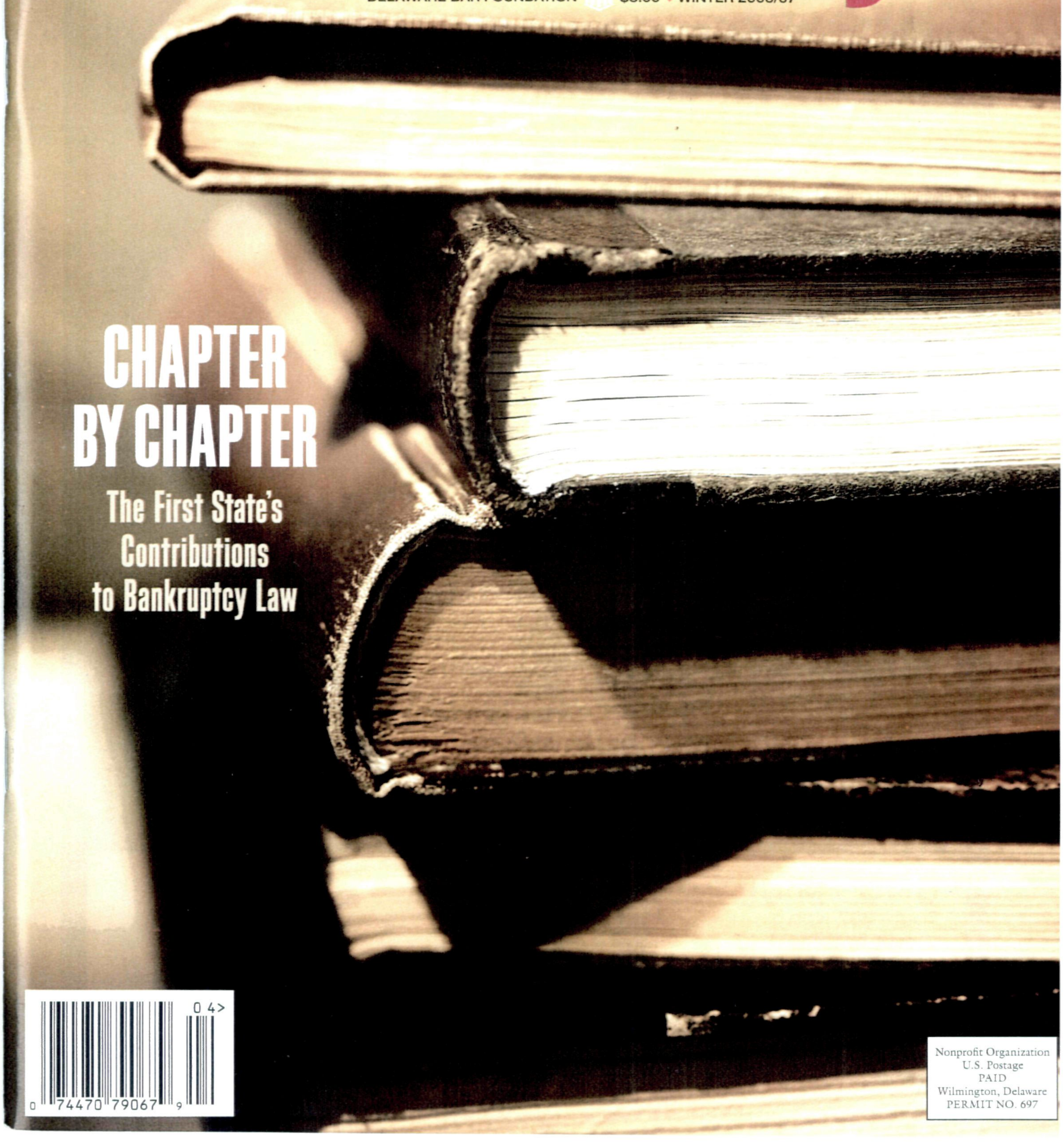
**INSIDE:** Colonial Legislation, Asbestos Liability, The Path to Reform, Modern Bankruptcy History

# Delaware Lawyer

A PUBLICATION OF THE DELAWARE BAR FOUNDATION

VOLUME 24 ◆ NUMBER 4

$3.00 ◆ WINTER 2006/07



## CHAPTER BY CHAPTER

### The First State's Contributions to Bankruptcy Law

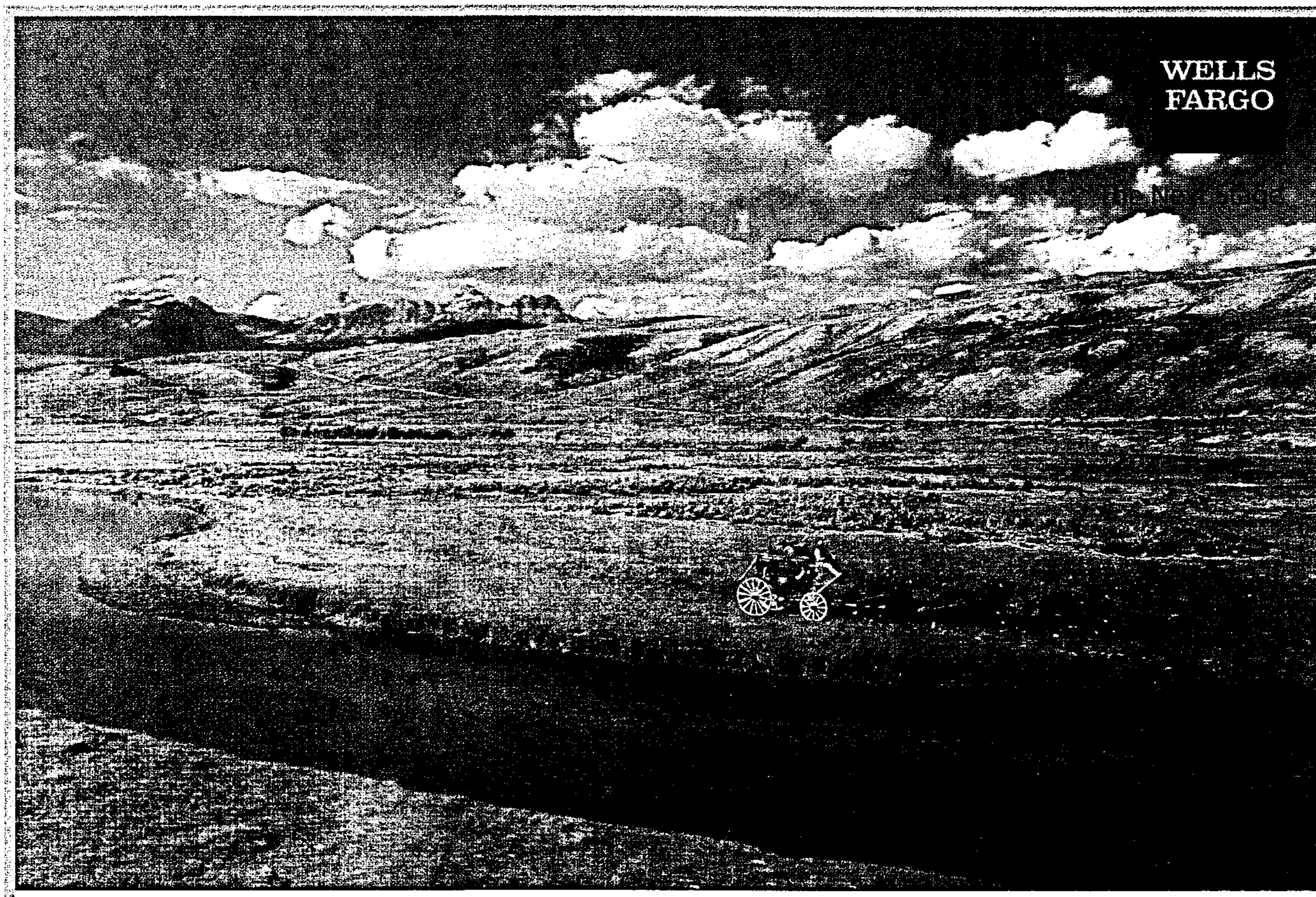
MINI

# MEET MINI AT OTTO'S MINI.


**OTTO'S MINI**
Route 202 North
West Chester, PA
610-399-8060
www.ottosmini.com



MINIUSA.COM




# Wells Fargo Bank N.A.

*A Diversified Financial Services Company*


## Michael Orendorf - VP

Business Development
919 North Market Street, Suite 700
Wilmington, DE 19801
302.575.2000 - tel
302.575.2006 - fax
michael.orendorf@wellsfargo.com



# Delaware Lawyer

CONTENTS WINTER 2006/07



EDITOR'S NOTE 5

CONTRIBUTORS 6

FEATURES

8 DELAWARE'S LEGACY IN ORIGINAL BANKRUPTCY LEGISLATION
Jeffrey M. Schlerf

12 A MODERN HISTORY OF BANKRUPTCY IN DELAWARE
James L. Patton Jr.
Robert S. Brady
Ian S. Fredericks

18 FILINGS BY COMPANIES WITH ASBESTOS LIABILITIES
Francis E. McGovern

24 THE LONG AND TUMULTUOUS ROAD TO REFORM
Mark D. Collins

29 BANKRUPTCY EXEMPTIONS UNDER FEDERAL AND STATE LAW
Michael B. Joseph


# Delaware Lawyer

*A publication of Delaware Bar Foundation*
*Volume 24, Number 4*





**DELAWARE LAWYER**
*is produced for the Delaware Bar Foundation by:*
Media Two, Inc.
22 W. Pennsylvania Ave., Ste. 305
Towson, MD 21204

*Editorial Coordinator*
Peter L. Kerzel

*Art Director*
Samantha Carol Smith

*Subscription orders and address changes should be directed to:*
Chris Calloway 302-656-1809

*Requests for advertising information should be directed to:*
Howard B. Hyatt 1-800-466-8721 x250


*Delaware Lawyer* is published by the Delaware Bar Foundation as part of its commitment to publish and distribute addresses, reports, treatises, and other literary works on legal subjects of general interest to Delaware judges, lawyers, and the community at large. As it is one of the objectives of *Delaware Lawyer* to be a forum for the free expression and interchange of ideas, the opinions and positions stated in signed material are those of the authors and not, by the fact of publication, necessarily those of the Delaware Bar Foundation or *Delaware Lawyer*. All manuscripts are carefully considered by the Board of Editors. Material accepted for publication becomes the property of Delaware Bar Foundation. Contributing authors are requested and expected to disclose any financial, economic, or professional interests or affiliations that may have influenced positions taken or advocated in the articles. That they have done so is an implied representation by each author.

# EDITOR'S NOTE

Jeffrey M. Schlerf

The day after the Third Circuit named four new bankruptcy judges to the bench in the District of Delaware, I volunteered to be the editor for this issue. At that time there was widespread elation among members of the Delaware bankruptcy community. These new judges would be superb additions to a court already blessed with two highly esteemed jurists. There was also a sigh of relief. After all, this was the culmination of an eight-year wait before Congress passed major bankruptcy reform legislation, including authorization for additional judgeships. This District had the additional judges it sorely needed, and had survived legislative threats aimed at its very existence.

When the legislative process began in 1997, Delaware had become a victim of its own success. I personally experienced the explosion in Delaware bankruptcy filings as a young practitioner. By the mid-1990s, the bankruptcy court was overwhelmed. This jurisdiction sustained itself during the unexpected lengthy legislative process by being resourceful. First, the District Court stepped in and assisted in administering chapter 11 cases. Then, a steady rotation of visiting judges from other jurisdictions throughout the country kept things going. Yet, these temporary arrangements were not ideal. At the time of the announcement of the four new judges, there was a sense that this jurisdiction had survived, and the future was bright.

The bankruptcy community was also relieved that this jurisdiction was no longer under siege. The Bankruptcy Review Commission, the catalyst for the bankruptcy reform legislative process, had been critical of Delaware as a venue in the mid-1990s. After the legislative process got under way, there were periodic efforts by some to eliminate corporate domicile or residence as a basis for venue. These threats would continue until final passage of the legislation in early 2005.

This issue should interest even the casual observer of the bankruptcy world. The national prominence of Delaware as a chapter 11 forum is still a relatively recent phenomenon, going back barely 20 years. But, this issue begins with an article which goes back 200 years to the origins of this country when a Delaware congressman, James Bayard, spearheaded passage of this country's original federal bankruptcy legislation. The next article jumps to the modern era to describe this jurisdiction's rise to prominence. Then, there is a fascinating piece about a more recent trend, bankruptcy filings by companies experiencing massive tort liabilities — in this instance, companies with significant asbestos liabilities which file in Delaware. This issue concludes with two articles on new bankruptcy legislation. The first is a fascinating narrative of the legislative battle before Congress. The other piece addresses statutory changes affecting the less glamorous but very "real world" of chapter 7 and 13 bankruptcies.

I am fortunate to practice in such a fascinating area of the law in Delaware. This issue will help you understand why.

Jeffrey M. Schlerf

## CONTRIBUTORS

### Robert S. Brady

chairs the Bankruptcy & Corporate Restructuring section of Young Conaway Stargatt & Taylor, LLP. He has been recognized consistently by national publications, including *Chambers USA: America's Leading Lawyers for Business* and *The Best Lawyers in America*, as a leading bankruptcy practitioner.

### Mark D. Collins

is a member of Richards, Layton & Finger, P.A., and is chair of the firm's Restructuring & Bankruptcy Group. Collins is currently co-chair of the Finance and Banking Committee of the American Bankruptcy Institute and chair of the Legislation Committee of the Bankruptcy Section of the Delaware State Bar Association.

### Ian S. Fredericks

is an associate in the Bankruptcy & Corporate Restructuring section of Young Conaway Stargatt & Taylor, LLP.

### Michael B. Joseph

is a partner at Ferry, Joseph, & Pearce, P.A. and is the chapter 13 Trustee for the District of Delaware. He serves on the board of directors of the National Association of Chapter 13 Trustees and is the chair of the Delaware State Bar Association Bankruptcy Law Section Chapter 7 and 13 Committee.

### Francis E. McGovern

is a professor at Duke University School of Law and the University of California at Berkeley School of Law. He is a prolific writer and speaker both in the United States and internationally. He has also served as a special master or a neutral in more than 75 complex litigations.

### James L. Patton Jr.

is the Chairman of Young Conaway Stargatt & Taylor, LLP and a partner in the Bankruptcy & Corporate Restructuring section. He is a fellow of the American College of Bankruptcy.

### Jeffrey M. Schlerf

is a director and shareholder at The Bayard Firm. Jeffrey's chapter 11 practice focuses on the representation of debtors, committees, trustees, secured and unsecured creditors, and purchasers. Prior to becoming a lawyer, Jeffrey worked as an economist at the Federal Reserve and then at a commercial bank.

Jeffrey M. Schlerf

# Delaware's Legacy in Original Bankruptcy

*James Asheton Bayard*

**Until uniform bankruptcy laws were passed, the Constitution did not preclude states from passing their own laws regarding bankruptcy, which many of them did.**

Delaware boasts a distinctive connection to the original federal bankruptcy legislation in the United States. James Asheton Bayard,[1] Delaware's sole member of the House of Representatives from 1797 until 1803, and then a member of the U.S. Senate from 1804 through 1816, was at the forefront of passage of federal bankruptcy legislation in 1800. In fact, in the minds of many, he was the namesake of the first bankruptcy legislation, known as "Mr. Bayard's Bill."[2]

During the Colonial period, England operated under a bankruptcy statute enacted in 1732. The statute provided for the discharge of debt. This law applied only to debtor merchants and traders, and allowed for only involuntary petitions to be brought by creditors. The prospect of debtor's prison remained.[3] The United States Constitution passed in 1787 provided, under Article I, Section 8, for Congress to promulgate "uniform Laws on the subject of Bankruptcies throughout the United States."[4] The new republic would not act upon the opportunity to pass uniform bankruptcy laws among the states for more than a decade. In the meantime, the Constitution did not preclude states from passing their own laws regarding bankruptcy, which many of them did.[5]

James Bayard became a member of Congress in the late 1790s, a decade that was marked by the emergence of two political parties with widely divergent views on the role of the new federal government in many areas, including commerce.[6] The young nation was increasingly divided between Federalists such as John Adams and Alexander

Hamilton and the Republicans, who were lead by Thomas Jefferson and James Madison. This partisanship culminated in the hotly contested presidential election of 1800, in which Jefferson was ultimately victorious after 36 rounds of voting before the House of Representatives (necessitated by deadlock in the Electoral College).[7]

In fact, the great ideological divide impacted passage of America's first bankruptcy law.[8] The Republicans, led by Jefferson, viewed unfavorably modern commerce that relied upon the extension of credit.[9] The agricultural South already relied heavily upon credit between harvests, and feared that new laws would enable big city creditors to appropriate their land.[10] Moreover, the issue got caught up in the brewing debate regarding the role of the central government versus "states rights."[11] Many states already had enacted insolvency laws to some degree,[12] and states' rights advocates viewed federal bankruptcy legislation as ceding more power to the central government.

On the other hand, Bayard, a pragmatic Federalist, believed that "wherever there is an extensive commerce, extensive credit must be given."[13] Bayard supported the commercial development of the nation. This "capitalistic" perspective required what he called "the most important law of any society — the law regulating the relation of debtor and creditor."[14] The growth of commerce, in turn, depended upon uniform laws regarding commerce — a point not lost on Bayard: "as the United States are one great commercial Republic, it behooves us to have one universal rule co-extensive with the Union, that the merchant in New Hampshire may know the laws of Georgia."[15] An important component of commercial law was bankruptcy, where the Constitution invited "uniform Laws."

Passage of federal bankruptcy legislation proved slow and contentious. A series of financial crises in the 1790s may have been the catalyst for Congress to take an interest in this issue.[16] Three bills had already languished and died before Bayard stood before his fellow congressmen and argued the merits of federal legislation.[17] Indeed, crashes in the markets for federal scrip and excessive land speculation led to the impoverishment of many and the disgrace of early American luminaries such as Robert Morris and William Duer.[18] To avoid debtor's prison, Supreme Court Associate Justice James Wilson fled from Pennsylvania to North Carolina.[19] Adding to the realization that federal action was in order was growing tension with France. The French were seizing American trade ships with greater frequency in the late 1790s, contributing to a lesser amount of credit being available.[20]

**Many states had enacted insolvency laws to some degree, and states' rights advocates viewed federal bankruptcy legislation as ceding more power to the central government.**

These circumstances made it ripe for "Mr. Bayard's Bill." Bayard argued passionately in the winter of 1799 before his fellow congressmen in support of his bill. Like England's 1732 statute, the legislation would punish fraudulent conduct while giving aid to the honest debtor. It would allow a merchant bankrupt's debts to be discharged upon good behavior, and upon two-thirds' creditor approval. A federal court, upon the petition of a creditor, would appoint a commissioner to administer the estate of the debtor. A debtor was permitted an "allowance" from the estate under certain conditions.[21]

Before his fellow congressmen, Bayard argued that bankruptcy legislation at the federal level would temper the speculative excesses of a capitalist economy, while providing relief to the honest merchant facing unavoidable economic adversity. In response to agricultural interests among the Republicans who demanded an exemption from the new bankruptcy law for their real property, Bayard argued that such protection would be "a remnant of the feudal system, of the principle of the ancient aristocracy of England."[22] He queried: "is it not an unjust principle that in a nation so commercial as we are, land should not be liable to be sold for the payment of debt?"[23] Bayard feared that a nefarious debtor would invest in real estate, thereby frustrating his creditors. Ever the faithful Federalist, Bayard concluded his speech on the floor of the House of Representatives in support of the legislation by reminding other members of Congress: "for more than two centuries and a half, England has been the most flourishing commercial country upon the face of the earth, owing to her civil policy, the essential part of which was the bankrupt system."[24]

The bill passed, barely: The speaker of the house, a Federalist, cast the tie-breaking vote in February 1800.[25] However, the law would survive only three short years. The country's political winds turned decidedly Republican after the law's passage. On March 1, 1801, Jefferson became president — thanks to none other than Federalist Bayard, who averted a constitutional crisis by breaking a deadlock in the House of Representatives after 35 rounds of balloting by changing Delaware's vote. With this change in the political environment, public sentiment was turning against the new bankruptcy law, and in November 1803, the law was revoked.[26] In a twist of fate, another famous Delawarean, Caesar Rodney, who replaced Bayard as Delaware's lone House representative after Bayard was elected to the U.S. Senate in the 1802 election, voted in favor of revoking the law.[27] The United States would not see permanent federal bankruptcy legislation again until later in the 19th century. Looking back, Delaware's Bayard was ahead of his time in supporting federal law in an area that would become such a fundamental part of the modern capitalistic economy. ◆

*The author thanks Katharine V. Jackson, Esquire, for her valuable assistance.*

FOOTNOTES

1. MORTON BORDEN, THE FEDERALISM OF JAMES A. BAYARD 62 (Columbia University Press 1955); Mark Bradshaw, *The Role of Politics and Economics in Early American Bankruptcy Law,* 18 Whittier L. Rev. 739, 752-754 (1997).

2. Borden, *supra*, at 69.

3. *Id.* at 63; Rhett Frimet, *The Birth of Bankruptcy in the United States*, 96 Comm. L.J. 160, 162-63; Andrew J. Duncan, *From Dismemberment to Discharge: The Origins of Modern American Bankruptcy Law*, 100 Comm. L.J. 191, 199-200.

4. U.S. Const. art. I, § 8.

5. *See Ogden v. Saunders*, 12 Wheat. 213, 6 L.Ed. 606 (1827).

6. *See* Richard C. Sauer, *Bankruptcy Law and the Maturing of American Capitalism*, 55 Ohio St. L.J. 291, 291-318 (1994) and Duncan, *supra*, at 218.

7. *See* JOHN FERLING, ADAMS V. JEFFERSON: THE TUMULTUOUS ELECTION OF 1800 (Oxford University Press 2004).

8. *See* Duncan, *supra*, at 218-219; Bradshaw, *supra*, at 746-47; Sauer, *supra*, at 317-18.

9. Sauer, *supra*, at 292-93; Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 Am. Bankr. Inst. L. Rev. 5, 9 (1995).

10. *See* Sauer, *supra*, at 291-304; Bradshaw, *supra*, at 749-50; Borden, *supra*, at 67; and Frimet, *supra*, at 167.

11. Bradshaw, *supra*, at 751; Frimet, *supra*, 165.

12. Duncan, *supra*, at 216, 219.

13. Annals of Cong., 5th Cong., 3d Sess. 2656 (1799).

14. *Id.* at 2664.

15. Annals of Cong., 7th Cong., 2d Sess. 549 (1803).

16. Frimet, *supra*, 166.

17. Borden, *supra*, 65; Duncan, *supra*, 219.

18. Bradshaw, *supra*, at 747-749; Borden, *supra*, at 65; Frimet, *supra*, at 166.

19. Borden, *supra*, at 65.

20. *Id.*; Frimet, *supra*, 168-69.

21. Borden, *supra*, at 70; Frimet, *supra*, 169.

22. Annals of Cong., 5th Cong., 3d Sess., 2660 (1799).

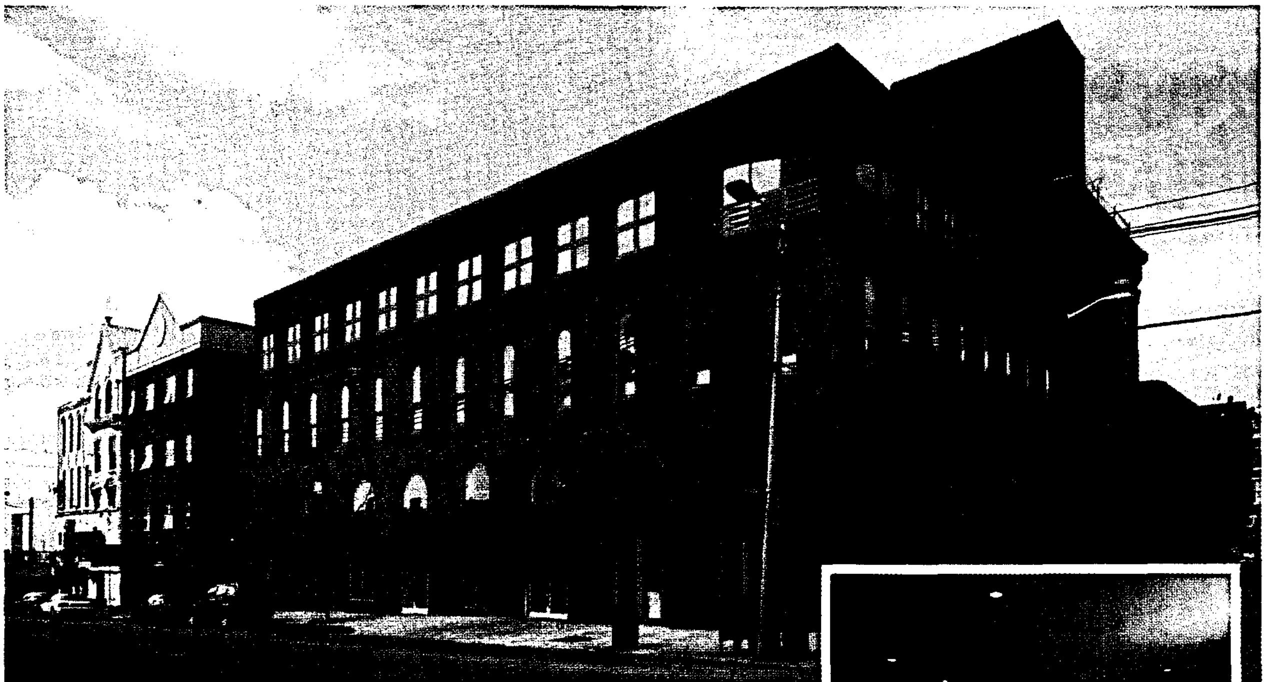
23. *Id.*

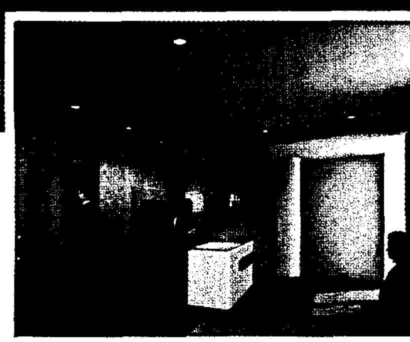
24. *Id.* at 2663.

25. Borden, *supra*, at 69; Frimet, *supra*, 169.

26. Bradshaw, *supra*, at 753-54; Frimet, *supra*, 169.

27. Borden, *supra*, at 72.





# king street court

## at the court house steps

**Discover exceptional office opportunities for lease or sale at 233 King Street in Wilmington, DE**

- **4,000 to 22,000 +/- square foot office condominiums available**
- **Over $500,000 in capital improvements will be complete in December 2006**
- **Across the street from New Castle County Courthouse**
- **Two blocks from Wilmington Train Station**
- **Adjacent to Wilmington Riverfront and Ships Tavern District**
- **Open floor plans**

for more information:

**John Kaczowka**
302.661.6709
john.kaczowka@cbre.com
www.cbre.com/johnkaczowka

**Brian Hopkins**
302.661.6712
brian.hopkins@cbre.com
www.cbre.com/brian hopkins

**CB Richard Ellis, Inc.**
The Nemours Building
1007 N. Orange Street
Wilmington, DE 09801
main: 302.661.6700
fax: 302.661.6792
www.cbre.com/wilmington

**CBRE**
CB RICHARD ELLIS

Another Project by:

BPG

The Buccini/Pollin Group

OWNER • BUILDER • MANAGER

**bpgroup.net**

**302.691.2100**

FEATURE

James L. Patton Jr.
Robert S. Brady
Ian S. Fredericks

# A Modern History of Bankrupt


*Judge Helen S. Balick*

The Bankruptcy Code inaugurated a new rescue culture for distressed American businesses, eliminated Referees and created "bankruptcy judges" with broad powers.

For the overwhelming majority of Americans, Oct. 1, 1979 was just another day. However, for many Delaware lawyers and one judge, in particular, what happened that day defined their careers and sparked a series of events that no one predicted. Oct. 1, 1979 marked the effective date of the Bankruptcy Reform Act of 1978 or, as it is more commonly referred to, the Bankruptcy Code. The Bankruptcy Code was the first substantial overhaul of U.S. bankruptcy law since 1898.

**The Bankruptcy Code's Impact on Delaware**

Prior to the enactment of the Bankruptcy Code, bankruptcies were governed by the Bankruptcy Act of 1898 (the Act). Under the Act, rescuing a failing business was a cumbersome and messy affair. Bankruptcy referees, rather than judges, oversaw the liquidations and, in rare instances, reorganizations of U.S. companies. The Bankruptcy Code, however, inaugurated a new rescue culture for distressed American businesses, eliminated Referees and created "bankruptcy judges" with broad powers to oversee the nation's bankruptcies.[1]

Under the Act, Delaware had one referee and, during most of the 1970s, the position was filled by Judge Helen S. Balick. Judge Balick graduated from The Dickinson School of Law in 1966, having never attended college. At the time, a person could be admitted to law school after obtaining a college degree or by taking an exam. After graduating from Dickinson, Judge Balick was engaged in private practice until 1974, when she took the bench.

Judge Balick was appointed in 1974 to serve as both magistrate judge for the District Court for the District of Delaware and bankruptcy referee. After the Bankruptcy Code became effective, then-Referee Balick assumed the role of Delaware's sole bankruptcy judge, and she continued to serve as a part-time magistrate judge until 1980, when she became a full-time bankruptcy judge.

In addition to creating a business rescue culture and powerful bankruptcy judges, Congress reinstated place of incorporation as an appropriate venue choice. Congress had adopted, in 1973, Bankruptcy Rule 116, which, for no apparent reason, eliminated a company's domicile and residence as appropriate bases for venue. In conjunction with enacting the Bankruptcy Code, Congress added section 1421 (later renumbered 1408) to Title 28 of the United States Code. Section 1408 provides four alternative bases for venue: domicile, residence, principal place of business and location of the debtor's principal assets. Thus, a company could once again properly file bankruptcy in the jurisdiction in which it resided or was domiciled. Over the next two decades, this venue rule would prove to be the basis by which many of the largest business bankruptcies in this country's history would be adjudicated before the United States Bankruptcy Court for the District of Delaware.

**1980s – The Beginning**

When Judge Balick assumed the full-time responsibilities of a bankruptcy judge in 1980, Delaware's bankruptcy docket was small and manageable. In fact, the entire docket was managed by a clerk's office comprised of three people housed in a very small space in the Boggs Federal Building. These people, including Carolyn Raniszewski, the clerk, and Nancy Hunt, a judicial assistant, were instrumental in managing the docket and the cases. Today, the bankruptcy clerk's office, headed by David Bird, boasts 72 employees, and the Bankruptcy Court sprawls over 65,000 square feet on 3½ floors at 824 N. Market St.

The bankruptcy practice in Delaware during the 1980s was punctuated by just four significant cases: *Phoenix Steel I*[2], *Phoenix Steel II*[3], *Ocean Properties*[4] and *SCI Television*[5]. Phoenix Steel was a Delaware corporation headquartered in Claymont, Del. On Aug. 12, 1983, Phoenix Steel filed its first bankruptcy. Levin & Weintraub & Crames (LWC), together with Drinker Biddle & Reath and Young Conaway, served as counsel to the debtor. After operating for almost two years under the supervision of Judge Balick, Phoenix Steel's chapter 11 plan of reorganization was confirmed in July 1985. At the time, *Phoenix Steel I* was coined a "success" because the debtor emerged from bankruptcy and began conducting business as usual. Tumbling steel prices would later tarnish Phoenix Steel's success story.

**In addition to creating a business rescue culture and powerful bankruptcy judges, Congress reinstated place of incorporation as an appropriate venue choice.**

For Delaware bankruptcy practitioners, *Phoenix Steel I* is also remembered as a success because it was responsible for bringing together the bankruptcy bars of New York and Delaware. Unlike today, in the early 1980s, many of the large New York law firms did not have prominent departments devoted to bankruptcy. Under the Act, the practice of bankruptcy law was seen as unsavory and unprofitable. Quite frankly, a large firm's business model could not support the discounted hourly rates and uncertainty of payment that were typical in bankruptcies governed by the Act. Instead, small boutique firms like LWC specialized in bankruptcy, and the boutiques were firms to whom larger firms referred their financially distressed clients. Thus, the New York bankruptcy bar was largely concentrated among a select few firms, and strong ties between Delaware and New York were quickly established.

In 1978, with the passage of the Bankruptcy Code, Congress eliminated many of the fee limitations imposed by the Act and set forth uniform rules governing professional fees. In the years that followed, large firms actively recruited prominent attorneys from boutique firms, including LWC, to launch or expand their bankruptcy departments. As the boutiques were absorbed into the large New York firms, so were their relationships with the Delaware bar.

Although *Phoenix Steel I* was largely responsible for introducing New York to Delaware, New York's confidence in Judge Balick's ability to handle complex restructuring cases was not solidified until *Phoenix Steel II*. After emerging from bankruptcy in 1985, Phoenix Steel filed its second bankruptcy on April 20, 1987. Many large New York firms, along with many members of the Delaware bankruptcy bar, were involved in the case in various capacities. Throughout *Phoenix Steel II*, Judge Balick demonstrated a very strong practical grasp of the business problems facing a chapter 11 debtor and her decisions reflected her sophistication and understanding of the reorganization process. By *Phoenix Steel II* 's conclusion, lawyers from across the country were praising Judge Balick's handling of the case.

For the next year, companies continued to seek chapter 11 protection in Delaware, but the filings were limited to companies headquartered in Delaware. On Sept. 28, 1988, this trend changed when Ocean Properties and its affiliate filed in Delaware. The debtors owned and operated properties in Miami Beach, Fla., but were both Delaware corporations. After the cases filed, a group of creditors moved to transfer venue to the Southern District of Florida.

In ruling on the motion, Judge Balick held that because "the debtors were

Delaware corporations, venue in [the District of Delaware] was proper under 28 U.S.C. § 1408." In other words, Judge Balick held that a company is domiciled or has its residence in the state in which it is incorporated. Although Judge Balick found that venue was proper in Delaware, she transferred the cases to Florida because the "scales [tipped] in favor of a Florida forum."

On Nov. 16, 1989, a group of creditors, rather than a company, took another run at the venue statute by commencing an involuntary bankruptcy against SCI Television. At the time, SCI Television was pursuing a high-profile exchange offer among its bondholders involving many of the country's leading law firms. The involuntary petition was filed in Delaware based exclusively on the fact that SCI Television, a Minnesota-based operation, was incorporated in Delaware. After the case was filed, counsel to the debtor moved to dismiss the case. Although Judge Balick could have easily transferred the case to another jurisdiction based on the venue statute and avoided ruling on the motion, she ordered a telephonic hearing. At the conclusion of the hearing, Judge Balick dismissed the involuntary case, but not because of improper venue.

Judge Balick's willingness to hold court on an expedited basis using what was then considered unconventional means, as well as her ability to facilitate the reorganization process, demonstrated to bankruptcy lawyers throughout the country that Delaware's Bankruptcy Court was a sophisticated forum. The only remaining question was: could a case filed in Delaware based exclusively on place of incorporation withstand a motion to change venue?

**Early 1990s – Case Filings Increase**

In *United Merchants & Manufacturing* [6], Judge Balick answered the question affirmatively. On November 2, 1990, United Merchants & Manufacturing, Inc. (UM&M) and its affiliates filed bankruptcy in Delaware. UM&M was incorporated in Delaware, but headquartered in New York.

UM&M had considered filing in the Southern District of New York, but was concerned that unfavorable law in the jurisdiction could have a dramatic, negative impact on its ability to reorganize. With the assistance of its counsel, Michael Cook, then of Skadden, Arps, Slate, Meagher & Flom LLP in New York, the company began to evaluate Delaware as an alternative forum. After discussions with the local bar and based on prior appearances before Judge Balick in *Phoenix Steel II*, Cook recommended that UM&M file in Delaware.

*Continental* was a landmark case in Delaware for many reasons, not the least of which was that it propelled Judge Balick to national prominence for her deft handling of the case.

From the outset, UM&M was dogged by two nagging questions: would a party move to transfer venue, and would Judge Balick send the case to New York? Shortly after UM&M filed, the Official Committee of Unsecured Creditors decided to call the first question and filed a motion to transfer. After a contentious venue fight, Judge Balick denied the Committee's motion. At last, the Delaware bankruptcy bar's interpretation of the venue statute had been challenged and upheld.

While *United Merchants & Manufacturing* was pending, two Delaware firms were approached on a highly confidential basis about the possibility of another Delaware corporation headquartered halfway across the country filing in Delaware — a filing that would change everything. The client's primary concern was that if it filed in Delaware, its case might be transferred. Based on the decision in *United Merchants & Manufacturing*, the company felt comfortable that Judge Balick would be unlikely to transfer the case and, on Dec. 3, 1990, Continental Airlines filed bankruptcy in Delaware. Morris Nichols and Young Conaway served as lead co-counsel to Continental.

At the time Continental filed, it was the largest bankruptcy ever filed in Delaware. Bob Brady of Young Conaway, a young associate at the time, remembers a conference table that could seat 12 completely covered with first-day motions and orders. Judge Balick was undaunted by the challenge and the large binders of documents placed before her. She conducted a hearing the same day Continental filed and, as Bill Sudell of Morris Nichols recalls, "handled it masterfully."

*Continental* was a landmark case in Delaware for many reasons, not the least of which was that it propelled Judge Balick to national prominence for her deft handling of the case and her willingness to spend eight to 10 hours on the bench to finish her docket. Cases started pouring into the District. To illustrate, from 1991 to 1995, 522 chapter 11 cases were filed in Delaware, including Fortune 500 companies like Days Inn Hotels, Columbia Gas Systems and Trans World Airlines. In the prior four years, only 93 chapter 11 cases were filed in Delaware.

From 1990 through late 1993, Judge Balick presided over every bankruptcy case filed in Delaware. As her caseload grew, practitioners in Delaware, led by now Third Circuit Judge Thomas L. Ambro, began to reach out to their Congressional representatives and requested additional bankruptcy judges. Finally, in late 1993, Congress approved one additional bankruptcy judge for the District of Delaware. In October 1993, Peter J. Walsh, an experienced chapter 11 practitioner and a major player in

*Continental Airlines* [7], joined Judge Balick on the bench. Once on the bench, Judge Walsh quickly impressed the bar with his intelligence and expeditious handling of complex chapter 11 cases and established himself as an excellent judge.

However, the relief realized by Judge Walsh's appointment was short-lived. With Judge Walsh came more cases, new challenges and a new home for the court. Space constraints forced the Bankruptcy Court to move out of the Boggs Federal Building to its present location at 824 N. Market St.

**The Pre-pack Phenomenon**

*Memorex-Telex*[8], filed in 1992, introduced Delaware and the world to the phenomenon of fast-track pre-packaged bankruptcies. Before filing bankruptcy, Memorex-Telex negotiated a plan of reorganization with its creditors and solicited their votes. With enough votes in hand to confirm its plan, counsel to Memorex-Telex filed its bankruptcy case on Jan. 6, 1992 and walked out of Judge Balick's courtroom 32 days later with a confirmed plan of reorganization — by reducing to one month, for the first time ever, what typically took years, Judge Balick's courtroom had once again captured the attention of bankruptcy lawyers across the country.

The pre-pack phenomenon peaked in 1994 when Congress passed amendments to the Internal Revenue Code. Once effective in 1995, the amendments would drastically impact the ability of a company reorganizing in bankruptcy to carryover its net operating losses (NOLs), to offset future income. To avoid the impact of the amendments and preserve their NOLs, companies contemplating a bankruptcy filing rushed to negotiate and confirm pre-packaged plans of reorganization before the amendment's effective date. Judges Balick and Walsh, confirmed numerous "pre-packs" in 1994, six of which confirmed during November and December of that year, with one company's bankruptcy lasting only 16 days.

**1995-1999 – The Trend Continues**

Although the amendments to the Tax Code became effective in 1995, the number of case filings in Delaware showed no signs of slowing. Between 1995 and 1997, 635 chapter 11 cases were filed. In fact, during 1996, 10 of the 11 largest chapter 11 cases in the nation were filed in Delaware. As Mark Collins of Richards Layton & Finger remembers, "The second part of the '90s was beyond anything we could have imagined — the number and types of companies that filed for chapter 11 in Delaware just kept growing and growing."

Notwithstanding their overwhelming caseloads, Judges Balick and Walsh continued to demonstrate the ability to handle complex business reorganizations efficiently. Before 1997, Judge Balick and Judge Walsh handled dockets typically handled by six to eight judges. Confronted with overworked and overwhelmed bankruptcy judges and seemingly endless dockets, the Delaware District Court decided it was necessary to assist the Bankruptcy Court. Accordingly, on Jan. 23, 1997, the District Court withdrew the automatic referral of bankruptcy cases to the Bankruptcy Court, citing the need "to assist with the handling of new cases." Both Judge Balick and Judge Walsh welcomed the assistance. Although the District Court was hearing new bankruptcy cases, both bankruptcy judges continued to preside over their existing cases and continued to receive additional cases. Even with the automatic referral withdrawn, the cases did not stop.

In retrospect, the District Court's action could not have come at a better time because, in 1998, Judge Balick retired. Her retirement followed 18 years as a bankruptcy judge, during five of which she was joined by Judge Walsh on the bench, and nearly 25 years of public service. Judge Balick timed her retirement to coincide with the retirement of her husband, Vice Chancellor Bernard Balick, from the Delaware Chancery Court. As Jim Patton remembers, "When asked about retirement, Judge Balick would say, 'I want to retire with my husband.' We were sorry to lose her from the bench, but her retirement was well deserved."

After Judge Balick retired, Judge Mary F. Walrath, a former bankruptcy lawyer in Philadelphia, joined the Bankruptcy Court. Judge Walrath quickly proved to be an impressive and worthy successor to Judge Balick. During the late 1990s, she and Judge Walsh continued to efficiently and effectively preside over the busiest bankruptcy docket in the country.

**2000-2005 – Overworked Judges, Crowded Dockets and, Finally, Real Relief**

The first five years of the 21st century represented a transition period for the Delaware Bankruptcy Court. Early on, cases continued to file in record numbers and the Bankruptcy and District Courts took steps to increase efficiency, including implementing comprehensive local rules and a visiting judge program. In light of these and other initiatives, which helped streamline cases and lightened the Judges' caseloads, on Feb. 3, 2001, the District Court reinstated the automatic reference.

Prior to these initiatives, practitioners were becoming concerned about the crowded dockets in Delaware and began to investigate alternative forums. Beginning with Enron's bankruptcy, large and complex chapter 11s started filing in other jurisdictions. Decision-makers, including Enron's legal team, were concerned that the very busy Delaware court could not give their clients the kind of attention and responsiveness that such a complex case required.

Filings in other jurisdictions, coupled with decreased chapter 11 filings nationwide, allowed Delaware's judges, including the visiting judges, sufficient time to move cases off their dockets. For those cases that did file, the attorneys and their clients found that the Delaware Bankruptcy Court gave their cases the time and attention they required. In addition, Judge Walrath continued to solidify her national reputation while presiding over such cases as *Integrated Health Services* [9], *Budget Group* [10] and *Fleming Companies*.[11]

Although Judges Walrath and Walsh were regarded as two of the best bankruptcy judges in the country, case filings continued to steadily decrease. In large part this was due to national filing trends. But, at the same time, the rotating visiting judge program had cost the Bankruptcy Court some of the consistency and predictability that debtors had come to expect. Simultaneously, in alternative jurisdictions, debtors began to experience a degree of consistency, sophistication and predictability that rivaled their experiences in Delaware.

Finally, in April 2005, Congress took steps to provide Delaware with the judicial resources it had long required. In conjunction with passing the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Congress approved four additional judgeships for the Bankruptcy Court in Delaware. These judgeships marked the end of the visiting judge program and promised to relieve the caseload of the Bankruptcy Court's weary bench. By the end of 2005, the Third Circuit Court of Appeals filled all four judgeships.

**2006 – The Future is Bright**

Beginning in January and ending in March 2006, four new bankruptcy judges joined Judges Walrath and Walsh on the Delaware Bankruptcy Court's bench. Judge Kevin J. Carey transitioned to the Delaware Bankruptcy Court from his position in the Eastern District of Pennsylvania and after participating in the visiting judge program. During his years on the bench, he has presided over large and complex chapter 11 cases, including the Delaware cases of *Touch America Holdings* [12] and *Exide Technologies*.[13] Judges Kevin Gross, Brendan Linehan Shannon and Christopher S. Sontchi all practiced in Delaware during the 1990s and the first half of the 2000s. Through their busy and sophisticated practices, these judges gained substantial experience in complex business reorganizations.

These new judgeships are the culmination of years of hard work and perseverance by Delaware's bar and congressional delegation. Most importantly, they provide much needed and well-deserved relief for Judges Walrath and Walsh. Together, the six judges that comprise the Delaware Bankruptcy Court bring years of experience presiding over or representing debtors and creditors in some of the largest and most complex chapter 11 cases ever filed under the Bankruptcy Code. As the new judges took the bench in early 2006, the trickle of cases filing in Delaware grew to a steady stream. As of Oct. 31, 2006, year-to-date chapter 11 filings exceeded chapter 11 filings for all of 2005. At the same time, mega cases (debtors with assets in excess of $100 million) are now being filed at more than twice last year's rate. With a strong six-judge panel, led by Chief Judge Walrath, and a sophisticated bankruptcy bar, Delaware remains a forum of choice to handle the nation's most complex business bankruptcies. ◆

*The authors give special thanks to David Stratton, Marc Abrams, William Sudell and David Bird, clerk of the United States Bankruptcy Court for the District of Delaware, for their time and input.*

FOOTNOTES

1. Bankruptcy Judges are appointed for 14-year terms pursuant to Article 1 of the United States Constitution. Each Circuit Court of Appeals is charged with the appointments and has discretion with respect to the appointment process. For the District of Delaware, the Third Circuit Court of Appeals utilizes a merit selection panel comprised of members of the Delaware bar. The merit selection panel conducts initial interviews and forwards recommendations to the Third Circuit. Based on these recommendations, the Third Circuit conducts additional interviews and, ultimately, appoints the judges.

2. *Matter of Phoenix Steel Corp.*, 82 B.R. 334 (Bankr. D. Del. 1987).

3. *Matter of Phoenix Steel Corp.*, 110 B.R. 258 (Bankr. D. Del. 1989).

4. *Matter of Ocean Properties of Delaware, Inc.*, 95 B.R. 304 (Bankr. D. Del. 1988).

5. *Matter of SCI Television, Inc.*, No. 89-00660 (Bankr. D. Del. 1989).

6. *Matter of United Merchants and Manufacturing*, No. 90-827 (Bankr. D. Del. 1990).

7. *Matter of Continental Airlines, Inc.*, No. 90-932 (Bankr. D. Del. 1990).

8. *Metter of Memorex Telex, Inc.*, No. 92-08 (Bankr. D. Del. 1992).

9. *In re Integrated Health Services, Inc.*, No. 00-389 (Bankr. D. Del. 2000).

10. *In re Budget Group, Inc. v. 5331 Cicero, LLC*, No. 02-12152 (Bankr. D. Del. 2002).

11. *In re Fleming Companies, Inc.*, No. 02-10945 (Bankr. D. Del. 2003).

12. *In re Touch America Holdings, Inc.*, No. 03-11915 (Bankr. D. Del. 2003).

13. *In re Exide Technologies*, No. 02-11125 (Bankr. D. Del. 2002).

FEATURE

Francis E. McGovern

# Filings by Companies with

Approximately 70 companies with a total value of more than $50 billion have sought protection in the bankruptcy courts. More than 30 of those filings have occurred since 2000.

There have been an estimated 27 million U.S. workers exposed to asbestos in high-risk industries and occupations. By the 1990s, more than 750,000 people had filed asbestos claims against more than 8,400 companies at a rate of more than 50,000 a year. Future filing estimates range from 180,000 to 1 million. Courts have faced a volume of cases that cannot be resolved in a timely fashion by normal litigation procedures.

In the 1970s and 1980s, courts grappled with an increasing volume of cases by using a variety of aggregative devices: consolidated discovery, consolidated trials, class action trials, deferral dockets, bifurcated trials, reverse bifurcation and many others. Yet, the backlog of cases and the cost of litigation continued to mount. In 1982, as a defendant against these kinds of claims, the Johns-Manville Corporation became dissatisfied with these litigation approaches and sought to solve its asbestos problems by filing for bankruptcy.[1] Johns-Manville was a pioneer in this approach. Other parties attempted to seek a "global" settlement of asbestos claims by using the class action device, Rule 23 of the Federal Rules of Civil Procedure, in either an opt-out or mandatory class. After the U.S. Supreme Court rejected these class action efforts in *Amchem v. Windsor*[2] in 1997 and *Ortiz v. Fiberboard*[3] in 1999, an increasing number of corporations with asbestos legacies sought to resolve this issue on a comprehensive scale by filing for bankruptcy.

Approximately 70 companies with a total value of more than $50 billion have sought protection in the bankruptcy courts. More than 30 of those filings have occurred since 2000, once it became apparent that there was no other procedural mechanism for resolving all of a company's asbestos exposure in a single legal proceeding. The five largest cases — *Armstrong World Industries*, *Federal-Mogul*, *Owens-Corning*, *USG* and *W.R. Grace*[4] — were filed in the District of Delaware.

Filed at time when the Delaware bankruptcy docket was heavily burdened, the five Delaware cases were initially assigned to two visiting bankruptcy judges. An assignment of a visiting judge to a chapter 11 case in Delaware was not unusual at that time.[5] But in November 2001, then-Chief Judge Edward Becker of the Third Circuit Court of Appeals ordered on his own motion that all five of these cases be transferred to Senior District Court Judge Alfred M. Wolin of the United States District Court for the District of New Jersey. Judge Wolin had successfully managed many complex cases, including the massive insurance litigation involving Prudential Insurance.

The theory behind the assignment to one experienced district court judge was to enable the court to develop and implement a "coordinated plan for management" by having one judge oversee all the asbestos bankruptcies. Because of the differences among the five cases, Judge Wolin decided initially on a *seriatim* case management model, attempting to achieve an early settlement where the parties were inclined to exit bankruptcy quickly and to litigate those cases that could not be settled. One of the byproducts of the consolidation of cases in one court and separate treatment of each case was to allow the litigants to observe decisions in the earlier cases that would eventually need to be resolved in the later ones. Litigants were often able to predict rulings in their cases long before the issues would actually arise; this form of consolidation thereby created a dynamic that eventually led to the demise of this "coordinated plan for management."

Asbestos bankruptcies are particularly difficult to manage because of the complexity of the parties' interests, the difficulty in evaluating present and future personal injury claims, the disparate bargaining power of the parties and the virtually infinite opportunities for strategic and tactical maneuvering. There are asbestos personal injury plaintiffs as well as asbestos property damage plaintiffs. There are severe, moderate and minimal personal injuries. There are lawyers and plaintiffs who have already filed lawsuits, who can file lawsuits, and who may file lawsuits in the future. Needless to say, these differences in plaintiffs creates a corresponding disparity in interests: Each group wants to maximize the recovery for their respective claims.

The many other types of parties have differing interests. Insurance companies are significant parties in asbestos bankruptcies. There are insurers who have settled, those who have partially settled, those who have outstanding claims, those whose policies cover different time periods, those who are in excess of other policies and those whose policies contain different terms and conditions.

**The theory behind the assignment to one experienced district court judge was to enable the court to develop and implement a "coordinated plan for management."**

Financial institutions (financial creditors) are often in conflict with each other, depending upon the nature of the debt and the security (if any) provided. Adding further complication, their interests may be divided further depending upon whether they acquired their claim from the original creditor and, if purchased, the extent to which such purchase was at a discount. Even members of a debtor's own corporate family — equity holders, management, boards of directors, labor unions — have differing interests with any given subject. Adding to the list of parties in interest are the trade creditors, the United States Trustee, and various public interest groups.

The *Owens Corning* case highlighted these differing interests. The interests of two sets of financial creditors were so different that the bankruptcy counsel for the financial creditors had to defer to the parties' two separate counsel. Eventually, one group of financial creditors, the bondholders, settled with the debtor and the asbestos claimants. The other group fought this alliance. The issue turned on "substantive consolidation," specifically whether there could be under the chapter 11 plan of reorganization a consolidation of the assets and liabilities of the debtor–borrower and affiliated guarantors.

The District Court, acting as the bankruptcy court, approved this plan. The Third Circuit reversed the District Court, holding that the prepetition agreement between the debtor and the bondholders with "guarantees" could not be undone by altering the debtor's pre-loan choices of organizational form.[6] The Third Circuit reversed even though there were subsequent changes in the corporate organization, and notwithstanding that the bonds had subsequently been purchased at a steep discount. To do otherwise, reasoned the court, would overturn the original bargain and cause chaos in the marketplace. In a classic conflict between the strict terms of a financial document and the overall equities of the case, the appellate court was faithful in adhering to the terms of the original agreements and the notion of financial predictability.

One of the most unusual sources of friction in asbestos bankruptcies is found in the relationship between the tort bar and the bankruptcy bar. Normally, clients in bankruptcy cases defer to the bankruptcy counsel; whereas, the tort plaintiffs' lawyers have tended to be their own counsel. This reality goes as far back as the *Johns-Manville* case, where there were several changes in bankruptcy counsel for the asbestos personal injury claimants because fundamental assumptions about the underlying cases, the legal process, and virtually every other aspect of a chapter 11 case varied so greatly. Fundamentally, basic communication between the bankruptcy and tort bar was difficult. In fact, this phenomenon is not limited to the asbestos claimants. In some instances the lead lawyers for the debtor have been from the tort bar whereas in other cases the bankruptcy lawyers have taken the lead, which has on occasion caused similar friction.

One of the more interesting issues that arises in any mass tort bankruptcy is the evaluation of the personal injury claims either for purposes of an estimation under Section 502(c) of the Bankruptcy Code or for purposes of a Section 1129 "fair and equitable" determination. In order for a debtor to emerge from bankruptcy, its chapter 11 plan must provide for the same treatment for similarly situated creditors. For example, bondholders, if unsecured, are often put in a class of creditors with the same treatment as tort claimants. It is relatively easy to determine the value of the bondholders' claims, but what is the value of all of the present and future tort claims? In order that similarly situated creditors receive the same treatment (i.e., percentage distribution), it is necessary to determine the total value of the asbestos claims so that the "pie" available for distribution may be fairly apportioned.

Given the large volume of tort claimants, it is virtually impossible to have a separate trial for each claim prior to a chapter 11 plan confirmation hearing in order to reach an aggregate class value. Instead, courts have used a variety of approaches to "estimate" the total value of present and future asbestos personal injury claims, as an alternative to determining the value of any individual claims. Once that estimate has been made, then under this approach the total amount to be distributed to asbestos creditors can be determined. A trust is established pursuant to the plan of reorganization to allow and pay present and future tort claims.

The more intriguing variables in estimating claims are how many future claims will be filed and the relationship between the propensity to sue and the process of resolving suits. Asbestos is a highly "elastic" mass tort — the faster and cheaper cases are resolved, the greater the incentive for the plaintiffs' bar to file new cases. If the assumption is that cases can be resolved quickly, even if the per case value is low, then the projected future filings can inflate the estimation aggregate of claims far more than a simple increase in average value of each claim. With filing estimates for future claims varying by as much as 500 percent, there is ample opportunity for judicial discretion in the estimation. The judge's proclivities in this area often make a difference. The parties may argue, as they have done in *W.R. Grace*, for several different methodologies for estimating claims: extrapolating from historic outcomes into the future, assuming each claim to be invalid unless substantiated by conclusive evidence, establishing medical thresholds that must be met by each claim, or examining randomly selected claims and extrapolating from those results. Typically the task is given to the judge, who uses the debtor's asbestos litigation settlement and trial history in order to predict the future.

**Asbestos is a highly "elastic" mass tort — the faster and cheaper cases are resolved, the greater the incentive for the plaintiffs' bar to file new cases.**

In asbestos bankruptcies, however, Section 524(g) of the Bankruptcy Code carries great weight. In earlier years after the first few asbestos bankruptcies were resolved, the shadow of potential future asbestos liability still loomed over reorganized debtors. These companies did have an injunction channeling all future asbestos claims to a separate trust fund created under the plan of reorganization, but what would happen if the funds to pay future asbestos claimants ran short? Would the reorganized debtor have to continue to pay? The risk of future liability reduced the market value of reorganized debtors to a sufficient degree that in 1994 Congress, at the instigation of potential debtors, passed Section 524(g) of the Bankruptcy Code.[7] The statute was designed to eliminate this overhang of asbestos liability for a company emerging from bankruptcy.

Section 524(g) provides for protection against future asbestos liability for the reorganized debtor if:

(a) a trust is created which assumes the present and future asbestos personal injury and/or property damage liabilities of the debtor;

(b) the trust is funded in whole or in part by securities of the debtor and obligations of the debtor to make future payments, including dividends;

(c) the trust will own, or by exercise of rights granted under the plan will be entitled to own, a majority of the voting stock of the debtor, parent or subsidiary, if specified contingencies occur;

(d) the trust will pay the present and future asbestos claims against the debtor;

(e) the present and future claims will all be valued and paid in substantially the same manner;

(f) the plan is approved by at least 75 percent of all asbestos claimants who vote; and

(g) a futures representative is appointed.

If the above conditions are met, then the plan of reorganization can include an injunction issued by the district court barring the following claims:

a) claims against the reorganized

debtor for the debtor's asbestos torts; b) claims against third-parties who were or are past and present affiliates of the debtor, officers or directors of the debtor or a related party, insurers of the debtor, lenders to a purchaser of the debtor who have provided or agreed to provide benefits to the trust in amounts that make such protection fair and equitable.

In addition, any enforcement of or construction of the terms of injunction must be done by the same district court.

Aside from increasing the market value of the reorganized company, the net effect of Section 524(g) has been to give veto power over any consensual reorganization to asbestos personal injury claimants in general and to the least injured claimants in particular. These circumstances have led to outcomes that appellate courts, including the Third Circuit, have found to be wanting in fundamental fairness.

If a bankruptcy court deems every asbestos claim to be of relatively equal value because of the impossibility of placing different values on different claims in advance of plan confirmation, the inevitable effect is to disenfranchise the smaller number of serious claims and overenfranchise the vastly larger number of least serious claims. In addition, the lower the scrutiny by the court to determine the validity of each claim, the larger the number of less serious claims. The requirement of a 75 percent positive vote and the inability of the court to "cram down" the asbestos claimant constituency under Section 524(g) means that the lawyers representing the larger volume of claims, in effect, tend to control the negotiations of plans of reorganization.

In certain cases, most notably in *Combustion Engineering, Inc.*, the Third Circuit found that the overwhelming bargaining power of the less injured led to an unacceptable outcome.[8] Combustion Engineering engaged in negotiations with counsel for the personal injury claimants prior to filing for bankruptcy. The company reached agreements with these claimants which enabled it to file a "pre-packaged" bankruptcy. These "pre-packs" have traditionally been favored by debtors because negotiations and solicitation of a plan of reorganization occur prior to the chapter 11 filing, resulting in a short tenure in bankruptcy. Yet, the outcome of the pre-bankruptcy negotiations is shaped by the bargaining power of the interested parties, which is defined in part by their rights under the Bankruptcy Code.

The Third Circuit found the Combustion Engineering "pre-pack" wanting on at least three grounds: (1) the injunctive relief protecting non-debtors from future asbestos claims went too far; (2) there was unacceptable discrimination against certain asbestos personal injury claimants; and (3) certain asbestos claimants were improperly allowed to vote because they were "artificially impaired." In essence, the court held that the larger number of less impaired claimants received too much value in comparison to the more severely impaired claimants, that the vote was biased by the voting by those claimants, and that the debtor's related companies received more protection than permissible. In essence, the Third Circuit determined that the pre-packaged bankruptcy negotiation process had led to a bargain that was unfair. Since that decision, courts have reached similar conclusions in other cases in this Circuit.[9]

Adding to the complexity of the bankruptcy bargaining process has been the legislative effort in this decade to address asbestos liability. A broad range of corporations and other organizations decided that the tort litigation system was broken and there needed to be a federal compensation system to pay asbestos claims with a defined pool of money. Needless to say, this legislation effort was opposed vociferously by the plaintiffs' bar and a major segment of the insurance industry. A Senate bill called for a $100 billion-plus trust fund to be the exclusive source of compensation for asbestos injury claims. The trust would be funded from contributions from asbestos defendants and their insurers, rather than the public treasury. Eventually, the bill was reported favorably out of the Senate Judiciary Committee, but not put to vote before the full Senate. The proposed legislation has been politically charged and well publicized.

The pendency of the bill for several years, however, dramatically affected the bargaining process in the asbestos bankruptcies. For some of the parties — notably equity holders and some financial institutions — the legislation would have a beneficial effect. As a result, they favored slowing the bankruptcy process with the hope that a new statute would supersede the existing tort system and the paramount bargaining power of the tort claimants in bankruptcy.

**Probably the most unexpected outcome of the consolidation of the five asbestos bankruptcies in Delaware was the dismantling of the consolidation itself.**

For other parties — most notably the personal injury claimants and insurance carriers who would need to shoulder much of the contribution to the trust fund — the legislation would have had an extremely negative effect and they desired to expedite the bankruptcy proceedings before any proposed legislation like this succeeded. The effect was paralysis in the bankruptcy negotiations — virtually every issue became contested. Key parties had little incentive to settle in bankruptcy when the potential effects of legislation could be so beneficial, and yet the outcome of the legislative process was so uncertain that other parties did not feel sufficient pressure to reach an accommodation.

Probably the most unexpected outcome of the consolidation of the five asbestos bankruptcies in Delaware was the dismantling of the consolidation itself. The Third Circuit in *Kensington International, Ltd.* granted petitions for a writ of mandamus disqualifying the federal district judge.[10] The five Delaware asbestos bankruptcies were then reassigned to different district judges.

The judge was disqualified following accusations by some parties that he had a conflict of interest. The events surrounding these accusations are beyond the scope of this article. The Third Circuit's specific holding was:

> ... [A] reasonable person, knowing all of the relevant circumstances, would conclude that Judge Wolin's impartiality might reasonably be questioned in the Owens Corning, W.R. Grace & Co. and USG Corp. bankruptcies ... We emphasize that our review of the record has not revealed the slightest hint of any actual bias or partisanship by Judge Wolin. On the contrary, Judge Wolin has throughout his stewardship over the Five Asbestos Cases exhibited all of the judicial qualities, ethical conduct, and characteristics emblematic of the most experienced, competent, and distinguished Article III jurists. But the test for disqualification under § 455(a) is not actual bias; it is the perception of bias.[11]

The facts alleged in support of the disqualification effort were challenged by some, who contend the disqualification was a byproduct of efforts by the judge to use innovative and contested methods of gathering information and of overseeing the discussions among the parties. Some believe the effort was supported by parties who expected to receive adverse rulings in the bankruptcy and those with a desire to delay the bankruptcy process pending federal legislation.

This asbestos battle over the bargaining power created by Section 524(g) and by the potential for a change in bargaining power with new legislation manifested itself in substantial political contributions, intense public relations activity involving newspaper editors, academics, and politicians, and, ultimately, attacks on the judiciary. By consolidating the asbestos bankruptcy cases, the amount of money involving the decisions of one judge was increased substantially. Financial investors in one case could see opportunities to invest in other cases with a resulting concentration of parties and intensification of money at risk. Additionally, by consolidation, normally mundane legal issues became elevated in the public eye and subject to public relations companies and related political pressures.

The bankruptcy saga in the five Delaware asbestos cases continues, even without consolidation. There is an end in sight for three of these asbestos bankruptcies. The moral of this story is that practitioners can benefit from this experience by being wary of altering accepted judicial processes, even when tempted with seemingly pragmatic solutions with the promise of successful outcomes. ◆

FOOTNOTES

1. *In re Johns-Manville Corporation, et al.*, No. 82-11656 (Bankr. S.D.N.Y. 1982).

2. *Amchem Products, Inc. v. Windsor*, 521 U.S. 591 (1997).

3. *Ortiz v. Fibreboard Corp.*, 527 U.S. 815 (1999).

4. No. 00-14471 (Bankr. D. Del.), No. 01-10578 (Bankr. D. Del.), No. 00-03837 (Bankr. D. Del.), No. 01-02094 (Bankr. D. Del.) and No. 01-01139 (Bankr. D. Del.), respectively.

5. On Jan. 23, 1997, the United States District Court for the District of Delaware revoked the automatic withdrawal of reference. This enabled the District Court judges to support Delaware's two bankruptcy judges in administering a large docket of pending chapter 11 cases. On Feb. 3, 2001, the District Court reimposed the automatic withdrawal of reference, and visiting judges from various jurisdiction around the country began hearing Delaware cases in place of the District Court.

6. *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005).

7. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994).

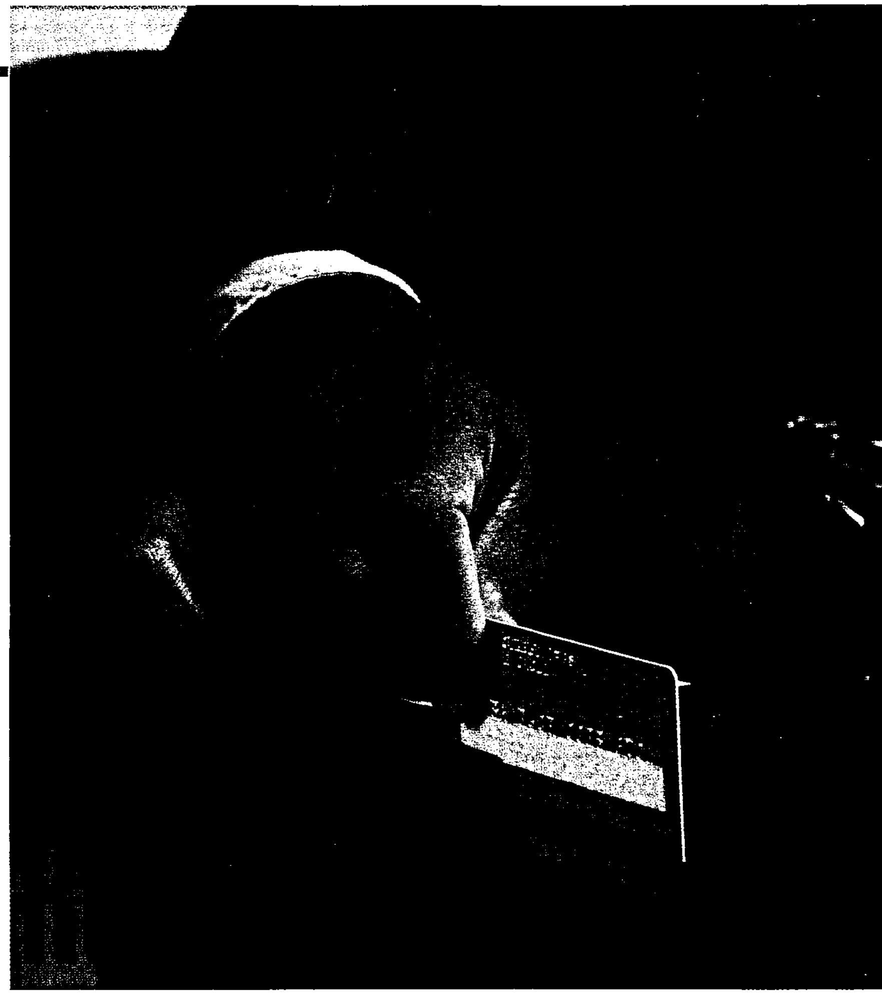
8. *In re Combustion Engineering Inc.*, 391 F.3d 190 (3d Cir. 2006).

9. *In re AC and S, Inc.*, 311 B.R. 36 (Bankr. D. Del. 2004); *In re Century Indem. Co. v. Congoleum Corp.*, 426 F.3d 645 (3d Cir. 2005).

10. *In re Kensington Int'l. Ltd.*, 368 F.3d. 289 (3d Cir. 2004).

11. *Id.*

Mark D. Collins



# The Long and Tumultuous

Spurred by a surge in consumer bankruptcy filings in the late 1990s, the task of reforming the Bankruptcy Code turned into an eight-year struggle.

Celebrity bankruptcy filers living the high life on sheltered assets, stiffing creditors from the safety of their multimillion-dollar homesteads. Destitute single mothers shoved aside by greedy creditors in the race to the courthouse. In the debate over bankruptcy reform from 1997 until final passage of legislation in 2005,[1] sensational charges were launched by both supporters and opponents. Drawn out over eight years and five Congresses, the legislative fight over its passage provided more than its share of drama.

A cursory reading of the national press during that long fight told the story of a pitched battle between opposed interests. And that process was indeed a monumental legislative struggle. But a look at the consistently strong bipartisan support for the reform legislation, year after year, tells a different story, one where there was a lot less fundamental disagreement on reform, but one in which the pitched battles often occurred over issues at best tangential to the core issues of the Bankruptcy Code.[2]

As a lesson in the politics of the legislative process, bankruptcy reform had it all: majority power steamrolling opposition, small minorities making use of every parliamentary tactic, powerful financial interests that lost the public relations fight, underfunded underdogs who succeeded in defining the debate but losing the votes and even a constitutional law footnote, a pocket veto.

For the State of Delaware, the stakes were high. Delaware is home to a thriving bankruptcy bar and to bankruptcy courts whose cases set national precedent; saddled with a massive caseload, the Delaware bankruptcy bench needed federal authorization for new judgeships. Before the process was over, the weighted caseload of Delaware bankruptcy bench warranted fully 18 judgeships to carry it. Delaware is the state of incorporation of over half of all publicly traded U.S. corporations, which are thus eligible under federal law to file for bankruptcy protection there. And Delaware is home to major credit card banks, among the industries spearheading the drive for reform.

Spurred by a surge in consumer bankruptcy filings that ranged from 1.2 million to 1.6 million annually in the late 1990s, the task of reforming the Bankruptcy Code turned into an eight-year struggle, spanning the 105th, 106th, 107th, 108th, and 109th Congresses.

The Bankruptcy Code was enacted in 1978, replacing the Bankruptcy Act of 1898. This new statutory scheme was followed by a steady acceleration in the number of personal filings. In the decade leading up to 1997, personal filings increased from a little more than 500,000 to 1.4 million. Legislation passed in 1994 established the National Bankruptcy Review Commission,[3] charged with reviewing the Bankruptcy Code and recommending reforms.

The Commission's hearings provided a rehearsal for the conflict that would follow, with creditors and consumer advocates squaring off, along with a re-examination of many aspects of the Bankruptcy Code.

While not central to the national debate on the reform legislation, two issues of great interest to Delaware would be caught up in the years of legislative struggle. One Bankruptcy Review Commission recommendation aimed right at Delaware involved venue. The Commission recommended eliminating a company's state of incorporation as a basis for venue. Repeal of that venue provision was sought by representatives in other federal bankruptcy districts, in the hope of securing some of the high-profile cases heard before the Delaware bankruptcy bench.

And the urgent need for new bankruptcy judgeships for the District of Delaware, along with other judgeships needed in other jurisdictions around the country, had the strong support of the Delaware delegation and delegations from other overloaded districts. But any answer to their needs would have to wait for final passage of a comprehensive reform bill: reform advocates wanted to maintain support for their efforts by holding the judgeships hostage to their ultimate goal.

At key junctures in the process, the Delaware congressional delegation, with bicameral and bipartisan unity, and led by senior Judiciary Committee member Sen. Joseph R. Biden Jr., preserved Delaware's venue provision and pushed to increase the number of judgeships to meet the pressing demands of the District of Delaware.

**The surge in personal bankruptcies presented a chicken-and-egg problem: Was it excessive lending or was it excessive borrowing that was pushing so many millions of consumers beyond their means?**

Soon after the Bankruptcy Review Commission presented its findings in 1997, subcommittees of both the House and Senate Judiciary Committees began hearing testimony and drafting legislation. From the outset, the legislation was accompanied by a highly publicized lobbying effort by creditors — including Delaware-based credit card banks, but ultimately including virtually everyone from landlords to department stores and anyone else for whom a bankruptcy filing could mean a debt unpaid. At the same time, particularly in the Senate, concerns were expressed that it was irresponsible lenders, not irresponsible borrowers, who were the root cause of the flood of personal bankruptcy filings.

As a public policy problem, the surge in personal bankruptcies during the 1990s presented a chicken-and-egg problem: Was it excessive lending or was it excessive borrowing that was pushing so many millions of consumers beyond their means? Both propositions were backed by motivated advocates — when the debate was joined, those two camps defined it. For those who focused on the behavior of consumers, chapter 7 liquidations were too attractive, and too available for filers who might have the ability to make repayments under chapter 13. For those who believed that creditors were making debt too attractive to unsuspecting and unprepared consumers, more transparency and stricter regulation of lending practices, as well as protection for the most vulnerable filers, were priorities.

Bipartisan majorities supported comprehensive reform legislation in each of the five Congresses that would eventually vote on it, but until final passage in 2005, a presidential signature and final enactment remained just out of reach. During that torturous process, the process took a different route on each side of Capitol Hill. From the outset, the House, with its more structured majority-dominated process, was able to move legislation along the lines favored by the coalition of creditors seeking to tighten access to chapter 7 by demanding evidence that filers lacked the ability to pay. The key to that approach was the institution of a means test, a calculation of a debtor's ability to pay. Removing the determination of abuse from the judge's discretion, that approach substituted a mathematical calculation of a filer's debts and income. Upon a showing of the ability to pay at least 20 percent of their unsecured debt, a chapter 13 filing and a repayment plan rather than a chapter 7 liquidation was required.

Over in the Senate, the power of the minority was felt in the literally hundreds of amendments voted on, in subcommittee, full committee, floor debate and in conferences between the two houses. Those amendments were aimed at protecting filers without the resources to repay, and directing attention to the lending and marketing practices of creditors.

Those lines were drawn early. In the House, the first Judiciary Subcommittee debate in 1998 saw more than 20 Democratic amendments rejected by the Republican majority. In the Senate, the first subcommittee action was on a bipartisan bill, passed out on a 6-1 vote. Like the House bill, it was aimed at moving those with the ability to pay from chapter 7 to chapter 13, but left more judicial discretion and did not require a strict financial means test for access to chapter 7. Instead, it gave trustees and creditors standing to charge a filer with abuse if there was evidence of ability to pay. As the debate proceeded over the years, this pattern would not substantially change.

The full committee vote in the House was 18-10, almost right down party lines. In the Senate, the Judiciary Committee sent its version to the Senate floor by a 16-2 vote, a sign of greater bipartisan support.

But despite a show of bipartisanship on the committee vote, Democrats balked at Republican attempts to prevent amendments when the bill was brought to the Senate floor. There the strength of the minority — partly based on concerns about the legislation itself and partly on the minority's rights to debate and amendment — would slow the process down. At the end of the lengthy debate, amendments had been adopted to require more disclosure by credit card companies and others of the terms under which credit is extended, balancing some of the new demands on consumers with demands for more responsible lending practices.

That version passed the Senate almost unanimously, 97-1, on Sept. 23, 1998. But that moment of overwhelming bipartisanship was short-lived. The next step was a House-Senate conference to reconcile very different approaches to reform. During the conference with the House, the Senate approach was essentially dismissed, and the House version largely adopted. The House passed that version by a strong bipartisan margin of 300-125. The Senate did not take up the bill for the remainder of that Congress. With a veto threat from President Bill Clinton in the air, bankruptcy reform was dead as of the end of the 1997-1998 Congressional session.

So far in this legislative process, Delaware had deflected potential attacks on venue, but the workload on its bankruptcy judges continued to grow, and hope for new judgeships dimmed without passage of a reform bill. For the next four Congresses, time and again the debates rehearsed in the 105th Congress were replayed.

**Both sides were dug in; the legislative version of trench warfare was under way. Lengthy battles, with neither side gaining much ground, would follow into the new decade.**

In April 1999, the Senate Judiciary Committee reported legislation that applied a strict means test, based on Internal Revenue Service standards for calculating a debtor's ability to pay, bringing the Senate version much closer to the House plan. Nevertheless, this change did not fundamentally alter the bipartisan dynamic in the Senate. Many of the numerous amendments offered during committee debate were withdrawn with the intention of revisiting on the Senate floor such issues as restrictions on the lending and marketing practices of creditors. The Committee vote, 14-4, once again reflected more bipartisanship than could be mustered in the House, where the House bill was sent out on a narrower, more partisan 22-13 margin.

But while prospects for passage appeared to improve — and with them prospects for some additional judgeships for Delaware and other districts with massive caseloads — a new wrinkle was added to the bankruptcy reform debate. A provision that would prevent the discharge of settlements awarded against protestors at family planning clinics was narrowly rejected in the Senate Judiciary Committee. It would return to complicate the already messy politics surrounding bankruptcy reform. That provision was adopted during a prolonged Senate floor debate, along with some other extraneous provisions. At the end of that process, on Feb. 2, 2000, the Senate version gained an overwhelming vote of 83-14.

The full House passed its version of reform legislation by an almost three-to-one margin, 313-108.

But once again, the power the Senate grants to the minority was in evidence, as objections from Sen. Paul Wellstone of Minnesota prevented the timely naming of conferees to work out the differences between House and Senate versions. This delayed action on a conference agreement until late in the 1999-2000 legislative session, where limited time magnifies the power of delaying tactics. Final Senate passage of the conference report, without the clinic settlement language, minimum wage, or other Senate provisions, was by another strong 70-28 margin, more than enough to override the veto threatened by President Clinton. However, the vote was held so close to the end of the 1999-2000 Congressional session that President Clinton, who was completing his second and final term in the White House, was able to kill it by simple inaction — a pocket veto. Once again, bankruptcy reform, and the Delaware judgeships attached to it, failed to become law despite strong bipartisan votes in both Houses. Battle lines had been drawn. Both sides were dug in; the legislative version of trench warfare was under way. Lengthy battles, with neither side gaining much ground, would follow into the new decade.

In 2001, the 107th Congress saw the re-introduction of reform bills in both houses. While the public debate remained heated, strong bipartisan and bicameral support for the key reforms of consumer bankruptcy persisted. Under current law, the filing of a chapter 7 petition was at the discretion of the individual filing for bankruptcy. The proposed legislation established a means test to determine a filer's ability to pay at least 25 percent of outstanding debt, or $10,000, whichever was less. If resources were available to make such a repayment, the legislation required the individual to file under a chapter 13 with a repayment plan. Only those filers with less than the median annual income in their state would be allowed to file a chapter 7 petition.

The legislation also required consumer counseling before filing, and increased the size of certain non-dischargeable debts incurred immediately prior to filing. Extensive protection for child support and alimony liabilities was also included. On the creditor side, credit card issuers would be required to disclose more information, so-called "teaser rates" as well as the costs of making only minimum payments on credit balances.

While important changes affecting the chapter 11 portion of the Bankruptcy Code, such as netting of complex hedge fund liabilities in bankruptcy were also included, they received little attention in legislative debates. Also, there would eventually be some significant changes to the Bankruptcy Code impacting larger corporate bankruptcies under chapter 11.[4] Once again, the basic contours of the reform package were established, as were the lines of debate.

Two issues, affecting a very small number of bankruptcy cases, however, became focal points for legislative debates: the unlimited homestead exemption available in some states, which had allowed some notorious individuals to shield millions in bankruptcy, and the use of bankruptcy by anti-abortion activists to prevent payment of settlements against them. While the first issue affected a small percentage of filings in only a few states, it was used as an example of the unfairness of a system that allowed the wealthy to game the Bankruptcy Code to their advantage. And while no settlement against protesters had ever been avoided in bankruptcy, filing had become an announced tactic of the protest groups, delaying payments to victims, costing them substantial legal fees, and reigniting debate over the Free Access to Clinic Entrances (FACE) Act, passed in 1994.[5] During earlier House debate on that legislation, Sen. Charles Schumer of New York and U.S. Rep. Henry Hyde, now House Judiciary chairman, had squared off over that always-contentious issue, with Hyde losing. That history meant the issue would remain the most difficult to resolve in this new context.

**The tragic events of Sept. 11 pushed bankruptcy reform off the calendar until 2002. The delay did nothing to reduce the differences between House and the Senate conferees.**

An amendment by Sens. Diane Feinstein of California and Herb Kohl of Wisconsin limiting the homestead exemption to $125,000 was accepted during Senate floor debate. Yet, strong and well-placed delegations from Texas and Florida ensured that those states' unlimited exemptions would be protected in the House. Also added during the Senate floor debate was an amendment by Sen. Schumer to block the discharge of settlements resulting from violations of the FACE Act.

That Senate debate took fully two weeks, during which literally hundreds of amendments were filed, many intended by opponents of the legislation to highlight perceived inequities between borrowers and lenders. Despite the often-heated debate, and the failure of most of those amendments, reform legislation passed the Senate by the overwhelming margin of 83-15 in March 2001. The House, with its stronger majority controls over amendments, had earlier that same month cleared its version, 306-108. The stage was once again set for a House-Senate conference.

However, formation of a conference committee was no easy task. Following the November 2000 elections, the Senate was split 50/50, and for months under those unusual circumstances there was no agreement on how to manage Senate appointments to conference committees. By June 2001, however, because Vermont Sen. Jim Jeffords chose to caucus with the Democrats, a majority was established and appointments were made. Finally, the first meeting of conferees was scheduled for Sept. 12, 2001.

The tragic events of Sept. 11 pushed bankruptcy reform, as well as most of the normal legislative agenda, off the calendar until 2002. The delay did nothing to reduce the differences between House and the Senate conferees on many substantive details, none of which presented a major roadblock to a final agreement, but each of which required weeks and sometimes months of staff negotiations. The most contentious issue, the question of the dischargeability of clinic violence settlements, would be reserved for the members themselves. The provision in dispute during the final conference negotiations was the Senate language, defining as non-dischargeable a broader range of settlements, not just those resulting from a violation of the FACE Act. Nevertheless, pro-life interest groups and representatives, such as Chairman Hyde who shared their perspective, felt that the provision was aimed directly at them, no matter how broad the language.

The fate of creditors and debtors who would be affected by the reform bill, and the fate of Delaware's bankruptcy judgeships, hung on a series of closed-door sessions in the private Capitol office of Rep. Dick Armey of Texas, the House majority leader. By late July 2002, the announcement came that a decision had been reached: fines for "intentional, knowing or reckless actions" that interfered with the provision of "lawful goods or services" would not be dischargeable in bankruptcy. The last issue had been resolved.

Or so it seemed. When the conference report containing that version came before the House in November, pro-life interests protested that Chairman Hyde, whom one anti-abortion House member called "the George Washington of the pro-life movement," had failed to adequately protect their interests. Confronted with that reaction from a core constituency, the Republican leadership could not muster the votes needed to bring the bill up. A version not containing the problematic provision was passed, but the Senate refused to vote on it. Bankruptcy reform was dead for another Congress.

So, the 108th Congress convened in January 2003 with bankruptcy reform legislation still on the agenda. A bill closely tracking the earlier versions moved swiftly through the House Judiciary Committee, but the continued threat of the "Schumer Amendment," likely to be supported by the Democratic majority and to once again derail any House-Senate conference, meant the Congress adjourned with no further action. Bipartisan majorities on both sides of the Hill were on record in favor of the core package of reforms, but the radioactive issue of abortion clinics precluded action for two years. Eight years had now elapsed since the legislative process began.

However, with the elections of November 2004 restoring a strong 55-seat Republican majority in the Senate, there was light at the end of the long legislative tunnel. The Senate Judiciary Committee acted quickly, passing out the by-now established version of the reform legislation — with a new effective date — by a vote of 12-5 on Feb. 17, 2005. The House Judiciary Committee, under the new chair, Rep. James Sensenbrenner of Wisconsin, chose to wait for Senate passage, aiming to reduce House-Senate differences to a minimum.

In March, the full Senate took up that bill, voting against amendments by Democrats which revisited issues raised in past Congresses. Debate began on Feb. 28, and continued into the week of March 7, 2005.

During that debate, an issue that previously had been successfully blocked by the Delaware bracket delegation briefly reappeared. Senator John Cornyn of Texas filed an amendment to eliminate state of incorporation as a grounds for venue in a chapter 11 bankruptcy filing. The Delaware delegation made it clear that such a move would be met with a proposal to eliminate the homestead exemption that Texas cherished. Reopening that contentious issue had the potential to derail the reform bill yet again. Under pressure from Republicans who didnot want to lose the bipartisan support of Delaware Democratic Sens. Biden and Tom Carper, Sen. Cornyn chose to withdraw his amendment.

While more than 125 amendments to the bill were filed for the floor debate, the most anticipated vote was on the "lawful goods and services" amendment by Sen. Schumer. After weeks of speculation about the outcome of the vote, the Schumer amendment was rejected, 46-53. Again, despite the vigorous debate and the failure of many amendments, the vote for final passage reflected the kind of bipartisan consensus that is rarely achieved on ostensibly controversial legislation.

On March 10, 2005, by a vote of 74-25, with a majority of both parties voting "aye," the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 passed the Senate. The margin of the House vote on April 14, 2005 was also, at 302-126, unusually large for controversial legislation. Less than a week later, President George W. Bush signed the bill. While the effective date of the legislation was to be Oct. 17, 2005, many aspects of implementation were to be worked out.

Objective observers agree that it is still too early to assess the impact of the legislation. But one thing is sure — the long, difficult road to passage of significant Bankruptcy Code reform, including the effort to ease the burden of Delaware's overloaded bankruptcy judges, had finally reached its happy destination. ◆

*The author acknowledges and thanks James B. Greene and Jonathan Meyer for their assistance with this article.*

FOOTNOTES

1. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, 119 Stat. 23 (2005).

2. 11 U.S.C. §§ 101, *et seq.* (the "Bankruptcy Code").

3. National Bankruptcy Review Commission Act, Pub. L. No. 103-394 §§ 601-10, 108 Stat. 4106, 4147-48 (1994).

4. Such amendments related to management retention bonuses, reclamation claims, length of the "exclusivity" period for a corporate debtor to file a chapter 11 plan and time in which a debtor can assume or reject unexpired leases.

5. Freedom of Access to Clinic Entrances Act of 1994, 18 U.S.C. § 248 (1994).

FEATURE

Michael B. Joseph

# Bankruptcy Exemptions

## Under Federal and State Laws

**Sweeping changes enacted in both federal bankruptcy law and Delaware's exemption statute have had an impact on personal bankruptcies filed in Delaware.**

Certain federal and state laws shield property from creditors and provide valuable rights to individuals in financial distress. Such laws are called exemptions, and assets that may be exempt are placed beyond the reach of creditors. Historically, exemption laws evolved to prevent punitive seizures of personal effects, clothing and items of little economic value. Also, exempting assets promoted eventual solvency by protecting such things as tools of trade, farm implements, vehicles and retirement accounts. Exemptions in individual bankruptcy cases are therefore of utmost importance. In 2005, sweeping changes were enacted in both federal bankruptcy law and Delaware's exemption statute that have had an impact on personal bankruptcies filed in Delaware.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) was signed by President George W. Bush on April 20, 2005 and substantially became effective on Oct. 17, 2005.[1] The national media spotlighted these broad changes in the law and the potential difficulties for future consumer bankruptcy filers. However, little attention was given to certain state laws that were also amended during this same time period. Effective July 7, 2005, Delaware amended its longstanding exemption laws that affect all Delawareans that file for bankruptcy.[2] The provisions in both of these new laws contain the most sweeping and comprehensive changes to consumer bankruptcy in more than 20 years. Personal bankruptcy in Delaware has been altered dramatically since these new laws have taken effect.

Most of the publicity in the last year regarding BAPCPA focused upon the means test, or the requirement that for those above median income debtors who have disposable income and the means to pay something to their creditors are presumed to have abused the bankruptcy system by the filing of a chapter 7 case.[3] Unless these debtors agree to convert to a chapter 13 and propose a repayment plan, the Court must dismiss their case as an abusive filing. So initially, when a debtor is contemplating the filing of a case, an analysis must be performed regarding a debtor's income and whether it is above or below the state's median. If it is above the median income, the debtor must be able to pass the means test to file a chapter 7. Hence, the means test will determine the type of bankruptcy relief available.[4]

Not receiving as much publicity but also critical to the bankruptcy analysis is the liquidation test.[5] The liquidation test focuses on property of the debtor rather than the debtor's income. In this analysis the question to be answered is what property would be available in a chapter 7 case for a trustee to liquidate on behalf of creditors. The calculation is the value of all real and personal property, less liens and judgments, and less allowed exemptions. This formula will either leave certain property available to creditors or leave nothing. Determination of the amount of property or value of non-exempt assets may be the most critical analysis for debtors contemplating filing bankruptcy as it determines what if any property or assets they will retain in a bankruptcy proceeding. Chapter 7 bankruptcy becomes an attractive option where the liquidation test shows zero or no equity net of liens and exemptions. Under new federal bankruptcy law and the new Delaware exemption statute, this analysis has remarkably changed.

Delaware state law provides that (a) an individual may exempt from execution or attachment the following articles of personal property: the family Bible, school books and family library, family pictures, a seat or pew in any church or place of public worship, a lot in any burial ground, all the wearing apparel of the debtor and debtor's family; (b) each person residing in the State shall have exempt the tools, implements, and fixtures necessary for carrying on his or her trade or business, not exceeding in value $75 in New Castle and Sussex Counties, and $50 in Kent County; (c) all sewing machines owned by seamstresses and private families are exempt; (d) all pianos, piano playing attachments and organs leased or hired by any person residing in this State are exempt.[6] Non-exempt property may be seized and sold at a sheriff's sale or auction sale pursuant to a writ or court order to satisfy (i.e., pay) a judgment after notice to the public.[7] These state exemption laws have been enforced in various forms for many years in state civil collection actions.[8]

**The Bankruptcy Code enacted in 1978 contained a provision that permitted each state to opt out of the federal bankruptcy exemptions.**

The Bankruptcy Code enacted in 1978 contained a provision that permitted each state to opt out of the federal bankruptcy exemptions.[9] The amounts allowed under federal law increased over the years and currently the following amounts applies in a bankruptcy liquidation:

- Real or personal property used as a residence: $18,450
- Motor vehicle: $2,950
- Household items: $475 per item; $9,850 aggregate
- Jewelry: $1,225
- Wildcard: Unused exemptions may use $975 per item; up to $9,250 of unused exemptions
- Tools of trade and professional books: $1,850.

It is noted that in a joint husband and wife case, all of these exemptions are doubled.

In 1981, Delaware quickly passed a law opting out of the federal bankruptcy exemptions under the new Bankruptcy Code, providing that in any bankruptcy proceeding an individual domiciled in Delaware was not authorized to elect the federal exemptions and was limited to exempt a total of $5,000 in aggregate fair market value in any property.[10] This meant real and personal property, including equity in real estate, bank accounts, vehicles, furnishings and household appliances. A husband and wife in a joint case could exempt a total of $10,000 in value in all such property. Therefore, if a husband and wife had equity in their home, money in the bank, furniture, appliances and jewelry in an amount that would be valued in excess of $10,000, theoretically a bankruptcy trustee could liquidate or sell the property and distribute the non-exempt proceeds to creditors. Alternatively, the debtors could choose to file a chapter 13 bankruptcy, retain all of their property and propose to pay the non-exempt equity to creditors under a court supervised repayment plan.

The right to exempt property in bankruptcy is extremely valuable to debtors. It may determine what type of personal bankruptcy to file, and whether individuals will be able to remain in their homes and retain their vehicles and personal property. Once property is deemed or held to be exempt in a bankruptcy, it is no longer part of the bankruptcy estate, and is available for the debtor's use. So, if a debtor lists as exempt certain property, and neither the trustee nor creditors object (within the 30-day time limit after conclusion of section 341 meeting of creditors), the property is deemed exempt.[11] After the debtor receives a bankruptcy discharge the debtor is free to use and enjoy all exempt property free from creditors whose claims were discharged.

Prior to the 2005 amendments,

the Delaware bankruptcy exemption allowances were fairly stingy in comparison to many states. For example, Pennsylvania and New Jersey allow a choice of federal or state exemptions and Maryland allows exemptions totaling approximately $12,000 in value of real or personal property.[12] There seemed to be no inclination to change Delaware law until 1997 when the governor signed into law a new provision that exempted funds held in retirement accounts including 401(k)s and IRAs.[13] Although this additional exemption allowance generously preserved retirement savings, other property remained subject to the original bankruptcy exemption laws even with the surge in value of residential property in Delaware.

The effect of the prior Delaware exemptions can be viewed in the following example: A 75-year-old husband and his 73-year-old wife are both retired and receive Social Security and a small monthly pension. Their mobile home is paid for and worth $55,000. They have monthly household expenses for lot rent, taxes, insurance, utilities, food, clothing and medicine. They barely cover their expenses with their income and have accumulated credit card debt over many years. Although they no longer use credit cards, they must forestall collection efforts by some of their creditors and need to file bankruptcy. Since they may only exempt up to $10,000 in all of their property, the couple should not file a chapter 7 case as they would lose their home. They should contemplate chapter 13 and propose a plan to pay creditors as much as the creditors might receive if their home was sold. However, the difficulty they face is they lack even a small amount of excess monthly income to fund a plan. Under the prior exemption law bankruptcy lawyers were forced to be creative and submitted to the court plans that provided, for example, stepped up payment schedules, or promises to sell or refinance the home prior to the end of the plan term.

This all changed in 2005. In the spring of 2005 after it had been well publicized that the federal bankruptcy laws had been amended and were to take effect as of Oct. 17, 2005, Senate Bill 143 was introduced in the Delaware Senate proposing extensive increases to exemptions taken in bankruptcy proceedings filed in Delaware. The legislation obtained broad support, and as amended was signed into law by Gov. Ruth Ann Minner on July 7, 2005 and was effective immediately.[14] This meant that it applied to all bankruptcy cases filed on or after that date. The increases are dramatic: 1) $50,000 in equity in the principal residence of an individual or a joint husband-and-wife case; 2) $25,000 in personal property; and 3) a vehicle and/or tools of trade necessary for employment of a value not to exceed $15,000 each.[15]

Looking at the above example of a retired couple, the new law would have a major impact on their bankruptcy analysis. Under the new exemptions they may exempt up to $50,000 in equity in their home, and after deducting 10 percent liquidation costs from their $55,000 mobile home, there would be nothing available for a trustee or creditors. As such, if they were to file a bankruptcy under the new law they most likely would be candidates for a chapter 7 bankruptcy, retain their home without having to pay anything to their creditors. The favorable financial impact of the new exemption law on the debtors is obvious in this example. Delaware's law now provides a measure of protection and a safe harbor for its citizens in financial distress, allowing them to maintain basic necessities of living without becoming completely impoverished merely because they sought a bankruptcy discharge.[16]

The increased exemptions also have an effect on other personal bankruptcy issues. For example, debtors may use certain provisions of the Bankruptcy Code to avoid liens, recover money on preferences or fraudulent transfers that impair exemptions.[17] This means that if debtors have certain judgment liens filed against them prior to the filing of a bankruptcy and those liens attach to some or all of the exempt equity in real estate, the debtor may seek a court order avoiding or stripping off the liens to preserve their residential exemption. The increase from $10,000 in real and personal property to $50,000 in exempt equity in real property and $25,000 in personal property makes these powers under bankruptcy law quite significant in Delaware bankruptcy filings.

There were also changes made in the bankruptcy law itself that affect an individual's right to assert a particular exemption. In order to stop exemption shopping (e.g., O.J. Simpson moving to Florida to enjoy Florida's unlimited homestead exemption), one of the new provisions to claim a state's exemptions requires a debtor to reside or have a domicile in a state for 730 days before filing bankruptcy.[18] It further provides that if the debtor did not have a single state domicile during the two-year period, the debtor's principle residence during the 180 days immediately preceding the two years is examined.[19] Accordingly, if an individual moved to Delaware from Pennsylvania in 2005 and purchased a home, the exemptions in real estate equity would have to be determined under Pennsylvania law, which is less generous than Delaware's current exemptions. Under the new law, trustees and creditors have to be vigilant in examining debtor's prior addresses and become familiar with 50 different exemption statutes.

**Legal scholars and commentators have written that the intent of Congress was to fairly balance personal bankruptcy, stop abuse and make those who can pay their debts pay.**

There was a perception prior to the enactment of BAPCPA that the bankruptcy laws favored debtors and that too many individuals were avoiding paying their debts.[20] Legal scholars and commentators have written that the intent of Congress was to fairly balance personal bankruptcy, stop abuse and make those who can pay their debts pay.[21] Under the new bankruptcy law, debtors have numerous additional duties and requirements and creditors have been given new rights. Possibly, the new law may have a harsh effect on certain people. However, many individuals seeking bankruptcy relief will benefit with the increase in Delaware's exemptions. This is especially so for debtors who fall below the state's median income levels. Under new law, debtors filing bankruptcy in Delaware are more likely to retain their homes, cars, household furnishings and retirement savings while discharging debt. ◆

*The author acknowledges and thanks Lisa Coggins, Esquire for her assistance with this article.*

FOOTNOTES

1. Pub. L. No. 109-8, 119 Stat. 23 (2005).
2. Del. Code Ann. tit. 10 § 4914 (2004).
3. As of October 1, 2006 the Delaware median income for an individual was $45,182.
4. 11 U.S.C. § 707(b) (2005).
5. 11 U.S.C. §§ 704, 1325(a)(4) (2004).
6. Del. Code Ann. tit. 10 § 4902 (2004).
7. Del. Code Ann. tit. 10 §§ 4961, 4972 *et seq* (2004).
8. *See e.g., H.L. Evans & Co.*, 158 F. 153 (D. Del. 1907).
9. 11 U.S.C. § 522(b) (2005).
10. Del. Code Ann. tit. 10 § 4914 (2004).
11. *See e.g., Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992).
12. Pennsylvania & New Jersey did not opt out of the Federal exemption, while Maryland did.
13. Del. Code Ann. tit. 10 § 4915 (2005).
14. Del. Code Ann. tit. 10 § 4914 (2005).
15. *Id.*
16. *See e.g. In re McVey*, 345 B.R. 846, 851 (Bankr. N.D. Ohio 2006) ("Exemptions... are meant to allow a debtor to maintain life's basic necessities").
17. 11 U.S.C. § 522(f) (2005).
18. 11 U.S.C. § 522(b)(3)(A) (2005).
19. *Id.*
20. *See* Chuck Grassley, Senator (Iowa), Press Release, Grassley Praises President for Signing Compehensive Bankruptcy Reform Legislation (April 20, 2005), http://grassley.senate.gov/index.cfm?FuseAction=PressReleases.Detail&PressRelease_id=4897&Month=4&Year=2005.
21. *See e.g.,* Keith M. Lundin, *Ten Principles of BAPCPA: Not what was Advertised*, 23 Am. Bankr. Inst. J. 1 (2005).

# STONEGATES

## LOCATION - LOCATION - REPUTATION!

Cottage with Sunroom

Apartment with Den

A Million Dollar View

Your Own Private Oasis

***There is a unique opportunity to own a one bedroom apartment at Stonegates with no waiting.***

*Stonegates retirement community offers multiple choices and... access to our Health Center should the need arise.*

To arrange a tour of our retirement community, please call (302) 658-6200 or visit us online at www.stonegates.com