BANKRUPTCY AS IT AFFECTS CHARACTER AND FITNESS

by Hon. Niles Jackson

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Last year in this country, 1.7 million bankruptcies were filed—a record year and a record last quarter—and 97 percent of those bankruptcies were filed by individuals. Since December 2001, six of the largest business bankruptcies in U.S. history were filed, including Enron, WorldCom, Transcom, and United Airlines. The incidence of bankruptcy is not likely to decrease in the near future, even with the changes to the bankruptcy code proposed by Congress, and bar admission authorities are likely to see more and more bar applicants who have filed for bankruptcy protection.

Young people are no longer strangers to bankruptcy court. Bankruptcies for persons under age 25 increased 51 percent between 1991 and 1999. It is also becoming increasingly easier for young men and women to obtain credit and debit cards. There are now special debit cards available to college students—parents of the cardholder can add or subtract from the account by telephone or through the Internet and can check on how the money is spent. Some credit cards for college students allow parents to set the maximum credit limit for their son or daughter and to check the spending over the Internet or via telephone. Other credit card companies assign a credit limit based on the student's credit history. Recent statistics show that 92 percent of college students carry a credit card and 47 percent have four or more credit cards.

The ready availability of credit makes it more likely that young people will run into financial trouble further down the road. For example, a student with a $5,000 debt on one credit card and who makes only the minimum monthly payment at 18 percent interest will take 26 years to pay off the entire debt.

A SHORT HISTORY OF BANKRUPTCY

The term "bankruptcy" is derived from two sources. The first is the Italian phrase "banco rotta," which means "broken bench"; in medieval Italy, when a merchant did not pay his debts, his creditors would break his trading bench, sometimes over his head. The second term is "banqueroute," a French word that describes being on the "route" or on the lam, a fugitive from creditors, but often living quite well off their money.

Bankruptcy law can be traced to ancient Roman law, under which creditors were allowed to attach a debtor's person as well as property. In fact, creditors could sell the debtor and his family into slavery to satisfy the debts because the law considered the debtor's body to be a part of the bankruptcy estate.

The first modern bankruptcy laws were adopted in England in 1542. Those laws were not intended to give relief to debtors but to give remedies to creditors. A bankrupt debtor could be sentenced to prison or even death. Minor changes over the next 100 years increased assets that could be seized, increased penalties for the debtor, and even allowed the debtor's ear to be cut off.

In 1705, England introduced the concept of a discharge of debts. That system, which applied only to merchant debtors, rewarded the honest debtor who appeared in court instead of hiding and who revealed his property instead of fleeing.

In 1785, Pennsylvania enacted a bankruptcy law borrowed from England. This new law called for standing the debtor in a public place for two hours with his ear nailed to a pillory before cutting it off—the term "earmark" was thus born. Not to be outdone, New York branded its bankrupts on the palm with the letter "T" for thief.

The U.S. Constitution gives Congress authority to enact national bankruptcy laws in Art. I, Section 8: "The Congress shall have Power . . . To establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." States are unable to interfere with the federal bankruptcy laws under the Supremacy Clause in Art. VI: "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land; and the Judges of every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding."

Congress passed the first national bankruptcy law in 1800; it was similar to the English law, but contained no death penalty. That law was repealed three years later due to excessive debtor fraud. The next bankruptcy law emerged in 1841. For the first time, non-merchants could file for bankruptcy. This law was repealed only 13 months after its effective date due to the unprecedented number of bankruptcies filed.

Congress tried another bankruptcy law in 1867 in order to absorb the bad debts from the Civil War (or as we Southerners call it, "The War Between the States"). Under this law, debtors were required to take an oath of allegiance to the United States. For the first time the states were allowed to set out their own property exemptions, a practice still followed today. The 1867 law also provided protection for corporations. This act was repealed 11 years later amidst widespread fraud and a general economic upturn.

The 1898 bankruptcy act was passed due to the depression that followed the Panic of 1893. This act allowed both voluntary and involuntary filings and for the first time removed most barriers from discharging virtually all debts. Also for the first time discharge became an entitlement rather than discretionary. Amendments to this law occurred over the years until Congress made wholesale changes in 1978. Under those changes, in which the term "bankruptcy code" was first used, the law merged corporate bankruptcies into Chapter 11, encouraged individuals to repay debts through use of Chapter 13, and allowed states to adopt their own exemption statutes.

The most recent major changes to the Bankruptcy Code were in 1994; among those changes, Congress created the National Bankruptcy Review Commission and charged it with the responsibility of submitting a report suggesting proposed reforms. That report was filed in October of 1997.

During the past three years there has been pending in Congress another major Bankruptcy Code reform bill. The original bill was held hostage to the question of the dischargeability of fines levied against abortion clinic protesters. The bill is pending again. Under the proposed changes

- individuals will have to file Chapter 13 (reorganization) instead of Chapter 7 (liquidation) if their income is above a certain level;
- Chapter 7 (liquidation) discharges will be allowed only once every 8 years instead of the current 6 years;
- individuals will not be able to discharge debts associated with divorce, including property division debts which are dischargeable under current bankruptcy law; and
- debtors will be required to take a consumer education course before filing.[1]

Types of Bankruptcy

Four chapters of the Bankruptcy Code cover four different types of bankruptcy relief. Each "chapter" is discussed briefly below.

Chapter 7

Chapter 7 is known as the "liquidation" chapter. A debtor who files a Chapter 7 petition will lose most of the debtor's assets in exchange for discharging most debts. A Chapter 7 trustee oversees each case; the trustee is charged with locating all of the debtor's assets and, once the bankruptcy estate has been collected, will sell present assets to pay past debts.

In a Chapter 7 liquidation, individuals can keep certain assets that are "exempt" from liquidation. Most states have their own list of bankruptcy exemptions, including homestead exemptions. Seven states have unlimited homestead exemptions, meaning that debtors can keep all of the equity in their principal homes, regardless of value.

Individuals who file for Chapter 7 protection can also discharge, or wipe out, most unsecured debts, including credit card debts. Under 11 U.S.C. § 523, individuals cannot discharge the following types of debt, among others:

- their last three years of income taxes;
- child support and support alimony obligations;
- debt incurred through fraud or misrepresentation;
- fines and penalties owed to a government entity;
- debts due to willful and malicious injury;
- damages owed by drunk drivers for death or injury;
- court costs;
- criminal restitution;
- condominium ownership dues.

Debtors who file Chapter 7 petitions can obtain a discharge only once every six years. The fact of discharge will remain on the debtor's credit report for 10 years.

A debtor who is planning to file a Chapter 7 petition may sometimes engage in what might be called "creative bankruptcy planning." There are provisions in the code that allow the trustee to cancel certain pre-bankruptcy transfers and recover the assets for the bankruptcy estate; a debtor may not remove, transfer or hide property within 12 months before filing if the action was done to defraud creditors or if the debtor received less than fair market value for the asset. One pre-filing plan that apparently works well for debtors is to sell non-exempt property (a second home, for example) at fair market value and put the proceeds into exempt property, such as the debtor's principal residence.

Chapter 11

Chapter 11 bankruptcy is known as "reorganization," where the debtor, usually a corporation, stays in business and acts as its own trustee. The WorldCom, Enron, and United Airlines bankruptcies were all Chapter 11 filings. After coming out of the bankruptcy, the company will still exist but in most cases it will be much smaller than before and the management makeup will usually change.

In a Chapter 11 bankruptcy, the debtor is overseen by a watchdog committee composed of the 20 largest ("largest" by the amount of money owed to them by the debtor) unsecured creditors. While this group looks out for the interests of unsecured creditors, those creditors rarely recover significant amounts. On the other hand, the real losers in Chapter 11 cases are usually the stockholders and pensioners of the corporation. Secured creditors generally get adequate or near adequate protection.

Chapter 12

Chapter 12 was created to provide bankruptcy relief for family farmers with regular income. Chapter 12 debtors, like those in a Chapter 13 consumer bankruptcy (see following), continue to pay on their debts, but at a reduced rate. The activities of a Chapter 12 debtor are monitored by a Chapter 12 trustee.

Chapter 13

An individual with a regular income can file bankruptcy under Chapter 13. This bankruptcy relief is designed to keep the individual paying bills, but slows down the payment process. It is often used by debtors who have defaulted on loans to allow them to keep a house or car that is in danger of foreclosure or repossession; the debtor creates a plan to repay the arrearage during the next three to five years.

A Chapter 13 trustee oversees the debtor's estate and distributes to the unsecured creditors that portion of the debtor's income not needed for reasonable living expenses.

The trustee uses future money to satisfy past debts. The amount paid on the debts can range from 0 to 100 percent. Most (approximately 70 percent) Chapter 13 plans fail; the debtor does not obtain a discharge within the three- to five-year window. This is true despite the fact that during the pendency of the bankruptcy the debtor cannot incur new debt without the bankruptcy court's permission. In paying off a loan, a debtor can reduce the amount of a secured debt over the creditor's objection (e.g., "cramdown" the secured value of a car to no more than its actual fair market value).

Bankruptcy Effects

The automatic stay

One outstanding feature of filing bankruptcy is the "automatic stay" under 11 U.S.C. § 362. The stay is effective immediately and stops all court proceedings against the debtor, all collection efforts, all foreclosures. The stay can even operate to "undo" some creditors' actions (e.g., a repossessed car must be returned). Any creditor can ask the court to "lift the stay" to allow collection litigation to continue, but the stay is not easily lifted.

Possible discharge of student loans

It is possible for a debtor to discharge student loans (including law school student loans) under 11 U.S.C. § 523(a)(8)(B), but only when not discharging them would create an "undue hardship" on the debtor or the debtor's dependents. What constitutes an "undue hardship"? Many jurisdictions have adopted the test approved in ***Brunner v. New York State Higher Education Services,*** 831 F.2d 395, 396 (2nd Cir. 1987): "(1) that the debtor cannot maintain, based on current income and expenses, a 'minimal' standard of living for herself and her dependents if forced to repay the loans; (2) that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and (3) that the debtor has made good faith efforts to repay the loans."

CHARACTER AND FITNESS EFFECTS OF BANKRUPTCY

When applying for admission to the bar, applicants must demonstrate their character and fitness to the satisfaction of the board or court. "From a profession charged with such responsibilities there must be exacted those qualities of truth-speaking, of a high sense of honor, of granite discretion, of the strictest observance of fiduciary responsibility, that have, throughout the centuries, been compendiously described as 'moral character.'" Justice Felix Frankfurter concurring in ***Schware v. Board of Bar Examiners of New Mexico***, 353 U.S. 232, 239 (1957). An applicant may be denied admission to the bar for "acts and conduct which would cause a reasonable man to have substantial doubts about an individual's honesty, fairness, and respect for the rights of others and for the laws of the state and nation." ***Florida Board of Bar Examiners re G.W.L.***, 364 So. 2d 454, 458 (Fla. 1978). In reviewing an applicant's character, courts will consider that past conduct reflects on future conduct. ***In re Tobiga***, 791 P.2d 830, 832 (Or. 1982).

So if an applicant has filed for bankruptcy, how does the bankruptcy or the behavior underlying the bankruptcy affect that applicant's character and fitness determination?

The mere filing of bankruptcy

Government agencies may not discriminate against bankruptcy filers:

> [A] governmental unit may not deny, revoke, suspend, or refuse to renew a license . . . against, a person that is or has been a . . . bankrupt or a debtor under the Bankruptcy Act, or another person with whom such bankrupt or debtor has been associated, ***solely*** because such bankrupt or debtor is or has been a debtor under this title or a bankrupt or debtor under the Bankruptcy Act . . . .

11 U.S.C. § 525 (emphasis added). The fact of merely filing a bankruptcy petition or the refusal to reinstate obligations discharged in bankruptcy cannot be a basis for denial of admission to the bar. Such coercion contravenes the Bankruptcy Act's objective of giving debtors a "'new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt.'" ***Perez v. Campbell***, 402 U.S. 637, 647, 91 S. Ct. 1704, 1710, 29 L. Ed. 2d 233 (1971).

> Federal law has established the right to declare bankruptcy, and state law may not chill the exercise of that right. However, these constitutional limitations do not preclude a court from inquiring into the bar applicant's responsibility or moral character

> in financial matters. The inquiry is impermissible only when the fact of bankruptcy is labeled 'immoral' or 'irresponsible,' and admission is denied for that reason. In other words, we cannot declare bankruptcy a wrong when Federal law has declared it a right.

Application of Gahan, 279 N.W.2d 826 (Minn. 1979).

Circumstances surrounding or leading to bankruptcy

Section 525, however, does not prohibit questioning the circumstances that resulted in the filing of a bankruptcy petition, especially when those circumstances reflect on a person's fitness to be licensed to practice law. ***See In re Anonymous***, 549 N.E.2d 472, 473 (N.Y. App. Div. 1989).

In a Florida case, the state supreme court reviewed the applicant's financial history that led to her bankruptcy filing. The court found her conduct to be morally acceptable, in that she had declared bankruptcy only after all other reasonable alternatives had been exhausted; she could find only part-time, impermanent employment, she tried but failed to renegotiate her debts, and much of her debt was incurred to cover her living expenses while in law school. ***Florida Board of Bar Examiners re S.M.D.,*** 609 So. 2d 1311 (Fla. 1992).

Discharge of student loans

The discharge in bankruptcy of student loan debt raises some interesting issues. In another Florida case an applicant to the bar who had discharged undergraduate and law school loans three days before graduation was denied admission. ***In re G.W.L.***, 364 So. 2d 454 (Fla. 1978). The court said that the applicant's action was "morally reprehensible" considering that the first payments were not due for nine months, he had not fully explored the job market, and he had demonstrated no extreme hardship nor any exceptional misfortune. The court said, "Conduct that is not unlawful may nevertheless fall short of the standards of moral character which must be met before one is qualified for admission to the bar." The court found that the applicant had acted "with absolutely no regard for his moral responsibility to his creditors," and that his conduct raised "serious questions concerning the propriety of his being a counselor to others in their legal affairs."

However the Florida Supreme Court did admit an applicant who had discharged his student loans where the applicant's personal finances were in general disarray: he had incurred hospital debts for the birth of his child, and after divorcing his wife and moving, he was unable to immediately find a job. ***In re Groot***, 365 So. 2d 164 (Fla. 1978).

Fraud or deceit

If the debtor's conduct evidences a lack of regard for the rights of others, including creditors, admission to the bar is less likely. In ***In re Gahan***, 279 N.W.2d 826 (Minn. 1979), the attorney-applicant had left his job and moved from another state. In his bankruptcy he protected all but $7 of his assets from his creditors. (Most of the discharged debt was for student loans.) For instance, he mortgaged his Jaguar sports car to a friend and deposited the proceeds in an exempt bank account. After discharge he withdrew the money and repaid the mortgage, having kept the car the entire time. The Minnesota Supreme Court, in denying admission, said that the applicant had exhibited a "flagrant disregard [for] the rights of others" before, during and after the bankruptcy proceedings.

An applicant who has made misstatements or omissions in his or her bankruptcy petition or schedules will also be subject to scrutiny. In an Oklahoma case, an applicant had failed to list a closed bank account and two of his creditors; he also had sworn that he had never been a corporate officer when in fact he had been. "By failing to disclose the existence of such funds to his creditors and the bankruptcy court, [the applicant] 'engaged in conduct involving dishonesty, fraud, deceit or misrepresentation.'" ***State ex rel. Oklahoma Bar Association v. Perry***, 936 P.2d 897, 905 (Okla. 1997).

Obtaining credit by fraud and then discharging the debt in bankruptcy is also not looked upon kindly by the courts. In ***In re Fitzpatrick***, 273 S.E.2d 618 (Ga. 1981), the Georgia Supreme Court denied an applicant admission to the bar, and cited the bankruptcy court's finding that the applicant had "intentionally and purposefully deceived and defrauded [a creditor] in obtaining the money in question."

Other fiscal irresponsibility

It is not only bankruptcy, or conduct leading to bankruptcy, that puts into question the character and fitness of a bar applicant with respect to fiscal trustworthiness. Financial irresponsibility of other kinds or degrees is a common concern for character and fitness committees.

For example, an applicant's failure to file income taxes,[2] to pay child support, and to refrain from writing worthless checks may prevent the applicant's admission to the bar.[3] Similarly, the court was unimpressed with an applicant who had trouble paying student loans, but neglected to try to negotiate a new payment plan, saying that he had exhibited "a selfish exercise of legal rights and a disregard of moral responsibilities."[4] Even a failure to pay traffic tickets, albeit numerous ones, may prevent the applicant's admission.[5] Evidence of psychological problems will not necessarily excuse or mitigate an applicant's misconduct.[6]

Most committees are concerned with candor in the application process and rehabilitation. Readily disclosing financial problems, rather than attempting to conceal them, and demonstrating a commitment to remedy those problems will increase the chances of admission. An applicant was admitted to the Oregon bar who had failed to pay income taxes, but had filed his tax returns on time, admitted his responsibility for failure to pay the taxes due, and was making payments.[7]

Choices for boards of bar examiners

Applicants who have exhibited financial irresponsibility, whether through one or more bankruptcies or by other evidence, are unlikely to be admitted immediately absent exigent circumstances. But a board or committee may want to table the application rather than deny it.[8] For example, if judgments, liens or collections show up in the file, a board might require the applicant to demonstrate six consecutive months of payments to show good faith in clearing up the debts. If student loan debt or child support is not being paid, a board might require the applicant to arrange with the lender to repay the debt and to then demonstrate six consecutive and uninterrupted monthly payments.

Another option for applicants who have had financial troubles in the past, but are making progress, is conditional admission in those jurisdictions that have a conditional admission rule. For example, in an Oregon case involving unfiled tax returns and unpaid taxes, the court allowed conditional admission with certain requirements for the applicant; one of those requirements was that he work with the loss prevention service of a professional liability company in setting up his law practice, with particular attention paid to instruction in lawyer trust accounts and trust accounting practices.[9]

CONCLUSION

Bankruptcies and other evidence of financial irresponsibility are often red flags for character and fitness committee members. Members of the bar often handle client funds and must demonstrate the capacity to do so responsibly. While a committee may not discriminate against an applicant for having filed for bankruptcy protection, prudent committee members will want to conduct some investigation into the applicant's financial history and will ask the applicant to provide recent evidence of fiscal responsibility.

REFERENCES

U.S. Bankruptcy Courts website: www.uscourts.gov. For individual bankruptcy courts, click on "U. S. Bankruptcy Courts," then "U.S. Bankruptcy Court web sites," then on the circuit or state in question and the district within the state in question. Access to case files usually requires an application and may require a fee.

"Failure to Pay Creditors as Affecting Applicant's Moral Character for Purposes of Admission to the Bar," 108 A.L.R.5th 289 (2003); see p. 293 for citation of cases by jurisdiction.

"Falsehoods, Misrepresentations, Impersonations, and Other Irresponsible Conduct as Bearing on Requisite Good Moral Character for Admission to Bar—Conduct Related to Admission to Bar," 107 A.L.R.5th 167 (2003).

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Weiss, William Owen, "Evaluation of a Bar Applicant's Moral Character: May a State Consider the Circumstances Surrounding a Discharge in Bankruptcy?" 56 INDIANA LAW JOURNAL 703, 718 (1981).

Policy Statement of the Georgia Board to Determine Fitness of Bar Applicants regarding Character and Fitness Reviews: www.gabaradmissions.org.

ENDNOTES

1. This history is borrowed with permission from an article entitled "The history of bankruptcy laws," by Gary Hammond and Jeffrey Tate, printed in ***The Journal Record*** (Oklahoma City, Oklahoma) legal newspaper, the September 26, 2002, issue.
2. ***Florida Board of Bar Examiners re J.A.F.***, 587 So. 2d 1309 (Fla. 1991); ***Florida Board of Bar Examiners re M.A.R.***, 755 So. 2d 89 (Fla. 2000).
3. ***In re Admission to the Bar of Commonwealth***, 729 N.E.2d 1085 (Mass. 2000)
4. ***In re Taylor***, 647 P.2d 466 (Ore. 1982)
5. ***Application of Parry***, 647 N.E.2d 774 (Ohio 1995).
6. ***Bernstein vs. Committee of Bar Examiners***, 443 P.2d 570 (Cal. 1968)
7. ***Application of Scallon***, 956 P.2d 982 (Or. 1998)
8. The Georgia Board's information on tabling applications can be found at www.gabaradmissions.org.
9. ***Id.***

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