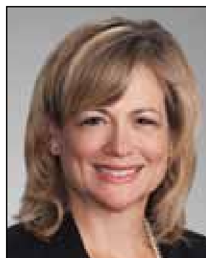
By Patricia B. Tomasco

When States Are Creditors

Why § 525 Matters and Should Be Expanded



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One of the pillars of a debtor's fresh start is the anti-discrimination provisions of § 525 of the Bankruptcy Code, which codifies the U.S. Supreme Court's decision in *Perez v. Campbell*.[1] The Court held that two state statutes that required satisfaction of a dischargeable tort claim as a condition for the renewal of the debtor's drivers' license were invalidated by the discharge provisions of the Bankruptcy Act. The section featured prominently in the Court's decision to overturn the Federal Communications Commission's (FCC) revocation of the debtor's wireless spectrum licenses in *FCC v. NextWave Pers. Communs. Inc.*,[2] wherein the FCC sought to recover the auction value of those licenses.

The utility of § 525 extends beyond the Code's fresh-start policy. State-created priorities violate the common pool problem by advancing a state's creditor self-interest by contravening the interests of all creditors as a group.[3] Although the statute prohibits post-discharge discrimination with respect to state-issued licenses and private employment, the potential for harm to the bankruptcy estate and reorganization arises most acutely with respect to licenses. Corporate debtors face discrimination with unpaid fees in a variety of regulatory environments or government contracting. The following are some examples:

- refusal to transfer or renew a liquor license in the face of unpaid regulatory fees or franchise taxes;[4]
- refusal to approve the transfer of retail customers to the purchaser of a corporate telecom debtor's assets based on unpaid fees;[5]
- refusal to approve an organization's report based on officer involvement in prior violation of well-closing and other financial regulations of mineral rights;[6]
- refusal to license a general contractor based on officer involvement in prior license suspension due to financial issues;[7] and
- the government's refusal to renew corporate debtor's procurement contract.[8]

Thus, § 525 prevents value drain resulting from the state, as a creditor, acting against the interests of the collective creditor body. Naturally, state and government advocates seek to limit the section's application to a variety of regulatory fees by couching those fees and financial provisions as serving other regulatory objectives. There might also be a sufficiently pure regulatory motive for post-bankruptcy regulatory decisions to not run afoul of § 525. Some requirement of a prospective financial wherewithal is a proper regulatory requirement post-discharge.[9] Courts have had little problem distinguishing between discrimination based on an unpaid dischargeable debt and legitimate regulatory concerns, as seen in the following examples.

- A city's ban of turboprop operations at a particular terminal had no evidentiary relationship to a discriminatory motive; the city wanted to allocate gate resources away from turboprops to increase overall passenger capacity.[10]
- A debtor's prospective financial issues were properly the subject of a discrimination where suitability and security were legitimate concerns.[11]
- Saturation of the pari-mutuel horse-racing market and lack of current financial integrity justified denial of license.[12]
- Numerous decisions have properly held that § 525 has no application to the extension of credit outside the student loan arena.[13]

Despite an abundance of examples of bankruptcy courts teasing out discriminatory vs. nondiscriminatory motives, state advocates propose that § 525 be amended to allow for the "enforcement of economic and consumer protection regulations." One has to wonder how the enforcement of "economic regulations" could ever be reconciled with the underpinnings of § 525.[14] State advocates also seek to allow for discrimination in connection with contracting decisions and self-insurance programs.[15] However, these proposals would nullify many of the fresh start principles on which § 525 and many other Code provisions are based. If a corporation that was a debtor, or

1 402 U.S. 637, 91 S. Ct. 1704, 29 L. Ed. 2d 233 (1971).
2 537 U.S. 293, 123 S. Ct. 832, 154 L. Ed. 2d 863 (2002).
3 Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard University Press, 1986).
4 *See, e.g., In re Aegean Fare Inc.*, 35 B.R. 923 (Bankr. D. Mass. 1983) (finding violation of both §§ 362(a) and 525 by Boston's licensing board's refusing to renew debtor's liquor license without payment of pre-petition debts).
5 *See, e.g., NextWave*, 537 U.S. 293, and subsequent cases.
6 *See, e.g.*, Tex. Admin. Code § 3.80(c)(2) (conditioning eligibility to hold authority to conduct oil and gas operations on the absence of unpaid fees for any organization with which officer was affiliated for prior seven years). Section 525 also protects those "with whom such bankrupt or debtor has been associated" and might also protect purchasers of assets. 11 U.S.C. § 525(a). *See also In re Betty Owen Schools Inc.*, 195 B.R. 23, 29 (Bankr. S.D.N.Y. 1996).
7 *In re Ray*, 355 B.R. 253 (Bankr. D. Ore. 2006).
8 *Exquisito Servs. Inv. v. U.S. (In re Exquisito Servs.)*, 823 F.2d 151 (5th Cir. 1987).
9 *Ellis v. U.S. Dept. of Homeland Security*, Civil Action No. 10-cv-1879-AP (D. Colo. Sept. 9, 2010) (future financial responsibility appropriate to hiring of officer).
10 *United Airlines Inc. v. City of Los Angeles (In re UAL Corp.)*, 391 B.R. 791 (Bankr. N.D. Ill. 2008).
11 *Ellis, supra* n.9.
12 *In re Will Rogers Jockey & Polo Club Inc.*, 111 B.R. 948 (Bankr. N.D. Okla. 1990).
13 *See, e.g., In re Cleasby*, 139 B.R. 897 (W.D. Wis. 1992).
14 Peter C.L. Roth, "Amendments to Section 525(a)," presented to the ABI Commission to Study the Reform of Chapter 11 at the SABA/NAAG Annual Seminar, Santa Fe, N.M., October 2013, *available at* commission.abi.org/sites/default/files/statements/.
15 *Id.*

a corporation that has an officer that was once an officer of a debtor, can presently demonstrate current financial responsibility, no harm befalls the state as contractor or self-insured programs in order for § 525 to continue to prohibit references to past debts. To suggest otherwise is to paint corporate debtors and the officers of those debtors with a scarlet "B" that would follow them the rest of their economic lives.

Relegating corporate debtors and officers to a suspect class solely by virtue of having been associated with a bankruptcy case serves no regulatory interest and ascribes a moral sanction that should have died with Charles Dickens,[16] yet that is the result that state advocates seek. Modifying the statute to include value-laden financial terms such as "public security and trust" and "enforcement of economic regulations" simply eviscerates the bankruptcy courts' ability to negate state-created priorities and barriers to reorganization disguised as regulation. This is particularly borne out by the tendency of state agencies to condition licensure or benefits to the payment of dischargeable debts.[17]

Empirical evidence supports the policy underlying § 525. State collection strategies disguised as regulations limit the economic potential of both corporations and their officers simply by virtue of being associated with a failed enterprise. Empirical evidence suggests that this result thwarts both capitalism and entrepreneurship.[18] Section 525 implements important bankruptcy policies as well. Any successful reorganization effort is dependent on the continued wealth-creating capacity of the corporate entity. Government-administered licenses, permits and privileges are integral to maximizing corporate value for the benefit of all creditors.

Ascribing more power to governmental entity through the proposed amendments to § 525 foments more money grabs and harmful state-created priorities. As expressed by Thomas Jackson, pre-petition creditors should not be allowed to leverage post-petition privileges and attributes to extract preferential payment to the detriment of the common pool.[19] Critics should see these proposals for what they are: additional methods for extracting priority of payment to the detriment of other creditors and enterprise value. "Unlike all other creditors, however the state occupies a dual position as both a player and a referee in bankruptcy law. At the same time, the state competes with banks and small firms and consumers for unpaid debts, the state devises and enforces bankruptcy law.... In this unique ... situation, it seems likely that governments will try to ensure a high priority to state claims and will endeavor to [e]nsure that their revenue interests would be satisfied as completely as possible."[20]

Again, courts addressing § 525 as it is currently written readily recognize when a state's regulatory vs. pecuniary interest is at stake. State advocates understandably seek to weaken its provisions in specific, economic terms because of a perception that it will increase the state's recovery on its claim or other revenue sources. Although this postulate has little empirical support,[21] the proposed amendments belie the states' mostly pecuniary motives.

Other issues with § 525 do merit statutory amendment. The most discussed are the results in *Rea v. Federated Investors*[22] and other cases that allow for discrimination in hiring despite § 525(b)'s prohibition of discrimination "with respect to employment." The job-applicant issue is the subject of several articles urging the amendment to § 525(b) to prohibit hiring discrimination based on prior bankruptcy filings.[23] One democratic congressman has introduced at least one bill proposing to remedy this language.[24]

More relevant to this article's focus on state issues is the exception to § 525(a), which was enunciated in *In re Betty Owen Schools Inc.*[25] and *In re Lon Morris College*[26] that gut § 525 for a sole creditor: the Department of Education. The issue is far more muddied, and in both cases, the issue is the Student Loan Default Prevention Initiative Act of 1990, as contained within the Omnibus Reconciliation Act of 1990. The legislation modified the definition of "property of the estate" to exclude "[a]ny eligibility of the debtor to participate in programs authorized under [the Higher Education Act (HEA)]."[27] Congress, in turn, limited the application of automatic stay to exempt "any action ... regarding the eligibility of the debtor to participate in programs under [HEA]" from the "automatic stay."[28] The legislation also amended the HEA to exclude from its definition of "eligible institution" any school that filed for bankruptcy protection.[29]

The bankruptcy court in *Betty Owen* cited to the Senate Report on "Abuses in Federal Student Aid Programs," which referenced, among the issues facing student aid and loans, institutions taking refuge in bankruptcy to prevent accrediting agencies from taking action to conserve scarce funds, even when the debtor school might not be able to make loan refund payments to former students and might continue to admit new students despite the fact that the school might close or otherwise cut back its edu-

16 Dickens's father was confined to debtors' prison, and the plight of debtors was highlighted in several of Dickens' novels. Angus Easson, *Charles Dickens and the Marshalsea* (University of Oxford Press, 1967). One cannot imagine a worse strategy for maximizing creditor recoveries than putting a working person in prison. Restricting a corporate debtor or the purchaser of the enterprise from extracting full economic value from the enterprise is similarly antithetical to the value maximization goals of bankruptcy.

17 *See, e.g., NextWave*, *supra* n.2; *In re Elsinore Shore Assocs.*, 66 B.R. 708 (Bankr. D.N.J. 1986) (conditioning liquor license on paying pre-petition debt).

18 Wei Fan and Michelle J. White, "Personal Bankruptcy and the Level of Entrepreneurial Activity," *J.L. & Econ.* 01/2003; 46(2):543-67; John Armour and Douglas Cumming, "Bankruptcy Law and Entrepreneurship, *American Law and Economics Review*, 10 (2) (2008), 303-50 (availability of bankruptcy has positive correlation with entrepreneurial activity); *cf.*, David M. Primo and Wm. Scott Green, "Bankruptcy Law and Entrepreneurship," *Entrepreneurship Research Journal*, Vol. 1, Issue 2, Article 5, 2011 (finding that entrepreneurial activity increases with levels of state exemptions but taper off at high end).

19 Jackson, *supra* n.3, at 266-69. Jackson opined that "[t]he core of bankruptcy's fresh start policy is a protection of human capital and its future manifestations."

20 Bruce Carruthers and Terence C. Haladay, *Rescuing Business: The Marking of Corporate Bankruptcy Law in England and the United States*, p. 212 (Clarendon Press, 1998).

21 *Id.* at pp. 216-17 (citing Minutes of the Bankruptcy Commission, 11-12 Sept. 1972:23: "[T]he Justice and Treasury Departments spent far more attempting to collect by use of the priority and lien provisions [than] was realized.").

22 627 F.3d 937 (3d Cir. 2010) (holding private employer discrimination against job applicants to be not within intended scope of § 525(b)). *See also Burnett v. Stewart Title Inc. (In re Burnett)*, 635 F.3d 169, 171 (5th Cir. 2011); *Myers v. TooJay's Mgmt. Corp.*, 640 F.3d 1278 (11th Cir. 2011); *In re Stinson*, 285 B.R. 239 (Bankr. W.D. Va. 2002); *Fiorani v. CACI*, 192 B.R. 401 (E.D. Va. 1996); *Pastore v. Medford Sav. Bank*, 186 B.R. 553 (D. Mass. 1995); *In re Madison Madison Int'l*, 77 B.R. 678 (Bankr. E.D. Wis. 1987).

23 "Comment: The Bankruptcy Shadow: Section 525(b) and the Job Applicant's Sisyphean Struggle for a Fresh Start," 29 *Emory Bankr. Dev. J.* 553 (2013); David D. Schein, *Evaluation of the Proposal to Amend the Bankruptcy Code to Prohibit Private Employers from Refusing to Hire Applicants on the Basis of Bankruptcy Filing*, *available at* www.alsb.org/wp-content/uploads/2013/11/NP-2013-Schein_Evaluation1.pdf (2013); Lea Shepard, "Toward a Stronger Financial History Antidiscrimination Norm," 53 *B.C. L. Rev.* 1695 (2012); Jina Kim Yun, "The New Danger of Being Fired: Section 525(b)'s Disproportionate Effect on Older Workers and a Call to Amend," 7 *NW. J. L. & Soc. Pol'y* 196 (2012).

24 Bankruptcy Nondiscrimination Enhancement Act of 2013; H.R. 646, 113th Congress (2013), *available at* www.govtrack.us/congress/bills/113/hr646/text (proposing to insert "deny employment to" after "may" and striking "solely").

25 195 B.R. 23 (Bankr. S.D.N.Y. 1996).

26 *In re Lon Morris College*, Order Denying Debtor's Expedited Motion under Section 525 for Relief Against the Department of Education, Case No. 12-60557 (Bankr. E.D. Tex. Aug. 20, 2012).

27 11 U.S.C. § 541(b)(1).

28 11 U.S.C. § 362(b)(16).

29 20 U.S.C. § 1002(a)(4)(A).

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cational programming.[30] The report further lamented the "unscrupulous, inept and dishonest elements that have flourished throughout the 1980s [and] have reaped huge profits."[31] The court concluded that "Congress intended to limit educational-assistance resources from financially unsound institutions, including schools, which have filed for bankruptcy."[32]

In *Lon Morris College*, the institution at issue was not the "unscrupulous" and "dishonest" for-profit institution that the 1990s legislation targeted. Lon Morris College was a non-profit junior college in East Texas that was founded by the Methodist Church in 1854 — before student aid was invented. Its bankruptcy filing was necessitated by decreasing enrollment followed by over-enrollment that necessitated the construction of dorms and other facilities, and the borrowing that goes with such necessities.[33] The bankruptcy court acknowledged in its oral ruling that the school was not of the kind that was targeted by the legislation but that congressional intent was unyielding to any distinction. Necessarily, the amendments to the HEA also hamstring the Department of Education from making any distinction.

One could argue that a bankruptcy court charged with "good-faith" findings on a consistent basis should have the ability to distinguish between a sham operation and a long-standing institution with recent financial difficulties. Congress took that discretion away from the Department of Education, so bankruptcy courts might sound the death knell for other landmark institutions.

Unlike the state-created priorities garnered through discriminatory licensure used by government institutions such as the FCC in *In re NextWave*, the Department of Education does not use title VII eligibility to extract payment ahead of other creditors or any payment at all. The goal of the exclusion from eligibility is to protect students and taxpayers from abusive practices. Nonetheless, creditors, jobs and enterprise value are decimated even for legitimate institutions in the wake of this goal. *Lon Morris* exemplifies the effects of overbroad legislation.

Section 525 works hand-in-glove with other provisions of the Bankruptcy Code that implement a debtor's fresh start. Particularly in the reorganization context, the section also prevents state-created priorities from thwarting enterprise value maximization and equality of distribution. As much as state advocates lament the result in *NextWave*, the decision demonstrates that § 525 is a necessary supplement to § 362 to preclude debt prioritization through the subterfuge of regulation. Courts have had no issue teasing out legitimate regulatory goals from pecuniary interests disguised as regulation. Aberrant results, however, occur with respect to private-employer discrimination against prospective applicants and the overbroad legislation amending the HEA. abi

30 195 B.R. at 32 (citing S. Rep. 102-58, 102nd Cong., 1st Sess. (1991)).

31 S. Rep. 102-58, 102d Cong., 1st Sess. at 10 (1991) ("Despite the acknowledged contributions of the well-intended competent and honest individuals and institutions comprising the large majority of GSLP participants, unscrupulous inept and dishonest elements among them have flourished throughout the 1980s. The latter have done so by exploiting both the ready availability of billions of dollars of guaranteed student loans and the week and inattentive system responsible for them, leaving hundreds of thousands of students will little or no training, no jobs, and significant debts that they cannot possibly repay.").

32 195 B.R. at 32, quoting the House Report [H. Rep. 102-447, 102d Cong. 2d Sess. at 73-74 (1992)]: "In amending this section of the Higher Education Act, the Committee intends to improve the integrity of the Federal student assistance programs.... The committee intends that institutions who file for bankruptcy will automatically be ineligible to participate in Title IV."

33 *See* "Lon Morris College Files for Bankruptcy," *United Methodist Reporter*, July 3, 2012, *available at* http://unitedmethodistreporter.com/2012/07/03/lon-morris-college-files-for-bankruptcy/ (quoting school's press release: "Officials succeeded in boosting enrollment in recent years, in part through adding academic programs and restarting a football program, but income has consistently failed to meet expenses. The college has experienced negative cash flow in recent years by overextending itself in an attempt to increase enrollment, taking on significant debt").

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