capital markets as it represents a rate of return that investors would be able to get from almost any bank, with minimal effort." *Definition of "Treasury Index,"* INVESTOPEDIA, http://www.investopedia.com/terms/t/treasuryindex.asp [https://perma.cc/3MZN-LBVD].

[56] *See* CFPB PSL REPORT, *supra* note 12.

[57] Ang & Jiménez, *supra* note 17, at 176; *see also* Jonathan D. Glater, *The Unsupportable Cost of Variable Pricing of Student Loans*, 70 WASH. & LEE L. REV. 2137 (2013) (critiquing a proposal to vary federal loan pricing based on risk).

[58] Ang & Jiménez, *supra* note 17, at 176; Glater, *supra* note 57.

[59] Credit scores order consumers by their level of credit risk and their construction "usually takes advantage of accepted statistical methods (such as logistic regression or probit models), which attach probability estimates to something happening, such as paying a bill on time." Meta S. Brown, *Credit Scores: Every Day Predictive Analysis*, FORBES (Aug. 31, 2015), http://www.forbes.com/sites/metabrown/2015/08/31/credit-scores-everyday-predictive-analytics/#138ae1d767e6. The credit scores that we observe in our sample are built from these, typically, continuous measures, and are rounded to the nearest integer.

[60] *See* CFPB PSL REPORT, *supra* note 12; *see also* Ang & Jiménez, *supra* note 17; Susan M. Dynarski, *The RNC Wants to Make Student Loans Competitive Again. They Never Were*, BROOKINGS (July 21, 2016), https://www.brookings.edu/research/the-rnc-wants-to-make-student-loans-competitive-again-they-never-were [https://perma.cc/756A-T4DZ].

[61] CFPB PSL REPORT, *supra* note 12, at 27. For an argument that borrowing with a co-borrower who is more creditworthy than the student arguably takes these loans out of the "student loan" category, see Dynarski, *supra* note 60.

[62] Pardo & Lacey, *supra* note 16.

bill, that Congress made all outstanding PSLs practically impossible to discharge.[63]

The presumption of nondischargeability means that a debtor must file an adversarial proceeding within the bankruptcy case (in effect, a federal lawsuit) and prove that having to repay the loan after the bankruptcy would "impose an undue hardship" on her and her dependents.[64] "Undue hardship" is not defined in the Bankruptcy Code and the Supreme Court has not spoken on the issue.[65] Over time, courts have adopted one of two standards to analyze whether a borrower has met her burden: a three-part test developed by the Second Circuit in 1987 or a "totality of the circumstances" approach which looks to the three-part test as some of the circumstances the judge should examine.[66]

Despite the apparent uniformity, however, scholars have found that the same test is applied quite differently. According to Professors Pardo and Lacey, legal outcomes of the cases they examined are "best explained by differing judicial perceptions of how the same standard applies to similarly situated debtors."[67] Instead, as another commentator has noted: "Judges define the standard differently, [sic] they impose different conceptual tests on debtors, and when undue hardship is found, relief is often dependent upon judicial philosophy rather than the merits of the case."[68] The only national empirical examination of this issue found that less than 0.1% of borrowers with outstanding student loans attempted to discharge them in bankruptcy.[69] The law thus has the practical effect of making student loans nondischargeable.

Since the BAPCPA applied retroactively to PSLs that were originated before the law took effect but had not yet been fully repaid, the law also created a windfall for holders of outstanding PSLs originated before

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[63] For a discussion of this change, see Ang & Jiménez, *supra* note 17, at 176.

[64] 11 U.S.C. § 523(a)(8)(B) (2012); Fed. R. Bankr. P. 7001.

[65] The Court did speak on an aspect of undue hardship in 2009. It held, 9-0, that a bankruptcy court was required to determine whether a debtor suffered from undue hardship before canceling their student loans. *See* United Student Aid Funds, Inc. v. Espinosa, 559 U.S. 260, 276 (2010). Just last term the Supreme Court declined to hear a case on this exact issue. Tetzlaff v. Educ. Credit Mgmt. Corp., 794 F.3d 756 (7th Cir. 2015), *cert. denied*, 136 S. Ct. 803 (2016) (mem.).

[66] The *Brunner* test requires "a three-part showing: (1) that the debtor cannot maintain, based on current income and expenses, a 'minimal' standard of living for herself and her dependents if forced to repay the loans; (2) that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and (3) that the debtor has made good faith efforts to repay the loans." Brunner v. New York State Higher Educ. Servs. Corp., 831 F.2d 395, 396 (2d Cir. 1987) (citation omitted).

The totality test uses similar prongs but affords more judicial discretion. *See* C. Tyler Flores, Book Note, *Unprecedented Uncertainty: The Corinthian Colleges Debacle, the Department of Education's Response, and the Bankruptcy Practitioner's Dilemma*, 39 Am. J. Trial Advoc. 651, 675 (2016).

[67] Pardo & Lacey, *supra* note 16, at 406.

[68] Aaron N. Taylor, *Undo Undue Hardship: An Objective Approach to Discharging Federal Student Loans in Bankruptcy*, 38 J. Leg. 185, 188 (2012).

[69] *See* Iuliano, *supra* note 18, at 505.

BAPCPA—and a corresponding loss to the borrowers who suddenly lost the option of discharging these loans. Those loans, originated at a time when PSLs were easily (and automatically) dischargeable in bankruptcy, presumably included within their price a larger risk premium to compensate lenders for the free availability of the bankruptcy discharge. Pre-BAPCPA, borrowers presumably had no choice but to pay for this premium.[70] Nevertheless, after bankruptcy reform became effective, all PSLs, no matter when originated, became equally difficult to discharge in bankruptcy.

Recent analysis of the best and largest dataset available on student loans indicates that the probability of a student defaulting on a loan varies drastically across the types of institutions that the student is attending, even after taking into account various other characteristics such as race and family income.[71] For 2005 graduates (the year when BAPCPA was enacted), the five-year default rate ranged from thirty-six percent at for-profit schools to six percent at selective four-year institutions.[72] The rates were higher for two-year schools than for four-year schools.[73] Other data also show differences in outcomes by major.[74] For example, ten years after graduation, engineering majors owe a significantly smaller share of their debts than do other majors, while social science and humanities majors owe a larger share.[75] Default rates (percentage of borrowers in default) are lowest for business majors, and health majors default on the lowest fraction of their debts (percentage of dollars lent in default).[76]

This leads us to a point of clarification: when discussing our findings, we often assume that the only students materially affected by BAPCPA are students who are *ex ante* more likely to default (for example, students with subprime credit scores).[77] This is in contrast to students who are *ex ante* unlikely to default (for example, prime students at flagship institutions) since, by definition, lenders have less reason to think that these students would file for bankruptcy. These differences across schools and majors, including the fact that the fraction of students at selective four-year institutions

[70] A consumer cannot waive the ability to obtain a bankruptcy discharge by contract. Economic theory suggests that in a competitive market with constant marginal cost the incidence falls on the consumers. *See, e.g.*, E. Glen Weyl & Michal Fabinger, *Pass-Through as an Economic Tool: Principles of Incidence under Imperfect Competition*, 121 J. POL. ECON. 528 (2013). We do not have any evidence to suggest considerable economies of scale that would make marginal cost nonconstant.

[71] *See generally* Adam Looney & Constantine Yannelis, *A Crisis in Student Loans? How Changes in the Characteristics of Borrowers and the Institutions They Attended Contributed to Rising Loan Defaults*, BROOKINGS PAPERS ON ECON. ACTIVITY (2015), https://www.brookings.edu/wp-content/uploads/2016/07/ConferenceDraft_LooneyYannelis_StudentLoanDefaults.pdf [https://perma.cc/C3B3-GSLQ].

[72] *Id.*

[73] *Id.*

[74] *See* Lance Lochner & Alexander Monge-Naranjo, *Student Loans and Repayment: Theory, Evidence and Policy* 36–38 (Nat'l Bureau of Econ. Research, Working Paper No. 20849, 2015), http://www.nber.org/papers/w20849 [https://perma.cc/UN8N-6847].

[75] *Id.*

[76] *Id.*

[77] *Id.*

who default is low both in absolute and in relative terms, suggests that this assumption is valid. Even if BAPCPA made lending to the lower-risk students (such as the ones attending selective schools) even safer, that change was comparatively small relative to the change for the riskier students, such as the ones attending for-profit schools. Further supporting this intuition is the fact that being in default on student loans does not automatically imply that a bankruptcy would be filed. Hence, BAPCPA made it safer to lend to students at selective four-year institutions only through the effect on a fraction of the six percent of those students that end up defaulting.

B. *Rebutting Economic Justifications for Special Treatment of PSLs in Bankruptcy*

In this section, we begin to rebut some of the frequently-heard justifications for the special treatment afforded to PSLs in bankruptcy after 2005.

One of the more common refrains of *laissez-faire* economists and law and economics scholars is that a perfectly competitive market will ensure an efficient outcome.[78] In the case of PSLs post-BAPCPA, the argument would proceed as follows: if having dischargeable student loans would benefit consumers more than it would harm lenders, lenders would offer contracts that ensure effectively dischargeable loans, BAPCPA notwithstanding.[79] However, lenders do not offer such loans, and thus it must be the case that *non-dischargeable* loans benefit consumers since consumers get all the benefits of market competition, whether it is through lower prices or through more efficient contract terms. In short, if dischargeable (and more expensive) loans were efficient, the market would offer them, despite the bankruptcy laws. This particular argument, as any argument that perfect competition results in an efficient outcome, has many assumptions built in, assumptions that do not seem to be satisfied in this particular case.[80] In the next few

[78] This is the first fundamental theorem of welfare economics, derived by economists like Kenneth Arrow and Gerard Debreu in the 1950s. For a more modern treatment, see MAS-COLELL, WHINSTON & GREEN, MICROECONOMIC THEORY (1995). Since then several economists attempted to effectively extend the setting where this theorem applies. *See, e.g.*, Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981) (arguing that reputation incentives in a competitive market might be sufficient to assure contractual performance without the need for regulation or contracts).

[79] The contract could have a provision specifying that if the consumer obtains a discharge in a bankruptcy proceeding, the lender will not enforce this loan. Such language would not affect the bankruptcy proceedings themselves: the loan is still non-dischargeable. Nonetheless the lender has contractually obligated itself to effectively forgive the loan after the borrower gets a bankruptcy discharge. Attempting to collect the loan post-bankruptcy would of course be allowed, since bankruptcy did not discharge the loan. However, the lender who chose to do this would likely run afoul of consumer laws enforced by the CFPB. In particular, the CFPB would likely consider it an unfair act or practice to continue to collect and debt collectors might be subject to lawsuits under the Fair Debt Collection Practices Act. Although a novel issue, the lender might also be subject to contract damages.

[80] According to a prominent education economist, "[t]here has never been a large-scale, competitive, private market for student loans in the U.S. Further, economic theory predicts

paragraphs, we outline the argument and the main assumptions in detail, as well as the reasons that we do not believe that the main assumptions of the argument are satisfied in this instance.

For the sake of the next few paragraphs, suppose that consumers are perfectly informed, rational, and forward-looking. Also suppose that, in addition to choosing the product's price (or quantity), lenders also choose additional attributes of the loan. One attribute could be, for example, whether the loan is dischargeable in bankruptcy. If the lender chooses dischargeable loans, it can also choose how much of the loan is dischargeable and in which circumstances. In general, this attribute could be anything that consumers value, for example quality of the product. Regardless of the nature of the attribute, Professor Spence illustrated that firms do not have the right incentives to reach an efficient outcome, even in a perfectly competitive market.[81] A profit-maximizing firm caters to the marginal consumer (the one indifferent between taking out a loan with this firm, as opposed to a loan with another firm or no loan at all) as opposed to the average consumer (a consumer who is likely to take out a loan regardless of marginal changes in pricing or in quality). Nevertheless, for the purposes of a social welfare-maximizing outcome, the firm should have been catering to its average consumer. This type of catering to the marginal consumer, who matters for profit, as opposed to the average consumer, who matters for efficiency and social welfare, is present regardless of whether firms are in a perfectly competitive market.[82]

Similar issues arise if there is asymmetric information (lenders do not know consumers' riskiness) and consumers can signal the fact that they are low-risk by agreeing to particularly onerous contract terms. The model is that of lower-risk and higher-risk consumers, with lenders being unable to differentiate between the two. However, given a contract with particularly onerous terms in case of default, a lower-risk consumer will agree to the contract since the consumer knows that she is unlikely to incur the onerous

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there will never be a large-scale, competitive, private market for student loans. Milton Friedman pointed this out in 1955." Dynarski, *supra* note 55.

[81] *See* A. Michael Spence, *The Economics of Internal Organization: An Introduction*, 6 BELL J. ECON. 163, 163–72 (1975) (discussing importance of firm incentives to reach efficient outcomes); *see also* Eytan Sheshinski, *Direct Versus Indirect Remedies for Externalities,* 84 J. POL. ECON. 797, 797–808 (1976) (discussing tax policies designed to obtain improved competitive allocation in the presence of consumption externalities). Spence won the 2001 Nobel Prize in Economics.

[82] This paragraph does not apply in several knife-edge cases. Most notably, it does not apply in a perfectly competitive market where each firm has only one decision variable. For example, if each firm chooses only quantity produced, the products are homogeneous, the market is perfectly competitive, with perfectly informed consumers, then the argument in this paragraph does not apply and instead the first fundamental welfare theorem mentioned above applies: the market outcome is efficient.

However, relaxing any of these conditions results in a market inefficiency described in the paragraph. Note that this market inefficiency is relative to a hypothetical first-best world. In the real world, where the government is not omnipotent, omniscient, and frictionless, the inefficient market outcome has to be compared with the inefficient government intervention outcome. *See* RONALD COASE, ESSAYS ON ECONOMICS AND ECONOMISTS (1994).

default costs. On the other hand, a higher-risk consumer will not agree to the same terms since the likelihood of the onerous default costs is higher. This leads to a separation between lower-risk consumers (who pay lower prices) and higher-risk consumers. A perfectly competitive market results in too much signaling: lower-risk consumers want to signal that they are low risk to separate themselves from higher-risk consumers, but this signaling is excessive from the efficiency perspective as lower-risk consumers end up taking riskier terms than necessary simply to signal that they are in fact lower risk.[83] For example, in the context of bankruptcy, low-risk consumers might agree to take a loan that is nondischargeable simply to show the lender that they are low-risk consumers, while all loans being dischargeable could be a more efficient outcome.[84]

For similar reasons, requiring an opt-in—consumers having to opt into loans that are nondischargeable (and receiving a price cut)—might also not result in an efficient outcome. All the lower-risk consumers will opt into a nondischargeable loan, effectively agreeing to the onerous contract terms discussed above, with all the same issues arising. In other words, regardless of the starting point—an opt-in or a menu of choices as in the previous paragraph —the market outcome is inefficient. The fact that consumers possess private information that can affect lenders' profits is, in a sense, a Coasian transaction cost that prevents an optimal outcome.[85]

Finally, for the last several paragraphs we assumed that consumers are perfectly informed, rational, and forward-looking: assumptions that can be immediately rejected by interacting with a typical consumer obtaining their first student loan (a seventeen or an eighteen-year-old who just graduated from high school). In addition to voluminous evidence of consumers' behavioral biases in general,[86] there are also numerous studies showing students are significantly affected by various nudges in presentation of the disclosure form, often in contrast to much smaller effects of lower interest rates.[87] Un-

[83] *See, e.g.*, Leah Shepard, *Seeking Solutions to Financial History Discrimination*, 46 Conn. L. Rev. 993 (2014).

[84] *See* Samuel A. Rea Jr., *Arm-Breaking, Consumer Credit and Personal Bankruptcy*, 22 Econ. Inquiry 188, 188–208 (1984) (discussing complex contracts with secured credit transactions attempting to provide efficient repayment).

[85] *See* Ronald H. Coase, *The Problem of Social Cost*, 3 J. Law & Econ. 1, 1–44 (1960) (discussing the economic problem of externalities). Coase postulated that, in the absence of transaction costs, market participants will be able to negotiate their way to an efficient outcome. For example, if a factory produces too much pollution that makes people living around the factory develop health issues, people living around the factory will simply pay the factory owner to adopt greener technology. However, transaction costs might negate that: for example, some people will be unaware of the true extent of the issue, and others will want to free-ride on their neighbors. If enough of my neighbors pay for the greener technology, then I do not need to.

[86] *See, e.g.*, Daniel Kanehman, Thinking, Fast and Slow (2011).

[87] *See, e.g.*, Richard H. Thaler & Cass R. Sunstein, Nudge: Improving Decisions About Health, Wellness, and Happiness (2008). For more recent applications to student loan choices, see Maximilian Schmeiser et al., *Does Salient Financial Information Affect Academic Performance and Borrowing Behavior Among College Students?*, 75 Fin. & Econ. Discussion Series 1–38 (2015); Benjamin L. Castleman & Lindsay C. Page, *Freshman Year Financial Aid Nudges: An Experiment to Increase FAFSA Renewal and College Persistence*

surprisingly, consumer behavioral biases frequently result in competitive markets not leading to efficient outcomes: firms cater to consumers' biases as opposed to consumers' true long-term well-being.[88]

II. Data

Our data includes origination records of all private student loans originated or purchased by the nine largest private student lenders from 2005 through 2011.[89] These data were voluntarily submitted to the CFPB by the participating lenders for the purposes of a 2012 report to Congress on Private Student Loans.[90] We refer to these data as the CFPB PSL Loan Level Data Set.[91]

These data are at the loan level and include the information that private student loan lenders may use in underwriting such as borrower and co-borrower credit scores, school and program attended, year in school, and amount borrowed.[92] In addition, the data include information about the terms of the loan including the deferment term, the repayment period, and pricing information. Almost all of the PSLs in the sample are variable rate loans indexed to prime, LIBOR, T-Bills, or another index. The data includes the original interest rate, the index the interest rate is tied to, and the "margin"

1–32 (EdPolicyWorks, Working Paper No. 29, 2014); Xialing Ang & Alexei Alexandrov, Choice Architecture Versus Price: Comparing the Effects of Changes in the U.S. Student Loan Market (2016) (unpublished manuscript) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2504060; Christa Gibbs, Essays on Financial Aid and Loan Aversion (May 26, 2016) (unpublished Ph.D. dissertation, University of Wisconsin—Madison), http://gradworks.umi.com/10/12/10124982.html [https://perma.cc/4M6G-EAXX].

[88] *See, e.g.*, Oren Bar-Gill, Seduction by Contract: Law, Economics, and Psychology in Consumer Markets (2012); Alexei Alexandrov, *Competing for Consumers with Self-Control Problems*, 25 J. Econ. Mgmt. & Strategy 179, 179–94 (2015); Sefano Dellavigna & Ulrike Malendier, *Paying Not to Go to the Gym*, 96 Am. Econ. Rev. 694, 694–712 (2006); Michael D. Grubb, *Overconfident Consumers in the Marketplace*, 29 J. Econ. Persp. 9, 9–35 (2015); Paul Heidues & Botond Köszegi, *Exploiting Naivete About Self-Control in the Credit Market*, 100 Am. Econ. Rev. 2279, 2279–2303 (2010); *see also* Kathy Chu, *Credit Cards Go After College Students*, USA Today (Apr. 4, 2008), http://usatoday30.usatoday.com/money/perfi/college/2008-03-30-credit-cards-college_N.htm [https://perma.cc/TV2K-QN9V]; Thomas Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard Law Sch. Program in Law & Econ., Discussion Paper No. 16, 1985), http://www.law.harvard.edu/programs/olin_center/papers/pdf/Jackson_16.pdf [https://perma.cc/V4WE-3XG9].

[89] "The participating lenders included: RBS Citizens N.A., Discover Financial Services, The First Marblehead Corporation, JPMorgan Chase Bank, N.A., PNC Bank, N.A., Sallie Mae, Inc., SunTrust Banks, Inc., U.S. Bank National Association, and Wells Fargo Bank, N.A. The information was provided under a non-disclosure agreement and is protected under various federal laws as proprietary and confidential business information." CFPB PSL Report, *supra* note 12, at 109.

[90] *Id.*

[91] We only use data from 2005 to 2007. Unfortunately, both for the country and for our purposes, the great recession happened right after that, thus any comparisons of pre-2007 data with post-2007 data in the same regression is at best suspect.

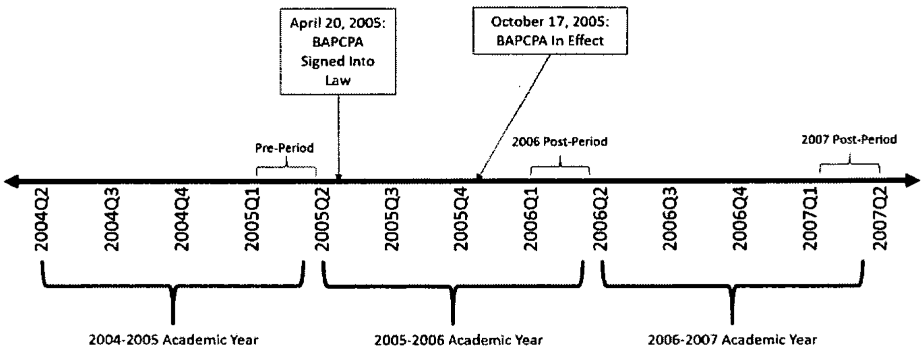
[92] The actual information and algorithms used by lenders to make financing decisions are closely guarded proprietary secrets. However, while it is possible that some lenders in the sample used information we do not have here to make lending decisions, we do not believe that information would have been used for pricing decisions.

for a particular loan. The margin is the risk-based premium the lender charges over this cost of funds. The data were standardized across lenders. In order to preserve the confidentiality of the participating lenders' business practices, the loans were anonymized so that loans to the same borrower can be linked within lender but cannot be linked across lenders.

We augment the data by merging the PSL Loan Level Data Set to two Department of Education administrative datasets: the Integrated Postsecondary Student Aid Study (IPEDS) and the Postsecondary Education Participants System (PEPS). IPEDS is an annual census of schools that participate in Title IV federal student aid programs and includes information on enrollments, graduation rates, and institution financial condition. PEPS rolls up data from federal student aid programs at the institution and program level.

Given the timing of the introduction of BAPCPA and the start of the CFPB PSL Loan Level Dataset, illustrated in Figure II-1, we restrict attention to the first quarter of each year.[93] This allows us to net out any seasonal patterns in borrowing that may affect our analysis. We also restrict the sample to four-year undergraduates at private non-profit or public institutions.

FIGURE II-1: TIMELINE OF POLICY CHANGE[94]



Descriptive statistics for select variable in each quarter included in the analysis dataset are presented in Table 2. Over time, average original interest rates increase from 7.1% to 8.6% to 10.4%, due to a combination of rising

[93] BAPCPA was not a new law. In 2000, both the Senate and the House passed a bankruptcy reform bill that was substantially similar to the one that eventually became BAPCPA. With regard to the presumptive nondischargeability of PSLs, it was exactly the same. President Bill Clinton vetoed that bill, but after President Bush was elected, a veto was no longer an obstacle. Well before March 2005, many newspapers reported that BAPCPA was imminent. Nevertheless, lenders would not have changed their policies before April 20, 2005 for two major reasons. First, because the timing of when the law would be signed and become effective was not known. And second, because regulators would have likely frowned upon a bank who decided to change their lending policies to give higher-risk borrowers more loans (or give them a discount in loans) before the loans themselves actually became nondischargeable. For further discussion, see Ang & Jiménez, *supra* note 17, at 195–96.

[94] This graphic was also used in Ang & Jiménez, *supra* note 17. It is used here with permission.

index rates as well as increasing margins. The characteristics of borrowers are relatively stable over time: mean graduation rate is roughly fifty-two to fifty-three percent for all three quarters, average tuition and fees are approximately $12,000 per year,[95] and about a third of borrowers attend a private institution. It appears that the average credit characteristics of borrowers are also relatively stable: approximately eighty percent of borrowers have a co-borrower, and the maximum FICO among co-borrowers (maximum FICO) is between 710 and 720, while the average student borrower's FICO score is roughly 650.

TABLE 2: DESCRIPTIVE STATISTICS BY QUARTER (AVERAGES)

	(1) 2005Q1	(2) 2006Q1	(3) 2007Q1
Original Rate	7.147%	8.620%	10.359%
Original Balance	$10,780	$11,220	$11,515
Origination Fee	7.286%	7.074%	6.748%
Margin	4.369%	4.652%	5.047%
Has a Co-Borrower	78.7%	80.5%	79.8%
Maximum FICO Score	720	718	710
Borrower FICO Score	654	651	643
Tuition and Fees	$11,548	$11,849	$12,154
Private School	35.2%	31.7%	30.2%
Graduation Rate	52.83%	53.05%	52.43%
Observations	17,054	57,183	82,167

Notes:
Restricted to four-year undergraduates at public and private not-for profit schools in the first quarters of 2005, 2006, and 2007.
Source:
CFPB PSL Loan Level Dataset, IPEDS, and PEPS.

These averages tell a story of increasingly more expensive loans as well as decreased borrower credit quality. The average starting rate of the loans (original rate) increased over 1.5% between 2005–06 and 2006–07. Recall that the original rate is made up of the index (e.g., LIBOR or three-month treasury bill) plus the margin. Margins increased also over time, although not as much as did the original rate. At the same time as interest rates were increasing, so were the number of loans being issued. Between 2005 and 2006, the number of loans more than tripled. In separate work, we attribute some of the increase from Q1 2005 to Q1 2006 to bankruptcy reform.[96] The further increase in 2007 is also consistent with the increasing volumes seen in the securitization of mortgages, auto, credit card, and equipment asset-

[95] We exclude room and board from our calculation to abstract from the on-campus versus commuting or off-campus decision.
[96] Ang & Jiménez, *supra* note 17.

backed securities seen during this time.[97] An increased appetite for private student loan asset-backed securities (PSLABS) might also explain the decreasing borrower credit quality between 2005 and 2007.[98]

III. Empirical Strategy

This part describes our empirical approach. We begin by describing our assumptions and justifications for each. We then describe the two techniques we use in our analysis, the regression discontinuity design (RD) and the difference-in-differences (DD) strategy. These econometric techniques allow us to make causal inferences about the effect of BAPCPA on the PSL market but only if the assumptions are plausible.

A. *Assumptions*

Since our data is limited to loans that were originated, we do not observe loans that were offered to consumers but not accepted. We make two plausible assumptions throughout our analysis:

(1) Consumers are not manipulating their credit scores around the 645 FICO score threshold[99] and
(2) Loan terms are based on observable characteristics that appear in the data.

The first assumption implies that demand for loans and application rates are the same for potential borrowers on either side of the threshold. This assumption is equivalent to saying that individuals on either side of the threshold are also similar on factors that we do not observe in the data: for example, metrics of ability such as students' high school grades or test scores. We tested whether the consumers on different sides of the threshold differ on the dimensions that we can observe, and it does not appear that they do. Of course this is different from being able to say with certainty that there is no unobservable characteristic on which 644 and 646 consumers differ dramatically, but even in that case this unobservable characteristic is

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[97] *See Statistics*, Sec. Indus. & Fin. Mkts. Assoc. (SIFMA) (June 3, 2014), http://www.sifma.org/research/statistics.aspx [https://perma.cc/A42F-XJYL].

[98] *See* CFPB PSL Report, *supra* note 12, at 18 ("A large portion of student loan volume during the boom was funded by asset-backed securities ('ABS'). In this respect, the private student loan market resembled the subprime mortgage market. During the boom, high investor demand for student loan ABS ('SLABS') allowed SLABS issuers to create structures with very low collateralization ratios. As a result of these factors, $100 in student loans could generate immediate cash proceeds from securitization of $105 or more. Generally speaking, the buyer assumed all of the risk that the borrower would fail to repay the loan after such a transaction. Therefore, a PSL lender had an incentive to increase loan volumes made for such a sale, with less incentive to assure the creditworthiness of those loans. This dynamic provided the means and the incentive for PSL lenders and SLABS issuers to originate and securitize greater and greater amounts of PSLs between 2005 and 2007 . . . .").

[99] In other words, the density of credit scores for private student loan applicants and their co-borrowers is smooth through the threshold.

not observed by either us or the lenders, making it unlikely that this is the reason for the price differential. This first assumption is crucial but eminently plausible for the following reasons.

First, FICO scores are generated solely from the information in a consumer's credit report, and consumers have little control over the information on their credit report. The information in a credit report is reported by entities the consumer has a financial relationship with. Most typically, these are lenders who issue credit cards, mortgage, auto, or personal loans. It may also include landlords, utility companies, or medical service providers.[100] The only way to "opt out" of having information in a credit report is to avoid a financial relationship with someone. There is also no way to "opt in" to reporting to a traditional credit bureau. There is no law requiring anyone to report information to a credit bureau.[101]

Second, consumers also have no control over when information in a credit report is actually transmitted to a credit bureau. Credit scores are recalculated whenever a lender requests a score, so that even the consumer herself could not know exactly what information would be in her credit report when the lender requests a score.[102] The effect of all of this is to make it near-impossible to successfully manipulate a credit score at just the right time for a particular credit application, particularly within a few credit score points of 645 as we are talking about here.

Finally, in order to manipulate her credit score, a consumer would first have to know her score. But few consumers ever obtain their credit reports or know their credit score.[103] Moreover, there is no single credit score that every lender uses. FICO, which sells ninety percent of the credit scores sold in the market, offers over forty-nine different kinds of FICO scores to lenders and others.[104] A consumer has no visibility into which kind of FICO score a lender uses to make a decision about her loan. Even if the consumer somehow knew the exact type of score, it is unlikely that she could purchase this same score type herself.[105] Thus, while the preceding paragraphs suggest

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[100] Rich Smith, *CFPB Report: The Credit Report Game Is Rigged—And Not In Your Favor*, MOTLEY FOOL (Mar. 26, 2014), http://www.fool.com/investing/general/2014/05/26/cfpb-reports-the-credit-report-game-is-rigged-and.aspx [https://perma.cc/3HGN-R5Y5].

[101] Robert B. Avery et. al., *An Overview of Consumer Data and Credit Reporting*, 89 FED. RES. BULL. 47, 49 (2003)

[102] The only sort of "control" a consumer has with regard to their credit report is that she can dispute erroneous information she finds in that report.

[103] In fact, only one in five consumers obtain their free credit report annually. *See* CONSUMER FIN. PROT. BUREAU, KEY DIMENSIONS AND PROCESSES IN THE U.S. CREDIT REPORTING SYSTEM: A REVIEW OF HOW THE NATION'S LARGEST CREDIT BUREAUS MANAGE CONSUMER DATA 27 (2012) (noting that very few consumers visit www.annualcreditreport.com to obtain the free credit report that federal law mandates that everyone be entitled to every twelve months); CONSUMER FIN. PROT. BUREAU, CONSUMER VOICES ON CREDIT REPORTS AND SCORES 9 (2015) (noting consumer confusion over credit reports and scores).

[104] *See* CONSUMER FIN. PROT. BUREAU, ANALYSIS OF DIFFERENCES BETWEEN CONSUMER- AND CREDITOR-PURCHASED CREDIT SCORES 20 (2012).

[105] *See id.* at 8 (finding that credit scores used by lenders can differ from the educational scores that a consumer can purchase and noting that the different credit scores can sometimes differ significantly).

that a consumer might find it difficult to manipulate her credit score, it is not clear how many consumers even know that they should consider doing it, even if it were possible.[106]

The second assumption—that loan terms are based on observable characteristics in the data—is corroborated by qualitative questions that were submitted to the participating lenders as part of the data request for the CFPB Loan Level Private Student Loan Data. These questions related to their current loan terms and conditions, underwriting criteria, and default management policies.[107]

The pricing and availability of credit for a given individual is determined by automated underwriting models. These models are formulas for the loan terms a customer receives, and are based on the customer's observable characteristics at a particular point in time. The inputs into these formulas can include information such as school attended, program enrolled in, whether there is a co-borrower on the loan, and the applicant's credit score.[108] This type of underwriting technology is pervasive in consumer credit markets: some of the best-known examples are Desktop Underwriter and Loan Prospector, which are automated decision-making tools for mortgage lending that were introduced in 1995 by Fannie Mae and Freddie Mac.[109] It thus seems likely that lenders relied only on the student-level data available in our dataset when deciding what interest rate to charge.

B. The Regression Discontinuity (RD) Design

Our empirical strategy takes advantage of the fact that lenders' pricing policies separate borrowers into groups and offer different prices to each. The simplest of these groupings involves picking a particular cutoff credit score that determines the "prime" borrowers (those with the higher credit score and lower risk of default) and "subprime" (lower credit scores and higher risk of default). Because borrowers do not have precise control over the credit scores, we are able to use a quasi-experimental design to study the effects of BAPCPA. Specifically, we use a regression discontinuity (RD) design to estimate the effect of BAPCPA on students' decisions to borrow and creditors' decisions to lend. In other words, we use RD to estimate effect

[106] Even if consumers wanted to and could somehow overcome all of the difficulties discussed earlier to manipulate their score, they have less of an incentive to do so if they are interested in obtaining any other types of credit products. That is because threshold credit scores can differ between consumer products. For example, Fannie Mae sets a minimum representative credit score of 620 for the fixed rate mortgages it purchases and a minimum representative credit score of 640 for adjustable rate loans. *See* FANNIE MAE, SELLING GUIDE: FANNIE MAE SINGLE FAMILY 486 (2015).

[107] CFPB PSL REPORT, *supra* note 12, at 7.

[108] We will use FICO score and credit score interchangeably in the discussion.

[109] *See* Michael La Cour-Little, *The Evolving Role of Technology in Mortgage Finance*, 11 J. HOUSING RES. 173 (2000).

three from the Introduction: whether students are induced by lower interest rates to take out more loans.[110]

Lenders typically divide borrowers into categories based on being at or above a threshold credit score. Applicants for a particular product are then given offers that may vary a great deal depending on whether they end up below or above that threshold. Assuming that consumers do not have precise control over their credit scores, as explained above, consumers just above or below a threshold credit score should be similar. However, the consumer just above the threshold would be offered a different product from the consumer just below the threshold. This is an ideal opportunity to implement an RD design. This technique makes use of this hair-trigger difference in product offerings by credit score to estimate the effects of being offered one product over the other (or no product at all).[111]

We compare similarly situated students on different sides of the 645 threshold. The only observable difference is that students just under the threshold received a loan offer with an interest rate that is three percent higher. Finding a significant difference in loan take-up rates between these two groups of students would imply that students are price elastic, meaning that students make their decisions, at least in part, based on the interest rate of the loan. In contrast, finding no difference in the rates at which students take up loans would suggest that students are price inelastic, meaning that they are driven primarily by factors other than the interest rate they are charged. Either finding sheds light on effect three mentioned in the Introduction: if the lenders were to pass through some of the savings to the students in terms of lower interest rates, would more students enter the market? To preview our results, we do not find a statistically significant difference in take-up rates between these two groups of students, implying that even if lenders passed savings from stricter bankruptcy rules to borrowers, the result would be little or no increase in borrowing—effect three from the Introduction is effectively absent in this setting.

We compare borrowers who are close to, but above, the 645 FICO threshold with borrowers who are close to, but below, the threshold. Note that this method does not shed light on the behavior of borrowers far from the threshold. For example, while we can confidently say that a borrower with a 644 FICO is very much like a borrower with a 646 FICO, we cannot

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[110] For a discussion on the regression discontinuity design, see Miguel de Figuereido, *Throw Away the Key or Throw Away the Jail? The Effect of Punishment on Recidivism and Cost*, 47 ARIZ. ST. L. REV. 1017, 1044 (2016).

[111] Our data are limited to loans that are originated, so we unfortunately neither observe individuals who applied for loans and were denied nor individuals who were offered loans but decided not to take them. However, we believe that while firms may differentiate their product offerings across a credit score threshold, it is unlikely that the population of consumers would have preferences that differ so starkly on either side of a particular credit score. Consequently, we assume that we have the full range of products over which consumers are making decisions, although we may not have the proportions in which they were offered to the population. We also introduce density regression discontinuity, which is discussed in more detail in Section B and Appendix A.

compare a borrower with a 500 FICO to a borrower with an 800 FICO. Thus, our estimates should be interpreted in light of this limitation—estimates that economists refer to as local average treatment effects.

It is easy to see that 644 is sufficiently close to 646, while 500 is too far from 800, but the more intermediate cases are not obvious. Economists have developed various approaches to estimate just how far away from the threshold we can move and still include observations without fearing that they are too far away from the threshold. In our analysis, we use one of the latest such techniques,[112] a data-driven approach.[113] This approach allows us to compare outcomes within a reasonable distance of the 645 threshold. The method uses the underlying data to determine how far away one can move from the threshold and still be able to use observations in our analysis (this distance is called the "bandwidth").[114] By way of illustration, when we report a bandwidth of 5, this means that our analysis is only applicable to those loans issued to students with within five credit score points from the 645 threshold. In other words, students with maximum FICO scores of 640–44 and 645–49.

C. *The Difference-in-Differences (DD)* Strategy

Borrowers with lower FICO scores are by definition at higher risk of defaulting on their debts. But after BAPCPA, a default on a student loan debt does not have the same effect as a default on other types of debts. The student loan debt is more collectible since the borrower is (practically) unable to discharge it in bankruptcy. Thus, post BAPCPA, the difference in pricing between higher- and lower-risk borrowers should have narrowed. To investigate whether this happened, we take the difference between the difference at the discontinuity in 2006 Q1 and the difference at the discontinuity in 2005 Q1. We refer to this as the difference-in-differences (DD) strategy. This analysis allows us to estimate the magnitude (or presence) of effect two from the Introduction: whether the lenders pass through savings in terms of interest rates, and if so, how much.

[112] Previously, researchers used a global polynomial approach which fits a model on each side of the threshold and compares the estimated values for each model evaluated at the discontinuity. *See* David Card & Lara D. Shore-Sheppard, *Using Discontinuous Eligibility Rules to Identify the Effects of the Federal Medicaid Expansions on Low-Income Children*, 86 REV. ECON. & STAT. 752, 752–66 (2004).

[113] Calonico, Cattaneo, and Titiunik's approach is based on the concept of minimizing mean-squared errors. While previous literature suggested choosing the optimal bandwidth based on minimizing the mean squared error of the estimator, CCT also adjusts the bandwidth choice to account for the small sample bias and, accordingly, bandwidths that are "too large" if derived simply by minimizing mean squared error. *See generally* Sebastian Calonico et al., *Robust Nonparametric Confidence Intervals for Regression-Discontinuity Designs*, 82 ECONOMETRICA 2295 (2014).

[114] Note that since the comparison is restricted to a bandwidth that is smaller than the full range of FICO scores in the population our sample sizes used to estimate the effects of the lenders' policies at the threshold will be smaller than the size of the underlying sample.

We cannot stop there, however. It is possible that any shrinking of the gap we observe is as a result of a separate trend. This is because in the DD strategy just described we are only comparing a period immediately before BAPCPA to a period after BAPCPA. To rule out whether a pre-existing trend, separate from the enactment of BAPCPA, might be responsible for the narrowing of the differences, we compare our DD estimate between 2005 Q1 and 2006 Q1 to a DD estimate for a period where there was no change in law related to PSLs, 2006 Q1 to 2007 Q1. The idea here is that if BAPCPA caused the narrowing in the difference between the interest rates offered to high-risk students to the interest rates offered to low-risk students, we should not see a narrowing the following year. We call this estimate our difference-in-difference-in-differences (DDD) estimate.[115] This is essentially the subtraction of the DD estimate from the period around BAPCPA from the DD estimate from the period one year after BAPCPA.

In other words, we analyze whether the difference in interest rates between risky and safe students shrunk as a result of BAPCPA. If the difference remained constant, then despite risky students not being able to discharge loans in bankruptcy, the lenders are still charging them the same risk premium as before, suggesting no pass through of savings by the lenders to the students. In contrast, a shrinking gap would suggest that the lenders passed through some of the savings to the students in terms of lower interest rates. This analysis allows us to estimate the magnitude (or presence) of effect two from the Introduction: whether the lenders pass through savings in terms of interest rates, and if so, how much.

[115] As described in the text, we first estimate the regression discontinuity (RD)—the difference between FICO 644 and FICO 646 consumers—results for each year: 2005, 2006, and 2007. Then, we compare results across years: 2005 vs. 2006 and 2006 vs. 2007—so-called differences-in-differences (DD). In particular, the 2005 vs. 2006 DD shows how the change was different in a non-BAPCPA year. Finally, to see whether we are simply picking up a trend (as it turns out that we are), we compare the 2005 vs. 2006 DD with 2006 vs. 2007 DD—differences in differences-in-differences (DDD).

We assume that the 2005 Q1, 2006 Q1, and 2007 Q1 samples are independent, so we can calculate the DD and DDD standard errors by treating each quarter's RD estimate as an estimate from an independent random variable so the variance of the sum is the sum of the variances. Richard Larsen & Morris Marx, An Introduction to Mathematical Statistics and Its Applications 223 (3rd ed., 2001). The standard error is computed as the square root of the sum of the squares of the RD estimated standard errors for each RD included in the computation of the DD or DDD. The difference between two random variables is the sum of the first random variable and the random variable that is the negative of the second random variable. Note that when 2006 Q1 enters into the DDD twice it also enters into the standard error calculation.

Regarding the assumption of independence, we realize that there may be some individuals who appear in multiple samples as they are borrowing for multiple terms. Although we can observe multiple loans within lender we cannot observe loans across lenders, and we see few borrower-lender pairs across multiple calendar years. Consequently, our standard errors may be underestimated, which may overstate the precision of the estimates. This is only relevant to the extent that borrowers' maximum FICO scores are within the relevant bandwidths for all years that the borrower appears in the sample, which may be mitigated by FICO scores changing over time.

As a preview of our results, we find that the gap indeed shrunk somewhat. However, we also find that the gap kept on shrinking two years after BAPCPA as well, suggesting that the diminishing risk premium is a part of a trend not caused by BAPCPA. After we control for the trend, we do not find statistically significant evidence that BAPCPA decreased the risk premium of risky student borrowers, suggesting that effect two from the Introduction is effectively absent in this setting as well: despite borrowers losing their ability to discharge private student loans in bankruptcy, there was no associated drop in interest rates. Unfortunately, our ability to control for a trend that might have been ongoing before 2005 is limited by the data because the available data does not begin until the first quarter of 2005. This is why we employ the DDD approach described above to control for the trend. That is to say, we assume that without BAPCPA there was a permanent trend: the same trend as we can observe when comparing 2006 to. 2007. Thus, we ask whether the difference between 2005 and 2006 is sufficiently different from the underlying (2006 versus 2007) trend.[116]

IV. Results

As mentioned earlier, we find a discontinuity in interest rates that students pay at the 645 FICO score: students whose maximum FICO score is just below 645 have to borrow at a considerably higher interest rate (close to three percentage points higher) than students whose maximum FICO score is just above 645. We document this discontinuity in the Appendix and also discuss in detail why it is highly unlikely that students are able to manipulate their, or their co-borrowers', credit scores.[117]

Given this discontinuity, we can employ the RD economic technique since students with a FICO score of just below 645 (such as 644) are likely to be very similar to students with FICO scores of just above 645 (such as 646), with the only major difference being that the first group faces much higher interest rates.[118]

Recall that we are interested in learning about whether BAPCPA caused consumers to enjoy lower prices (what we called "effect two" in the Introduction). We are also interested in whether new borrowers would decide to enter the market as a result of lower prices (what we called "effect three").

In Part IV.A we use the DD setup (discussed in Part III.C) to analyze whether interest rates indeed decreased due to BAPCPA. We postulate, based

[116] For this method to be reasonable, we assume that any trend that was occurring between 2005 and 2006 would have continued through 2007.

[117] In brief, we use econometric techniques to show that lenders are using a FICO score cutoff at 645 in deciding who is a subprime (high risk) and a prime (low risk) borrower.

[118] The same analysis applies if we are talking about students who apply with a co-borrower. As the lenders in the sample told the CFPB, at this time the underwriting used the "maximum FICO" score as between a borrower and their co-borrower. But the same reasons that it would be difficult (if not impossible) for a borrower to manipulate her credit score around the threshold apply to a co-borrower, as detailed in the Appendix.

on literature discussed above, that some students are likely to be much safer borrowers from the loan issuers' perspective. For these safer, prime, borrowers BAPCPA should not have changed interest rates significantly—these borrowers are unlikely to end up in bankruptcy, and thus BAPCPA is largely irrelevant from the loan issuers' perspective as applied to the prime borrowers. To make sure that we do not attribute the impact of other changes in the economy and education markets at the time to BAPCPA, we analyze the difference between the interest rates paid by subprime and prime borrowers, and how that difference changed from before to after BAPCPA. We find that in 2006 (first year post-BAPCPA) relative to 2005 (last year pre-BAPCPA), the difference between subprime and prime borrowers shrunk by 0.91 percentage points. However, we find that in 2007 relative to 2006, the difference between subprime and prime shrunk again by 0.84 percentage points.[119] Thus, the 2005 to 2006 difference seems to be part of a trend.

Our de-trended estimate of BAPCPA impact is thus the difference between 2005 to 2006 and 2006 to 2007: 0.07 percentage points. Unfortunately, we do not have data before 2005 to be able to make a more precise finding. Thus, the estimate that we find most persuasive (the de-trended estimate) is that the issuers' cost decrease passed through to consumers (effect two from the Introduction) is 0.07 percentage points—both statistically and economically indistinguishable from zero.

Despite its promise then, it appears that BAPCPA did not lower prices. But what if it had? In Part IV.B, we measure whether students take out more loans at lower interest rates. In other words, would BAPCPA's promised (though undelivered) cost savings have enticed more students to take out loans? One might expect so, but our data suggests instead that students around the FICO threshold are not price sensitive. Using the RD design described in Part III.B, we find no statistically significant difference in borrowing rates between students whose maximum credit score is just above 645 and students whose maximum credit score is just below 645, despite a considerable difference in interest rates faced by the two groups.

Our finding suggests that, at least for the students with subprime co-borrowers and in the range of a three percentage point interest rate changes, a lower interest rate does not result in more students taking out loans.[120] This means that even if BAPCPA had lowered interest rates for students with subprime co-borrowers, even by as much as three percentage points, this interest rate decrease would not have resulted in additional students entering the market due to their inelastic demand. In other words, effect three from the Introduction is absent for BAPCPA.

[119] In 2005, borrowers whose maximum FICO score was just above the 645 threshold paid 1.76% lower in the margin of their loan than borrowers whose maximum FICO was just below the threshold. In 2006, the difference between those borrowers was 0.92%. In other words, the difference in price around the threshold decreased by almost half.

[120] This result was significant at the one percent level. See Table 3, Part IV.A *infra* and accompanying discussion.

Of course even if the effect is much higher—and given our standard errors we cannot rule out an effect as high as one percentage point—findings in Part IV.B. still suggest that lower prices did not lead new consumers to enter the market.

A. *BAPCPA Did Not Lower Prices*

In this section, we analyze the change in interest rate margins between safe and risky borrowers before and after BAPCPA. As discussed above, the effects of bankruptcy nondischargeability on default rates and loss-given-default should theoretically be larger for riskier borrowers, so we should expect the price differential between riskier borrowers with lower FICO scores and less risky borrowers with higher FICO scores to narrow after the implementation of BAPCPA. Contrary to expectation, we do not find evidence of such narrowing that can be attributed to BAPCPA.

TABLE 3: DIFFERENCE-IN-DIFFERENCES AND DIFFERENCE-IN-DIFFERENCE-IN-DIFFERENCES REGRESSION DISCONTINUITY[121]

	(1) All Students Margin (%)	(2) Private Margin (%)	(3) Public Margin (%)	(4) Extensive Ph.D. Granting Institutions Margin (%)
(1) 2005 RD (Pre-BAPCPA)	-2.67***	-2.75***	-2.38***	-3.17***
	(0.15)	(0. 20)	(0.19)	(0.65)
(2) 2006 RD (Post-BAPCPA)	-1.76***	-1.76***	-1.78***	-1.77***
	(0.30)	(0.39)	(0.17)	(0.33)
(3) 2007 RD (Post-BAPCPA)	-0.92***	-0.99***	-1.23***	-0.82***
	(0.12)	(0.17)	(0.12)	(0.10)
(4) 2006 vs. 2005 DD (2006 RD	0.91***	0.99**	0.60***	1.40*
less 2005 RD)	-0.34	(0.44)	(0.25)	(0.73)
(5) 2007 vs. 2006 DD (2007 RD	0.84***	0.77*	0.55***	0.95***
less 2006 RD)	(0.32)	(0.43)	(0.21)	(0.34)
(6) DDD (2007 vs. 2006 DD less	0.07	0.22	0.05	0.45
2006 vs. 2005 DD)	(0.47)	(0.61)	(0.33)	(0.81)
Discontinuity Credit Score	645	645	645	645
N 2005 Below 645	39	27	56	32
N 2005 Above 645	144	340	346	94
N 2006 Below 645	170	80	135	167
N 2006 Above 645	355	207	217	370
N 2007 Below 645	355	207	217	370
N 2007 Above 645	1032	502	483	2747

Numbers in parentheses denote standard errors.
* Significant at the 10% level; ** Significant at the 5% level; *** Significant at the 1% level.
Restricted to four year undergraduates at public and private not-for profit schools in the first quarters of 2005, 2006, and 2007.
Source: CFPB Loan Level Private Student Loan Dataset and IPEDS.

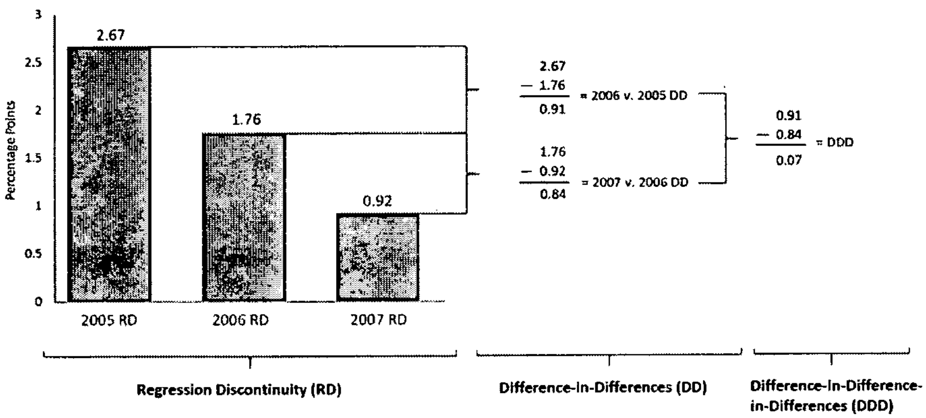
The first six rows of Table 3 present point estimates from each of the specifications for 2005 Q1, 2006 Q1, and 2007 Q1 respectively. The patterns in the following years are broadly consistent with what we observe in 2005 Q1: there is a statistically significant decrease in the interest rate charged as one moves past the 645 FICO score threshold.[122]

[121] Regression discontinuity calculated using Calonico, Cattaneo, and Titiunik robust regression discontinuity; DD and DDD standard errors assumes independence between quarters. *See generally* Calonico et al., *supra* note 113.

[122] In addition, with the exception of a result at the ten percent level of significance for 2006 Q1 in column 8, there is no significant difference in the amount borrowed. This is consistent with borrowers not adjusting their demand for loans along the intensive margin (amount borrowed conditional on having loans) as a result of BAPCPA. Table 3 presents results for both margins, to reflect effects on price per dollar borrowed, as well as the original balance of the loans, to reflect the extent to which borrowers who qualified for loans may have been restricted in their amount borrowed. Unfortunately, the standard error on balances is economi-

The first three rows of Table 3 represent the difference in margin or original balance between higher and lower risk borrowers in 2005, 2006, and 2007, respectively. Here, we are looking for discontinuities in the price borrowers are offered for loans (margin). We see from the columns that there is a statistically significant discontinuity in price (margin) for each group at the 645 FICO score threshold. This discontinuity is consistently around three percent for all of the groups considered in 2005 Q1. In other words, the data strongly suggests that a student with a 644 FICO score faced an interest rate roughly three percent higher than a virtually identical student with a 645 FICO score. We show this discontinuity graphically using bar graphs in Figure IV-1.[123]

FIGURE IV-1: GRAPHICAL REPRESENTATION OF TABLE 3 FOR ALL STUDENTS



To begin to test whether this difference between the rates that 644 and 646 FICO students face can be attributed to BAPCPA, we first compare the difference in price between the period before BAPCPA (2005Q1) to the period after (2006Q1). In row four (2006 versus 2005 DD), we show how the gap between subprime and prime interest rates narrowed between 2005 and 2006. The gap for all students (column 1) was at 2.67 percentage points in 2005 (row 1, 2005 Pre-BAPCPA), and then it narrowed to 1.76 percentage points in 2006 (row 2, 2006 Post-BAPCPA).

cally significant and often larger than the coefficients, thus it is hard to interpret results of these regressions on amount borrowed.

[123] Note that if BAPCPA were to have an effect, we would expect a drop-off from 2005 to 2006, with virtually no change from 2006 to 2007. If anything, the percentage (as opposed to percentage point) change is considerably higher from 2006 to 2007, in comparison to 2005 to 2006.

The amount by which the gap narrowed, 2.67-1.76=0.91 percentage points, is what we have called the DD presented in row 4 of Table 3.[124] This amount represents the change in the gap between prime and subprime interest rates around BAPCPA.

In other words, for all students, the difference in the interest rate paid by the subprime group and the interest rate paid by prime borrowers decreased by 0.91 percentage points around the time of BAPCPA. The difference is statistically significant at the one percent level.

The coefficients are of similar magnitudes for subgroups: prime borrowers in private schools pay 0.99 percentage points less than subprime, while in public schools the number is 0.60 percentage points, and 1.4 percentage points in highly competitive schools.[125]

If there would be no underlying trend in the difference in rates charged to prime and subprime consumers, then we would attribute the 2006 versus 2005 DD estimate to BAPCPA, and would stop the analysis by stating that we found a 0.91 percentage point improvement in the relative interest rates (row 4). However, this 0.91 percentage point decrease in rate difference could simply be a part of another trend, caused by other events.

As discussed in Section III.C, *supra*, to see whether this change in differentials is part of an overall trend or attributable to BAPCPA, we compare the 2005 to 2006 differential (row 4) to the 2006 to 2007 differential (row 5).[126] In row 6, we see that the average effect is no longer significant once we subtract off the 0.84 percentage point change between 2006 and 2007. We estimate a difference-in-difference-in-differences (DDD) for the whole undergraduate population, the results of which are presented in row 6 and shown in Figure IV-1 for the entire population. The effects on margin are also not statistically significant for the subgroups we consider, including individuals at private schools, public schools, and extensive Ph.D. granting institutions.

This suggests that the year-over-year change after BAPCPA was implemented is attributable to a trend and not necessarily to the introduction of bankruptcy nondischargeability.[127] In other words, our analysis suggests that

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[124] This is in the spirit of a DD estimate between prime and subprime maximum FICO score groups. *See* Marianne Bertrand et al., *How Much Should We Trust Differences-in-Differences Estimates?*, 119 Q.J. ECON. 249 (2004).

[125] The result for highly competitive schools is puzzling relative to the other categories. The prime "discount" is inconsistent with a model in which lenders factor expected future earnings into the price of the loan. The different performance between prime and subprime borrowers should not matter much if the main source of repayment is assumed to be future earnings and not a co-borrower's ability to manage current income as signaled by credit score, unless one believes that a subprime student attending an Ivy League institution majoring in economics or engineering is somehow still a major risk.

[126] A trend could occur independently of BAPCPA due to a variety of factors, including changes in tuition and fees, demographics, the returns to education, or labor market prospects of borrowers.

[127] Although the amount borrowed per loan did not change significantly, more students decided to borrow in each subsequent year, as shown in Table 1. Given the lack of price sensitivity of borrowers at the 645 FICO threshold, it is possible that the increase in loan volume was driven by a change in the supply of loans.

making PSLs effectively nondischargeable had no effect on the price of loans. This is arguably better than what one of us found in previous work, where the finding was that BAPCPA caused an *increase* of 0.3 percentage points on PSL margins for the average loan.[128]

B. Students Are Not Sensitive to Price

Although lenders experienced a decrease in expected losses after BAPCPA made PSLs presumptively nondischargeable, our empirical findings demonstrate that none of those savings seem to have been passed on to students. Nonetheless, in this part, we endeavor to find out whether students might have reacted in the way Congress expected if BAPCPA had lowered prices.

We consider the effect of the price of student loans, measured by the loan's margin, on demand for PSLs. The ratio of the percentage change in loans demanded to the percentage change in the price of the loans is the elasticity of demand for PSLs.[129] If some consumers decline loans because they think the price is too high, we should see a fall-off in loan originations above the 645 maximum FICO score threshold, since virtually identical borrowers pay is a 2.67% difference in price at that point, as illustrated in Table 3. We would expect to see this manifested in a gap in the density of credit scores. In other words, we would expect more borrowers on the high side of the threshold (the prime side) where prices are lower.

Table 4 presents the results from the implementation of the density discontinuity estimation described above.

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[128] Ang & Jiménez, *supra* note 17, at 23.
[129] N. Gregory Mankiw, Principles of Microeconomics 90 (3d ed. 2004).

TABLE 4: RESPONSE TO PRICE: DENSITY AMONG BORROWERS WITH CO-BORROWERS, 2005Q1[130]

	(1) All Undergraduates	(2) Private Schools	(3) Public Schools	(4) Extensive Ph.D. Granting Institutions
Difference (%)	-0.11	-0.07	-0.04	-0.01
	(0.07)	(0.09)	(0.08)	(0.04)
Density Below 645 (%)	0.39	0.38	0.38	0.25
Density Above 645 (%)	0.29	0.30	0.34	0.24

Notes:
Numbers in parentheses denote standard errors.
* Significant at the 10% level; ** Significant at the 5% level; *** Significant at the 1% level.
Restricted to four-year undergraduates at public and private not-for profit schools in the first quarters of 2005, 2006, and 2007.
Source:
CFPB PSL Loan Level Dataset, IPEDS, and PEPS.

This analysis focuses on the price elasticity of demand for student loans based on the change in the density of borrowers with co-borrowers. We restrict our data to students with co-borrowers to consider the elasticity of demand because to the extent they cannot find a co-borrower, solo borrowers who have credit scores below 645 may have trouble accessing credit.[131]

Across all four sample restrictions—all undergraduates, undergraduates at private schools, undergraduates at public schools, and undergraduates at extensive Ph.D. granting institutions—we do not observe significant differences in density between those just above and just below the 645 threshold. Our confidence intervals are large, and thus our results are not precise. However, note that all four points estimates are negative—whereas if students were price-sensitive we would expect positive results. This further bolsters our claim that subprime students around the threshold do not react to changes in price.

[130] Regression discontinuity calculated using Calonico, Cattaneo, and Titiunik robust regression discontinuity. *See* Calonico et al., *supra* note 113. Bandwidth and number of observations selected using CCT; kernel for local polynomial estimators is triangular. Bandwidths for regression are, respectively, 4, 6, 6, and 6. Bandwidths for bias correction are, respectively, 8, 10, 10, and 10. The number of observations below the 645 threshold are 29, 24, 25, and 28, respectively. Observations at or above 645 threshold are 46, 38, 40, and 34, respectively. Note that the number of observations above and below the 645 threshold correspond to the number of observations in the optimal bandwidth in the seventh row, and not to the much larger number of observations in the data.

[131] Since we do not observe solo borrowers with scores below 645, solo borrowers with scores just above 645 may not have comparable borrowers on the other side of the threshold. This is of particular concern because borrowers without co-borrowers may be less likely to have other financial support such as parents who are willing to co-sign or pay for a portion of the student's educational expenses out-of-pocket.

For example, let us focus on the first column. The first row says that the density is 0.11 *lower* just above 645: fewer students taking loans when interest rates are lower. The standard error of 0.07 implies that we cannot rule out that in fact the density is 0.03 *higher* just above 645.[132] Given the density of 0.39 just below 645, 0.03 change is a 0.03/0.39, or roughly an eight percent response to the interest rate decrease. But the interest rate decrease is from about nine percent to about six percent—a 1.5 times decrease. Note that this is an upper bound on price elasticity (with ninety-five percent confidence). In short, we cannot reject the null hypothesis that student loan borrowers are not price sensitive.

V. Discussion and Policy Recommendations

This article has two main empirical findings. First, we find that bankruptcy reform did not result in low credit-score students at four-year undergraduate institutions paying less for PSLs, despite the fact that these loans were now presumptively nondischargeable. Second, we find no evidence that college students are sensitive to price, so that even if lenders had passed on the savings from BAPCPA in the form of lower prices, it likely would not have caused an increase in the number of students who took up loans. Both of these findings are troubling from the point of view of consumer protection. The second finding poses a problem for regulators. If students are not sensitive to large (around three percent) price differences, regulation that aims to use price as a way to change the behavior of students has little chance of working. Similarly, lenders might not have much of an incentive to compete on prices.

We make a number of recommendations to address these issues. First, we argue that Congress should stop the special treatment of private student loans and make them immediately dischargeable in bankruptcy. Our second recommendation is a realistic "backup" of sorts. It would not be necessary if Congress were to reverse the special treatment of PSLs in bankruptcy. In that case, we recommend a policy from the mortgage markets and suggest that the CFPB should require issuers of private student loans to consider a borrower's ability-to-repay the loan before they can issue one. We suggest a number of ways in which lenders could satisfy the ability-to-repay requirement, including by implementing an income-based-repayment program.

We could argue for this type of a change simply from the fairness perspective: borrowers lost a right in 2005, and they did not seem to get much in return. However, we believe that an economic welfare argument might be also persuasive. There are two parts to the economic argument.

First, as we noted above, the right to discharge loans is very valuable to the borrower.[133] However, our results suggest that the lack of this right is not very valuable to the lenders, since they do not compete any of the expected

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132 -0.11+1.95*0.07.
133 *See, e.g.*, Dobbie & Song, *supra* note 31.

cost decrease away. Thus, perhaps due to consumers not realizing how valuable the ability to discharge their student loans is when they decide to borrow, we have a market failure of consumers losing a very valuable right that might not cost lenders that much (as evidenced by lenders not competing any potential gains away).[134]

Second, lenders have much better information regarding a student's future prospects. This is because they are much better positioned to be able to weigh the likely consequences of the student's choice of school and major. Making a student loan dischargeable in bankruptcy would incentivize lenders to act on this information, on behalf of consumers. Today, it is the rare seventeen-year-old who could get a credit card with a thirty thousand dollar limit. However, a typical undergraduate graduates with more than that in student loan debt today.[135] Sometimes, the student is highly unlikely to default even with this loan amount—say, a loan to an engineering major at a flagship state school—and thus any lender will make this loan regardless of whether the loan is dischargeable in bankruptcy. But other times the student has a significant likelihood of defaulting—say, a loan to an accounting major at Corinthian Colleges (or any other major there for that matter)—and thus whether the loan is dischargeable might make a difference in whether this loan is made and whether this student is loaded with debt for the next few decades of their life.[136]

A. *Reforming Bankruptcy Reform*

Many have lamented the 2005 bankruptcy changes that added PSLs to the list of presumptively nondischargeable loans.[137] In previous work, one of us found that BAPCPA, a law that reduced consumer protections for students, and increased the average cost of PSLs: the average loan interest rate

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[134] Importantly, our finding that students around the FICO credit score cutoff are not sensitive to price does not mean no cross-price elasticity. In other words, if *all* prices increase by three percentage points, nobody might react. On the other hand, if *one* lender charges a one percentage point lower interest rate, everyone might switch to that lender (say, when I go to the supermarket, I buy milk regardless of the price, but I always get the cheapest milk available).

[135] Christine DiGangi, *The Class of 2016 Will Graduate With an Average of $37,172 in Debt*, Fox Bus. (May 16, 2016), http://www.foxbusiness.com/features/2016/05/06/class-2016-will-graduate-with-average-37172-in-debt.html [https://perma.cc/V53S-3MZ7].

[136] While the stereotypical press story is an New York University (NYU) arts or humanities major with a $100,000+ debt working as a barista at a coffee store after graduation, this type of a college debt is a considerable outlier in the data. In addition to being outliers, given the socioeconomic profile of families of students at schools like NYU versus that of families with students at schools like Corinthian Colleges, we are more concerned about the latter.

[137] *See, e.g.*, Daniel Austin, *The Indentured Generation: Bankruptcy and Student Loan Debt*, 53 Santa Clara L. Rev. 329 (2013); Jennifer L. Frattini, *Note & Comment: The Dischargability of Student Loans: An Undue Burden?*, 17 Bankr. Dev. J. 537 (2001); B.J. Huey, *Comment: Undue Hardship or Undue Burden: Has the Time Finally Arrived for Congress to Discharge Section 523(a)(8) of the Bankruptcy Code?*, 34 Tex. Tech L. Rev. 89 (2002); Note, *Ending Student Loan Exceptionalism: The Case for Risk-Based Pricing and Dischargeability*, 126 Harv. L. Rev. 587 (2012); Pottow, *supra* note 15.

increased 0.3% as a result of the law.[138] In this article, we find that BAPCPA did not narrow the gap in price between risky and safe borrowers. In other words, BAPCPA did not help those students who were most likely to benefit from a law making student loans effectively nondischargeable.[139] This finding leads us to join the chorus of scholars, economists, and policymakers calling for the repeal of PSLs' special treatment in bankruptcy.[140]

One prominent economist has noted that making PSLs effectively nondischargeable "[was] a blatant giveaway to lenders, who (on the front end) are allowed to screen borrowers for creditworthiness and (on the back end) benefit from the special protections intended for [federal] student loans, which have no such screening."[141] BAPCPA was certainly a giveaway with regards to PSLs originated before it was enacted, since those borrowers were both screened for creditworthiness but also obtained their loans when they presumably included an additional cost because they were dischargeable in bankruptcy. The giveaway might have ended there if students had received some of the benefit of the law change in lower prices. But, as we have shown here, we see no evidence that the law indeed lowered interest rates. Calls for reform typically encounter the objection that students will strategically default and file bankruptcy *en masse* if the law were reversed. But those arguments overlook a few basic facts about bankruptcy law and PSLs.

First, all manner of private debts are currently dischargeable: credit cards, car loans, mortgage loans, medical debts, utility debts, and more.[142] And yet, many consumers who could benefit from bankruptcy by discharging these types of debts fail to seek bankruptcy protection.[143] While we do not have data on the percentage of student loan borrowers who filed bankruptcy before BAPCPA to discharge their private student loans, after

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[138] *See* Ang & Jiménez, *supra* note 17, at 179.

[139] *See* Michael Simkovic, *The Effect of BAPCPA on Credit Card Industry Profits and Prices*, 83 Am. Bankr. L.J. 1, 22 (2009) ("The data is unambiguous: BAPCPA benefited credit card companies and hurt their customers. While bankruptcy protection became increasingly unavailable, credit card companies increased prices by five percent to seventeen percent. This contributed to a twenty-five percent increase in credit card industry annual profits from 2005 to 2007.").

[140] *See, e.g.*, Austin, *supra* note 137, at 400–15; Brendan Baker, *Deeper Debt, Denial of Discharge: The Harsh Treatment of Student Loan Debt in Bankruptcy, Recent Developments, and Proposed Reforms*, 14 U. Pa. J. Bus. L. 1213, 1215 (2012); Dynarski, *supra* note 60; Rafael Pardo & Michelle R. Lacey, *The Real Student Loan Scandal: Undue Hardship Discharge Litigation*, 83 Am. Bankr. L.J. 179, 182 (2009); Michael Stratford, *New Push on Bankruptcy Protections*, Inside Higher Ed (Oct. 2, 2015), https://www.insidehighered.com/news/2015/10/02/obama-administration-backs-easier-bankruptcy-path-private-student-loans [https://perma.cc/25NY-3JWL]; Letter from Am. Ass'n of Collegiate Registrars & Admissions Officers et al., to Steve Cohen, Ranking Member, Subcomm. on Regulatory Reform, Commercial and Antitrust Law, U.S. House of Representatives (Feb. 6, 2013), http://ticas.org/sites/default/files/pub_files/Bankruptcy_coalition_letter_to_Rep_Cohen_Jan_2013.pdf) [https://perma.cc/T68P-E3EV].

[141] Dynarski, *supra* note 60.

[142] Bob Lawless, *2016 Bankruptcy Forecast—Let's say 780,000*, Credit Slips (Jan. 13, 2016, 3:07 PM), http://www.creditslips.org/creditslips/2016/01/2016-bankruptcy-forecast-lets-say-780000.html [https://perma.cc/AWY9-QNV5].

[143] *See, e.g.*, Michelle J. White, *Why Don't More Households File for Bankruptcy?*, 14 J.L. Econ. & Org. 205, 206 (1998).

BAPCPA, we know that very few student borrowers have filed. The CFPB found that less than 1.3% of outstanding loans issued between 1999–2011 were in a bankruptcy status at any point between 2005–11.[144]

Even if the bankruptcy laws were changed, and PSLs became presumptively dischargeable, it does not necessarily follow that all borrowers would receive a discharge. Bankruptcy judges and trustees (as well as creditors' attorneys) could still scrutinize bankruptcy petitions and can seek to prevent the discharge of a particular loan (or category of loans) for fraud or for abuse. This provision would cover the prototypical example of the newly minted lawyer or doctor who seeks to discharge their student loans soon after graduation. Judges could find that this would be an abuse of the Bankruptcy Code and either not permit a discharge of a particular loan,[145] or of any other debts—a far more severe punishment than the inability to discharge PSLs alone.[146]

As Professor Pottow has noted, "[t]he concern must be more than just a fear of opportunism *per se*."[147] Pottow explores six possible theories to explain the special treatment of student loans. The first two center around fraud.[148] The third theory starts from a position that education confers a private benefit and thus the student should be the one to bear—or internalize—the cost.[149] The fourth focuses on a potential desire by the public to shame debtors who do not repay their student debt.[150] The first four theories apply much more broadly than student loan debt, and because we still allow discharge for most of these debts, one must search elsewhere to find a justification for student loans specifically. The fifth theory, protecting the public fisc, does not apply with regard to PSLs.[151] Only the sixth and final theory provides a plausible theoretical explanation for the expansion of nondischargeability to PSLs. This last theory, which Pottow terms "the cost of private capital," is compatible with what the congressional record tells us about the expressed reasons for the special protection to PSLs. This theory

[144] *See* CFPB PSL Report, *supra* note 12, at 72. Table 18, denoting the percent of outstanding loans that were in bankruptcy status as of the close of the year is reproduced below:

2005	2006	2007	2008	2009	2010	2011
0.8%	0.4%	0.4%	0.5%	1.0%	1.2%	1.3%

[145] *See* 11 U.S.C.A. § 523(a)(2)(A) (2012) (denying discharge for a debt incurred by fraud).

[146] *See* 11 U.S.C. § 707(b)(1) (2012) (allowing a court to deny a discharge in a bankruptcy case if "it finds that the granting of relief would be an abuse of the provisions of this Chapter").

[147] Pottow, *supra* note 15, at 254.

[148] The first theory relies on an assumption that the student loan debtor seeking a bankruptcy discharge is presumptively fraudulent. The second theory concerns what Pottow terms "soft fraud," a display of rational economic behavior that has the same effect as what the proponents of the 1976 amendments to the bankruptcy laws claimed was widespread. *See id.* at 251–55.

[149] *See id.* at 256–59.

[150] *See id.* at 259–61.

[151] *See id.* at 275–76.

argues that nondischargeability can be justified "as an attempt to make private loans 'cheaper' for students."[152]

And herein lies the problem. As this article has shown, we found no evidence that granting PSL lenders special protections in bankruptcy lead to lower prices for even those borrowers whom we might expect would be most likely to enjoy them: those with higher risk credit scores. Add to this the knowledge that we have regarding the employment and health benefits of discharging debts in bankruptcy,[153] and there remain few credible (non-rent-seeking) arguments for the continued inability to discharge PSLs in bankruptcy.

The reality is, however, that there has never been evidence of widespread bankruptcy fraud with regards to student loans.[154] And there is no reason to predict that there would widespread fraud if the law were changed today.[155] PSLs should be returned to automatic dischargeability.[156]

B. An Ability-to-Repay Rule in the Private Student Loan Market

Rolling back the special treatment PSLs currently enjoy in bankruptcy is our top policy recommendation for improving this market. We believe doing so would impose a greater level of discipline on lenders: to only lend to borrowers who can be expected to repay. Recognizing that while eminently reasonable, a roll-back of the existing protections that PSL lenders enjoy in bankruptcy has a low likelihood of getting through our political process at the moment, we propose an alternative grounded in an existing rule issued by the CFPB and the CFPB's already-existing authority.

Borrowers who took on higher mortgages than they could afford have been cited by many as a cause of the financial crisis. Congress's response was to establish the CFPB and to mandate that it write an Ability-to-Repay (ATR) rule for certain mortgages.[157] The rule requires lenders to consider and verify a borrower's ability-to-repay by requiring that they "make a reasona-

[152] *See id.* at 262.

[153] *See* discussion in the Introduction, *supra*.

[154] *See* Pottow, *supra* note 15, at 255 ("The General Accounting Office study, for example, found only seven attorneys and five doctors of the 411 employed debtors.").

[155] *But see* Christopher Mayer et al., *Mortgage Modification and Strategic Behavior: Evidence from a Legal Settlement with Countrywide*, 104 Am. Econ. Rev. 2830 (2014) (finding evidence of strategic default among homeowners once a mortgage modification program was announced, but not finding evidence of increased bankruptcy filings, which involve a great deal more than defaulting on one debt (a mortgage)).

[156] Some might argue that only PSLs originated after a new such law should be eligible for a discharge. We disagree. There is no legal barrier to making all outstanding PSLs automatically dischargeable as of the enactment of the law. The "Contracts Clause," let it be remembered, only applies against the states. *See* U.S. Const. art. I, §10, cl. 1. In any event, when Congress enacted BAPCPA it modified the contracts of millions of student loan borrowers who had taken out PSLs thinking that they would be dischargeable in bankruptcy. Suddenly they were not, and the students had no recourse. A law undoing this provision of BAPCPA should encompass all outstanding PSLs.

[157] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§1411–12, 124 Stat. 1376, 1871 (2010).

ble, good-faith determination before or when you consummate a mortgage loan that the consumer has a reasonable ability-to-repay the loan, considering such factors as the consumer's income or assets and employment status."[158] As an enforcement mechanism, the rule establishes a private cause of action when the lender had not verified the borrower's ability-to-repay: for example, when a lender forecloses on a borrower in default, then the borrower can sue the lender for failing to verify the borrower's ability-to-repay when the loan was originated.[159] If successful, the borrower can recover damages equal to all the interest and fees charged, as well as statutory damages under the Truth In Lending Act (currently $4,000).[160] The rule is designed to incentivize the lenders to ensure that the borrower will indeed be able to pay back the loan. The ATR is considered especially helpful since borrowers often misunderstand the terms of their mortgages and simply do not have the same data as the lender to be able to tell what their chances of repaying the loan actually are.[161]

Much in this logic seems applicable directly to private student lenders. These lenders may be in a much better position to gauge a student's future ability-to-repay than the student is, based on the school and on the major, since they observe the repayment profiles of many earlier borrowers.[162] Additionally, it is likely that many students do not understand the terms of their

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[158] According to the CFPB's guidance to regulated entities:

> The ATR/QM rule requires that you make a reasonable, good-faith determination before or when you consummate a mortgage loan that the consumer has a reasonable ability-to-repay the loan, considering such factors as the consumer's income or assets and employment status (if relied on) against: [1] The mortgage loan payment; [2] Ongoing expenses related to the mortgage loan or the property that secures it, such as property taxes and insurance you require the consumer to buy; [3] Payments on simultaneous loans that are secured by the same property; [4] Other debt obligations, alimony, and child-support payments. The rule also requires you to consider and verify the consumer's credit history.

Consumer Fin. Prot. Bureau, Ability-to-Repay and Qualified Mortgage Rule: Small Entity Compliance Guide 11 (2014), http://files.consumerfinance.gov/f/201401_cfpb_atr-qm_small-entity-compliance-guide.pdf [https://perma.cc/AA2G-UB4W].

[159] *See* Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6408, 6416 (Jan. 30, 2013) (to be codified at. 12 C.F.R pt. 1026); *see also* Truth In Lending Act (TILA), 15 U.S.C. § 1601 (2012). Although the mortgage industry immediately braced itself for a flood of lawsuits, we are not aware that any have yet been filed. *See* Jonathan Green, *Preparing for Litigation Under the Ability to Repay Rule*, Nat'l Mortg. News (Feb. 24, 2014), http://www.nationalmortgagenews.com/blogs/lens/preparing-for-litigation-under-the-ability-to-repay-rule-1041172-1.html [https://perma.cc/9JNG-KL75].

[160] 15 U.S.C. § 1640 (2012).

[161] "The Bureau believes that these criteria will protect consumers by ensuring that creditors use a set of underwriting requirements that generally safeguard affordability." *Ability-to-Repay/Qualified Mortgage Rule: Hearing on 12 C.F.R. pt. 1026 Before the H. Comm. on Fin. Servs.*, 113th Cong. 1 (2013) (Statements of Peter Carroll, Assistant Director for Mortgage Markets, and Kelly Thompson, Assistant Director for Regulations, CFPB); *see also* Brian Bucks & Karen Pence, *Do Borrowers Know Their Mortgage Terms?*, 64 J. Urban Econ. 218 (2008).

[162] *But see* Alan B. Krueger & William G. Bowen, *Policy Watch: Income-Contingent College Loans*, 7 J. Econ. Persp. 193, 195–96 (1993).

loans as well as they should.[163] In contrast to mortgage borrowing, where one house in foreclosure would drive all the neighborhood's houses down in price, a default by a student loan borrower is unlikely to cause harm to unrelated parties.[164] However, there might still be spillover to the borrower's family, either because a family member is a co-borrower or through downstream impacts on the borrower's future family. And while student loans, at least for now, are typically much smaller than mortgages, monthly payments are typically quite high relative to a new graduate's income. In addition, the students taking out these loans might also be considerably less ready to deal with these decisions, especially for students who just graduated from high school.

Our policy proposal is thus straightforward: subject private student loan lenders to ability-to-repay requirements. Like a mortgage loan, the ability to repay a student loan depends not only on the student/homeowner's future income. It is also affected by the value of the asset the loan is financing. In the mortgage case, the asset is the home. In the student's case, the asset is the student's increased human capital. We discuss the pros, the cons, and the details of implementation of this proposal in the following paragraphs.

For undergraduate students without a co-borrower, verifying ability to repay would involve something different than verifying income or credit history. It is likely that they would have none. Instead, a loan to a first-year student might involve verifying the school's ability to successfully graduate (perhaps not lending to schools with the lowest graduation rates). In subsequent years of study it could, for example, require that the lender verify that the student is making adequate progress towards graduation by taking and passing classes that count towards their degree. Understandably, setting an ability-to-repay policy that applies across all possible student loans is a tall order, insofar as there are a variety of factors that may affect an individual's earnings beyond his academics. Consequently, well-defined regulator guidelines or safe harbors would be essential for an ability-to-repay policy to be tractable.

As in the mortgage market, lenders cannot predict student loan defaults perfectly. If a borrower has sufficient income, but the borrower's employer files bankruptcy unexpectedly, with the borrower hard-pressed to find another job, then that lender should not be liable under this rule. Similarly, if a student takes out a loan to attend a school with a high graduation rate and low cohort default rate, selects a major that typically results in sufficient income after graduation at that particular school, and makes adequate progress towards his degree, and the student is simply unlucky for whatever reason, the lender should not face any ability-to-repay liability. However, in

[163] Some lenders have an incentive to make loan terms difficult to understand, or in the most egregious cases, outright misrepresent the loan terms. *See, e.g.*, Bridgepoint Educ., Inc., Fed. Bankr. L. Rep. (CCH) ¶ 154–550 (Consumer Fin. Prot. Bureau Sept. 12, 2016) (finding that Bridgestone Education staff misrepresented the monthly payment students would have to make on private loans).

[164] This statement is based on the assumption that most of the spillover effect from a foreclosure is a drop in house values of nearby houses.

cases where the failure is not just theoretically possible, but instead is frequent, and when even upon graduating it is unlikely that the borrower will earn much money based on the school's former students' (including those that do not complete their course of study) labor market performance, the lender should be liable for making this loan.

All of this verification could become quite burdensome. For this same reason, the mortgage ATR rule includes a rule on "qualified mortgages" (QMs), which are presumptively compliant. The CFPB decided that QM loans would enjoy a safe harbor from the ATR rule. A mortgage is "qualified" if, for example, the lender considered and verified the "consumer's income or assets, current debt obligations, and child support payments;" "determine[d] that the consumer's total monthly debt-to-income ratio is no more than 43 percent," and underwrote the loan "based on a fully amortizing schedule using the maximum interest rate permitted during the first five years after the first periodic payment."[165] In addition, these loans "may not have negative-amortization, interest-only, or balloon-payment features or terms that exceed thirty years. They also may not have points and fees that exceed the specified limits."[166]

The general idea of a QM is that loans with those characteristics are considered safe, which is why lenders have a safe harbor from the ATR rule if they use them. Part of the reason these loans are considered safe is because there is some verification of the borrower's income and assets.[167] But they are also considered safe because they are not allowed to have some of the worst features of the subprime loans that were originated during the boom—features like negative amortization, interest-only periods, balloon payments, and the like.[168] Translating this to the PSL context, there are a few features that would make PSLs safer and could be part of an ability-to-repay safe harbor.

The first is that PSL lenders should be required to certify the loan with the student's school.[169] This would ensure that students are not borrowing

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[165] CONSUMER FIN. PROT. BUREAU, *supra* note 158, at 39.

[166] *See id.* at 36.

[167] *See* Wei Jiang et al., *Liar's Loan? Effects of Origination Channel and Information Falsification Mortgage Delinquency*, 96 REV. ECON. & STAT. 1–18 (2014) (stated-income loans, also known as "liar's loans" were credited with causing some of the issues in the financial crisis, for example); *see also Liar Loan*, INVESTOPEDIA, http://www.investopedia.com/terms/l/liar_loan.asp [https://perma.cc/JDH3-PM88].

[168] These features delay borrowers' acquisition of equity in their houses, making foreclosure more likely. These features are also not easy to understand, and thus might make home ownership seem cheaper than it actually is, with the borrower realizing the true cost only several years after acquiring the loan.

[169] *See, e.g.*, Letter from Student Loan Coal. to Dir. Richard Cordray, Consumer Fin. Prot. Bureau (June 17, 2013), http://ticas.org/sites/default/files/pub_files/6_17_13_Cordray_Letter.pdf [https://perma.cc/48CK-VJB9] (urging the CFPB to Require School Certification for Private Education Loans); Ctr. for Am. Progress and Campus Progress, Comment Letter on an Initiative to Promote Student Loan Affordability 7 (Apr. 8, 2013), https://cdn.americanprogress.org/wp-content/uploads/2013/04/Student_loan_affordability_CAP.pdf [https://perma.cc/65EC-USAY]; COPIRG FOUND., PRIVATE LOANS, PUBLIC COMPLAINTS: THE CFPB'S CONSUMER COMPLAINT DATABASE GETS REAL RESULTS FOR STUDENT BORROWERS 30

more than their cost of attendance. It would also give the school a chance to counsel students about PSLs and if they have not maxed out their federal loans, perhaps to encourage them to do so. Some PSL lenders are seeking school certification at the moment, but it is not legally required. As an analog to the mortgage market, the borrower is typically unable to include their next vacation in the first-lien mortgage.[170]

Second, similar to the points and fees restrictions on QMs, the CFPB could also set a restriction on qualified PSLs origination fees and require that qualified PSLs not to have repayment fees.[171] Third, a qualified PSL could be required to be made only to students attending educational institutions that had a minimum graduation rate or federal student loan repayment rate. Fourth, qualified PSLs should be completely discharged by the lender in the event of a debtor's death or disability.

But perhaps the single most important feature the CFPB could require of a qualified PSL would be one that addressed what happens to borrowers who have difficulty repaying. We can imagine one of two scenarios. One scenario would involve a new form of *ipso facto* clause:[172] the rule could require qualified PSLs to contain a contractual provision where the lender promises not to collect from the consumer once a bankruptcy court had entered a bankruptcy discharge. Note that this does not require Congressional action. Instead it can be accomplished solely by contract.[173] Note also, however, that because this "discharge" of the loan would not be through bankruptcy, it could create a tax liability for the consumer.[174] Ultimately,

(2013), http://www.copirgfoundation.org/sites/pirg/files/reports/Private%20Loans,%20Public%20Complaints%20vCO102413.pdf [https://perma.cc/7FVW-AYMK].

[170] A discussion of a Home Equity Line of Credit (HELOC) analog in student lending could be fascinating, but is outside of scope of this article.

[171] PSL origination fees in 2006 Q1 averaged just over seven percent, meaning that if a student needed $10,000 to attend school, she actually would borrow $10,700, with the extra money going to the lender. *See supra* Table 1.

[172] In bankruptcy, these clauses generally state "that if the party in question experiences bankruptcy . . . then depending on the contract, either the other party may terminate the contract or the contract will terminate automatically." Kenneth A. Adams et al., *Termination-on-Bankruptcy Provisions: Some Proposed Language*, AM. BAR ASS'N BUS. L. TODAY (June 2014), http://www.americanbar.org/publications/blt/2014/06/07_adams.html [https://perma.cc/2LD8-MYB8].

[173] However, because the terms of the contract would be prescribed by regulatory action, the CFPB would still need to develop a record regarding the usefulness of doing this. That record is arguably in progress, as the agency has been prolific in this area with enforcement actions, reports, and a complaint database tracking student loan borrowers' issues with their servicers/lenders, among other things. *See generally* CFPB PSL REPORT, *supra* note 12; CONSUMER FIN. PROT. BUREAU, MIDYEAR UPDATE ON STUDENT LOAN COMPLAINTS (Aug. 2016), https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/201608_cfpb_StudentLoanOmbudsmanMidYearReport.pdf [https://perma.cc/79DR-8JFW]; *CFPB Takes Action Against Wells Fargo for Illegal Student Loan Servicing Practices: Wells Fargo to Pay $3.6 Million Penalty to the Bureau*, CONSUMER FIN. PROT. BUREAU (Aug. 22, 2016), http://www.consumerfinance.gov/about-us/newsroom/cfpb-takes-action-against-wells-fargo-illegal-student-loan-servicing-practices/ [https://perma.cc/UX4V-7BZG].

[174] *See* Martin J. McMahon, Jr. & Daniel L. Simmons, *A Field Guide to Cancelation of Debt Income*, 63 TAX LAW. 415, 418 (2010).

however, this is unlikely since the consumer would almost certainly be insolvent, which would absolve them of paying taxes on the forgiven debt.[175]

The second scenario we suggest would allow students to join an income-based-repayment (IBR) program immediately upon repayment. An IBR program would necessarily extend the repayment period of the loan, but students could always opt out by paying more per month if desired. As one scholar has noted, "[w]e have a repayment crisis because student loans are due when borrowers have the least capacity to pay. . . . It often takes years for college graduates to settle into a steady, high-paying job that reflects the value of their education."[176] An IBR program would fix this issue.

Federal student loans allow for IBR programs. However, these programs suffer from a number of problems.[177] Fortunately, a number of scholars have analyzed these deficiencies and proposed many workable solutions.[178] For our purposes, a qualified PSL IBR should be as automatic and automated as possible—automatic in that it would be the default for a qualified loan, and automated in that PSL borrowers would not need to do anything to keep it going.[179] We do not here propose a specific percentage of the student's income at which the IBR would be capped. Instead, we hypothesize that this could be a place where the market might produce some competition. Different lenders could agree to different future percentages of income and that might be a way in which they could differentiate themselves to students.

A likely argument against this proposal (and one made against the current ATR rule in the mortgage context) is that its restrictions will cause lenders to cease making PSLs. In the mortgage context, one of the industry arguments was that lenders will not make mortgages that are not Qualified Mortgages. Similarly, the argument in student lending could be that lenders will not make loans for students attending riskier colleges and choosing riskier majors. That argument did not materialize in the mortgage market: jumbo loans with features like interest-only amortization and with forty-year terms

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[175] *See id.* at 417.

[176] *See* Michael Stratford, *Income-Based Loans Made Simple*, INSIDE HIGHER ED (Oct. 22, 2013), https://www.insidehighered.com/news/2013/10/22/new-report-calls-income-based-repayment-system-operates-payroll-taxes [https://perma.cc/5QQZ-5MFL]; *see also* Megan Slack, *Income Based Repayment: Everything You Need to Know*, WHITE HOUSE (June 7, 2012, 10:59 AM), https://www.whitehouse.gov/blog/2012/06/07/income-based-repayment-everything-you-need-know [https://perma.cc/4WFZ-KQUG].

[177] For critiques of the federal income-based-repayment plans, see Susan M. Dynarski & J. Scott-Clayton, *The Cost of Complexity in Federal Student Aid: Lessons from Optimal Tax Theory and Behavioral Economics*, 59 NAT'L TAX J. 319 (2006); Frank Pasquale, *Democratizing Higher Education: Defending and Extending Income-Based Repayment Programs*, 28 LOY. CONSUMER L. REV. 1 (2015).

[178] *See, e.g.*, Dynarski & Scott-Clayton, *supra* note 177; Pasquale, *supra* note 177.

[179] In order for the lender to calculate the correct payment amount, PSL borrowers could allow the Internal Revenue Service to share income information on a yearly basis with the PSL lender or servicer, who would then set the appropriate level of repayment. *See* Dynarski & Scott-Clayton, *supra* note 177, at 320.

are one of the fast-growing products currently, most likely being non-Qualified Mortgage loans.[180]

Second, in the school context, this does not mean that only loans to students of elite schools would qualify. A loan to a state school student, especially majoring in something like engineering and economics, might be even safer as the amount to repay is much lower. This is even more true for community college students. The dimension where the requirement might bite is expensive private schools that do not have the same quality as more selective private schools, especially so for majors that have a lower expected income, for example, arts. But making these students borrowers much more attuned to dangers of such an investment would be a benefit, not a cost, of such a requirement. And if students are unable to get a loan at particularly expensive private schools that graduate students that are highly unlikely to repay the loans (or simply do not graduate students), and this causes these students to choose cheaper or more practical alternatives instead, this might also be a benefit instead of a cost. So far, this does not seem to have happened in the mortgage market, so we may reasonably assume the same effect for PSLs.

It is also important to note that the PSL market has shrunk before, to no apparent great effect.[181] PSL issuance shrank dramatically in late 2007, "as developments in the asset-backed securities market . . . negatively impacted investor demand for [Student Loan Asset-Backed Securities]."[182] This occurred after BAPCPA was enacted. The volume of PSLs has never recovered to pre-recession levels.[183]

Another argument is that, even if PSLs continue to be made, the lenders will increase interest rates to account for the additional costs. However, as we argue in this article, interest rates did not appear to decrease when the student loans switched from dischargeable to nondischargeable. Thus, it is hard to see how making *only some* of the student loans dischargeable again would lead to higher interest rates. Again, this is similar to the outcome in the mortgage market, where there is no evidence that lenders charge higher interest rates for loans that are not QMs.

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[180] *See* Neil Bhutta & Daniel Ringo, *Effects of the Ability to Repay and Qualified Mortgage Rules on the Mortgage Market*, Bd. of Governors of the Fed. Reserve Sys.: FEDS Notes (Dec. 29, 2015) https://www.federalreserve.gov/econresdata/notes/feds-notes/2015/effects-of-the-ability-to-repay-and-qualified-mortgage-rules-on-the-mortgage-market-20151229.html [https://perma.cc/74R7-SLBZ]; Alexei Alexandrov, *Making Firms Liable for Consumers' Mistaken Beliefs: Theoretical Model and Empirical Applications to the U.S. Mortgage and Credit Card Markets* (Consumer Fin. Prot. Bureau, Paper No. 2599424, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2599424 [https://perma.cc/X235-MSQH]; *see also* Robyn A. Friedman, *Borrowers Who Make Less Money Are Now Getting Jumbo Home Loans*, Wall St. J. (Oct. 18, 2016, 10:57 AM), http://www.wsj.com/articles/borrowers-who-make-less-money-are-now-getting-jumbo-home-loans-1476802631 [https://perma.cc/3KPS-V8RZ].

[181] CFPB PSL Report, *supra* note 12, at 24–25.

[182] *Id.* at 18.

[183] *See* College Board, Trends in Student Aid (2013), http://trends.collegeboard.org/sites/default/files/student-aid-2013-full-report.pdf [https://perma.cc/F2Q5-94Q2].

Finally, there might be an argument that all this information collection is simply costly. However, the lenders will already have much of this information at their disposal: they could analyze the historic performance of loans based on schools and majors of students. Thus, it is highly unlikely that the administrative costs are going to be anywhere close to prohibitive.

In June of 2016, the CFPB released a Notice of Proposed Rulemaking regarding the payday market.[184] The notice proposes a rule that would require payday lenders to verify a consumer's ability-to-repay certain short term loans unless that loan falls under one of the safe harbors. While we do not here take a stance on whether this regime makes sense in the payday market,[185] the CFPB's willingness to expand the concept of ability-to-repay beyond the mortgage market is encouraging. The payday proposed rulemaking is partially premised on the CFPB deeming payday loans that are not subject to the ability-to-repay verification are unfair or abusive acts or practices, part of the larger CFPB-authority to ban unfair, abusive, or deceptive acts or practices (UDAAP).[186] Unfortunately, the proposed rule gives lenders the ability to design their own measurements of a borrower's ability-to-repay. As one of us has commented elsewhere, this threatens to make the rule a "paper tiger."[187]

An ART requirement in the PSL market is a second-best solution to the problem of nondischargeability of student loans. The ideal solution is to roll back the special protection PSL lenders obtained in 2005.

Conclusion

In the United States, students are bombarded by messages that the key to obtaining a well-paying job is through a college degree. While these messages may be true for many students, in focusing on the "average" gains from a college degree, they obscure some hard truths. For example, these messages do not generally reveal that certain majors and schools (or combinations) offer more reliable paths to said well-paying jobs.[188] They also tend

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[184] Payday, Vehicle Title, and Certain High-Cost Installment Loans, 81 Fed. Reg. 141 (proposed July 22, 2016), http://files.consumerfinance.gov/f/documents/Rulemaking_Payday_Vehicle_Title_Certain_High-Cost_Installment_Loans.pdf [https://perma.cc/PD74-L3UN] (proposing to "identify it as an abusive and unfair practice for a lender to make a covered longer-term loan without reasonably determining that the consumer will have the ability-to-repay the loan").

[185] *But see* Adam J. Levitin et al., Consumer Fin. Prot. Bureau, Comment Letter on Proposed Rule on Payday, Vehicle Title, and Certain High-Cost Installment Loans (Sept. 5, 2016), https://www.regulations.gov/document?D=CFPB-2016-0025-88018 [https://perma.cc/NF9U-4G3B] (arguing that the ability-to-repay requirement should be extended to all types of short-term loans).

[186] *See* Payday, Vehicle Title, and Certain High-Cost Installment Loans, *supra* note 184 (describing statutory authority to issue rule).

[187] *See* Levitin et al., *supra* note 185.

[188] Not all majors yield the same expected returns. For a controversial proposal to make student loan repayments contingent on majors, see Michael Simkovic, *Risk-Based Student Loans*, 70 Wash. & Lee L. Rev. 527 (2013). For a thoughtful response, see Jonathan D.

to ignore the fact that the income boost of a college degree is not the same for everyone: it is only half as big for low-income students as compared to students from higher income families.[189] Graduation rates are also heavily correlated with the student's family background—students from low-income families have significantly lower graduation rates than students from higher-income families,[190] and minority students have worse graduation rates than non-minorities.[191] Students themselves rarely have sufficient information and well-formed expectations of the future,[192] with study after study showing that students' borrowing decisions are influenced by factors that should not matter.[193] And lenders, including the federal government, keep lending. These patterns should be familiar to us from the financial crisis. We do not think that student loans are in some kind of a bubble, the deflation of which might result in another crisis.[194] However, as numerous studies and popular press articles suggest, the debt incurred while many of these borrowers are teenagers could influence the timing of later decisions in life, such as a career

Glater, *The Unsupportable Cost of Variable Pricing of Student Loans*, 70 WASH. & LEE L. REV. 2137 (2013).

[189] *See* Timothy J. Bartik & Brad Hershbein, *Degrees of Poverty: Family Income Background and the College Earnings Premium*, EMP. RES. NEWSL. (UpJohn Inst. for Emp't Research, Kalamazoo, M.I.), July 2016, at 3. This is particularly unfortunate since it is precisely these students who are most likely to need student loans in order to attend college.

[190] *See, e.g.*, Martha J. Bailey & Susan M. Dynarski, *Gains and Gaps: Changing Inequality in U.S. College Entry and Completion* 25–30 (Nat'l Bureau Econ. Research, Working Paper No. 17633, 2011), http://www.nber.org/papers/w17633 [https://perma.cc/RT2C-QVYZ] (finding that "rates of college completion increased by only four percentage points for low-income cohorts born around 1980 relative to cohorts born in the early 1960s, but by eighteen percentage points for corresponding cohorts who grew up in high-income families").

[191] *See, e.g.*, Kevin Carey, *Graduation Rate Watch: Making Minority Student Success a Priority*, EDUC. SECTOR REP. (Apr. 23, 2008), http://www.issuelab.org/resource/graduation_rate_watch_making_minority_student_success_a_priority [https://perma.cc/KV9S-4W9R].

[192] *See* Brian A. Jacob & Tamara Wilder, *Educational Expenses and Attainment* 14–20 (Nat'l Bureau of Econ. Research, Working Paper No. 15683, 2010), http://www.nber.org/papers/w15683 [https://perma.cc/CH3N-YRRR].

[193] *See, e.g.*, Eric P. Bettinger et al., *The Role of Application Assistance and Information in College Decisions: Results from the H&R Block FAFSA Experiment*, 127 Q.J. ECON. 1205 (2012); Benjamin L. Castleman & Lindsay C. Page, *Summer Nudging: Can Personalized Text Messages and Peer Mentor Outreach Increase College Going Among Low-Income High School Graduates?*, 115 J. ECON. BEHAV. & ORG. 144 (2015); Xiaoling Ang & Alexei Alexandrov, *Choice Architecture Versus Price: Comparing the Effects of Changes in the U.S. Student Loan Market* (Consumer Fin. Prot. Bureau, Paper No. 2504660, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2504660 [https://perma.cc/ZQ2C-DAWD]; Maximilian D. Schmeiser et al., *Does Salient Financial Information Affect Academic Performance and Borrowing Behavior Among College Students?* 1–36, (Bd. of Governors of the Fed. Reserve Sys. Fin. and Econ. Discussion Series, Paper No. 2015-075, 2015), http://dx.doi.org/10.17016/FEDS.2015.075 [https://perma.cc/2LVG-QBGD].

[194] While current student debt is quickly approaching the subprime mortgage debt levels from 2006 and 2007, over ninety percent of student debt is currently underwritten by the United States through the Department of Education. *See* Adam Levitin, *Is there a Student Loan Crisis?*, CREDITSLIPS (June 23, 2015, 2:16 PM), http://www.creditslips.org/creditslips/2015/06/is-there-a-student-loan-debt-crisis.html [https://perma.cc/DC38-FY2Q].

choice,[195] house purchase,[196] or moving out of their parents' house.[197] This may have significant long-term effects for the economy as a whole.[198]

Student loan debt is special because unlike mortgage, credit card, and medical debts, to name a few, it is very difficult to get rid of in bankruptcy. This has been so for federal loans since 1976. In 2005, Congress reformed the bankruptcy laws and added PSLs to the list of presumptively nondischargeable debts. This change created a windfall for lenders since it applied to any loan that was unpaid as of the law's enactment, even if the loan originated before the law was passed and was made on the presumption that it *would* be dischargeable.[199]

In this article, we have used statistical techniques to analyze some of the outcomes of this legal change. Based on our analysis of a loan-level dataset, we found no statistically significant effects of either (a) lenders passing through the expected savings of the law change to students through lower interest rates or (b) that students would have reacted to lower prices by taking out more private loans even if lenders had passed any of the savings to consumers. Our findings (with the caveats described in the text) suggest that losing the ability to discharge loans in bankruptcy was a net loss for students, even after taking into account market response by the lenders.

Our findings lead us to recommend two policy changes. First and foremost, we argue that Congress should roll back the special protections it has granted to private educational loans: students should be able to automatically discharge their private student loan debt in bankruptcy as easily as they discharge their credit card debt. Recognizing that it does not currently seem politically feasible to do this, we detail an alternative proposal: an ability-to-repay rule for private student loans. Borrowing from the Dodd-Frank Act and subsequent CFPB mortgage regulations, we suggest that a lender should incur liability if it did not verify the student's potential to repay the loan by comparing the loan amount with the student's choice of school and major's expected graduation rates and earnings post-graduation (if student even graduates). In the text we expand on our suggestion by, for example, dis-

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195 *See, e.g.*, Erica Field, *Educational Debt Burden and Career Choice: Evidence from a Financial Aid Experiment at NYU Law School*, 1 Am. Econ. J.: Applied Econ. 1 (2009); David M. Linsenmeier et al., *Financial Aid Packages and College Enrollment Decisions: An Econometric Case Study*, 88 Rev. Econ. & Stat. 126–45 (2006); Jesse Rothstein & Cecilia Elena Rouse, *Constrained After College: Student Loans and Early-Career Occupational Choices*, 95 J. Pub. Econ. 149 (2011).

196 *See, e.g.*, Mezza et al., *supra* note 30.

197 *See, e.g.*, David Dayen, *When Millenials Can't Move Out of Their Parents' Basements the Entire Economy Suffers*, New Republic (Feb. 21, 2014), https://newrepublic.com/article/116707/student-debt-crisis-slowing-household-formation-millenials [https://perma.cc/94BM-NBLB].

198 Josh Mitchell, *Soaring Student Debt Prompts Calls for Relief*, Wall St. J. (Sept. 13, 2016), http://www.wsj.com/articles/soaring-student-debt-prompts-calls-for-relief-1473759003 [https://perma.cc/3TDE-BEVS].

199 BAPCPA merely added PSLs to the list of presumptively nondischargeable loans. That list has never specified when the loans were originated. Instead, the list of nondischargeable loans only becomes relevant when a consumer files for bankruptcy. *See* 11 U.S.C. 523(a)(8) (2012); Ang & Jiménez, *supra* note 17, at 177.

cussing possible safe harbors for the ease of administrability: high graduation rates at the school that student chose, high salaries after graduating with a given major from this particular school, and an income-based repayment plan (that forces the lender to have a stake in the student's eventual post-college outcome). While we do not make exact prescriptions for a safe harbor, we do encourage the CFPB to use its supervisory authority to obtain data that would help craft a tailored policy.

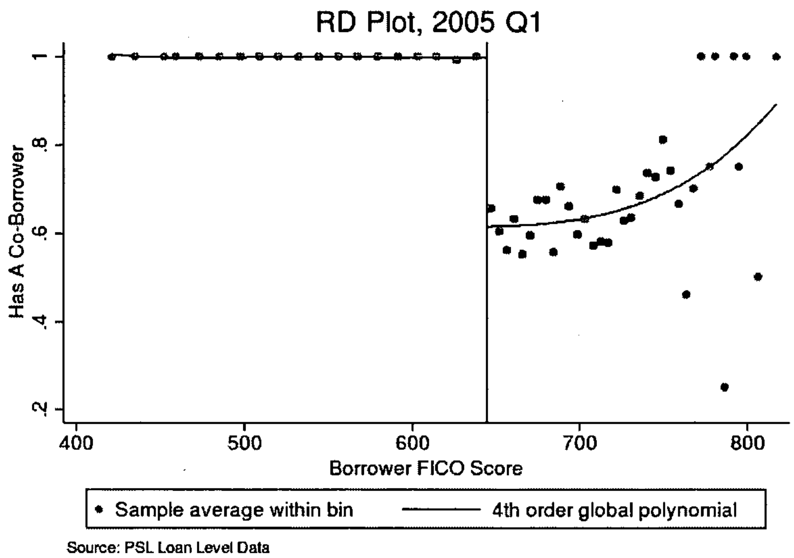
Technical Appendix

A. *Documenting the Discontinuity at 645 FICO Score*

We document that there is a discontinuity at a maximum FICO of 645: students whose maximum FICO score is just below 645 have to borrow at a considerably higher interest rate (close to three percentage points) than students whose maximum FICO score is just above 645. This corroborates the information received from lenders that underwriting in the sample period was based on the maximum FICO score of borrower and co-borrower. We show that there are significant effects on both the presence of a co-borrower and interest rate at origination. We show in our placebo test[200] that, in contrast, borrower FICO (instead of maximum FICO) does not exhibit a similar change in interest rate at origination at a 645 FICO score.

Appendix Figure 1 exemplifies the classic RD setup. It shows that at four-year public schools in the first quarter of 2005, one hundred percent of loans with maximum FICO below 645 have a co-borrower whereas only fifty-five percent of borrowers with a score just above 645 have a co-borrower. This stark difference indicates that lenders imposed a co-borrower requirement for borrowers with low credit scores.

Appendix Figure 1: Proportion of Borrowers with Co-Borrowers by FICO Score, 2005 Q1, Public



[200] A placebo test is a falsification exercise that implements the same empirical tests as the main analysis where an effect would not be expected to be detected. In this case, we performed the tests at maximum FICO scores other than 645.

Appendix Table 1 formalizes both of these findings. The structure of this table is similar to the other tables in which we present estimates for RD. The first row represents the difference in the proportion of loans with a co-borrower just below a maximum FICO of 645 and at or above a maximum FICO of 645. The numbers in parenthesis just below the first row are the standard errors.

APPENDIX TABLE 1: PROPORTION OF BORROWERS WITH A CO-BORROWER, 2005 Q1, BASED ON BORROWER CREDIT SCORE[201]

	(1) All Undergraduates	(2) Private Schools	(3) Public Schools
Difference	-0.51***	-0.54***	-0.45***
	(0.09)	(0.06)	(0.12)
Has a Co-Borrower Below 645	1.00	1.00	1.00
Has a Co-Borrower Above 645	0.49	0.46	0.55
Observations Below 645[202]	39	27	25
Observations At or Above 645	144	573	94
Bandwidth for Regression	6.89	67.62	6.59
Bandwidth for Bias Correction	10.17	101.99	10.20

Notes:
Numbers in parentheses denote standard errors.
* Significant at the 10% level; ** Significant at the 5% level; *** Significant at the 1% level.
Restricted to four-year undergraduates at public and private not-for profit schools in the first quarters of 2005, 2006, and 2007.
Source:
CFPB PSL Loan Level Dataset, IPEDS, and PEPS.

A negative number in the first row indicates that the proportion of borrowers with a credit score decreased when the student's credit score is just above 645. This can be seen in Figure A-1 and it is precisely as we would expect when lenders use a threshold to divide borrowers into risky/less risky categories. The difference in prevalence of co-borrowers across the threshold differs by type of school. The first row of Appendix Table 1 shows the estimated difference between co-borrower rates among sub-prime/prime borrowers: In columns 2 and 3 of row 1, we estimate that difference to be fifty-four percent at private schools versus forty-five percent at public schools (in column 3). Given that one hundred percent of borrowers whose maximum FICO was below 645 had a co-borrower, this corresponds to borrowers in

[201] Regression discontinuity calculated using robust regression discontinuity. *See* Calonico et al., *supra* note 113. Bandwidth and number of observations selected using CCT; kernel for local polynomial estimators is triangular.
[202] Note that the number of observations above and below the 645 threshold correspond to the number of observations in the optimal bandwidth in the eighth row and not to the much larger number of observations in the data.

private institutions having a co-borrower forty-six percent of the time and those in public institutions having a co-borrower fifty-five percent of the time, as per row 4.[203]

It is also important to note that the observable characteristics of the borrowers in the sample vary smoothly across the 645 maximum FICO threshold, which indicates that the borrowers just above and just below the threshold are comparable—at least as far as we can tell—and there is unlikely to be manipulation of FICO scores around the threshold. This assumption is further bolstered by there being no significant change in tuition and fees at the schools attended by borrowers and no significant change in graduation rates. The following tables and figures show supporting evidence.

Appendix Table 2: Tuition and Fees at Maximum FICO 645[204]

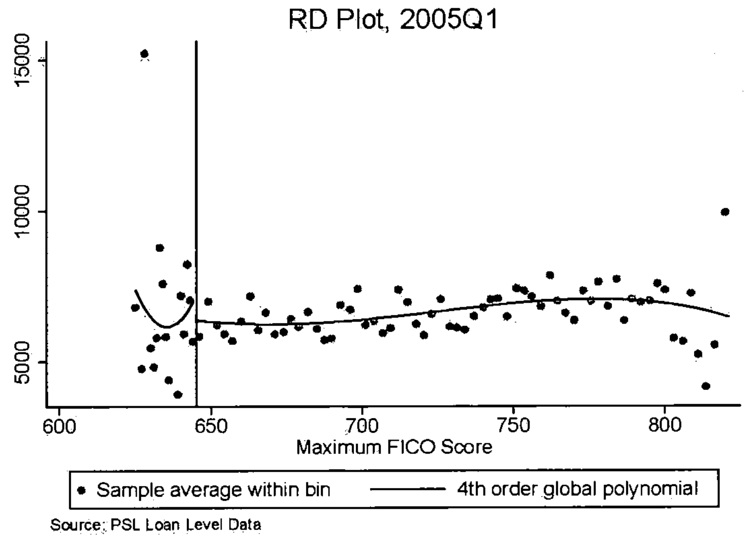
	(1) All Undergraduates	(2) Private Schools	(3) Public Schools	(4) With Co-Borrowers	(5) Extensive Ph.D. Granting Institutions
Difference ($)	-4,518 (3,728)	814 (2,247)	-246 (1,498)	-5,013 (4,521)	1,030 (2,366)
Tuition and Fees Below 645 ($)	15,541	17,482	5,495	16,030	10,200
Tuition and Fees Above 645 ($)	11,022	18,296	5,249	11,017	10,965
N Below 645	35	17	25	29	2,335
N At or Above 645	119	64	106	46	4,386
Bandwidth for Regression	5.45	8.84	7.40	4.87	35.78
Bandwidth for Bias Correction	9.71	13.69	10.43	9.14	60.35

Notes:
Numbers in parentheses denote standard errors.
* Significant at the 10% level; ** Significant at the 5% level; *** Significant at the 1% level.
Restricted to four-year undergraduates at public and private not-for profit schools in the first quarters of 2005, 2006, and 2007.
Source:
CFPB PSL Loan Level Dataset, IPEDS, and PEPS.

[203] These differences were calculated using the CCT robust regression discontinuity method, Calonico et al., *supra* note 113, implemented using the authors' algorithm for Stata. Note that there are two optimal bandwidths calculated: one for the regression that is specific to the calculation of the estimate, and one for the bias correction, which is necessary for correctly calculating the standard errors.

[204] Regression discontinuity calculated using robust regression discontinuity. *See* Calonico et al., *supra* note 113. Bandwidth and number of observations selected using CCT; kernel for local polynomial estimators is triangular.

Appendix Figure 2: Tuition and Fees by In-State Status, Undergraduates at Four Year or Higher Institutions

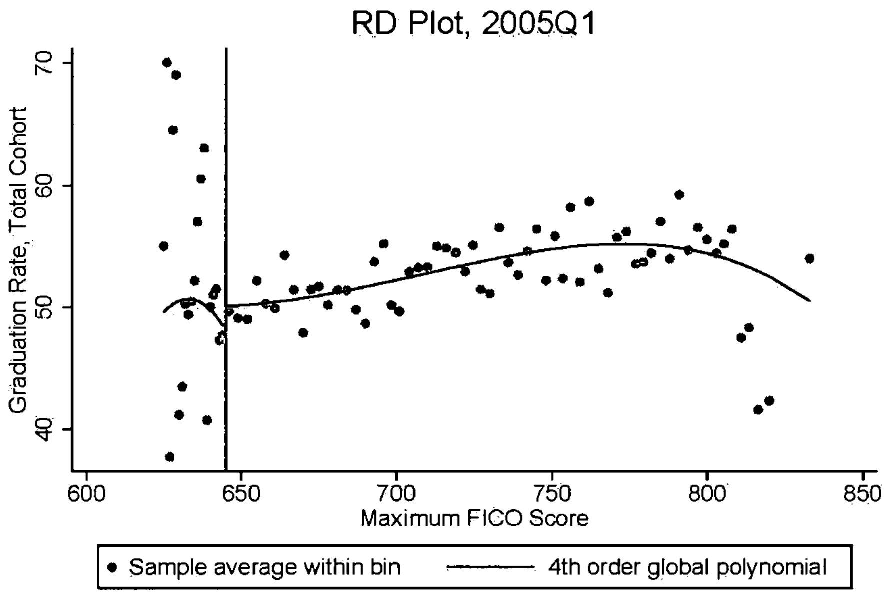


Appendix Table 3: Graduation Rates at Maximum FICO 645

	(1) All Undergraduates	(2) Private Schools	(3) Public Schools	(4) With Co-Borrowers	(5) Extensive Ph.D. Granting Institutions
Difference	1.18	-16.21	11.72	-2.55	5.65
	(7.23)	(13.73)	(11.86)	(8.64)	(5.52)
Graduation Rate Below 645	48.0547	67.9612	36.1915	47.29	63.87
Graduation Rate Above 645	49.2381	51.7544	47.9072	44.75	59.62
N Below 645	39	12	24	38	760
N At or Above 645	162	41	105	63	1542
Bandwidth for Regression	49.18	5.37	7.33	6.24	40.80
Bandwidth for Bias Correction	47.72	10.22	12.72	9.89	69.06

Notes:
Numbers in parentheses denote standard errors.
* Significant at the 10% level; ** Significant at the 5% level; *** Significant at the 1% level.
Restricted to four-year undergraduates at public and private not-for profit schools in the first quarters of 2005, 2006, and 2007.
Regression discontinuity calculated using Calonico, Cattaneo, and Titiunik (2014) robust regression discontinuity.
Bandwidth and number of observations selected using CCT; kernel for local polynomial estimators is triangular.
Source:
CFPB PSL Loan Level Dataset, IPEDS, and PEPS.

Appendix Figure 3: Graduation Rates, Undergraduates at Public Four Year or Higher Institutions



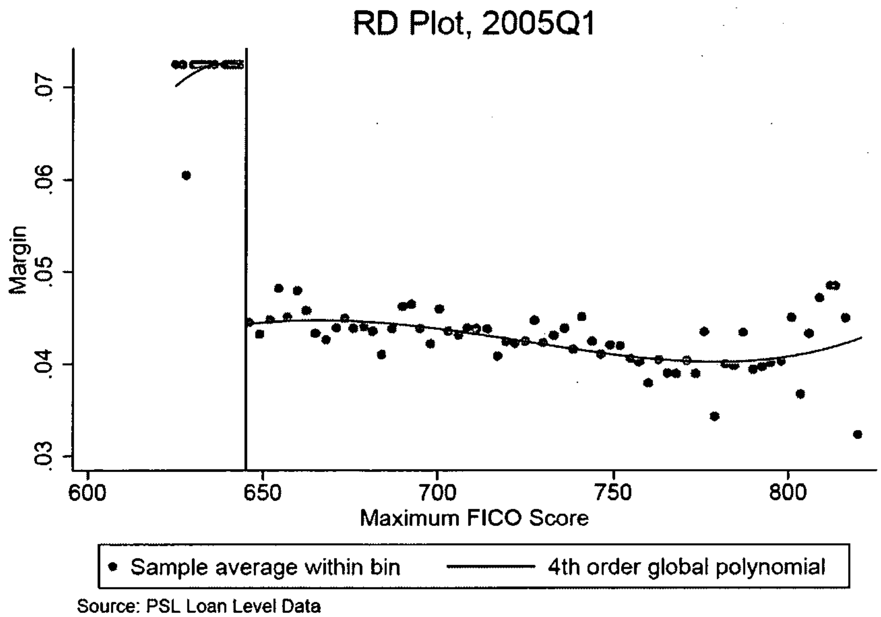
Source: PSL Loan Level Data

The difference in underwriting across the 645 threshold is also evident in pricing. Since practically all of the PSLs in the sample are variable rate loans indexed to prime, LIBOR, T-Bills, or another index, we use margin above the index as our measure of price.[205]

Appendix Figure 4, below, plots the average margin for a specific maximum FICO score versus the maximum FICO score among all co-borrowers for undergraduates at public four-year or higher institutions.

[205] Since these are variable rate loans, the interest charged on them can be thought of as index plus margin, where the index is a public interest rate indicator (such as LIBOR) and the margin is the premium that the lender charges above that indicator. As noted earlier, we refer to interest rates in percentages in this article. The same applies to margins since they are relative to interest rates.

Appendix Figure 4: Margin vs. Maximum FICO Score, 2005Q1, Undergraduates at Public Four Year or Higher Institutions[206]



There is a sharp discontinuity in price at a FICO score of 645: the average margin is 7.25% left of the threshold and it is 4.58% right of the threshold, and pricing appears flat for a given side of the 645 FICO score. These estimates are presented in Appendix Table 4.

[206] The fitted line is a fourth degree polynomial in FICO score.

Appendix Table 4: Price Differences at a Maximum FICO Score of 645 Measured in Margin, 2005[207]

	(1) All Undergrads	(2) Private Schools	(3) Public Schools	(4) With Co-Borrowers	(5) Extensive Ph.D.-Granting Institutions
Difference (%)	-2.67***	-2.75***	-2.65***	-2.42***	-3.17***
	(0.15)	(0.20)	(0.22)	(0.17)	(0.65)
Margin Below 645 (%)	4.58	7.25	7.25	7.25	7.80
Margin At or Above 645 (%)	7.25	4.50	4.60	4.83	4.63
Observations Below 645[208]	39	27	25	83	32
Observations At or Above 645	144	340	94	512	94
Bandwidth for Regression	6.16	43.28	6.23	36.43	4.22
Bandwidth for Bias Correction	9.83	64.95	9.84	61.45	7.25

Notes:
Numbers in parentheses denote standard errors.
* Significant at the 10% level; ** Significant at the 5% level; *** Significant at the 1% level.
Restricted to four-year undergraduates at public and private not-for profit schools in the first quarters of 2005, 2006, and 2007.
Source:
CFPB PSL Loan Level Dataset, IPEDS, and PEPS.

The estimates of the price differential are similar across different subgroups: for all undergraduates, interest rates are on average 2.67% lower for loans with a maximum FICO at or above 645, which corresponds to a 2.75% differential in margins for private school loans in column 2 and 2.65% differential in margins for public school loans.

We present separate estimates for public and private schools since tuition and fees tend to be higher at private schools. One might expect the difference in price between prime and subprime borrowers to be smaller for borrowers at more academically competitive schools since the earnings risk for their student is lower. In fact, when we restrict attention to students at schools with a Carnegie classification[209] of extensive Ph.D.-granting institu-

[207] Regression discontinuity calculated using Calonico, Cattaneo, and Titiunik, *supra* note 130, robust regression discontinuity. Bandwidth and number of observations selected using CCT; kernel for local polynomial estimators is triangular.

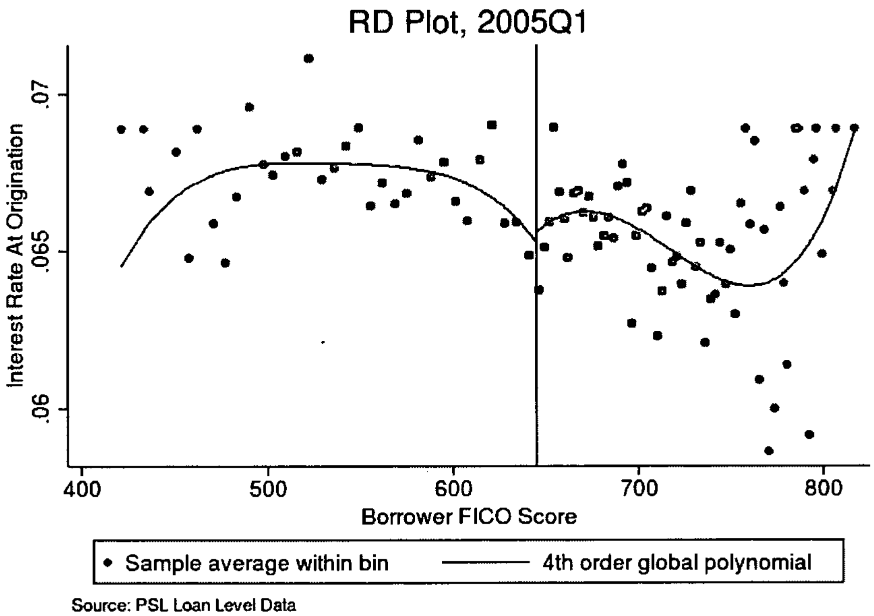
[208] Note that the number of observations above and below the 645 threshold correspond to the number of observations in the optimal bandwidth in the seventh row, and not to the much larger number of observations in the data.

[209] *See* Carnegie Classifications of Inst. of Higher Educ., http://carnegieclassifications.iu.edu [https://perma.cc/9HMH-EX99]. The Carnegie Classification is a commonly accepted standard of academic characteristics and rigor for U.S. academic institutions that is used in data released by the Department of Education. We focus on extensive Ph.D.-granting institutions because flagship public schools tend to be extensive Ph.D.-granting institutions and there are few public analogues to elite private liberal arts colleges. "Ph.D.-granting institution" is considered the most rigorous designation for universities.

tion[210] we estimate the differential to be 3.17% (about eighteen percent higher than the average for all students), as shown in column 5. However, the differences between these margins are not statistically significant.

To corroborate that underwriting is based on maximum FICO score, we repeat the exercise of plotting the relationship between the average interest rate and the *borrower's* FICO score.[211] As shown in Appendix Figure 5, we do not observe a similar discontinuity (compare to Appendix Figure 4). This corroborates the assertion that underwriting is based on maximum FICO.

APPENDIX FIGURE 5: MARGIN VS. BORROWER FICO SCORE, 2005Q1, UNDERGRADUATES AT PUBLIC FOUR YEAR OR HIGHER INSTITUTIONS (PLACEBO TEST)[212]



B. *Density Discontinuity*

Testing for the gap in density is mechanically similar to the procedure in a McCrary test for whether there is strategic movement to one side of a

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[210] *See id.* This corresponds to Carnegie classification 15; schools in this category include Princeton, Rutgers New Brunswick, Brandeis, University of Rochester, and University of Illinois.

[211] That is, even if the borrower has a co-borrower whose credit score is higher than his or her own, we use only the borrower's score.

[212] Includes all borrowers, regardless of whether they have co-borrowers.

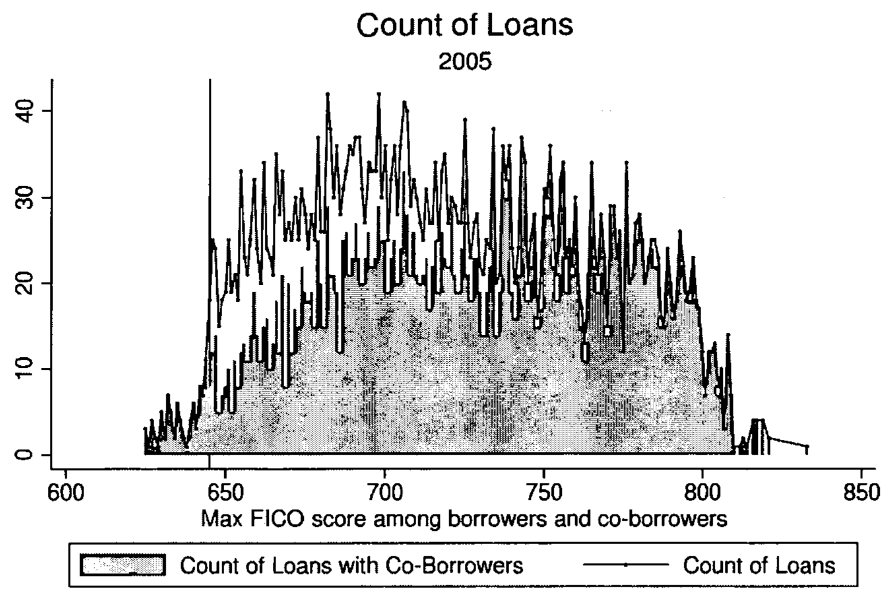
policy cutoff (manipulation of a running variable) in the RD design.[213] The McCrary Test looks for evidence consistent with manipulation of the running variable—in this case maximum FICO score—in a RD design. If the running variable is manipulated, then the assumption that individuals on either side of the threshold are similar is violated since the people who wanted to and could change the value of their score would sort to the "better" side of the threshold. The intuition behind the test can be thought of as making histograms with finer and finer bin width, with the threshold being the start point of one of the bins, and comparing the height of the bins just above or just below the threshold. If they differ in height, then the running variable may have been manipulated. The difference between the standard use of the McCrary test and this application is in the inference: we assume that our running variable, the credit score, is continuous in the population of interest and cannot be manipulated, so the estimated gap in density captures the difference in take-up rates of student loans.

This sets the stage for an RD design in the terms and conditions of loans. For example, the price elasticity of demand for PSLs can be estimated by exploiting the discontinuity in margin at a FICO score of 645. One challenge is that we only observe originated loans. A standard RD setup would focus on the take-up rate of loans, but we do not have information about applicants who did not accept the loans they were offered or who were denied loans. If we assume that demand for loans is smooth through the 645 FICO score threshold and applicants on either side of the threshold are eligible to receive loans, then we can recover the effect of the price on loan take-up through its effect on the density of FICO scores among originated loans. For a visual example, see Appendix Figure 1.

As discussed in the main text, solo borrowers with FICO scores below 645 are virtually non-existent, so we focus this analysis on loans with co-borrowers. Loans with co-borrowers can fall into two categories: loans that would have been applied for with a co-borrower anyway and those that were applied for with a co-borrower only after a solo application was denied. For the group that would have a co-borrower anyway FICO scores should be smooth through 645. Although solo borrowers who were previously denied should be more likely to have scores below 645, the co-borrowers that they tap for their co-borrowed application should also be smooth through 645. Since pricing is discretely determined by the maximum credit score, the pricing for those with co-borrower scores below the threshold will receive the same price regardless of whether their score or their co-borrower's score is used. Therefore, the running variable—the FICO score used in underwriting—is smooth through 645.

[213] Justin McCrary, *Manipulation of the Running Variable in the Regression Discontinuity Design: A Density Test*, 142 J. ECONOMETRICS 698, 701 (2008).

APPENDIX FIGURE 6: DENSITY OF LOANS ORIGINATED, 2005Q1



Source: CFPB PSL Loan Level Dataset, 2005Q1, Vertical line at 645.

C. *Formalizing the Regression Discontinuity Strategy*

To formalize the RD strategy used in this paper, let $\varphi_c(x, p)$ be the take-up rate of co-borrowed loans with maximum FICO scores of x and price p Let θ be the FICO score threshold at which the price changes from p_0 to p_1 and let $f_c(x)$ be the population density of FICO scores of individuals eligible to apply for PSLs with willing co-borrowers. The price elasticity of demand can be calculated by:

$$\epsilon_D = \frac{\lim_{x \downarrow \theta} \varphi_c(x, p_1) - \lim_{x \uparrow \theta} \varphi_c(x, p_0)}{\frac{p_0 - p_1}{p_1}}.$$

We don't observe φ_c though, and instead observe the density relative to originated loans for a fixed price schedule:

$$g(x) = \frac{f_c(x)\varphi_c(x,p)}{\int_a^b f_c(t)\varphi_c(t)dt},$$

where $[a, b]$ is the support of the distribution of scores.

Note that:

$$\lim_{x \downarrow \theta} g(x) - \lim_{x \uparrow \theta} g(x) = \lim_{x \downarrow \theta} \frac{f_c(x)\varphi_c(x, p_1)}{\int_a^b f_c(t)\varphi_c(t)dt} - \lim_{x \uparrow \theta} \frac{f_c(x)\varphi_c(x, p_0)}{\int_a^b f_c(t)\varphi_c(t)dt}$$
$$= \frac{f_c(x)}{\int_a^b f_c(t)\varphi_c(t)dt}\left[\lim_{x \downarrow \theta} \varphi_c(x, p_1) - \lim_{x \uparrow \theta} \varphi_c(x, p_0)\right]$$
$$= \frac{f_c(x)}{\int_a^b f_c(t)\varphi_c(t)dt} \times \frac{p_1}{p_0 - p_1} \times \epsilon_D,$$

so we can estimate the elasticity of demand up to a constant multiple.

The analysis described above is restricted to co-borrowed loans. Some solo borrowers who do not qualify for loans on their own may not be able to find a willing co-borrower and may therefore be credit constrained. If this is happening, then there should be solo borrowers just above the 645 FICO score threshold but not just below it. Assuming that solo borrower demand just above and just below the threshold is similar we can measure the extent of the credit constraint by considering how many solo borrowers are "missing" just below the 645 FICO threshold. Let be the population density of solo borrowers and let be the takeup rate of solo borrowers. Assume that solo borrowers are only permitted to borrow if their credit score is greater than or equal to . Then the probability density function of all observed loans is represented by *h*(*x*):

$$h(x) = \begin{cases} \dfrac{f_c(x)\varphi_c(x,p)}{\int_a^\theta f_c(t)\varphi_c(t,p)dt + \int_\theta^b [f_c(t)\varphi_c(t,p) + f_s(t)\varphi_s(t,p)]\,dt} & x < \theta \\ \dfrac{f_c(x)\varphi_c(x,p)}{\int_a^\theta f_c(t)\varphi_c(t,p)dt + \int_\theta^b [f_c(t)\varphi_c(t,p) + f_s(t)\varphi_s(t,p)]\,dt} & x \geq \theta \end{cases}.$$

If φ_s, f_s, φ_c, and f_c are continuous, then $\lim_{x \to \theta} + h(x) - \lim_{x \to \text{gki\_q;}} - h(x) > 0$ implies that solo borrowers are credit constrained.

The Small Business Prepack: How Subchapter V Paves the Way for Bankruptcy's Fastest Cases

Christopher D. Hampson & Jeffrey A. Katz***

Abstract

America has long styled itself as a place where entrepreneurs can dream big and—if things go well—make it big, too. But when small businesses fail, does the U.S. bankruptcy system provide a real opportunity to preserve value and try again? For decades, bankruptcy professionals, judges, and lawmakers have tried various approaches to small business bankruptcies, none of which worked particularly well. But in 2019, Congress passed the Small Business Reorganization Act ("SBRA"), one of the most significant amendments to the Bankruptcy Code in a generation. As practitioners, scholars, and judges work out the contours of the rules, we shine new light on one strategy for creditors and debtors that has gone unexplored so far: the small business prepack. Prepackaged bankruptcies, or "prepacks," are an aggressive and controversial approach for chapter 11 debtors that prioritize speed and certainty. Prepack debtors develop their reorganization plans, solicit votes, and prepare all necessary filings before entering court. At their fastest, some debtors have managed to get in and out of bankruptcy court in less than twenty-four hours. Filing a prepack reduces costs, lowers unpredictability, and keeps the debtor out of the public eye. Although stringent notice, disclosure, and voting requirements make prepack bankruptcies challenging and contentious under regular chapter 11, we argue that subchapter V provides a more hospitable procedural outlet for the strategy. Although the SBRA did not address prepacks expressly, the SBRA facilitates prepacks for small businesses, paving the way for bankruptcy's fastest cases both theoretically and practically. This Article walks through what a small business prepack would look like and analyzes which small businesses would benefit most from this strategy. It concludes with several proposals to

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refine subchapter V to make small business prepacks more predictable, efficient, and fair. Not all bankruptcy cases can be fast, but the SBRA may now make it easier for some small businesses to reorganize at rocket speed.

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[The] case will move fast and that alone will reduce costs.

–Hon. A. Thomas Small[1]

[T]he primary benefits . . . are speed, cost, and value.

–Sarah Borders & Steven M. Blank[2]

Introduction

Bankruptcy professionals and their clients have long valued expediency and efficiency. Yet throughout much of bankruptcy's history in the United States, financially distressed small businesses often found themselves trapped in protracted and intricate bankruptcy cases or attempting to survive outside the auspices of the Bankruptcy Code.[3] Recognizing the incongruence of these options with the objectives of bankruptcy, and in the wake of numerous judicial and legislative attempts to solve the problem, Congress tried a new approach in 2019 by creating a new subchapter tailored to small businesses.[4]

The Small Business Reorganization Act ("SBRA")[5] is one of the most significant amendments to the Bankruptcy Code in a generation.[6] It adds a new process for small business bankruptcies—subchapter V—within chapter 11 of the Bankruptcy Code.[7] Subchapter V removes many of the complex requirements that had made bankruptcy unapproachable

1 *Oversight of Bankruptcy Law and Legislative Proposals: Hearing Before the Subcomm. on Antitrust, Com., & Admin. L. of the H. Comm. on the Judiciary*, 116th Cong. 5 (2019) [hereinafter Small Testimony] (revised testimony of Hon. A. Thomas Small, U.S. Bankr. J. E.D.N.C., on behalf of the Nat'l Bankr. Conf. in support of H.R. 3311), https://www.congress.gov/116/meeting/house/109657/witnesses/HHRG-116-JU05-Wstate-SmallT-20190625.pdf [https://perma.cc/4SBB-CV92].

2 Sarah Borders & Stephen M. Blank, *1-Day Prepackaged Bankruptcy*, Bloomberg L. (Aug. 2021), https://www.bloomberglaw.com/external/document/X36CBBNO000000/bankruptcy-professional-perspective-1-day-prepackaged-bankruptcy [https://perma.cc/65HE-S79R].

3 11 U.S.C. §§ 101–1532.

4 *See infra* Section I.A (describing historical changes to the Bankruptcy Code to benefit small business debtors).

5 Small Business Reorganization Act of 2019, Pub. L. No. 116-54, 133 Stat. 1079 (codified as amended at 11 U.S.C. §§ 1181 *et seq*.).

6 *See, e.g.*, David A. Mawhinney, *Saving the Stakeholders*, 61 Judges' J. 26, 28 (2022) (describing the bipartisan legislation as "ushering in the most radical changes to federal bankruptcy law in 40 years"). As Mawhinney points out, the SBRA had mustered impressive support. *See id.* The bill was signed into law only fifty-six days after it was introduced in the U.S. House of Representatives, and Congress debated it for only four minutes. *See id.* at 28 n.5.

7 11 U.S.C. §§ 1181–1195.

for small businesses.[8] It shortens the length of the bankruptcy process, lowers costs, reduces the number of seats at the negotiating table, and offers entrepreneurs the chance to start afresh by keeping a stake in their company after three to five years of making payments out of disposable income.[9] By implementing these changes, the SBRA creates a more accessible and streamlined framework for small businesses.

Subchapter V's innovations for small businesses arise at the culmination of a decades-long experiment by debtors' counsel to speed up chapter 11 cases by soliciting votes for a plan of reorganization before even filing the case. Debtors who file a prepackaged bankruptcy, or "prepack," enter bankruptcy court with their exit plan already set.[10] So, although the plan of reorganization stands as the natural climax of a business bankruptcy and is typically filed six to nine months after the petition date, in a prepack case, the debtor seeks the initial protection of the bankruptcy court and final endorsement of its plan in the same breath—right as it walks into court.[11] Judges do not close a bankruptcy case after confirming a plan, but plan confirmation represents the definitive end to what are usually the most controversial and contested matters in a chapter 11 reorganization case, leaving subsidiary and administrative matters for further resolution.

Over the past two decades, prepack debtors have strategized to enter and exit court under this approach more and more quickly.[12] For many bankruptcy attorneys, a longstanding goal was the twenty-four-hour prepack: a bankruptcy petition filed at night and a confirmed plan the next day.[13] In 2019, preeminent debtor-side firm Kirkland & Ellis broke the record, confirming the first-ever twenty-four-hour prepack.[14]

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8 *See id.*

9 *See infra* Section I.B (describing the SBRA's adjustments to the Bankruptcy Code that make the process smoother for small businesses).

10 *See* Borders & Blank, *supra* note 2 ("[A] Prepack is a bankruptcy filing in which a debtor fully negotiates the terms of a chapter 11 plan . . . before the actual bankruptcy filing.").

11 If that endorsement requires creditor votes, then the debtor has formally sought acceptance of its plan before filing for the bankruptcy. *See, e.g.*, Aurelio Gurrea-Martinez, *The Rise of Pre-Packs as a Restructuring Tool: Theory, Evidence and Policy*, 24 Eur. Bus. Org. L. Rev. 93, 96 (2022); Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Survival*, 62 UCLA L. Rev. 970, 994 (2015).

12 *See* Jonathan M. Seymour & Steven L. Schwarcz, *Corporate Restructuring Under Relative and Absolute Priority Default Rules: A Comparative Assessment*, 2021 U. Ill. L. Rev. 1, 9 (2021).

13 *All in a Day's Work. Belk Achieves Confirmation of Pre-Packaged Plan in Record Time*, Patterson Belknap (Mar. 3, 2021), https://www.pbwt.com/bankruptcy-update-blog/all-in-a-days-work-belk-achieves-confirmation-of-pre-packaged-plan-in-record-time [https://perma.cc/QKU5-GGAU].

14 *See generally In re* FullBeauty Brands Holding Corp., Case No. 19-22185 (Bankr. S.D.N.Y. Feb. 3, 2019). *See also* David I. Swan & Thuc-Doan Phan, *Prepackaged Plans in 24 Hours*, Am. Bankr. Inst. J., Sept. 2019, at 28–29, 60, https://s3.amazonaws.com/abi-org-corp/journals/news_09-19.pdf [https://perma.cc/JJ86-WB86]. In numerous cases, debtors' counsel have successfully pushed a chapter 11 case from petition filing to plan confirmation in just a few days or less.

The two quotes at the outset of this Article endorse the twin values of expediency and efficiency. Yet the first statement refers to subchapter V, and the second refers to a chapter 11 prepack. Despite sharing a common objective, these two mechanisms operate quite differently. Subchapter V accomplishes speed through explicit, congressionally approved provisions that shorten timelines and promote negotiation between the debtor and its creditors.[15] In stark contrast, ultra-expedited prepacks are a development of zealous advocacy—to some, overzealous—by bankruptcy attorneys, greenlit by bankruptcy judges who approve the model by collapsing the default deadlines set forth in the Bankruptcy Code.

These two phenomena should be analyzed together. The rise of prepacks[16] and the creation of subchapter V[17] each generated professional and scholarly discussion. Many of the reasons debtors choose to file prepacks—increased speed, reduced uncertainty, and decreased costs—can be accomplished for many small business debtors through a small business prepack. This Article, however, is the first piece of

See, e.g., Order Approving the Debtors' Disclosure Statement for, and Confirming, the Debtors' Joint Prepackaged Chapter 11 Plan, *In re* Belk, Inc., No. 21-30630 (Bankr. S.D. Tex. Feb. 24, 2021), ECF No. 61 (less than twenty-four hours); Order (I) Approving the Disclosure Statement and Confirming the Joint Prepackaged Plan of Reorganization of SunGard Availability Services Capital, Inc. and Its Debtor Affiliates Pursuant to Chapter 11 of the Bankruptcy Code and (II) Granting Related Relief, *In re* SunGard Availability Servs. Cap., Inc., No. 19-22915 (Bankr. S.D.N.Y. May 2, 2019), ECF No. 46 (less than twenty-four hours).

15 *See* Small Business Reorganization Act of 2019, Pub. L. No. 116-54, 133 Stat. 1079 (codified as amended at 11 U.S.C. § 1181 *et seq.*). A consensual plan is a reorganization plan under chapter 11 that has been agreed to and approved by the various classes of creditors involved in the bankruptcy case. *See* 11 U.S.C. § 1129(a)(8).

16 Some of the most prominent critics of the super-fast prepack strategy include Professor Lynn LoPucki, who describes the *Belk* prepack as part of "[c]hapter 11's [d]escent into [l]awlessness," and Professor Adam Levitin, who describes the super-fast prepacked bankruptcy case as a "24-[h]our [d]rive-[t]hru [b]ankruptc[y]." *See* Lynn M. LoPucki, *Chapter 11's Descent into Lawlessness*, 96 Am. Bankr. L.J. 247, 247 (2022); Adam J. Levitin, Purdue's *Poison Pill: The Breakdown of Chapter 11's Checks and Balances*, 100 Tex. L. Rev. 1079, 1099–1103 (2022).

17 For example, in 2020, then-Professor, now-Bankruptcy Judge Christopher G. Bradley published an incisive assessment of strategies for creditors under subchapter V. Christopher G. Bradley, *The New Small Business Bankruptcy Game: Strategies for Creditors Under the Small Business Reorganization Act*, 28 Am. Bankr. Inst. L. Rev. 251 (2020). Bradley focused on the creditors' perspective, concluding (among other things) that they should resist delay and avoid holding general unsecured claims. *See id.* at 254–56. Due to the focus on creditor-driven strategies, Bradley's assessment does not cover whether a small business prepack is possible or desirable. For other excellent treatments of the SBRA, see Brook E. Gotberg, *Reluctant to Restructure: Small Businesses, the SBRA, and COVID-19*, 95 Am. Bankr. L.J. 389 (2021) (cataloguing and analyzing results of interviews with forty-three small business owners or managers in Columbia, Missouri in the first few months of the COVID-19 pandemic), and Nicole C. Cipriano, Note, *The Big Short: How the Big Step of the Small Business Reorganization Act Fell Short*, 50 Hofstra L. Rev. 145 (2021) (discussing the SBRA and advocating for improvements).

scholarship—of which the Authors are aware—to analyze how the two might interrelate.

This scarcity of scholarship may be in part because, despite many thousands of subchapter V cases filed since its inception, bankruptcy courts have yet to see a prototypical subchapter V prepack. But change may be on the horizon. In 2023, a restructuring group at Akerman LLP achieved what this Article dubs a "functional prepack" under subchapter V.[18] In *In re BPI Sports*,[19] the debtor "locked up" most of the votes through a restructuring support agreement ("RSA") before filing bankruptcy. After filing, the debtor solicited votes and successfully confirmed its plan in just thirty-three days.[20] This approach, what one might call a "functional" or "lock-up" prepack because votes were cast after entering court, heralds the arrival of the small business prepack.

Still, no other debtor has attempted a prepack under subchapter V.[21] Part of this is because not every small business debtor fits the mold for a prepack. Another chunk of this void is because bankruptcy practitioners are still coming to understand subchapter V. Conversely, the central promise of the prepack is certainty and speed. Without these elements, parties will hesitate to commit upfront to a prepack strategy. As the contours of subchapter V have become clearer, the bankruptcy bar is inching toward the true small business prepack. Small business debtors are pushing for faster and faster confirmation of their plans. And some debtors have filed plans of reorganization alongside their petitions as a sort of initial offer for negotiations.[22] For certain debtors, the prepack strategy represents the cutting edge of subchapter V practice—or so this Article argues.

The legislative innovations of subchapter V clear the way for small business prepack bankruptcies and address the most serious concerns of the prepack's detractors. Beyond that, small businesses are already less susceptible to some of bankruptcy's other problems, most notably forum and judge shopping.[23] As numerous scholars have underscored,

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18 *See In re* BPI Sports, Case No. 23-17463 (Bankr. S.D. Fla. Oct. 20, 2023). To our knowledge, *In re BPI Sports* is the first subchapter V prepack to date. See *infra* Section IV.B for more about this case.

19 Case No. 23-17463 (Bankr. S.D. Fla. Oct. 20, 2023).

20 *See infra* Section I.C.

21 At least to our knowledge.

22 In his testimony to the Subchapter V Task Force, Attorney Daniel Etlinger noted that a growing number of debtors are filing "first day plans" that they "present[] as an opening offer to the creditors anticipating there will be negotiated modifications." Daniel Ettinger, *Post Hearing Written Statement of Daniel Etlinger*, Am. Bankr. Inst. 2 (Sept. 8, 2023), https://abi-subv.s3.amazonaws.com/statements/Daniel_Etlinger_Post-Hearing_Statement.pdf?VersionId=xkdJcjOzw93YHlr7L-cWJyK0zp1elMGLp [https://perma.cc/36J9-5SS7].

23 For an overview of forum shopping, see, for example, Sarah Jones, Note, *Ameliorating Bankruptcy's Forum Shopping Crisis Through Abstention and Venue Transfer*, 76 Fla. L. Rev. 405 (2024); Adam J. Levitin, *Judge Shopping in Chapter 11 Bankruptcy*, 2023 U. Ill. L. Rev. 351 (2023).

bankruptcy's loose venue rules allow national conglomerates to file in almost any district they like,[24] leading to a proverbial "race to the bottom."[25] Although big businesses can file almost anywhere, small businesses are much more likely to file for bankruptcy where they are headquartered or incorporated.

This Article proceeds in four parts. Part I delves into the historical underpinnings of subchapter V and explores its unique procedures that make it an ideal choice for small business debtors seeking to restructure quickly. Part II analyzes how chapter 11 prepacks have reshaped chapter 11 cases despite certain limitations they may pose. Part III steps back to provide a theoretical lens on subchapter V and prepacks, elucidating why the speed of a prepack can best be achieved within the subchapter V framework. The new subchapter helps assuage the concerns of critics of ultra-expedited prepacks, most notably Professor Lynn LoPucki. Finally, Part IV walks through what a small business prepack would look like and proposes concrete suggestions to further streamline prepacks under subchapter V so that the model adheres to the subchapter's legislative goals.

American small businesses, their founders, and their creditors deserve a bankruptcy model that works for them. Subchapter V is the best solution to date. At the same time, the intense pace of the prepack strategy has put pressure on the bankruptcy system, streamlining the process but undermining its legitimacy and transparency. This Article argues that subchapter V presents an appropriate channel for fast-track bankruptcies and sketches out how the bankruptcy bench and bar can best take advantage of it.

I. A New Era for Small Business Bankruptcy

Small businesses and their founders face challenges from the onset: intense competition, limited resources, evolving markets, and more. When small businesses fall into economic or financial trouble, they can face acute and persistent financial distress. During these periods of

See generally Lynn M. LoPucki, Courting Failure: How Competition for Big Cases Is Corrupting the Bankruptcy Courts (2005).

24 28 U.S.C. § 1408(1) allows a business debtor to file in either its state of incorporation or the state where its principal place of business is located. 28 U.S.C. § 1408(1). On its own, that provision might lead to a concentration of bankruptcy cases in Delaware, where many businesses are incorporated, but it would not allow forum shopping otherwise. *See id.* But 28 U.S.C. § 1408(2) allows a debtor to file in the district where a case of its affiliate is pending. *Id.* § 1408(2). Thus, a large corporate family can select (or incorporate) a subsidiary almost anywhere it likes, file the subsidiary into bankruptcy, then follow with the rest of the corporate family on the basis of subsection (2). *See id.*

25 *See, e.g.*, LoPucki, *supra* note 16, at 250; Levitin, *supra* note 16, at 1128–50; Brook E. Gotberg, *The Market for Bankruptcy Courts: A Case for Regulation, Not Obliteration*, 49 BYU L. Rev. 647 (2024).

financial instability, entrepreneurs or subsequent owners may turn to bankruptcy for a potential solution to their companies' financial woes,[26] which are often entwined with the owners' own financial futures. The United States bankruptcy system—long admired around the globe—can preserve the value of a small business as a going concern, giving the company breathing room to negotiate with creditors and a chance to restructure its financial obligations.

Until recently, though, small businesses in financial distress had two options under the Bankruptcy Code—filing for chapter 7 or chapter 11 bankruptcy relief. And neither option was attractive to small businesses or their owners. Filing a petition in bankruptcy under the Code creates an estate comprising the debtor's assets.[27] In chapter 7, creditors elect a trustee to liquidate these assets and use the proceeds to repay the debtor's debts.[28] Since the assets will be sold, chapter 7 liquidation cannot satisfy the evergreen optimism of a founder who hopes to retain control of her business and continue operating after the bankruptcy.[29]

Chapter 11 offers a different path, allowing a debtor to restructure its debts through a court-approved plan while retaining control over its business operations during the case and possibly afterward as the "debtor in possession."[30] But chapter 11 is inhospitable to many small businesses for other reasons. The bankruptcy court supervises the restructuring process, and the debtor must follow stringent guidelines to have its plan confirmed and a discharge granted. As a result, chapter 11 is time- and labor-intensive—as well as expensive.[31] This practical reality left small businesses as "bankruptcy misfits," as Professor Laura Coordes terms them.[32]

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26 *See* David A. Mawhinney, *Written Statement of David A. Mawhinney*, Am. Bankr. Inst. 7 (June 9, 2023), https://abi-org.s3.amazonaws.com/SubV/wstatements/David_Mawhinney_Statement.pdf [https://perma.cc/N9BH-A2U2] ("[B]ankruptcy relief remains the best tool we have to truly repair and restore the nodes in our economy.").

27 11 U.S.C. § 541(a).

28 *Id.* §§ 702, 704(a)(1) ("The trustee shall . . . collect and reduce to money the property of the estate for which such trustee serves, and close such estate as expeditiously as is compatible with the best interests of parties in interest.").

29 *Id.* § 541(a)–(b) (describing which property is included in the estate). Individual debtors (who are not the focus of this Article) can also exempt certain property from the estate under section 522(b). *See id.* § 522(b).

30 *Id.* § 1107 (allowing the debtor to step into the shoes of the chapter 11 trustee as the "debtor in possession"); *see also* Grant M. Hayden & Matthew T. Bodie, *Codetermination in Theory and Practice*, 73 Fla. L. Rev. 321, 348 (2021) (noting that the U.S. bankruptcy system relies on a "debtor-in-possession running the show").

31 *See* Laura N. Coordes, *Bespoke Bankruptcy*, 73 Fla. L. Rev. 359, 378 (2021) ("Chapter 11, designed primarily with large businesses in mind, was often too expensive and demanding for a small business debtor.").

32 *Id.* at 377 ("Small business debtors were bankruptcy misfits because the available Bankruptcy Code chapters did not work well for them.").

In 2019, Congress enacted the SBRA to help small businesses navigate bankruptcy more effectively.[33] The SBRA created a new subchapter V within chapter 11 of the Bankruptcy Code, another form of what Coordes calls "bespoke bankruptcy," and what one of the Authors (riffing off of Coordes) has called "tailored bankruptcy."[34] Subchapter V was designed to simplify the complex requirements of chapter 11, shorten the length of cases, and reduce associated costs.[35] This Part sets out the origins and framework of subchapter V, showing its promise for a streamlined insolvency proceeding for small business debtors.

A. The Origins of Subchapter V

Congress has long wrestled with the problem of expediting a bankruptcy case while ensuring consistency, fairness, and accessibility.[36] Chapter 11 bankruptcy was intended to establish "a framework for reorganizing a bankrupt business."[37] Since over 99.7% of businesses with paid employees in the United States are small businesses,[38] it would make sense for the Bankruptcy Code to account for their lack of resources and need for speed compared with large enterprises. Unfortunately, this has not been the case. Chapter 11 takes too much time and money for it to be a viable solution for many small businesses. Before the SBRA, bankruptcy judges and federal legislatures tried several times to solve this problem—all of which were incomplete solutions.

Shortly after the Bankruptcy Code's enactment in 1978,[39] bankruptcy judges realized the need for quick bankruptcies for small business

33 Small Business Reorganization Act of 2019, Pub. L. No. 116-54, 133 Stat. 1079 (codified as amended at 11 U.S.C. §§ 1181 *et seq.*).

34 *See* Coordes, *supra* note 31, at 359, 377–78; Christopher D. Hampson, *Bespoke, Tailored, and Off-the-Rack Bankruptcy: A Response to Professor Coordes's 'Bespoke Bankruptcy'*, 73 Fla. L. Rev. F. 15, 19 & n.33 (2023).

35 *See* Paul W. Bonapfel, *A Guide to the Small Business Reorganization Act of 2019*, 93 Am. Bankr. L.J. 571, 574 (2019); *see also In re* Keffer, 628 B.R. 897, 910 (Bankr. S.D. W. Va. 2021) ("It is a brave new world for bankruptcy courts following enactment of the SBRA. SubChapter V is a valuable tool for qualifying debtors and will facilitate reorganizations that were not possible before.").

36 H.R. Rep. No. 116-171, at 3 (2019).

37 Mission Prod. Holdings, Inc. v. Tempnology, LLC, 587 U.S. 370, 373 (2019).

38 *Frequently Asked Questions*, U.S. Small Bus. Admin. Off. of Advoc. (Oct. 2020), https://advocacy.sba.gov/wp-content/uploads/2020/11/Small-Business-FAQ-2020.pdf [https://perma.cc/JEH3-9K22].

39 Small business reforms predate the Bankruptcy Code, of course. They were a major part of the bankruptcy reforms of the 1938 Chandler Act. *See* Douglas G. Baird, The Unwritten Law of Corporate Reorganizations 109 (2022). Under the Act, small businesses would generally reorganize under Chapter XI, which gave more control to prebankruptcy directors. *See id.* at 103, 109. Although Congress initially required absolute priority in Chapter XI, it eventually dropped the requirement. *See id.* at 77, 107, 109.

debtors.[40] Judges used their discretionary power to speed up cases for small businesses.[41] They set early deadlines for the debtor to file its bankruptcy plan while simultaneously reviewing the debtor's disclosure statement.[42] And by consolidating the final disclosure approval with the plan confirmation hearing, their innovations seemed to work for some debtors.[43] But the sporadic adoption of these processes sparked concerns about consistency, transparency, and legitimacy.[44]

In 1994, Congress responded with the Bankruptcy Reform Act of 1994 ("BRA").[45] This act codified the fast track option for small businesses in chapter 11 that allowed a court to conditionally approve the disclosure statement, combine the disclosure statement hearing with the plan confirmation hearing, or even determine that "the plan itself provides adequate information and that a separate disclosure statement is not necessary."[46] Under the BRA, a debtor could file a chapter 11 petition and begin soliciting votes on a plan immediately after filing.[47]

Approximately three years later, however, the National Bankruptcy Review Commission found the modified small business bankruptcy procedures under the BRA inadequate.[48] To be sure, small businesses benefited from various provisions of the "fast track" option, including the automatic stay and retention of business operations.[49] But too often, a business's ability to delay filing its chapter 11 plan only prolonged

40 Brian A. Blum, *The Goals and Process of Reorganizing Small Businesses in Bankruptcy*, 4 J. Small & Emerging Bus. L. 181, 206 (2000).

41 *Id.*

42 Cipriano, *supra* note 17, at 153. A plan confirmation hearing is where the bankruptcy judge reviews and approves or denies a proposed repayment plan for a debtor's debts. *See* 11 U.S.C. §§ 1128–1129.

43 Cipriano, *supra* note 17, at 153*; see also* 11 U.S.C. §§ 1128–1129.

44 *See* Blum, *supra* note 40, at 208 (noting that "the creation by courts of an innovative discretionary procedure raises a more general policy concern: A discretionary process, not mandated or regulated by the Code, is not universally adopted and, even where it is used, can vary quite significantly in the details of its scope and nature").

45 Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 217, 108 Stat. 4106.

46 11 U.S.C. § 1125(f).

47 *See* Jeffrey T. Kucera, Margaret R. Westbrook, David A. Mawhinney & Javier A. Roldan Cora, *Small Business Debtor Reorganization: An Overview of Chapter 11's New Subchapter V*, K&L Gates (Sept. 23, 2019), https://www.klgates.com/Small-Business-Debtor-Reorganization-An-Overview-of-Chapter-11s-New-Subchapter-V-09-23-2019 [https://perma.cc/EA2F-DGTS].

48 *See* James B. Haines Jr. & Philip J. Hendel, *No Easy Answers: Small Business Bankruptcies After BAPCPA*, 47 B.C. L. Rev. 71, 74–75 (2005); *see also* Daniel O'Hare, Note, *The Long and Winding Road to the Small Business Reorganization Act: Why Our Next Stop Should Be Simplicity and Accessibility*, 124 W. Va. L. Rev. 567, 578 (2022).

49 *See* Haines Jr. & Hendel, *supra* note 48, at 74.

its ultimate failure.[50] Even with some incremental successes, the BRA left much to be desired for small businesses and was the catalyst for an additional wave of legislative reform—the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA").[51]

In addition to its other goals, BAPCPA attempted to streamline chapter 11 reorganizations for small businesses.[52] BAPCPA retained a small business debtor's ability to "fast track" its chapter 11 case and further tightened the deadlines in such cases.[53]

It was not enough. From 2008 to 2015, only 27% of the 18,000 small businesses that filed for chapter 11 had a successful reorganization.[54] Those figures do not include the small businesses that never filed a bankruptcy petition in the first place "because the Bankruptcy Code [was] seen as broken and unworkable."[55] It was clear bankruptcy was still impractical for many small businesses.[56] Even if a small business wanted to circumvent the small business provisions, a standard "[c]hapter 11 [was] . . . too slow and too costly for the majority of

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50 *See* O'Hare, *supra* note 48, at 578.

51 Pub. L. No. 109-8, 119 Stat. 23, 59. BAPCPA had an enormous impact when it went into effect. *See* Richard M. Hynes, *Broke but Not Bankrupt: Consumer Debt Collection in State Courts*, 60 Fla. L. Rev. 1, 29 (2008) ("[BAPCPA] went into effect in October 2005 and had an immediate and dramatic effect on the number of bankruptcy filings.").

52 Robert J. Landry III, *Subchapter V and the COVID-19 Disruption: Did Congress Get Small Business Bankruptcy Reform Right This Time?*, 16 Ohio St. Bus. L.J. 66, 72 (2021).

53 *See* David L. Bury Jr., *ABI Commission Report—Small and Medium-Sized Debtor Enterprises*, Plan Proponent (Aug. 18, 2015), www.planproponent.com/2015/08/abi-commission-report-small-and-medium-sized-debtor-enterprises [https://perma.cc/3Q2C-AJJB]. Under BAPCPA, a small business debtor had the exclusive right to file a plan during the first 180 days of the case (compared with 120 days for non-small-business debtors) and had to file a plan within 300 days of filing its petition. 11 U.S.C. § 1121(b), (e)(1)–(2). Additionally, the court was required to confirm a small business plan (so long as it met all the requirements) within forty-five days after the debtor filed it. *Id.* § 1129(e). Courts could grant extensions to these timelines only if the debtor could demonstrate that it would "more likely than not" get a plan confirmed within the enlarged period. *Id.* § 1121(e)(3).

54 *Oversight of Bankruptcy Law and Legislative Proposals: Hearing Before the Subcomm. on Antitrust, Com., & Admin. L. of the H. Comm. on the Judiciary*, 116th Cong. 52 (2019) (statement of Robert J. Keach), https://docs.house.gov/meetings/JU/JU05/20190625/109657/HHRG-116-JU05-Wstate-KeachR-20190625.pdf [https://perma.cc/BV37-BQRF].

55 *Id.* at 52.

56 *See* Small Testimony, *supra* note 1, at 1. Unlike regular chapter 11 cases where creditors play an oversight role that is crucial for a case's success, creditors in small business cases are largely absent because "creditors in these smaller cases do not have claims large enough to warrant the time and money to participate actively in these cases." H.R. Rep. No. 116-171, at 3 (2019).

middle market companies to do anything other than sell its going concern assets in a 363 sale[57] or to simply liquidate the company."[58]

In 2009, the National Bankruptcy Conference ("NBC") formed a group to study small business bankruptcies.[59] The group found that "chapter 11 generate[d] exorbitant administrative costs, and chapter 11 include[d] requirements such as a high voting threshold and elaborate disclosures" that presented "roadblocks to reorganization."[60] The NBC proposed adding a subchapter to chapter 11 that was specifically tailored to the needs of small businesses.

Similarly, in 2012, the American Bankruptcy Institute ("ABI") formed a commission to study and recommend a reform of chapter 11 for small businesses.[61] The commission drafted a report that mirrored many of the NBC's concerns about the chapter 11 provisions hindering successful reorganizations.[62]

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57 Section 363 of the Code allows the bankruptcy trustee to sell assets of the estate (up to the entire company) and use the proceeds to pay claims. *See* 11 U.S.C. § 363. Section 363 sales have become so prevalent that two prominent bankruptcy scholars announced that they spelled the "[e]nd of [b]ankruptcy." *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 Stan. L. Rev. 751, 751–55, 777–78, 787 (2002). For a description of 363 sales, see, for example, Kimon Korres, *Bankrupting Bankruptcy: Circumventing Chapter 11 Protections Through Manipulation of the Business Justification Standard in § 363 Asset Sales, and a Refined Standard to Safeguard Against Abuse*, 63 Fla. L. Rev. 959, 960 (2011) ("Section 363(b) of the Bankruptcy Code authorizes a Chapter 11 debtor-in-possession . . . to 'use, sell, or lease' estate property outside the ordinary course of business. Section 363 sales tend to be cheaper and more time efficient than reorganization alternatives."). Whether section 363 sales produce values sufficiently close to market value has been the subject of intense debate. *See, e.g.*, Jean-Marie Meier & Henri Servaes, *The Bright Side of Fire Sales*, 32 Rev. Fin. Stud. 4228, 4231 (2019); James J. White, *Bankruptcy Noir*, 106 Mich. L. Rev. 691, 692 (2008); Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 Mich. L. Rev. 1, 3–4 (2007).

58 Dan Dooley, *Dan Dooley Comments to ABI Commission Studying Chapter 11 Reform* (Apr. 18, 2013), https://commission.abi.org/sites/default/files/statements/19apr2013/ABI%20Testimony.pdf [https://perma.cc/JEV3-F4QT]; *see also* Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 Mich. L. Rev. 603, 636 (2009) ("[T]he costs of Chapter 11 are sufficiently high that many small companies were squeezed out of the system, forcing the managers to liquidate the business quickly in Chapter 7 or die quietly completely outside the bankruptcy system."); Michael St. James, *Statement for ABI Subchapter V Task Force*, Am. Bankr. Inst. (June 9, 2023), https://abi-org.s3.amazonaws.com/SubV/wstatements/Michael_StJames_Statement.pdf [https://perma.cc/Y3UY-EJRW] ("I had never seen a successful Chapter 11 that did not incur at least $100,000 in Chapter 11 attorney's fees and . . . a 'fast' reorganization would still likely take at least 8 months.").

59 Small Testimony, *supra* note 1, at 1.

60 *Id.* at 117.

61 *See* Am. Bankr. Inst., Commission to Study the Reform of Chapter 11 at 2 (2014), https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h [https://perma.cc/396R-KK4E].

62 *See id.*

Congress used the ABI and NBC reports as a framework for the SBRA, which took effect on February 19, 2020.[63] Although the SBRA differed slightly from the ABI's proposed procedures, Congress's intent remained consistent with the ABI's recommendation to streamline bankruptcy for small business debtors.[64]

B. New Framework for Small Businesses

Congress created subchapter V to provide small business debtors with a more efficient, less expensive, and more obtainable path to a chapter 11 discharge.[65] The subchapter contains several key innovations that streamline the process. Some of those innovations—the ones that made headlines—make subchapter V more attractive for entrepreneurs. Under the subchapter, debtor companies can receive a discharge if they pay off their secured debt and pay their disposable income to unsecured creditors for three to five years. After the discharge, the founder of the company can retain ownership and control of the company. This innovation makes bankruptcy more palatable to ever-optimistic founders and represents a departure from bankruptcy's famous absolute priority rule.[66] Less dramatically, but no less important, subchapter V also gets rid of the required quarterly fees to the Office of the United States Trustee ("U.S. Trustee"), a division of the Department of Justice and bankruptcy's watchdog.[67]

The following discussion, however, emphasizes how subchapter V might pave the way for a small business prepack. Specifically, the SBRA (1) set forth broad debtor eligibility, (2) compressed early case deadlines, (3) reduced the cast of estate professionals, and (4) gave the debtor in possession tighter control over the plan confirmation process. Each is covered in turn.

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63 *Subchapter V Small Business Reorganizations*, U.S. Dep't Just. (Mar. 5, 2024), https://www.justice.gov/ust/subchapter-v [https://perma.cc/WW4X-ZH9Y]; *President Signs Small Business Reorganization Act into Law*, Am. Bankr. Inst. (Aug. 23, 2019), https://www.abi.org/newsroom/press-releases/president-signs-small-business-reorganization-act-into-law [https://perma.cc/JMC3-YPSX].

64 The key term here is *debtors*. As attorney Michael St. James artfully framed it, "Congress has appropriately established two reorganization regimes. In traditional Chapter 11, fairness to creditors takes precedence over expense and delay. In Sub V, access for small businesses and the concomitant requirements of speed and inexpensiveness take precedence over some creditor rights." St. James, *supra* note 58.

65 H.R. Rep. No. 116-171, at 1 (2019).

66 The absolute priority rule requires that the plan pay senior creditors in full before junior creditors can receive any distribution. *See infra* Section I.B.4.

67 28 U.S.C. § 1930(a)(6) (excepting cases under subchapter V from quarterly U.S. trustee fees based on disbursements from the estate).

1. *Broad Debtor Eligibility*

First, subchapter V is available to a wide swath of financially distressed firms.[68] Although subchapter V is only available to small business debtors, the statutory definition is more capacious than many people realize.[69] Professor Robert Lawless calculated that approximately 40% of chapter 11 debtors in cases filed after October 2007 would have qualified.[70]

To qualify, a debtor must be "engaged in commercial or business activities"[71] and have "aggregate noncontingent liquidated secured and unsecured debts" as of the date of the petition of no more than

68 *See* Craig Goldblatt, *Remarks of Craig Goldblatt*, Am. Bankr. Inst. 1 (July 14, 2023), https://abi-org.s3.amazonaws.com/SubV/wstatements/Craig_Goldblatt_Written_Statement.pdf [https://perma.cc/TL9S-GLBL] ("Is every subchapter V case that files before us the kind of case that Congress had in mind when it enacted the Small Business Reorganization Act of 2019—the corner grocer or local dry cleaner, run by a hard-working entrepreneur who has hit a bump in the road and is looking to save his small business? No.").

69 Subchapter V requires a qualifying debtor to elect its application. Fed. R. Bankr. P. 1020 (requiring a voluntary debtor to state in its petition, and an involuntary debtor to state within fourteen days of the order for relief, whether it is a small business debtor and whether it is electing to proceed under subchapter V of chapter 11). A qualifying debtor who does not elect subchapter V will proceed under chapter 11's regular rules, unless it is small enough to fit within the definition of a "small business debtor" under the BRA, which has a much lower cap of $2 million in qualifying debt. *See* 11 U.S.C. § 101(51D)(A).

70 Bob Lawless, *How Many New Small Business Chapter 11s?*, Credit Slips (Sept. 14, 2019, 4:28 PM), www.creditslips.org/creditslips/2019/09/how-many-new-small-business-chapter-11s.html [https://perma.cc/35UF-ALU3]; *see also* Paul W. Bonapfel, *A Guide to the Small Business Reorganization Act of 2019*, U.S. Bankr. Ct. N.D. Ga. 3 (June 2022), https://www.ganb.uscourts.gov/sites/default/files/sbra_guide_pwb.pdf [https://perma.cc/NG87-BGLX]. Professor Lawless made his calculation when the debt limit for a subchapter V debtor was $2.7 million.

71 11 U.S.C. § 1182(1)(A). For a thorough overview of the developing case law of the phrase "commercial or business activities," see Christopher G. Bradley, *"Commercial or Business Activities" and Subchapter V Eligibility*, 43 Bankr. L. Letter 1 (2023). Some commentators believe that the statutory language requiring a subchapter V debtor to be engaged in a "commercial or business activity" does not limit debtors to those engaged in business or commercial activities when they file for bankruptcy. *See, e.g.*, *In re* Wright, Case No. 20-01035, 2020 WL 2193240, at *3 (Bankr. D. S.C. Apr. 27, 2020) ("The definition of a 'small business debtor' is not restricted to a person who at the time of the filing of the petition is presently engaged in commercial or business activities and who expects to continue in those same activities under a plan of reorganization." (quoting 2 Collier on Bankruptcy ¶ 101.51D (16th ed. 2020))). Numerous courts have addressed the issue and reached differing opinions. *Compare In re* Vertical Mac Constr., LLC, No. 6:21-BK-01520, 2021 WL 3668037, at *3 (Bankr. M.D. Fla. July 23, 2021) (holding that debtor was eligible for subchapter V despite not having business operations because the inclusion of "activities" under the statute includes "maintaining bank accounts, having accounts receivable, analyzing claims and winding down its business"), *and Wright*, 2020 WL 2193240, at *2–3 (holding debtor who sold all assets and was no longer operating a business met the statutory definition of a small business debtor because he was "'engaged in commercial or business activities' by addressing residual business debt"), *with In re* Thurmon, 625 B.R. 417, 422 (Bankr. W.D. Mo. 2020) (reasoning that "[t]he plain meaning of 'engaged in' means to be actively and currently involved. . . . 'engaged in' is written not in the past or future but in the present tense"), *and* Nat'l Loan Invs., L.P. v. Rickerson (*In re* Rickerson), 636

a statutorily defined limit,[72] "excluding debts owed to . . . affiliates or insiders," most of which must arise "from the commercial or business activities of the debtor."[73] That definition sounds more restrictive than it really is: it does not include contingent debts, unliquidated debts, or debts owed to affiliates or insiders.[74] As an illustration, Imagine GatorCo is a retail store with estimated liabilities of $40 million, far above the nominal limit for subchapter V, which, for our purposes, we will set at $7.5 million, the debt limit for most of subchapter V's existence so far. GatorCo is a defendant in a slip-and-fall case where it estimates its liability will be $8 million. It has a $12 million mortgage note owed to its parent company, a $15 million secured note also owed to its parent company, and a $5 million outstanding balance owed to its suppliers.

Although GatorCo's total debts far exceed the $7.5 million limit, the company may still be eligible for subchapter V because the only

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B.R. 416, 423 (Bankr. W.D. Pa. 2021) (holding that eligibility requires the debtor to be engaged in commercial or business activity on the petition date).

72 *See* 11 U.S.C. § 1182(1)(A). Congress initially set the debt limit for subchapter V debtors at $2,725,625 and then temporarily increased it to $7.5 million under the Coronavirus Aid, Relief, and Economic Security Act. *See* Jeffrey Katz, *Tracking the Up(s) and Down of the SBRA Debt Limit*, *in* Five Secrets to a Magical Sub-V, 3–4 (Oct. 2022), https://ncbjmeeting.org/2022/materials/NCBJ%20Five%20Secrets%20to%20Magical%20Sub-V.pdf [https://perma.cc/B5UM-VQK4] (discussing amendments to subchapter V's debt limit). There is broad consensus that the subchapter V debt limit increase should be permanent. *See, e.g.*, Am. Bankr. Inst., Final Report of the American Bankruptcy Institute Subchapter V Task Force 10 (2024) [hereinafter ABI Final Report], https://abi-org.s3.amazonaws.com/Newsroom/ABI_SubV_TaskForce_FinalReport_Embargoed.pdf [https://perma.cc/6MS7-GLEM] (recommending that "eligibility for Subchapter V should remain at $7,500,000 . . . .").

Unfortunately, before this Article went to print, Congress has not acted to extend or make permanent the debt limit and the relief sunsetted on June 21, 2024. *See* Joy Kleisinger, *The Expiration of the Increased Subchapter V Debt Limit and Its Impact on Small Business Debtors*, Am. Bankr. Inst. J., Mar. 2024, at 8, 48. The debt limit has reverted to $3,024,725 until it increases for inflation on April 1, 2025, or Congress adjusts it. *See id.* at 8, 48. Some commentators have compared subchapter V's debt limit to chapter 12's $11 million debt limit for family farmers. *See* Coordes, *supra* note 31, at 370, 379; *see also* 11 U.S.C. §§ 101(18), 109(f). While subchapter V may benefit from a higher debt limit, a comparison between the two chapters cannot be straightforwardly made because the debt that qualifies in each chapter differs—the chapter 12 debt limit counts all secured and unsecured debts, whereas the subchapter V debt limit counts the more limited set of debts described above. *See id.*; *id.* at § 1182(1)(A).

73 11 U.S.C § 1182(1)(A).

74 *See id.* Even with the expansive definition, practitioners should remain hesitant to elect subchapter V for an ineligible debtor. *See, e.g.*, *In re* Sullivan, 626 B.R. 326 (Bankr. D. Colo. 2021) (converting a case to chapter 7 after holding debtor filed in bad faith and finding debtor's debt made him ineligible for subchapter V); *In re* Phenomenon Mktg. & Ent., LLC, No. 2:22-BK-10132, 2022 WL 1262001 (Bankr. C.D. Cal. Apr. 28, 2022) (converting a case to a standard chapter 11 after holding debtor was an affiliate of an ineligible corporation and not a small business). A debtor is also ineligible for subchapter V if its primary activity is the business of owning single-asset real estate, it is a corporation subject to reporting requirements under the Securities Exchange Act of 1934, or it is a member of a group of affiliated debtors of a corporation subject to the reporting requirements of the Securities and Exchange Act of 1934. 11 U.S.C. § 1182(1).

qualifying debt to establish its eligibility is the $5 million debt owed to suppliers. GatorCo's mortgage and secured note owed to its parent company are excluded from eligibility calculations under 11 U.S.C. § 1182(a) because they are owed to affiliates. Similarly, any damages from the slip-and-fall litigation are not yet liquidated. So long as GatorCo's other debts are less than $2.5 million, it can file for subchapter V bankruptcy.[75]

With these carve-outs, the term "small business" is somewhat misleading. The businesses are not as small as they might seem, and in the aggregate, the subchapter can cover a wide swath of financially distressed firms. Small businesses in the United States account for 99.7% of all firms with paid employees.[76] From a bankruptcy perspective, "approximately 90% of all chapter 11 debtors have less than $10 million in assets or liabilities, less than $10 million in annual revenues, and 50 or fewer employees."[77] Even a debtor who normally would not be eligible for subchapter V may find itself in luck[78]: friendly creditors may be willing to take a "pre-petition 'haircut'" to lower the debtor's debt to under the limit.[79] Similarly, a debtor could refinance some of its debt with an affiliate or insider so that the debt would not qualify toward the limit.[80]

2. *Compressed Early Case Deadlines*

Second, subchapter V deviates from the chapter 11 model by accelerating deadlines.[81] After a small business debtor files its bankruptcy case, deadlines follow quickly. Within ten days, the initial debtor interview

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75 11 U.S.C. § 1182(1)(A).

76 *See* U.S. Small Bus. Admin. Off. of Advoc., *supra* note 38.

77 Michelle Harner, *Rethinking "Small" Business Bankruptcies*, Credit Slips (Jan. 26, 2015, 6:48 AM), www.creditslips.org/creditslips/2015/01/rethinking-small-business-bankruptcies.html [https://perma.cc/3SBD-FFS2].

78 *But see* Adam R. Prescott, *Written Statement of Adam R. Prescott*, Am. Bankr. Inst. 3 (June 23, 2023), https://abi-subv.s3.amazonaws.com/statements/Adam_Prescott_Post-Hearing_Statement.pdf [https://perma.cc/KFB6-UWHC] ("[E]ligibility is a gating issue: Getting through the Subchapter V gate does not mean the debtor ultimately will benefit from the protections and powers of Subchapter V, as that debtor still must satisfy the many other obligations and statutory requirements in the case.").

79 Bradley, *supra* note 17, at 265.

80 *Id.* at 265 ("It is possible that debtors seeking subchapter V eligibility will try to game the eligibility cap. For instance, a debtor might employ mechanisms to assign debts to non-affiliate insiders . . . .").

81 *See In re* Rockland Indus., Inc., No. 21-02590, 2022 WL 451542, at *3 (Bankr. D.S.C. Feb. 14, 2022) ("Subchapter V . . . permit[s] small business debtors with the opportunity to reorganize more quickly . . . ."); *In re* Seven Stars on the Hudson Corp., 618 B.R. 333, 340 (Bankr. S.D. Fla. 2020) ("Subchapter V by its very nature is intended to be an expedited process.").

for a subchapter V case occurs.[82] Within forty-six days, the debtor must submit a status report describing its efforts to reach a consensual plan.[83] Fourteen days later—a mere two months after the petition—the court must hold a status conference "to further the expeditious and economical resolution" of the case.[84] After only ninety days (three months) from the commencement of the case, a debtor must file its plan.[85] Although subchapter V contains no deadline for plan confirmation and no limit on plan amendments—features that Bankruptcy Judge Christopher G. Bradley points out debtors may use to cause delay[86]—once the plan is filed, the timeline is officially in the hands of the bankruptcy judge.

Subchapter V again departs from chapter 11 by constraining a judge's authority to grant extensions of the prescribed deadlines. In subchapter V, a judge may only grant an extension to the debtor's ninety-day deadline to file a plan "if the need for the extension is attributable to circumstances for which the debtor should not justly be held accountable."[87] Most courts make this standard very hard to satisfy, citing the legislative intent of subchapter V to facilitate an expedited process.[88] This standard is a big change from chapter 11, under which enlargement can be granted "for cause," a loose standard that many bankruptcy judges grant as a matter of course.[89]

Congress has compressed case timelines and hindered opportunities to extend deadlines when it enacted subchapter V. If a debtor does

82 *See* 28 U.S.C. § 586(7) (stating that the U.S. Trustee must conduct the initial debtor interview before the first meeting of creditors).

83 11 U.S.C. § 1188(c).

84 *Id.* § 1188(a).

85 *Id.* § 1189(b).

86 *See* Bradley, *supra* note 17, at 272. Even with the notable absence of those deadlines, Bradley agrees that "the subchapter V scheme evidences an overall intention for cases to be prosecuted expeditiously by debtors." *Id.*

87 11 U.S.C. § 1189(b); *see also In re* Seven Stars on the Hudson Corp., 618 B.R. 333, 344 (Bankr. S.D. Fla. 2020) ("Based on a plain reading of this phrase, it is a clearly higher standard than the mere 'for cause' standard . . . .").

88 *See, e.g.*, *In re* Trinity Legacy Consortium, LLC, 656 B.R. 429, 434 (Bankr. D.N.M. 2023) (noting that "[c]ourts agree that § 1189(b) imposes a stricter standard than the 'for cause' standard set forth in § 1121(d)(1)"); *In re* Online King LLC, 629 B.R. 340, 344 (Bankr. E.D.N.Y. 2021) (denying a debtor's motion to extend for failure to satisfy the stringent burden of demonstrating it was entitled to extension and holding that the fact no party in interest opposed debtor's motion did not relieve the debtor of its burden to establish the extension was warranted); *Seven Stars on the Hudson Corp.*, 618 B.R. at 345 ("Congress purposefully set a short deadline for a debtor to file a plan under Subchapter V, and set a very high standard for an extension of that deadline.").

89 *Seven Stars on the Hudson Corp.*, 618 B.R. at 344.

not want to comply with the swift timeline of a subchapter V case, the solution is simple: do not opt in.[90]

3. *Smaller Cast of Estate Professionals*

Third, subchapter V has simplified the cast of estate professionals who typically sit around the table in a chapter 11 case. This Section briefly outlines the key distinctions in a subchapter V case.

a. *Estate Professionals & Financing*

Subchapter V makes it easier for debtors to work with their longstanding attorneys, accountants, and other professionals throughout the bankruptcy case. Chapter 11 generally prevents professionals with outstanding fees from continuing to represent a debtor after the petition is filed due to the conflict arising from the professional becoming a creditor.[91] Even worse, once a debtor has fallen behind on payments due to its law firm or accountant, it cannot readily avoid the conflict by paying off the debt shortly before the bankruptcy filing: such a payment would be an avoidable preference.[92]

Large debtors solve this problem by retaining new bankruptcy counsel and paying them from a retainer.[93] The bankruptcy counsel releases any prepetition debt to avoid conflicts. That solution, though, requires bringing new professionals up to speed and is too expensive for many small business debtors and their professionals. For subchapter V debtors, however, prepetition professionals are not disqualified so long as their unpaid fees, as of the filing date, do not exceed $10,000.[94] In other words, the debtor's counsel do not have to waive all their claims to avoid disqualification, making it easier for debtors to convince their

90 *See* Small Testimony, *supra* note 1, at 6 ("Subchapter V is a voluntary chapter, and if a debtor does not believe it can be reorganized on the fast track . . . , the debtor is not compelled to elect to be a small business enterprise debtor under subchapter V.").

91 *See* 11 U.S.C. § 327(a) (providing that the trustee may retain professionals "that do not hold or represent an interest adverse to the estate"); *see also* Craig R. Tractenberg, John R. Gotaskie Jr. & Keith C. Owens, *Subchapter V Bankruptcy Is Available for Franchise Companies*, 24 Franchise Law. 16, 16 (2021).

92 An avoidable preference is a prepetition payment that improperly prefers one creditor over others similarly situated. *See, e.g.*, *In re* Ozcelebi, 631 B.R. 629, 645 (Bankr. S.D. Tex. 2021) (finding that a $9,999 prepetition payment to a law firm for unbilled time was allowed under subchapter V after a creditor asserted it was an avoidable preference).

93 *See In re* Atlas Contractors, Inc., 2004 Bankr. LEXIS 802, at *8 (Bankr. E.D. Ky. June 16, 2004) ("Prior to commencement of a chapter 11 case, it is common for a debtor's professionals to obtain retainer agreements and fees to insure compensation for costs anticipated during the pendency of the case.").

94 11 U.S.C. § 1195.

longstanding professionals to continue working with them through the bankruptcy case.

Similarly, subchapter V makes it easier for small business debtors to obtain financing for their case.[95] Because subchapter V allows a debtor to pay postpetition administrative expenses over a period of three to five years through the plan,[96] lenders can spread the debtor-in-possession financing repayment throughout the plan. As a result of this increased runway for repayment, subchapter V makes bankruptcy more accessible to many debtors.

b. Committees

In a regular chapter 11 case, the U.S. Trustee appoints a committee of unsecured creditors as a matter of course.[97] Not so in a case under subchapter V. In small business cases, an unsecured creditors' committee may not be appointed "[u]nless the court for cause orders otherwise."[98] This adjustment reflects the fact that small businesses tend to have fewer creditors and a simpler financial profile.

c. Trustees

Instead of an unsecured creditors' committee, subchapter V requires a trustee to be appointed in every case.[99] The "trustee is unlike any other trustee appointed in the bankruptcy process"[100] because it is the only trustee whose primary function is not to operate or liquidate the estate but to promote a consensual reorganization plan.[101] Consistent with this directive, the trustee must attend the status conference where "one function . . . is 'to encourage and facilitate the attainment of

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95 *See id.* § 364 (authorizing debtor-in-possession financing to fund the business's ongoing operations during its bankruptcy case, which is designed for debtors that lack the capital required to retain lawyers to prepare its bankruptcy); *see also* Sandeep Dahiya & Korok Ray, *A Theoretical Framework for Evaluating Debtor-in-Possession Financing*, 34 Emory Bankr. Devs. J. 57, 60 (2017).

96 11 U.S.C. § 1192.

97 *Id.* § 1102(a)(1).

98 *Id.* § 1181(b).

99 *Id.* § 1183(a).

100 Jim White, *Understanding the Purpose of the Subchapter V Trustee*, NCBarBlog (Nov. 11, 2021), https://ncbarblog.com/bk-understanding-the-purpose-of-the-subchapter-v-trustee [https://perma.cc/L3DA-BAPG].

101 *See id.*; U.S. Dep't Just., Handbook for Small Business Chapter 11 Subchapter V Trustees 1-1 (Feb. 2020) [hereinafter SBRA Handbook], https://www.justice.gov/ust/file/subchapterv_trustee_handbook.pdf/dl [https://perma.cc/95SZ-KSJT] (describing the most important duties of a subchapter V trustee); *see also In re* 218 Jackson LLC, 631 B.R. 937, 947 (Bankr. M.D. Fla. 2021) ("[T]he subchapter V trustee is the *only* trustee directed to 'facilitate the development of a consensual plan of reorganization'. . . . This distinction is significant." (quoting 11 U.S.C. § 1183(b)(7))).

a consensual plan of reorganization.'"[102] That the subchapter V trustee's role effectively ends upon plan confirmation—along with her fees[103]—provides additional support for their faciliatory function.[104]

4. *Tighter Plan Control*

Fourth, subchapter V gives the debtor tighter control over the plan proposal and confirmation process.

a. *No Required Disclosure Statement*

In a traditional chapter 11 case, a debtor needs to file a court-approved disclosure statement before votes on a plan can be solicited.[105] Disclosure statements give all parties the information necessary to make an informed vote on the plan.[106] But those statements also drive up the expense of chapter 11[107] and prolong the debtor's exit from bankruptcy.[108] Subchapter V addressed these costs by eliminating the disclosure statement altogether.[109] Instead, the debtor's plan must

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102 Small Testimony, *supra* note 1, at 4.

103 Subchapter V trustees bill hourly, and their fees can range from $300 to $600 per hour. *See* Bradley, *supra* note 17, at 258–59, 261 n.48 (emphasizing that additional administrative fees could be the difference between a plan's success and its failure). In rare circumstances, subchapter V trustee fees may exceed what a debtor may have paid to a U.S. Trustee in a traditional chapter 11 case. *See id.* at 268 (noting that the absence of U.S. Trustee fees does not offer a material cost savings because for small business cases the fees are manageable and giving an example of a $650 fee for cases with quarterly disbursements under $75,000). This is more likely if there is a nonconsensual plan requiring the subchapter V trustee to persist throughout the case. *See id.* at 278.

104 *See id.* at 277 ("The additional trustee fees seem to be a deadweight loss imposed to attempt to bludgeon parties into agreement."); Ralph Brubaker, *The Small Business Reorganization Act of 2019*, 39 Bankr. L. Letter 1, 10 (2019) (noting that "creditors will prefer to avoid the fees the Subchapter V trustee will collect from the debtor's plan payments (before payments to creditors) if confirmation is via cram-down").

105 *See generally* 11 U.S.C. § 1125(a).

106 *Id.*

107 *See* Larry Ream & Nika Aldrich, *Chapter 11 Bankruptcy Is Expensive; the Small Business Reorganization Act Provides a Realistic Opportunity for Small Businesses to Reorganize*, Schwabe (July 2, 2020), https://www.schwabe.com/publication/chapter-11-bankruptcy-is-expensive-the-small-business-reorganization-act-provides-a-realistic-opportunity-for-small-businesses-to-reorganize [https://perma.cc/F2PK-NKW2] (noting that chapter 11 bankruptcy is "notoriously expensive" because of procedural requirements including a "comprehensive disclosure statement").

108 *See* Jordan Weiss, *A More Accessible Chapter 11: Subchapter V*, Meyer, Suozzi, English & Klein (July 19, 2022), www.msek.com/blog/a-more-accessible-chapter-11-subchapter-v-by-jordan-weiss [https://perma.cc/B49H-B6F7]. Indeed, one side effect of removing the laborious disclosure statement is a reduced amount of time for a subchapter V debtor to stabilize its business while under the protection of the bankruptcy court. The debtor is therefore forced into working quickly and considering all reorganization options prior to filing—factors required in a prepack.

109 *See* 11 U.S.C. § 1181(b) (making section 1125, which requires disclosure statements, inapplicable in subchapter V, "Unless the court for cause orders otherwise"). The express removal of

include a brief history of the debtor's business operations, a liquidation analysis, and projections of the debtor's ability to make payments.[110]

To be sure, the court can reimpose the disclosure statement rules for cause.[111] Even if it does so, the rules enacted under the BRA for small businesses still apply.[112] That means the court can conclude that a disclosure statement is not necessary, approve a standard form disclosure statement previously approved by the bankruptcy court, conditionally approve a disclosure statement, and consolidate a final hearing on the disclosure statement with the plan confirmation hearing.[113]

b. Small Business Payment Plans & Plan Exclusivity

Lastly, subchapter V gives debtors permanent plan exclusivity.[114] This gives small business debtors the benefit of never having to compete with a creditor's plan or defend against a proposed reduction in or termination of the debtor's exclusivity period.[115]

Aside from the traditional chapter 11 rules of classes under § 1123(a)(1), a subchapter V plan must include a brief history of the debtor's operations, a liquidation analysis, and projections regarding the debtor's ability to make payments under the proposed plan.[116] Moreover, the plan must provide a means for the debtor's future earnings to be in the subchapter V trustee's supervision and control if needed to execute the plan.[117] If all the requirements of § 1129(a) are met and all impaired classes accept the plan, the plan will be confirmed

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the disclosure statement addresses one of LoPucki's critiques of the *Belk* prepack: a disclosure statement cannot be inadequate or provided to creditors on inadequate notice if it is not required in the first place. *See* LoPucki, *supra* note 16, at 276–77.

110 11 U.S.C. § 1190(a); *see also Subchapter V Cases—Small Business Reorganization Act of 2019*, U.S. Bankr. Ct. W.D. Okla., www.okwb.uscourts.gov/subchapter-v-cases-small-business-reorganization-act-2019 [https://perma.cc/M94A-SEA2].

111 *See* 11 U.S.C. § 1181(b).

112 *See id.* § 1187(c) ("If the court orders under section 1181(b) of this title that section 1125 of this title applies, section 1125(f) of this title shall apply."); *id.* § 1125(f); *see also supra* note 46 and accompanying text. The interaction of 11 U.S.C. § 1187(c) and § 1125(f) present a neat problem in statutory interpretation. § 1125(f), by its terms, only applies in a "small business case," which might lead one to think that the streamlined provisions for disclosure statements apply only where the subchapter V debtor also falls below the (far lower) $2 million debt ceiling. But the term "small business case" is defined by § 101(51C) to *exclude* debtors who have elected subchapter V. Thus, for § 1187(c) to mean anything, it must mean that the streamlined provisions of § 1125(f) apply to subchapter V cases even though the text plainly says the opposite.

113 *Id.* § 1125(f)(2)–(3).

114 *See id.* § 1189(a).

115 Tractenberg, et al., *supra* note 91, at 16–17.

116 11 U.S.C. § 1190(1).

117 *Id.* § 1190(2).

on a consensual basis.[118] The subchapter V trustee's service is terminated when the plan is substantially consummated, reducing fees and expenses.[119]

Most radically, subchapter V departs from the absolute priority rule for cramdown cases. The absolute priority rule, unless all classes of creditors accept the plan, requires that the plan pay senior creditors in full before junior creditors can receive any distribution.[120] In regular chapter 11 cases, this rule has the effect of wiping out an entrepreneur's equity stake—the price for a nonconsensual or "cramdown" plan.[121] By contrast, in a cramdown plan under subchapter V, the debtor must apply all projected disposable income[122] received within the first three to five years of the plan to make payments under the plan, or distribute property under the plan in the first three to five years of a value that is at least the projected disposable income of the debtor.[123]

Abandoning the absolute priority rule allows a small business debtor to confirm a nonconsensual plan by making payments to creditors and, three to five years later, having its unsecured debt wiped away.[124] This innovation solves a longstanding problem in small business cases: under the absolute priority rule, the entrepreneur has a strong incentive to avoid bankruptcy to protect her equity stake; without the absolute priority rule, the entrepreneur may consider bankruptcy a more attractive option for resolving financial distress.[125]

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118 *Id.* § 1191(a).

119 *Id.* § 1183(c).

120 *See id.* § 1129(b)(2); *see also* Seymour & Schwarcz, *supra* note 12, at 2–3.

121 *See* Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 947 (2001).

122 Although there are various definitions of disposable income in the Bankruptcy Code, disposable income in a subchapter V case is the income the debtor receives that is not reasonably necessary to be spent on maintenance or support of the debtor, a domestic support obligation, or payments needed for the "continuation, preservation, or operation" of the debtor's business. 11 U.S.C. § 1191(d).

123 *See id.* § 1191(c)(1)(2). The debtor must be able to make all payments under the plan or have a reasonable likelihood of making all payments. *Id.* § 1191(c)(3)(A).

124 *See id.* §§ 1181, 1191(b); *see also* Coordes, *supra* note 31, at 379 ("This modification allows small business owners to retain their businesses even if they do not pay their creditors in full, provided they commit all of their disposable income to plan payments during the life of the plan."); *In re* Chip's Southington, LLC, No. 20-21458, 2021 WL 5313546, at *4 n.5 (Bankr. D. Conn. Nov. 13, 2021) ("[A] Subchapter V plan may be crammed down on unsecured creditors even if stockholders, who are junior to unsecured creditors, retain their equity under the plan."). Crucially, this projected disposable income rule for an individual debtor applies only when one or more classes do not accept the plan. *See* 11 U.S.C. § 1191(b). Scholars disagree about the relative merits of the absolute and relative priority rules. *Compare* Douglas G. Baird, *Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy*, 165 U. PA. L. REV. 785, 792 (2017), *with* Seymour & Schwarcz, *supra* note 12, at 4.

125 *See, e.g.*, Baird & Rasmussen, *supra* note 121, at 947 (noting the perverse incentives created by the absolute priority rule).

C. Growing Case Law & Coming Refinements

Bankruptcy practitioners, judges, and scholars are still working out the mechanics of subchapter V and devising strategies for debtors and creditors.[126] Most commentators seem to welcome bankruptcy's newest subchapter, recognizing that the default chapter 11 rules were too complex, too expensive, and led too many small business debtors with going-concern value to eschew the bankruptcy courts altogether.[127] In 2021, Judge Michelle M. Harner, Emily Lamasa, and Kimberly Goodwin-Maigetter studied 465 subchapter V cases filed in 2020, noting that of those cases that reached confirmation, they did so in approximately six months.[128] A study of all business bankruptcies filed from 2017 to 2023 conducted by Professors Edith Hotchkiss, Benjamin Iverson, and Xiang Zheng found that subchapter V allows small businesses to reorganize when they otherwise would have liquidated.[129] Indeed, the researchers found that subchapter V doubles the odds of plan confirmation, and cases that reach confirmation get there 42% faster than nonsubchapter V cases.[130] Even more impressively, the study suggests that the subchapter does not harm expected recovery for unsecured creditors.[131]

A growing body of case law applying the subchapter is starting to develop over uncertain parts of the text.[132] Even so, the bankruptcy

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126 *See* Bradley, *supra* note 17 (discussing creditor strategies in subchapter V). The American Bankruptcy Institute assembled a task force to review subchapter V's efficacy and evaluate whether changes are needed. *See ABI Subchapter V Task Force*, Am. Bankr. Inst., https://subvtaskforce.abi.org [https://perma.cc/H53F-9KRB]. The task force recently issued its final report, finding that, among other things, "Subchapter V is working as Congress intended . . . . [H]owever, [there exists] certain practices and procedures that may benefit from further refinement or statutory amendment." ABI Final Report, *supra* note 72, at 1.

127 *See, e.g.*, Brian L. Shaw, *Written Statement of Brian L. Shaw*, Am. Bankr. Inst. (June 9, 2023), https://abi-org.s3.amazonaws.com/SubV/wstatements/Brian_Shaw_Statement.pdf [https://perma.cc/ZTJ9-7BR8].

128 *See* Michelle M. Harner, Emily Lamasa & Kimberly Goodwin-Maigetter, *Subchapter V Cases by the Numbers*, Am. Bankr. Inst. J., Oct. 2021, at 12, 59–60, https://s3.amazonaws.com/abi-org-corp/journals/numbers_10-21.pdf [https://perma.cc/6WSG-5KDT].

129 *See* Edith Hotchkiss, Benjamin Iverson & Xiang Zheng, *Can Small Businesses Survive Chapter 11?*, Mar. 13, 2024, at 2, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4726391 [https://perma.cc/LYL8-VSYH].

130 *See id.* at 5.

131 *See id.* at 7.

132 *See* Bonapfel, *supra* note 35 (compiling recent subchapter V cases). There is increasing disagreement, for example, over whether the discharge exceptions in § 523(a) of the Code apply to both corporate and individual subchapter V debtors, as both the Fourth Circuit and Fifth Circuit hold, or only to individual debtors, as most bankruptcy courts to address the issue hold. *Compare* Avion Funding, LLC v. GFS Indus., LLC (*In re* GFS Indus., LLC), 99 F.4th 223, 232 (5th Cir. 2024), *and* Cantwell-Cleary Co. v. Cleary Packaging, LLC (*In re* Cleary Packaging, LLC), 36 F.4th 509, 517–18 (4th Cir. 2022), *with* Lafferty v. Off-Spec Solutions, LLC (*In re* Off-Spec Sols., LLC), 651 B.R. 862, 867 (B.A.P. 9th Cir. 2023), *and* Nutrien Ag Sols., Inc. v. Hall (*In re* Hall), 651 B.R. 62, 67–69 (Bankr. M.D. Fla. 2023). The Eleventh Circuit is now considering the issue, and nine amici

community continues to express concerns that debtors will use the subchapter to drag out resolution of cases or to avoid paying creditors.[133] Policymakers continue to debate the optimal debt limit for eligibility and whether it should be automatically or periodically updated.[134] Some commentators query whether the subchapter V trustee should be able to propose a plan along with the debtor.[135]

And among this flurry of uncertainty, debtors continue to experiment with new strategies in subchapter V cases. A prime illustration is *In re BPI Sports*.[136] Nutritional supplement company BPI Sports filed for bankruptcy on September 18, 2023, and had its plan confirmed on October 20, 2023—just thirty-three days total. Although votes were solicited and cast postfiling, BPI Sports entered court with its plan and immediately requested confirmation of its plan since major constituencies had already committed to the plan through an RSA. This strategy marks *BPI Sports* as the first "functional" or "lock-up" prepack under subchapter V of the Bankruptcy Code.[137]

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have filed briefs. *See* Benshot, LLC v. 2 Monkey Trading, LLC, No. 23-90015 (11th Cir. filed July 19, 2023). Until a uniform and binding decision is reached, debtors may seek to file in jurisdictions that do not limit a business entity's subchapter V discharge, while creditors may prefer the additional protections of a discharge exception. *But cf.* Jacob Sandler, Note, *Compelling Uniformity*, 76 FLA. L. REV. (forthcoming 2024) ("Considering uniformity throws courts into the world of policymaking as they will have to balance competing values such as predictability and correctness. It is Congress's job to make that determination—not the courts'.").

133 *See, e.g.*, Bradley, *supra* note 17, at 271–72.

134 *Compare* Sumner A. Bourne, *Written Statement of Sumner A. Bourne*, AM. BANKR. INST. 4 (June 23, 2023), https://abi-org.s3.amazonaws.com/SubV/wstatements/Sumner_Bourne_Statement.pdf [https://perma.cc/3WHK-PCVY] ("I . . . would favor a permanent raise to $10,000,000 . . . ."), *and* Cipriano, *supra* note 17, at 148 (arguing that the debt limit should be raised to $10 million), *with* Paul M. Black, *Statement*, AM. BANKR. INST. (June 23, 2023), https://abi-org.s3.amazonaws.com/SubV/wstatements/Paul_Black_Statement.pdf [https://perma.cc/ZV2C-DXWT] ("[T]he current debt limit of $7,500,000 is effective and appropriate. It should be maintained . . . .").

135 *See, e.g.*, Amy Denton Mayer, *Remarks of Amy Denton Mayer Regarding the Role of the Subchapter V Trustee*, AM. BANKR. INST. 8 (July 14, 2023), https://abi-org.s3.amazonaws.com/SubV/wstatements/Amy_Denton_Mayer_Written_Statement.pdf [https://perma.cc/GVC3-MQ52] ("Should the Subchapter V trustee be permitted to file a plan if the debtor is removed from possession pursuant to Section 1185?"); Hannah L. Blumenstiel, *Written Statement of the Hon. Hannah L. Blumenstiel*, AM. BANKR. INST. 4–7 (June 9, 2023), https://abi-org.s3.amazonaws.com/SubV/wstatements/Hannah_Blumenstiel_Statement.pdf [https://perma.cc/LL7R-3FFK] ("Where a debtor proves unable to propose a confirmable plan, whether due to feasibility concerns, bad faith, or other reasons, it might make sense to terminate the permanent exclusivity afforded by Subchapter V and to allow the SubV trustee to propose a plan.").

136 Eyal Berger of Akerman LLP was lead counsel on the *BPI Sports* bankruptcy.

137 Order Confirming the Debtor's Subchapter V Plan of Reorganization, *In re* BPI Sports, LLC, No. 23-17463 (Bankr. S.D. Fla. Oct. 20, 2023), ECF No. 121; *Akerman Uses Innovative Subchapter V Strategy to Complete Bankruptcy in 33 Days*, AKERMAN (Nov. 17, 2023), https://www.akerman.com/en/firm/newsroom/akerman-uses-innovative-subchapter-v-strategy-to-complete-bankruptcy-in-33-days.html [https://perma.cc/FVQ9-6QXF].

So, although *BPI Sports* is an exciting preview of the rise of small business prepacks, the potential of a full small business prepack remains to be fully explored. Because Congress intended for subchapter V cases to be more streamlined, the prepack approach seems like a natural fit for the subchapter. Part II explores the prepack litigation strategy.

II. How Prepackaged Cases Have Reshaped Chapter 11

Even as Congress enacted subchapter V to streamline bankruptcy for small businesses, chapter 11 debtors and their legal counsel have been refining their own strategy to minimize the costs and publicity of being in bankruptcy court. As described above, this strategy is called a "prepackaged" bankruptcy, or a "prepack" for short.[138] The approach is counterintuitive—and controversial. To the layperson, the filing of a petition in bankruptcy might represent the end of business as usual and the beginning of a prolonged, public court process. But neither is necessarily true: under the modern U.S. bankruptcy regime, businesses reorganize under chapter 11 all the time—and some of them do so at rocket speed.

Take the case of Belk, Inc., a large department store headquartered in North Carolina that experienced financial distress in the early days of 2021.[139] On February 23, 2021, Belk filed for chapter 11 bankruptcy.[140] An informed observer of traditional, large retail bankruptcies might have guessed that Belk's bankruptcy case would take somewhere between six and eighteen months.[141] But at 10:08 AM the next morning, the bankruptcy court confirmed Belk's reorganization plan, blessing its exit from bankruptcy.[142] Nor was the plan somehow dreamed up overnight: Belk is not a small company, and the plan was complex. It reduced Belk's debt by $450 million, approved $225 million in new capital, and extended maturities on its term loans by three years.[143]

Belk was able to get its plan confirmed in just over twelve hours because it filed a prepack.[144] In addition to its regular first-day filings, a debtor filing a prepack submits its reorganization plan along with

138 *See supra* note 14 and accompanying text.

139 *See Sycamore Partners Reaches Agreement to Recapitalize and Retain Control of Belk*, Belk (Jan. 26, 2021), https://newsroom.belk.com/restructuring [https://perma.cc/M9CY-NF45].

140 Order Approving the Debtors' Disclosure Statement for, and Confirming, the Debtors' Joint Prepackaged Chapter 11 Plan, *In re* Belk, Inc., No. 21-30630 (Bankr. S.D. Tex. Feb. 24, 2021), ECF No. 61.

141 *See, e.g.*, Warren & Westbrook, *supra* note 58, at 626, 629 (estimating that the average time spent in chapter 11 is approximately eleven months).

142 Transcript of First Day and Confirmation Hearing at 66, *In re* Belk, Inc., No. 21-30630 (Bankr. S.D. Tex. Feb. 26, 2021), ECF No. 98.

143 *Id.*

144 *Id.*

its petition.[145] This move is a deviation from the default practice. In a traditional chapter 11 case, after filing for bankruptcy, the debtor must submit its plan, along with a disclosure statement, to the creditor body and solicit the votes of the creditors. In a prepack, the debtor has already distributed the proposed plan and disclosure statement and has already solicited votes for its plan before filing its petition. The debtor comes into court saying, in effect, here we are, this is what we want to do, our creditors have already voted, so please confirm our plan.[146]

Prepacks have become increasingly popular,[147] and, for many debtors, rightfully so. A prepack minimizes the time a debtor remains in bankruptcy and thus reduces the costs of litigating through a drawn-out court process.[148] But prepacks have generated concern and controversy too, particularly when debtors seek plan confirmation at rocket speed. Critics of the practice, most notably LoPucki, argue that prepacks circumvent statutory periods and risk unjust results.[149]

This Part describes the prepack litigation strategy, describes why debtors—and some creditors—choose it, and explains the limitations and risks of the approach. Part III then explains why the new rules for small business bankruptcies may be especially appropriate for prepacks.

A. Prepacks as Litigation Strategy

When a business enterprise files for bankruptcy, the case can proceed along several different paths, such as a liquidation under chapter 7 of the Bankruptcy Code, a plan of reorganization under chapter 11,

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145 *See, e.g.*, Morris J. Massel, *The Pros and Cons of Prepackaged Bankruptcy*, Simpson Thacher & Bartlett (Oct. 2, 2013, 4:58 PM), https://www.stblaw.com/docs/default-source/cold-fusion-existing-content/publications/pub1647.pdf?sfvrsn=2 [https://perma.cc/XJ4B-DMVF].

146 Belk's one-day prepack is an extreme example that requires the retention of many professionals and significant planning. Although a few debtors have the resources required to expedite their exit to this degree, most prepacks typically take several months to reach plan confirmation. *See, e.g.*, David M. Hillman, *Restructuring Trend: The Ultrafast Prepack for Private Credit Deals* (Nov. 4, 2019), https://www.proskauer.com/pub/restructuring-trend-the-ultrafast-prepack-for-private-credit-deals [https://perma.cc/BDU7-ZE3U]. Nevertheless, a four-month exit remains relatively fast in the chapter 11 context, deviating from the ordinary chapter 11 timeline of approximately one year to eighteen months. *See* Warren & Westbrook, *supra* note 58, at 631–32.

147 Indeed, there is a growing literature discussing prepacks in insolvency practice around the globe. *See, e.g.*, Gurrea-Martinez, *supra* note 11, at 96–98 (detailing the rise of prepacks in Singapore, India, Spain, the Netherlands, and the Philippines); Anja Droege Gagnier, *The French 'Prepack' Is Now Available*, Insolvency & Restructuring Int'l, Apr. 2011, at 32–33 (analyzing the *Sauvegarde Financière Accélérée*, inspired by American chapter 11 practice); Barbara Tomczyk & Przemyslaw Wierzbicki, *Pre-Pack Under Polish Law*, Insolvency & Restructuring Int'l, Sept. 2017, at 42–44 (analyzing the prepack in Polish law, inspired by American chapter 11 practice).

148 *See, e.g.*, *In re* Genco Shipping & Trading Ltd., 509 B.R. 455, 462 (Bankr. S.D.N.Y. 2014) ("A successful prepack can cut down the duration of a bankruptcy case and, therefore, the incredible cost associated with a long, drawn out bankruptcy process.").

149 LoPucki, *supra* note 16, at 277–78.

or a sale of the business's assets under section 363.[150] The Code does not direct which path a debtor selects and leaves the decision to the debtor—at least in the first instance. Indeed, the Code gives the debtor a period of exclusivity during which it, and only it, may propose a plan for how to reorganize the business.[151] Before filing, debtors considering a bankruptcy filing—at least when the case is not a "freefall" bankruptcy[152]—discuss their approach to the litigation with their legal team. And, as has been the practice for several decades now, debtors generally invite their senior secured creditor, or whoever is paying for the bankruptcy case, into that discussion.[153]

Debtor control of the trajectory of a bankruptcy case applies to prepack cases. In a prepack case, even as the debtor files its petition in bankruptcy, it formally proposes its chapter 11 plan and seeks confirmation of that plan. If creditor voting is required to confirm the plan, the debtor has already solicited votes. This strategy collapses the beginning and the end of the bankruptcy case into a single moment and represents a dramatic acceleration of the normal timelines in bankruptcy.

Consider the standard timeline. The Code's notice requirements contemplate a confirmation hearing no earlier than four weeks after the petition date. This is because the debtor is typically required to file a disclosure statement with its plan and provide time for creditors to vote on the plan. In its disclosure statement, the debtor must describe the plan so that creditors can understand the proposal. The debtor must obtain court approval of the disclosure statement and distribute the plan and disclosure statement to creditors four weeks (twenty-eight

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150 *See* 11 U.S.C. § 363.

151 *See id.* § 1121(b).

152 A freefall bankruptcy, termed for its swift and unanticipated nature, occurs when a debtor files for bankruptcy without prior negotiation or strategic planning with creditors. *See* Borders & Blank, *supra* note 2.

153 Companies in financial distress usually do not have any cash available to pay for the bankruptcy process and must turn to a secured creditor, or less commonly, a new lender, to fund the bankruptcy process. *See* Jay Lawrence Westbrook, *Secured Creditor Control and Bankruptcy Sales: An Empirical View*, 2015 U. Ill. L. Rev. 831, 835–36 (2015). The Bankruptcy Code strictly curtails the ability of debtors to use cash collateral and, in 1998, amendments to Article 9 of the Uniform Commercial Code (U.C.C.) made it easier for lenders to perfect a security interest in substantially all of their borrowers' assets, including cash and proceeds of collateral. 11 U.S.C. § 363(c)(2). *See generally* Cynthia Grant, *Description of the Collateral Under Revised Article 9*, 4 DePaul Bus. & Com. L.J. 235 (2006) (discussing the revised U.C.C. § 9-504). As a result of the U.C.C. revisions, new credit markets for distressed firms, and the eternal reluctance of American debtors to file any sooner than necessary, companies filing for bankruptcy in recent decades have tended to enter bankruptcy with their cash already serving as collateral. *See, e.g.*, David Skeel, *Bankruptcy's Identity Crisis*, 171 U. Pa. L. Rev. 2097, 2102–03 (2023); David A. Skeel Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. Pa. L. Rev. 917, 925 (2003); Charles J. Tabb, *Credit Bidding, Security, and the Obsolescence of Chapter 11*, 2013 U. Ill. L. Rev. 103, 142 (2013). *But see* Westbrook, *supra* note 153, at 837–41 (2015) (presenting empirical findings challenging the prevalence of the "hog-tied" debtor in bankruptcy).

days) before a hearing on the disclosure statement.[154] Once the court has approved the disclosure statement, the creditor body typically has another four weeks (twenty-eight days) to vote on the plan. After the creditor body has voted, the debtor moves for plan confirmation.[155] Correspondingly, the period during which only the debtor may file a plan is 120 days.[156] The Bankruptcy Code thus contemplates plan confirmation between an inside date of two months after the petition and an outside date of four months after the petition, subject to court adjustment of those deadlines.

In a prepack case, the debtor seeks to move as much of this process as possible back before the petition date. Working with creditor constituencies, it thus drafts the plan and disclosure statement along with its petition in bankruptcy, distributes the documents to its creditor body, solicits votes if necessary, and, in an "ultra-expedited prepack,"[157] even gives creditors the statutory opportunity to draft objections—all before filing the case. By the time the bankruptcy begins, key creditors are locked into supporting the plan through an RSA, a development that Professor Douglas Baird calls a "quiet revolution."[158] Commercial litigation practice has no obvious parallel; it would be as if the plaintiff sent the complaint to the defendant, the parties engaged in discovery, agreed that trial would not be necessary, and filed the complaint, answer, and motions for summary judgment all on day one.

Although the prepack strategy represents an extreme departure from the standard trajectory envisioned by the Bankruptcy Code, it is not without statutory hooks. The prepack goes back at least to the beginning of today's Bankruptcy Code.[159] When Congress enacted the

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154 *See* Fed. R. Bankr. P. 3017(a).

155 *See* 11 U.S.C. § 1129.

156 *Id.* § 1121(b). The bankruptcy court may, for cause, extend this period up to 180 days after the petition date. Any such extensions are subject to outer limits that cannot be adjusted by the bankruptcy court. *See id.*; *see also id.* § 1121(d) (authorizing the court to "reduce or increase" the exclusivity period up to eighteen months).

157 *See* Eric Chafetz & Myles R. MacDonald, *Ultra-Expedited Prepacks Are No Longer an Academic Curiosity*, Lowenstein Sandler LLP (Dec. 31, 2019), www.lowenstein.com/media/5419/20191230-new-york-law-journal-ultra-expedited-prepacks-are-no-longer-an-academic-curiosity-chafetz-macdonald.pdf [https://perma.cc/Q93H-QWBX] (defining ultra-expedited prepacks as "prepacks in which at least half of the 28-day period provided for filing objections to confirmation under Rule 2002(b) of the Federal Rules of Bankruptcy Procedure . . . has elapsed prior to the filing of the debtor's petition . . . .").

158 *See* Douglas G. Baird, *Bankruptcy's Quiet Revolution*, 91 Am. Bankr. L.J. 593 (2017).

159 Indeed, prepackaged cases can be traced back to nineteenth-century receivership proceedings. *See, e.g.*, Dennis F. Dunne, Dennis C. O'Donnell & Nelly Almeida, *Pre-Packaged Chapter 11 in the United States: An Overview*, Glob. Restructuring Rev. (Dec. 11, 2019), https://globalrestructuringreview.com/guide/the-art-of-the-pre-pack/edition-1/article/pre-packaged-chapter-11-in-the-united-states-overview [https://perma.cc/8Q4C-YVH4]. Bondholders could deposit their bonds with a committee that would then propose a reorganization plan and seek confirmation. *Id.* In chapter X of the old Bankruptcy Act, Congress banned this prepetition solicitation of plan

Code in 1978, it included provisions implicitly accepting prepackaged cases.[160] Specifically, the Code expressly authorizes a debtor to file its chapter 11 plans with its petition,[161] as well as to solicit votes prior to the case's commencement—the quintessential feature of a prepack.[162] It also provides a crucial workaround to the requirement of an official unsecured creditors' committee, allowing the bankruptcy court to deem ad hoc prepetition committees as having satisfied that statutory requirement.[163]

BAPCPA, too, modified procedures of standard chapter 11 cases to facilitate prepacks.[164] Before BAPCPA, a debtor filing a prepack had to complete its solicitation before it filed for bankruptcy.[165] If the solicitation was interrupted for any reason, such as an involuntary bankruptcy

acceptances, responding to concerns that insiders were controlling the committees at the expense of bondholders. *Id.* However, in 1978, Congress got rid of chapter X's prohibition of prepetition solicitation. *Id.*

160 *See id.*; *In re* Genco Shipping & Trading Ltd., 509 B.R. 455, 462 (Bankr. S.D.N.Y. 2014) ("The Bankruptcy Code clearly contemplates the use of prepack plans."). One of the attorneys involved in drafting the 1978 Code, J. Ronald Trost, advocated for provisions clearly allowing parties to negotiate their way to a solution before filing the case. Baird, *supra* note 39, at 138–39. As Professor Baird puts it, "Trost was not fashioning something out of whole cloth": Chapter XI reorganizations had often followed this template. *Id.* at 139.

161 11 U.S.C. § 1121(a) ("The debtor may file a plan with a petition commencing a voluntary case, or at any time in a voluntary case or an involuntary case.").

162 *See id.* § 1126(b); *see also id.* §§ 341(e), 1125(g) (allowing solicitation of votes before the bankruptcy case starts); Fed. R. Bankr. P. 3018(b) (setting forth procedure for equity security holders and creditors who vote on the plan before the commencement of the case); Robert K. Rasmussen & David A. Skeel Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 Am. Bankr. Inst. L. Rev. 85, 97 n.54 (1995) ("Congress explicitly contemplated that some debtors would use this [prepackaged bankruptcy] strategy.").

163 *See* 11 U.S.C. § 1102(b)(1) (providing for the appointment of the official creditors' committee but allowing for the committee to consist of "the members of a committee organized by creditors before the commencement of the case under this chapter, if such committee was fairly chosen and is representative of the different kinds of claims to be represented").

164 *See* Andrew M. Troop, Lisa G. Beckerman, Mildred Cabán, Eric A.W. Danner & Michael J. Pappone, Am. Bankr. Inst., The Mechanics of Prepacks: What Happens Pre-Petition, and How to Make It Stick Post-Petition 131–32 (2014), https://abi-org-corp.s3.amazonaws.com/cle/materials/2014/Jul/MechanicsOfPrepacks.pdf [https://perma.cc/UVR3-WFEF]. Unfortunately, BAPCPA's focus on speed neglected other important considerations. *See, e.g.*, Gerald P. Buccino, *Statement of Gerald P. Buccino to the American Bankruptcy Institute Commission to Study the Reform of Chapter 11*, Am. Bankr. Inst. (Nov. 3, 2012), https://commission.abi.org/sites/default/files/statements/03nov2012/Buccino.pdf [https://perma.cc/P5WG-KCQ2] ("While BAPCPA may have sought to reduce the cost of bankruptcy by shortening the time period for developing a reorganization plan, it appears to have impaired the rehabilitative goal of bankruptcy by leaving insufficient time to rehabilitate or fix many bankruptcy businesses . . . ."). BAPCPA was also "confusing, overlapping, and sometimes self-contradictory" to the extent that trying to understand its provisions was "like trying to solve a Rubik's Cube that arrived with a manufacturer's defect." *In re* Donald, 343 B.R. 524, 529 (Bankr. E.D.N.C. 2006).

165 Troop et al., *supra* note 164, at 131.

being filed, the debtor had to start over.[166] This changed with BAPCPA's addition of sections 1125(g) and 341(e) to the Bankruptcy Code. Section 1125(g) permits a debtor to continue soliciting votes postpetition and without a court-approved disclosure statement.[167] Section 341(e) allows the court to order the United States trustee not to convene a meeting of creditors in a prepack case.[168]

True, approving a chapter 11 plan so quickly runs afoul of various statutorily prescribed deadlines, something LoPucki and other critics have assailed.[169] The Bankruptcy Code expressly empowers the bankruptcy court to shorten those deadlines for cause, but those reduction provisions would almost never allow a bankruptcy plan to be confirmed faster than four days after the filing of the petition.[170] Although the Code also gives the bankruptcy court broad authority to issue any orders "necessary or appropriate to carry out the provisions" of the Code, that authority cannot be wielded to contravene anything in the Code[171] but only to fill in statutory gaps.[172]

B. *Strategic Advantages for Debtors and Creditors*

Prepacks provide both debtors and creditors with significant advantages. Bankruptcy courts can provide extraordinary relief, and prepacks allow business enterprises to spend a significantly reduced time in court to obtain that relief.[173]

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166 *Id.* at 131–32.

167 11 U.S.C. § 1125(g).

168 *Id.* § 341(e).

169 *See generally* LoPucki, *supra* note 16 (criticizing Belk's bankruptcy case as unlawful).

170 *See* Fed. R. Bankr. P. 9006(b) (covering enlargement), Fed. R. Bankr. P. 9006(c) (covering reduction); *see also infra* notes 224–25 and accompanying text.

171 *See* 11 U.S.C. § 105(a), (d)(2); Czyzewski v. Jevic Holding Corp., 580 U.S. 451, 452 (2017) (holding that the bankruptcy court could not rely on § 105(a) to modify creditors' rights upon dismissal of a case, in contravention of distribution and priority rules); Law v. Siegel, 571 U.S. 415, 421–22 (2014) (holding that the bankruptcy court could not rely on § 105(a) to surcharge a debtor's homestead exemption in contravention of § 522); *see also* 28 U.S.C. § 2075 (providing that the Bankruptcy Rules "shall not abridge, enlarge, or modify any substantive right"); Jonathan M. Seymour, *Against Bankruptcy Exceptionalism*, 89 U. Chi. L. Rev. 1925, 1981–82 (2022) (comparing § 105(a) to the All Writs Act, 28 U.S.C. § 2851, and pointing out that the former only "authorizes a limited selection of procedural remedies, such as the right to issue injunctions in order to make effective some other provision of the statute").

172 *But see* Chafetz & MacDonald, *supra* note 157, at 2 (citing *In re* Blue Bird Body Co., No. 06-50026, 2006 Bankr. LEXIS 5223 (Bankr. D. Nev. Feb. 15, 2006)) (summarizing a prepackaged case where the court "was not certain that it had a statutory basis to confirm a plan of reorganization so quickly, [so] the court heavily relied on its equitable powers, which are themselves codified in § 105(a) of the Bankruptcy Code").

173 *See supra* note 14 (listing several cases in which debtors' counsel successfully brought their clients from petition to plan within a matter of days).

Debtors cannot always solve their financial problems outside of bankruptcy. Although some out-of-court restructurings may provide some benefits, they cannot provide all the protections that bankruptcy offers. Most important, bankruptcy can eliminate holdouts.[174] Holdout problems are a common thorn in the side of financially distressed firms and occur when one creditor refuses to work with the debtor in the hopes that all the other creditors will work with the debtor to reduce *their* claims, leaving its claim unaffected.[175] Out-of-court restructurings do not allow modification of a creditor's claim without that creditor's consent, and so debtors face a one-by-one negotiation with every single creditor, each of whom has an incentive to "hold out" for the best deal possible. Holdouts can frustrate otherwise productive negotiations and stymie efforts by debtors and their creditors to reach consensual modification of the debtor's balance sheet. The Bankruptcy Code, however, permits a court to modify creditors' claims without their consent. This is done by classifiying the claims and seeking consent within each class. If consent is not achieved, the court can enforce a "cramdown," imposing a plan on nonconsenting classes.[176]

At the same time, bankruptcy comes at a price:

First, of course, there is the matter of sheer cost. As many commentators have noted, a chapter 11 case is expensive—with debtors required to submit monthly financial reports, pay quarterly fees to the U.S. Trustee, and retain counsel throughout the reorganization plan.[177] Although some of those costs parallel costs outside of bankruptcy (a distressed firm might still retain outside counsel, for example), not all of the costs of chapter 11 have nonbankruptcy parallels. In a chapter 11 bankruptcy, for example, the court appoints a statutory committee of unsecured creditors, a committee whose legal fees are usually paid out of estate assets, at least in part.[178] Outside bankruptcy, creditors are typically responsible for their own legal fees. All told, the difference in cost between an out-of-court workout and an in-court restructuring can create significant sticker shock.

Second, bankruptcy comes with court oversight and significant limitations on a debtor's ability to operate. Although debtors may continue to operate in the ordinary course of business, the Bankruptcy Code keeps a sharp eye on payments going out from the estate for any prepetition debts. A debtor in bankruptcy thus needs court approval for

174 *See, e.g.*, Robert K. Rasmussen & Randall S. Thomas, *Whither the Race? A Comment on the Effects of the Delawarization of Corporate Reorganizations*, 54 Vand. L. Rev. 283, 288 (2001).

175 *See id.*

176 *See* 11 U.S.C. § 1126. If the debtor solicits a positive vote from a majority of creditors in each class who hold over two-thirds of the debt, that class has "accepted" the plan, even though individual creditors have not accepted the plan. *See id.*

177 *See, e.g.*, Dunne et al., *supra* note 159.

178 11 U.S.C. § 1102.

even mundane tasks such as paying utility bills or taxes.[179] Any business decision outside the ordinary course requires court approval as well,[180] sharply curtailing the debtor's ability to change its approach. This, too, creates a high price of admission that is reduced when a debtor exits bankruptcy quickly.

Prepacks thus allow debtors—and those creditors who support the plan—to access the protections of bankruptcy without incurring all the costs of a drawn-out bankruptcy case.[181] Debtors filing a prepack receive these benefits of bankruptcy and the speed and privacy seen in certain out-of-court restructuring strategies. Getting in and out of court quickly reduces costs, keeps the debtor out of the public eye, allows the debtor to continue operating as usual, and instills confidence in stakeholders.[182] Whether prepacks lead to success is hard to determine empirically. A 2015 study by LoPucki and Doherty determined that prepackaging a bankruptcy case was marginally more likely to result in a successful reorganization, but the authors concluded that selection bias likely explains the result: companies with a prepack in hand that suspect imminent failure decide not to file.[183]

C. Limitations, Risks, and Legitimacy of Prepacks

With all this said, the prepack strategy comes with significant limitations, some risks, and sharp concerns about legitimacy.

Let us start with limitations. Prepacks work only for debtors with certain types of capital structures because the plan must still meet the Bankruptcy Code's stringent requirements for plan confirmation. Those requirements mean, in effect, that a prepack debtor must have a viable underlying business and plan to use the bankruptcy process to reduce the debt overhang in coordination with its secured creditors.[184]

First, the prepack strategy cannot work for debtor companies with unsecured creditors that (1) cannot be identified in advance and

179 *See, e.g.*, *Region 21 Operating Guidelines & Reporting Requirements for Chapter 11 Debtors in Possession and Chapter 11 Trustees*, U.S. Dep't Just. 3 (Oct. 2022), https://www.justice.gov/ust/ust-regions-r21/file/ch11_guidelines_reporting_req.pdf/dl?inline [https://perma.cc/M4JV-3URT].

180 *See* 11 U.S.C. § 363(b).

181 *See* Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 Nw. U. L. Rev. 1357, 1375 (2000) ("The prepackaged bankruptcy thus provides the firm with the benefit of class-wide voting to minimize holdout problems, while simultaneously minimizing the time the firm spends in bankruptcy.").

182 *See* Dunne et al., *supra* note 159. Having votes solicited before commencing the case gives key stakeholders certainty that the company will continue business as usual. *See id.* This reduced uncertainty makes it more likely that the business will continue operating as usual. *See id.*

183 *See* LoPucki & Doherty, *supra* note 11, at 995.

184 *See* Chafetz & MacDonald, *supra* note 157, at 3 (stating that an ultra-expedited prepack requires "(1) a debtor with a healthy underlying business filing solely because of too much debt; (2) a fulcrum class of secured creditors . . . and (3) no holdouts").

(2) stand to recover some percentage of their debt in bankruptcy. This is because the voting rules in bankruptcy require one class of creditors who will not be repaid in full to sign off on the plan.[185] When that role can be filled by a small set of identifiable secured creditors, they can design a plan with the debtor and vote on it in advance. If the secured creditors can be paid in full, the next class of creditors whose consent is needed becomes the class of unsecured creditors. But if those unsecured creditors cannot be identified in advance, as is usually the case for operating companies, they cannot vote on the plan before confirmation. The result is that prepacks tend to be used either by (1) operating companies that are deep enough in debt that the unsecured creditors will receive no distribution under the plan or (2) holding or mezzanine companies who, by virtue of not being operating companies, have a closed universe of unsecured creditors.

Second, even apart from voting requirements, the bankruptcy court must sign off on the plan as feasible and authorize any sales of estate property out of the ordinary course.[186] A debtor that proposes to sell the business or slash major business lines will be unlikely to convince a bankruptcy judge that such dramatic changes are appropriate without notice and an opportunity to hear objections—including from the U.S. Trustee. For that reason, prepack cases typically propose only balance-sheet restructuring rather than wholesale reworking of business plans.

Then there are risks to the prepack strategy. A financially distressed firm that attempts to negotiate a global resolution outside of bankruptcy does not have the benefit of bankruptcy's automatic stay, which provides helpful "breathing room" for debtors in bankruptcy.[187] Soliciting votes before the stay may cause creditors to attempt to collect debts or alter terms of their contract.[188] Bankruptcy is no small decision, and "[i]f word of an impending bankruptcy filing leaks out, . . . vendors may cease shipping, other creditors may seek to exercise remedies, competitors may seek to take away business, customers may look elsewhere, and employees may hit the street looking for a more secure job."[189]

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185 11 U.S.C. § 1129.

186 *See id.* § 363(b).

187 For a description of the automatic stay, see *Auriga Polymers Inc. v. PMCM2, LLC*, 40 F.4th 1273, 1277–78 (11th Cir. 2022) ("The automatic stay provides breathing room for the debtor to negotiate with its creditors and craft a plan of reorganization . . . .").

188 Douglas M. Foley & James E. Van Horn, *Prepacks on the Rise in Chapter 11 Bankruptcies: Prenegotiated Plans Can Accelerate Reorganizations*, J. Corp. Renewal, Aug. 2008, at 12–13, www.mcguirewoods.com/news-resources/publications/prepacks.pdf [https://perma.cc/L9TT-23NK].

189 John D. Ayer, Michael Bernstein & Jonathan Friedland, *The Life Cycle of a Chapter 11 Debtor Through the Debtor's Eyes*, Am. Bankr. Inst. J., Sept. 2003, at 20, 50–52, https://www.kirkland.com/siteFiles/kirkexp/publications/2455/Document1/Friedland%20-%20Life%20Cycle%20of%20a%20Chapter%2011%20Debtor%202.pdf [https://perma.cc/ER98-JHLV].

And even though involuntary bankruptcy cases are rare,[190] circulating a proposed prepack could be used to support the propriety of a creditor-filed, involuntary bankruptcy case.[191]

Debtors may also find they have inadequate leverage when attempting to negotiate before filing a bankruptcy petition because they cannot invoke certain rights received in bankruptcy court. For example, chapter 11 allows debtors to reject certain executory contracts and leases—turning those debts into unsecured claims—and, in some instances, to cap the damages for breach of contract.[192] This power gives the debtor the ability to defang certain creditors in bankruptcy court.[193]

Additionally, there is no guarantee that the bankruptcy court will find the debtor's efforts adequate. If the court finds that the proposed disclosure statement or solicitations do not meet the stringent requirements set forth in chapter 11, the debtor is back at square one and has lost a lot of money from the prepetition preparation. Not only can the court raise concerns with the prepack process sua sponte, a single creditor or the U.S. Trustee's office can object to plan confirmation and claim the prepetition disclosure, notice, and solicitation were inadequate.[194] The consequences of getting it wrong can derail the chance of a consensual resolution, especially when many prepacks "are agreed to by creditors on the assumption that they will proceed through bankruptcy with the unusual speed for prepackaged plans for which the Bankruptcy Code provides."[195]

Even where the prepackaged plan is confirmed, the speed of the case may heighten the risk that the reorganization is insufficient to solve the debtor's financial problems—resulting in a second chapter 11 case within a few years, sometimes cheekily called a "chapter 22."[196]

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190 *See, e.g.*, Richard M. Hynes & Steven D. Walt, *Revitalizing Involuntary Bankruptcy*, 105 Iowa L. Rev. 1127, 1127 (2020) ("Just 0.05 percent of petitions are involuntary . . . .").

191 A debtor in the process of negotiating a prepackaged bankruptcy when an involuntary petition is filed might simply not contest the involuntary petition and regain control of the case by converting it to chapter 11 and seeking a subchapter V designation. Under Bankruptcy Rule 1020, an involuntary debtor has fourteen days after the court rules on the involuntary petition to state whether it elects subchapter V. *See* 11 U.S.C. § 303(h); Fed. R. Bankr. P. 1020(a).

192 *See* 11 U.S.C. § 365(b)(1), (3)–(4).

193 *See id.*

194 *See, e.g.*, *In re* LATAM Airlines Grp. S.A., 55 F.4th 377, 381, 388–89 (2d Cir. 2022) (ruling on a U.S. Trustee's objection to confirmation due to, in part, inadequate solicitation).

195 *See In re* Houghton Mifflin Harcourt Publ'g Co., 474 B.R. 122, 138 n.51 (Bankr. S.D.N.Y. 2012) ("[S]takeholders can be grievously injured, and value can be destroyed, when chapter 11 cases are not concluded quickly. . . ." (citations omitted)).

196 *See, e.g.*, Eyal Berger, *Written Statement of Eyal Berger*, Am. Bankr. Inst. 2 https://abi-subv.s3.amazonaws.com/statements/Eyal_Berger_Written_Statement.pdf [https://perma.cc/SV8T-BNJ4]. For example, the reorganized SunGard filed for a second chapter 11 case in 2022. *See* Declaration of Michael K. Robinson, Chief Executive Officer and President of the Debtors in Support of Chapter 11 Petitions and First Day Pleadings at ¶ 7, *In re* SunGard AS New Holdings, LLC,

All these risks take place against the backdrop of significant critique of the prepack strategy. The Bankruptcy Code provides for notice periods that the ultra-expedited prepacks, at best, distort and, at worst, violate.[197] For example, in *Belk*, "[t]he court did not give the creditors notice of the disclosure statement or plan confirmation hearings until after those hearings were held."[198] The court in *Belk* attempted to assuage concerns by issuing a "due process preservation order," which allowed parties to raise due process objections after confirmation.[199] Even so, for LoPucki, this approach represents part of bankruptcy's recent "descent into lawlessness."[200] To be sure, other commentators do not share the same concerns. Creditors' acceptance of prepackaged plans may indicate their approval and support the contention that the modified procedures injure no one.[201] Even so, the notion of codified rules not being followed may erode the perceived legitimacy of the Bankruptcy Code and weaken the legal footing of the prepack strategy.[202]

The reader may already start to see how, in subchapter V, Congress addressed many of the same risks described above for small business debtors, including inadequate leverage with creditors, the uncertainty of success, and the need to adjust the Bankruptcy Code's standard notice provisions. The next Part shows how the prepack strategy fits neatly into Congress's innovation for small business bankruptcies.

III. Why Prepacks Fit Neatly into Subchapter V

A. *For Whom Are the Bankruptcy Courts Open?*

Bankruptcy law and policy have always presented a mix of public and private values—and this is no less true for prepacks. As noted in Part II, the prepack litigation strategy has generated a firestorm of

No. 22-90018 (Bankr. S.D. Tex. Apr. 11, 2022), ECF No. 7 (stating that the previous bankruptcy "did not comprehensively address the Company's operating cost structure and capacity utilization challenges").

197 The U.S. Trustee has critiqued ultra-fast prepacks for violating due process. *See, e.g.*, Objection of United States Trustee to Debtors' Emergency Scheduling Motion and Joint Prepackaged Plan of Reorganization, *In re* Belk, Inc., No. 21-30630 (Bankr. S.D. Tex. Feb. 23, 2021), ECF No. 44. The U.S. Trustee's objections did not impede the prepack.

198 LoPucki, *supra* note 16, at 247.

199 Due Process Preservation Order, *In re Belk, Inc.*, No. 21-30630 (Bankr. S.D. Tex. Feb. 24, 2021), ECF No. 62.

200 LoPucki, *supra* note 16, at 250.

201 *But see id.* at 252 ("[T]he acceptance of a Chapter 11 plan signals approval of the plan no more than turning over one's wallet signals approval of an armed robbery.").

202 *See id.* ("[T]he bankruptcy courts have no authority to ignore the law."). Even with chapter 11's premium on creditor voting, Skeel points out that flat bans on distortions (like RSAs and "deathtrap" provisions) might cause more harm than good. *See* David A. Skeel Jr., *Distorted Choice in Corporate Bankruptcy*, 130 Yale L.J. 366, 366, 370–71 (2020). The same principle might apply to prepacks.

controversy. That controversy is particularly acute because prepacks attempt to take as much of the bankruptcy process out of the public eye as possible. Whether that gambit seems evasive or prudent turns in large part on one's priorities about what bankruptcy courts are meant to accomplish. Put differently, for whom are the bankruptcy courts open?

The two major schools of thought are called traditionalist, or functionalist, and proceduralist. Each of them present both a descriptive and normative portrayal of how bankruptcy works and how it should be reformed. The differences between the two camps run deep. Indeed, after years of debate, in a 1998 law review article, Professor Baird declared an impasse, arguing that the two camps were building from different "uncontested axioms."[203] Yet while each school of thought has a leading paladin or two, most bankruptcy professionals find themselves somewhere in the middle.

1. *The Traditionalist Take on Prepacks*

For the traditionalist or functionalist school, bankruptcy is a public solution to private financial distress. Championed by then-law professor, now-Senator Elizabeth Warren,[204] the traditionalist school sees bankruptcy courts as a sort of emergency room, funded by the public and taking all comers. And, to push the metaphor perhaps too far, the goal of the system is to stabilize the patient and stop the bleeding. The bankruptcy system cannot accomplish that goal in a way that makes everyone happy: they will implement rough justice. And, more aggressively, bankruptcy policymakers can impose policy goals upon the process.[205] If they want to insulate workers from being fired on the petition date, they can do so. If they want to ensure that healthcare companies do not leave their patients high and dry, they can do that too.

Perhaps a better name for this way of thinking about bankruptcy is "institutionalist," rather than traditionalist. Warren and others value the bankruptcy courts as public institutions with public goals.[206] Just like the Securities and Exchange Commission and Commodity Futures Trading

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203 Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 Yale L.J. 573, 573–74 (1998).

204 *See* Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 Mich. L. Rev. 336, 344 (1993); Elizabeth Warren, *Bankruptcy Policy*, 54 U. Chi. L. Rev. 775, 777 (1987) [hereinafter Warren, *Bankruptcy Policy*] ("I see bankruptcy as an attempt to reckon with a debtor's multiple defaults and to distribute the consequences among a number of different actors. Bankruptcy encompasses a number of competing—and sometimes conflicting—values in this distribution. As I see it, no one value dominates, so that bankruptcy policy becomes a composite of factors that bear on a better answer to the question, 'How shall the losses be distributed?'" (footnote omitted)).

205 Professor Ronald Mann has argued that any reorganization surplus created by the bankruptcy process can be allocated by the state to whichever stakeholder it chooses. *See* Ronald J. Mann, *Bankruptcy and the Entitlements of the Government: Whose Money Is It Anyway?*, 70 N.Y.U. L. Rev. 993, 1000 (1995).

206 *See* Warren, *Bankruptcy Policy*, *supra* note 204, at 788.

Commission set out to protect investors,[207] and the Consumer Financial Protection Bureau sets out to protect consumers,[208] the bankruptcy courts set out to preserve go-forward value in a way that spreads around the pain and ensures that communities across the country are not devastated by financial distress.[209] These values are the price of admission.[210]

Viewed in this light, traditionalist bankruptcy scholars tend to view prepacks with suspicion, even alarm. After all, the premise of the prepack is to take advantage of bankruptcy rules while spending almost no time in bankruptcy court. And if bankruptcy courts are meant to keep a watchful eye out for unsecured creditors, the fact that the debtor and secured creditors have conducted most of the process before notifying the court or unsecured creditors seems evasive.

2. *The Proceduralist Take on Prepacks*

By contrast, the proceduralist school sees the primary goal of bankruptcy as providing a level playing field whereupon parties can compete toward a resolution of the company's financial distress. Spearheaded by Professors Thomas H. Jackson and Douglas Baird,[211] the proceduralists argued that bankruptcy is not about adjusting debtors' or creditors' legal rights, but rather about providing "breathing room" and a forum for debate. Their arguments were both descriptive and normative: not only was this theoretical framing the best way to depict bankruptcy law as it exists, but it was also the best way to safeguard and reform it in those areas where it deviated from this vision. Bankruptcy judges, for example, should not put a "thumb on the scale," as Baird recently described it, but should restrain themselves to overseeing a fair and inclusive process, reserving their suspicion and ire for breakdowns in the negotiating process.[212] Any entitlements provided to the parties by the bankruptcy courts over and above their state law entitlements

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207 *See* Benjamin P. Edwards, *Supreme Risk*, 74 Fla. L. Rev. 543, 556–57 (2022).

208 *See id.* at 585; 12 U.S.C. § 5511(a); Alexandra Sickler & Kara Bruce, *Bankruptcy's Adjunct Regulator*, 72 Fla. L. Rev. 159, 164 (2020).

209 *See* Warren, *Bankruptcy Policy*, *supra* note 204, at 788.

210 Whether bankruptcy values clash with or resonate with the values of debtor enterprises with an expanded social mission is an open question, and one that one of the Authors has explored at length when it comes to benefit corporations in bankruptcy. *See* Christopher D. Hampson, *Bankruptcy & the Benefit Corporation*, 96 Am. Bankr. L.J. 93, 118 (2022).

211 *See e.g.*, Thomas H. Jackson, The Logic and Limits of Bankruptcy Law 10 (1986); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97, 101 (1984).

212 *See* Baird, *supra* note 39, at 108.

would create a perverse incentive for parties to bring their disputes to bankruptcy court when they should be working it out in the state court system.[213]

Professor Robert K. Rasmussen took this logic a step further, arguing that firms should be able to design the regime that would govern in the event of insolvency, selecting from a menu of options.[214]

Viewed in this light, proceduralist scholars have largely endorsed prepacks as a way of making bankruptcy negotiations even more efficient. If inclusivity and disclosure are the guiding lights of bankruptcy negotiation postpetition, then so too prepetition. And while the bankruptcy judge may not be able to supervise any prepetition process, so long as the judge is given an opportunity to assess the process and determine whether it provided an appropriate forum, the threat of judicial oversight is still serving its function within the system.

Still, even proceduralist scholars may hold some discomfort with prepack bankruptcy cases. After all, the prepack takes the bankruptcy procedure and moves most of it earlier, away from court supervision. The prepack thus runs roughshod over bankruptcy's default notice provisions, and bankruptcy professionals may well suspect that certain deviations in the process may undermine its inclusivity or fairness.

B. Small Business Cases Complicate the Picture

1. Bankruptcy Values in Miniature

Small businesses bring unique issues to the bankruptcy debate. They are, as Professor Coordes puts it, "bankruptcy misfits."[215] Small businesses tend to be owned by one person—or a small group of people—whose business identity is tied to the company.[216] The owner may be the founder or entrepreneur who started the business, someone who has been building the company for twenty years. The owner may

213 *See* Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. Chi. L. Rev. 815, 828 (1987) ("Allowing priorities outside of bankruptcy but not inside is an open invitation to forum shopping and would exacerbate all the problems Jackson and I want to minimize.").

214 *See* Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 Tex. L. Rev. 51, 66–67 (1992). Contractualism provoked another debate among bankruptcy scholars. *See, e.g.*, Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 Harv. L. Rev. 1197, 1202 (2005); Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 U. Ill. L. Rev. 503, 518 (2001); Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 Yale L.J. 343, 346–48 (1999) (proposing a rolling contractualist approach to bankruptcy); Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 Tex. L. Rev. 515, 584–85 (1999); Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 Yale L.J. 317, 341–42 (1999).

215 Coordes, *supra* note 31, at 377.

216 *See, e.g.*, Baird, *supra* note 39, at 188 n.13.

also be the business's sole key employee, someone without whom the business simply cannot run. And, correspondingly, the owner's financial future may be tightly connected to the success of the business. Indeed, small business owners sometimes do not take salaries from the business; they are compensated wholly in profits—if there are any.[217]

Additionally, the economies of scale that allow middle-market to large debtors to hire bankruptcy counsel for an expensive chapter 11 case simply are not in play with small business debtors. When they face financial distress, they have no large corporate treasury to draw on.

For those reasons, prepacks fit neatly into the financial profiles and business situations of many small businesses. Owners want to maintain their control over the company and want the certainty that a prepack provides, and constituencies like secured creditors may see a prepack bankruptcy as an efficient and clear-cut approach to an in-court restructuring.

From a theoretical perspective, proceduralist scholars may see some small businesses as the paradigmatic example of cases where prepacks may be helpful. Small businesses—with limited funds and strong reputational concerns from ownership—may find especially appealing a resolution to financial distress that spends as little time in bankruptcy court as possible. Traditionalist scholars, too, may see some small business cases as presenting strong candidates for prepacks. Although large businesses are owned either by the wealthy, diffuse individual investors, or institutional investors with diverse portfolios, small businesses can be the "nest egg" for their owners. Giving ownership a chance to work out a plan with their secured creditors before the bankruptcy gets underway carries the same risks of trampling the rights of the unsecured creditors as it does in a large case, but the benefits are correspondingly higher.

This conclusion is buttressed by the reforms of the SBRA. As discussed above, the SBRA makes the bankruptcy process more streamlined for small businesses and reduces the number of players at the bargaining table—innovations that make prepacks easier to accomplish. The SBRA has thus addressed some of the prepack critics' most compelling arguments against the strategy. For example, LoPucki points out that no official unsecured creditors' committee was appointed in *Belk*, and that the court blessed Belk's prepetition "ad hoc groups."[218] In a subchapter V case, of course, the absence of an official unsecured creditors' committee is a nonissue. Similarly, although a standard chapter 11 case generally requires twenty-eight days' notice for the disclosure

217 *See* Gotberg, note 17, at 433.

218 *See* LoPucki, *supra* note 16, at 289. LoPucki does not address whether Belk's prepetition ad hoc groups could have been appropriate under section 1102(b)(1), which specifically authorizes the court to bless creditor-organized, prepetition committees if they were "fairly chosen and [] representative of the different kinds of claims to be represented." 11 U.S.C § 1102(b)(1).

statement hearing and, subsequently, for the confirmation hearing, in a small business case, those deadlines can be collapsed.[219]

Vote solicitation may be easier in subchapter V, too. Because plan confirmation does not require an impaired accepting class,[220] some courts have concluded that a subchapter V cramdown plan does not require voting at all so long as the other requirements are met.[221]

To be clear, ultra-expedited prepacks may not comply with the Bankruptcy Code, whether under subchapter V or chapter 11. As Professor LoPucki and Professor Levitin have pointed out,[222] the Bankruptcy Code's requirement of twenty-eight days' notice of plan confirmation can be shortened for cause,[223] but it is still subject to other rules that constrain the limits of the strategy. For example, as LoPucki points out, the Rule 2002 notice usually must be given by mail[224] so that even if a bankruptcy judge reduced the notice period to one day, the shortest effective deadline—given the Bankruptcy Code's other rules for mailings—would be four days.[225]

Subchapter V does not alleviate those concerns, so for small business debtors hoping to avoid any impropriety, a twenty-eight-day prepack may be the fastest possible case.

219 *See* Fed. R. Bankr. P. 2002, 3017, 3017.1.

220 *See* 11 U.S.C. § 1191(b) (eliminating the 11 U.S.C. § 1129(10) requirement for confirmation).

221 *See, e.g.*, *In re* Arsenal Intermediate Holdings, LLC, No. 23-10097, 2023 WL 2655592, at *2 (Bankr. D. Del. Mar. 27, 2023).

222 *See* LoPucki, *supra* note 16, at 276; Levitin, *supra* note 16, at 1099–1103.

223 *See* Fed. R. Bankr. P. 9006(c)(1) ("[W]hen an act is required or allowed to be done at or within a specified time by these rules or by a notice given thereunder or by order of court, the court for cause shown may in its discretion with or without motion or notice order the period reduced."). Indeed, Rule 9006(c)(1) is subject to exceptions in subsection (c)(2), one of which are the deadlines for filing a plan of reorganization under Rule 3015 in a chapter 12 or chapter 13 case, which cannot be shortened. *See* Fed. R. Bankr. P. 9006(c)(2). The negative implication is, of course, that the bankruptcy court may shorten other deadlines relating to confirmation. Similarly, the plan exclusivity period is subject to strict outer deadlines, deadlines which do not apply in subchapter V. *See* 11 U.S.C. § 1121(d)(2).

224 *See* Fed. R. Bankr. P. 2002(b). Excluding adversary proceedings, the court can send electronic notices, instead of mailings, to any recipient who consents in writing or who is a registered user of the court's electronic case file system ("ECF"). *See* Fed. R. Bankr. P. 9036(b).

225 *See* LoPucki, *supra* note 16, at 278 (providing that "when a notice is given by mail, three days are added to the prescribed period after the prescribed period would otherwise expire" under Rule 9006(a) (citing Fed. R. Bankr. P. 9006(f))). LoPucki registers "doubt that a court could reduce the 28-day periods to one day without abusing its discretion." *Id.* at 278. Of course, abuse of discretion is an appellate standard of review, so the real question is whether a party asking for such a reduction can show cause under Rule 9006(f)—a standard that should require, at a minimum, an evidentiary hearing. The only possible workaround would be if the entire universe of creditors had consented to electronic notice or were registered ECF users. *See supra* note 224.

2. *Small Is Not Always Simple*

Even so, not all small businesses are appropriate candidates for prepack bankruptcies. Small does not always mean simple. A small business that readily clears the debt ceiling for subchapter V might have a messy balance sheet with disputed, contingent, or unliquidated debt—or a universe of creditors that are unknown or unknowable.[226] And since a prepack typically requires the cooperation of secured creditors,[227] small businesses whose secured creditors are unaccustomed to prepack practice (landlords, trade creditors, or regional banks, say) may have a harder time prompting an effective out-of-court negotiation. Small business debtors who cannot bring the required parties to the table outside of bankruptcy, or who cannot pay for the transaction costs of doing so, may face debt collection action and need the automatic stay and bankruptcy's forum to work out a deal.

Conversely, not all simple cases are small. Imagine a holding company ("HoldCo") or a mezzanine company ("MezzCo") whose only business is holding stock in an operating company ("OpCo"). Absent rare legal remedies like piercing the corporate veil, counsel for HoldCo or MezzCo may know—with as close to certainty as one can get—the identities of the entire creditor body. If HoldCo or MezzCo cannot negotiate an out-of-court workout, they may need bankruptcy to cram a plan down on holdouts. But that plan might be close to consensual, and even if it is not, the attorneys for HoldCo and MezzCo can solicit a prepetition vote and provide any nonconsenting debtors with notice of their bankruptcy filing. Now, appreciate that the simplicity of this situation does not turn on the dollar amounts in the capital structure. HoldCo and MezzCo could be small business debtors eligible for subchapter V—or they could have billions of dollars in debt on their books.

3. *Ideal Debtors for Small Business Prepacks*

At least two types of debtors may fit the small business prepack strategy. First, consider a holding company or a mezzanine company that can identify its universe of creditors because it is not an operating company. In situations where the debt burden starts to become overwhelming, the secured creditor might decide to deleverage the balance sheet by filing a quick chapter 11 case to sweep away the unsecured

226 *See, e.g.*, Shaw, *supra* note 127, at 3 ("[T]he misguided Chapter 11 Lite moniker has resulted in a less expected issue that is raised by sophisticated parties that are surprised when they occasionally find themselves in a Subchapter V. That issue is the erroneous belief that Subchapter V is only for the cheap and easy cases—and that anything that is complicated or deemed sophisticated should not be able to take advantage of Subchapter V despite fitting within its debt cap defined parameters—which belief is wrong.").

227 *See* Swan & Phan, *supra* note 14, at 28.

bond or bank debt—or to negotiate a composition or extension against the backdrop of the threat of a discharge. Such a plan could be fully consensual; if it were, the advantages of subchapter V would be in reduced trustee fees and greater certainty of a smooth path to confirmation.[228] If such a plan were not fully consensual, the secured creditor might well decide that the regular chapter 11 cramdown provisions—which emphasize absolute priority and pro rata treatment—are easier to meet at a contested confirmation hearing than subchapter V's cramdown provisions. If the secured creditor is undersecured, which is the case for many small businesses, the unsecured creditors stand to gain nothing in a cramdown chapter 11 plan. But their cooperation could be obtained in exchange for some of the value provided by the relatively more streamlined subchapter V consensual plan. The negotiation over whether to do a prepack bankruptcy at all would thus encompass whether the prepack was filed under subchapter V or not.

Second, imagine a small operating business who owes significant debt to a bank that holds liens on all or substantially all the assets of the debtor. The collateral is currently worth more than the amount of the secured debt, so the bank is oversecured. In addition to the bank, the debtor owes numerous unsecured creditors, like trade vendors and employees, who are therefore partially in the money and partially out of the money. The business is limping along, making enough money to service its secured debt, but not much else. The problem for the creditors is that the cooperation of the founder is required: the business will plummet in value without the founder's labor and expertise. The secured creditor wants to wipe the slate clean of unsecured debt, but it cannot cram a plan down in chapter 11 without washing away the founder's equity. Instead, the secured creditor proposes a cramdown subchapter V plan that pays off the secured debt, pays nominal or no disposable income over the life of the plan, and then allows the founder to emerge from bankruptcy with a cleaner balance sheet.

Taking all this into account, subchapter V smooths the path for small business prepacks, but that does not mean that prepack cases and small business cases will be coextensive. The next Part explores several initiatives that bankruptcy professionals could undertake to help achieve prepack speed in a subchapter V case.

IV. Achieving Prepack Speed in a Subchapter V Case

As explained above, subchapter V's new rules incentivize debtors and creditors to reach a consensual plan[229] and thus increase the

[228] *See* Bradley, *supra* note 17, at 278.

[229] *See In re* Louis, No. 20-71283, 2022 WL 2055290, at *17 (Bankr. C.D. Ill. June 7, 2022) ("[A]lthough the provisions of Subchapter V do not affirmatively require a debtor to try to attain

chance of a successful prepack.[230] The debtor will want to avoid the costs associated with up to five years of a subchapter V trustee's supervision and receive its discharge sooner.[231] Unsecured creditors have a greater incentive to reach a consensual plan, too, because subchapter V makes cramdowns easier for a debtor.[232] This result is also consistent with the legislative intent to promote a consensual plan, shown by the subchapter V trustee's statutory obligation to "facilitate the development of a consensual plan of reorganization."[233]

This Part first walks through what a subchapter V prepack would look like, imagining the case of GatorCo. It then turns to the closest example of a subchapter V prepack to date, *In re BPI Sports*, and highlights some of the challenges the debtor faced along the way. This Part then advocates for several changes that, although representing only minor adjustments to the SBRA's framework, would further smooth the path toward a small business prepack.

A. The Small Business Prepack: A Walk-Through

This Section illustrates how our fictitious retail store from earlier, GatorCo,[234] would file its subchapter V case.

a consensual confirmation . . . the Debtor's decision in this case to forego that effort from the start was certainly contrary to the spirit of the law. And, as it pertains to the Trustee's role, it was contrary to both the spirit and letter of the law.").

230 A prepack is more likely to result in a successful reorganization when the debtor obtains a consensual plan. *See generally* Practical Law Bankruptcy & Restructuring and Practical Law Finance, *The Prepackaged Bankruptcy Strategy*, THOMSON REUTERS PRAC. L. (2023), https://us.practicallaw.thomsonreuters.com/9-503-4934 [https://perma.cc/58W2-3L8S] ("Execution risk is reduced if the deal is highly consensual, with most key creditors supporting the plan.").

231 Courts, too, may put pressure on debtors to propose shorter plans. *See, e.g.*, *In re* Urgent Care Physicians, Ltd., No. 21-24000, 2021 WL 6090985, at *10 (Bankr. E.D. Wis. Dec. 20, 2021) ("Congress's recognition that small businesses typically have shorter life-spans than large businesses suggests that a plan term of three years is more reasonable, generally speaking (or as a default), than a five-year term, absent unusual circumstances. And Congress's concern for not only small business owners, but small business employees, customers, and others who rely on such businesses, reflects an intent to balance the shorter life-span planning of small businesses and timely cost-effective benefits to debtors, against the benefits to creditors.").

232 *See* Barcelona Cap., LLC v. Neno Cab Corp., 648 B.R. 578, 589 (E.D.N.Y. 2023) ("Subchapter V modifies the rules under which particular classes of claims can be crammed down,' which means that a bankruptcy court has greater authority to adopt a debtor's plan even if creditors object to the plan." (quoting *In re Chip's Southington, LLC*, No. 20-21458, 2021 WL 5313546, at *4–5 (Bankr. D. Conn. Nov. 13, 2021))).

233 *See* 11 U.S.C. § 1183(b)(7); *see also* Harner et al., *supra* note 128 (finding preliminary data shows that over half of subchapter V cases were able to reach a consensual plan, with most cases being confirmed within 168 days). When a consensual reorganization plan is developed, the trustee's role is terminated, and administrative costs are diminished. This saving aligns with subchapter V's and prepacks' goals of reducing costs. *See* Small Testimony, *supra* note 1, at 4.

234 See *supra* Section I.B.1 for an analysis of GatorCo's eligibility under Subchapter V.

By this point, GatorCo has concluded bankruptcy makes the most sense after considering out-of-court remedies. After consultation with counsel, GatorCo has concluded it would like to continue operating after bankruptcy, and therefore a chapter 7 liquidation does not make sense. Moreover, GatorCo would like to maintain a positive public image and has emphasized it would like to exit bankruptcy court as quickly as possible.

GatorCo has two options: it can proceed as a small business case under chapter 11 or elect subchapter V. After a review of the costs and benefits of each approach, GatorCo determined subchapter V makes the most sense.[235]

GatorCo's first step will be to review its financials. GatorCo begins preparing its twelve-week cash flow models and long-term feasibility model spreadsheets. GatorCo should also investigate whether it anticipates realizing any recovery from a fraudulent, preferential, or other avoidable transfer. GatorCo asks its secured creditor if it wants to advance new funds to pay for the bankruptcy case. With the newly established local rules and guidance regarding subchapter V prepacks,[236] GatorCo can go to its secured creditor with confidence that it can promise a quick reorganization.

GatorCo then reaches out to its unsecured creditors. Unsecured creditors have much less leverage under subchapter V. In some respects, the debtor's outreach to the creditors is out of courtesy, since even if all classes reject the plan—or as is often the case, do not vote at all—it can still be crammed down if it does not discriminate unfairly and is "fair and equitable" concerning each class of claims.[237] Consequently, GatorCo tells the creditors it would like to reach an amicable resolution and, if the creditors agree and sign an RSA, they may receive a better distribution plus the bankruptcy case will be cheaper than if the plan had to be crammed down.[238]

In form, GatorCo's restructuring plan is much more condensed than a typical chapter 11 plan. GatorCo has decided to take advantage of the easy-to-use Official Form 425A—essentially a "fill-in-the-blank" reorganization plan.[239] None of the information required to complete

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235 In particular, GatorCo's founder, Allie, is willing to keep working her backbreaking schedule to keep the business in operation, but only if she stands to recover some of the equity value once GatorCo emerges from the plan. Without Allie, the business cannot survive, so debtor's counsel determines that subchapter V is the best option for a path through bankruptcy.

236 *See infra* Section IV.B.

237 *See* 11 U.S.C. § 1191(c).

238 This additional money results from the subchapter V trustee's role and payments being terminated earlier than if the plan was a cramdown.

239 *See Official Form 425A: Plan of Reorganization for Small Business Under Chapter 11*, USCourts.gov, https://www.uscourts.gov/sites/default/files/b_425a_0.pdf [https://perma.cc/PU2X-W8XZ].

the form is contingent on postpetition activity and can be completed before the bankruptcy filing.

Once GatorCo prepares its first-day filings, it reaches out to the U.S. Trustee's office a few days before it files to ask the U.S. Trustee and the subchapter V trustee likely to be assigned to its case[240] to pass along any comments that they may have. GatorCo has followed all requirements of solicitation and disclosure for subchapter V and the U.S. Trustee and subchapter V trustee had only minor changes. In particular, the office asks GatorCo to draft a clearer backup plan in case it cannot make payments.[241] GatorCo's submittal of the supplemental filings required by the local rules also puts most of its creditors at ease.

When GatorCo submits all its filings, the court agrees at the First Day Hearing that no disclosure statement is required and sets a plan confirmation hearing for twenty-eight days out. One especially testy creditor objects to plan confirmation on the grounds that the plan is infeasible. But with support from the secured creditor, the U.S. Trustee, and the subchapter V trustee, the bankruptcy judge has her concerns assuaged, decides that GatorCo's plan complies with the law, and confirms the plan. One month after filing its petition, GatorCo emerges from bankruptcy and begins making payments.

Ultimately, by using subchapter V as an avenue to restructure its debt, GatorCo was successfully able to exit bankruptcy within a month. The ball was in GatorCo's court during the case, allowing it to bypass many of the risks it would have faced had subchapter V not existed.

B. Real-Life Limitations

GatorCo epitomizes the theoretical model of an ideal small business prepack, yet such an archetype remains to be seen. The closest approximation to date is *In re BPI Sports*. Although *BPI Sports* did not fulfill every criterion to be classified strictly as a prepackaged bankruptcy—most notably, the absence of all votes being cast before the filing—it still represents a significant milestone as the first case where the debtor filed a subchapter V plan and a motion to set a confirmation hearing alongside the petition. By looking at *BPI Sports*, we can preview some limitations and challenges for future small business prepacks.

BPI Sports is a company specializing in manufacturing branded supplements for the health industry. In 2023, it faced financial troubles after a failed sales process did not secure the approval of a minority investor. Its circumstances were further worsened by a cash flow shortage that made debt servicing unfeasible. BPI Sports's only way forward, it seemed, was bankruptcy.

240 *See infra* Section IV.B.

241 *See* 11 U.S.C. § 1191(c)(3).

BPI Sports's debts qualified it as a small business debtor under subchapter V. But like many small businesses that would benefit from all of subchapter V's improvements, BPI Sports lacked the funds needed to organize its case. Fortunately, BPI Sports found a lifeline through negotiations with High-Tech Pharmaceuticals ("HTP"), its principal creditor that was owed a supermajority of the debt. HTP committed to finance the administrative expenses associated with bankruptcy, guarantee funding of plan payments to other unsecured creditors, and forgive nearly $900,000 in prepetition debt. In return, HTP's debt would convert to equity. The sole stipulation was that BPI Sports promptly seek plan confirmation as it entered court. The only way to do this would be through a small business prepack.

BPI Sports did just that.[242] It filed for subchapter V bankruptcy, submitted its plan, and moved for a confirmation hearing on September 18, 2023.[243] The plan, which forgave $900,000 in debt, converted over $5 million of debt into equity, and funded $1.8 million for the payment to holders of BPI Sports's remaining debts, received votes of approval from twenty-six creditors shortly thereafter. On October 20, 2023, the court confirmed BPI Sports's plan.[244]

BPI Sports is the herald of a small business prepack. But it also had some limitations and previews some potential hurdles in the prepack strategy.

First, the Department of Justice and subchapter V trustee seemed reticent throughout the process. For example, the subchapter V trustee asked the court for more time to object to the plan.[245] For *BPI Sports*, these concerns did not amount to any true hurdles. The plan was confirmed with no objections. But the warning shot by the subchapter V trustee does signify a potential resistance to a growing practice of prepacks, a concern addressed below by urging increased communication with the subchapter V trustee.[246]

Second, BPI Sports did not solicit all votes prepetition. Although HTP—the critical vendor—had a supermajority claim, BPI Sports's

242 BPI Sports's proposed order cited a prepublication version of this Article and stated that the strategy outlined in the Article "is precisely what has occurred here." *See* Notice of Filing Proposed Confirmation Order, *In re* BPI Sports, LLC, No. 23-17463 (Bankr. S.D. Fla. Oct. 19, 2023), ECF No. 114.

243 *BPI Sports* filed an emergency motion to set confirmation hearing, citing the pre negotiated RSAs that required an immediate request for confirmation. *See* Debtor's Emergency Motion to Set Confirmation Hearing and for Related Relief at 1, *In re* BPI Sports, LLC, No. 23-17463 (Bankr. S.D. Fla. Sept. 18, 2023), ECF No. 17 ("[T]he petition and plan of reorganization in this case hinges upon an expedient administration of the case that minimizes administrative costs to preserve the going concern, enterprise value of the business.").

244 Order Confirming the Debtor's Subchapter V Plan of Reorganization, *supra* note 137.

245 *See* Subchapter V Trustee's *Ex Parte* Motion for Extension of Time to File Objection to Confirmation, *In re* BPI Sports, LLC, No. 23-17463 (Bankr. S.D. Fla. Oct. 6, 2023), ECF No. 88.

246 *See infra* Section IV.C.4.

trade creditors were still entitled to vote.[247] In other words, not all the creditors were solicited and accepted the plan prepetition.[248] If BPI Sports had not met the numerosity requirement, the plan would have to be a cramdown.[249] A few trade creditors voting "no" would have made the plan nonconsensual. That concern did not materialize in *BPI Sports*, but it could in other cases.

C. How to Smooth the Path Forward

This Article has emphasized the legislative intent of subchapter V to promote speed. However, as Bankruptcy Judge Benjamin Kahn framed it, a better iteration of its purpose is "to provide small businesses with the presumption of a faster, more efficient, and feasible path to reorganization."[250] A debtor entering subchapter V is not guaranteed to exit quickly. And although not all small businesses are suited to have their cases disposed of quickly, or filed as a prepack,[251] there are multiple ways to streamline the process for those debtors who are suited for the small business prepack. Those improvements are discussed below.

1. Promote Precrisis Preparation

First, small businesses should insulate their businesses from the chaos of financial distress by maintaining good records beforehand. Financial distress can feel like a maze for small businesses, leaving them puzzling "how did we get here?" and "what is the best escape route?" Answering these questions is not usually a simple task, and one that is best undertaken before a bankruptcy filing.

To be sure, subchapter V makes bankruptcy cases simpler.[252] Even still, it is difficult to file a subchapter V without preparing beforehand: "the roadmap for [the] fast path to success must be ready early on in the case. So, without the necessary advance preparation, the subchapter V

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247 BPI's counsel remarked that soliciting all trade creditors before the petition date was not feasible. *September 22, 2023, Virtual Public Hearing*, at 56:17–56:52, Am. Bankr. Inst., https://subvtaskforce.abi.org/hearings/september-22-2023-virtual-public-hearing [https://perma.cc/EEL9-KHBF].

248 *See id.*

249 11 U.S.C. § 1191(b).

250 Benjamin A. Kahn, *Written Statement of the Hon. Benjamin A. Kahn*, Am. Bankr. Inst. 3 (June 23, 2023) (emphasis omitted), https://abi-org.s3.amazonaws.com/SubV/wstatements/Benjamin_Kahn_Statement.pdf [https://perma.cc/3RMU-LMAH].

251 Some debtors enter bankruptcy ill-prepared or needing the protection of the bankruptcy court while it works out its issues. *See supra* Part III.

252 The easy-to-use form plan B 425A and the contracted disclosure under the SBRA—which can be set out in the plan and need not be a separate form—all point toward subchapter V's inherent efficiency.

cannot possibly work . . . ."[253] Some courts have even revoked the subchapter V designation when the debtor has not moved with the speed envisioned by Congress.[254]

Because the cramdown and feasibility rules in subchapter V are more demanding than under chapter 11, small business debtors may need to do an even better job at keeping records than their chapter 11 counterparts. If GatorCo has no documentation of its revenues or operating expenses, how will it formulate a reorganization plan? Similarly, how will it prove projected disposable income or feasibility of its plan—if it can create one?

For small businesses to navigate bankruptcy swiftly, they must maintain accurate records. For that reason, small business debtors should engage in precrisis preparation. The costs of professional help feel high to cash-strapped businesses, and many small businesses cannot afford not to hire professionals.[255] Those outside of the bankruptcy bar—corporate counsel, accountants, and tax preparers—should urge their small business clients to invest in professional help or, at a minimum, use financial management software like QuickBooks. Even with subchapter V, this preemptive approach is a prerequisite to escaping the protracted financial nightmares that bankruptcy was for small businesses not too long ago.

2. *Clarify Standards for Cramdown Plans*

Second, the standards for cramdown plans must be sketched out with greater clarity, whether by adjudication, local rule, or congressional action.[256] In the context of subchapter V, the "fair and equitable" standard and the "feasibility" standard are both ambiguous. This ambiguity makes plan confirmation ripe for contestation—especially since feasibility "is the most important element of [plan confirmation]."[257]

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253 Cathy Peek McEwen, *Don't Put the Brakes on a Subchapter V*, Tampa Bay Bankr. Bar Ass'n (Aug. 26, 2021), https://www.tbbba.com/dont-put-the-brakes-on-a-subchapter-v [https://perma.cc/GXF9-JQWA]; *see also In re* Seven Stars on the Hudson Corp., 618 B.R. 333, 347 (Bankr. S.D. Fla. 2020) ("Subchapter V is intended to be an expedited process. The debtor has the opportunity to use new, powerful tools to reorganize and save its business; but it must do so quickly.").

254 *See, e.g.*, *In re* Nat'l Small Bus. All., Inc., 642 B.R. 345, 349 (Bankr. D.D.C. 2022) (revoking the debtor's subchapter V designation after finding "the Debtor's case has not progressed with the expediency Subchapter V case[s] are expected to achieve").

255 Many thanks to subchapter V trustee Amy Denton Mayer for this point. Mayer was also HTP's counsel in *BPI Sports*.

256 *See* Michael C. Dorf, *Legal Indeterminacy and Institutional Design*, 78 N.Y.U. L. Rev. 875, 915 (2003) ("[A]mbiguity is the enemy of law.").

257 *In re* Bashas' Inc., 437 B.R. 874, 915 (Bankr. D. Ariz. 2010). Feasibility functions to distinguish aspirational plans from realistic plans—a distinction that can alter the outcome of any case. *In re* Curiel, 651 B.R. 548, 561 (B.A.P. 9th Cir. 2023) ("[T]he purpose of the feasibility requirement 'is to prevent confirmation of visionary schemes which promise creditors and equity security

Recall that subchapter V plans must be "fair and equitable concerning each class of claims or interests."[258] The Code introduces two requirements for a cramdown plan to be "fair and equitable": the plan must (1) pay secured creditors in full (whether through cash, deferred payments, or retained liens), the same as in a normal chapter 11, and (2) pay projected disposable income toward unsecured debt. In addition, the plan must be "feasible": the debtor must prove it will be able to make all payments under the plan, or it has a reasonable likelihood of making all plan payments and has an appropriate contingency plan if that fails.[259] Notably, the provisions of subchapter V allow a debtor to obtain "micro exit financing": use the new line of credit to pay the present value of its projected disposable income, exit bankruptcy entirely, and make its ongoing payments to the new lender, rather than the old creditors.[260]

The definition of "disposable income" in subchapter V, however, is so flexible that, as Bradley points out, debtors may exploit it to their advantage.[261] For business debtors in subchapter V, "disposable income" means income "not reasonably necessary to be expended . . . for the payment of expenditures necessary for the continuation, preservation, or operation of the business of the debtor."[262] Even though "disposable income" is more sharply defined in chapters 12[263] and 13,[264] income requirements are hard to write and susceptible to gaming.[265] Debtors have every incentive to allocate generous amounts to the "continuation, preservation, or operation" of the business, lowballing payments to creditors. Creditors, conversely, will focus on the word "necessary." Any uncertainty may lead to a contested confirmation hearing, especially when debtors propose to pay creditors with actual disposable income rather than fixed payments. Courts will have to address how disposable income fits into decisions to grow or shrink the business, as well as

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holders more under a proposed plan than the debtor can possibly attain after confirmation.'" (quoting Pizza of Haw, Inc. v. Shawkey's Inc. (*In re* Pizza of Haw, Inc.), 761 F.2d 1374, 1382 (9th Cir. 1985))).

258 11 U.S.C. § 1191(c); *see also id.* § 1129(b)(2)(A).

259 *See id.* § 1191(c)(2)–(3).

260 *See id.* § 1191(c)(2)(B). This "micro exit financing" concept was discussed by attorney Robert Keach at the 2024 Southeastern Bankruptcy Law Institute's 50th Annual Seminar.

261 *See* Bradley, *supra* note 17, at 274 ("Debtors will have every incentive to lowball their projected revenues and to maximize their projected expenses, leaving a fig leaf of a plan payment to unsecured creditors beyond what is required to pay priority and secured claims.").

262 11 U.S.C. § 1191(d).

263 *Id.* § 1225(b)(2).

264 *Id.* § 1325(b)(2).

265 *See* Bradley, *supra* note 17, at 273 n.101; *see also, e.g.*, Trustee's Objections to Debtors' First Amended Chapter 11 Plan at 3, *In re* Sizzler USA Restaurants, Inc., No. 20-30748 (Bankr. N.D. Cal. Dec. 29, 2020), ECF No. 108 (the subchapter V trustee objected to the plan because the debtor's projections were a "moving target").

clarify whether the owner may take a salary over the life of the plan. If the contours of the rule are not successfully sketched out by case law, Congress may need to provide further clarity.

The third requirement, subchapter V's "feasibility" test, requires a more in-depth look than a standard chapter 11 analysis. Although chapter 11 requires a court to find that the plan is not likely to lead to another liquidation or reorganization,[266] subchapter V also requires the court to conclude that the debtor can make all the payments—and if the court is not convinced, that the debtor has an appropriate backup plan.[267] But courts struggle to effectively oversee debt adjustment plans extending far into the future.[268] Although each determination must be made on a case-by-case basis, courts can provide guidance on what types of financial documents and evidentiary support are most helpful to supporting a plan at confirmation. Providing additional legislative or judicial clarity on the feasibility determination will ensure that courts are confirming only the plans that actually meet the requirements and will assist parties in negotiating their way to a confirmable plan prior to the bankruptcy case being filed.[269]

3. *Clarify the Subchapter V Trustee's Role as "Facilitator" and "Watchdog"*

Third, the role of the subchapter V trustee should be clarified. A subchapter V trustee plays an imperative role in the case. Perhaps most notably, the subchapter V trustee's presence helps judges who benefit from the subchapter V's unbiased opinions.[270] As emphasized by Bankruptcy Judge Deborah L. Thorne, "The negotiations which happen during phone calls or in conference rooms are what lead to success, and the subchapter V trustee—who is present for these discussions but has no emotional or financial ties to the debtor—can provide sage

266 *See* 11 U.S.C. § 1129(a)(11) ("Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.").

267 *In re* Samurai Martial Sports, Inc., 644 B.R. 667, 698 (Bankr. S.D. Tex. 2022) ("[Section 1191(c)(3)] fortifies the more relaxed feasibility test that § 1129(a)(11) contains.").

268 For a helpful overview of the theoretical and practical problems plaguing the bankruptcy courts' supervision of estates, see generally Jonathan M. Seymour, *The Limited Lifespan of the Bankruptcy Estate: Managing Consumer and Small Business Reorganizations*, 37 Emory Bankr. Dev. J. 1 (2020).

269 *See, e.g.*, LoPucki, *supra* note 16, at 252–53 (underscoring the importance of the feasibility determination in prepack cases).

270 *See* Deborah L. Thorne, *Remarks of Deborah L. Thorne*, Am. Bankr. Inst. (July 14, 2023), https://abi-org.s3.amazonaws.com/SubV/wstatements/Deborah_Thorne_Written_Statment.pdf [https://perma.cc/W4PF-H6UY] ("Having a third party who can evaluate without emotion or financial interest has greatly assisted judges and has increased the success rate in subchapter V cases.").

and independent insight to the court."[271] According to proceduralists, the bench should endorse these out-of-court workouts with open arms. Some judges, however, value an impartial endorsement from someone who was "in the room" during negotiations. But even if the subchapter V trustee is "in the room," are they obligated to vet for and report misconduct, such as an insider transaction? The law is not clear.

Bankruptcy Judge Craig Goldblatt frames this question as whether the subchapter V trustee, as an "honest broker," has a duty to be a "watchdog."[272] The watchdog role is traditionally undertaken by the U.S. Trustee's office and the creditors' committee—the latter of which subchapter V removed.[273]

Subchapter V trustees should be obligated to take on this role, but only to an extent. The trustee's explicit duty to "facilitate the development of a consensual plan of reorganization" implicitly requires the trustee to help develop a *lawful* plan.[274] In this sense, Judge Goldblatt's belief that the watchdog role of the trustee should be delineated through case law, not necessarily congressional clarification, may be correct.[275] The Department of Justice's Subchapter V Trustee Handbook already requires the trustee to report any bankruptcy crime under sections 152 and 157.[276] The Handbook, however, should be revised to require that the subchapter V trustee report any suspected insider dealings to the U.S. Trustee.[277] The "watchdog" role is necessary to streamline subchapter V cases. When a plan is filed with the court immediately, the subchapter V trustee's scrutiny may alleviate some of the concerns associated with the lack of court oversight in regular prepack cases.[278]

4. *Facilitate Coordination with the Subchapter V Trustee*

Fourth, court districts should facilitate prefiling coordination with the subchapter V trustee likely to be assigned to the case. Not only do trustees provide value to judges when attesting to what happened "in the room," but they can also provide guidance to debtors during

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271 *Id.*; *see also* Goldblatt, *supra* note 68, at 2 ("[J]udges should be careful not to jump to conclusions about what they think is happening in rooms that they are not in.").

272 *See* Goldblatt, *supra* note 68, at 6.

273 Should the court be made aware of a potential improper dealing, it retains the authority to appoint a creditors' committee. *See* 11 U.S.C. § 1181(b). Case law seems like the best choice to establish when the court should appoint a creditors' committee.

274 *See* 11 U.S.C. § 1183(b)(7).

275 *See* Goldblatt, *supra* note 68, at 7.

276 *See* SBRA Handbook, *supra* note 101, at 5-4.

277 *See, e.g.*, *In re* Corinthian Commc'ns, Inc., 642 B.R. 224, 233 (Bankr. S.D.N.Y. 2022).

278 However, additional time may be required because the subchapter V Trustee must communicate any concerns with the plan to the U.S. Trustee before filing an objection with the court. *See* SBRA Handbook, *supra* note 101, at 3-10.

negotiations.[279] Subchapter V trustees possess unique skill sets.[280] Some are litigators, and others are accountants or turnaround specialists. This knowledge, however, is valueless if the debtor does not communicate with the trustee.

The SBRA anticipated that subchapter V filings would become common enough that jurisdictions might need one or more standing subchapter V trustees.[281] Districts that want to encourage subchapter V prepacks should consider appointing standing subchapter V trustees, so that debtors' counsel can share the plan with them before filing.[282]

For the same reason, jurisdictions should require debtors to communicate regularly with the subchapter V trustee. Take, for example, the initial order for debtors in the Middle District of Florida:

> Communication with Subchapter V Trustee. Debtor's counsel or, if Debtor is self-represented, Debtor, shall contact the Subchapter V Trustee (the "Trustee") within five days of the date of this order to discuss the Trustee's facilitation of the development of a consensual plan of reorganization. The Debtor is expected to communicate regularly and share information with the Subchapter V Trustee as is appropriate under the facts of the case.[283]

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279 *See* Thorne, *supra* note 270, at 2 ("In several cases, the operational experience of the subchapter V trustee has led to improved pricing, marketing, and other business advice which has saved businesses and led to confirmable plans.").

280 In theory, all subchapter V trustees should hold the requisite skills need to facilitate plans efficiently. However, as some practitioners note, "the skill sets and motivations of the pool of applicants were understandably varied." *See* Meredith S. Grabill, *Written Statement of The Hon. Meredith S. Grabill*, AM. BANKR. INST. 4 (July 14, 2023), https://abi-org.s3.amazonaws.com/SubV/wstatements/Meredith_Grabill_Written_Statement.pdf [https://perma.cc/9TQX-XDTK]. For this reason, we also urge the U.S. Trustee to offer training to potential trustees to "promote uniformity and consistency in skills sets among [them]." *Id.* at 5. Some jurisdictions are already doing so. *See, e.g.*, Susan K. Seflin, *Written Statement of Susan K. Seflin*, AM. BANKR. INST. (July 14, 2023), https://abi-org.s3.amazonaws.com/SubV/wstatements/Susan_Seflin_Written_Statement.pdf [https://perma.cc/6QGP-G98Z] ("In January of 2021, the subchapter [V] trustees in the Central District of California participated in a weeklong mediation training program to improve our mediation skills and it was incredibly helpful.").

281 *See* 28 U.S.C. § 586(b) ("If the number of cases under chapter 12 or 13 of title 11 commenced in a particular region so warrants, the United States trustee for such region may, subject to the approval of the Attorney General, appoint one or more individuals to serve as standing trustee, or designate one or more assistant United States trustees to serve in cases under such chapter."); *see also* 11 U.S.C. § 1183(a).

282 Subchapter V trustees are paid out of the plan, so their business model already relies on deferred payments. *See* 28 U.S.C. § 586(e)(2). Thus, a subchapter trustee might welcome the opportunity to review a small business prepack plan before it was filed, saving time and expense later in the case.

283 Order Prescribing Procedures in Chapter 11 Subchapter V Case, Setting Deadline for Filing Plan, and Setting Status Conference (M.D.F.L. Bankr.) (on file with authors). Penalties for failing to comply include "imposition of sanctions against the Debtor or Debtor's counsel, including, but not limited to, conversion or dismissal of the case, removal of the Debtor as debtor-in-possession, and monetary sanctions." *Id.*

The rule is a step in the correct direction but should go further in specifying the minimum timing of communication. For example, a debtor must submit a plan within ninety days of the initial petition.[284] This means the debtor could submit the plan on the ninetieth day, without the trustee ever seeing the plan. And some debtors do. Unfortunately, many of these plans are mere "placeholders" where the debtor did not provide the trustee with an opportunity to review the plan.[285] A rule specifying the requirements of communication, specifically requiring the debtor to submit filings to the trustee, may streamline the case. Consider this addition:

> The Debtor shall submit any disclosure statement, proposed plan, and related motions to the Trustee no later than three days before the Debtor files the papers with the court.[286]

The addition of one sentence would not only allow the subchapter V trustee to advise the debtor of any oversight but would also force regular correspondence with the trustee.

5. *Clarify or Develop Local Rules*

Finally, and consistent with bankruptcy's objective to facilitate the efficient resolution of cases, courts can promulgate local rules that delineate what is necessary to streamline a debtor's time in court.[287] Local rules work in tandem with the Bankruptcy Code provisions to achieve "the orderly and expeditious disposition of cases."[288] A significant advantage of local rules is their ability to be implemented and revised quickly by the judiciary. Moreover, local rules can respond to the differing needs of specific jurisdictions. Notably, although numerous jurisdictions have promulgated local rules for chapter 11 prepacks,[289]

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284 11 U.S.C. § 1189(b).

285 *See* ABI Final Report, *supra* note 72, at 53 (explaining that a "placeholder plan" is where a "practitioner[] file[s an] incomplete or bare-bones plan solely to meet the 90-day statutory deadline with the expectation that they can remedy the deficiencies prior to the confirmation hearing").

286 This order is entered into a case after the debtor files its case, and thus would not require the debtor to submit filings to anyone before entering court. However, we do suggest that jurisdiction enact local rules doing exactly that. *See infra* Section IV.C.5.

287 *See* Fed. R. Civ. P. 83(a); Fed. R. Bankr. P. 9029(a).

288 *Federal Rules, Local Rules & General Orders*, U.S. Dist. Ct., N.D.N.Y., www.nynd.uscourts.gov/federal-rules-local-rules-general-orders [https://perma.cc/N3ZR-T7HQ]; *see Procedural Guidelines for Prepackaged Chapter 11 Cases in the United States Bankruptcy Court for the Southern District of New York*, U.S. Bankr. Ct., S.D.N.Y. [hereinafter SDNY Prepack Guidelines], www.nysb.uscourts.gov/sites/default/files/prepack.pdf [https://perma.cc/YYC4-EZY8] ("[T]his document . . . attempts to provide bankruptcy practitioners with help in dealing with practical matters which either are not addressed at all by statute or rules or are addressed indirectly in a piecemeal fashion . . . .").

289 The Bankruptcy Court for the Southern District of New York promulgated local rules for prepacks in 2024 without mentioning subchapter V. *See In re Amended Procedural Guidelines for*

the Authors have not identified any local rules explicitly addressing subchapter V prepacks.

Although courts have not specifically addressed subchapter V prepacks, local rules governing chapter 11 prepacks should apply equally to subchapter V.[290] These established local rules address a range of matters relevant to the small business prepack, including filing requirements, disclosure obligations, notice procedures, and plan confirmation standards.[291]

First, local rules should require a debtor desiring a small business prepack to submit its plan and all first-day papers to the U.S. Trustee's office at least one week before it intends to enter court.[292] With the imperative role that a subchapter V trustee plays in a subchapter V case, submitting filings to the U.S. Trustee's office—and, through that office, to the subchapter V trustee assigned to the case—before the case's start would allow the debtor to resolve any issues the trustee has with the filing, reduce the uncertainty of whether the trustee will delay the case with objections, and reduce the administrative burden on the U.S. Trustee's office. The U.S. Trustee's office already mandates that a prospective subchapter V trustee review initial case filings within two days of the case being filed.[293] And, "[i]mmediately upon appointment, the trustee must determine the status of the case."[294] The subchapter V trustee thus has no time to waste after the initial case filing, and prescribing for early satisfaction of those obligations will alleviate some of the pressure the office is under to ensure a speedy case.

Prepackaged Chapter 11 Cases, U.S. Bankr. Ct., S.D.N.Y. (Jan. 22, 2024), https://www.nysb.uscourts.gov/sites/default/files/m621.pdf [https://perma.cc/9N6V-MLHS]. The Bankruptcy Court for the Southern District of Florida recently abrogated its local rule for chapter 11 prepacks in favor of the "current local rules and procedures set forth on the individual web pages for each judge." *In re Abrogation of Local Rule 3017-3, Court Guidelines for Prepackaged Chapter 11 Cases, and Clerk's Instructions for Chapter 11 Cases*, U.S. Bankr. Ct., S.D. Fla. (May 27, 2021), https://www.flsb.uscourts.gov/sites/flsb/files/documents/general-orders/AO_2021-04_Abrogation_of_Local_Rule_3017-3%2C_Court_Guidelines_for_Prepackaged_Chapter_11_Cases%2C_and_Clerk's_Instructions_for_Chapter_11_Cases.pdf [https://perma.cc/6JNL-5QFP].

290 *See In re* Double H Transp. LLC, 603 F. Supp. 3d 468, 473 (W.D. Tex. 2022) ("[S]tatutory sections that apply to standard Chapter 11 bankruptcies apply to Subchapter V. . . .").

291 For example, although the Southern District of New York Prepack Guidelines outlines rules such as Creditors' Committees and voting requirements that are not relevant in subchapter V, other rules such as scheduling motions and notice requirement are applicable to subchapter V cases. *See* SDNY Prepack Guidelines, *supra* note 288; *see also supra* Section II.B (noting the lack of a statutory committee of unsecured creditors); *In re* Arsenal Intermediate Holdings, LLC, No. 23-10097, 2023 WL 2655592, at *2 (Bankr. D. Del. Mar. 27, 2023) ("[T]here is no requirement that creditor votes be solicited in a case under subchapter V.").

292 Standard chapter 11 prepack guidelines consistently have provisions requiring a debtor to communicate with the U.S. Trustee before filing bankruptcy. *See, e.g.*, SDNY Prepack Guidelines, *supra* note 288.

293 SBRA Handbook, *supra* note 101, at 3-10.

294 *Id.* at 3-1.

Second, courts adopting subchapter V guidelines should address presumptively reasonable notice periods[295] and provide a model official ballot. Presumptive notice period will give creditors ample opportunity to contest the plan, even though such objections may be overcome with subchapter V's easier path to cramming down a plan. Similarly, the model official ballot provides a preapproved means to collect votes, diminishing the chance that a successful objection can be made as to the ballot's adequacy.[296]

Conclusion

Small businesses need a bankruptcy process that enables them to reorganize effectively—especially given the vital role that small businesses play in the American economy.[297] For decades, Congress has tried to speed up chapter 11 bankruptcies without hindering bankruptcy's rehabilitative goals. Those attempts have not worked for small businesses. The Bankruptcy Reform Act of 1994 codified a fast-track option for small businesses but neglected to account for small business debtors' lack of resources. BAPCPA directly addressed prepacks and sped up small business cases, but its provisions were so convoluted that very few debtors could successfully exit bankruptcy.

The SBRA represents Congress's best approach to date. Subchapter V's departure from the absolute priority rule, simplified paperwork, and quicker timelines allow debtors to successfully exit bankruptcy quickly.[298] The ability for a small business owner to keep equity in the company after getting through the subchapter V payment plan incentivizes small business owners to take advantage of bankruptcy. For their part, creditors are more likely to work with debtors to facilitate

295 *Cf.* SDNY Prepack Guidelines, *supra* note 288, at 22 (requiring a twenty-day notice period).

296 *Cf. In re* Walat, 87 B.R. 408, 414 (Bankr. E.D. Va. 1988), *aff'd*, 89 B.R. 11 (E.D. Va. 1988) (finding that a bankruptcy court had the authority to issue a local rule prescribing a form for chapter 13 plans that differed from the Official Forms and that the rule "insure[d] the just, speedy and inexpensive determination of chapter 13 plan confirmations").

297 *See, e.g.*, Cipriano, *supra* note 17, at 149 (describing how small businesses "drive the American economy"); Mawhinney, *supra* note 6, at 29 ("There is a saying in bankruptcy: Equality is equity. The social good bankruptcy delivers is preserving something for the greatest number of stakeholders. Subchapter V helps small business owners hold onto what they have. It is a bulwark against financialization, preserving individual wealth and keeping it diffuse across society. Ultimately, this increases the number of stakeholders and strengthens the legitimacy of our institutions. A strong liberal society depends on lots of individuals with a vested stake.").

298 *See* Robert J. Gonzales, *Written Statement for June 23, 2023 Public Hearing on Eligibility Issues in Subchapter V Cases*, Am. Banker. Inst. (June 22, 2023), https://abi-org.s3.amazonaws.com/SubV/wstatements/Robert_Gonzales_Statement.pdf [https://perma.cc/7RGD-U7U8] ("My firm has successfully confirmed every Subchapter V case we have filed, and the timeframe for confirmation has been as little as 49 days (petition date to confirmation order).").

a consensual plan so that they avoid subchapter V's easier path to a cramdown.

As argued above, these innovations also make subchapter V a particularly viable forum for a small business prepack. Subchapter V implicitly fosters prepacks while avoiding many of the limitations of standard chapter 11 prepacks, including scholars' concerns with prepacks violating notice periods. Because of this revolution in bankruptcy law, practitioners should reassess their standard bankruptcy practices. Debtors who want to exit bankruptcy quickly should reassess their subchapter V eligibility. Similarly, debtors already filing a subchapter V case should consider whether their case might make sense as a prepack. A debtor who fails to be ready early in the case lacks respect for the legislative intent of subchapter V and may "artificially press[] the brakes" on its case.[299]

Time will tell. Small businesses have been using the Bankruptcy Code to reorganize for a long time, but subchapter V practice is still relatively young. The Authors take no position on how voluminous small business prepacks will become. Subchapter V's prodebtor innovations may alter the equilibrium so that prepacks are less necessary than they were before the SBRA. Debtors may file for subchapter V to obtain the benefits and expertise of a subchapter V trustee. And as discussed above, not every small business debtor fits the profile for a prepack strategy; the approach only works in very particular circumstances—and most crucially require debtors and creditors who can coordinate prebankruptcy.

There is still a lot to be worked out, as discussed above in Part IV. The standards for cramdown plans under subchapter V are murky. Even though courts can attempt to delineate the edges of projected income, Congress may need to provide further clarity. Similarly, coordination with the U.S. Trustee's office, subchapter V trustees, and precrisis preparation may help smooth the path forward to fast-track reorganization. Lastly, courts should provide clear guidance with local rules, as many already do for chapter 11 and chapter 11 prepack cases.

Chapter 11 is not always the end of the story for American businesses. It can represent an opportunity for a fresh start, and the system accordingly sets out to preserve not just the value of the business's assets but the go-forward value of the enterprise as a whole. To be sure, bankruptcy is an area of hard-edged negotiation and—in the big business context—attracts bankruptcy professionals who spend their working days in the gritty world of financial distress.[300] But for small business owners, bankruptcy also stands for American pragmatism and

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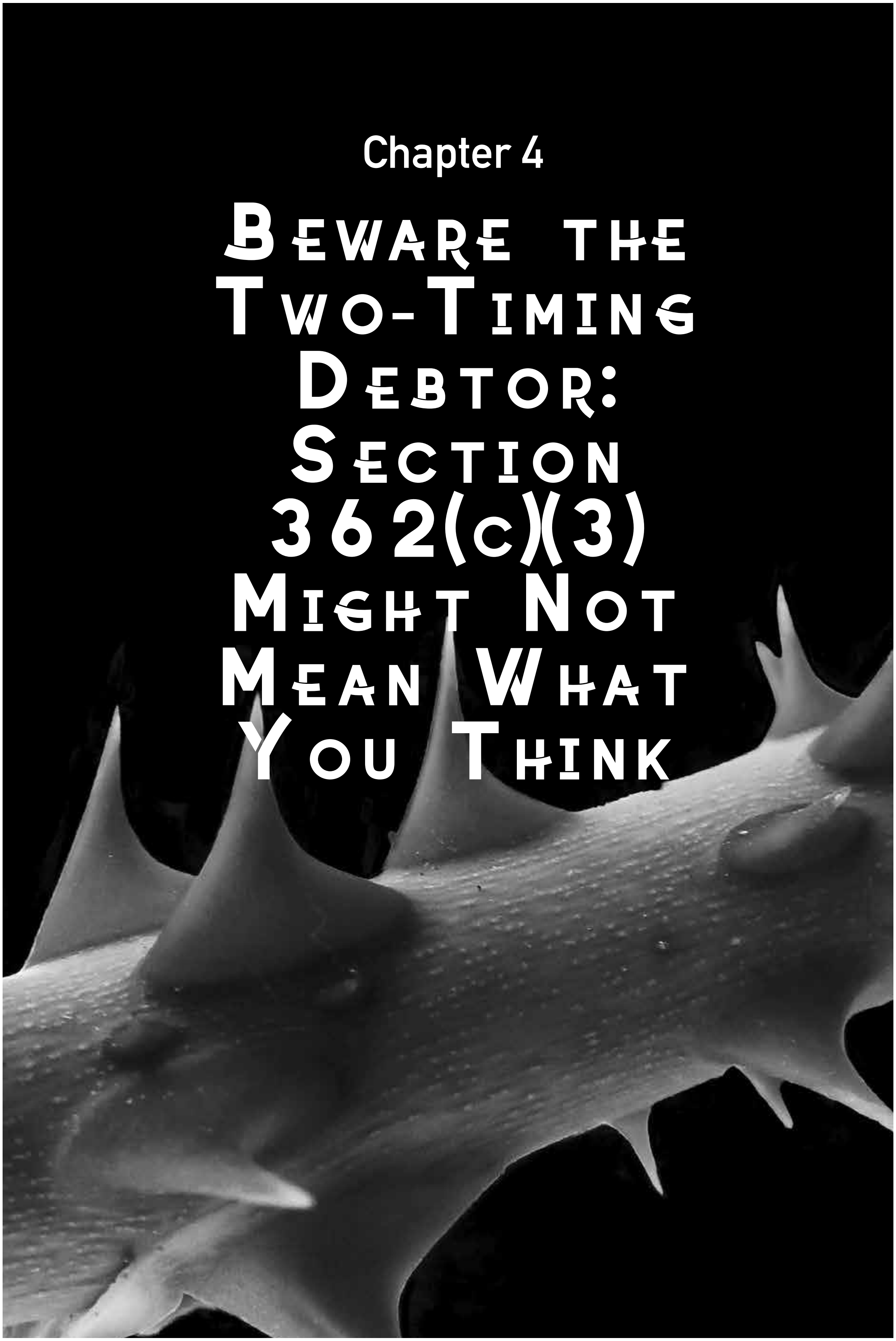
299 McEwen, *supra* note 253.

300 *See, e.g.*, Jared A. Ellias, Ehud Kamar & Kobi Kastiel, *The Rise of Bankruptcy Directors*, 95 S. Cal. L. Rev. 1083, 1095–96 (2022) (analyzing the increasing role of bankruptcy directors

American optimism. Creative and problem-solving lawyers who represent small businesses, their creditors, and their stakeholders, should take advantage of the SBRA—prepacks and all—to find strategies that enable small business debtors to turn around and try again.

appointed prepetition); Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 Cal. L. Rev. 745, 757–62 (2020) (describing the rise in hard-edged tactics in insolvency).



Chapter 4

Beware the Two-Timing Debtor: Section 362(c)(3) Might Not Mean What You Think

A. Introduction

Section 362(c)(3) was enacted to mitigate the impact of abusive two-time filers on secured creditors and landlords by "automatically" terminating § 362(a)'s automatic stay[89] "with respect to the debtor" 30 days after the filing of a second case within a year of a prior case, unless the court within that 30-day period orders the stay extended.[90] The First and Fifth Circuits and over 70

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89 Section 362(a) imposes an automatic stay of all acts to collect a debt against the debtor, and property of the debtor and property of the estate:

> (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title ... operates as a stay, applicable to all entities, of —
>
> > (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;...
> >
> > (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;...
> >
> > (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title[.] 11 U.S.C. § 362(a).

The automatic stay serves several goals of bankruptcy. *In re Smith*, 910 F.3d 576, 580 (1st Cir. 2019). The automatic stay "offers debtors 'breathing room' during the period of financial reshuffling. The stay also protects the debtor's assets from disorderly, piecemeal dismemberment ... outside the bankruptcy proceedings. And it enabl[es] the bankruptcy court to centralize all disputes concerning property of the debtor's estate so that reorganization can proceed efficiently, unimpeded by uncoordinated proceedings. [Internal citations omitted.] Property of the estate includes most (but not all) 'legal or equitable interests of the debtor in property as of the commencement of the case.'" 11 U.S.C. § 541(a)(1). The fact that in the vast majority of individual and joint cases very little property is property of the debtor and not property of the estate factors heavily into the analysis of courts holding the minority view.

90 Section 362(c)(3) provides (all emphasis supplied):

> (3) if a single or joint case is filed by or against a debtor who is an individual in a case under chapter 7, 11, or 13, and if a single or joint case of the debtor was pending within the preceding 1-year period but was dismissed, other than a case refiled under a chapter other than chapter 7 after dismissal under section 707(b) —

lower courts have split into two camps regarding the meaning of "with respect to the debtor." "The divergent authority has been attributed to a statute described as, "at best, particularly difficult to parse and, at worst, virtually incoherent."[91] The question is whether § 362(c)(3) terminates the automatic stay (a) only as to property of the debtor (the majority view) or (b) as to *both* property of the debtor *and* property of the estate (the minority view).[92] This chapter discusses the rationale behind the majority and minority views.[93]

(A) the stay under subsection (a) with respect to any action taken with respect to a debt or property securing such debt or with respect to any lease shall terminate with respect to the debtor on the 30th day after the filing of the case;

(B) on the motion of a party in interest for continuation of the automatic stay and upon notice and a hearing, the court may extend the stay in particular cases as to any or all creditors (subject to such conditions or limitations as the court may then impose) after notice and a hearing completed before the expiration of the 30-day period only if the party in interest demonstrates that the filing of the later case is in good faith as to the creditors to be stayed; and

(C) for purposes of subparagraph (B), a case is presumptively filed not in good faith (but such presumption may be rebutted by clear and convincing evidence to the contrary)....

91 *St. Anne's Credit Union v. Ackell,* 490 B.R. 141, 144 n. 1 (D.C. Mass. 2013) (quoting *In re Charles,* 332 B.R. 538, 541 (Bankr. S.D. Tex. 2005)).

92 The Supreme Court recently ducked the question addressed in this chapter — whether § 362(c)(3)(A) terminates the automatic bankruptcy stay as to property of the bankruptcy estate — when it denied *certiorari* in the case that created the circuit-level split. *Rose v. Select Portfolio Serving Corp.*, 945 F.3d 226 (5th Cir. Dec. 10, 2019), *cert denied* June 29, 2020.

93 The issues discussed in this chapter *do not* arise in cases in which the debtor has been a debtor in *more than two* cases pending within a one-year period, a situation to which § 362(c)(4) applies and that unambiguously provides that the automatic stay simply does not go into effect upon the filing of a third case within a 12-month period.

B. The Purpose of § 362(c)(3)(A): To Give Secured Lenders and Landlords a Break by Making Bankruptcy More Complicated for Second-Time Filers

Courts and commentators uniformly agree on the *purpose* of the statute, explained most recently in *In re Thu Thi Dao*:[94]

> The background behind § 362(c)(3) was the abuse perceived in the stratagem of some consumer debtors using repetitive filings of bankruptcy cases to exploit the automatic stay as a delay tactic invoked on the eve of a foreclosure or an eviction without actually intending to complete the bankruptcy process.
>
> Read as a whole, § 362(c)(3) [*sic*], and [in] sub-, subsub-, and subsubsub-sections is a 489-word provision designed to forestall serial filings intended to delay foreclosures or evictions.

94 *In re Thu Thi Dao,* 616 B.R. 103 (Bankr. E.D. Cal. 2020).

C. Section 362(C)(3)(A): The 30-Day Clock Is Ticking, but as to What and to Whom?

Courts analyzing § 362(c)(3)(A) make the following observations:

1. Section 362(c)(3)(A) applies in cases filed under chapters 7, 11 and 13, not simply to cases under chapter 13.

The fact that § 362(c)(3)(A) applies in cases filed under chapters 7, 11 and 13, not simply to cases under chapter 13, is a significant factor in how courts holding the majority view interpret the statute and is ignored by most courts adopting the minority view.[95]

2. Section 362(c)(3)(A) causes the stay to terminate "with respect to the debtor."

The artlessness of the phrase "with respect to the debtor" lies at the heart of the kerfuffle over § 362(c)(3)(A). Courts holding the majority view infer that the statute means "with respect to *property of* the debtor," as opposed to "with respect to *property of* the estate."[96] By contrast, minority-view courts interpret the phrase "with respect to the debtor"

95 *See, e.g., In re Thu Thi Dao, supra* at 106 ("It is puzzling that the debaters, particularly the minority, ignore the chapter 7 implications of the chapter 13 rulings regarding § 362(c)(3). From the chapter 7 perspective, inferentially extending stay termination to property of the estate amounts to throwing the baby out with the bathwater.... [W]hile paying lip service to stricture to attend to the entire statutory text and the broader context of the statute, chapter 13 tunnel vision manifests itself by way of disregard of how § 362(c)(3) applies in chapter 7.").

96 *See, e.g., Rose v. Select Portfolio Servicing Inc.*; US Bancorp. 945 F.3d 226, 230 (5th Cir. 2019) ("[W]e believe the meaning of the provision [in § 362(c)(3)(A)] is clear. Moreover, we are not unsympathetic to other courts' conclusion that a contrary interpretation may better serve the BAPCPA's policy goals. But in a statutory construction case such as this, we begin with the plain language of the statute. When that language is clear, that is where our inquiry ends. Such is the case here." [Internal citations omitted.] *See also In re Holcomb*, 380 B.R. 813, 816 (B.A.P. 10th Cir. 2008) (finding "no ambiguity in the language of the statute"); *In re Williford,* 2013 WL at 3 ("[T]he relevant statutory language is clear."); *In re Rinard*, 451 B.R. 12, 19 ("[T]he plain text of § 362(c)(3)(A) is crystal clear.").

as ambiguous,[97] because a literal, uncontextualized reading would result, after 30 days, in the lifting of the automatic stay protecting merely the debtor, but not as to either the debtor's property or property of the estate.[98]

Minority-view courts find that the limited benefit to secured creditors and landlords arising from either a literal interpretation of the statute (*i.e.,* the stay being lifted as to the debtor only, but not as to *property* of the debtor or as to *property* of the estate) or even the majority view's quasi-textualist interpretation (stay lifted as to debtor and property of the debtor, but not as to property of the estate) yields an absurd result. As explained above, both interpretations appear at odds with congressional intent and the legislative history of the statute.[99]

Minority-view courts note that the majority view does not account for § 362(a)(3)(A)'s first "with respect to" phrase, which would lift the automatic stay after 30 days "with respect to a debt or property securing such debt." Minority-view courts posit that § 362(a)(3)(A)'s "property securing such debt" phrase encompasses a creditor's collateral whether it is property of the estate or property of the debtor, and that it does not support the distinction between the debtor's property and the estate's property, which lies at the heart of the majority view.[100]

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97 *In re Reswick*, 446 B.R. 362, 370 (B.A.P. 9th Cir. 2011) ("[W]hile we recognize the desire to be cautious in designating statutory text as 'ambiguous,' we believe that such a designation is appropriate here. Our interpretation of section 362(c)(3)(A) finds support in legislative history."); *In re Daniel*, 404 B.R. 318, 327 (Bankr. N.D. Ill. 2009) (The concept of terminating the stay "with respect to the debtor" might be ambiguous given the complexity of BAPCPA"); *In re Jupiter,* 344 B.R. 754 (Bankr. D.S.C. 2006) ("[T]his new subsection is imperfectly drafted, may be subject to multiple interpretations, and therefore considered ambiguous.").

98 *In re Smith*, 910 F.3d 576, 582 (1st Cir. 2018) ("Noting that the statute would 'most naturally be read to terminate the stay only for actions against the debtor, and not ... for actions against both debtor and the debtor's property'" and further noting that no court has read the statute in such a way), citing both *In re Daniel*, 404 B.R. 318, 323 (Bankr. N.D. Ill. 2009), and *In re Reswick*, 446 B.R. 362, 370 (B.A.P. 9th Cir. 2011).

99 *See, e.g., In re Smith,* 910 F.3d 576 (1st Cir. 2018); *In re Reswick*, 446 B.R. 362, 370 (B.A.P. 9th Cir. 2011).

100 *In re Smith*, 910 F.3d 576, 582 (1st Cir. 2018).

Minority-view courts emphasize the need to read § 362(C)(3)(A) as a whole,[101] and in doing so, some discover that the phrase "with respect to the debtor" refers to the *repeat filing debtor* in contradistinction to his or her *non-repeat filing co-debtor* spouse.[102] Minority-view courts embracing this distinction point to § 362(c)(3)'s twin references to a "single or joint case," signaling the drafters' awareness of a potential case in which the one of the debtors — the co-debtor — is not a repeat filer. Not all minority-view courts, including the First Circuit, find the debtor/joint-debtor distinction illuminating.[103]

3. Congress knows how to distinguish "property of the debtor" from "property of the estate."

Majority-view courts note that the phrase "property of the estate or of the debtor" in § 362(h) shows that Congress well knows how to distinguish property of the debtor from property of the estate. Such courts point to this language in § 362(h) as further evidence that § 362(c)(3) was *not* intended to give secured creditors and landlords relief from stay as to property of the estate.[104]

101 "A court must consider 'the language itself, the specific context in which that language was used, and the broader context of the statute as a whole." *In re Reswick*, 446 B.R. at 367, citing *Robinson v Shell Oil Co*. 519 U.S. 337, 341, 117 S. Ct. 843, 136 L. Ed. 2d 808 (1997).

102 *See, e.g., In re Reswick*, 446 B.R. 362, 370 (B.A.P. 9th Cir. 2011) ("Rather than reading 'with respect to the debtor as a distinction between *property*, the minority interpretation persuasively reads the phrase as a distinction regarding *persons* in the context of multiple bankruptcy filings. The most plausible and least troublesome reading of 'with respect to the debtor' places its meaning in the context of joint cases filed by a married couple."); *In re Daniel*, 404 B.R. 318, 325-326 (Bankr N.D. Ill. 2009) (Interpreting 'with respect to the debtor' as distinguishing between a debtor and his or her spouse and identifying multiple Bankruptcy Code provisions that clearly distinguish "the debtor" from "the debtor's spouse," including §§ 101(10A), 707(b)(7) and 1325(b)).

103 *In re Smith*, 910 F.3d 576, 582 (1st Cir. 2018) ("We disagree that this introductory phrase requires clarification. Joint bankruptcy petitions are jointly administered but generally keep the rights of the two debtors separate. As a result, even without the addition of 'with respect to the debtor,' it would be clear that § 362(c)(3)(A) is inapplicable to the non-repeat-filing spouse.").

104 *See, e.g., In re Thu Thai Dao, supra* at *13 ("Congress well knew how to terminate the automatic stay with respect to property of the estate, and actually did so in plain language at § 362(h), which was enacted as part of the same Act of Congress that enact-

Courts holding the minority view ignore § 362(h), which they reason would be irrelevant if § 362(c)(3)(A)'s "with respect to the debtor" is read to distinguish a repeat filing debtor from his or her non-repeat filing co-debtor spouse.[105]

4. Section 362(c)(3)(B)'s 30-day time limit is practically impossible for creditors and trustees to meet.

Section 362(c)(3)(B) requires the hearing on a motion seeking to keep the stay in place to be *completed* before the 30th day after the case is filed. Majority-view courts note that § 362(c)(3)(B)'s highly compressed time frame is virtually impossible for a chapter 7 trustee or a creditor to meet if § 362(c)(3)(A) were interpreted as causing the automatic stay to expire as to property of the estate.[106]

At least one court has noted that the issue is just as relevant in chapter 11 and chapter 13 cases, because such cases are often converted to chapter 7 cases and trustees can be appointed in chapter 11 cases.[107] Therefore, limiting the application of the minority view to chapter 13 cases does not resolve the issue.

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ed § 362(c)(3).... The asymmetry between § 362(c)(3) and § 362(h) further confirms that Congress did not intend to in the phrase 'with respect to the debtor' to sweep in the estate and property of the estate.").

105 *See, e.g., In re Reswick*, 446 B.R. at 369 ("The better reading interprets section 362(c)(3)(A) as distinguishing between the debtor and a joint filing spouse."); *In re Daniel*, 404 B.R. 318 Bankr. N.D. Ill. 2009); *In re Jupiter,* 344 B.R. 754, 759 (Bankr. D.S.C. 2006); *In re Parker,* 336 B.R. 678, 680-81 (Bankr. S.D.N.Y. 2006).

106 *See, e.g., In re Thu Thai Dao, supra* at *9 ("Those who contend that the stay protecting property of the state evaporates on day 31 of a chapter 7 case do not explain how a chapter 7 trustee can be expected to meet the § 362(c)(3)(B) deadline before the meeting of creditors is held. The reality is that the timing is impossibly contradictory.").

107 *See, e.g., In re Thu Thai Dao, supra* at *12 ("Is there a way to harmonize the chapter 13 minority view with chapter 7? Not really.... A basic problem is that a firm boundary between chapter 7 and chapters 11 and 12 cannot be drawn. Every chapter 7 and 13 case has the potential to be converted to chapter 7 by court order.... If the stay has previously been terminated under § 362(c)(3) with respect to property of the estate, then the trustee would still have been shorn of a key tool going forward.").

For their part, minority-view courts, which to date have encountered § 362(c)(3) only in the context of chapter 13 cases, do not address § 362(c)(3)'s potential impact in chapter 7 or 11 cases.

D. Section 362(c)(3)(C) Heightened Standard of Proof Is an Undue Burden on Creditors and Trustees

To extend the automatic stay, majority-view courts note that § 362(c)(3)(C) requires chapter 7 trustees to prove by *clear and convincing* evidence that the debtor(s) filed their case in good faith, even in voluntary cases in which the *debtors'* good faith or bad faith is not obviously relevant to whether their *creditors* should benefit from the automatic stay. Majority-view courts see the minority view as implausible, indeed absurd, because they believe that Congress could not have intended to place on blameless *trustees* a heightened burden of proof as to the *debtor's* reason for filing the case.[108]

By contrast, minority-view courts point to § 362(c)(4), which prevents the automatic stay from going into effect *at all* upon a third filing within 12 months, unless and until a party-in-interest convinces the court to impose the stay within the first 30 days of the case.[109] In other

108 *See, e.g., In re Thu Thi Dao, supra* at 105 ("The § 362(c)(3)(C) burden of proof for request to preserve the stay is impossible for a chapter 7 trustee to satisfy.... How is a chapter 7 trustee at the outset of a case in a position to assess the good faith of the debtor? If the trustee's suspicions about unscheduled property turn out to be correct, there will be substantial grounds to question the debtor's good faith. So what? Regardless of the debtor's good or bad faith, it is still a chapter 7 case with property of the estate controlled by a trustee who has a duty to collect and reduce to money the property of the estate.... There is a canon against construing a statute to achieve absurd results. Extending "against [*sic*] the debtor" in § 362(c)(3) to encompass the chapter 7 trustee's interest in 'property of the estate' is Exhibit A for absurdity.").

109 *See, e.g., In re Reswick*, 446 B.R. at 371-372, citing *In re Nelson*, 391 B.R. 437, 452 (B.A.P. 9th Cir.) (noting that § 362(c)(4) does not differentiate among protecting the

words, minority-view courts read § 362(c) as Congress giving ammunition to secured creditors and landlords in their wars against abusive debtors, and, as evidenced by § 362(c)(4), Congress had few qualms about prioritizing the very real interests of frustrated secured creditors and landlords over the hypothetical interests of unsecured creditors.[110]

E. The Majority View: "With Respect to the Debtor" Sort of Kind of Means What It Says, and if Congress Had Meant Otherwise, It Would Have Said So

In *Rose v. Select Portfolio Serving*,[111] the Fifth Circuit became the first *circuit*-level court to reject the minority view in general and the First Circuit's reasoning in *Smith* in particular.[112]

debtor, property of the debtor or property of the estate and thus there is no need to make such a distinction, and further highlighting, "Clearly, Congress could, and did, intend the consequences of repeat filing to be different, and potentially more severe, as the number of successive filings increase").

110 The landlord's and secured creditors' interests are "real" in the sense that such creditors *must always exist* in a given case for § 362(c) to come into play. By contrast, § 362(c)'s impact on unsecured creditors is merely "hypothetical" because there is no reason to presume that, in any given case, a secured creditor's collateral or a debtor's lease would, if sold by a trustee or debtor in possession, result in a benefit to the estate.

111 945 F.3d 226 (5th Cir. Dec. 10, 2019).

112 The facts in *Rose* were unusual in that the *secured creditor* (not the trustee or unsecured creditors) was advocating for the proposition that § 362(c)(3)(A) applies narrowly to property of the debtor because, if it also applied to property of the estate, the secured creditor's post-bankruptcy judicial foreclosure action would have been time-barred under Texas law.

The *Rose* court found that § 362(c)(3)(A) is unambiguous and that interpreting the statute according to its plain meaning does not yield absurd results.[113] The *Rose* court, pointing to § 362(h)(1), observed that Congress knows how to say "property of the estate" when it intends to do so, that it purposefully chose the words "with respect to the debtor" to exclude property of the estate, and that the only way to give effect to those words is to hold that, after 30 days, § 362(c)(3)(A) causes the automatic stay to terminate only as to property of the *debtor* and not as to property of the *estate*.[114]

Six months after the Fifth Circuit parted company with the First Circuit, Judge Christopher Klein in *In re Thu Thi Dao*, *supra*, brushed aside both *Smith* and the Ninth Circuit BAP's nuanced and impactful *Reswick v. Reswick*[115] decision and laid out the most comprehensive and passionate exposition of the majority view to date. Here, Judge Klein set the scene in the case before him:

> The chapter 7 trustee ... fearing *Reswick*, asks this court to assure the automatic stay continues unabated. He believes unscheduled assets exist that need protection.[116]

Judge Klein then set the bar for correctly interpreting the statute:

> Convincing analysis of § 362(c)(3) would also explain why Congress chose not to use in § 362(c)(3) the lan-

113 *Rose*, 945 F.3d 226, 231 ("[W]e are not convinced that this plain meaning interpretation substantially harms creditors ... even if the automatic stay remains in effect with respect to the bankruptcy estate — as is the case under our interpretation of § 362(c)(3)(A) — creditors can still obtain judicial relief under § 362(d) if the circumstances demand it.") (Internal citations omitted.).

114 *Rose*, 945 F.3d 226, 231 ("Congress knew how to terminate the entire stay, and in fact did so in the very next section of the statute."), citing *In re Williford, supra* at *3.

115 *In re Reswick*, 446 B.R. 362 (B.A.P. 9th Cir. 2011).

116 *In re Thu Thi Dao, supra* at 93.

> guage it used in the same Act of Congress in the parallel provision at § 362(h) expressly terminating the stay protecting secured personal property of the estate in specified circumstances in a manner that meshed perfectly with § 362(c)(1): "the stay provided by subsection (a) is terminated with respect to personal property of the estate or of the debtor securing in whole or in part a claim ... and such personal property shall no longer be property of the estate." 11 U.S.C. § 362(h)(1).[117]

In considering § 362(c)(3), Judge Klein identified three alternatives:

> The first possibility is that the drafters of § 362(c)(3) were mindful of the separate stay duration status for "property of the estate" under § 362(c)(1) and the rights of a chapter 7 trustee and, by using the phrase "terminate with respect to the debtor," were referring only to stay duration regarding the debtor under § 362(c)(2), while taking care to preserve the stay with respect to the trustee's interest in property of the estate.
>
> The second possibility is that Congress intended to strip chapter 7 trustees of automatic stay protection for property of the estate but chose not to say anything about it.
>
> The third alternative is that Congress gave no thought to the issue of the trustee's rights in property of the estate.[118]

Judge Klein omitted any reference to a fourth plausible interpretation identified (and rejected) by the minority-view courts —

117 *Id.* at 4.

118 *In re Thu Thi Dao* at *5-6.

that Congress intended "with respect to the debtor" to mean only the debtor and not property of either the debtor or the estate.[119]

Underlying Judge Klein's analysis was (1) his awareness that, especially in chapter 7 cases, the automatic stay exists to protect unsecured creditors through a trustee and (2) his conviction that if Congress had intended to deprive them of that protection, it would have said so explicitly:

> The importance of property of the estate to chapter 7 cases warrants emphasis ... [that a] crucial tool in the chapter 7 trustee's toolbox is the automatic stay.... It would be extraordinary for Congress to have eviscerated this fundamental protection for property of the estate without so much as an explanatory comment.... An essential tool for chapter 7 trustees in performance of their duties is not likely to have been stripped away merely because the debtor earlier filed a case that was not completed. Yet, that is the gravamen of what the minority in the § 362(c)(3) debate contends when it says that the stay terminates with respect to property of the estate in chapter 7 cases. And it does so with zero analysis of how the chapter 7 trustee fits in.[120]

Judge Klein criticized the minority view courts for reading § 362(c)(3) through a chapter 13 lens:

> A review of how § 362(c)(3) would apply in chapter 7 exposes the absurdity of extending § 362(c)(3) to property of the estate. Nor is the inclusion of chapter 7 in § 362(c)(3) a side show; rather, chapter 7, which comprises 60% of all

119 *See* n.12, *supra*.

120 *In re Thu Thi Dao* at *7.

> bankruptcy filings, is the main event. It is chapter 13 decisions that amount to the tail wagging the dog.[121]

Typical of courts adopting the majority view, Judge Klein concluded:

> The phrase "shall terminate with respect to the debtor" in § 362(c)(3) cannot be construed by inference to extend to "with respect to the estate and property of the estate" because the consequences in chapter 7, to which § 362(c)(3) also applies, are so far at odds with basic chapter 7 administration that Congress would not have intended such dramatic consequences without unambiguous explanation.[122]

F. The Minority View: The Statute Is Ambiguous, So Let's Look at Congressional Intent Through the Tea Leaves of Legislative History

In re Smith, like *In re Resnick* and the other minority view cases, interprets § 362(c)(3) in the context of a chapter 13. After finding that "the parties' ... textual arguments do not resolve the issue," the *Smith* panel turns to the statute's "context and congressional purpose," ultimately "decid[ing] that [the minority

121 *Id.* at 3 (Citing 2019 Annual Report of U.S. Court, Table-F-2).

122 *In re Thu Thi Dao* at *10.

view] is the only one compatible with the text, seen in light of its context and purpose."[123]

The *In re Smith* panel noted that "Congress, concerned about abuses of the automatic stay, altered the stay's applicability to repeat-filing debtors like Smith in BAPCPA"[124] and, after finding the statute to be unclear and the customary canons of construction unhelpful, zeroed in on congressional intent:

> [W]e do not think that legislative purpose and history should be disregarded in interpreting § 362(c)(3)(A).... BAPCPA aimed "to correct perceived abuses of the bankruptcy system...." At the heart of [BAPCPA's] consumer bankruptcy reforms ... were provisions intended to deter serial and abusive bankruptcy filings. Among these reforms was § 362(c)(3)(A). Congress described that provision as an amendment to section 362(c) of the Bankruptcy Code to terminate the automatic stay within 30 days in a chapter 7, 11, or 13 case filed by or against an individual if such individual was a debtor in a previously dismissed case pending within the preceding one-year period.[125]

Rarely does a court go to the legislative history behind the legislative history to discern congressional intent when reading a statute, but *Smith* appears to do just that. After examining the legislative history of the 2005 BAPCPA, the *Smith* panel dug into BAPCPA's precursor legislation and noted:

> In 1998, Congress attempted reform of the Bankruptcy Code, including an amendment that was "essentially

123 *In re Smith*, 910 F.3d 576 (1st Cir. 2018).

124 *Ibid.*

125 *In re Smith*, 910 F.3d at 589-90 (internal quotations and citations omitted).

> identical" to § 362(c)(3)(A); even though that legislation was vetoed, we look to its purposes, given the uniformity of its language with the language of the provision at issue.[126]

The *Smith* panel intuited that the 1998 amendment was animated by the same concerns as BAPCPA and observes the proposed 1998 amendment was "substantially identical" to § 362(c)(3)(A). The *Smith* panel concluded that "Congress simply imported the language from the 1998 proposal into § 362(c)(3)(A)," and goes on to find that "[b]ased on the provision's text, the statutory context, and Congress's intent in enacting BAPCPA," the minority view was the correct view and holds that "§ 362(c)(3)(A) terminates the entire automatic stay — as to actions against the debtor, the debtor's property, and property of the bankruptcy estate — after 30 days."[127]

G. Conclusion

Section 362(c)(3) is the stuff of law school exams. There are good statutory interpretation and policy arguments to be made all around, but only half of them will win. Until Congress clarifies the statute or the Supreme Court weighs in, "with respect to the debtor" in § 362(c)(3) means "with respect to the debtor and property of the debtor" in the Fifth Circuit and "with respect to property of the debtor, debtor's property, the estate and the estate's property" in the First Circuit. It is a coin toss everywhere else.

126 *Ibid.* (internal quotations and citations omitted).

127 *Id.* at 591.

In every circuit save the First Circuit, a secured creditor seeking to foreclose on its collateral should seek either a traditional relief-from-stay order under § 362(d) or a "comfort order" under § 362(j). Similarly, trustees, unsecured creditors and debtors concerned that valuable property will be lost as a result of § 362(c)(3)(A) should move quickly under § 362(c)(3)(B) on an *ex parte* basis or seek to shorten time for an order seeking a continuation of the automatic stay.

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Problems in the Code

By Donald L. Swanson

Involuntary Bankruptcy: BAPCPA Amendment to § 303(b) Needs to Be Revoked

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Filing an involuntary bankruptcy petition as a petitioning creditor is a precarious action. The risks involved are intense, including potential liability for the debtor's costs, attorneys' fees, actual damages and punitive damages.[1] To qualify as an involuntary bankruptcy petitioner, under 11 U.S.C. § 303(b) a creditor's claim must not be subject to a "*bona fide* dispute."

Before 2005, a creditor could be disqualified under the *bona fide* dispute standard only if its entire claim was disputed: "To eliminate a creditor as an eligible petitioning creditor, the *bona fide* dispute must go to the entire claim. A *bona fide* dispute as to a portion of the petitioning creditor's claim does not disqualify that creditor from filing an involuntary case."[2]

This "entire claim" disqualification standard was difficult and threatening enough for petitioning creditors. However, in 2005, the standard got even tougher. Since 2005, a creditor is now ineligible to be an involuntary petitioner if *any portion of the creditor's claim* is disputed. A November 2023 bankruptcy opinion explained the post-2005 rule: "[A] dispute as to any portion of a claim, even if some dollar amount would be left undisputed, means there is a *bona fide* dispute," and the creditor is ineligible to be a petitioning creditor under § 303(b).[3] The 2005 change occurred by the addition of five words to § 303(b)(1) (emphasis added):

> (b) An involuntary case against a person is commenced by the filing with the bankruptcy court of a petition under chapter 7 or 11 of this title — (1) by three or more entities, each of which is either a holder of a claim against such person that is not contingent as to liability or the subject of a *bona fide* dispute *as to liability or amount*....

This addition occurred as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). The design behind BAPCPA has been described as (1) "to deter people from pursuing bankruptcy by making filing for it more difficult and expensive, as well as less financially advantageous";[4] and (2) "to make filing for bankruptcy more difficult, more expensive and less financially advantageous for households."[5] BAPCPA's enactment succeeded in its purpose: A million fewer consumer bankruptcy filings occurred in the two years following BAPCPA than what would have otherwise been expected.[6] Consistent with the intention to reduce the number of bankruptcy filings, those five words were added to § 303(b) to make petitioning-creditor eligibility more difficult to achieve.

The addition of those five words created both an irony and a tension. On the one hand, involuntary bankruptcy is an effective creditor tool for addressing a debtor's existing and potential financial abuses (such as avoiding insider preferences and fraudulent transfers), as well as gaining bankruptcy protections (such as disclosure requirements),

1 11 U.S.C. § 303(i).
2 *Collier on Bankruptcy*, Vol. 2, ¶ 303.03[2][b][iii], at 303-24 & 25 (15th ed.).
3 *In re Azteca, S.A.B. de C.V., et al.*, Case No. 23-10385, (Bankr. S.D.N.Y. Nov. 20, 2023), 2023 Bankr. LEXIS 2786.
4 Matthew Notowidigdo, "Assessing the Bankruptcy Law of 2005," Inst. for Policy Research, Northwestern Univ. (Dec. 16, 2019), *available at* ipr.northwestern.edu/news/2019/assessing-the-bankruptcy-law-of-2005.html (last visited July 23, 2024).
5 Steve Maas, "Bankruptcy Reform of 2005 Sharply Reduced Filings," *The Digest*, published by Nat'l Bureau of Econ. Research (Dec. 1, 2019).
6 *Id.*

but on the other hand, BAPCPA views the very act of filing an involuntary bankruptcy petition as a potential abuse that might need to be prevented. It is fair to suggest that Congress, in its desire to decrease the number of bankruptcy filings through BAPCPA, may have overreacted and made involuntary petitioning creditor eligibility excessively stringent. For example, consider this vendor hypothetical under existing § 303(b)(1) language.

A vendor sells 100 items of its product to the debtor, and payment is now long past due. The vendor learns that the debtor is transferring assets to insiders without fair consideration, so the vendor accepts the invitation of two other creditors to join in an involuntary bankruptcy petition against the debtor.

Once the petition has been filed, the debtor argues that one of the vendor's 100 product items was defective — and therefore the vendor's claim is a *bona fide* dispute for § 303(b)(1) purposes. In response, the vendor could presumably waive its claim as to the allegedly defective item, amend the petition accordingly and still proceed.

Suppose that the debtor instead alleges that 90 of the vendor's 100 items are defective. The vendor feels sure that the defectiveness claim is without merit and does not want to waive its claim to the 90 items, but the vendor also does not want to run the risk of a trial. In this scenario, the vendor may effectively be left without the ability to file an involuntary bankruptcy under § 303(b)(1) as it currently exists, which appears to portray a problem without a viable solution.

Purpose and History of § 303(b)

The purpose and history of § 303(b) shed light on this present situation.[7] The purpose of involuntary bankruptcy is to provide a method for creditors to protect their rights against debtors who are not meeting their debts.[8] Bankruptcy in general, and § 303 in particular, encourage group action by creditors and discourage a "race to the courthouse" by individual creditors for their separate benefit.[9] The Bankruptcy Code's initial version of § 303(b) did not contain a "*bona fide* dispute" limitation on creditor eligibility; the only such limitation was that the creditor's claim not be "contingent as to liability." Yet, even under that initial version, courts disagreed on whether a disputed claim would qualify as a basis for a petitioning creditor's eligibility.[10]

Congress then enacted the Bankruptcy Amendments and Federal Judgeship Act of 1984 (BAFJA) in response to the U.S. Supreme Court's 1982 *Northern Pipeline Construction Co v. Marathon Pipe Line Co.* decision.[11] The BAFJA added the "*bona fide* dispute" eligibility requirement to § 303(b)(1).[12] The legislative record for the "*bona fide* dispute" addition includes this explanation from Sen. Max Baucus (D-Mont.) about its purpose:

> Some courts have interpreted section 303's language ... as allowing the filing of involuntary petitions and the granting of involuntary relief even when the debtor's reason for not paying is a legitimate and good-faith dispute over his or her liability. This interpretation allows creditors to use the Bankruptcy Code as a club against debtors who have *bona fide* questions about their liability, but who would rather pay up than suffer the stigma of involuntary bankruptcy proceedings.
>
> My amendment would correct this problem. Under my amendment, the original filing of an involuntary petition could not be based on debts that are the subject of a good-faith dispute between the debtor and his or her creditors.[13]

Immediately following Sen. Baucus's statement, the Senate adopted his "*bona fide* dispute" amendment to § 303(b)(1).[14] President Ronald Reagan said in his statement at signing the BAFJA into law, "The bill ... remedies abuses by both debtors and creditors in consumer bankruptcy proceedings." The BAFJA's legislative history reflects that the primary purpose of § 303(b)(1)'s "*bona fide* dispute" requirement for creditor eligibility is to protect debtors from coercive creditors.[15]

Few Involuntary Cases

The incidence of involuntary bankruptcy filings is, actually, very low.[16] Bankruptcy began in 16th century England as an entirely involuntary procedure: Creditors initiated a bankruptcy proceeding by filing a complaint against their debtor. Debtors could not file for bankruptcy voluntarily in England or the U.S. until the mid-1800s, and American corporations could not file voluntarily until 1910.

Despite the late emergence of voluntary bankruptcy, it has come to utterly dominate modern American bankruptcy practice — at the expense of the involuntary process.[17] Today, involuntary bankruptcy plays almost no role in real-world practice except, perhaps, as an action available to creditors that they may threaten, but almost never exercise.[18] A 2020 study of involuntary bankruptcy filings from 2007-17 provides the following data:

Total Bankruptcy Petitions: 11,244,521
Total Involuntary Petitions: 5,512
Involuntary Petition Percentage: 0.05 percent.[19]

When the data focuses exclusively on bankruptcies with business debts, the numbers are dramatically less, but

7 *See generally* Steven J. Winkelman, "A Dispute over Bona Fide Disputes in Involuntary Bankruptcy Proceedings," *Univ. of Chicago Law Review*, Vol. 81: Issue 3, Article 10 (2014).
8 *Id.* at 1344 (citing *In re All Media Props. Inc.*, 5 Bankr. 126, 137 (Bankr. S.D. Tex. 1980); *In re Apache Trading Grp. Inc.*, 229 Bankr. 891, 894 (Bankr. S.D. Fla. 1999)).
9 *Id.* at 1344-45 (citing *Coral Petroleum Inc. v. Banque Paribas-London*, 797 F.2d 1351, 1355 (5th Cir. 1986), quoting Bankruptcy Law Revision, H.R. Rep No. 95-595, 95th Cong, 1st Sess. 177 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138).
10 *Id.* at 1345-46, *see* fns.21-25.
11 458 U.S. 50 (1982).
12 *Id.* at 1347.
13 *Id.* at 1347-48.
14 *Id.* at 1348.
15 *Id.*
16 *See* Richard M. Hynes & Steven D. Walt, "Revitalizing Involuntary Bankruptcy," 105 *Iowa Law Review* 1127, at 1150-61 (2020).
17 *Id.* at 1128 (citing Max Radin, "The Nature of Bankruptcy", 89 *U. Pa. L. Rev.* 1, 3-4 (1940); Louis Edward Levinthal, "The Early History of English Bankruptcy," 67 *U. Pa. L. Rev.* 1, 14-15 (1919); W.J. Jones, "The Foundations of English Bankruptcy: Statutes and Commissions in the Early Modern Period," 69 *Transactions Am. Phil. Soc'y*, No. 3 (July 1979), at 25; John C. McCoid II, "The Origins of Voluntary Bankruptcy," 5 Bankr. Dev. J. 361, 361 n.4-5 (1988); Garrard Glenn, "The Law Governing Liquidation: As Pertaining to Corporations, Partnerships, Individuals, Decedents, Bankruptcy, Receivership, Reorganization," 136-40, 310 (1935)).
18 *Id.* at 1132.
19 *Id.* at 1152.

the percentage of involuntary cases is still less than half of 1 percent:

> Bankruptcy Petitions with Business Debts: 238,906
> Involuntary Petitions with Business Debts: 1,016
> Involuntary Petition Percentage: 0.43 percent.[20]

The same study also reported that many of the involuntary bankruptcies filed from 2007-17 were filed by petitioners acting *pro se*. It is no surprise that an "overwhelming majority" of *pro se* involuntary cases are dismissed.[21] Thus, the study made this recommendation for improving involuntary bankruptcy law: "[A]n involuntary petition filed without an attorney's signature should not be placed on the court's docket or reported to credit bureaus and should not trigger the automatic stay. In short, bankruptcy law should ban *pro se* involuntary petitions."[22] Based on this evidence, it is hard to understand how Congress could conclude that involuntary bankruptcy filings are out of control and need to be limited, except for involuntary cases filed by *pro se* petitioners.

Involuntary Bankruptcies Should Be Encouraged?

Moreover, the same study also argued that involuntary bankruptcy cases are not only a good thing ... they should be encouraged! Here is the argument:

> Evidence from both theory and practice suggests that the demise of involuntary bankruptcy has had significant social costs.... This Article [provides] a comprehensive study of the previously vibrant practice of involuntary bankruptcy. Crucially, we find that early twentieth-century bankruptcy practice provided *de facto* incentives for involuntary petitions by rewarding filing attorneys with lucrative post-petition work. Such rewards helped overcome the collective-action problems that otherwise discourage creditors from filing.
>
> The law of involuntary bankruptcy should look back to that past to find its future. We propose a number of reforms, including instituting a system of *de jure* "bankruptcy bounties" to encourage involuntary petitions that will revitalize involuntary bankruptcy and restore its rightful place in the law and theory of bankruptcy.[23]

These views are at great variance with the supposed purpose of BAPCPA of tightening up eligibility for filing an involuntary bankruptcy petition as a way to prevent abuse.

Solution

There is an important difference between being coerced by a creditor whose entire claim is in *bona fide* dispute vs. being placed into involuntary bankruptcy by a creditor with a completely or mostly undisputed claim (even when a portion is disputed). In managing the tension between limiting the number of bankruptcy filings and providing an involuntary bankruptcy tool for creditors, BAPCPA's five-word addition to § 303(b)(1), "as to liability or amount," should simply be removed from that Bankruptcy Code provision. abi

20 *Id.*
21 *Id.* at 1132.
22 *Id.*
23 *Id.* at 1127.

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HISTORY AND IMPACT OF THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005 (BAPCPA)

By Megan Friner[*]

HISTORY

The United States Congress considered bankruptcy reform for almost a decade before George W. Bush finally signed the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA" or "the Act") into law on April 20, 2005.[1] This legislation marked the most significant overhaul of the Bankruptcy Code since its enactment in 1978.[2] Driven by banks and credit card companies' heavy lobbying efforts, the legislation reflected a growing perception that individuals were exploiting the bankruptcy system to discharge debts they could afford to repay.[3]

At its core, the Act sought to shrink "unnecessary" filings by making it more difficult for individuals to take advantage of the relatively quick debt discharge available under Chapter 7 of the Bankruptcy Code.[4] Chapter 7 individual debtors generally can extinguish most prepetition debt by turning over their non-exempt assets to the bankruptcy trustee for liquidation to repay creditors.[5] Instead, the Act attempted to steer most individual filers toward Chapter 13 repayment plans.[6] The Chapter 13 plan process allows individual debtors to keep more of their non-exempt assets by repaying their creditors from future income under a court-approved repayment plan.[7] Creditors tend to prefer these plans, as they enable creditors to recover a greater portion of what they are owed over time.[8] However, debtors must remain in bankruptcy for the three- to five-year plan

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[1] Elizabeth L. Morgan, *Asset Protection: Dead or Alive Under The Bankruptcy Abuse Prevention And Consumer Protection Act Of 2005?*, https://www.emalegal.com/wp-content/uploads/2018/09/Asset-Protection-Dead-or-Alive-Under-the-Bankruptcy-Abuse-Prevention-Consumer-Protection-Act-of-2005.pdf, (last accessed Mar. 28, 2025).

[2] Rachel Ruser, *Analysis of The Bankruptcy Abuse Prevention and Consumer Protection Act Of 2005 (BAPCPA)*, 2 SPNA REV. 86, 86 (2006).

[3] Robert H. Scott, III, *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: How the Credit Card Industry's Perseverance Paid Off*, 41 J. ECON. ISSUES 943, 945 (2007). To be fair, these concerns did not arise out of thin air. As one author noted:

> Statistical data supported the argument for reform. During the decade preceding enactment of the legislation, bankruptcy filings increased seventy percent. More than 1.6 million bankruptcy petitions were reportedly filed by consumer debtors in 2004, and debts discharged in bankruptcy were estimated to total tens of billions of dollars every year. To illustrate the cost, Senator Hatch reported on the congressional floor that the amount was sufficient to fund thirteen million Pell grants or the entire United States Department of Transportation for one year.

Margaret Romero, Comment, *Killing with Kindness: The Myth of "Consumer Protection" in the Bankruptcy Abuse and Consumer Protection Act of 2005*, UNM SCHOOL OF LAW (2006), https://digitalrepository.unm.edu/law_studentscholarship/48.

[4] Matthew Mazewski, Good, but Not Good Enough: Biden, Warren & Bankruptcy Reform, COMMONWEAL MAGAZINE (Mar. 23, 2020), https://www.commonwealmagazine.org/good-not-good-enough. *See also* Christian E. Weller, et al., *Desperate vs. Deadbeat: Can We Quantify the Effect of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005?* 1 (Pol. Econ. Rsch. Inst. at Univ. Mass. Amherst, Working Paper No. 185).

[5] Mazewski, *supra* note 4.

[6] *Id.*

[7] *Id.*

[8] *Id.*

repayment period (referred to as the commitment period) and possibly receive fewer economic benefits.[9]

At the time of its passage, creditors and consumer advocates disagreed about how BAPCPA would impact consumers.[10] Supporters of the Act claimed the law would limit Chapter 7 relief to those in genuine financial need.[11] They argued that this in turn would protect consumers from the effects of bad actors who abused the system by filing frivolous bankruptcies despite their full capability of repaying their debts.[12] Conversely, consumer advocates strongly opposed the Act, arguing that the proposed reforms would raise costs and place hurdles in the way of debtors in dire need of relief.[13]

IMPACT

1. Structural Transformation of Consumer Bankruptcy Access

BAPCPA fundamentally reshaped consumer access to bankruptcy relief on several fronts.

First, the Act instituted a means test for determining whether a consumer is eligible for bankruptcy relief under Chapter 7, 13, or 11 of the Bankruptcy Code.[14] According to the U.S. Government Accountability Office (GAO), satisfying the means test "requires completing a lengthy form that includes various calculations of the debtor's income and expenses."[15] The means test also resulted in more filers being required to proceed under Chapter 13 plans.[16] As suggested above, Chapter 13 may be difficult for debtors to navigate. For example, Chapter 13 debtors' circumstances may change during the commitment period, making it harder for such debtors to complete their plan payments and receive their discharge.[17] Second, the Act increased the cost of consumer bankruptcy cases.[18] The complexities introduced by the Act are "widely believed" to have impacted the fees bankruptcy attorneys charge consumers for their cases.[19] Finally, the Act imposed additional procedures on consumers by requiring them to receive approved credit counseling before filing a petition for relief and to take an approved debtor education course before

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[9] *Weller*, *supra* note 4.
[10] *Id.*
[11] *Id.*
[12] *Romero*, *supra* note 4 at 4. The idea being that discharged debts imposed a "hidden tax" on consumers through higher prices and interest rates. *Bankruptcy Revision: Hearing Before the S. Comm. on the Judiciary, 109th Congress* (Feb 10, 2005) (statement of Professor Todd J. Zywicki, Visiting Professor of Law, Georgetown University Law Center, "Like other business expenses, when creditors are unable to collect debts because of bankruptcy, some of those losses are inevitably passed on to responsible Americans who live up to their financial obligations. Every phone bill, electric bill, mortgage, furniture purchase, medical bill, and car loan contains an implicit bankruptcy 'tax' that the rest of us pay to subsidize those who do not pay their bills.").
[13] Robert M. Lawless et al., *Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors*, 82 AM. BANKR. L.J. 349, 362 n.53 (2008).
[14] U.S. Gov't Accountability Off., GA0-08-697, *Bankruptcy Reform: Dollar Costs Associated with the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, at 1 (2008).
[15] *Id.* at 21.
[16] *Weller*, *supra* note 4.
[17] *Id.*
[18] *Bankruptcy Reform*, *supra* note 14.
[19] *Id.*

their debts could be discharged.[20] In sum, these changes resulted in higher filing costs for debtors,[21] fewer canceled consumer debts,[22] and "significantly more" legal work to meet BAPCPA's requirements.[23]

2. Falling U.S. Bankruptcy Rates[24] and Who Benefited

The U.S. bankruptcy filing rate fell sharply after BAPCPA went into effect in late 2005.[25] Economists estimate that the Act cut the rate of household bankruptcy filings in half.[26] Specifically, there were roughly one million fewer filings in the two years following BAPCPA than otherwise would have occurred under the old system.[27] Yet, these decreases were not as targeted as BAPCPA's proponents had intended.[28] Though rates fell overall, there was not a stark change in the income composition of filers as economists would have expected.[29] Had BAPCPA deterred high-income filers as planned, there would have been a downward shift in the average incomes of filers.[30] Economists observed, however, that average incomes seemed to rise slightly following the reform.[31] In sum, individuals at middle- and lower-income levels were deterred from filing for bankruptcy, rather than higher-income individuals who arguably sought to declare bankruptcy unnecessarily solely to avoid repaying their consumer debt.[32]

Even so, as proponents of BAPCPA expected, the drop in bankruptcy rates appears to have resulted in lower interest rates for consumers.[33] One group of researchers found that "a one percentage point decline in bankruptcy filing risk within a credit-score segment decreases average interest rates by 67 basis points."[34] In layman's terms, such estimates suggest that after the Act's passage, credit card companies passed along a portion of their savings from reduced bankruptcy write-offs to consumers through lower interest rates.[35]

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[20] *Id.*
[21] Richard M. Hynes & Nathaniel Pattison, *A Modern Poor Debtor's Oath*, 108 VA. L. REV. ASSOC. 915, 930 (2022).
[22] *Weller*, *supra* note 4.
[23] *Bankruptcy Reform*, *supra* note 14.
[24] The U.S. bankruptcy rate reflects the total number of Chapter 7 and Chapter 13 filings across all 50 states, the District of Columbia, Guam, the Northern Mariana Islands, Puerto Rico, and the Virgin Islands in a given quarter, relative to the number of households. The ratio is then annualized. *Weller*, *supra* note 4 at 3.
[25] *Id.*
[26] Tal Gross et al., *The Economic Consequences of Bankruptcy Reform* 2 (Becker Friedman Inst. Econ. at Univ. Chi., Working Paper No. 2020-164).
[27] *Id.*
[28] *Id.* at 27 ("A key goal of bankruptcy reform was to deter high-income filers from accessing bankruptcy relief 'opportunistically;' lawmakers referenced the income-based means test as the 'heart of the bill' . . . By excluding households with income above the state median from the option to liquidate their debts, the law intended to target the bankruptcy code's most-generous provisions to lower-income filers." (citations omitted)).
[29] *Id.* at 28–29.
[30] *Id.*
[31] *Id.*
[32] *Id.*
[33] *Id.* at 2.
[34] *Id.*
[35] *Id.*

It is worth noting, however, that the post-reform bankruptcy rates did not remain stable.[36] Despite BAPCPA, bankruptcy rates began to climb again as the U.S. economy entered the Great Recession, with total filings reaching a high of nearly 1.6 million in September 2010.[37] As the economy recovered, so too did consumers' finances.[38] Bankruptcy rates steadily dropped over the next decade, reaching a low of approximately 288,000 filings in 2021 (in large part due to the COVID-19 pandemic and related economic polices).[39] Since then, filings have begun to inch upward again.[40] Despite the recent rise, total filings remain far below the peaks reached during the high-bankruptcy decades of the 1980s and 1990s, as well as the surge that followed the Great Recession. [41]

3. What was Gained, and What was Not

Nearly two decades later, BAPCPA remains a case study in the difficulty of balancing competing interests in bankruptcy policy.[42]

Creditors achieved many of their goals, including fewer Chapter 7 discharges and lower interest rates.[43] Yet, many industry stakeholders still argue the law did not go far enough.[44] Some Chapter 13 debtors remain unable to complete their plan payments, and bankruptcy judges retain discretion that limits uniform outcomes.[45] While the law helped increase the likelihood that creditors would get paid by reducing the number of immediate Chapter 7 discharges, it did not guarantee a certain percentage recovery or actual distributions to those creditors.[46]

For individuals navigating financial distress, BAPCPA's impact was more acute.[47] As discussed above, in practice, the Act reduced filings by increasing barriers on all individuals—not just for those looking to game the system.[48] Congress designed the Act to reduce strategic filings, but in practice, it also swept in those involving individuals with little financial flexibility.[49] One area of particular concern has been medical debt.[50] Researchers have found that following an uninsured hospitalization, the likelihood of filing for bankruptcy dropped by 70% after BAPCPA

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[36] Bankruptcy Filings Rise 14.2 Percent, UNITED STATES COURTS (Feb. 4, 2025), https://www.uscourts.gov/data-news/judiciary-news/2025/02/04/bankruptcy-filings-rise-14-2-percent.
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] Richard M. Hynes & Nathaniel Pattison, *A Modern Poor Debtor's Oath*, 108 VA. L. REV. ASSOC. 915, 930 (2022).
[43] *Gross*, *supra* note 26.
[44] Lawrence Ponoroff, *Rethinking Chapter 13*, 59 ARIZ. L. REV. 1, 22 (2017) ("Congress has converted chapter 13 from a kind of Eden to a chaotic purgatory. Not surprisingly, therefore, it has neither met with any meaningful success in invigorating repayment over liquidation nor has it advanced particularly well the interests of any of the parties involved in a bankruptcy case.").
[45] Sara S. Greene, et al., *Cracking the Code: An Empirical Analysis of Consumer Bankruptcy Outcomes*, 101 MINN. L. REV. 1031, 1042 (2017).
[46] Lawrence Ponoroff, *Chapter 13: Let's Call the Whole Thing Off*, 40 EMORY BANKR. DEV. J. 1 (2024).
[47] *Gross*, *supra* note 26.
[48] *Id.*
[49] *Id.*
[50] *Id.*

took effect.[51] That decline was not due to fewer people facing financial hardship.[52] Instead, it reflected fewer people accessing relief.[53] These findings point to a core challenge of the law: targeting.[54] While deterring abuse is a valid policy objective, designing mechanisms that achieve that goal without excluding those in need is far more complex.[55] In reducing opportunistic filings, BAPCPA also limited access to relief for households experiencing involuntary and unpredictable financial shocks.[56]

Ultimately, BAPCPA did not fundamentally resolve the tension between creditor recovery and debtor protection.[57] It reallocated risk and imposed new limits, but without fully satisfying either side.[58] As economic volatility persists and filings begin to rise again, the question remains whether the current system can adequately balance the financial challenges faced by consumers with the goal of maximizing creditor recoveries.[59]

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[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] Michelle J. White, *Abuse or Protection? Consumer Bankruptcy Reform* 28–35 (Nat'l Bureau of Econ. Rsch., Working Paper No. 13265).
[58] *Id.*
[59] *Id.*

Faculty

Hon. Michelle M. Harner is a U.S. Bankruptcy Judge for the District of Maryland in Baltimore, appointed in 2017. Prior to her appointment to the bench, she was the Francis King Carey Professor of Law and the Director of the Business Law Program at the University of Maryland Francis King Carey School of Law, where she taught courses in bankruptcy and creditors' rights, business associations, business planning, corporate finance and the legal profession. Judge Harner lectured frequently during her academic career on various topics involving corporate governance, financially distressed entities, risk management and related legal issues. Her academic scholarship is widely published, with her publications appearing in, among others, the *Vanderbilt Law Review*, *Notre Dame Law Review*, *Washington University Law Review*, *Minnesota Law Review*, *Indiana Law Journal*, *Fordham Law Review* (reprinted in *Corporate Practice Commentator*), *Washington & Lee Law Review*, *William & Mary Law Review*, *University of Illinois Law Review*, *Arizona Law Review* (reprinted in *Corporate Practice Commentator*) and *Florida Law Review*. Judge Harner has served as the Associate Reporter to the Advisory Committee on the Federal Rules of Bankruptcy Procedure, the Reporter to the ABI Commission to Study the Reform of Chapter 11, and most recently chaired the Dodd-Frank Study Working Group for the Administrative Office of the U.S. Courts. She also served as the Robert M. Zinman ABI Resident Scholar for the fall of 2015. She most recently served as the chair of the Dodd-Frank Study Working Group for the Administrative Office of the U.S. Courts, and she is currently serving as a member of the Advisory Committee on the Federal Rules of Bankruptcy Procedure and an associate editor of the *American Bankruptcy Law Journal*. Judge Harner is an elected conferee of the National Bankruptcy Conference, an elected Fellow of the American College of Bankruptcy, and an elected member of the American Law Institute. She previously was in private practice in the business restructuring, insolvency, bankruptcy and related transactional fields, most recently as a partner at the Chicago office of the international law firm Jones Day. Judge Harner received her B.A. *cum laude* from Boston College in 1992 and her J.D. *summa cum laude* from The Ohio State University College of Law in 1995.

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Donald L. Swanson is a shareholder with Koley Jessen P.C., L.L.O. in Omaha, Neb., and has been practicing bankruptcy law since 1980. He grew up on a livestock farm in Nebraska's Sandhills, became Nebraska State FFA President (1973-74), and achieved FFA's "American Farmer Degree." During the 1980s farm crisis, Mr. Swanson represented debtors in more than 40 chapter 12 cases, achieving a confirmed plan and discharge in all but one. In Delaware's $1.5 billion ethanol bankruptcy (*In re VeraSun*), he held an *ex officio* seat on the creditors' committee as counsel for the ad hoc committee of grain suppliers. Mr. Swanson is a subchapter V trustee in the District of Nebraska and serves on ABI's Subchapter V Task Force, and he is a court-approved mediator for both the U.S. District and the U.S. Bankruptcy courts of Nebraska. He also is a member of the Nebraska Delegation to the Uniform Law Commission and serves on its Drafting Committee for a uniform law on assignments for benefit of creditors, is a court-approved mediator in both the U.S. District and Bankruptcy Courts of Nebraska, and is Board Certified in Business Bankruptcy Law by the American Board of Certification. Mr. Swanson publishes a blog on bankruptcy and mediation topics at https://mediatbankry.com, and he is rated AV-Preeminent by Martindale-Hubbell. In addition, he is a Fellow of the Nebraska State Bar Foundation, and he has served on the board for Legal Aid of Nebraska, providing free legal services to low-income Nebraskans, and on the board for Global Partners in Hope, which provides clean drinking water and medical centers in West Africa. In 2022, as a commissioner on the Uniform Law Commission (ULC), Mr. Swanson proposed that ULC study the need for a uniform law on assignments for benefit of creditors. That proposal was accepted, and he now serves on the ULC's Drafting Committee on Assignments for Benefit of Creditors. Mr. Swanson is a member of the Uniform Law Commission and is licensed to practice in the states of Nebraska, Iowa and South Dakota. He has been recognized in *The Best Lawyers in America* and *Super Lawyers*. Mr. Swanson received his A.A. from Grace University in 1976, his B.S. in political science from the University of Nebraska - Omaha in 1977, and his J.D. from the University of Nebraska - Lincoln in 1980, where he was an associate editor of the *Nebraska Law Review*.