Testimony of

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Vice Chair

on behalf of the

National Bankruptcy Conference

before the

Subcommittee on Commercial and Administrative Law

of the

House Judiciary Committee

110th Congress, 1st Session

for Hearings on

Straightening Out the Mortgage Mess: How Can We Protect Homeownership and Provide Relief to Consumers in Financial Distress?

October 30, 2007

The National Bankruptcy Conference appreciates the opportunity to participate in these oversight hearings on protecting homeownership and providing families relief from burdensome home mortgages and thanks the Subcommittee for its invitation. The NBC believes that carefully crafted amendments to the Bankruptcy Code, as well as other approaches,[2] can contribute favorably to the management of the subprime mortgage crisis. We therefore commend the Subcommittee for focusing on this issue.

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[2] *See* "The Subprime Lending Crisis," Report and Recommendation by the Majority Staff of the Joint Economic Committee, Oct. 2007, at 23-25. Much of the factual background described in this Testimony is supported by the Joint Economic Committee Report.

As you may be aware, by letter and Report dated July 17, 2007 the NBC provided technical comments on drafts of bills, some of which have since been introduced, and set forth policy positions to which the NBC remains committed. We take this opportunity to explain how targeted modifications to the Bankruptcy Code could provide appropriate relief to some homeowners caught up in the subprime mortgage crisis.

The Conference is a voluntary, non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws. Attached to this statement is a Fact Sheet about the Conference, including a list of its Conferees.

MODIFICATION OF MORTGAGES

The Problem

This Subcommittee—indeed, nearly everyone—is well aware of the crisis affecting homeowners in this country in the wake of the extraordinary increase in the amount and kind of home mortgage loans made over the past several years. A combination of a rapidly falling housing market and tighter credit markets, coupled with 100% (or more) loan-to-value mortgages, negative amortization, exploding ARM's with interest rate increases far beyond the ability of ordinary homeowners to pay, and more have squeezed homeowners between an inability to make their monthly mortgage payments and an inability to sell or refinance their homes to escape the pressure. The result has been a dramatic increase in mortgage loan defaults and a corresponding increase in foreclosures. In some neighborhoods, foreclosure signs are popping up on every street, and home values are being driven into the ground, hurting neighbors who need to sell or refinance their own homes and creating a downward spiral that threatens to take even more hard working homeowners down with it.[3] The only hope is to get some relief from the terms of the mortgages themselves to allow the debtors to stay where they are until the foreclosures storm clears.

As much as borrowers have over-borrowed, lenders have contributed to the crisis in many ways. "No doc" loans, appraisals based solely on computer data and not a property inspection,[4] separation of lending risk assessment from investment, reliance on rating agencies to rate pools rather than individual mortgages, and the focus on fees, fees, and fees, rather than ability to repay all have blown up the bubble. (What ever happened to traditional, responsible lending?)

More important for our purposes here today, lender behavior in the face of defaults can worsen the crisis. Servicers for securitized mortgage loans are often restricted by the servicing agreements with the securitization investors from consenting to home-saving modifications. Even when they are not restricted, they have little incentive to do anything but to start foreclosure proceedings, in part because of fee structures and in part because they may fear that working with homeowners and waiting too long could put them at a disadvantage in a falling market as against other lenders or servicers who rush to foreclose before the market completely collapses.

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[3] "Lenders Curb New Mortgages in Weaker Areas," *Wall St. Journal*, Oct. 23, 2007, at D1 (lender rejected a refinancing because "the lender didn't feel that it could get an accurate valuation of the property, given the high number of foreclsoure sales in the neighborhood.").

[4] *Id.* ("Bank of America Corp. says … appraisers are being told to drive by the property to get a better estimate of its value instead of just running information about the home through a computer model.").

But rushing to the exits creates a self-fulfilling prophecy that pushes home prices down further. The S&L crisis of 1990 resulted in part from a similar combination of over-lending, followed by extensive foreclosures and excess amounts of unsaleable “REO”—real estate owned by savings and loan associations after foreclosures. But a moratorium on foreclosures, as was attempted by some States in the 1930’s, would be far too draconian.

By contrast, amendment to chapter 13 of the Bankruptcy Code to permit both borrowers and lenders to work out a constructive solution under the supervision of the bankruptcy court could go a long way to preserving families’ homes, preserving neighborhoods, and preserving home and mortgage values. What’s more, leaving families in their homes, rather than evicting them through foreclosures, keeps houses and yards tended and relieves the lender of the burden of taxes, insurance, and maintenance. It’s a win-win solution, but it needs legislation to help break the cycle and get the lenders and borrowers to the table.

The Solution

There is, of course, clear precedent for Congress to solve such a mortgage crisis. As in the mortgage crisis today, farm values were falling dramatically in the mid-1980’s. As in the mortgage crisis today, lenders could not renegotiate farm mortgages to reflect falling land prices and the changing economics of family farmers. In 1986, the good work of Representative Mike Synar and Senator Charles Grassley created chapter 12 of the Bankruptcy Code to help family farmers. Chapter 12 provided a platform for the rational modification and reamortization of farm loans that became the standard for solving the farm loan crisis.

Chapter 12 has been a great success. Though originally enacted as a temporary measure, its sunset provision was extended several times until it was made a permanent part of the

Bankruptcy Code in 2005. Ironically, its very success has resulted in a substantial decrease in its use. As lenders and borrowers understand its operation, they are often able to get to family farm mortgage modifications on their own, without the bankruptcy court's intercession.

In another irony, the chapter 12 experience provides the model for amending chapter 13 to address the current mortgage crisis. Chapter 12 of the Bankruptcy Code was created on the model of Chapter 13, with the added power for family farmers to modify mortgage debt on their farm land, to reamortize the debt, and to save the family farm over a period of years. Chapter 12 overcame the inability of farm lenders to negotiate terms that reflected the economic realities of family farmers in the 1980's. Many home mortgage lenders today face the same inability to realize the economic reality of today's rapidly falling housing market. Now, chapter 12-style adjustments to Chapter 13 can provide the same sort of relief to homeowners trapped in impossible mortgages.

Such an adjustment to chapter 13 would not be a major departure. In 1978, in a compromise between the House and the Senate bills that was partially undone by the Supreme Court's 1993 decision in *Nobleman v. Am. Sav. Bank*,[5] Congress limited modification in chapter 13 of a mortgage on the debtor's principal residence. No similar limtiations were imposed on mortgages on vacation or second homes, on investment, rental, or business property, or on any other form of collateral. Whatever justification there might have been in 1978 for granting special protections to mortgages on a debtor's principal residence has evaporated as the marketplace has produced a baffling array of loans based more on a lender's ability to sell than on a borrower's ability to repay. Current financial conditions—both the markets that produced

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[5] 508 U.S. 324 (1993).

this baffling array of loans and the resulting rising tide of foreclosures—demand that the Bankruptcy Code be amended to reflect the extraordianry changes in mortgage finance that have occurred in the past 30 years.

The necessary adjustment to chapter 13 would permit reamortization of home mortgage debt to reflect the value of the home and reasonable fixed interest rates. Resetting the length of the loan is necessary to deal with the many new short term mortgage products that now exist in the marketplace. Some adjustments to the discharge provisions in chapter 13 are also necessary to allow entry of discharge at the completion of payments to other creditors and survival of the restructured mortgage loan. Importantly, such a change would do no more to the lender than reflect economic reality: A foreclosure will not realize for the lender more than the current value of the home. Indeed, it will likely net less to the lender, after deduction of foreclosure expenses and carrying expenses such as taxes, insurance, and maintenance. And it will evict a family from its home for no real gain to the lender. It's a lose-lose strategy. By contrast, reamortization benefits both sides.

The Effect on Mortgage Markets and Lending

The NBC believes that fears that allowing home mortgage debt modification in chapter 13 cases will upset mortgage markets or the availability of mortgage funding are completely unwarranted and unsubstantiated. There is no evidence that such a change would have any effect on the market for home mortgage loans. Consider the following:

- Mortgage credit has been widely available for vacation and second homes, as well as for single family homes purchased or financed for investment or rental, despite the absence of lender protection in chapter 13 and despite the greater fluctuation in a recession in values of secondary homes than of principle residences.

- From 1979 until 1993, the proposed legislation was already the law in much of the country. Until the Supreme Court ruled otherwise in *Nobleman v. Am. Sav. Bank*,[6] four federal courts of appeals had ruled that chapter 13 permitted mortgage write downs,[7] yet there is no evidence that mortgage credit was less available or more expensive in those circuits.
- Many states already have the economic effect of writing down mortgages to the value of the property through non-recourse provisions, which prohibit the lender from collecting any deficiency over the property value. The supply of mortgage money has been high in these states, indeed, was higher in some of them, like California, than anywhere else in the country.
- Lenders have always used credit price and availability arguments against any amendment to the bankruptcy laws that protects families and consumers. If their arguments were true, the converse also would be true—tightening bankruptcy laws against families and consumers should reduce the price of credit and increase its availability. Yet there is no evidence that the adoption of the 2005 Amendments did anything to reduce the price or increase the availability of credit. Have you seen interest rates on your credit cards, auto loans or mortgages drop in the past two years? There are simply too many other forces at work in the consumer credit markets for a bankruptcy law change, even one as major as the 2005 Amendments, to have any

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[6] 508 U.S. 324 (1993).
[7] In re Bellamy, 962 F.2d 176 (CA2 1992); In re Hart, 923 F.2d 1410 (CA10 1991); Wilson v. Commonwealth Mortgage Corp., 895 F.2d 123 (CA3 1990); In re Hougland, 886 F.2d 1182 (CA9 1989).

noticeable effect.

More important, even if the predictions of less or more expensive credit are accurate, would a little less credit availability in the past two or three years have been such a bad thing? Lenders may argue that availability hurts those who are good credit risks as well as those who aren't. Does that mean that lenders haven't been distinguishing between the two groups and that a chapter 13 amendment would cause them to do so now? Wouldn't that be a good idea? What's more, lenders are already restricting credit now, even though chapter 13 does not currently permit mortgage modification.[8]

Other Mortgage Modification Issues

Valuation and Interest Rate Standard

There is little risk that bankruptcy judges will have the ability to adjust mortgages arbitrarily. The Supreme Court has set out strict standards that must be applied by a judge both in valuing property in chapter 13[9] and in determining the appropriate interest rate.[10] It is important for bankruptcy judges to have flexibility to adjust mortgages within those standards in accordance with the circumstances of each case. There are no similar limitations in chapter 12, but bankruptcy judge have not had "free rein" to make arbitrary decisions. In addition, under the proposal, any modification can only be accomplished through a confirmed chapter 13 plan that

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[8] "Lenders Curb New Mortgages in Weaker Areas," *Wall St. Journal*, Oct. 23, 2007, at D1 ("Some lenders are now making it tougher for borrowers in softening housing markets to get a mortgage.… Among the areas being hit by the tougher standards are parts of California, Florida and Michigan.… The sharper focus on soft housing markets comes after mortgage lenders have tightened their standards for all borrowers amid a slowing housing market, a widespread credit crunch and rising delinquencies.")

[9] *Assocs. Comm'l Corp. v. Rash*, 520 U.S. 953, 117 S. Ct. 1879 (1997). The NBC supports a liquidation value test for valuation of mortgaged property, although *Rash* requires use of fair market value. Unlike for a truck in use in a business, however, there is not likely to be a substantial difference between liquidation and fair market value of a family's home in chapter 13.

meets the chapter 13 confirmation requirements including a good faith test and a disposable income test.

Lender Consent

Some have suggested lender consent should be required as a condition to home mortgage modification. The currrent Bankruptcy Code already allows for home mortgage modification with the consent of the lender,[11] but that has not alleviated the foreclosure crisis. As noted above, lenders often race to the courthouse to get an advantage in a declining market. More important, in a world with securitized mortgage pools and contract mortgage servicers, it isn't always clear who can negotiate on behalf of the lender and whether the servicer that agrees to renegotiate terms runs some legal risk in the exercise of its fiduciary duty. A generation ago, when the 1978 Code enacted the lender consent requirement, lenders held their own paper, and they could make rational decisions to deal with a borrower in trouble. Diverse ownership makes that much more difficult today.

The NBC therefore believes that any use of the Bankrupty Code to address the mortgage crisis must include some form of mortgage debt modification that does not depend on lender consent.

"Entry Ticket"

Chapter 12 was carefully targeted at family farmers of a certain size, with a maximum permissible amount of debt. Chapter 13 offers the same sort of vehicle and limitations. Chapter 13 has strict eligibility limitations that will act as a natural barrier to any flood of

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[10] *Till v. SCS Credit Corp.*, 541 U.S. 465, 124 S. Ct. 1951 (2004).

[11] 11 U.S.C. § 1325(a)(5)(A).

debtors seeking to modify their mortgages.[12] The current debt limitations admit only debtors and families with small economies for whom a modest home mortgage is the largest and most important debt they will ever see.

And debtors who can qualify for chapter 13 then face substantial tests and obstacles that will prevent abuse of home mortgage modification. Bankruptcy courts will supervise the valuation of property. Every chapter 13 debtor must satisfy a "good faith" test, both in filing the petition[13] and in confirming a plan.[14] There is a demanding disposable income test that mandates that every chapter 13 debtor pay creditors all disposable income over a period of three to five years.[15] Every chapter 13 debtor must devote the value of all unencumbered assets to payment of unsecured creditors.[16] Chapter 13 already provides substantial gatekeepers to any new power to modify home mortgage debt.

The NBC believes, therefore, that no additional entry requirements should be imposed for home mortgage modification. However, if an additional barrier is required, a condition based on current monthly income (CMI) along the lines of H.R. 3778 seems more workable than some of the alternatives. CMI is a new and complex concept introduced by the 2005 Amendments. Generally speaking it is an average of a debtor's income over the six months before the month in which a bankruptcy case is filed.[17] It is a number that must be calculated and supplied by every

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[12] *See* 11 U.S.C. § 109(e) ($1,010,650 in secured debt and $336,900 in unsecured debt).

[13] Marrama v. Citizens Bank of Mass., 127 S. Ct. 1105 (2007)

[14] 11 U.S.C. § 1325(a)(3).

[15] 11 U.S.C. § 1325(b).

[16] 11 U.S.C. § 1325(a)(4).

[17] *See* 11 U.S.C. §101(10A).

individual filing a chapter 13 case. Limiting the availability of mortgage modification to chapter 13 debtors with CMI less than 150% of applicable median family income could be implemented without substantial new calculations or issues for litigation. A spouse's CMI is included in this calculation in a joint case but should not be included in a single case. The use of other limitations—such as a budget-based formula—will require new forms, new calculations and new costly litigation over eligibility.

OTHER NECESSARY PROTECTIONS FOR HOMEOWNERS IN CHAPTER 13

Fees And Charges During A Chapter 13 Case

A recurring problem with home mortgages in chapter 13 cases is the hidden accrual of fees and charges by mortgage lenders during the chapter 13 case. Home mortgage instruments typically include many provisions that allow the lender to charge fees for such things as attorneys, inspections, appraisals, late payments and the like. Chapter 13 debtors who want to keep their homes during the three to five years of a chapter 13 case need to know what charges are being added by the mortgage holder and need an opportunity both to challenge charges that may be improper and to pay the proper charges during the case.

What often happens now is that the lender accumulates fees and charges during the chapter 13 case without notice to the debtor, the trustee or the court. The debtor completes payments under the plan and receives a discharge, only to receive an immediate demand and foreclosure notice based on thousands of dollars of unpaid accrued fees, charges and expenses of which the debtor never had notice. Some of those charges may be prohibited by the Bankruptcy Code, but there has been no opportunity to review them during the bankruptcy case. Although it has been held that a lender does not violate the automatic stay by accumulating postpetition fees on its internal records,[18] lenders fear that they will violate the automatic stay by asserting post petition fees and charges *during* the chapter 13 case, creating a perverse incentive to accrue those charges secretly without notice and to assert them only after bankruptcy. Some courts have even questioned the authority of the bankruptcy court to police the imposition of such fees, charges and expenses by mortgage holders after confirmation in chapter 13 cases.[19] The fees can be quite substantial, putting a family's home at risk even after they have done everything they can to pay the original mortgage. If family can't understand the terms, it can't review them to see if they are accurate, and it can't budget for them to get them paid.

The NBC therefore supports a statutory amendment to require timely notice to the debtor and trustee of all postpetition fees, charges and expenses by mortgage holders during chapter 13 cases, together with a procedure for detrmining their validity and satisfying them during the case.

Prefiling Briefing

The Bankruptcy Code currently imposes an eligibility limitation on all individual debtors. They must receive a prepetition briefing from a certified nonprofit budget and credit counseling agency that outlines the availability of credit counseling services and provides related budget analysis.[20] Without such a prepetition briefing, the individual debtor is not eligibile for any kind of bankruptcy relief.

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[18] Mann v. Chase Manhattan Corp., 316 F.3d. 1 (1st Cir. 2003).

[19] *See* In re Telfair v. First Union Mortgage Corp., 216 F.3d 1333 (11th Cir. 2000), *cert. denied*, 531 U.S. 1073, 121 S. Ct. 765 (2001).

[20] *See* 11 U.S.C. §109(h).

Homeowners in trouble with their mortgages often do not seek bankruptcy relief until the eve (or day!) of a foreclosure, sometimes because the borrower and the lender are trying to work things out and just can't, sometimes because the borrower really sees bankruptcy as the last and least desireable alternative, sometimes because of simple human emotion such as fear or denial. For many reasons, individual debtors often can't obtain the briefing before a foreclosure sale would render bankruptcy relief useless for saving a home.

Since the service available through the credit briefing (consensual debt management plan with creditors) cannot address the problem caused by a pending foreclosure, the requirement for a prepetition briefing should be eliminated for a debtor with a home in foreclosure.

Arbitration Clauses

Clauses requiring arbitration are increasingly common in consumer debt documents such as home mortgages and car notes. These clauses are asserted by lenders in consumer bankruptcy cases typically in response to a debtor's or trustee's claim objection or when the lender is sued by a debtor or trustee in the bankruptcy court under a consumer protection statute such as the Truth in Lending Act. Some courts have permitted arbitration, but the law in this area is both confused and confusing, driving up costs and increasing litigation for everyone.

Claims objections and some lawsuits by debtors and trustees clearly fall with the "core" bankruptcy jurisdiction that is essential to the orderly administration of bankruptcy cases. Arbitration clauses in consumer debt contracts therefore create a problem in consumer bankruptcy cases. The confirmation of plans and the payment of creditors in chapter 13 cases is impossible when the claims resolution process in the bankrutpcy court is interrupted by an arbitration clause.

For these reasons, the NBC believes the statute should be clarified, making clear that any arbitration clause in a consumer debt instrument in a consumer bankruptcy case is unenforceable in a core proceeding. Care must be taken, however, to avoid any negative inferences with respect to the enforceability of arbitration clauses in other bankruptcy contexts.

Judicial Estoppel

After a 1999 decision by the Georgia Court of Appeals,[21] some courts concluded that a trustee in bankruptcy can be "judicially estopped" from asserting a cause of action on behalf of creditors in a bankruptcy estate, based on the *debtor's* failure to schedule that cause of action as an asset in a bankruptcy case. Even if the debtor has misbehaved, the trustee and the creditors did not, and they should not lose the benefit that the law otherwise makes available to them if one creditor (like the mortgage lender) has over-reached.

The NBC therefore believes that it is inappropriate to bar recovery on behalf of creditors based on a debtor's failure to schedule a cause of action properly as an asset. Because judicial estoppel is a judge-made rule of decision, and because the NBC believes judicial estoppel is sometimes used inappropriately to reduce the reasonable expectations of creditors in bankruptcy cases, the NBC supports a provision that would preclude the use of judicial estoppel to prevent liability to a bankruptcy trustee based on the failure of a debtor to schedule a cause of action in a bankruptcy case.

Sunset Provision

Finally, the NBC does not support any sunset provision for mortgage modification legislation. The NBC believes that the idea reflects sound policy and will not have any adverse

[21] Wolfork v. Tackett, 273 Ga. 328, 540 S.E.2d 611 (2001).

affect on mortgage markets. It therefore believes that legislation along the lines that the NBC supports should be adopted as a permanent amendment to the Bankruptcy Code.

CONCLUSION

Once again, I would like to thank the Chair and the rest of the Subcommittee for inviting the National Bankruptcy Conference to testify in these important hearings. The Conference would be pleased to formulate drafting proposals and assist in technical matters if the Subcommittee would find that helpful.

National Bankruptcy Conference

A non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws.

History. The National Bankruptcy Conference (NBC) was formed from a nucleus of the nation's leading bankruptcy scholars and practitioners, who gathered informally in the 1930's at the request of Congress to assist in the drafting of major Depression-era bankruptcy law amendments, ultimately resulting in the Chandler Act of 1938. The NBC was formalized in the 1940's and has been a resource to Congress on every significant piece of bankruptcy legislation since that time. Members of the NBC formed the core of the Commission on the Bankruptcy Laws of the United States, which in 1973 proposed the overhaul of our bankruptcy laws that led to enactment of the Bankruptcy Code in 1978, and were heavily involved in the work of the National Bankruptcy Review Commission (NBRC), whose 1997 report initiated the process that led to significant amendments to the Bankruptcy Code in 2005.

Current Members. Membership in the NBC is by invitation only. Among the NBC's 60 active members are leading bankruptcy scholars at major law schools, as well as current and former judges from eleven different judicial districts and practitioners from leading law firms throughout the country who have been involved in most of the major corporate reorganization cases of the last three decades. The NBC includes leading consumer bankruptcy experts and experts on commercial, employment, pension, mass tort and tax related bankruptcy issues. It also includes former members of the congressional staff who participated in drafting the Bankruptcy Code as originally passed in 1978 and former members and staff of the NBRC. The current members of the NBC and their affiliations are set forth on the second page of this fact sheet.

Policy Positions. The Conference regularly takes substantive positions on issues implicating bankruptcy law and policy. It does not, however, take positions on behalf of any organization or interest group. Instead, the NBC seeks to reach a consensus of its members - who represent a broad spectrum of political and economic perspectives - based on their knowledge and experience as practitioners, judges and scholars. The Conference's positions are considered in light of the stated goals of our bankruptcy system: debtor rehabilitation, equal treatment of similarly situated creditors, preservation of jobs, prevention of fraud and abuse, and economical insolvency administration. Conferees are always mindful of their mutual pledge to "leave their clients at the door" when they participate in the deliberations of the Conference.

Technical and Advisory Services to Congress. To facilitate the work of Congress, the NBC offers members of Congress, Congressional Committees and their staffs the services of its Conferees as non-partisan technical advisors. These services are offered without regard to any substantive positions the NBC may take on matters of bankruptcy law and policy.

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