The Law of Unintended Consequences

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THE LAW OF UNINTENDED CONSEQUENCES*

Margaret Howard**

My purpose is to talk about the 2005 Amendments and how things are going with the new provisions. But where do you start, with a bad law? We could start with the enactment process, but that’s old news now. And besides, you’ve already heard the line: “Some members of Congress could not be bought; for everyone else there was MasterCard.” We could talk about the policy choices, and the 2005 Amendments clearly represent a shift in that respect—perhaps in the category of “seismic” or “cataclysmic.”

For me, even worse than the embracing of policies with which I deeply differ, is the lack of open-minded, honest debate. Instead, the policies represented by the new provisions were captured in a sound-bite: “Don’t you think debtors should repay their debts when they can?” There cannot be any answer other than, “Of course I do.” I do believe that, but I cannot capture in an equally-appealing sound-bite all the reasons why this legislation falls short. And anyway, those battles are also old news.

So, instead, I want to talk about the law of unintended consequences, which holds, quite simply, that actions have unforeseen effects. Examples abound: Let’s go straight to a Southern favorite—since I’m Southern, it seems appropriate—kudzu, called by Charles Kuralt, “the vine that ate the South.” It was first brought to the United States in 1876, displayed at the Centennial Exposition in Philadelphia in a garden built by the Japanese government. In the 1920s it was promoted as an erosion control, and it is a good one.1 The problem is that the Southern United States is an ideal environment for kudzu;


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it can grow as much as a foot per day in the summer and sixty feet per year. It will cover anything—buildings, mature trees, entire forests—with a suffocating green blanket.² And it’s virtually impossible to kill. The roots are exceedingly deep, and most herbicides are ineffective. Dr. James H. Miller of the U.S. Forest Service in Auburn, Alabama, in eighteen years of research, has found that one herbicide actually makes kudzu grow better, and even the most effective herbicides may need repeated treatments for as long as ten years.³

Laws can have unintended consequences, too. In the wake of the Exxon Valdez oil spill in 1989, many coastal states enacted statutes placing unlimited liability on tanker operators.⁴ The Royal Dutch group, one of the world’s biggest oil companies, began hiring independent ships to deliver to the United States. But if independent operators, with leaky ships and iffy insurance, take over the business, we may actually have more spills and fewer dollars collected in damages than if those statutes had never been passed.⁵ And would World War II have happened if the Treaty of Versailles had not been so harsh toward Germany?

Sociologist Robert Merton, back in the 1930s, identified factors that lead to unintended consequences. Several of those factors are particularly relevant in the bankruptcy context—namely, ignorance, error, and what Merton called the “imperious immediacy of interest.”⁶ He was referring to instances in which an individual wants to accomplish the intended consequences so much that he or she purposefully chooses to ignore the possibility of unintended effects.

Let’s begin with credit counseling—now there’s a misguided idea. Timing is part of the problem with this requirement. The 2005 Amendments added a requirement of counseling (or a “briefing”) for every individual filing bankruptcy at the very moment the IRS has been reviewing the tax-exempt status of nonprofit credit counseling agencies,⁷ and finding problems with those agencies. A recent Washington Post article reported that forty-one IRS audits—conducted in different parts of the country, by different auditors—came up with the very same result: forty-one recommendations that tax-exempt

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² Id.
³ Id.
status be revoked.8 Criminal investigations have even been begun in some of these cases, at the very moment that Congress is sending tens of thousands of people to these agencies.

Pre-filing counseling sounded good, but it does not even come close to living up to its billing. The point of the requirement is to be sure that debtors know of available non-bankruptcy options, such as payment plans. But we know already, beyond all doubt, that despite the newness of this provision, pre-filing counseling is identifying a negligible number of debtors who have any viable option other than bankruptcy. Even if a “briefing” delivered over the phone or via the internet provides useful, understandable information (something I personally doubt), it comes way too late to help debtors avert bankruptcy. Apparently, only three percent of debtors opt for debt management plans.9 Could it be, unlike what we were told, that debtors have not been casually filing bankruptcy instead of meeting their moral obligations to pay their just debts?

Of course, ineffectiveness is one thing; unintended consequences, another. But such consequences are to be found, too, stemming in part from the provision permitting a waiver of the requirement under designated circumstances. (In actuality, this so-called waiver is only an extension of time—a deferral—but let’s not quibble). There are three requirements for this waiver.10 Two of them are for the debtor: the debtor has to (1) describe exigent circumstances that merit waiver, and (2) state that services were requested but could not be obtained within five days. The third requirement is for the court—it has to find the debtor’s explanation satisfactory.

Consider the facts in Dixon,11 which are probably not all that unusual. Debtor got the statutorily-mandated twenty days notice of foreclosure on his home, set for noon on November 10th. He tried, first, to work something out with the mortgage company. That was unsuccessful, and he finally consulted a lawyer—on November 9th.12 Debtor found out about the credit counseling requirement, but there was a two-week wait for counseling over the phone and a twenty-four-hour wait for Internet counseling. Dixon did not have twenty-

9. A one-year evaluation of the pre-filing credit briefing requirement, done by the National Foundation of Credit Counseling, found that only 3.4% of debtors counseled by agencies affiliated with the NFCC enrolled in a debt management plan. Consumer Counseling and Education under BAPCPA: Year One Report, available at http://www.nfcc.org/NFCC_Year_One_Bankruptcy_Report2.pdf, at 7-8 (last visited May 21, 2007).
12. Id. at 385.
four hours, so the case was filed on the morning of the 10th and debtor sought a waiver for exigent circumstances.\textsuperscript{13}

The Eighth Circuit Bankruptcy Appellate Panel held that it’s not exigent circumstances when debtor had twenty days notice of foreclosure and filed bankruptcy that very morning. Thus, the third requirement was not met—debtor’s explanation was not satisfactory to the court.\textsuperscript{14} The court observed if “exigent circumstances” means that something bad is about to happen, then it describes every debtor in bankruptcy.\textsuperscript{15} It’s a little like the old saying, “Your failure to plan ahead does not constitute my emergency.” But the court was right, to some extent. Most filings are precipitated by financial adversity—not just the grinding on of money problems, but a looming crisis. Dixon’s circumstances, however, could just as easily have been satisfactory, given that he spent a large part of that twenty days trying to work it out.

In a different case, one in which the foreclosure is not looming quite so large, the debtor might be able to get the counseling and refile. But then he becomes one of the Code’s most disfavored characters—the true abuser, the serialfiler. The second filing is presumptively lacking in good faith under § 362(c)(3)(C),\textsuperscript{16} and the debtor may lose the automatic stay at the end of thirty days. And then the home will be gone.

So, we end up with a provision touted as a protection for debtors—to give debtors information upon which to make informed decisions about filing bankruptcy—that operates to exclude debtors who have the least information about bankruptcy. What the requirement is doing is costing the Dixons of the world their homes. I couldn’t design something so perverse if I tried.

If I’m going to talk about the unintended consequences in this statute, I have to spend at least a moment with the new, unnumbered paragraph codified after § 1325(a)(9)\textsuperscript{17}, stating that, for purposes of (a)(5), § 506 shall not apply to a claim if the creditor has a purchase money security interest in property securing a debt incurred within 910 days of filing. Now, this makes automobile lenders the big winners, when debtors choose to keep their cars in chapter 13, as long as the car was bought within the requisite time, because this provision prevents cramdown—most courts have held that the creditor has a secured claim in the full amount of the debt, and that’s what debtors have to pay to keep their cars.

\begin{itemize}
\item \textsuperscript{13} \textit{Id.}
\item \textsuperscript{14} \textit{Id.} at 390.
\item \textsuperscript{15} \textit{Id.} at 388.
\item \textsuperscript{16} 11 U.S.C.A. § 362(c)(3)(C) (West Supp. 2006).
\item \textsuperscript{17} 11 U.S.C.A. § 1325(a)(9) (West Supp. 2006).
\end{itemize}
But consider another scenario—what if the debtor chooses to give up the car? If the car is worth substantially less than the debt, giving it up may make a great deal more sense than keeping it. But how does the language of the new provision operate in this second fact pattern? Several courts have held that if the creditor has a fully secured claim because § 506 doesn’t apply, then the claim is fully satisfied when the car is surrendered. After all, it’s § 506 that bifurcates claims, and § 506 does not apply. The creditor, as a result, has no deficiency claim. Was that intended? Probably not, but not all unintended consequences are necessarily bad. Perhaps this outcome is the proper come-upance for auto lenders getting greedy.

Let’s turn to corporate reorganizations and, first, the information sharing requirements. Previously, debtor-companies had to share information with the creditors’ committee. Now, under § 1102, the committee must disseminate any information it receives to all unsecured creditors with claims of the type represented by that committee, not just to creditors who are members of the committee. The provision was intended to promote transparency and disclosure, but it may have some other effects.

Consider the possibility that a financial institution is a creditor that isn’t on the committee, and that it’s engaged in trading debtor’s securities. When that institution receives non-public information, its ability to trade may be compromised. Another possibility is that one of debtor’s competitors is also a creditor. Debtor may share less information overall, in an effort to keep privileged information out of the hands of a competitor. Not what the provision was designed to accomplish.

A really easy example of a provision with unintended consequences is § 1121(d), regarding the exclusivity period. As you know, the amended section does not permit extension of the exclusivity period beyond the designated time, without regard to really good reasons for doing so. Proponents of this change claimed that some debtors were languishing in bankruptcy, with the complicity of the judges. We would probably all agree that if the case is a real dog, it should be humanely put down. But surely this provision will be directly responsible for failed reorganizations when, with a little more time, those debtors could have succeeded.

20. The Refco court issued a comfort order, permitting the committee to hold back confidential information and information that would have resulted in waiver of the attorney-client privilege, but the very need for such an order is rooted in the fact that the statute says something we probably did not mean. In re Refco Inc., 336 B.R. 187 (Bankr. S.D.N.Y. 2006).
And then there are key-employee retention plans, or "KERPs." These plans have been fairly commonplace in chapter 11 bankruptcy cases for quite some time. In the past, courts simply asked whether the plan could be justified by a sound business purpose, or whether debtor exercised reasonable business judgment.

Now we have § 503(c), which prohibits a transfer to an insider "for the purpose of inducing [that] person to remain with the debtor’s business," unless the payment is in response to a bona fide job offer and the payment doesn’t exceed the statutory restrictions. Unlike most of the other provisions enacted in 2005, this language was inserted very late in the game by Senator Kennedy. We can surmise that the amendment came in response to the eye-popping bonuses paid to executives in a couple of the big cases.

There are some interpretive problems, as you would imagine. The one I particularly like is that the language prohibits "a transfer"—any transfer—made for the purpose of keeping an insider from accepting another job. Now I love what I do for a living, probably more than most people like their work, but I wouldn’t do it for long without getting a check every month. That check is, without any doubt whatsoever, "a transfer" as that term is defined in the Bankruptcy Code. Is it intended to keep me from quitting? Is a "but-for" relationship enough—I would quit but for getting paid? If so, then even the most innocuous payment of salary, as long as it goes to an insider who’s holding another job offer, could be subjected to § 503(c).

I could go on parsing the language, but I’ll spare you. Let’s focus instead on how effective this provision has been. And the answer is, not very. It seems that lawyers and judges are finding ways to address compensation issues without running afoul of § 503(c). The easy answer is to tie the payment to some performance standard, such as specific financial goals. In Nobex Corp., for example, the bonus was tied to bringing in a higher offer during a § 363 sale. Are these thinly veiled KERPS? Yes, probably, and that’s the ground on which United States Trustees and creditors’ committees have objected.

The most recent of those objections came in the bankruptcy of the Dana Corporation, an auto parts manufacturer. In September 2006, Judge Lifland

24. § 503(c).
held that the plan in that case did not satisfy the new requirements. The payments were characterized as “incentive” payments, but the judge said that the scheme walked like a duck and quacked like a duck, so it was a duck—or, in this case, a retention bonus. He stated that an incentivizing—or “produce value for pay”—compensation plan may be acceptable, even if it has some components with a “pay to stay” retentive effect. But the plan proposed in that case failed to pass muster under either § 363’s business judgment rule, or § 503(c)’s limitations. This was one of the few cases in which those objections prevailed, and there was some reason to think it marked a turning point.

But, as they say, the night is young, and it proved to be for the objecting parties in Dana. In November, Judge Lifland approved a revised plan, finding it a true incentivizing plan and wholly different from the earlier proposal. “A true incentive plan,” according to the court, is not “constrained by 503(c).” “[M]erely because a plan has some retentive effect does not mean that the plan, overall, is retentive rather than incentivizing in nature.” Of course, the point is that most debtors who need to retain key employees have been able, so far, to find a way to do so, § 503(c) notwithstanding.

Ineffectiveness is not the same thing as unintended consequences, you say. True enough, but § 503(c) still makes the cut. The problem is that KERPs can only be paid when a key employee has a bona fide job offer. Thus, this provision will encourage employees to go out searching for other job opportunities—just the sort of distraction KERPs are supposed to prevent. And that creates the risk that the employee, forced to look for another job in order to qualify for the KERP, will end up finding something that’s, well, bona fide—and attractive enough to take. So we’re comforted by knowing that the debtor-company did not offend by making a retention payment, but the key employee is gone.

What can we learn from this brief review of a few of the issues arising out of the 2005 amendments? One conclusion is that the drafting is wretched. But you did not bring me all the way here to tell you that. You know it. I know it. Every lawyer who has dealt with the new provisions knows it, and judges all over the country have been bashing the drafting. One of those

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27. Id. at 102.
28. Id. at 102 n.3.
29. Id. at 103.
31. Id. at 126.
32. Id.
judges, Bruce Markell, wrote an opinion\textsuperscript{33} in which he quoted an exchange between a bankruptcy professor, Todd Zywicki, and Senator Feingold at one of the hearings held shortly before passage in 2005. Senator Feingold asked Zywicki "is there anything about this bill that you think should be changed?" Zywicki responded, "This bill is fine as it is. . . . There is no word that I would change in this particular piece of legislation."\textsuperscript{34}

Zywicki must have had an awakening, a real epiphany, because he seems to have recently discovered that the amendments aren't quite so perfect. He now claims that Markell took his remarks out of context; he just meant that the bill wasn't obsolete, even though eight years had passed since it was originally drafted.\textsuperscript{35} But nobody's buying that. Zywicki was one of only two bankruptcy professors in the country who supported the amendments. He hitched his wagon to that star and, to mix my metaphors, now he's being hoist on his own petard. And I'll be honest—I'm enjoying the show. If my conscience gives me so much as a twinge, I just remember that Zywicki is the guy who promised us that our credit costs would go down by $400 apiece if this legislation would just get enacted. I don't know about yours, but my reimbursement must have gotten lost in the mail. But let me leave Zywicki for the moment, and come back to the question of unintended consequences.

Whether the goals of the legislation have been or will be achieved depends, of course, on what those goals were. If the goal was to reduce the number of filings, then that has clearly been accomplished—at least for the time being. Of course, on the basis of this success, I would suggest that we close the hospitals so that we can improve the health of the American people. If the goals were to achieve more responsible filings, to lower the cost of credit, to obtain higher payouts for creditors, and the like, then the answer is no.

Of course, it is entirely possible that some of the supporters of the amendments have achieved exactly what they wanted—in other words, that there are no unintended consequences here. Into that group, I would put credit card issuers. They were, after all, the ones who bankrolled the enactment process. They are very sophisticated lenders, so you have to figure that not too much is going to take them by surprise. On the surface of things, you might think that even the credit card industry missed it, since it's already pretty clear that bankruptcy recoveries are not going to be enhanced by means testing. But that industry probably never thought so. They had something else

\textsuperscript{33} In re Kane, 336 B.R. 477 (Bankr. D. Nev. 2006).
\textsuperscript{34} Id. at 481 n.7.
entirely in mind, as Ron Mann pointed out in a recent article—namely, delaying the filing of bankruptcy by even a month or two.

Credit card issuers make their profits on cardholders who pay, but pay only the minimum amount. Add in the fees and penalties that are routine, as consumer debtors encounter financial distress, and you have a situation in which the lender can recover its principle plus its cost of funds long before the cardholder has even come close to paying the balance. Every extra payment is gravy, and there’s a whole lot of gravy to be generated from postponing bankruptcy for just a bit. But how do we delay that filing? By loading on the procedural requirements, such as counseling, and by increasing the costs of filing—either directly, by increasing the filing fees, or indirectly, by making it harder to find a lawyer still willing and able to provide representation.

Another possible goal of the 2005 amendments was to reduce judges’ discretion and to commit an assault on lawyers representing debtors. If so, those goals have certainly been achieved. The means test is an excellent example of a very successful effort to reduce judicial discretion. Clamping down on the exclusivity period is another example. And the assault on debtors’ attorneys is clearly evident in the provisions making them debt relief agencies and subjecting them to elaborate requirements. These aren’t examples of unintended consequences as much as they are examples of the fecklessness and capture of the Congress.

But I’m more interested in the fact that much of the rhetoric about bankruptcy debtors was plainly wrong on the facts. I’m not enough of a conspiracy theorist to believe that everybody came at this knowing that the amendments were based on erroneous conceptions as to who files bankruptcy and why. I think many supporters of the changes actually believed their own rhetoric—they believed that these changes were needed.

Let’s start with the notion that the mushrooming numbers of bankruptcy filings resulted in part from a decline in the stigma of bankruptcy. Stigma being a good thing. Nothing like a little shame to keep people in line. One of the most vocal proponents of that proposition has been Judge Edith Jones of the Fifth Circuit, a member of the Bankruptcy Review Commission. She and Todd Zywicki (I told you we’d come back to him) published an article in 1999 titled “It’s Time for Means Testing.” Much of their support for that assertion—that it is time for means testing—was based on the notion that stigma is declining.

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38. Id. at 180, 208–09, 215–217, 219.
But look at the authority they cited for that proposition. One cite was to the Report of the Bankruptcy Review Commission—actually, to the dissent to that Report written by Jones.\textsuperscript{39} So, what was the authority she cited in her dissent to the Commission Report? Well, it was an unidentified, but, she assures us, “prominent,” judge whom she quoted as saying that back in the 1950s, when he graduated from law school, people didn’t do things like file bankruptcy.\textsuperscript{40} I hate to break it to Judge Jones, but that’s not evidence, that’s anecdote. Real authority as to sociological phenomena is based on empirically-valid sociological research; it does not derive from saying something, and then citing yourself saying it.

Okay, to be fair, Jones and Zywicki did cite empirical work for their proposition that stigma is declining. They cited a study, done by two of Professor Zywicki’s colleagues.\textsuperscript{41} Those authors predicted that consumer bankruptcy filing rates depend upon the social stigma of promise-breaking. Their proxy for the social stigma of promise-breaking, however, was the divorce rate—the breaking of a pretty important promise, I suppose. But we’ve known for years that a correlation exists between divorce and bankruptcy, yet the authors of this study used divorce as a proxy for the very phenomenon they were seeking to isolate. Jones and Zywicki did not so much as mention the massive—indeed, probably damning—assumptions built into this work. All of which seems akin to the economists’ method of opening a can: first, you assume a can opener.

The Consumer Bankruptcy Project recently reported that eighty-four percent of debtors in bankruptcy say they would be very embarrassed if their family and friends found out.\textsuperscript{42} That number sounds high enough to suspect that declining stigma is so much malarkey, but eighty-four percent may very well underreport the extent to which bankruptcy is a stigma in the eyes of the general public. Why? Because the Consumer Bankruptcy Project asked only people who were already in bankruptcy.

Elementary psychology teaches us, however, that individuals who act in ways that are inconsistent with their attitudes, experience what is known as “cognitive dissonance.” The tension created thereby is so uncomfortable that either the attitudes or the behaviors tend to change so as to reduce the

\textsuperscript{39} Id. at 216 n.145.
\textsuperscript{41} Jones, supra note 36, at 215 n.142. (citing Elizabeth Hoffman et. al., Behavioral Foundations of Reciprocity: Experimental Economics and Evolutionary Psychology, 36 ECON. INQUIRY 335 (1998)).
\textsuperscript{42} Katie Porter, After Failure, 45 IOWA ADVOC. 13, 14 (2006).
inconsistency. If the behavior is filing bankruptcy, it’s hard to change that, so the attitude towards bankruptcy—the belief that bankruptcy is bad, in some way—tends to change. Thus, we can predict that debtors in bankruptcy are less likely to think bankruptcy is a bad thing than are people generally. So, if eighty-four percent of bankruptcy debtors wouldn’t want others to know, it doesn’t sound like an absence of stigma to me. In fact, it sounds like the scarlet letter may no longer be “A;” today it’s “B.”

Another striking feature of the Jones-Zywicki article is the fervor with which it rejected the findings of the best empirical work done to date on the subject of who files bankruptcy and why—namely, the work of Elizabeth Warren, Jay Westbrook and Teresa Sullivan. Jones and Zywicki did not merely beg to differ. They rejected the empirical work in terms that, when found in an academic article, are the functional equivalent of a screaming fit. Expressions they used to describe opponents of the amendments included “overwrought” and “bizarre.” Critics of means testing were said to “tar,” “castigate” and “inveigh.” To use “apocalyptic rhetoric” and make “blunderbuss assertions.” Such critics were “bankruptcy advocates,” “spreaders of anti-creditor populism,” and, the unkindest cut of all, engaged in “little more than . . . faculty lounge speculation.” That was the level of debate that preceded enactment of the 2005 amendments. You really got the sense of two sides talking past each other. Way past.

This is, perhaps, just another verse in an old song—namely, that people who are already committed to certain viewpoints tend to reject ideas inconsistent with those preconceived notions. This has been demonstrated, over and over, since the early 1960s, when Thomas Kuhn, in The Structure of Scientific Revolutions, reported an experiment asking people to identify playing cards, some of which were the wrong color. A red 6 of spades, or a black ten of hearts, for example. More than ten percent of the test subjects were unable to adjust their expected categories; they would identify these as normal cards, even when allowed to look at them forty times as long as it took to identify the cards that actually were normal.

And in more recent times, Drew Weston, a psychologist at Emory, used brain-scan experiments to show that political partisans quickly spot hypocrisy and inconsistencies, but only in the opposing candidate. When the flaws in their own candidate were presented, their brains lit up in areas that are used

to turn down negative emotions—the same areas that remind you how fattening ice cream is, when the store closed two minutes before you got there.\textsuperscript{45}

All of this leads back to Merton’s third source of unintended consequences—the “imperious immediacy of interest.” That is, wanting the intended consequence so much that one purposefully chooses to ignore the possibility of unintended effects. What we ended up with was a perception of problems, many of which either didn’t exist at all, or, if they did, weren’t really understood—at least, not by the people with the power to reform the law. The solution wasn’t to seek better understanding. Rather, these Amendments just throw law (and a lot of it) at the problems, whether real or imagined. I question whether that’s ever going to do much more than create unintended consequences.

Grant Gilmore told us thirty years ago, but we don’t seem to learn: “In hell there will be nothing but law . . . .”\textsuperscript{46} Is it just me, or is it getting a bit warm in here?
